Fiscal Crisis as Failure of Progressivist Democracy

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Abstract

The American system of political economy surely faces a fiscal crisis illustrated by but not limited to a trend of growing deficits and debt that cannot continue. What can’t continue won’t continue. In what fashion change occurs will be governed by forthcoming interactions between power and ideology. The present crisis has been building for nearly a century, and it resides in the morphing of a constitutional system of limited democracy into one of progressivist or oligarchic democracy. The clear and present danger is that the present crisis will end up strengthening the conservative forces of progressivist democracy and its program of continually extending the reach of politics into society. The avoidance of that danger requires some bold reconstitution of the American civil order in tune with its foundation in a constitution of liberty. Pursuit of this alternative path requires recognition that the progressivist century has done much to eviscerate the exceptional qualities of the American political heritage. That evisceration, however, can be transcended by a muscular liberalism that overcomes the soft power-based sentimentality that is the hallmark of the oligarchic form of democracy.

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The American federal government has run budget deficits almost continuously since 1960, and not since the 1920s has there been any significant effort to reduce the federal debt. Today that debt stands at around $18 trillion, or about $60,000 per person in a nation of 300 million. That growth of deficits and debt, moreover, shows no sign of stopping let alone reversing. The same situation prevails on a smaller scale throughout our state and local governments. The total volume of state and local indebtedness now stands at around $4 trillion, and continues to grow despite the existence of balanced budget requirements in 49 states. At the federal level, moreover, legislation was enacted in 1978 to prohibit budget deficits after 1981. This legislation, named Byrd-Grassley after its sponsors, was never repealed, but neither were deficits eliminated, as David Primo (2007: 109) explains. For the better part of a century, democratic governments have shown a strong tendency to operate with budget deficits and accumulate public debt, as Buchanan and Wagner (1977) explore and Wagner (2012) amplifies and elaborates.

Traditional measures of public debt show only the proverbial tip of the iceberg. Just as the larger part of an iceberg lies below the surface, so too does the larger part of the looming fiscal crisis. This unseen component of public debt is described as unfunded liability. The major sources of unfunded liability in the United States reside with the social security and Medicare programs. State and local governments also create unfunded liabilities, often through pension programs, and which have been implicated in recent years in a number of municipal bankruptcies (Moberg and Wagner 2014). Unfunded liabilities, unlike ordinary public debt, are not made explicit at the time
they are created. Hence their magnitude must be estimated. While there is variation in estimated magnitudes that depends on the estimator and the technique used, a magnitude in the vicinity of $100 trillion seems to be a reasonable estimate. This unfunded liability thus amounts to more than $300,000 when placed on a per capita basis, and which Kotlikoff (2005) and Kotlikoff and Burns (2012) describe as looming generational storms.

It seems clear that the present path of budget deficits and public debts can’t continue. What can’t continue won’t continue. Hence, an alternative fiscal trajectory is looming. Just what that trajectory might be will be determined through political and social controversy and conflict. Public perceptions about the sources of the crisis will surely have significant bearing on that future fiscal trajectory. In this respect, two types of trajectory can be identified. One trajectory is relatively conservative in that it would reinforce the progressivist political economy of the past century by presenting a convincing narrative to the effect that the present crisis illustrates what can happen when a well-working progressivist system is buffeted by strong external shocks. In this case, nothing is required to overcome the crisis than to keep the faith with the political authorities who are working hard to get beyond the crisis. The crisis does not point to any kind of systemic failure, but rather illustrates the damage that a long string of bad luck can do to a well-working system. The alternative trajectory entails a relatively bold narrative grounded in growing recognition that the crisis is a systemic reflection of a century-long morphing of the original American constitution of liberty into a progressivist constitution of democratic oligarchy. This alternative trajectory would embrace something like Richard Epstein’s (2014) articulation of the classical liberal foundations
of the American Constitution. The present crisis is, in any case, an intelligible feature of the democratic competition for power, and this trajectory can be changed only by rearranging the constitutional framework through which that competition proceeds.

The ability of democratic governments to generate fiscal crises has long been recognized by scholars prior to the advent of the Progressivist era. For instance, William Niskanen (1978) quotes Alexander Tytler, a Scottish historian from the 18th century who summarized thusly the views across two millennia of scholarship about the tenuous character of a well-working democracy:

A democracy can’t exist as a permanent form of government. It can only exist until the majority discovers it can vote itself largess out of the public treasury. After that, the majority always votes for the candidate promising the most benefits with the result that democracy collapses because of the loose fiscal policy ensuing, always to be followed by a dictatorship, then a monarchy.

While there seems to be some uncertainty as to whether Tytler actually put those words to paper or if instead they were part of some oral tradition, there is no doubt that Tytler’s words resonate well with two millennia of political thought on democracy, as amplified by modern scholarship on public choice, which Richard Wagner (2006) sets forth in his analysis of retrogressive regime drift.

In explaining how the present crisis is a facet of the democratic competition for power that generated the present system of oligarchic democracy, I start with the theory of public debt. The theory of public debt is a source of huge public confusion because of

1 Richard Wagner (2014a) provides a flying buttress to Epstein’s book from the perspective of public choice theory.
the strong proclivity people have to treat public debt as similar to personal or corporate debt. There are points of similarity, to be sure, because indebtedness always spans time in that obligations incurred today won’t be discharged until tomorrow or the day after tomorrow. For personal or corporate debt, however, it is clear who is indebted to whom. It is not so clear with respect to public debt, so straight-thinking on this matter is essential for gaining a solid understanding of fiscal crises and democratic public finance. After exploring the theory of public debt, the rest of the essay examines how a constitutional system of limited or liberal democracy can morph into a system of essentially unlimited or oligarchic democracy. That morphing arises through the constitution and reconstitution of democratic power. After exploring how democratic competition can reconstitute the pattern of Power, the rest of the essay explores some possible paths for the restoration of a constitutional system of liberal democracy where the reach of politics is limited, in contrast to its presently unlimited reach.

