



**Social Contract vs. Invisible Hand:  
Agreeing to Solve Social Dilemmas**

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## 1. Introduction

In their preface to *The Calculus of Consent*, a classic in *Public Choice* and a founding treatise in *Constitutional Economics*, the authors say about their project:

“This analysis can perhaps be described by the term ‘methodological individualism.’ Human beings are conceived as the only ultimate choice-makers in determining group as well as private action. Economists have explored in considerable detail the process of individual decision-making in what is somewhat erroneously called the ‘market sector.’ Modern social scientists have, by contrast, tended to neglect the individual decision-making that must be present in the formation of group action in the ‘public sector.’ In their rejection of the contract theory of the state as an explanation of either the origin or the basis of political power, a rejection that was in itself appropriate, theorists have tended to overlook those elements within the contractarian tradition that do provide us with the ‘bridge’ between the individual-choice calculus and group decisions” (Buchanan and Tullock 1999 [1962]: xvi).

It was, as they note, the “fortunate compatibility of ideas” (ibid.: xvii) they had separately developed that prompted James Buchanan’s and Gordon Tullock’s co-authorship. While the perspectives they brought to their joint project were sufficiently compatible to allow for a productive cooperation, they were also characteristically different. In particular, the above-quoted reference to “the contract theory of the state” clearly reflects Buchanan’s distinctive *contractarian constitutionalist* outlook, an outlook that he had begun to develop in earlier writings (Buchanan 1999 [1949]; 1999 [1954]; 1999 [1959]) and later expanded into the research program of *constitutional political economy*.

The purpose of this essay is to take a closer look at the relation between the invisible hand paradigm that is at the heart of economists’ theoretical outlook at markets and the social contract paradigm. In support of the above-quoted claim that the *contractarian paradigm* can “provide us with the ‘bridge’ between the individual-choice calculus and group decisions,” I shall seek to show that this paradigm, with its individualistic approach to *organized collective action*, provides indeed the fitting complement to the *invisible hand* paradigm as a theory of *spontaneous social order*, paradigmatically exemplified by the order of the market.

The paper is organized as follows. Section 2 looks at the principal tenets of the social contract tradition. Section 3 reviews the 18<sup>th</sup> century origins of the “invisible hand” paradigm as the

theoretical core of the economics tradition. Section 4 examines the limits of invisible hand accounts, specifically with regard to the problems posed by social dilemmas. Section 5 deals with the modern revival of social contract theory. Section 6 looks specifically at the contractarian constitutionalism of James Buchanan, the economist among the “new contractarians.” The concluding section relates the contrast between the *invisible hand paradigm* and *social contract theory* to the distinction between the “two kinds of order,” *spontaneous orders* and *corporate orders*, that plays a central role in F.A. Hayek’s work.

## 2. Social Contract Theory and its Critique

At the core of social contract theories of the state is the notion that governmental authority originates in, and derives its legitimacy from the consent of the governed.<sup>1</sup> While contractarian arguments can be traced far back in the history of Western political thought, social contract theory proper came to prominence in the 17<sup>th</sup> and 18<sup>th</sup> century by, in particular, Thomas Hobbes’s *Leviathan* (1651), John Locke’s *Two Treatises of Government* (1690), and Jean-Jacques Rousseau’s *Contrat Social* (1762).<sup>2</sup> There exist more or less significant differences in the particular ways in which these authors and other contractarians specify the content of the social contract, the conditions under which it is concluded, and the nature of the contracting parties. For the purposes of the present paper it suffices to focus on their essential commonality, namely that the exercise of political power is interpreted in terms of contractual relations among the individuals which constitute the body politic, analogous to the civil contracts they conclude among each other as private law subjects.<sup>3</sup>

An early and particularly forceful critique of social contract theory came from David Hume, whose essay “Of the Original Contract” is often portrayed as a major reason for the post 18<sup>th</sup> century decline of contractarianism, a decline that had already begun when Rousseau published his treatise. For the purposes of the present paper it is useful to take a look at Hume’s principal arguments because this provides an opportunity to draw some clarifying distinctions between different kinds of claims that social contract theories may entail.

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<sup>1</sup> J.W. Gough (1957 [1936]: 254): “The ultimate *raison d’être* for the contract theory, all through its history, has been to reconcile the apparently conflicting claims of liberty and law. The demands of government could be explained and justified, it was thought, if they were based on the consent of the governed.”

<sup>2</sup> On the history of social contract theory see e.g. Gough 1957 [1936]. For a brief account see Vanberg 1994b.

<sup>3</sup> Gough (1957 [1936]: 5): “(T)he essence of both the social contract and the ordinary civil contract consists in there being mutual and reciprocal agreement between two (or more) parties, with rights and obligations on both sides.”

There are two principal objections Hume raises against contractarian conceptions of government. On the one hand he questions their adequacy as *historical accounts* of the origins of government, arguing:

“Almost all the governments which exist at present or of which there remains any record in story have been founded originally, either on usurpation or conquest, or both, without any pretense of a fair consent or voluntary subjection of the people” (Hume 1963 [1748]).

On the other hand Hume doubts their suitability for answering the *question of legitimacy*. Even if there had been an original contract, he argues, “being so ancient, and being obliterated by a thousand changes in government and princes, it cannot now be supposed to retain authority” (ibid.).

As Hume’s critique indicates, a fundamental distinction must be drawn between a *positive* and a *normative* version of social contract theory, between its *explanatory* and its *legitimizing* purposes. As *explanatory accounts* of the “origin” of government, contractarian theories can, in turn, be given two fundamentally different interpretations. If they were meant to explain the factual historical origins of governments, they would surely be subject to Hume’s (1967 [1739]: 542) verdict that social contract theory, “when carried so far as to comprehend government in all its ages and situations, is entirely erroneous.” Yet, the term “origin” can be given a quite different meaning, a meaning which is in no way affected by Hume’s argument. As J.W. Gough (1957 [1936]: 4) has put it, “in so far as the social contract theory is really an attempt to analyzing the logical presuppositions rather than the historical antecedents of the state, the argument is besides the mark.”<sup>4</sup>

As an account of what Gough calls “the logical presuppositions of the state” social contract theory provides a *rationale* for government. It identifies prudential reasons that can motivate rational individuals to agree to be constrained by rules,<sup>5</sup> and to have these rules backed up by the enforcement apparatus of government. Understood in this sense, contractarian accounts may be likened to what Hayek (2014 [1967a]: 287) refers to as “*conjectural history*,” an explanatory method which aims at “the reconstruction of a hypothetical kind of process which may never have been observed but which, if it had taken place, would have produced phenomena of the kind we observe.” As conjectural history social

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<sup>4</sup> Gough (1957 [1936]: 244): “(A)s an historical theory the contract theory has long been discredited, and its more recent adherents have wisely confined themselves to the claim that a contract is the philosophical basis of the state.”

<sup>5</sup> J. Rachels (2003: 145) summarizes “the social contract conception of morality” as follows: “Morality consists in the set of rules, governing how people are to treat one another, that rational people will agree to accept, for their mutual benefit, on the condition that others follow those rules as well.”

contract theory shows how *in principle*<sup>6</sup> social rules and their enforcement may have come about. It need not claim at all that the contractual mode is the general source from which governments may originate, nor need it deny the plausibility of alternative conjectural histories.<sup>7</sup>

In its *normative interpretation* social contract theory holds that the voluntary consent of the individuals subject to them is the ultimate source from which the coercive apparatus of government and the rules it enforces derive their legitimacy. This contractarian criterion of legitimacy has found different interpretations which can be classified into three categories, the notions of an *original*, a *hypothetical*, and an *implicit* contract, all three of which have been subject to criticism. The notion that an *original* contract can carry its legitimizing force over numerous generations into the future has been the target of David Hume's above-quoted objections. The concept of a *hypothetical* contract that rational persons are conjectured voluntarily to consent to under hypothetical conditions of constitutional choice is subject to the critique that such hypothetical construction cannot serve to legitimize the particular rules and the apparatus of enforcement to which people are actually subject. The notion of an *implicit* contract holds that, even if they not explicitly voice their consent, the fact that members of a polity voluntarily remain within its jurisdiction can be interpreted as an indication of tacit consent. It was, again, David Hume (1963 [1748]: 462) who famously dismissed this notion:

“Can we seriously say that a poor peasant or artisan has a free choice to leave his country when he knows no foreign language or manners and lives from day to day by the small wages he acquires? We may as well assert that a man, by remaining in a vessel, freely consents to the dominion of the master, though he was carried on board while asleep and must leap into the ocean and perish the moment he leaves her.”

