

ENTERPRISE-BASED PUBLIC FINANCE: BLENDING THE OLD AND THE NEW

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Abstract

This paper seeks to overcome a deep antinomy within the theory of public finance: while market outcomes are treated as resulting from polycentric competition, political outcomes are treated as resulting from hierarchic planning. We seek to overcome this antinomy by treating political outcomes as likewise resulting from polycentric competition, taking due account of relevant institutional differences. For example, a parliamentary assembly is treated as a peculiar form of investment bank: a parliament intermediates between the sponsors of enterprises and those within the citizenry who have means to support those enterprises. What results is a theory in which budgets emerge in largely bottom-up fashion through complex networks of exchanges. Much of the inspiration for this paper arises from the Italian School of Public Finance, particularly Giovanni Montemartini, Maffeo Pantaleoni and, in more general terms, Antonio De Viti de Marco.

Keywords: political pricing, political-economic interaction, polycentric politics, economic calculation, emergence, spontaneous order, order vs. organization

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There is a theoretical antinomy with respect to the treatment of polity and economy within the theory of public finance. Economy is treated as an order (Hayek 1973) which is organized through polycentric processes of competition. In contrast, polity is treated as an organization, a gigantic one to be sure, that imposes teleologically-guided planning onto what otherwise would have been market-generated outcomes. The relation between market and state is thus sequential, with state's acting in light of given market outcomes.

Our alternative research program seeks to eliminate this antinomy by treating polity from the same scholarly orientation as economists treat economy. As an order, polity contains many organizations within its precincts, and with those organizations interacting both among themselves and with various organizations organized within economy. The relation between market and state is thus simultaneous, with mutual interactions operating in both directions.

While all organizations are oriented teleologically through plans, the resulting order emerges spontaneously through interaction among participants. Within polity there is no one organization that denotes polity, for polity is plural and not singular with respect to its organizational pattern. Neither a president nor a parliamentary assembly represent a polity but rather denote particular organizations within polity. For instance, we treat a parliamentary assembly as a peculiar form of investment bank that operates inside a polity: people come to a parliament to secure support for the enterprises they are sponsoring, and

parliament intermediates between the sponsors of those enterprises and those among the citizenry who have means to support those enterprises. That those who have the means are often forced investors is what makes parliament a peculiar and not a regular form of investment bank. This analytical framework treats budgetary configurations as emerging in largely bottom-up fashion through complex networks of transactions, in contrast to the typical top-down framework of contemporary political economy.

The core of this theoretical effort entails dissolution of the theoretical antinomy within the orthodox model of political economy. It should be noted that this antinomy was recognized long ago in Paul Samuelson's (1954)(1955) formulations of the theory of public goods, where he noted the institutional disjuncture between polity and economy. Subsequent work has not bridged that disjuncture but has evaded it through making claims about demand revelation. The most common evasion in this respect is the claim that an election selects the set of policies that maximizes utility for the median voter, as illustrated nicely by Persson and Tabellini (2000). Dissolution of this theoretical antinomy requires an alternative framework where both policy and economy contain numerous enterprises, each teleologically oriented, and that all such enterprises operate within a non-teleological order where organizational actions are framed by constitutive rules. The earlier portions of this paper explain the theoretical distinction between these alternative orientations toward political economy; the later portions explore some possible avenues for pursuing an integrated, order-based orientation toward the material of public finance.

Society as an Emergent and Entangled Ecology of Enterprises

The conventional polarization leads theoretical thought astray by ignoring the ecological nature of human enterprise. A society contains an entangled set of enterprises, some commercial and others political. Those enterprises don't operate independently of one another in separate ponds of activity. They are entangled in a complex human ecology. Prices emerge through commerce, which is possible only with alienable property. Economists study how alienable property promotes social cooperation through competition among commercial enterprises. Complex forms of social organization are made possible by the information that is created by the market prices that arise from commercial transactions. Those prices provide navigational aids that promote the growth of complex commercial ecologies. These could never have arisen without private property. If anyone doubts this, just compare South and North Korea now or West and East Germany 20 years ago.

