Journal of Economic Behavior & Organization
Vol. 59 (2006) 460–477

JOURNAL OF
Economic Behavior
& Organization

www.elsevier.com/locate/econbase

Public finance and welfare: From the ignorance of the veil to the veil of ignorance

Giuseppe Eusepi *

Università degli Studi di Roma "La Sapienza", Facoltà di Economia, Dipartimento di Economia, Pubblica, Via del Castro Laurenziano 9, 00161 Roma, Italy

Received 1 October 2004; accepted 2 June 2005
Available online 24 January 2006

Abstract

Present-day welfare states may survive as long as bureaucracies and governments can create "optimistic" illusions among taxpayers–voters. This setting is destined to fail and indirectly to open up the pathway for a constitutional welfare state. Mazzola and Wicksell first offered a constitutional view on both public choice and public goods, but the intellectual godfathers of the genuine alternative to the present welfare state are Buchanan and Tullock in the early sixties and Rawls a decade later. The virtuous circuit obligations–entitlements–rights, which the institutions of present welfare states helped to make crumble, may be restored behind the veil of ignorance.
© 2005 Elsevier B.V. All rights reserved.

JEL classification: H30

Keywords: Welfare; Fiscal illusion; Constitution

> *It would seem to be a blatant injustice if someone should be forced to contribute toward the cost of some activity which does not further his interests or may even be diametrically opposed to them.*
>
> Knut Wicksell, A new principle of just taxation, English translation in R.A. Musgrave, A.T. Peacock (1958).

* Tel.: +39 06 49766955; fax: +39 06 4461964.
E-mail address: Giuseppe.Eusepi@uniroma1.it.

0167-2681/$ – see front matter © 2005 Elsevier B.V. All rights reserved.
doi:10.1016/j.jebo.2005.06.005

1. Introduction

Seeking the "roots" of the welfare state to see whether this "tree" has overgrown (as I believe) or has simply grown in a disorganic way (as Musgrave, 1966 believes) is of cardinal importance in any consideration of public economics. The first thing to be stressed is that an enormous number of branches have intertwined over the roots and trunk of welfare economics so that they could hardly be separated unless a time perspective is introduced. This paper tries to shed light on the alternatives to the present-day or unconstitutional welfare states.

The focal point of Section 1 is a review of the historical developments of public finance theory that have led to the post-war II welfare state. Specifically, it outlines the debate among the various continental schools (German, Italian and Swedish), and their opposition to the Anglo-Saxon tradition. The historical perspective allows me to move from the simple to the complex and to separate theories from ideologies more easily. Since value judgements are inherent in this kind of analysis, I examine the welfare state of the "real" world from the perspective of methodological individualism in light of the Wicksell–Buchanan constitutional logic.[1]

Section 2, which is the innovative part of the paper, extends Puviani's theory of fiscal illusion, which was intended to explain government behaviour in a non-democratic polity, to a democratic context such as that of the welfare state. This is done in two ways: (1) by showing the active role that bureaucracies of the present welfare states play in creating illusions and (2) by showing that a centralised tax-system allows local governments and bureaucracies to exploit voters' illusion through a mechanism that entitles them to spend without being accountable for the future revenues that are needed to exploit voters' illusion. The constitutionalisation of the welfare state is suggested in Sections 3 and 4 as the only alternative to the failures of the real welfare states. It would be unwise here to deal with the passage from welfare state to the constitutional welfare state because such an analysis would involve a general theory of constitutional revision indicating the path to reforms. The aim here is simply to suggest how to supplement customary democratic constitutions of the welfare state with a fiscal constitution. On this basis, Section 4 explores the obligations that have to be incurred to cover the entitlements–rights circle and then analyses the role that transfers may play at a constitutional level by distinguishing between a weak and a robust version of Rawls's difference principle. The paper ends with a critical discussion of some possible ambiguities coming from a robust version of the difference principle. Some concluding remarks are offered in Section 5.