The cited objections against the three versions of the consent criterion carry different weight as challenges for the contractarian paradigm. The notion that legitimacy is conferred for all times by an *original* contract is clearly the most objectionable, but it is also the version that, as such, has scarcely been advocated by anyone among the social contract theorists. The

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<sup>6</sup> Hayek (2014 [1961]: 382): “... ‘explanations of the principle’ ... (show, V.V.) that it is possible ‘in principle’ to explain how this or that phenomenon is produced.”

<sup>7</sup> In one of his late contributions Mancur Olson (1993) proposes such an alternative conjectural history, arguing that in a world where roving bandits destroy the incentives for investments in productive activity, a “stationary bandit” can extract more revenue than his roving rivals by maintaining incentives for productive activity of his subjects. The first Olsonian “stationary bandit” can be viewed as a social entrepreneur whose institutional innovation evolved over time into our modern form of government. Olson unnecessarily connects his surely plausible conjectural history with an outright rejection of contractarian accounts, arguing that “no one has ever found a large society that obtained a peaceful order or other public goods through an agreement among the individuals in the society” (1993: 568).

concept of a *hypothetical* contract can surely be criticized for not answering the question of what legitimizes the rules and enforcement apparatus that people actually face, nor the question of what real people in the circumstances they actually face can be expected to consent to. Yet, even if the notion of a hypothetical contract can hardly serve to answer these questions, it can serve a useful heuristic function in providing a reference point in debates on the reform of existing rules and institutions, a function on which I will have more to say below. Finally, Hume's objection against the notion of an *implicit* contract, as suggestive as it is, carries less weight than it may appear. By painting an extreme case in which there is no trace of voluntariness, he fails to acknowledge that the freedom of exit is not generally as limited as in the examples he cites, but may vary significantly – as, e.g., between North Korea and the United States – and that, accordingly, the extent to which a person's choice to remain within a jurisdiction can be a meaningful indicator of tacit consent varies as well.<sup>8</sup> Specified in terms of the availability of exit options, tacit consent can, in this sense, be used for purposes of comparison, even if not as an absolute measure of voluntary consent.

To be sure, all three interpretations of the contractarian consent criterion have their shortcomings. In comparison it appears, though, that – in the absence of *explicit* agreement – the concept of an implicit contract provides the most workable indicator of voluntary acceptance of a socio-political order, even if it is far from being perfect. Yet, perfectness is not a relevant standard of comparison. Whatever its shortcomings may be, there is no other, superior criterion of legitimacy in sight, if one starts, as social contract theories do, from a *normative individualism*, from the premise that the individual members of a polity and their evaluations – rather than some supra-individual source of value – are the ultimate reference point in normative assessments of a socio-political order.<sup>9</sup> It is worth noting that David Hume, despite his critique of social contract theory, acknowledges the normative status of the consent criterion when he states:

“My intention here is not to exclude the consent of the people from being one just foundation of government. Where it has place, it is surely the best and most sacred of any. I only contend that it has very seldom had place in any degree and never almost in its full extent; and that, therefore, some other foundation of government must also be admitted” (Hume 1963 [1748]: 460).

### 3. The Invisible Hand Paradigm and its Limits

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<sup>8</sup> For a more detailed critique of Hume's critique see Vanberg (1994a [1986]: 228ff.).

<sup>9</sup> G. Brennan and J.M. Buchanan (2000 [1985]: 21): “The critical normative presupposition on which the whole contractarian construction stands or falls is the location of value exclusively in the individual human being.”

Invoking Adam Smith's famous phrase<sup>10</sup>, the label *invisible hand paradigm* has been coined to denote the theoretical outlook economists typically use in their explanations of market processes and social phenomena more generally. The aim of invisible hand explanations is to show how aggregate social phenomena, as in the paradigmatic case of market prices, result from the spontaneous mutual adjustment of individual agents separately pursuing their own purpose.<sup>11</sup>

In several contributions F.A. Hayek has examined the role the eighteenth century Scottish moral philosophy had in founding the invisible hand paradigm as a general social theory,<sup>12</sup> emphasizing in particular the significance of David Hume's "anti-rationalist theory of morals" (Hayek 1967 [1963]: 111). "What he produced," Hayek notes, "was above all a theory of the growth of human institutions which became ... the foundation of the work of the great Scottish moral philosophers, of Adam Ferguson, Adam Smith and Dugald Stewart" (ibid.). In explicit contrast to social contract theory, which they regarded as an unduly rationalistic account of social order and institutions,<sup>13</sup> the Scottish philosophers developed a theoretical outlook that revolves, as Hayek (1973: 23) has put it, around "the twin conceptions of evolution and the spontaneous formation of an order."<sup>14</sup> It is a theory that focuses on the unintended social effects of individual purposeful behavior and views social rules and institutions as, in Adam Ferguson's often quoted words, "the result of human action, but not the execution of any human design."<sup>15</sup>

As the invisible hand paradigm became the dominant theoretical perspective of economics as a science of "the spontaneous order of the market",<sup>16</sup> attention was naturally

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<sup>10</sup> A. Smith (1981 [1776]: 465): "By directing that industry in such a manner as its produce may be of the greatest value, he only intends his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention"

<sup>11</sup> Buchanan (2001b [1977]: 96): "(T)here is only one principle in economics that is worth stressing, ... the principle of the spontaneous order of the market, which was the great discovery of the eighteenth century."

<sup>12</sup> See e.g. Hayek 1967 [1963]; 2014 [1967b].

<sup>13</sup> Hayek (2011 [1960]: 112): "Those British philosophers ... find the origin of institutions not in contrivance or design, but in the survival of the successful. ... Their argument is directed throughout ... against the conception that civil society was formed by some wise legislator or an original 'contract'." – See also Hayek 2014 [1965]. For further references see Vanberg (1982: 41ff.).

<sup>14</sup> M. Polanyi 1998 [1951]: 195f.): "When order is achieved among human beings by allowing them to interact with each other on their own initiative – subject only to laws which uniformly apply to all of them – we have as system of spontaneous order in society. ... The most massive example of spontaneous order in society – the prototype of order established by an 'invisible hand' – is that of economic life based on an aggregate of competing individuals."

<sup>15</sup> Adam Ferguson (1995 [1767]: 119): "Every step and every movement of the multitude, even in what are termed enlightened ages, are made with equal blindness to the future; and nations stumble upon establishments, which are indeed the result of human action, but not the execution of any human design."

<sup>16</sup> Hayek (2014 [1967b]: 296): "(T)he British moral philosophers of the eighteenth century ... built up a social theory which made the undesigned result of individual action its central object, and in particular provided a comprehensive theory of the spontaneous order of the market." – Polanyi (1998 [1951]: 219): "The major result

drawn to the explanatory potential of invisible hand accounts and to the advantageous properties of social orders that result from spontaneous mutual adjustment of individual actions. Significantly less attention was paid to the paradigm's limitations, both in its explanatory and in its normative applications, limits to which Michael Polanyi (1998 [1951]: 193) points when he notes:

“(W)hile it may be possible to achieve certain socially desirable forms of co-ordination in society by allowing each individual to adjust his action to that of all the others ... there is no warrant to assume either (1) that any particular task of co-ordination can be attained by such a technique or (2) that any particular instance of free mutual adjustment between individuals will produce a desirable result.”

In a widely cited paper “The Tragedy of the Commons” biologist and ecologist Garrett Hardin commented on the economists’ biased outlook at the workings of the invisible hand:

“In economic affairs, *The Wealth of Nations* (1776) popularized the ‘invisible hand,’ the idea that an individual who ‘intends only his own gain’ is, as it were, ‘led by an invisible hand to promote ... the public interest.’ Adam Smith did not assert that this was invariably true, and perhaps neither did any of his followers. But he contributed to a dominant tendency of thought ..., namely, the tendency to assume that decisions reached individually will, in fact, be the best decisions for an entire society” (Hardin 1968: 1244).

The message of Hardin’s paper is that the noted “tendency of thought” distracts attention from an important class of social settings, paradigmatically exemplified by the *tragedy of the commons*, in which by separately pursuing their own interests individuals produce an outcome damaging for all, like the herdsmen in the commons example whose individual calculus of advantage leads them to increase their herds, with the result of overgrazing that “brings ruin to all” (ibid.).<sup>17</sup>

As an early “rebuttal to the invisible hand” Hardin cites an 1833 pamphlet in which the author, the mathematician and economist W.F. Lloyd, describes the perverse behavioral dynamics that unfolds not only in the case of commons<sup>18</sup> but generally in social settings in

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of economic theory is to show that an aggregate of individuals ... would achieve self-co-ordination as if directed by an ‘invisible hand’.”

