# States and the Crafting of Souls: Mind, Society, and Fiscal Sociology

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**Abstract**

For the most part, the theory of public finance follows economic theory in taking individual preferences as given. The resulting analytical agenda revolves around the ability of different fiscal institutions to reflect and aggregate those preferences into collective outcomes. This paper explores the possibility that to some extent fiscal institutions can influence and shape what are commonly referred to as preferences. Statecraft thus becomes necessarily a branch of soulcraft, in that the state is inescapably involved in shaping preferences through its impact on the moral imagination, and not just in reflecting or representing them. This paper first explores some general conceptual issues and then examines some particular illustrations.

**Keywords**: endogenous preferences, fiscal institutions, constitutional economics, public enterprise

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For the most part, the theory of public finance follows economic theory in taking individual preferences as given. The resulting analytical agenda revolves around the ability of different fiscal institutions to reflect and aggregate those preferences into collective outcomes. This paper explores the possibility that to some extent fiscal institutions, and the fiscal practice that those institutions generate, can influence and shape what are commonly referred to as preferences. In standard public finance, the activities of the state simply represent offerings by alternative vendors to those that exist in private markets. Hence, shoppers buy some things from public goods stores and other things from private goods stores. In contrast, this paper explores the possibility that fiscal institutions can shape preferences through the impact of fiscal practice on the moral imagination. This paper first explores in a general way how fiscal institutions might influence preferences through their impact on practice and the moral imagination. Subsequently, it explores some specific illustrations of this possibility, and concludes with an examination of some possible constitutional implications.

## Harmonious Fiscal Politics on Smooth Surfaces

For the most part fiscal scholars have developed their formulations under a presumption that there exists a deep homogeneity or harmony within the citizenry. The fiscal process is modeled as taking place on a smooth, twice differentiable surface. This leads to the easy and ready development of propositions about welfare and equilibria. People are characterized as having utility functions whose arguments, in a two commodity space, are a public good and a private good. Generalization of this setting to an n-good space simply converts two singulars into two plurals.

The optimal allocation of resources between public and private goods is conceptually simple and straightforward, even if there might be institutional difficulties in reaching this allocation, as Paul Samuelson (1954, 1955) noted. People receive some of the things they want from public goods stores and other things from private goods stores. The taxation of private activities, in one form or another, is the instrument that stocks the public goods stores and determines the relative sizes of the two categories of store. People may differ among themselves in their preferred public-private allocations, either because of differences in their utility functions or because of differences in their budget constraints.

The extent of those differences, moreover, will be influenced by the fiscal and political rules in place, a point that was made particularly strongly by James Buchanan (1967). People who have identical utility functions and incomes may still prefer different public-private mixes if they face different tax-price tradeoffs. Likewise, people who have different utility functions may nonetheless prefer the same public-private mix in the presence of particular tax-price tradeoffs. For instance, Buchanan (1964) presents a model where the income and price elasticities of demand for a public good is unitary and where the public good is financed by a proportional tax on income. The result is that everyone desires the same amount of the public good. As income rises, people would desire proportionately more of the public good. However, the tax-price they pay also rises proportionately with income, so everyone ends up preferring the same quantity of the public good regardless of their income.

Buchanan's model is highly particular, Other models will lead to people differing in their desired public-private mix. Those differences, however, may also be fully consistent with Pareto efficiency. The median voter outcome, for instance, is Pareto efficient provided that the distribution of preferred outcomes is symmetrical around the median. All of these various models represent fiscal politics as a process that operates on a smooth, twice differentiable surface. The political process proceeds peacefully and calmly, as people's minds all possess the same structure when it comes to the evaluation of public and private activity. The differences among people are only of secondary importance, and even these can often be eliminated through appropriate fiscal institutions, as illustrated by Wicksell's (1896) formulation.

These formulations all treat the fiscal process as revolving around the use of private property. Economic life is ordered through private property as envisaged by a model of competitive markets, and the use of property to support public goods stores is categorically indistinct from the use of property to support particular private goods stores. To be sure, it is only in some institutional settings, with the Wicksellian setting being a prominent illustration, that the marginal conditions for Pareto efficiency will apply to each person in the society.