2. Classical schools on the welfare state: an overview

The welfarist component appeared explicitly for the first time in Wagner (1958). Believing that taxation has two distinct though complementary objectives, he thought, following the traditional Anglo-Saxon scheme, that taxation is on the one hand a covering instrument of service costs; and on the other, it is the instrument through which government modifies distribution with the aim of increasing social welfare.[2]

[1] See Wicksell (1958), Buchanan and Tullock (1962), Jonung (1996), and Wagner (1988).

[2] The statement in the text on the distinctiveness-complementarity argument can be clarified by recalling that Wagner used two distinct instruments to fulfill the two objectives (proportional taxation to cover expenditures, progressive taxation to increase social welfare). As long as the expenditure side is supposed to be neutral, progressive taxation appears to be the only redistributive tool.

Although with the serious implications outlined by Musgrave and Peacock (1958, ix–xix), and especially by Buchanan (1960), the assumption that public expenditures are neutral might have found a justification in some way in the Anglo-Saxon tradition, which assigned the state a very restricted role. In that setting, in fact, where individual advantages from expenditures were marginally equal, the ability-to-pay principle appeared to be as a reasonable criterion for imputing the costs of public economy. But the ability-to-pay logic loses its legitimacy when transplanted into the Welfarist German tradition, which takes an explicitly organicist turn from Wagner onwards. The reason that could explain why the expenditure side was left out of the analysis lies in Wagner's way of designating expenditures as politically motivated and external, then, to the science of public finance and its connected principle of the ability-to-pay. Because the budget ends up concealing future obligations, it is separate and independent from the expenditure side. Although the limits of this reasoning will be covered at length further on, it should be mentioned here that this approach has at least the merit of making explicit that the political aim of transfers was that of correcting the existing distribution for welfare purposes. Hence, if public finance derives from an organic point of view as in Wagner as well as in Von Stein (1958), the introduction of a maximising welfare scheme cannot but have bureaucrats and politicians as executors. This is why utilities to be maximised do not hinge on someone's rights, in turn implying someone else's obligations, but are simply rights created by rules without covering entitlements; there is no way to link fiscal rights with fiscal obligations, unless we abandon the organic perspective and move towards an individualistic perspective.

We might say that (Mazzola, 1890, especially Chapter 9; see also Mazzola, 1958) was the first to strike a novel note by introducing the individualistic perspective, soon followed by Wicksell. Unfortunately, the Mazzola–Wicksell approach has had little impact for a period of about 60 years, and in fact the dominant school in public finance continued to be the Anglo-Saxon view, initially interested only in taxation and then, with the Keynesians, in expenditures. The 1980s developments[3] on optimal taxation go back to considering only the tax side with the aim of minimising both distortions and collection costs. Hence, we may say that the optimal taxation theory might solve public finance problems in a satisfactory way only under condition that the role of public spending is supposed to be unimportant. In this sense, the theory of optimal taxation could well serve as an efficiency test of the ability-to-pay principle[4] typical of the Anglo-Saxon tradition. Wicksell's statement in the epigraph, according to which no one can be forced to pay a tax that would not yield to him an at least equal benefit, assumes the individual as acting in a voluntary exchange relationship. This implies, of course, that the benefit principle or Value and Countervalue principle be the choosing criterion. The benefit principle is not only "compatible" with the theory of social contract, as Söderstrom puts it, but it is at the root of all contractarian paradigms.[5]

From the nineteen century onwards, the ability-to-pay principle has become generally accepted both in England and Germany. Although the political settings in the two countries were different (Liberal in the English case, Organicist in the German one), the ability-to-pay principle has been related solely to liberalism, at least in the political debate, and it has remained so also after the introduction of the theory of the minimisation of the aggregate marginal sacrifice. Clearly, such theory adopts a logic that is hardly consistent with liberalism.

[3] See Atkinson and Stiglitz (1980).

[4] See Söderstrom (1986) and Mill (1970).

[5] This explains why it has been adopted by Locke and Pufendorf as well as by Smith. See Seligman (1908) and Lindahl (1919).