<sup>17</sup> In retrospect Hardin (1998: 683) has commented on about his original argument: “To judge from the critical literature, the weightiest mistake in my synthesizing paper was the omission of the modifying adjective ‘unmanaged.’ In correcting this omission, one can generalize the practical conclusion in this way: ‘A “managed commons” describes either socialism or the privatism of free enterprise. Either one may work; either one may fail: “The devil is in the details.” But with an unmanaged commons, you can forget about the devil: As overuse of resources reduces carrying capacity, ruin is inevitable.’” – In her *Governing the Commons* Elinor Ostrom (1990) examines numerous examples from around the world for how people learned to manage commons in order to prevent their destruction.

<sup>18</sup> W.F. Lloyd (1833: 30f.): “Why are the cattle on a common so puny and stunted? Why is the commons itself so bare-worn, and cropped so differently from the adjoining enclosure? ... The difference depends on the difference of the way in which an increase of stock in the two cases affects the circumstances of the author of the increase.

which the benefits of particular activities are captured by their originators while the costs are collectivized.<sup>19</sup> Under such conditions, Lloyd suggests and Hardin explicitly concludes, the invisible hand shows the reverse of its beneficial side, letting socially detrimental outcomes result from the separate pursuit of individual interests. In such situations, Hardin argues, appeals to individuals' insight and conscience are to no avail if they are not backed up by effective sanctions, and he concludes:

“The social arrangements that *produce responsibility* are arrangements that create coercion of some sort. ... The only sort of coercion I recommend is mutual coercion, mutually agreed upon by the majority of the people affected. ... We institute ... coercive devices to escape the horrors of the commons” (Hardin 1968:1247).

Without explicitly using the term Hardin in effect invokes here the concept of a *social contract* as an instrument for solving the kinds of *social dilemmas* that he and Lloyd describe, i.e. social settings in which the actors involved are trapped in multilateral or many-person versions of the *prisoners' dilemma*.<sup>20</sup>

As has often been pointed out, already Thomas Hobbes in his *Leviathan* described in effect a multilateral prisoners' dilemma in order to illustrate the necessity of mutually agreed upon coercive enforcement of rules of conduct. Commenting on the pointlessness of unilateral willingness to co-operate in such dilemma settings Hobbes (1983 [1651]: 215) noted:

“For he that should be modest, and tractable, and perform all he promises, in such time, and place, where no man else should do so, should but make himself a prey to others, and procure his own certain ruin.”<sup>21</sup>

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If a person ... puts more cattle on a common, the food which they consume forms a deduction which is shared between all the cattle, and only a small part of it is taken from his own cattle. In an inclosed pasture, there is a point of saturation ... beyond which no prudent man will add to his stock.”

<sup>19</sup> Lloyd (1833: 19): “If a man takes a guinea out of his own purse, the remainder, which he can spend afterwards, is diminished by a guinea. But not so, if he takes it from a fund, to which he and another have an equal right to access. The loss falling upon both, he spends a guinea with as little consideration as he would in spending half a guinea, were the funds divided. ... Consequently, in a multitude of partners, where the diminution affected by each separate act of expenditure is insensible, the motive for economy entirely vanishes.” This example, Lloyd (*ibid.*: 20f.) argues, serves “to show how the future is struck out of the reckoning, when the constitution of society is such as to diffuse the effects of individual acts throughout the community at large, instead of appropriating them to the individual, by whom they are respectively committed. ... (T)he obligation to prudence being placed upon the society collectively, instead of being distributed to the individual members, the effect is that, though the reasoning faculty is in full force, and each man can clearly foresee the consequences of his actions, yet the conduct is the same as if that faculty had no existence.”

<sup>20</sup> In a chapter entitled “The Back of the Invisible Hand” Russel Hardin (1982: 6f.) notes: “Smith recognized the working of the back of the invisible hand (in his comments on national defense, the administration of justice and certain public works, V.V.) ... But ... *The Wealth of Nations* ... is almost entirely concerned with the benevolence of the invisible hand. ... The problem of the back of the invisible hand has become known as the problem of collective action or the Prisoner's Dilemma or the free rider problem.”

<sup>21</sup> Hobbes (1983 [1651]: 190): “For as long as every man holdeth this Right, of doing any thing he liketh; so long ... there is no reason for any one, to divert himself of his: For that were to expose himself to Prey, (which no man is bound to) rather than to dispose himselfe fo Peace.”

That the benevolence of the invisible hand finds its limits in the case of social dilemmas, and that in such cases multilateral agreement on coercive enforcement of co-operative conduct may be necessary, has, of course, never entirely escaped the attention of economists, even if this was not the focus of their research interest. In John Stuart Mill's *Principles of Political Economy* (2006 [1848]: 956ff.) one finds a section entitled "Cases in which public intervention may be necessary to give effect to the wishes of the persons interested." In this section Mill discusses instances in which individuals are unable to give effect to their common interests "except by concert, which concert again cannot be effectual unless it receives validity and sanction from the law" (ibid.: 956). Even if in such cases, Mill (ibid.: 957) argues, all persons involved can clearly recognize that if a certain rule were generally followed everybody would be better off it will not be in the individual's interest to abide by it "unless he is well assured that all or most others will follow it":

"For however beneficial the observance of the regulation might be to the class collectively, the immediate interest of every individual would lie in violating it: and the more numerous those were who adhered to the rule, the more would individuals gain by departing from it" (ibid.: 959f.).<sup>22</sup>

Significantly, even such an outspoken critic of social contract theory as David Hume found it necessary to take recourse to contractarian arguments when it comes to the question of how to deal with social-dilemma type problems. Even though men may well recognize that "an universal and inflexible observance of the rules of justice" (1967 [1739]: 534) is in everybody's interest, this interest, he argues will be of little effect in large societies.<sup>23</sup> In terms not all too different from Hobbes's above-quoted phrase, he reasons that in large number settings the individual will come to conclude:

"I should be the cully of my integrity, if I alone should impose on myself a severe restraint, amidst the licentiousness of others" (ibid.: 535).

The remedy, Hume adds, "can only come from the consent of men" (ibid.), namely to "lay themselves under the necessity of observing the laws of justice" (ibid.: 537):

"When men have once experienced the impossibility of preserving any steady order in society, while everybody is his own master, and violates or observes the laws of society, according to his present interest or pleasure, they naturally run into the

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<sup>22</sup> Mill (2006 [1848]: 959f.): "It is greatly the interest of the community collectively and individually, not to rob or defraud one another: but there is not the less necessity for laws to punish robbery and defraud one another. ... (E)ven an unanimous opinion that a certain line of conduct is for the general interest, does not always make it in people's interest to adhere to that line of conduct."

<sup>23</sup> Hume (1967 [1739]: "But when society has become numerous ... this interest is more remote; nor do men so readily perceive, that disorder and confusion follow upon every breach of these rules."

invention of government, and put it out of their own power, as far as possible, to transgress the laws of society. Government, therefore, arises from the voluntary convention of men.”<sup>24</sup>

F.A. Hayek, to cite a more recent critic of social contract theory, equally recognizes the limits of the invisible hand paradigm of “spontaneous order and evolution” when social dilemmas are concerned. Discussing the problem of collective or public goods provision he reasons that, though in comparatively small groups one might expect people voluntarily to cooperate in recognition of their common interests, this “is certainly not true of large groups” (1979: 44). And he continues:

“Where large numbers are involved, most individuals ... will reasonably believe that it will make no difference to the results whether they themselves agree to contribute to the costs or not. Nor will any individual who consents to contribute have the assurance that the others will also do so and that therefore the object will be attained. Indeed, wholly rational considerations will lead each individual, while wishing that all the others would contribute, to refuse himself to do so. If, on the other hand, he knows that compulsion can be applied only if it is applied to all including himself, it will be rational for him to agree to be compelled, provided this compulsion is also applied to others” (ibid.).<sup>25</sup>

To be sure, Hayek – as well as the Scottish moral philosophers whose pioneering contribution to modern economic thought he so much emphasizes – cannot be accused of naively believing in an *unconditional* beneficial working of the invisible hand. They well recognized the need for a collectively organized enforcement of rules that constrain the individuals’ self-seeking ambitions. They explicitly acknowledged that in order for the invisible hand to show its benevolent side “appropriate rules of conduct”<sup>26</sup> are required, rules that the invisible hand cannot be expected to produce.<sup>27</sup> Yet, the principal focus of the

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<sup>24</sup> Hume (1967 [1739]: 543): “But when men have observed that though the rules of justice be sufficient to maintain any society, yet it is impossible for them, of themselves, to observe those rules, in large and polished societies; they establish government, as a new invention to attain their ends ... by a more strict execution of justice.”

