

The state: Agent or proprietor? *

Herschel I. Grossman

Department of Economics, Brown University, Providence, RI 02912, USA
(e-mail: Herschel.Grossman@Brown.edu)

Received: March 2, 1999/Accepted: April 19, 1999

Abstract. This paper addresses the following question: Does characterizing the state to be an agent of its citizens provide a useful “as if” framework for positive analysis of economic policy? Or, can we understand economic policy only by explicitly characterizing the state as proprietary, the instrument of the ruling elite?

Key words: Political economy, state, ruling elite, credibility, economic policy

JEL classification: D78

Introduction

Current research in positive political economy reveals a tension between alternative characterizations of the state and between two associated ways to think about economic policy. One characterization views the state to be an agent of its citizens – specifically, the agent to whom the citizenry assigns the task of effectuating collective choices about resource allocation and income distribution. In this characterization the power to tax serves as the state’s essential method of enforcing collective choices. Taxation is the means by which the state prevents free riding on the provision of nonexcludable public goods.

In characterizing the state to be an agent of its citizens we implicitly define the citizenry to be the politically enfranchised subset of those people who are under the dominion of the state. In other words, the citizens are those subjects of the state who have political power. Given the characterization of the state as an agent of its citizens, basic problems for positive political economy are to identify the subset of subjects who comprise the citizenry and to explain the determination of this subset.

* Dmitry Gershenson, Juan Mendoza, Enrico Spolaore, and two anonymous referees have given me helpful comments.

Having identified the citizenry, the next problem is to understand how the citizenry exercises its political power — that is, to understand the relation between the citizenry as principal and the state as agent. A central part of this problem is to explore how the political system aggregates and reconciles the interests of different groups within the citizenry in order to effectuate collective choices. A further problem is to evaluate these collective choices according to criteria of efficiency. The effectuation and evaluation of collective choices is the subject of a large literature in positive political economy.¹

The objection to this research program is that viewing the state to be an agent of its citizens involves a paradox. In order for the state to enforce collective choices about resource allocation and income distribution, the citizenry must subject itself to the state's power to tax and to spend. The paradox is that with these sovereign powers in hand the state can exploit its citizens by taxing and spending for its own purposes.²

This observation leads to the alternative characterization of the state as the instrument of a ruling elite. The ruling elite is 'a generic name for whatever group appropriates the net revenues of the state.'³ Actual historical examples of ruling elites include a monarch and the royal court, the members of a ruling party, the military, the professional politicians, the bureaucrats, and, in contemporary American local government, the public employees' unions.⁴ Both theory and observation suggest that in stable democracies the ruling elite typically includes a political establishment that is an implicit coalition of ostensible political opponents.⁵ As the *Wall Street Journal* (October 24, 1990) has observed about the American federal government, "Republicans and Democrats have forged a political class to divvy up the profits, fighting only over precisely how to pick pockets". The apt term "proprietary state" emphasizes the analogies between the ruling elite and the owners of a private enterprise and between the characteri-

¹ David Austen-Smith and Jeffrey Banks (1999) provide a comprehensive treatment of the theory of preference aggregation for collective choices.

² The resulting dilemma was recognized even in biblical times. In First Samuel 8:4–22, the people of Israel are of one mind in requesting that the prophet Samuel "make us a king...[who] may judge us, and fight our battles", but Samuel warns the people that a king will impose heavy taxes for his own purposes and cause them "to cry out in that day because of your king whom ye shall have chosen you". Despite Samuel's apt warning of the potential for abuse of sovereign power, the Israelites decided that having a king would be better than not having a king. Indeed, almost all societies that have made the transition from hunting and gathering to settled agriculture and industry seem to have reached the same conclusion. Apparently the citizenry typically perceives itself to be better off with a state than without a state, even though the state can tax and spend for its own purposes.