Market-based cooperation, however, is only part of the story of social cooperation. A complete story requires political enterprises to be brought into the picture. Suppose you stay at a resort and rent a boat at a nearby marina. These activities are organized by businesses. But you travel between the resort and the marina over roads that are built and maintained by governments. Moreover, the marina may be adjacent to the mouth of a river that requires dredging by some government agency to remain usable. Your activities rely upon cooperation and coordination throughout an array of enterprises, private and public.

Within the complexity of modern societies, that ecology must necessarily rest heavily on alienable private property. Hence, commercial enterprises occupy the foreground and political enterprises the background of a healthy social ecology. The value of a marina, and of commercial activity generally, is determined directly by the willingness of people to support the marina. The value of the highways and the dredging that support the marina, and of political activity generally, are subordinate to and derived from the desires for the marina. People don't support dredging services for their own sake, but do so only in consequence of their desire to visit the marina; the demand for collective services is derived from the demand for market services.

All theories of public finance treat the economy as a complex organism that is self-organized through interaction among people in the presence of private property. To say something like "the market works" is to engage in metaphorical and not material speech. There is no market that does anything. "Market" is an abstract noun that is used to denote processes of commercial interaction. When it comes to polity, however, fiscal theorists typically treat the state as some optimizing entity. This is the state as a mechanic who tunes the social engine.¹ To be sure, the literature contains extensive debates over how competent the mechanic-state might actually be, but those debates occur within the presumed antinomy between polity and economy.

The alternative orientation public finance that we pursue here rejects this antinomy by treating political entities as operating on the same plane as

¹For presentations of this orientation, see Barzel (2002), Drazen (2000), and Persson and Tabellini (2000).

economic entities. The polity, just like the economy, contains multiple participants who differ both in what they know and in what they desire and yet who operate within the same social order. It is just as metaphorical to assert that the state does something as it is to assert that the market does something. What we denote as state activity, as with market activity, emerges out of complex patterns of interaction.

Achieving Coordination: Pricing and Calculation in Political Economy

The economic theory of markets treats only a subset of all economic relationships, those that are organized through private property and free exchange. We can use this theory to understand the coordinated network of activities through which hotels have food delivered to service their restaurants and nearby fishing boats are stocked with bait and gear. All of these activities are coordinated within a decentralized system of market-based arrangements without any person or office being in charge of the coordination. What this theory doesn't allow us to do is explain the full range of societal coordination because state activity is absent. In this respect, fiscal theory typically embraces a theoretical antinomy. On one side, market participants act on the basis of localized knowledge to generate societal patterns that no one intended directly to create. This is the spontaneous order of the market. On the other side, the state acts in unitary fashion on global knowledge to do such things as plug what are regarded as holes in the market order and to otherwise facilitate some notion of societal well-being.

Fiscal theory embraces this theoretical antinomy by injecting the state as a conceptual imposition onto the market economy and civil society. This reflects what Resnick (1994) calls the centralized mindset, in which order is attributed to some specific ordering agency when it really arises through some process of self-organization. Once it is recognized that polities are likewise self-organized, because there is really no option to self-organization for contemporary levels of social complexity, any more than there was genuinely an option to implement communist planning (Roberts 1971), a question arises of how such state action relates to the action organized within the precincts of market and civil society.

The alternative orientation toward public finance, which is elaborated in Wagner (2007) and which was central to the classical Italian approach to public finance during roughly 1880-1940 (Wagner 2003), is to treat all relationships in society as transactional in nature and governed universally by local and divided knowledge.² With respect to the preceding picture, deliveries of food and guests to the hotels in the city come over roads that are maintained by states. The harbor may lie at the mouth of a river, so the ability of boats to move in and out depends on a state agency to keep the harbor clear of silt deposits. The conceptual challenge is how to incorporate such state activity into this societal portrait when that incorporation expressly is not achieved through systemic planning, as against planning by individual enterprises as manifestations of economic calculation. Relationships among market entities are directly transactional in the exchange of service for money or other consideration. When