<sup>25</sup> Hayek refers in this passage to Mancur Olson’s *The Logic of Collective Action* (1965). Incidentally, Hayek organized the German translation of this book in a seminar he taught at the University of Freiburg in the summer of 1967 (see M. Olson, *Die Logik des kollektiven Handelns*, Tübingen 1968, p. x).

<sup>26</sup> Hayek (1978: 135): “At least the great founders of liberal theory in the eighteenth century, David Hume and Adam Smith, did not assume a natural harmony of interests, but rather contended that the divergent interests of the different individuals could be reconciled by the observance of appropriate rules of conduct.” – Hayek (2010 [1946]: 58): “(T)he great individualist writers ... were more than merely aware of the conflicts of individual interests and stressed the necessity of ‘well-constructed institutions’.” – Buchanan (2001d [1997]: 359): “Adam Smith ... was careful to say that the market order ... works well only within the appropriate set of ‘laws and institutions’.”

<sup>27</sup> Buchanan (2001a [1977]: 27): “The contractarian ... insists, with Adam Smith, that this (spontaneous, V.V.) coordination can be effective only if there are limits to individual actions defined by laws that cannot themselves spontaneously emerge.” – Buchanan (2001d [1996]: 296f.): “Smith emphasized ... that the market economy works only within a functioning set of ‘laws and institutions,’ which is ... necessarily political in the more

research program that the Scottish moral philosophers founded, and that became the paradigmatic core of economics as a distinct discipline, has clearly been on the invisible hand principle or, in Hayek's words, on "the twin ideas of spontaneous order and evolution," rather than on exploring the role collective action and explicit constitutional choice play in social life.<sup>28</sup> Furthermore, and more importantly, in rejecting the social contract theory for its alleged rationalism the early advocates of the invisible hand paradigm made themselves and their successors blind to the role that the contractarian paradigm can play as an *individualistic* outlook at collective action, complementing the individualistic invisible hand account of spontaneous social order.

#### 4. The Modern Revival of Social Contract Theory

As noted before, social contract theory lost much of its appeal after its heydays in the 17<sup>th</sup> and 18<sup>th</sup> century, a fact that is often attributed not least to David Hume's biting critique. Yet, the past decades have witnessed a remarkable revival of the contractarian paradigm, stimulated in particular by John Rawls' highly influential treatise *A Theory of Justice* (1971). Among the reasons for this modern contractarian revival one must surely count, I posit, the limits of the invisible hand paradigm discussed in the previous section, in particular limits in its ability to answer the analytical challenges posed by social dilemmas.<sup>29</sup>

The aim of his book Rawls (*ibid.*: 3) describes as "a theory of justice that generalizes and carries to a higher level of abstraction the traditional conception of the social contract." At the center of his argument is the idea of an "original position" (*ibid.*: 17ff) in which the contracting parties are placed behind a "veil of ignorance" (*ibid.*: 12) that deprives them of any possibility to anticipate how they will be specifically affected by the rules to be chosen, inducing them to judge the predictable working properties of alternative rules from an

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inclusive constitutional interpretation. ... The metaphor of the invisible hand was insufficiently expansive to comprehend the emergence of the legal-institutional framework."

<sup>28</sup> Hayek does on several occasions explicitly acknowledge the necessary role of deliberate legislation, such as when he notes that, if "our aim is to assist the formation of a spontaneous order ... our main task must be ... to create an appropriate legal framework" (2014 [1955]: 192). Yet his focus is typically on the forces of spontaneous, evolutionary change: "A change in the environment may require, if the whole is to persist, a change in the ... rules of conduct of the individuals; and a spontaneous change of the rules of individual conduct and of the resulting order may enable the group to persist in circumstances which, without such change, would have led to its destruction" (2014 [1967a]:282f.).

<sup>29</sup> D. Boucher and P. Kelley (1994: 1): "Whilst social contract theory never really fell into abeyance it is certainly true that it has enjoyed a renaissance of interest following the publication of Rawls' *A Theory of Justice* in 1971." – D. Castiglione (1994): "If there is such a thing, the history of social contract theory and of its critics needs to be rewritten. The re-emergence of the 'contract argument' as a central element in one of the most influential tendencies in contemporary political philosophy requires a change in our view of ... that history, which many thought had definitely come to an end with David Hume's devastating critique."

impartial viewpoint. As Rawls (2001: 16) puts it, the original position is defined so as to describe “a situation that is fair to the parties as free and equal, and as properly informed and rational.” The agreement reached under the so-defined conditions, Rawls (ibid.) expressly emphasizes, “must be regarded as both hypothetical and nonhistorical”:

“(i) It is hypothetical, since we ask what the parties (as described) could, or would, agree to, not what they have agreed to.

(ii) It is nonhistorical, since we do not suppose the agreement has ever, or indeed ever could actually be entered into. And even if it could, that would make no difference” (ibid.: 16f.)<sup>30</sup>

In response the critical question of what significance such hypothetical agreement could be, Rawls points to its role as “a thought-experiment for the purpose of public- and self-clarification” (ibid.: 17), by which he may be interpreted to mean that it can serve as a reference point in discourses on the justice of existing rules and their reform.<sup>31</sup>

This is not the place to examine Rawls’ theory of justice in more detail, nor to review the extensive debate that it has generated. Of particular interest in the present context, though, is the explicit connection he draws between the contractarian perspective and the social dilemma problem when he locates the “collective rationale of the principles of justice” in the fact that they help to remove the “hazards of the generalized prisoner’s dilemma” (1971: 576f.). Implicitly pointing to the limits of the invisible hand paradigm, Rawls notes that, due to the “free rider problem,” in the case of public goods “trade and voluntary agreement cannot be expected to develop” (ibid.: 267) and that, therefore, “some binding rule ... must be enforced” (ibid.). In such cases, he argues, there is “a divergence between private and social accounting that the market fails to register” (ibid.: 268), necessitating *collective agreements*.<sup>32</sup> Drawing a distinction “between the problems of isolation and assurance,” he elaborates:

“The first sort of problem arises whenever the outcome of the many individuals’ decisions made in isolation is worse for everyone than some other course of action, even though, taking the conduct of the others as given, each person’s decision is perfectly rational. This is simply the general case of the prisoner’s dilemma of which

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<sup>30</sup> Rawls (1999 [1969]: 188): “It should be noted straightaway that in this interpretation of the contract theory the principles of justice are understood as the outcome of a hypothetical agreement. They are principles which would be agreed to if the situation of the original position were to arise. ... This position is, to be sure, the analytic analogue of the traditional notion of the state of nature, but it must not be mistaken for a historical occasion. Rather it is a hypothetical situation which embodies the basic ideas of the contract doctrine.”

<sup>31</sup> Rawls (1999 [1971]: 400f.): “But if so, since hypothetical agreements cannot bind, what is the significance of the original position? ... (It is given by the role of the various features of the original position as a device of representation. Thus, that the parties are symmetrically situated is required if they are to be seen as representatives of free and equal citizens who are to reach an agreement under conditions that are fair.”

<sup>32</sup> Rawls (1971: 268): “The characteristic features of essential public goods necessitate collective agreements, and firm assurance must be given to all that they will be honored.”

Hobbes's state of nature is the classical example. The isolation problem is to identify these situations and to ascertain the binding collective undertaking that would be best from the standpoint of all. The assurance problem is different. Here the aim is to assure the cooperating parties that the common agreement is being carried out. Each person's willingness to contribute is contingent on the contribution of the others. Therefore to maintain public confidence in the scheme that is superior from everyone's point of view, or better anyway than the situation that would obtain in its absence, some device for administering fines and penalties must be established" (ibid.: 269f.).<sup>33</sup>

It is instructive to take, in comparison, a side-look at another prominent "new contractarian," David Gauthier, who says about his *Morals by Agreement* (1986: 10): "In Hobbes we find the true ancestor of the theory of morality that we shall present." Like Rawls, Gauthier (ibid.: 116) relates the contractarian perspective to the limits of the invisible hand when he notes that "the market fails" in situations that exhibit "the structure of the Prisoner's Dilemma," and when, like Rawls, he views contractarianism as a response to cases "when everyone follows self-interest would be harmful to everyone" (ibid.: 10), a response that shows the collective rationale of moral rules as a device to secure "the 'cooperative' outcome of a multi-lateral Prisoner's Dilemma" (Gauthier 1990:34).