³ The characterization of the state as the instrument of the ruling elite is independent of the historical origin of the state. In the biblical story, even though the state was formed at the initiative of the citizenry, having subjected themselves to the state's sovereign power to tax and to spend, the citizenry cannot prevent the king from imposing heavy taxes for his own purposes.

⁴ The present discussion assumes that the citizenry and the ruling elite are distinct groups. Martin McGuire and Mancur Olson (1996) relax this assumption. They assume that the ruling elite, in addition to appropriating the net revenues of the state, also pays taxes and utilizes public goods. McGuire and Olson show that the distinction between the state as an agent of its citizens and the state as the instrument of a ruling elite depends on the assumption that the state's economic policies affect the citizenry and the ruling elite differently.

⁵ Alberto Alesina (1988) provides a seminal treatment of the theory of political collusion.

zation of the state as maximizing the wealth of a ruling elite and the standard economic model of a private enterprise.⁶

This paper addresses the following question: Even if characterizing the state as the instrument of the ruling elite is descriptively correct, might it be a productive research strategy to abstract from this reality and to characterize the state instead to be an agent of its citizens? In other words, does characterizing the state to be an agent of its citizens provide a useful “as if” framework for positive analysis of economic policy? Or, can we understand economic policy only by explicitly characterizing the state as proprietary?

1. The constrained proprietary state

Like profit-maximizing private enterprises, the proprietary state must solve a constrained maximization problem. One constraint on the proprietary state derives from the ability of its subjects to avoid or to evade taxation. The Laffer curve summarizes this constraint.⁷ Another constraint on the proprietary state derives from the need for the state’s policies to be credible. A third constraint on the proprietary state results from the possibility that a maltreated citizenry would depose the incumbent ruling elite either by legal or extralegal means. In this context the ability to depose the incumbent ruling elite is a critical component of political power and, hence, is a distinguishing feature of the subset of subjects who comprise the citizenry.⁸

Pursuing the analogy between the proprietary state and a private enterprise, Herschel Grossman and Suk Jae Noh (1990, 1994) take the objective of maximizing the wealth of the ruling elite to be a generic property of the state. They show that, this objective notwithstanding, any configuration of policy choices

⁶ Some authors call the proprietary state “predatory”, but it is not clear why the state warrants this pejorative term, which is not usually applied to profit-maximizing private enterprises. A referee suggests that, if a proprietary state makes some people worse off than they would be under anarchy, then it would be appropriate to call the state “predatory”. But, in general the existence of a proprietary state need not make anybody worse off. In other words, a proprietary state can be a Pareto improvement over anarchy.

⁷ Focusing on the Laffer curve Grossman (1999) rationalizes the biblical request, “Make us a king”, by deriving within a general-equilibrium model of production and predation sufficient conditions under which a proprietary state that maximizes the wealth of the ruling elite is a Pareto improvement over anarchy.

⁸ Political theorists sometimes argue that constitutional devices can limit possible abuses of sovereign power and also can mitigate credibility problems. But, as students of “constitutional political economy” themselves recognize, this literature has not settled the issue of the viability of constitutional rules. To quote Geoffrey Brennan and James Buchanan (1980), “our whole construction is based on the belief, or faith, that constitutions can work, and that tax rules imposed within a constitution will prevail” (page 10). Similarly, Kenneth Rogoff (1985) suggests that the state could mitigate the credibility problem associated with monetary policy by delegating power to a person whose own conservative preferences are such that this agent opportunistically chooses the same policy that the state would choose if the state could make binding policy commitments. But, Rogoff does not explain how the state commits itself not to revoke the authority of this agent. The analysis sketched out here focuses on the preferences and constraints that underlie the political-economic equilibrium. It abstracts from the institutional question of whether or not this equilibrium is embodied in a formal constitution.

is possible depending on the constraints that the state faces. Most importantly, Grossman and Noh show how under “appropriate conditions” the possibility that maltreated citizens would depose the incumbent ruling elite can cause the proprietary state, in maximizing the wealth of a ruling elite, to act as if it were an agent of its citizens. In other words, Grossman and Noh show that Adam Smith’s metaphor of a self-interested individual being led by an “invisible hand” to promote the interest of the society can also be applicable to the proprietary state.