1. Public Debt and Contractual Mythology

Public debt is often treated as similar in form to personal debt. Doing this is to cover public debt with the mythology of contract. Nearly everyone has experience with personal debt. Such debts are genuine forms of contract. A person or a business wants to buy an asset today, but doesn’t want to sell another asset to acquire the funds. So the person borrows the money by promising to repay the lender with interest, according to the terms the borrower and lender agree to. All debtor-creditor relationships entail a bridging of time that maintains an open relationship between the debtor and creditor until that contract has been discharged at some later date. There is a fundamental
distinction between spot and credit transactions when it comes to political entities that remain in the background with commercial relationships among private entities. When transactions extend into the future, opportunities arise for what are effectively fraudulent transactions with respect to public debt.

The open-ended character of credit markets provides opportunities for post-contractual opportunism that don’t result with spot transactions. In the face of these opportunities, participants in credit markets have developed numerous practices and conventions to protect such market transactions against post-contractual opportunism. Credit reports help to provide assurance about a borrower’s reliability. Provisions for collateral offer added security to lenders. Borrower’s concerns with their reputations adds further security. Through these and numerous other features of credit markets, the unavoidable riskiness that accompanies open-ended contractual relationships is mitigated and the size of the market expands.

Most references to public debt treat such debt as analogous to personal debt. The earlier reference to present federal indebtedness as being about $60,000 on a per capita basis draws an explicit analogy between public debt and personal debt. It is easy enough to understand the ready acceptability of this analogy, for it expresses what seems to be intuitively obvious. As an individual you incur debts that you are obligated to repay. It seems intuitively obvious that it is the same with governments. What is intuitively obvious, however, is not always true. That the sun rises in the east and sets in the west is readily apparent, and was widely believed until Copernicus. It could still be widely believed today for all I know, as I know of no surveys that have posed this question to a broad population. Still, we have an accepted scientific theory that
countermands what appears to be intuitively obvious. Public debt presents us with the same problem of what appears to be intuitively obvious. Each of us has personal experience of what it means to be indebted. It is easy to recognize that someone can accumulate debts sufficiently large that servicing that debt might become difficult or even impossible. We also recognize that our indebtedness is a product of previous choices we have made. Normal morality thus tells us that we should make good on our debts because they are the current manifestations of past promises we have made.

It is accurate to say that the debt of the American federal government now exceeds $18 trillion, and with about one-third of that debt held by foreigners. It is not accurate, however, to identify the federal government as the entity that is indebted. To do this is to participate in a shell game where the game’s host diverts the attention of the spectators. To understand this shell-game quality, it is necessary to ask just who owes want to whom when it comes to public debt. We can ask such questions for personal or commercial debt, but the answers are obvious: borrowers owe repayment plus interest to lenders, and this is all there is to the matter. Public debt creates an entirely different situation.

To illustrate this distinction between public and personal debt, suppose a town of 10,000 decides through a town council to borrow $10 million, when the alternative is to raise that money through taxation. Further suppose that doing this is agreeable to all residents of the town and not just to the members of the town council and some of their supporters. James Buchanan (1958) explains that the analysis of public debt is the same regardless of whether the creditors live inside or outside the borrowing unit. The former situation is described as internal debt, while the latter situation is described as
external debt. The analytical properties of debt creation are the same in either case, so I shall focus on internal debt because it is simpler to illustrate. At a superficial level, it looks as though the town becomes indebted because it raises $10 million by selling bonds to a subset of town residents. But how can that town be liable for that debt? The deep as distinct from superficial answer is that the town can’t be liable because the town itself has no wealth from which it can amortize the debt. The ability of the town to service the debt depends on its ability to extract taxes from residents.

Liability for the debt resides with taxpayers. The town itself is simply an intermediary in a transaction between two sets of residents within the town. One set of residents buy the bonds. In doing this, they are paying current taxes for the other residents. The other set of residents pay taxes in later years to service the debt and retire the bonds. The people who buy the bonds are replacing what would have been tax payments by other town residents with the expectation that those bonds would be redeemed according to the terms of the debt issue. The remaining residents acquired an obligation to make future tax payments in exchange for the ability to escape having to make higher tax payments now. It is worth noting that this obligation is never assigned explicitly to these residents at the time the debt is created, though such an obligation could easily have been assigned. Instead, the apportionment of that obligation among residents is left to be worked out in future years as the debt is serviced. The town itself is a form of financial intermediary that stands between the people who buy the bonds and the people who will pay higher taxes in future years to amortize the bonds. Suppose we now ask why the town council would have issued
bonds rather than increasing taxes? The answer to this question matters hugely with respect to the political economy of public debt.

The essence of democratic public debt resides in recognition that it creates patterns of liability and obligation among the citizenry that extend through time, only with those obligations and liabilities never being made explicit. Contrary to Buchanan’s (1958) argument, present as well in Kotlikoff (2005) and Kotlikoff and Burns (2012), that public debt shifts the burden of current spending from present to future generations, public debt is actually a means by which some citizens shift burdens onto other citizens located at different points in time, as Wagner (2014b) explains. Yes, public debt still spans time by passing encumbrances forward, but those encumbrances are concentrated on subsets of the population and not distributed uniformly across the population. Public debt is but one among numerous instruments of fiscal domination by which some people exercise dominion over others. This quality of public debt requires recognition that there are two distinct situations under which political entities can create debt, one relatively innocuous and also rare and one more serious and also common. I shall address the innocuous case first under the heading of consensual democracy, before turning to the more serious case under the heading of factional democracy.