It was Pigou (1920) who first introduced the expenditure side into the Anglo-Saxon tradition, although his perspective was completely different from that of Mazzola–Wicksell. Pigou, in fact, mimicked the sacrifice theory by distributing the tax to equalise the marginal sacrifice. By extending the same logic to the expenditure side he assumed the equality between aggregate marginal sacrifice and aggregate marginal benefits as the maximising criterion.

With this Pigouvian trick a *two-sided* budget was formally introduced also into the Anglo-Saxon tradition. What can, then, ensure that the marginal evaluation of public expenditures be related to the marginal evaluation of taxation so that the equality makes a sense? Absolutely nothing, unless a subjectivist approach and the related opportunity cost theory is adopted.

The opportunity cost theory, being based on the benefit principle, makes marginal costs and benefits comparable and, as a consequence, meaningful in terms of individual tax/expenditure alternatives. As seen, the first economist to deliberately introduce this perspective was Mazzola whose work developed a system of equilibrium between private and public or complementary goods starting from the most radical form of the subjectivist or individualist approach.[6]

On this basis, it is clear that individual satisfaction or utility is maximised when the "final utility" that an individual receives from private expenditures is equal to the "final utility" he receives from public expenditures.[7] Mazzola's analysis is correct, but the scenario he has in mind is absolutely unrealistic. Where does the drawback of his theory lie? Not in the logical construction, but in his method. Since the equilibrium between demand and supply of complementary goods is attained in the absence of a political or voting market, it is as if it were possible that each single individual per se could choose his own equilibrium directly, not as a member of real institutions.[8] My evaluation would still be valid even in the case of direct democracy. If Mazzola had been aware of this, he would have realised that in the political market with non-excludible or complementary goods, the individual behaves differently than in the market. In fact, while in the latter the payment of a price is unavoidable, in the political market with "consolidated" or non-excludible goods, the individual would maximise his own satisfaction only if he paid a zero tax price or, in other words, if he were a free-rider. This, of course, would bear theoretical consequences, even in the absence of pressure groups, because bureaucracy would be eager to catch potential fiscal rents. Hence, even in a democratic political system with a reasonably efficient tax-system, if i is a free-rider his maximising function could not be explained in terms of his opportunity costs (that is i's tax price), but in terms of j's opportunity costs. This amounts to saying that if we leave aside the cost that the dodger incurs to evade the tax, i does not suffer any cost, and hence the maximisation of his equilibrium would involve that he pays a zero tax-bill. This, in turn, means that i's maximisation does not depend on his own opportunity costs, but on j's opportunity costs. In this case, however, his equilibrium is necessarily non-optimal in terms of j's opportunity costs.

This critique, which goes back to Wicksell, is undoubtedly meaningful, and it explains why the ability-to-pay logic should be abandoned in a fiscal system that mimics price formation. One should move instead to an individual choice framework based on the willingness-to-pay by introducing a decision-making process where individual wills would emerge as approxi-

6 See Mazzola (1890), especially Chapter 9.

7 In any economy, the tendency towards maximising utility causes available resources to be so distributed among various uses that the degrees of final utility of all the goods allocated are, after the distribution, equal. See Mazzola (1958), Section 15, p. 46.

8 Mazzola's references to Parliamentary decisions in the same Chapter 9 and his knowledge of Pantaleoni's analysis suggest an interpretation that is less strong than that of the text. At the moment of this writing, however, I see no reasons to modify it.

mating unanimity. The Wicksellian scheme hinges on the following basic elements: (1) the Value–Countervalue principle as a criterion of Parliamentary approval of an expenditure–taxation bill (Musgrave, 1939); (2) the proportional sacrifice theory applied to revenues covering expenditures that do not give specific benefits; (3) limits to the fiscal power of redistributing. Ostensibly, the Value–Countervalue theory is the very core of just taxation because it is exactly this principle that allows us to set an insurmountable limit to fiscal obligations or fiscal pressure.

On this point Wicksell's analysis is particularly convincing. The ability-to-pay principle, which is still present in Wicksell's work although in a residual position, is grounded on an organicistic perspective because the state is the one who has to establish the evaluating criteria concerning individuals' ability-to-pay.