This analysis does not depend on the process by which maltreated citizens would depose the incumbent ruling elite. It is not necessary to distinguish elections from revolutions or other extralegal actions. In applying the theory, however, it is necessary to distinguish deposition of the incumbent ruling elite from more common political changes in which the incumbent ruling elite merely replaces its own leadership, whether through an election or a coup d’etat.⁹ Furthermore, the possibility that maltreated citizens would depose the incumbent ruling elite requires either the existence or the potential existence of an alternative ruling elite, and this rival must be a genuine outsider. The threat or potential threat posed by a rival ruling elite is akin to the threat of entry of a rival firm that induces an incumbent monopolist to restrain its exercise of market power in a contestable market.

In this regard the identification of the ruling elite in stable democracies with a political establishment suggests that the electoral rivalry of established political parties, like Democrats and Republicans, who alternate in power according to a stationary stochastic process, is not the key to the accountability of the state to its citizens. As suggested above, such parties are likely to be only ostensible rivals, who actually share in appropriating the net revenues of the state. Rather, the key to accountability in democracies would seem to be freedom of entry into the electoral process, which allows new political groups to form and to become effective rivals of the existing political establishment.¹⁰

⁹ Bradford DeLong and Andrei Shleifer (1993) claim that prior to the industrial revolution, “Most European thrones were insecure”. As supporting evidence they offer the following facts about the throne of England between 1066 and 1702. “The succession of eighteen out of thirty- one [English] monarchs went seriously awry either before or upon their death ... There was only a 22 percent chance that the English throne would pass peacefully down to the legitimate grandson (or other heir of the second generation) of any monarch”. (pages 699–700) But, this evidence does not necessarily imply that English ruling elites, as distinct from their leaders, were insecure. As DeLong and Shleifer also acknowledge, “Usually the threat came from within the extended family of the king: of the rulers only Oliver Cromwell and William “the Bastard” came from outside the previous royal family”. (pages 699–700) It seems that more careful study is required to determine which of the successions that went awry involved the overthrow of the incumbent ruling elite and not merely the deposition of its leader.

¹⁰ Even with free entry, however, the frequency with which a new entrant replaces the incumbent ruling elite can be low. This observation suggests that the importance of outsiders like George Wallace and Ross Perot in recent America politics exceeds their modest electoral success.

2. Survival and credibility

What are the “appropriate conditions,” under which the possibility that maltreated citizens would depose the incumbent ruling elite can cause the proprietary state to act as if it were an agent of its citizens? In deriving these conditions Grossman and Noh emphasize that the proprietary state’s policies must be credible. Their analysis focuses on how the credibility requirement interacts with the possibility that maltreated citizens would depose the incumbent ruling elite to constrain the proprietary state’s policy choices.

This interaction is complex in that it involves two underlying components. The first component is that the credibility of the state’s policies depends on the survival probability of the incumbent ruling elite. Given this dependence Grossman and Noh show how, if the ruling elite has a low survival probability, the credibility requirement can negate the accountability of the proprietary state to its citizens.¹¹ The second component is that the survival probability of the incumbent ruling elite, and, hence, the credibility of the state’s policies, depend on the possibility that maltreated citizens would depose the incumbent ruling elite. With this dependence the possibility that maltreated citizens would depose the incumbent ruling elite becomes a two-edged sword.