2. Public Debt within a System of Consensual Democracy

Conventional ideology treats democracy as necessarily being a system where people govern themselves. Within this ideology of self-governance, there can be no principled limit to the reach of government because governments do only what people want it to do, as Bertrand de Jouvenel (1993) explains lucidly in his examination of the
tendency of democratic power to become unlimited, in contrast to monarchical power. This common ideological formulation is vague and vacuous, as it must be. There is no way that a collective entity can act as an entity. All collective action originates in desires of particular people who take leadership positions in gaining acceptance for those desired actions. Once this simple point is placed in the analytical foreground, it is easy enough to recognize that there are two broad categories of democratic action. One category reflects a general consensus within the relevant polity. In the early years of the American republic, this notion was reflected in the general welfare clause of the Constitution which limited federal appropriations to items of general welfare throughout the republic. In his masterful treatment of *Congress as Santa Claus*, Charles Warren (1932) described the morphing of the general welfare clause from a limit on the power of Congressional appropriation to subsequent recognition that the general welfare meant whatever a dominant Congressional coalition declared it to be. This shift brought about a system of factional democracy, wherein democracy becomes an instrument through which some people profit at the expense of others while laying down an ideological smokescreen to cover the arrangement.

Public debt plays out differently within a system of consensual democracy than it does within a system of factional democracy. Suppose an earthquake destroys a town-owned stadium. To keep within the motif of consensual democracy, suppose there is overwhelming if not universal support to rebuild the stadium. This situation might come about because all town residents make repeated use of the stadium in many ways throughout the year. In this situation it would not be surprising to find universal support for building a new stadium. The only publicly relevant issue is how to pay for rebuilding
the stadium. In this regard there are two options. One option is to adopt an extraordinary tax, which would entail a one-time doubling of the tax rate to raise the $10 million to reconstruct the stadium. The alternative option is to sell bonds to a willing subset of town residents, and with those bonds being amortized over a ten-year period. To further solidify this point about consensual governance, we can even imagine that liabilities for those future amortization payments are assigned at the time the bonds are sold. Each resident of the town would thus receive an explicit liability for their shares of future amortization payments.

Should the tax option be selected by the town, some people will discharge their tax liability by drawing down their cash balances or selling other assets. Others will turn to the credit market to borrow the money to discharge their liabilities. The stadium will be built, the town will issue no debt, and some number of town residents will borrow on the credit market to finance their share of the extraordinary tax liability. Should the town pursue the debt option instead, nothing of genuine significance is changed except that private financial intermediaries are replaced by the town as a financial intermediary. It is reasonable to wonder about the town’s qualities as an intermediary relative to those of private credit institutions. The general rule when private operation is replaced by public operation is some combination of less efficient operation in conjunction with bias in the execution and enforcement of contractual provisions.

With the tax alternative combined with recourse to private debt for those who choose not to fund the extraordinary tax from their current accounts, the contracted debts are personal liabilities. Those debts reside with the debtor regardless of future changes in economic circumstances, whether the debtor moves away from the town, or
dies, and with the debt becoming a charge against the debtor’s estate. When public
debt replaces what would have been an extraordinary tax increase, the situation
changes in several respects, each of which operates in the direction of increasing
support for public spending when it is financed by borrowing—even when that spending
is desired by everyone in general. For one thing, what was an individual’s explicit debt
obligation is now rendered implicit and contingent on a number of different
circumstances, and with Buchanan (1967) explaining the contingent character of the
liability that public debt entails. One of those circumstances is future changes in
taxation. Another is changes individuals make as their actions relate to the town’s tax
base. At this point the situation is morphing into one suitable for a system of factional
democracy.

3. Public Debt within a System of Factional Democracy

While some town residents might value the stadium highly, many others might
place little or no value on reconstructing the stadium. We might also presume that those
who support reconstructing the stadium do so only because they will not bear the full
cost of that reconstruction. In this respect, James Bennett (2012) provides a lucid
explanation of how billionaire owners and millionaire players are able dominate ordinary
taxpayers in securing subsidized construction of stadiums and arenas. This is factional
democracy at work. In this type of case, those who support reconstruction would not
support the reconstruction if they had to pay for it themselves. Tax financing shifts much
of the burden onto ordinary taxpayers. Suppose a majority of the council members
likewise supports stadium reconstruction, and face the problem of deflecting opposition
to that reconstruction. Where the imposition of an extraordinary tax to finance the reconstruction will surely galvanize the opposition, the resort to debt will surely stimulate less opposition, especially when liabilities for future amortization payments are not assigned at the time the debt is approved. In this case the town debt divides taxpayers into two sets: (1) supporters of the stadium and (2) opponents. Those town residents who bought the bonds gain from that transaction through the terms on which the debt is serviced. Among the remaining town residents, some gain and some lose. Those who support the added spending gain, while the other loose. These people have become forced debtors.

A deep fallacy is involved in treating public debt as an obligation that one entity owes to another. This fallacy is perpetuated in accounts that speak of aggregate public debt or which places that aggregate debt on a per capita basis. There is nothing wrong with such figures, for they are real and not fictional. There are federal bonds in existence that aggregate to a face value of some $18 trillion. All the same, it is false to think of public debts as something equivalent to what one person owes to another. In the days when monarchs borrowed from wealthy people within their realms, the monarch’s debts were personal debts owed to other people. The situation is very different for democratic regimes.