Because moral rules allow the persons involved in such dilemmas to realize better outcomes than they would otherwise, it is rational for them, Gauthier posits, not only to agree to jointly commit to such rules,<sup>34</sup> but also to follow up on their commitment without the need to be threatened by an external enforcement apparatus. While the claim that it is rational to agree to be bound by moral rules is a defining element of all social contract theories, the distinctive feature of Gauthier's contractarianism is his second claim, the claim that it is rational to comply with rules one has rational reasons to agree to.<sup>35</sup> Gauthier bases this claim

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<sup>33</sup> Rawls cites as reference for his distinction between the "isolation" and the "assurance" problem A.K. Sen's article "Isolation, Assurance and the Social Rate of Discount" (1967). Sen defines the distinction, however, somewhat differently from Rawls: "(T)he isolation paradox is an N-person extension of the two-person non-zero-sum game of the prisoners' dilemma. Here each individual has a strictly dominant strategy, and the pursuit of this by each produces an overall result that is Pareto-inferior. Individuals can do better than this by collusion, but the collective solution requires enforcement.

The second, the assurance problem, ... has a different analytical structure ... Here there is no strictly dominant strategy ... To get out of the problem all that is necessary is that each individual is assured that the others are doing the 'right' thing, and then it is in one's own interest also to do the 'right' thing. No enforcement is necessary" (Sen 1967: 122).

<sup>34</sup> Gauthier (1986: 9): "As rational persons understanding the structure of their interaction, they recognize a place for mutual constraint, and so far a moral dimension in their affairs. ... Agreed mutual constraint is the rational response to these structures."

<sup>35</sup> Gauthier (1986: 10): "To the conceptual underpinning that may be found in Hobbes ... we seek to add the rigour of rational choice. ... (T)he appeal to rational choice enables us to state ... why rational persons would agree *ex ante* to constraining principles ... and why rational persons would comply *ex post* with the agreed constraints.."

on a concept of “rationality” that he defines in contrast to the traditional interpretation which “identifies rationality with utility-maximization at the level of particular choices” (1986: 182):

“We identify rationality with utility-maximization at the level of dispositions to choose. A disposition is rational if and only if an actor holding it can expect his choices to yield no less utility than the choices he would make were he to hold any alternative dispositions” (ibid.).

Once the morality issue is viewed as a matter of dispositions rather than in terms of single choices, the question no longer is whether in particular instances defection promises higher payoffs than cooperation, but is instead whether a person disposed to comply with moral rules can expect to do better overall than an opportunist who decides case by case whether to defect or not.<sup>36</sup> This is, Gauthier (1986: 15) argues, indeed the case because “constrained maximizers,” i.e. persons “disposed to comply with mutually advantageous moral constraints” can reap benefits from cooperation that are foreclosed to their unconstrained counterparts, “straightforward maximizers” in Gauthier’s terminology. As he puts it:

“The key to my argument for the rationality of standing to one’s agreement is that a person who is believed to be a constrained maximizer will be accepted as a participant in ventures advantageous to her from which a person who is believed to be a straightforward maximizer will be excluded. The expectations of others about her behavior lead them to interact with the constrained maximizer in such a way that she enjoys superior opportunities, and so does better overall, than the straightforward maximizer. Therefore, I claim, it is rational to be a constrained maximizer” (1990: 4).<sup>37</sup>

Gauthier’s important contribution is to shift the analytical focus from the level of single choices to the level of “dispositions to choose,”<sup>38</sup> and he is surely right in claiming that in the presence of constrained maximizers the enforcement problem is far less severe than it would be in a world populated only by case-by-case maximizers. Yet, equally sure, there are limits to what constrained maximizers can be claimed to achieve, limits that Gauthier tends to underestimate. A closer look at these limits provides an opportunity to draw attention to an important distinction between two types of “generalized prisoner’s dilemmas.”

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<sup>36</sup> Gauthier (1986: 170): “To demonstrate the rationality of suitably constrained maximization we solve a problem of rational choice. We consider what a rational individual would choose, given the alternative of adopting straightforward maximization, and of adopting constrained maximization, as his disposition for strategic behavior.” – “A disposition is rational if and only if an actor holding it can expect his choices to yield no less utility than the choices he would make were he to hold any alternative disposition.”

<sup>37</sup> Gauthier (1986: 162): “The disposition to keep one’s agreements ... makes one an eligible partner in beneficial cooperation, and so is itself beneficial.”

<sup>38</sup> For a more general discussion of this issue see Vanberg 2012.

As Gauthier expressly notes, a constrained maximizer does not cooperate unconditionally but only “provided he expects similar compliance from others” (1986: 15).<sup>39</sup> Since a person disposed to cooperate can be exploited by straightforward maximizers, such a disposition can be rational only if the gains reaped from cooperation with equally disposed others overcompensate the losses endured in encounters with opportunists.<sup>40</sup> Of critical importance is therefore the reliability with which a morally disposed actor can recognize what type of persons he encounters. It is here that Gauthier introduced the assumption that persons are sufficiently *translucent* “so that their dispositions to cooperate or not may be ascertained by others, not with certainty, but as more than guesswork” (ibid.: 174), and that “for beings as translucent as we may reasonably consider ourselves to be, moral solutions are rationally available” (ibid.).

Critics have pointed out that the requirement of sufficient translucency limits the force of Gauthier’s claim about the rationality of constrained maximization and, accordingly, of the dispensability of external enforcement.<sup>41</sup> The extent to which a constrained maximizer can expect to benefit from his disposition obviously depends on the nature of the environment in which he operates. In particular, in large-number environments with increasingly anonymous interactions the uncertainty about others’ disposition increases, and with it the need of external enforcement as a facilitator of cooperation.<sup>42</sup> Furthermore, the force of Gauthier’s argument is limited in the sense that it applies only to one of two categorically different types of cooperation problems, both of which can be described in terms of the prisoner’s dilemma, but they exhibit fundamentally different properties in large-number settings. Only one of them represents a social dilemma in the sense of a genuine large-number dilemma, while the other, even if placed in a large-number setting, can be decomposed into ordinary bilateral prisoner’s dilemmas.<sup>43</sup>

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<sup>39</sup> Gauthier (1986: 162): “The disposition to keep one’s agreement, given sufficient security, ... makes one an eligible partner in beneficial cooperation, and so is itself beneficial.”

<sup>40</sup> Gauthier (1986: 15): “Of course, constrained maximizers sometimes lose by being disposed to compliance ... Nevertheless, we shall show that under plausible conditions, the net advantage that constrained maximizers reap from cooperation exceeds the exploitative benefits that others may expect. From this we conclude that it is rational to be disposed to ... internalizing moral principles.”

<sup>41</sup> M. Moore (1994: 216f.): “Gauthier assumes, without argument, that people can detect the dispositions of others with a very high degree of accuracy. ... If there are no other CMs, or very few, the CM agent will realize no benefit from her disposition, and, in fact may find herself the victim of defection and exploitation when she mistakenly interacts with SMs. ... And if there is enough uncertainty about dispositions because there are some people who are good at hiding their dispositions ..., then it will not be rational to adopt a constrained maximization disposition.”

<sup>42</sup> With his distinction between “personal exchange,” “impersonal exchange” and “impersonal exchange with third-party enforcement” D. North (1987) provides an instructive analytical perspective on this issue.

<sup>43</sup> For a more detailed discussion of this distinction see J.M. Buchanan and V.J. Vanberg (1994 [1986]: 68ff.).

The cooperation problem that Gauthier deals with belongs to the latter category. Even though he speaks of a “multi-lateral Prisoner’s Dilemma” (1990: 13), the problem that he discusses is not posed by a truly multi-lateral dilemma but, instead, by a multitude of bilateral dilemmas. In the setting that he describes the relevant interaction requiring a choice between cooperation and defection is always between two parties, and the payoffs that each agent can expect depends on the combination of his and the other party’s choice. Under such conditions, individuals who cooperate with each other are able to realize differential benefits, independent of the size of the group within which they are placed and no matter what the other members of the group do. It is the prospect of such differential gains from cooperation within sub-groups that makes it possible for constrained maximizers to benefit from their disposition, even if, as noted above, the cooperation-inducing force of this disposition diminishes with increasing numbers.