To analyze the resulting equilibrium Grossman and Noh make two assumptions. First, the incumbent ruling elite has a potential survival probability, which can be high or low, but which is determined by given sociological and geopolitical factors. Second, the incumbent ruling elite’s actual survival probability comes closer to its potential survival probability the more closely the state’s policies accord with the interests of its citizens.¹²

Using these assumptions Grossman and Noh show that dependence of the incumbent ruling elite’s actual survival probability on the state’s policies causes the proprietary state to act more like an agent of its citizens only if the incumbent ruling elite’s potential survival probability is sufficiently high. Furthermore, dependence of the incumbent ruling elite’s actual survival probability on the state’s policies does not have a monotonic effect on the state’s policies, because

¹¹ In a typically astute observation Mancur Olson (1996) argued that in monarchies dynastic succession is popular because in effect it increases a ruler’s potential survival probability. “Perhaps the most interesting evidence about the importance of a monarch’s time horizon comes from the historical concern about the longevity of monarchs and from the once- widespread belief in the social desirability of dynasties. There are many ways to wish a King well, but the King’s subjects...have reason to be sincere when they say “long live the King.” If the King anticipates and values dynastic succession, that further lengthens the planning horizon and is good for his subjects. The historical prevalence of dynastic succession, in spite of the near-zero probability that the oldest son of the king is the most talented person for the job, probably owes something to an intuitive sense that everyone in a domain, including the present ruler, gains when rulers have a reason to take a long view”. (Olson, 1996, chapter 2, page 25) I thank Charles Goodhart for this reference.

¹² Grossman and Noh implicitly focus on the willingness of the citizenry to depose the incumbent ruling elite. In contrast, other recent papers focus on the ability of the citizenry to depose the incumbent ruling elite. For example, Yoram Barzel (2000), François Bourguignon and Thierry Verdier (1996), and James Robinson (1997) argue that policies that foster economic development can decrease the survival probability of the incumbent ruling elite by enhancing the ability of the citizenry to take effective action against the ruling elite.

at some point further increases in this dependence, rather than increasing the accountability of the proprietary state to its citizens, would undermine the state's credibility.

Grossman and Noh also show that the higher is the incumbent ruling elite's potential survival probability the more can its actual survival probability depend on the state's policies without causing the credibility requirement to be a binding constraint. Thus, with both a high potential survival probability and a strong dependence of the incumbent ruling elite's actual survival probability on the state's policies the proprietary state maximizes the wealth of the ruling elite by acting as if the state were an agent of its citizens. Returning to the central question of research strategy, this analysis yields the following conclusion: *If for the state to act as if it were an agent of its citizens is necessary and sufficient for the incumbent ruling elite to have a high survival probability, then characterizing the state to be an agent of its citizens provides a useful "as if" framework for positive analysis of economic policy.*

3. Pathologies

These necessary and sufficient conditions fail to obtain most apparently in the many historical examples of ruling elites whose potential survival probabilities have been low. An incumbent ruling elite can have a low potential survival probability for many reasons, of which the most common probably are internal discord associated with ethnic rivalry;¹³ threat of conquest by an external foe; and dependence on the support of a capricious external patron. The results discussed above imply that, if the incumbent ruling elite's potential survival probability is low, then the proprietary state cannot credibly act as if it were an agent of its citizens. Even worse, if the credibility requirement is a binding constraint, then the possibility that maltreated citizens would depose the incumbent ruling elite further undermines the state's credibility. In extreme cases, with a sufficiently low potential survival probability for the ruling elite the state is unable to establish a credible regime of nonconfiscatory taxation and secure claims to property and even can be trapped on the wrong side of the Laffer curve.

The proprietary state also fails to act as if it were an agent of its citizens in cases in which the ruling elite's actual survival probability, although high, depends little on the state's policies. Historical examples include the great empires and dynasties of yore, which for generations either deterred or suppressed all threats to the survival of the incumbent ruling elite. In many cases such states also were able to use coercion to minimize the ability of their subjects to avoid or to evade taxation.

¹³ Recent empirical analysis by William Easterly and Ross Levine (1997) and Alesina, Reza Baqir, and Easterly (1997) suggests that ethnic diversity is associated with inadequate provision of public goods. To explain this observation these authors hypothesize that ethnic diversity causes political polarization and a resulting inability to effectuate efficient collective choices. An alternative hypothesis, suggested by the work of Grossman and Noh, is that ethnic diversity causes the ruling elite to have a low potential survival probability, which gives the proprietary state little incentive for adequate provision of public goods, especially public investments.