It is not sensible to describe public debt as something that “we owe to ourselves.” As an exercise in aggregate accounting, this aphorism is an identity that is established by double-entry accounting. The situation is no different, for that matter, in speaking about household debts. Those debts arise though contracts between borrowers and lenders, and the aggregate amount of household debt in the United States is currently
around $12 trillion. One could always aggregate all such debt throughout the nation, and declare that this aggregate debt is something we owe to ourselves. As a statement about aggregate accounting, this assertion is necessarily true. That truth, however, is a fiction that is created by constructing an artificial entity that is not an action-taking and responsibility-bearing entity. Indeed, it is the absence of any genuine locus of responsibility that is the source of democratic fiscal crises.

A monarch is an action-taking and responsibility-bearing entity. So is a business corporation. Even if that corporation is constituted through a plurality of investors, the corporation must attract investors in an environment where those investors are free to choose where to invest. Democratic political bodies, however, are not like corporations or monarchs. To be sure, it is possible to imagine how democratic political bodies could be transformed into corporate bodies with willing owners, as illustrated, for instance, by MacCallum (1970), Foldvary (1994), and Wagner (2011). When those bodies operate with transferable ownership shares, market values would be established for those entities. Short of such bold institutional reconfiguration, however, public debt will remain categorically distinct from personal debt because the locus of responsibility for personal debt that private property creates evaporates with public debt. Democratic debt is one of those proverbial tips of the iceberg that conceal the below-surface context in which that debt is created.

4. Two Forms of Democratic Budget Tragedy: Commons and Factional

There are two distinct formulations of the fiscal crises that plague democratic governments. One formulation treats democratic budgeting as a form of tragedy of the
commons. Economists have long recognized that there is a tendency for excessive resource exploitation in common property settings. Frank Knight (1924) recognized this tendency with respect to highway congestion. Scott Gordon (1954) used the excessive exploitation of fishers to illustrate the same point. Elinor Ostrom (1990) presents several case studies where people have been able to transcend the common tragedies they faced. In these instances, the ability to transcend the commons tragedy entailed the establishment of some form of ownership rights within the commons, as illustrated by assigning quotas on how much water someone might remove from an irrigation system.

Democratic budgeting creates a type of fiscal commons (Brubaker 1997; Wagner 1992, 2007). Within the image of the commons, taxation denotes the assignment of liabilities among taxpayers to stock the fiscal commons while appropriation denotes the removal of items from the fiscal commons. The outcome of budgeting on the fiscal commons entails the same excessive exploitation that holds for other commons settings. Suppose 100 people dine in a restaurant that operates according to the conventions of private property. The aggregate bill incurred by those diners might be $5,000, or $50 per diner on average. Within a setting of democratic budgeting, these people will comprise a dining club where the aggregate bill will be settled through taxation. With private property, someone who chooses a $30 item over a $50 item will save $20. This won't happen with common property because that $20 saving will be distributed among all the diners, and will amount to 20 cents per diner. Under these circumstances, we can appreciate that the less expensive option is less likely to be chosen under common property budgeting. We can also appreciate the strong tendencies that exist for spending to increase. After all, someone who adds $20 to be
bill will add only 20 cents to his or her share of the tax. The cost of taking an action is lower to any action-taker under common property budgeting, as Buchanan (1969) shows in explaining how cost varies with different settings for making choices. With common property budgeting, the aggregate bill might end up being $7,000 or $70 per diner. In this tragedy of the commons setting, everyone loses pretty much equally within the commons.

The tragedy of the commons is general or universal. Everyone loses through the excessive exploitation that occurs on the fiscal commons. It follows from the logic of the situation that everyone potentially can gain by eliminating that excessive exploitation. This situation is illustrated nicely by William Niskanen’s (1971) widely-recognized theory of bureaucracy. There, Niskanen argued that there were universal tendencies for governmental bureaus to spend more on their activities than private firms would spend because bureau officials could not directly remove profits from their bureaus. What they could do, though, was operate in more costly fashion to the extent such greater costliness supplied them with desired advantages.

Factional democracy points to a distinctly different form of democratic tragedy. This form of tragedy is better characterized not by excessive provision of collective activities but by qualitative changes in the character of collective activities and the governance of human activities. This is a model not of mutual exploitation on the commons but is a model where some parts of the population gain at the expense of the remainder of society. This is a world of domination and subordination. This is the world where billionaire owners and millionaire players are heavily subsidized by ordinary taxpayers (Bennett 2012). Within the American system of federal income taxation, for
instance, about half the population of voting age is free of tax liability. To the extent state activities are financed through the federal income tax, we would normally expect to find little opposition to increased spending. The income tax is not, of course, the sole source of federal revenue. Still, income tax burdens are highly concentrated on a small subset of the population, which means that the cost of government is low if not zero.

This situation can be described by a model of coalitional politics where winning subsets of the population gain by imposing burdens on the remainder of the population. The standard model of the fiscal commons is susceptible to correction through recognition that everyone is being overburdened by excessive exploitation of the commons. The coalitional politics of factional democracy is not susceptible to such a simple remedy. In this case the democratic processes masques a process where there are subsets of the population that are able to dominate other subsets, often using ideological tools to do so as Pareto (1935) explained. Pareto recognized that only some actions people took were subject directly to their appraisal. These actions Pareto described as logical, to denote a direct link between the action taken and the consequence experienced. Often, however, there is no direct link between action and consequence. Many of these cases entail political action, where political claims are more like claims about credence goods than claims about experience goods. With credence goods, claims are accepted or not, but in any case cannot be tested against experience.