Since the ability-to-pay principle is a criterion used to distribute taxation only and does not fix an aggregate upper limit, it becomes impossible to determine the upper individual tax-bill as a share of the aggregate one. It is thus arbitrary to fix limits to fiscal pressure. Clearly, when we speak of "just taxation" within a democratic framework, the benefit principle becomes its logical foundation with the exception, though partial, of interest payments on public debt that can be viewed as a simple ex post settlement of a previous negotiation that has led to a clearance account (Buchanan, 1969).

By imposing constraints on the amount which can be redistributed through the political market, the unanimous consent as a constitutional device is the only guarantee taxpayers have against whatever type of welfare state, where distribution is contingent on politicians' and bureaucrats' expected gains (Wicksell, p. 90). Moreover, since in real institutions, especially those characterised by a huge public sector, bureaucracy plays a pressure group role *par excellence*, the resulting equilibrium is more or less far from the Mazzola–Wicksell or Lindahl equilibria (Lindahl, 1919). This in no way means that their perspectives have lost either their theoretical value or explanatory power! It is rather revealing that the decision-making institutions of the real welfare states do not hinge on voters and taxpayers' interests, but on the politico-bureaucratic power that seeks advantages through bureaucratic and fiscal illusion.

Not only have existing welfare states exerted their legitimate fiscal power grounded on the ability-to-pay of *present* taxpayers, but they have even illegitimately presumed as to have fiscal power on future taxpayers through debt creation. It is exactly to this particular dangerous perspective (lacking a theoretical basis, but winning in the voting market) that Keynesianism has provided the necessary ethical framework even before giving a theoretical or political justification.

In my opinion, even the Wicksellian unanimity theory itself and a fortiori the less than unanimity versions do not guarantee that the decisions that individuals take in t are taken without harming individuals living in $t+1$, unless such decisions are constrained by a constitutional logic. This explains why in Sections 3 and 4 I shall maintain that only the existence of a fiscal constitution could have prevented the governments of the real welfare states from pursuing ex post adjustments through budget deficits. The constitutional perspective, however, would convert the real or bureaucratic welfare state into an ex ante welfare state, a state that becomes conceivable behind the veil of ignorance.

3. The role of illusion-creating institutions in present-day welfare state settings: a simplified graphic scheme

As surprising as this may appear, the most interesting interpretation of both the origin and the development of the real welfare state can be traced back to Puviani's theory of fiscal illusion. By considering the ruling class as the decision-making body both for taxation and expenditures, Puviani introduced a third option between an abstract individualism *à la* Mazzola and a pure organicism *à la* Wagner. My interpretation of Puviani's analysis as a third option (which by looking at the state as non-organic allows us to identify individuals and institutions[9] as its elementary components) legitimates the extension of his approach also to democratic conditions, including those of the real welfare states.

In a democratic context, in fact, politico-bureaucratic institutions still maintain both political and fiscal illusion as a means to gain power over the citizen–taxpayer, especially if the bureaucratic organisation is of the "long chain" model, and the fiscal system centralised. Having dealt with this topic elsewhere,[10] I shall develop here the fiscal illusion perspective by separating the active promotion of fiscal illusion by bureaucracy and the rents bureaucracy enjoys from a centralised tax-system.

Though the graphic analysis that follows may appear to be a polar case, it well depicts a stylised functioning of the real welfare state settings. This is especially the case with those countries characterised by a clear separation between the spending side and the taxing side as well as a centralised tax-system. This is the most favourable terrain for an illusion-creating bureaucracy.[11]

Assuming (1) a unifunctional local government providing a given good at constant marginal costs, (2) the degree of its publicness, (3) the number of users in the jurisdiction, and (4) the number of voters/taxpayers, it is possible to choose a quantitative measure unit of the good such that the tax price of each unit the average taxpayer has to pay is equal to one.