Grossman and Noh show that, if the ruling elite's survival probability is high and largely independent of the state's policies, then the Laffer curve, reflecting the ability of subjects to avoid or to evade taxation, is the only important constraint on the maximization of the stream of rents extracted by the ruling elite. In such cases the proprietary state is likely to impose tax rates at the peak of the Laffer curve. Even worse, Juan Mendoza (1999) shows that the proprietary state also might shirk from the task of enforcing collective choices about the provision of nonexcludable public goods and become a free-rider itself. Contemporary examples include many countries in Latin America and Africa, some places in Asia, as well as some neighborhoods in American cities in which the state does little to protect private property and in which citizens must undertake substantial private security measures, such as private guards, gated communities, and walled houses.

In situations in which the ruling elite's survival probability either is unavoidably low or is high and largely independent of the state's policies, we cannot understand economic policy by simply viewing the state to be an agent of its citizens. Instead, we have to take explicitly into account that the objective of the proprietary state is to maximize the wealth of the ruling elite. In this context the identity of the citizenry and the ability of the political system to aggregate and to reconcile the interests of different groups within the citizenry in order to effectuate collective choices are not the main factors determining economic policy. Explicit consideration both of how threats to the survival of ruling elite affect the credibility of the proprietary state and of how the Laffer curve evolves becomes an essential part of the research program of positive political economy.

4. The British legacy

When we look for examples in which viewing the state to be an agent of its citizens might be a good historical approximation, we think first of those countries that have adopted and adhered to Anglo-Saxon political traditions. Economic historians rightly emphasize the distinctive British legacy of a state that protects property rights and that is more accountable to its citizens than in most countries. In their often cited analysis of the Glorious Revolution of 1689, Douglass North and Barry Weingast (1989) attempt to explain the emergence in Britain of a regime in which the state's debts were safe from repudiation and in which, as a result, the state was able to borrow large amounts at low interest rates. North and Weingast argue that the key to the securing of debt and other property rights was the strengthening of parliament with a heavy representation of property owners together with the preservation of the monarchy as a check on parliament.¹⁴

There is no doubt that these new political arrangements of 1689 were important. But, the analysis of Grossman and Noh suggests that these new political

¹⁴ Barzel (2000) explains why the strengthening of parliament served the interests of both the monarch and property owners. Avner Greif, Paul Milgrom, and Weingast (1994) offer a similar interpretation of the development of merchant guilds during the late medieval period.

arrangements were not the entire story. More precisely, alone these new political arrangements would not have been sufficient to create the belief that property was secure from confiscation by the state.

A critical element of the Glorious Revolution of 1689, as North and Weingast themselves point out, was that the new political arrangements had the support of all of the politically powerful parties – Whig and Royalist, commercial and landed - that comprised the citizenry. Further, the military victories of the new king William III over the deposed James II and his French supporters, culminating in July 1690 at the Boyne, removed the external threat to the new regime. Because it enjoyed both wide internal support and external security, the new ruling elite, a coalition of parliament and the monarchy, had a high potential survival probability.

Accordingly, both investors and lenders could confidently expect that the British state now would take a long view. Investors could confidently expect that the state would value its productive subjects for their ability to generate tax revenues over the long run, and hence would refrain from opportunistic confiscation of property. Also, lenders could confidently expect that the state would honor its debts and maintain its credit, rather than myopically repudiate its debts. Moreover, because the ruling elite had a high potential survival probability, an electoral process with free entry, which would have made it relatively easy for a maltreated citizenry to depose the incumbent ruling elite, served to make the proprietary state accountable to its citizens without undermining the state's credibility.