² This Italian approach has been surveyed recently in Fausto (2003) and earlier in Buchanan (1960). For an extensive treatment of Pareto in relation to this Italian tradition, see McLure (2007). For a wide-ranging survey of fiscal sociology, see Cainzos (2006).

political entities enter, the relationships are still transactional, only not directly so because of the absence of alienable property. The central point, however, is that the political component of social organization does not occur through social-level planning, but through networks of exchange relationships of an indirect sort; moreover, the common portrait of an election as denoting the point of policy choice through candidate competition to match the preferences of a median voter is to postulate systemic planning as the explanation for the generally orderly character of political activity. In other words, the preferences of the median voter operate as a gigantic cost-benefit analysis of all collective activity, with subsequent collective activity simply executing commands based on that analysis.

Escaping this antinomy within the theory of public finance is not an easy task, and yet it is one that must be undertaken if there is ever to be an integrated theory of public finance that accounts for the observed orderliness of society in a polycentric, bottom-up fashion where no enterprise possesses all of the knowledge that is necessary to achieve coordination among the enterprises within a society.

Parasitical Calculation and Public Square Catallaxy

Fiscal theorists largely pursue a sequential mode of analysis where people write the first draft of the manuscript of social life, as it were, through their efforts in the precincts of market and civil society, and with the state subsequently revising and polishing the manuscript. The alternative, polycentric orientation we

pursue here leads to a coeval or simultaneous mode of analysis, in which the manuscript of social life is generated through continual interaction among participants within the precincts of market, state, and civil society. What is of particular significance is that the value of political activity can be calculated only in light of how that activity is refracted through market activity. Economic calculation requires prices as tools of calculation. But prices emerge only in the presence of alienable property. Collective property is inalienable. The internal economy of the state cannot generate prices. Prices can arise only within that part of society where property is alienable, and which is denoted as the market. Thus in a technical sense the state must act parasitically upon the market economy, as recognized both by Maffeo Pantaleoni (1911)³ and Joseph Schumpeter (1918). Political entities must use market prices as calculational aids even if they make incomplete use by staying within the state as against joining the market.

How much support will a highway department or a dredging department acquire from parliament? How will these enterprises choose their patterns of activity? How can such activities as these be given a catallactical explanation without falling into the snare of treating them as if they were ordinary market outcomes? The fundamental catallactical relationship is an exchange of support

³ The divide between Pantaleoni and De Viti in the treatment of prices in public services may be associated with their different methodological approaches. Pantaleoni conceives of political prices as different from market prices since he is anchored to the idea of explaining government behaviours as they were (or, better say, as they still are in a centralized polity). De Viti contrastingly introduces tax-price as a means of financing his cooperative state, where a fundamental role is played by citizens' demands for public goods and services and where, therefore, tax-price plays a disciplining role. For an extensive treatment of this point see G. Eusepi, R. E. Wagner (2009a).

for payment. We can explain the size of marinas, hotels, restaurants, and such things in this manner. But what about road maintenance, beach replenishment, and harbor dredging? There are public enterprises organized on the public square that provide such services. What might a theory of enterprise-based public finance look like? It would have to disavow both the planning that emanates from the treatment of polity as an organization and the reduction of polity to just another market participant. Polity is different from economy, and yet the resulting political economy must be emergent and transactional to match the nature of the object under examination.

To start on such an endeavor, we would call upon two analytical tools. One is Maffeo Pantaleoni's (1911) formulation of parasitical political pricing; the other is the theory of tie-in sales. Each of these conceptual formulations offers insight that seems potentially useful for approaching a catallactically-centered theory of public finance, recognizing that we don't limit catallaxy to voluntary transactions but extend it to duress, as illustrated by the aphorism: "going along to get along."

Political agencies that maintain highways and dredge harbors don't sell their services directly, so there is no way of generating independent estimates of the value of services or of the value of the enterprises. There are many possible places where silt could be dredged and beaches replenished. Scarcity is present here as it is everywhere else. Such issues as how many operations the agency can staff, where they operate, and to what extent are not answered in the same manner they would be if they were organized truly through market transactions.