The situation is categorically different where genuine large-number dilemmas are concerned, as in G. Hardin’s “tragedy of the commons” or in the public good case that Rawls (1971: 577) refers to as an example of a “generalized prisoner’s dilemma.” In these cases the benefits a cooperator produces are shared among all members of the relevant group, while the costs of group-beneficial acts are fully born by their authors. Accordingly, group members who might be disposed to cooperate with like-minded peers will not be able to do better than their defecting counterparts. To the contrary, to paraphrase John Stuart Mill’s above-quoted argument, “the more numerous those were who adhere to the group-beneficial maxim, the more would individuals gain by departing from it.” In other words, rather than offering a solution to commons-type problems Gauthier’s constrained maximizers protract such problems by encouraging free riding.

To have shifted the analytical focus from the level of single choices to the level of *dispositions to choose* is, as noted before, the important contribution of Gauthier’s theory of morality. Yet, with his version of *contractarianism* – this must be concluded from what has been said above – he does not answer the challenge posed by *social dilemmas*, i.e. by problems paradigmatically exemplified by the tragedy of the commons, problems about which Rawls (1971: 268f.) says:

“Some collective arrangement is necessary and everyone wants assurance that it will be adhered to if he is willingly to do his part. In a large community the degree of mutual confidence in one another’s integrity that renders enforcement superfluous is not to be expected.”

In fact, if, as I have suggested above, the specific contribution of social contract theory is to address the noted challenge, it is questionable whether Gauthier's contractarianism can be classified as a *social contract* theory. A "collective arrangement" in Rawls's sense does not play a role at all in Gauthier's theory. His arguments on the significance of constrained maximization as a cooperation-advancing disposition can, instead, be enlisted in support of invisible-hand accounts of morality.

### 5. James M. Buchanan's Contractarian Constitutionalism

Of particular interest in a *Handbook of Public Choice* is obviously the *contractarian constitutionalism* of James M. Buchanan who, along with John Rawls, counts as one of the most influential among the new contractarians. Buchanan came to adopt his contractarian approach to constitutional economics independently of Rawls' work, but felt, as he reports, encouraged in his own endeavor by the latter's *Theory of Justice*, an early version of which Rawls (1999 [1958]) had presented at a conference that they both attended.<sup>44</sup>

In "The Pure Theory of Government Finance," one of his very first publications, Buchanan (1999 [1949]) had advocated an "individualistic theory of the state" about which he said:

"The state has no ends other than those of its individual members and is not a separate decision-making unit. State decisions are, in the final analysis, the collective decisions of individuals. ... The fiscal system exists as one channel through which certain collective desires may be accomplished. The content of theory becomes the setting-up of a structural framework to enable the results of policies to be evaluated" (ibid.: 123, 132).

This statement may be read in retrospect as foreshadowing of the public choice/constitutional economics research program that Buchanan came to develop over the following decades, a research program that quite naturally led him to adopt the *contractarian perspective*<sup>45</sup> which became the theoretical core of *The Calculus of Consent* (Buchanan and Tullock 1999 [1962]).

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<sup>44</sup> Buchanan (1999 [1986a]: 23f.): "This construction of *The Calculus of Consent* was essentially worked out independently of the comparable construction of John Rawls. But discovery of his early paper on 'Justice as Fairness' during the course of writing our book served to give us confidence that we were on a reasonable track. ... The coincidence both in the timing of our initial work and in the basic similarity in analytical construction has made me share an affinity to Rawls that has seemed mysterious to critics of both of us." – See also Rawls' (1999 [1963]: 74, fn. 1) comments on the relation between his arguments in the "Justice as Fairness" paper "to that of James Buchanan and Gordon Tullock in their book *The Calculus of Consent* ..., which appeared after the meeting at which this paper was read."

<sup>45</sup> In his 1959 essay "Positive Economics, Welfare Economics, and Political Economy" Buchanan noted: "Governmental action ... is assumed to arise when ... individuals agree that certain tasks should be collectively performed. To this extent, my argument rests on some implicit acceptance of a contract theory of the state" (1999 [1959]: 204).

In “Marginal Notes on Reading Political Philosophy,” his appendix to *The Calculus*, Buchanan comments on the relation between the constitutional economics research program and the contractarian tradition,<sup>46</sup> emphasizing the commonality between his own “individualistic method of analyzing political and social action” (1999 [1962]: 316)<sup>47</sup> and the contract theorists’ purpose of “reducing the logic of collective organization to a logic of individual calculus” (ibid.).<sup>48</sup>

Buchanan, like the contractarians discussed before, looks at social contract theory as a paradigmatic counterpart to the invisible hand paradigm. While the latter’s focus is on social phenomena that result from the spontaneous mutual adjustment of individual actions, the contractarian paradigm focuses on the role played by deliberate coordination in shaping social outcomes. The social contract perspective’s principal contribution is, in Buchanan’s account, to draw attention to the fact that individuals are not limited to mutually adapt their separate efforts within the constraints they are facing, but that they can, through collective choice, change at least some of these constraints, most notably the social rules that define the institutional framework within which they operate. In order to illustrate the basic message of this contractarian-constitutionalist outlook Buchanan likes to use the analogy with ordinary games:

“We may, if we like, think of players as being continually engaged in two kinds of mental activity. First, they are trying to figure out moves or strategies with which their own interests can be advanced within the context of a well-defined game. Secondly, and simultaneously with this activity, they can be conceived as trying to figure out possible changes in the rules that would make for a better game. In this second activity they will realize that they must choose rule changes on which all players can agree if the game is to continue” (Buchanan and Tullock 1999 [1962]: 261).

The social contract perspective directs the focus of inquiry to the question of how individuals in the various “social games” they are involved in may overcome limits of the invisible hand by changing the rules according to which they are playing. Shifting the focus of attention from the question of how they may play a given game more successfully to the question of how they may come to play a better game, better for all involved, is, as Buchanan points out, of particular significance in cases in which the invisible hand systematically fails to do the

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<sup>46</sup> Buchanan (1999 [1962]: 319): “The contract theory of the State can be interpreted as representing both an attempt to divorce political theory from moral philosophy and as an attempt to derive a logic of collective action from an analysis of individual choice. Since our own efforts embody both of these elements, it follows that our work falls within the broadly defined limits of the contractarian tradition.”

<sup>47</sup> Buchanan and Tullock (1999 [1962]: 13): “Collective action is viewed as the action of individuals when they choose to accomplish purposes collectively rather than individually, and the government is seen as nothing more than the set of processes, the machine, which allows such collective action to take place.”

<sup>48</sup> Buchanan (1999 [1986a]: 24): “Almost by definition, the economist who shifts his attention to political process while retaining his methodological individualism must be contractarian.”

beneficial work that economists have traditionally emphasized.<sup>49</sup> In cases “of external diseconomies, of the generation of public bads, of a generalized prisoner’s dilemma” (2001b [1977]: 99), he argues, the interplay of market-type *bilateral transactions* will not produce a solution. Instead, the members of a group facing such dilemmas need to enter into a *multilateral contract*, transferring activities “to the community as a collective unit, with decisions delegated to specifically designated rules for making choices, and these decisions coercively enforced once they are made” (1999 [1964]: 38f.).<sup>50</sup> In other words, in such cases the ‘visible hand’ of deliberately coordinated collective action must step in because the invisible hand fails to do its beneficial work. As Buchanan puts it:

“In the large-number or n-person dilemma, the failure to attain desirable results through independent action is analytically equivalent to the orthodox prisoner’s dilemma. ... The organization and enforcement of efficient institutional arrangements will rarely be possible unless *all* persons are somehow brought into potential agreement. The alternative of ... remaining a free rider must be effectively eliminated. ... It is because they facilitate the elimination of this free-rider alternative that coercive arrangements, governmental in nature, tend to emerge from the preferences of individuals themselves, at least at some conceptual level of constitution-making” (1999 [1968]: 84).<sup>51</sup>

It is not only in the kind of social dilemma cases to which Buchanan refers that social contracts can allow the contracting parties to avoid the collective self-damage that tends to result from their uncoordinated self-seeking actions. With its focus on constitutional choice<sup>52</sup> Buchanan’s research program draws attention to the fact that social contracts may serve quite generally as devices through which individuals can bring about mutually beneficial changes in the rules under which they deal with each other, changes that could not be expected to result from decentralized mutual adaptation but require deliberately coordinated action.<sup>53</sup>

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<sup>49</sup> As Buchanan (2001b [1977]: 99) notes “‘invisible hand explanations’ may be applicable to ‘orders’ that are clearly recognized to be undesirable as to those that are recognized to be desirable.”