Pareto explained that political competition largely involved candidates in making claims about credence goods, where competitive success resides in creating images

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2 The length of Pareto’s analysis exceeds 2,000 pages. Raymond Aron (1967: 99-176) presents a cogent distillation of Pareto’s thought.
that allow voters to feel good about their actions. Ideological competition in the realm of credence goods takes the form of allowing voters to embrace rationalizations that they wish to embrace in any case. For instance, someone who might support a subsidized stadium might embrace the claim that the stadium provides public-good benefits for the town while shying away from recognizing the private benefit of being a contractor in the reconstruction. Political competition in the presence of credence goods is principally about finding the right buttons to push when no independent testing through experience of claims is possible in any case. To end this form of crisis requires bold moves of some type, as in lowering the progressivity of a tax system so as to bring the cost of government home to more people. This form of crisis arises through expansion in the number of tax eaters relative to tax suppliers, with reform requiring some form of rebellion by the tax suppliers along the lines that Stephen Walters (2014) describes once took place in the 1970s in California and Massachusetts, setting in motion a period of what he describes as boom towns.

5. Unfunded Liabilities: More of the Same

An unfunded liability is just public debt to which a different name is attached. With ordinary public debt a government sells bonds to buyers. The revenues required to retire those bonds will be imposed on taxpayers in future years, save to the extent that those future revenues are extracted from the buyers of bonds through default or inflation. However that revenue is acquired, it is easy to assign a value to the amount of public debt, for it is given by the amount governments promise to pay bondholders in future years, regardless of how future governments actually deal with those promises.
The situation is really no different for an unfunded liability, save only that no explicit liability is acknowledged at the time the liability is incurred. For an unfunded liability, the future liability is left implicit rather than being made explicit. The open ended quality of the liability means that the actual extent of the liability won’t be known until some future point in time. Yet a liability is there all the same, and with that future liability being a product of preceding political commitments. For the federal government, the bulk of unfunded liabilities accrue through the social security and Medicare programs. Those programs contain provisions to make payments in future years, with liabilities to provide those payments likewise to be imposed in those future years. For both unfunded liabilities and public debts, a present commitment is made to make payments in future years, and with those payments to be extracted from taxpayers in those future years. The only difference is the purely nominal difference that with public debt the magnitude of those future payments is established at the time the debt is created, though just on whom those future payments will be extracted will be determined in the future. By contrast, with unfunded liabilities the magnitude of those future payments won’t be determined until the future arrives.

Ordinary public debt entails a contingent liability, in that any person’s tax payments to service public debt is contingent upon the tax system in play when that future arrives, as well as on the taxpayers personal situations relative to the future tax structure. In contrast, unfunded liability entails a double contingency. One element of contingency is identical with what exists for ordinary public debt, in that a taxpayer’s liability for future payments will depend on his or her economic position at the time of tax extraction relative to the tax structure in place at the time those taxes are extracted. But
unfunded liability has a second layer of contingency, in that the amount of liability is also to be determined in the future, whereas with public debt it is stipulated at the time the debt is created. Hence we know that the explicit debt of the American federal government is around $18 trillion because this is the face value of the bonds that holders of public debt have bought over the years. We don’t know, today, what is the exact amount of the public debt associated with social security and Medicare, or with the various state and local health and pension programs that are also sources of unfunded liability. These amounts will be determined only in the future as people make their retirement choices and incur covered medical expenses. Unfunded liabilities are thus projections of a double contingency. They entail projections of future revenues and expenditures, usually over a 75-year period, with existing legislation assumed to remain unchanged over that period. When looked at from an accounting standpoint, unfunded liabilities seem to indicate a discrepancy that will have to be resolved in the coming years. That discrepancy can be resolved either through increasing taxes in future years or through reducing payments of benefits, or through some combination of both.

This accounting-based point of view treats growing public indebtedness as a temporary reflection of unusual circumstances that will be corrected as the years pass. What is unsustainable will not continue indefinitely, of course, so we may be sure that there will be some future change in the trajectory of unfunded liabilities. But is it reasonable to think that this unsustainable trajectory was simply a product of unforeseen and unforeseeable circumstances and forces? The alternative line of explanation is that the present trajectory reflects the playing out of intelligible political and economic forces at work. For instance, social security and Medicare are operated
as defined-benefit programs, which means that future payments cannot be known until future conditions are known. There is, however, no necessity that these programs be operated in this manner. They could be operated as defined-contribution programs, which would make those programs another forms of ordinary public debt.

Unfunded liabilities do not reflect errors due to natural complexities. It is easy enough to recognize that complexities in budgeting will generate errors. It is not easy to estimate revenues and expenditures a year or more in advance. In some years estimated revenues will exceed what was actually collected, while in other years they will fall short of what was collected. Complexity means that budgeting will be inaccurate. Sometimes revenues will exceed expenditures. Other times the expenditures will exceed the revenues. Over a period of years, however, the imbalances will roughly even out. There should be no systematic tendency toward budget deficits, at least not to the extent that the complexity of budgeting means that there will always exist gaps between \textit{ex ante} projections of budgetary magnitudes and the \textit{ex post} realization of those magnitudes.

The persistence of budget deficits and the accumulation of public debt can only be attributed to the operation of systematic qualities of political competition as this competition gets reflected in democratic budgetary processes. Unfunded liabilities reflect a form systemic lying, in that the democratic process countenances the making of contradictory political promises to different people. On one side are the promises made to taxpayers regarding the future cost of programs. To be sure, these promises are only implicit, but should be understood in contractual terms. That contractual frame of reference means that present taxes are sufficient to fund future payments, so that
taxpayers in evaluating present programs have some reasonable basis for doing so. On the other side are promises made to beneficiaries about what they can expect from those programs. The two sets of promises don’t balance, and the deficit is an unfunded liability. This liability will probably worsen in the coming years, and is not sustainable in any case. What is not sustainable will necessarily end sometime, but how will it end?