Otherwise, aggregate conditions for Pareto efficiency may be satisfied while the individual conditions are violated for most people, possibly all but the median voter. Even these violations of individual conditions would generally be treated as small in the sense that the gain from attaining the individual conditions would be less than the added cost of collective effort to satisfy those conditions, as exemplified by Buchanan and Tullock's (1962) formulation of a tradeoff between external costs and decision costs.

**Discordant Fiscal Politics on Tectonic Surfaces**

It is noteworthy that fiscal scholarship mostly treats property relationships identically regardless of the institutional arrangements that govern public-private relationships. This is surely not satisfactory in light of the flowering of scholarship on the economics of institutions and organizations, where it would be readily recognized that economic organizations that possess residual claimacy and alienable ownership would differ in important ways from cooperative organizations where ownership was inalienable. While a profit seeking firm can be generally assimilated to governance through private property, a cooperative takes on features of common property governance. To be sure, the governance of cooperative or common property relationships can in some cases proceed relatively harmoniously and efficiently, as noted in Elinor Ostrom (1990). In any case, though, the differences in institutional relationships and the arrangements for governance would be presumed to be economically significant, both with respect to the *ex ante* creation of different organizational forms and to the *ex post* conduct of those different organizations.

There are vast and significant differences among the institutional arrangements by which public-private relationships might be generated and governed. Some of those differences were central to the famous debate between Joseph Schumpeter and Rudolf Goldscheid, as collected in Rudolf Hickel (1976) and as elaborated in Jürgen Backhaus (1992). They also recall the huge difference between Adam Smith (1776) and Johann Heinrich Gottlob von Justi (1771) in their approaches to public finance. Smith argued that public activities should be financed by taxes and not through net revenues generated from state enterprises. Justi argued the reverse, and pretty much claimed that a prince who required taxes to support his activities had failed in his princely duties because he should have been able to raise sufficient revenue from his enterprise activities.

Smith and Justi, and Schumpeter and Goldscheid, were arguing that the institutional arrangements of property and governance were of great significance for the economic vitality of the citizenry. There is much merit in this proposition, which is explained and explored below. As a first-order simplification, private economic organization will be treated as governed by a simple framework of private property while public economic organization is treated as governed by a simple framework of common property. This is, of course, a simplification, and more elaborate and nuanced lines of analysis could be developed. Wicksell and Justi conceptualized a public sector that operated within the same institutional framework as private organizations, whereas Schumpeter and Smith treated the public institutional framework as categorically distinct from the framework that governed private enterprises.

What is of central interest here is to illustrate how the incorporation of property and governance arrangements into the theory of public finance generates an alternative orientation toward public-private relationships. In particular, what we call preferences can no longer be taken as independent of the private-public mix, for these are themselves influenced by that mix, and are even the objects of fiscal politics. Statecraft is necessarily soulcraft, to appropriate the title of a book by George Will (1983). If soulcraft is generated in part through institutionalized practice, we confront a significant difference of approaches. The line of thought represented by Justi and Wicksell looks to some institutional congruency between public and private, but the line of thought represented by Smith, Schumpeter, and Samuelson looks to institutional disharmony. This disharmony, however, generates discordant fiscal politics on tectonic surfaces, and not harmonious fiscal politics on smooth surfaces.

Some issues relating to the development of urban transportation in the United States offers good illustration of these points, particularly as illustrated by Eckert and Hilton (1972) and Klein (1997). Early in the 20$^{th}$ century, urban transportation was organized overwhelmingly through private enterprise. Jitney service formed a significant share of the market. Jitneys were operated by private automobile owners who contracted to carry people downtown in the morning and back out in the evening. Jitney service reduced traffic congestion without requiring large investments in busses or other forms of public transportation. Moreover, there was no need to recruit a staff of full time employees to operate capital equipment for which there was relatively little demand most of the day. Jitneys were organized within the market framework of private property and freedom of contract. People who did not want to drive their automobiles downtown and back could catch a ride with a jitney operator. This was a purchase from a private goods store.

Now consider the injection of a public goods store into the picture, in the form of a public transit enterprise. That public enterprise could be organized within the same institutional framework as private enterprises. This would be an institutional arrangement that would be more or less consistent with that envisioned by Wicksell and Justi. The fate of this public enterprise would depend on its ability to be successful in competing for patronage with privately organized enterprises. Such competitive success might arise through technical efficiency in the provision of the service. While there is good reason for doubting this possibility over a wide variety of activities as a general case, in comparison with enterprises organized under private property, we also know that a wide variety of cooperative organizations do thrive within a market setting. Hence, the possibility that a state-organized transit enterprise could survive with open market competition cannot be rejected out of hand.