<sup>50</sup> Buchanan (1999 [1964]: 39) adds to this argument the comment: “Therefore ... the approach to economics that I am advancing extends to cover the emergence of a political constitution. ... The contract theory of the state, and most of the writing in that tradition, represents the sort of approach to human activity that I think modern economics should be taking.”

<sup>51</sup> Buchanan (1999 [1965]: 321): “Each and every person may, of course, consider that he would be ‘better off,’ in terms of his own evaluation, in a different world where the moral law is widely accepted as an overriding ethical rule. But, privately and voluntarily, there is simply no means through which the single individual can choose to make this alternative state of the world more realizable.” – About the contractarian paradigm Buchanan (1999 [1959a]: 204) says: “State or governmental coercion enters only insofar as individuals, through collectively imposed rules prevent themselves from acting as they would act in the absence of such rules.”

<sup>52</sup> Buchanan and Tullock (1999 [1962]: xvii) comment on the term “constitution”: “We shall mean by this term a set of rules that is agreed upon in advance and within subsequent action will be conducted.”

<sup>53</sup> Buchanan (2001c [1977]: 102): “The forces of social evolution alone contain within their workings no guarantee that socially efficient results will emerge over time. The historically determined institutions of legal order ... can be ‘reformed,’ can be made more ‘efficient’.”

In labelling his theoretical outlook as *contractarian constitutionalism*, Buchanan wants to emphasize the intrinsic connection between “the contractarian philosophical perspective and the rules-oriented, or constitutionalist, perspective” (Brennan and Buchanan 2000 [1985]: 23).<sup>54</sup> As he notes:

“I am a constitutionalist and a contractarian: constitutionalist in the sense that the rules of order are, and must be, selected at a different level and via a different process than the decisions made within those rules, a contractarian in the sense that I believe that conceptual agreement among individuals provides the only benchmark against which to evaluate observed rules and actions within those rules” (2001a [1977]: 15).

With its emphasis on the contractarian agreement criterion his research program does nothing other, Buchanan insists, than to extend the criterion implied in the *exchange paradigm* that forms the core of economic theory from the market realm to the realm of politics and of collective or corporate action more generally.<sup>55</sup> In analogy to the mutual gains that market participants realize through ordinary voluntary exchange transactions, *social contracts* can be viewed, so Buchanan argues, as multilateral exchange relations that allow the parties involved to reap mutual benefits that they could not secure within the decentralized market-network of bilateral exchanges.<sup>56</sup> The generalized mutual-gains-from-exchange perspective should in fact, he posits, be viewed as the trademark of the economic approach to social matters:

“(M)utual gains can be secured through cooperative endeavor, that is, through exchange or trade. This mutuality of advantage that may be secured ... as a result of cooperative arrangements, be they simple or complex, is the one important truth in our discipline” (1999 [1964]: 36).<sup>57</sup>

And just as in market exchange there can be no other test for the presence of mutual gains than the parties’ voluntary agreement to the transaction,<sup>58</sup> the only ultimate test for mutual

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<sup>54</sup> The distinction between “constitutional” and “operational” decisions as two levels of choice, so Buchanan (1999 [1962]: 310) notes, is “one of the essential purposes or aims of the contractarian approach to political philosophy.” – Buchanan (1999 [1986a]: 24): “The contractarian or exchange program must shift, almost by necessity, to the stage of choices among rules. The contractarian becomes a constitutionalist, and I have often classified my own position with both these terms.”

<sup>55</sup> According to Buchanan (2001d [1988]: 150), “contractarianism ... can be interpreted as little more than an extension of the paradigm of free exchange to the broader setting. ... By shifting ‘voluntary exchange’ upward to the constitutional level of choices among rules, the consensual or general agreement test may be applied.”

<sup>56</sup> Buchanan and Tullock (1999 [1962]: 252): “The essence of the contractual conception of the collectivity ... involves the mutuality of gain among all members of the group.” - “The early theorists (Hobbes, Althusius, Locke, and Rousseau) did assume consensus in the formation of the original contract. They did so because the essence of any contractual arrangement is *voluntary* participation, and no rational being will voluntarily agree to something which yields him, in net terms, expected damage or harm” (ibid.: 19).

<sup>57</sup> Buchanan (1999 [1964]: 41f.): “I am simply proposing, in various ways, that economists concentrate attention on the institutions, the relationships among individuals as they participate in voluntary organized activity, in trade or exchange, broadly considered.”

<sup>58</sup> Buchanan and Tullock (1999 [1962]: 248): “The *only* test of the mutuality of advantage is the measure of agreement reached.”

gains in collective action, Buchanan posits, can be no other than voluntary agreement of all parties to the social contract involved.<sup>59</sup>

If economics is understood, as Buchanan claims it should be, as science of exchange or *catallactics*,<sup>60</sup> as “the study of the whole system of exchange relationships” (1999 [1964]: 40), it quite naturally extends its scope beyond the study of markets as “the institutional embodiment of voluntary exchange processes” (ibid.: 38) into the domain of political-collective action as an arena for multilateral exchanges that require the simultaneous agreement of all members of the group.<sup>61</sup> As Buchanan puts it:

“If we take the catallactics approach seriously, we then quite naturally bring into the analysis complex as well as simple exchange, with complex exchange being defined as that contractual agreement that goes beyond ... the simple two-person, two-commodity barter setting. The emphasis shifts, directly and immediately, to all processes of voluntary agreement among persons. ... By a more-or-less natural extension of the catallactic approach, economists can look on politics, and on political process, in terms of the exchange paradigm” (2000 [1983]: 17).<sup>62</sup>

In terms of the “catallactics approach,” constitutional choice can be interpreted as an *exchange of commitments* in which the participants agree to accept constraints on their individual freedom of choice in order to secure the gains that can be had from reciprocal constraints imposed on all others.<sup>63</sup> Individuals have prudential reasons to agree to such

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<sup>59</sup> Buchanan and Tullock (1999 [1962]: 7): “Agreement among all individuals in the group upon change becomes the only real measure of ‘improvement’.”

<sup>60</sup> Buchanan (2000 [1983]: 16): “The approach to economics that I have long urged ... was called catallactics, the science of exchange, by some 19<sup>th</sup>-century proponents. ... This approach to economics ... draws our attention directly to the *process* of exchange, trade, or agreement, to contract.” – Buchanan (1999 [1986a]: 24): “The subject matter of economics has always seemed to me to be the institution of exchange, embodying agreement between or among choosing parties.”

<sup>61</sup> As Buchanan (1999 [1979]: 50) notes, “‘political exchange’ necessarily involves *all* members of the relevant community rather than the two trading partners that characterize economic exchange.” – Buchanan and Tullock (1999 [1962]: 23, 250f.): “The economic approach ... incorporates political activity as a particular form of *exchange*; and, as in the market relation, mutual gains to all parties are ideally expected to result from the collective relation. ... The ‘social contract’ is, of course, vastly more complex than market exchange, involving as it does many individuals simultaneously. Nevertheless, the central notion of mutuality of gain may be carried over to the political relationship. When it is translated into individual behavior, mutuality of gain becomes equivalent to unanimous agreement among the contracting parties. The only test for the presence of gain is *agreement*.”

<sup>62</sup> Buchanan and Tullock (1999 [1962]: 18): “Both the economic relation and the political relation represent cooperation on the part of two or more individuals. The market and the State are both devices through which co-operation is organized and made possible. Men co-operate through exchange of goods and services in organized markets, and such co-operation implies mutual gain. ... At base, political or collective action under the individualistic view of the State is much the same. Two or more individuals find it mutually advantageous to join forces to accomplish certain common purposes.”

<sup>63</sup> Buchanan (1999 [1990]: 381): “(T)he choice of reciprocally binding constraints by individuals who are related one to another in an anticipated set of interactions becomes fully analogous to trade in ordinary goods and services.” – Buchanan (2001a [1986]: 221): “The complex exchange that describes a change in the constitution (in the rules) is not different in this fundamental respect from a simple exchange between two traders. A change in the rules (the laws) that is applicable to all members of the polity can be judged as value enhancing only on the expressed agreement among all members.”

constitutional exchange of commitments even if they anticipate that the rules to be adopted will, on particular occasions, work out to their disadvantage, as long as they can expect the “bargain” to be, “in the long run, beneficial to them” (Buchanan and Tullock 1999 [1962]: 249).<sup>64</sup>

In response to traditional critiques of social contract theories as historically and empirically inadequate accounts of political realities Buchanan explicitly stresses that the principal purpose of the contractarian paradigm is not to explain the factual origins and present structure of political communities but to provide a standard for judging the rules and institutions under which they operate, and to serve as guide in the search for mutually beneficial institutional reforms.<sup>65</sup> As Buchanan (1999 [1962]: 320) puts it:

“Adopting the criterion implicit in the contract theory, the analysis of political institutions asks: On what changes in the existing set of rules defining the political order can *all* citizens agree? This embodiment of the unanimity rule for all basic, structural reforms in political institutions, in the constitution, reflects the individualistic ethic in its broadest sense.”<sup>66</sup>

Accordingly, the contractarian constitutional economist sees his task in identifying possibilities for institutional reform that might benefit all members of the relevant community. The guiding question is: “What set of rules should the fully rational individual, motivated primarily by his own self-interest, seek to achieve if he recognizes that the approval of such rules must embody mutual agreement among his fellows?” (1999 [1962]: 311).