Two divergent paths can be discerned. The popular path will entail strengthening the forces of democratic oligarchy that have created the present situation. This path will entail a parade of tax increases and reductions in benefit, along with increased regulation to cover over remaining deficiencies. The other, uncommon path will entail a reconstitution of the American civil order and of the place of governments within that order. The Progressivist century will be recognized as having been a playing out of fiscal tragedy that the ancient Greeks understood as the down-side of democracy. Pursuit of this alternative path offers the prospect of transcending the democratic budget tragedy. To achieve that transcendence requires renewed recognition of how democratic governance must be restrained by the prior claims of private property and the social relationships that arise from this recognition.

6. Time, Democracy, and Political Capital Accounts

Public debts and unfunded liabilities point to significant problems that democratic governments having in dealing with programs and situations that extend through some duration of time. Each of us faces situations where the actions we take today will have consequences that will extend over some future interval of time. Many of these situations entail incurring debt today that we must repay at some future time. That future
payment might be inconvenient, but typically we repay the debt anyway, and that repayment is supported by several interrelated institutional reasons that are largely absent for public debts. One major institutional reason resides in private property as the basic social arrangement for governing relationships among individuals. The presence of private property means that individuals operate under conditions of residual claimancy, wherein individuals own the difference in value between good and bad choices. If the choice to borrow works out well in the end, they gain from having done so. Should that decision work our poorly, they will bear the loss. Either way, private property creates institutional conditions under which people are responsible for the value consequences of their actions.

This position of ownership means that borrowers will exercise care in taking on loans by virtue of the resulting obligation to repay the loans. To be sure, people can differ in how they appraise such future obligations. A debt contract that one potential borrower might accept might be rejected by another potential borrower. Economists typically describe this difference among people as time preference. In that children’s story of the *Three Little Pigs*, the pig who built the house of straw would be described as having high time preference while the pig who built the house of bricks would be described as having low time preference. Also significant for private debt is the position of the lender. Loans are the private property of lenders, and a loan is a rental of an asset. With all such rental contracts, the owner of the asset faces the problem of getting the asset back according to the terms of the contract. Among other things, this situation means that lenders will exercise care in extending loans, at least so long as the institutional rules of private ordering are in place. Under such rules, a lender who
extends loans on which the borrower defaults will lose the value of that loan to the extent collateral wasn’t attached to the loan.

To be sure, contemporary credit markets don’t operate exclusively under private ordering because political regulation impinges upon the operation of credit markets in many ways. Within wholly private ordering of credit transactions, whether a debt is extended and the terms on which it is extended is a matter that is determined between the lender and the borrower. A lender is not obligated to lend to a particular borrower nor does a borrower have some entitlement to a loan. The contractual principle of gains from trade pervade privately ordered credit markets. Modern credit markets, however, are not exclusively privately ordered because political regulation has high presence within modern credit markets. Those regulations do such things as regulate the portfolios of lenders, which in turn includes such things as placing constraints on how a loan portfolio must be distributed among various classes and categories of borrowers. The intrusion of public ordering means that actual credit markets will involve lenders in making loans they would not make based on prudent commercial calculation, but make such loans as part of the cost of doing business within the contemporary regulatory environment. That environment requires firms to make a mixture of what would be described as good and bad loans under private ordering, though much of the anticipated loss from bad loans is further covered through political guarantees, much of which is financed by taxpayers.

The situation changes dramatically with public debt, and in several ways. All corporate bodies have the property that the creation of liabilities rests with the entity and not with the officers who created the liability. For commercial corporations, however,
there are various institutional arrangements relating to private property that provide
strong inducements for corporate officials to manage their enterprises in value-
maximizing manners. With a small exception, there is no ownership value associated
with politically managed enterprises. This exception arises with local governments that
operate under institutional conditions that largely disappeared during the 20th century.
Those conditions entailed local governments that were financed by taxes on real estate
and in which all residents owned real estate. Within this institutional setting, a form of
tied sale is created between the ownership of real estate and the ownership of the town.
Should a town be mismanaged, the demand for residency in the town will fall relative to
demands elsewhere. This situation will show up as a decline in the value of real estate,
and at the same time will also provide information about the efficiency of town
management. Under such institutional conditions, there is much common territory
between town and commercial corporations with respect to their tendencies toward
managerial efficiency.

Over the past century or so, the institutional arrangements regarding municipal
operation have moved away from this efficiency-enhancing framework. Localities are no
longer financed wholly or even predominately by taxes on real estate. A good deal of
local financing now comes from state and federal governments. Voting, moreover, is no
longer the exclusive province of property owners. Tenants face a different situation with
respect to supporting public debt than do property owners. For an owner of property,
there is no significant advantage to borrowing over taxing because Ricardian
equivalence is a feature of ordinary credit markets (Barro 1974). For tenants, however,
borrowing is less costly than taxation, provided only that tenant can reasonably expect the leave the locality within a few years.

This institutional constraint on limiting future promises because of its impact on valuations through the capital market weakens even more as fiscal activity moves to state and federal governments. A city might use pension promises as a short-term measure to gain political support, but doing that places encumbrances on the city’s tax base that will create problems in future years, as Moberg and Wagner (2014) explore for municipal bankruptcy. At the federal level of government, there can be no territorially based competition among governments. There can be competition between Lubbock and Detroit because people can choose between the locations. For the federal government, however, there is no locational competition, for the federal tax base is approximately invariant between individual choices between Lubbock and Detroit. At the federal level of government, political officials can play Santa Claus, to borrow from Charles Warren’s (1932) masterful recounting of the denigration of the General Welfare clause of the American constitution from around 1800 to around 1930. In other words, the scale at which democratic governments operate matters greatly for the performance properties of those governments, and with the forces of oligarchy intensifying as the scale of government expands.