For Pantaleoni, a system of political prices was treated as existing parasitically upon the system of market prices; he called this system a political price system. Pantaleoni's prime concern was the relation between public production organized through taxation and market production, and this relationship generated the dual price system that involved collisions between the systems. For instance, political services financed by a proportional tax on income would represent a political price system where the price of the same service varied among people in proportion to their taxable income. Pantaleoni's prime interest resided in interaction between the two price systems. Ours is somewhat different though related, and likewise involves parasitical relationships: while enterprises within the polity cannot calculate directly through market prices, they nonetheless must use prices to achieve calculational guidance, though they do so in peculiar and indirect ways, which follows from our treatment of parliamentary assemblies as peculiar investment banks.

It is here where the theory of tie-in sales enters. One use of tied sales is to avoid price controls. The classic illustration is a rent-controlled apartment that can be leased only by also buying furniture at a price that exceeds the market price. The rent control creates a situation where there is a shortage at the controlled price. Thus demanders seek to gain a competitive advantage, which they can do by paying more in secondary market transactions. In some cases legislation can be enacted that seeks to prevent such tie-ins, which in turn would set in motion a further search for ways of competing for apartments when competition through price is not allowed. Regardless of the particular form that

such tied sales might take, the underlying principle in operation is that a restriction on alienability for one service will tend to induce a bundling of services to secure economic calculation in the absence of alienability for the controlled service.

Getting a road repaired or a harbor dredged is particularly valuable to enterprises whose operations depend on those facilities. We may think of the demand for marina services as a variable that depends on the quality of beach and harbor maintenance. In an open market, a marina owner would purchase the amount of such service that obtains the maximum value for the marina. But these services are not directly priced. Public-private interaction must still be catallactical, only this must be indirect and involve secondary markets, as with tie in sales. Indeed, road and harbor maintenance is available at a direct price of zero when financed through ordinary budgetary operations, which is below what would be the market clearing price. This does not mean, however, that there are no forms of pricing that serve to guide calculation and allocation.

What we should thus expect to find are other types of transaction that operate equivalently to the sale of furniture in cases of rent control. As a conceptual matter, we can say that such channels must exist for harbors to get dredged and in orderly fashion, with some people getting dredging done more quickly than others. What can't be determined is the particular channel that might be used. Indeed, there could be and probably are multiple channels in use. Some channels could be quite venal, as in bribery. Other channels would be less so, as illustrated by contributions to political campaigns. Invitations to speak before civic

clubs and even charitable contributions that support activities valued highly by relevant politicians are other possible channels that are farther removed from the exchange of service directly for money, and which work to secure standing all the same.

It is easy to imagine yet other channels that are less direct still, and yet which can be intelligible features of efforts to gain competitive advantage. The marina might take out a full page advertisement for a high school dramatic production where the relevant bureau chief has children attending school there or possibly even have roles in the production. We are dealing with an open range of possibilities here, all of which are intelligible as efforts to gain competitive advantage. There is a deep entanglement achieved between polity and economy in this formulation. Figure 1 presents a preliminary sketch of what we are thinking about in this respect. Panel A describes an ordinary market relationship between two enterprises denoted by the large circles. The mutual profitability of that relationship is denoted by the removal of profits denoted by the appended small circles.

Panel B is a preliminary effort to sketch what we have in mind by a parasitical relationship between polity-based and market based enterprise, with the polity-based enterprise denoted by the square. As with Panel A, the relationship is catallactical, and is presumed to be profitable to supporters of both enterprises. Yet the collective enterprise is nominally non-profit. This does not mean it doesn't return profits, for the expectation of profit is the *raison d'être* for its support. The second small circle on the lower right side of the market-based

enterprise, in conjunction with the third arrow connecting the two enterprises, indicates that there is some path by which profit is returned to supporters of the collective enterprise.

These matters are necessarily more complex than they are for relationships between market-based enterprises. Yet any effort to explain the operation of public-private interaction in polycentric fashion with widely dispersed and distributed knowledge must start from the presumption collective enterprises have sponsors who receive gains in excess of what they could expect to receive through market employments of their capital, as was central to Montemartini's (1900) suggestions⁴ for an enterprise-based orientation toward public finance. To be sure, political enterprises bring along forced investors as well, but our interest here resides only with those who support the enterprise and who are its effective owners.