The British experience leads to the following question: Why have the British institutions of Commons, Lords, and constitutional monarchy, or the American variant of congress, supreme court, and president, not been readily transferable to other nations? The answer, I think, is that the British legacy of a state that protects property rights and that is accountable to its citizens is not attributable to institutional design. Rather, the key to the British legacy, starting with the success of the Glorious Revolution of 1689, is its foundation on a consensus of the citizenry.

This consensus, akin to the Mayflower compact of 1620 on a national scale, supported a stable political coalition, which, together with the achievement of external security, gave the incumbent ruling elite a high potential survival probability and made a regime of secure property credible. Furthermore, because the incumbent ruling elite had a high potential survival probability, dependence of the incumbent ruling elite's actual survival probability on the state's policies made the state accountable to its citizens. Without a high potential survival probability, dependence of the incumbent ruling elite's actual survival probability on the state's policies would have undermined the state's credibility and would have been worse than worthless.

This analysis leaves us with a further series of questions that historians have long pondered. What explains the distinctive properties of the British nation? Why were British people in both Great Britain and America able to establish states in which the ruling elite has a high potential survival probability? How

important has been geography in minimizing the threat of conquest by an external foe? How important has been British ethnic homogeneity and the assimilating cultures of the United States and Canada in minimizing internal discord associated with ethnic rivalry? Most importantly, what is the source of the remarkable degree of national consensus that characterizes Anglo-Saxon countries? Being only an economist I leave these questions for others to answer.

References

- Alesina, A. (1988) Credibility and policy convergence in a two-party system with rational voters. *American Economic Review* 78(4): 796–805
- Alesina, A., Baqir, R., Easterly, W. (1997) Public goods and ethnic divisions. unpublished
- Austen-Smith, D., Banks, J. (1999) *Positive Political Theory I: Collective Preference*. University of Michigan Press, Ann Arbor, MI
- Barzel, Y. (2000) Property rights and the evolution of the state. *Economics of Governance* 1 (1): 25–51
- Bourguignon, F., Verdier, T. (1996) Oligarchy, democracy, inequality, and growth, unpublished
- Brennan, G., Buchanan, J. (1980) *The Power to Tax: Analytical Foundations of a Fiscal Constitution*. Cambridge University Press, New York
- DeLong, B., Shleifer, A. (1993) Princes and merchants: European city growth before the industrial revolution. *The Journal of Law and Economics* 36(2): 671–702; reprinted in: Shleifer, A., Vishny, R. (1998) *The Grabbing Hand: Government Pathologies and Their Cures*. Harvard University Press, Cambridge, MA
- Easterly, W., Levine, R. (1997) Africa's growth tragedy: Policies and ethnic divisions. *Quarterly Journal of Economics* 112(4): 1203–1250
- Greif, A., Milgrom, P., Weingast, B. (1994) Coordination, commitment, and enforcement: The case of the merchant guild. *Journal of Political Economy* 102(4): 745–776
- Grossman, H. (1999) Make us a king: Anarchy, predation, and the state. unpublished
- Grossman, H., Noh, S. (1990) A theory of kleptocracy with probabilistic survival and reputation. *Economics & Politics* 2(2): 157–171
- Grossman, H., Noh, S. (1994) Proprietary public finance and economic welfare. *Journal of Public Economics* 53(1): 187–204
- Mendoza, J. (1999) The protection of private property: The government as a free-rider. unpublished
- North, D., Weingast, B. (1989) Constitutions and commitment: The evolution of institutions governing public choice in seventeenth century England. *The Journal of Economic History* 49(4): 803–832
- McGuire, M., Olson, M. (1996) The economics of autocracy and majority rule: The invisible hand and the use of force. *Journal of Economic Literature* 34(1): 72–96
- Olson, M. (1996) Capitalism, socialism, and democracy. unpublished
- Robinson, J. (1997) When is a state predatory? unpublished
- Rogoff, K. (1985) The optimal degree of commitment to an intermediate monetary target. *Quarterly Journal of Economics* 100(4): 1169–1190