7. Expanding Governmental Scale and Intensifying Democratic Oligarchy

Within the framework of the economic theory of markets organized under conditions of open competition, the sizes of enterprises are pretty much irrelevant. Economies of scale may play out differently across different types of enterprises. Those
enterprises that manufacture simple products that are in high demand will typically be
larger than those that manufacture complex products for which manufacturing requires
paying particular attention to idiosyncratic differences and desires among customers.
Construction firms that specialize in high-rise office buildings operate on a larger scale
than firms that build houses or apartments. Economists have long recognized that the
most efficient scale or range of production can differ significantly among types of
production. Hence, a market economy organized through open competition will feature
enterprises of widely differing scale. But these differences of scale typically give no
advantage to larger firms relative to smaller ones. Economists have long recognized
that free competition tends toward a situation where the expected return on different
lines of activity tends toward equality across those lines. This tendency is just a
tendency because its operation is also continually buffeted by the creation of new
enterprises and new lines of production. Hence, the static state where returns on capital
would be equalized is never reached. All the same, however, this property of open
competition explains why the scale of enterprises is generally irrelevant with respect to
the rate of return that can be earned by investing in different sized enterprises.

The situation is strikingly different when it comes to the size of governments,
more so at national than at local levels. For instance, economies of scale would limit the
sizes of schools in a system of open competition more so than they would when
governments provide schooling. Market-based schools, or market-based providers of
any service, must attract customers in open competition with other providers. A provider
whose output declines in quality or increases in costliness will lose customers to more
efficient producers within a system of open competition. Governmental entities,
however, don’t face competition, save for a few, limited margins of competition. A public school faces limited competition from private schools and from home schooling. This competition is exceedingly limited, however, in that people who use private schools or who turn to home schooling must still pay taxes to support public schools. In this simple fact resides stark recognition of the competitive infirmities of public provision. To illustrate the extent of that infirmity, suppose groceries were provided through public commissaries which would be financed through taxation and with people picking up their designated bag of groceries once a week. With private schooling or home schooling, the equivalent situation is one where people don’t pick up their designated bags and instead shop at a private store despite having paid through taxation for the public store’s bag of groceries.

In the theory of networks, an important distinction is the distinction between networks that are scalable and networks that are free of scale (Barabási 2002). A network is a mapping that contains a number of entities along with various links that connect those entities. A new entity enters the network and establishes connections with some of the entities already in that network. One possible pattern of connection is random, which means that the pattern of new connections resembles the pattern of previous connections. Whatever pattern of connection might exist for a network of 1,000 entities would be duplicated for a network of 10,000 entities. In contrast, scale-free networks undergo changes in their patterns of connection as they expand. In particular, scale-free networks often experience dominance by a few nodes as scale expands. A random network might feature a normal distribution of enterprises in terms of the number of their connections. There would be about as many enterprises with a below-
average number of connections are there are enterprises with an above-average number of connections. In contrast, scale-free networks feature highly skewed distributions of connection, with a few enterprises having several times the average number of connections while many enterprises have a number of connections that is well below average.

To illustrate how scale might matter with respect to governments, compare Switzerland today with the United States, both in 1789 and today. Switzerland has around 7 million people distributed among 26 cantons, or an average of about 270,000 persons per canton. In 1790, the United States contained around 4 million people distributed among 13 states, or about 300,000 persons per state. Contemporary Switzerland and Colonial America had similar scales of government when appraised in terms of the number of citizens per canton or state. Today, the United States has in excess of 300 million people distributed among 50 states, or about 6 million persons per state. To restore governance on the scale of contemporary Switzerland or colonial America would require the United States now to have over 1,000 states. The scale of governance in the United States today is vastly larger than it was in 1790 or as it is in Switzerland today. But is this larger scale truly of any significance?

Compare, for instance, the scales of governance as between a town of 9,000 and a city of 90,000. In each case, suppose the unit is governed by a council of nine members elected by district. For the town, each official represents 1,000 people, whereas for the city each official represents 10,000 people. It is reasonable to think that for the town each official can know something about and have personal contact with each person. Much of that knowledge and contact, moreover, will take place informally,
as illustrated by chance meetings in grocery stores, theaters, churches, and parking lots. A network diagram of those connections would have pretty much a random character created mostly by chance meetings.

By contrast, a network diagram for the city would have power law features, meaning that only a subset of the citizenry had contact with the representative. One person can't truly know something about 10,000 people and have random contact with them in consequence of the daily pursuit of life. The pattern of contact will acquire a representational structure, by which I mean contact will flow through organized patterns of representation. Representatives will be linked with representatives of particular interest groups that claim to speak for large numbers of citizens who themselves have no contact with the representative. In this manner, representative democracy takes on oligarchic character as its scale increases and which Bertrand de Jouvenel (1961) illustrates crisply for the operation of representative assemblies. A gulf inexorably arises between governing officials and those who are governed, and with the width of that gulf varying directly with the scale of governance. For instance, 435 representatives combined with a population in excess of 300 million gives something like 700,000 per district.

Democracy is a generic term as it is commonly used. It means only that a subset of political officials is selected through an election. Democracy is a purely formal term that covers a wide variety of particular types of democracy. The relation between liberty and democracy, however, is surely one of those things that depend on particular details more than generic form. As oligarchic tendencies grow within democracies, the scope expands for political officials to act independently of the interests and concerns of
constituents. Indeed, it can’t be any other way because the scale of governance prevents any pattern of interaction and communication that reflects subject-to-subject relationships, and instead takes on properties of subject-to-object relationships which Martin Buber (1958) explores.