Competitive success for the state-organized enterprise could also arise because private competition was restricted. Indeed, if the public enterprise does not possess equal or superior technical efficiency, its survival will require that it restrict the competitive ability of private enterprises. The state has many ways it can restrict privately organized enterprises that otherwise would be competitive with it, short of outright abolition. The problem the public enterprise faces is that its costs must be higher than private enterprises, so long as the public enterprise is technically less efficient than private enterprises. Charging higher prices to cover higher costs, however, is no way to expand patronage.

Under these circumstances, a public enterprise can offer competitive prices to customers only by imposing higher prices on some subset of the citizenry. Even if private enterprises charged a single price for their service, a public enterprise would have to charge multiple prices. It would have to practice some form of price discrimination, where price reductions to a desired clientele were made possible through charging higher prices to others, people who would be forced riders with respect to the public transit enterprise.

There are two paths along which such forced ridership may be created. One is through taxation, as Pantaleoni (1911) explains and Wagner (1997) elaborates. Taxation creates a form of political pricing system that is parasitical upon the set of market prices. For instance, a proportional tax on income to subsidize public transportation would charge prices that varied across people in proportion to their incomes. People who pay taxes but do not use the services of the public enterprise are forced riders, paying for rides they don't take. The other form of forced ridership is through regulatory restrictions on the ability of people to patronize privately organized enterprises that compete with the public enterprise. For instance, a regulation that prohibited people from carrying other people for a fee without a taxi license would make private options more costly, thereby increasing the demand for public transit services. This increased demand for publicly provided services would really be a form of forced ridership that was generated through the restriction on market competition.

This extended illustration illustrates a problem that arises when public and private enterprises operate within the same neighborhood, commercially speaking, and yet are organized and supported under incongruent institutional arrangements. So long as technical inefficiency characterizes publicly organized enterprises, those enterprises will not be competitive with privately organized enterprises in their neighborhood. One possible public response to this inefficiency is to restore a semblance of competitiveness through price discrimination via taxation. Another possible response is to restrict the scope for private competition. The greater the restrictions on private competition, the higher the induced demand for the service offered by the public enterprise. This increased demand, moreover, is likely to increase the use of price discrimination through direct prices, as distinct from tax prices. This use of direct price discrimination simultaneously creates “cream” for private enterprises to try to skim, which generates still further efforts at regulation to restrict the cream skimming, the opportunities for which were set in motion by the relative inefficiency of the public enterprise, and which thereby generate the peculiar but understandable dynamics of the mixed economy (Ikeda 1997).

**Institutional Practice and the Moral Imagination**

Robert Frank (1987) asks "If Homo Economicus Could Choose His Own Utility Function, Would He Want One with a Conscience?" The point of Frank's paper was to argue that a conscience could be a valuable means of pre-commitment, which in turn suggests the value of an affirmative answer. In this formulation, it is taken for granted that conscience, or morality generally, is an object of choice. One can choose among moral precepts just as one can choose among books or shoes. This formulation treats the mind as a tabula rasa, onto which morality can be placed or erased as the author chooses.

In sharp contrast, the classical approach to moral education approached the moral imagination quite differently. Morality was not an object of choice on the same plane as ordinary consumer goods. An adult did not have the option to choose a morality because that morality had been implanted during childhood, for better or for worse. Morality was instilled through practice until the moral sentiments became habits outside the realm of conscious thought or reflection. The existence of a conscience, or the substantive structure of that conscience, was not an object of choice but rather was something that had been generated through practice during childhood.

This is not to say that morality remains invariant after leaving childhood. It is only to assert the primacy of practice as the means by which the substantive conduct that constitutes morality is acquired or extinguished. A system of bourgeois commercial relationships rests upon a legal order of property, contract, and liability. These legal institutions create the central governing framework for a market economy. These institutions also reflect a particular form of moral imagination. These legal institutions can be given a reasonably accurate representation as moral injunctions. The legal principle of property maps reasonably well into a moral injunction to refrain from taking what is not yours. The legal principle of contract maps reasonably well into a moral injunction to keep your promises (or to secure the permission of the aggrieved party before breaking a promise). The legal principle of liability maps reasonably well into a moral injunction to make good the wrongs you do onto others.