Publicly sponsored firms compete both with one another and with market-based firms, while at the same time fabricating networks of cooperative and mutually supportive relationships. Budgeting isn't a top-down, hierarchical process; it is an interactive, polycentric process. For instance, publicly sponsored firms advertise as methods of garnering support. Much of this advertisement is denoted as public relations, but it also extends to such things as assisting market-based firms in producing movies and television programming. It also

⁴ We could say that the political enterprise and the related political entrepreneur belong to a sort of an *ante litteram* polycentric order. Moreover, the distinction between small, average and large public political enterprises does not result from some a priori assignment of responsibilities among governments but rather is an emergent result of competition among political enterprises. In this formulation, Montemartini (1902, part 3, anticipates the subsequently articulated notion of competitive federalism.

includes such activities as providing speakers for a wide variety of civic forums. Not only might a marina owner contribute to political campaigns, but might also belong to civic clubs that invites speakers from particular public agencies, while also contributing selectively to charities that in turn have connections that impact positively both the marina and the relevant public enterprises. This is a further illustration of what we mean by entanglement between state-based and market-based enterprises.

A Constitutional Denouement

Our formulation treats polities as orders and not as organizations (Hayek 1973). Organizations have choice-theoretic coherence and not systemic coherence, while orders lack choice-theoretic coherence while possessing systemic coherence (or else we wouldn't even recognize an order). We don't observe coherence within markets: market processes support both butchers and vegetarian chefs. It is the same with polities: there are programs that subsidize job retraining while there are also programs that subsidize unemployment. Thinking about orders and their reform is different from thinking about organizations and their reform. What is dubbed economic policy, and also welfare economics, treats the polity as an organization, and with fiscal philosophers simultaneously seeking to sit beside Power and wondering what happens to their fine plans for optimizing this and that when the political realists ignore the fiscal philosophers.

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 as when Alexander is said to have sliced Gordius's knot. This is the approach of standard welfare economics, which calls for the use of state power to shift society to some alternative configuration. .

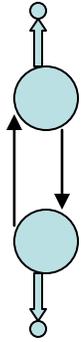
The alternative approach to public finance that we have been exploring here offers no place for the knot to be sliced. Rather it must somehow be unraveled because there is no singular point where the insertion of power will shift the direction of movement because the polity is an emergent order and not an organization. A conductor can change the direction of a marching band's movement in an instant because the band is an organization. Changing the movement of a crowd of spectators leaving a coliseum is a different matter because the crowd of spectators is an order and not an organization. As an order, it holds numerous organizations within its precincts (and an individual is an organization). For the emergent phenomena that are characteristic of orders, 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. At this point an enterprise-based theory of public finance makes contact with constitutional political economy (Buchanan 1990).

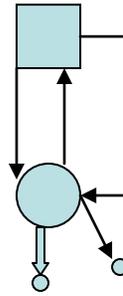
Concluding remarks and more.

Overcoming the antinomies between market order and political organization was the aim of this paper. This has been reached through the extension of the concept of catallaxy, which was originally designed to explain voluntary exchange only, to phenomena that imply exchanges not entirely voluntary due to the differences, *not antinomies*, between market choices and political choices. In such a way, market choices and political choices are simultaneous, not sequential. Along this line, the relationship between economics and politics – between private and public finance – requires that public finance should depart from monocentricity and be based on an enterprise-polycentric logic. While our position is highly controversial among conventional public finance scholars, it is, instead, in line with the so-called democratic Italian tradition in public finance (Montemartini, Pantaleoni and, above all, De Viti de Marco). We have simply dug into the Italian tradition and have found out that market order and political order are intertwined. But to understand the process underlying this sort of entanglement requires that attention be placed on the institutional setting (especially federalism). This, however, is an argument that we have developed in another paper⁵

⁵ See G. Eusepi and R. E. Wagner (2009b).



Panel A: Market-confined
Catalaxy



Panel B: Mixed Polity-
Economy Catalaxy

Figure 1: Catalactical Relationships in Public Finance

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