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<sup>64</sup> This “calculus of constitutional choice” applies to all kinds of rules, to rules of conduct as well as to the collective-choice rules that are the subject of *The Calculus of Consent*, on which Buchanan (1999 [1962]: 314) comments: “Our basic analysis of the individual calculus that is involved in choosing ... a political constitution, has demonstrated that it will be to the rational self-interest of the individual to select a particular rule that can be predicted to produce results on occasion that run counter to the self-interest of the individual calculated within a shorter time span. By shifting the choice ... to the stage of the constitutional decision, we have been able to incorporate the acquiescence of the individual to adverse collective action into a calculus that retains an economic dimension and that can still be analyzed in non-moral terms.”

<sup>65</sup> Buchanan (1999 [1962]: 319): “The contractarians have discussed the original formation of government out of the voluntary consent of rational, previously ‘free’ men. Their critics seem to have considered the contractarians demolished when they showed that such an original contract was, for all intents and purposes, a purely intellectual construction with little or no basis in reality. The relevance of contract theory must lie, however, not its explanation of the origins of government, but in its potential aid in perfecting existing institutions of government.” – Buchanan (1999 [1986]b: 466f.): “The purpose of the contractarian exercise is not explanatory in this sense. It is, by contrast, justificatory in that it offers a basis for normative evaluation. Could the observed rules that constrain the activity of ordinary politics have emerged from agreement in constitutional contract? ... To the extent that the question prompts a negative response, we have a basis for normative criticism of the existing order, and a criterion for advancing proposals for constitutional reform.”

<sup>66</sup> Brennan and Buchanan (2000 [1985]: 25): “The contractarian derives all value from individual participants in the community and rejects externally derived sources of value, including ‘natural rights’.” – Buchanan (2001a [1986]: 215): “If politics is to be interpreted in any justificatory or legitimizing sense without the introduction of supra-individual value norms, it must be modeled as a process within which individuals, with separate and potentially different interests and values, interact for the purpose of securing individually valued benefits of cooperative effort. If this presupposition about the nature of politics is accepted, the ultimate model of politics is *contractarian*.”

Buchanan takes care to emphasize that when he invokes the notion of a “hypothetical consent” this is not meant to constitute by itself a criterion for normative judgment.<sup>67</sup> It serves, instead, a heuristic function in the constitutional economist’s search for institutional reform proposals that may be suggested to the individuals concerned.<sup>68</sup> As Buchanan puts it:

“We may evaluate any element of the existing legal structure in terms of its possible consistency with ‘that which might emerge’ from a genuine ‘social contract’ among all persons who are involved in the interaction. ... The evaluative analyst must test all ‘law’ on such ‘as if’ contractarian criteria. But from such tests he can do nothing other than advance hypotheses of possible ‘failure.’ ... The ultimate test of his hypothesis is observed agreement on the change suggested” (2001 c [1977]: 103).<sup>69</sup>

“Normatively, the task of the constitutional political economist is to assist individuals, as citizens who ultimately control their own social order, in their continuing search for those rules of the political game that will best serve their purposes, whatever these might be” (1999 [1986b]: 467).

## 6. Conclusion: Social Contract, the Invisible Hand, and the “Two Kinds of Order”

In his essay “Individualism: True and False” Hayek (2010 [1946]: 56) contrasted “social contract individualism” with the Scottish moral philosophers’ “true individualism,” thereby implying that the former falls – along with other “‘design’ theories of social institutions” (ibid.) – in the “false individualism” category. In focusing his critique of the social contract paradigm on its alleged “rationalism” Hayek entirely ignores the role this paradigm can play in consistently complementing invisible hand accounts of “spontaneous order and evolution” with an individualistic approach to collective action. This is somewhat strange given the significance he otherwise attributes to the distinction between “two kinds of order” in society, a distinction he adopted from Michael Polanyi<sup>70</sup> and elaborated on in his own work.

Like Polanyi who distinguishes between a *spontaneous order* as “a system of mutual adjustment” (1998 [1951]: 226) and a deliberately established *corporate order*, Hayek (1973: 37) speaks of spontaneous order as a “self-generating or endogenous order” in contrast to a

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<sup>67</sup> Buchanan (2001c [1977]: 180f.): “There has been some tendency to interpret the contractarian position as implying that conceptual consent or agreement offers a criterion for imposing constitutional change ... This argument represents, however, a gross perversion of the contractarian position. ... Change in an existing rule, or changes in a set of rules, finds a contractarian justification only in agreement among all participants.”

<sup>68</sup> Buchanan (1999 [1959]: 195): “His task is that of diagnosing social situations and presenting to the choosing individuals a set of possible changes. ... He presents policy A as a hypothesis subject to testing.”

<sup>69</sup> Buchanan (1999 [1959]: 203): “Propositions advanced by political economists must always be considered as tentative hypotheses ..., hypotheses which are subject to testing in the collective choice process.” – Such hypotheses are necessarily based on empirical propositions about the comparative working properties of alternative institutions, propositions which are the subject of constitutional economics as an explanatory enterprise.

<sup>70</sup> See M. Polanyi 1998 [1951], in particular the sections “Spontaneous order compared with corporate order” (pp. 141ff.) and “Two Kinds of Order” (pp. 190ff.).

“directed social order,” describing the latter as “an exogenous order,” “a construction,” or “an *organization*” (ibid.).<sup>71</sup> In the latter kind of social order we are, as Hayek (2014 [1967b]: 294) explicitly notes, dealing with cases of “deliberate concerted action” to which the invisible hand paradigm is, obviously, not applicable. Accordingly, the question naturally arises of how such orders may be accounted for from a theoretical perspective that shares the methodological individualism of spontaneous order accounts. Strangely enough, Hayek remains silent about which theoretical approach, other than the social contract paradigm which he rejects, may in his view fill this lacuna.<sup>72</sup> The purpose of the foregoing sections was to substantiate Buchanan’s claim, quoted at the beginning, that the contractarian paradigm provides the economists with the “bridge” that allows them to move, while keeping their individualistic methodology, from their traditional domain, the study of market processes, to the study of collective action.

Before ending this paper a qualification should be added to the claim that the contractarian paradigm provides an individualistic account of collective action. The latter occurs obviously in various forms, not all of which are covered by the social contract theory. Specifically defined, social contract theories are about member-governed, co-operative, or democratic associations.<sup>73</sup> It is not meant to apply e.g. to autocratic or hierarchical organizations in which the right to decide on organizational matters is reserved for a subgroup.

As far as limits of applicability are concerned there is, though, a symmetry between a contractarian theory of collective action and its paradigmatic counterpart, the invisible hand perspective of economic theory. As a theory of markets the latter is not meant to apply to all conceivable kinds of spontaneously emerging social orders, but only to those forming within institutionally secured *arenas for voluntary exchange*. In other words, as it is typically applied in economics, the invisible hand paradigm is not about just any kind of spontaneous order but is about the working properties of markets as arenas for voluntary exchange. Likewise, social

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<sup>71</sup> See also Hayek 1964.

<sup>72</sup> An explanation for this omission may be inferred from Hayek’s (1973: 37) remark: “It would be no exaggeration to say that social theory begins with – and has an object only because of – the discovery that there exist orderly structures which are the product of the action of many men but are not the result of human design.” This sounds as if Hayek considered products of “deliberate concerted action” not a serious subject of social theory.

<sup>73</sup> Buchanan (1999 [1976]: 147): “In my view ... the exchange-contractarian paradigm is the only one that is wholly consistent with what we may legitimately call ‘democracy’ or with a social order that embodies ‘democratic values’.” – Rawls (1999 [1969]: 177): “I believe that the appropriate conception, at least for an account of political obligation in a constitutional democracy, is that of the social contract theory from which so much of our political thought derives.”

contract theory is not about just any kind of collective action but is about the working properties of member-governed, co-operative, or democratic associations.

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