8 Democracy and Liberty: Bridging the Gap between Ideology and Reality

There is a strong ideological current running throughout contemporary society that asserts that democracy and liberty are necessarily and inescapably complementary. According to this current, a democratic form of government is the appropriate way that a self-governing people manage their public affairs. This image is taught in schools starting from early grades, and is repeated throughout the various social media. So strongly does this current run throughout our society that little skepticism is voiced when politicians and other public figures express their hope that the reach of democracy will soon extend throughout the world. According to this ideology, democracy is the political value *par excellence* for a people who aspire to excellence in the practice of self-governance.

It is perhaps easy enough to understand the popularity of this sentiment. Vilfredo Pareto (1935) recognized that people will tend to embrace ideological articulations that enable them to feel good about themselves. America is governed by a democratic form of government, and most Americans like to think of themselves as constituting a free people. An ideology that links democracy in the service of liberty is surely an easy product to sell, particularly when the historical experience of the past century has been dominated by various forms of totalitarian bestiality. And yet there is always a potential
conflict between liberty and democracy. The principle of liberty holds that people use their rights of property to preserve and protect those rights. The Progressivist though not the liberal strand of democratic ideology holds that the determination of property rights is the province of government. Within this formulation, property rights are grants from government, which governments can bestow or remove as they choose. In this respect, two contemporary philosophers, Liam Murphy and Thomas Nagel (2002), claim that private property is a myth.

Constitutions do not enforce themselves any more than laws rule over men. Law can’t rule; only people can do that, as Rajagopalan and Wagner (2013) explain. Constitutions are what someone with authority to dominate the issue in question says it will be. In any conflict between guns and parchment, guns will win. What keeps that conflict in check and a liberal order from erosion is some conjunction of strong belief combined with arrangements of governance that require concurrence among different possessors of guns, and with each possessor able to maintain his own position, leading effective governance to require concurrence among the different possessors of guns.

In this respect, Federalism is a form of government that possibly has some potential to resist the scale-free qualities of democratic polities. In a federalism that reflected the principle of open competition, this would seem to be a definite possibility. The original American constitution mostly had this kind of federalist feature. The federal government was limited to a few explicitly enumerated powers. Everything else was reserved for the states or for individual citizens. The establishment of cities and towns and their jurisdictions, moreover, was the province of states and not the federal government. It is much less costly to move from one state to another than it is to change
nations of residence. It is less costly still to change localities within a state. In addition, capital market principles operate with localities to the extent those activities are financed by taxes on real estate.

Furthermore, one of the two chambers of the Federal Congress was appointed by the states. This meant that the Federal Senate sat as a kind of chamber of the states, and with individual senators subject to recall by the states they represented. The federal government, moreover, could not tax individual earnings, and federal revenues were pretty much limited to revenues from tariffs, which meant in turn that most federal spending was limited to military affairs. Furthermore, the federal government had no central bank that could accommodate an expansion in federal activity by buying federal debt as a particular way of printing money. The monetary authority of the federal government was limited to the certification of weights and measures, as illustrated by a dollar being defined as a unit of measure represented by one-twentieth of an ounce of gold of a particular fineness. In other words, monetary policy at this time was directed at offering protection against counterfeiting. In sharp contrast, monetary policy became a form of legalized counterfeiting after establishment of the Federal Reserve, and with the value of a dollar having declined some thousand-fold since the Federal Reserve was established.

This federalist arrangement stayed in place pretty well until early in the 20th century when the Constitution was amended to create direct election of Senators and the federal government granted the power to tax incomes. Also, the Federal Reserve was established. These three shifts in constitutional authority were all significant moves in the direction of democratic oligarchy, and we have been living under these oligarchic
arrangements for a century now. To be sure, “democratic oligarchy” is not a term currently in play, but it is an accurate description of contemporary democratic processes all the same. The constitutional promise is one which holds governments accountable to the same standards of conduct as private entities in society. The Fifth Amendment to the American Constitution exemplifies this standard nicely, as Richard Epstein explains nicely in his examination of the Fifth Amendment limiting on the takings power under the Constitution. That Amendment allows governments to take property through eminent domain, though that taking is subject to two conditions: (1) it must be for a genuine public purpose, as distinct from a purpose that advances the interests of some at the expense of others and (2) it must be accompanied by just compensation, and with just meaning that the owner of the taken property is left as well off as he or she would have been by selling that property. Where the original constitutional arrangement created what could reasonably be called a system that entailed more competition than collusion among governments, that system has been largely replaced by a system of collusive federalism over the past century or so as Michael Greve (2012) examines in his explanation of how the American Constitution has been turned upside-down.

I should like to close with two pieces of wisdom from the late 18th century, both of which are pertinent to the American Constitutional system. Samuel Johnson noted that “people are seldom so innocently engaged as when they are making money.” Around the same time Adam Smith noted that “not much good comes from those who claim to serve the public good.” These two pieces of wisdom fit nicely with the American Constitution of Liberty that was initiated in 1776 and affirmed in 1789. For a century or so, that wisdom has been stood on its head, doubtlessly under the supposition that
something repeated often enough will eventually be believed. Perhaps so, and possibly it is our fate to witness the death of American exceptionalism. More likely, however, is that the civilizing process (Elias 1982) that is always in play in any society has been misappropriated by a subset of the population that aspire to be shepherds tending sheep, only with much of the remainder of the population coming to recognize that the status of sheep is beneath their dignity.
References