A market order operates more effectively in the presence of people who possess such moral imaginations. At the same time, a market order tends to reward practice that conforms to that morality. For the most part, commercial activity that is consistent with the moral order that, in turn, is complementary with the legal order will yield higher commercial returns than will conduct that violates that moral order. Such traits as being reliable, energetic, and trustworthy will tend to bring larger commercial value than such traits as being unreliable, lazy, and dishonest. Hence, commercial practice tends to reinforce its supporting morality.

What happens when a state and its economic activities enter the picture? To address this question, it is necessary to look first of all to the kinds of practice that the state sponsors. This is because the crucible within which the moral imagination is shaped and reshaped is primarily the world of practice and not the world of conscious reflection. To pose the question in this fashion is to ask whether the state calls forth the same, or at least complementary, kinds of practice as do commercial enterprises.

**Constitutive Policy: Statecraft as Soulcraft**

The classical approach to moral education recognized that it is through practice that right conduct moves from becoming an object of conscious deliberation to becoming a central default setting of the soul or psyche. Wrong practice would, in turn, promote wrong conduct through its ability to generate an ill-ordered soul. In any case, the focus of classical moral education was upon the creation of individual souls, with society being built up through interaction among individuals whose souls might have possessed varying degrees of order or disorder.

It is also reasonable to ask how various institutional arrangements promote or extinguish notions of normativity though the kinds of collective practice they encourage or discourage. To go down this path is not to embrace a pure moral conventionalism. One can believe that our natures limit the range of moral belief while nonetheless recognizing that those natures can accommodate a wide variety of conventional practice, a point that is articulated nicely in Ekkehart Schlicht (1998).

It is a common textbook illustration to show the equivalence of a tariff and a quota. For any tariff that increases the price and reduces the amount imported, there will be a quota that can achieve the same outcome. There is an equivalence between a tariff and a quota as these are drawn on the blackboard.

They are not, however, equivalent in practice. A tariff and a quota generally involve different institutional frameworks that generate different forms of institutionalized practice and, hence, promote the formation of different beliefs about normativity. A tariff, so long as it is relatively low, is compatible with the market framework of properthy, contract, and liability, as noted in Eucken (1952) and as further exemplified in the essays collected in Liepold and Pies (2000). A tariff makes a product more expensive, but otherwise does not disrupt ordinary market processes. How much of that product is sold in the aggregate, and how that aggregate is distributed among different vendors, are governed in decentralized fashion through open competition and interaction among buyers and sellers. With a tariff, people are still free to work out commercial arrangements among themselves through private ordering, subject only to the surcharge that the tariff represents. A tariff disrupts ordinary market relationships only when it becomes so high as to encourage smuggling.

A quota disrupts ordinary market relationships from the start. As compared with a tariff, a quota creates a qualitatively different regime of human governance, as do what are called "voluntary restraints" on trade. With the quota, the distribution of sales across vendors and the specific types of products sold are not determined through ordinary commercial arrangements. Rather, they are determined through a political process where those who hold offices of political power are able to award allotments to the particular vendors that those holders of power choose. A quota necessarily injects venality, inequality, and hierarchy into political practice and changes the character of effective commercial conduct. What economists refer to as rent seeking (Tullock 1967)(Rowley, Tollison, and Tullock, eds. 1988) and rent extraction (McChesney (1997) will flourish under quotas, and such activities may eventually come to comprise new norms for commercial conduct.

A low tariff maintains the legal principles of property, contract, and liability, along with their supporting normative sentiments. With market conformable institutional arrangements, commercial practice reinforces the normative complements to the private ordering principles of property, contract, and liability. In contrast, the quota generates a different form of practice, one that is part of a hierarchical, status, or caste society and the values that support it. For no longer is everyone free to enter the competition for market share. Only those who receive a quota allotment can do so. Those in a position to award allotments hold a position of privileged status, as do those who receive allotments. Furthermore, a quota will generate incentives for people to evade the quota. State officials know that quotas have this effect, and to curb this evasion they will employ undercover agents to spy on people and to entrap them into evasion. Where the ordinary liberal institutions of property and contract spread trust and friendship throughout a society, the quota, and all policy measures of its type, promote suspicion and distrust, thereby generating a structured hierarchy of relationships within society.

A quota is, of course, but one particular outcome of a democratic process. Many similar outcomes can emerge, as illustrated by the vast and expanding literature on rent seeking and rent extraction. Democracy may clash severely with market conformability. Among other things, there is a fundamental clash among democracy, property, and an open society. Consider a small town with only three residents. Primo and Secunda like to play tennis, Terzo does not. Within the market framework of private property and freedom of contract, Primo and Secunda could readily finance from their own funds the building of a court on which to play tennis. However, they also comprise a voting majority, and could play tennis more cheaply if they to declare the provision of tennis courts to be a town activity. Democracy allows Primo and Secunda to rob Terzo to subsidize their tennis matches, only it is called democratic policy and not robbery (Epstein 1985).

There is a potentially deep cleavage between democratic ideology and democratic practice. The ideology treats government as an institution of common benefit that people create to promote their common interests. The practice, however, seems often to clash with the ideology. There are two approaches to limiting the clash. One looks to the cultivation of virtue within the populace, so that majorities would not exploit their voting power. The other looks to auxiliary measures that would limit the domain of democratic governance, as illustrated by a variety of constitutional provisions to limit and structure the exercise of governmental power. To the extent such constitutional limits are imposed, the governing regime becomes something other than purely democratic.

**Valuation, Cognition, and the Constitution of Governance**

Alexander Hamilton opened Federalist No. 1 by asking "whether societies of men are really capable or not of establishing good government from reflection and choice, or whether they are forever destined to depend for their political constitutions on accident and force." The task of securing good governance through reflection and choice requires the exercise of both the cognitive faculties and the moral imagination. The task can be likened to a form of social agriculture. Good social agriculture involves both appropriate valuation and accurate cognition.

With respect to valuation, one might dedicate some land to growing squash, and have no desire to support squash bugs or various forms of rust or blight. How to achieve these desired ends requires the exercise of the cognitive faculties across a variety of domains, including such things as soil chemistry and plant genetics. Normative desires about food will generally amount to little without the application of the cognitive faculties. Furthermore, the exercise of the cognitive faculties may in some cases influence the content of what is thought to be normative. For instance, the growth of knowledge may lead to a realization that squash bugs contain some enzyme that, when processed, offers protection against some dreaded disease.

What holds for agriculture holds as well for the social agriculture with which Hamilton was concerned in *Federalist* No. 1. Government necessarily involves a form of Faustian bargain, as Vincent Ostrom (1994) notes. Government injects an instrument of evil, force and violence, into human relationships, under the presumption or hope that the weight of the evil forestalled or prevented is even heavier.  Whether this hope is born out is a different matter that involves both cognition and valuation.

Valuation refers to desired principles for governing human relationships. Cognition refers to the scientific appraisal of the compatibility between those normative principles and the prudential imperatives that exist within a particular regime.  Liberal values may lead to the selection of a particular governing regime.  That regime, however, may promote practice that undermines those liberal values.  The prevention of such regime drift requires particular institutional arrangements that promote practice that reinforces the founding values. Cognition must be enlisted in the service of valuation, much as Hamilton recognized in *Federalist* #1.

In a very generic sense, liberal values will lead to institutional arrangements where human relationships are governed through the principles of property, contract, and voluntary association.  These abstract principles, however, are always instantiated through specific institutionalized practice.  That practice may, in turn, conflict with the governing principles, perhaps leading to a revision of the underlying values, at least to the extent that normative belief adapts to conventional practice.  For instance, a quota may be imposed in place of a low tariff, and with similar replacement occurring across a broad range of activities.

For a people who generally embrace the liberal values of a free and open society, the organization of human governance is both a limited and a tricky matter because of cognitive types of matters, as well as because of the interaction between cognition and valuation. Just as success in growing squash is constrained by such things as soil and climate, so is success in liberal governance constrained by the constitutional system of governance that we adopt. Liberal governance may flourish under some constitutional frameworks while morphing into various forms of illiberal governance under other constitutional frameworks. This conflict between what is held desirable and what is promoted through institutionalized practice is redolent with themes that have been central in the development of ordnungspolitik and ordnungstheorie (in addition to some of the works cited above, see the interesting comparison of Walter Eucken and Max Weber in Rath (1998)). Such themes, moreover, would surely occupy an important position in any reinvigoration of fiscal sociology.

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