In other words, if the quantity of the good that the average taxpayer perceives as average user is X, the corresponding tax price that this individual has to pay must be always X. Moreover, let us assume that individual preferences for the good to be provided by the local government is known. If in such a setting the majority rule is used as the decision-making criterion, the result that will prevail is determined by the median voter. If P denotes the average price of the public good, the tax price the median voter has to pay is P multiplied by an adjusting factor, say θ that incorporates the differences between the median voter and the average taxpayer in terms of their property or income depending on the type of taxation used (property tax or income tax). Concluding, the tax price that the median voter pays for each unit of a local public good he perceives is:

$$P_m = \theta. \tag{1}$$

If the local government receives transfers from the central government the setting changes as follows: let m denote the quota of local expenditures covered by a proportional grant from the central government; suppose moreover that the central government adds a lump-sum transfer to cover that expenditure. If G denotes the amount of transfer that goes to the voter taxpayer then the average price to the median voter becomes:

$$P_m = \theta(1 - m) - \frac{\theta G}{q}. \tag{2}$$

The reduction in the average price as a consequence of transfers can be visualised in Fig. 1 by shifting the line of the average price P_m downward so that it becomes a curve under a lump-sum

[9] This may also explain why, even in the basic ambiguities, Puviani was so interested in extending Marginalism to the just taxation–expenditure analysis. See Puviani (1896), especially p. 303.

[10] See on this in detail Eusepi (1998).

[11] This is exactly what happens in Italy with local expenditures local governments having no obligations to cover their bureaucracies' costs. One might say that the Italian version of welfare state is the one that maximizes the role of bureaucracy and, as such, represents the alternative polar case to the constitutional welfare state discussed below.

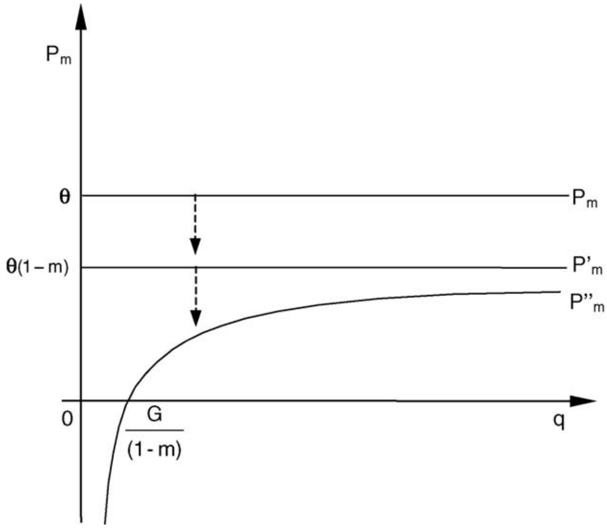

Fig. 1. Tax price perceived by the median voter.

transfer whose effect decreases with increasing production. Given his own budget constraint, the median voter chooses in such a way as to maximise his own utility. Hence, let us determine now the median voter budget constraint. Let y represent the net increase for the median voter, R his net income after central taxes only, and T_m his local tax-bill which, of course, depends on the quantity of the public good provided and the related price. The budget constraint of the median voter is given by:

$$y = R - T_m,$$

that is

$$y = R - P_m q, \tag{3}$$

If (2), which represents the average price for the median voter, is inserted into (3) we have the classical case of neutral lump-sum transfers. They would be perceived by the median voter as an increase in disposable income that can be visualised in Fig. 3 along the line R′B′:

$$y = R + \theta G - \theta(1 - m)q \tag{3a}$$

where θG represents the effect of a lump-sum transfer and $\theta(1 - m)$ is the effect of a proportional transfer.

But in my view, for this to be true bureaucratic behaviour has to be neutral and the median voter should have precise information at low costs. If these conditions are not satisfied, an event that is plausible in real world settings, the median voter may mix up the average price with the marginal cost. The politician (agent) supports this misperception of the voter (principal) as the pivot around which bureaucracy centres its active search for illusion. The perception of the average price as it were a marginal cost has a quantity q that, given G, implies an average price P_m^* to be inserted in (3), hence,

$$y = R - P_m^* q. \tag{3b}$$

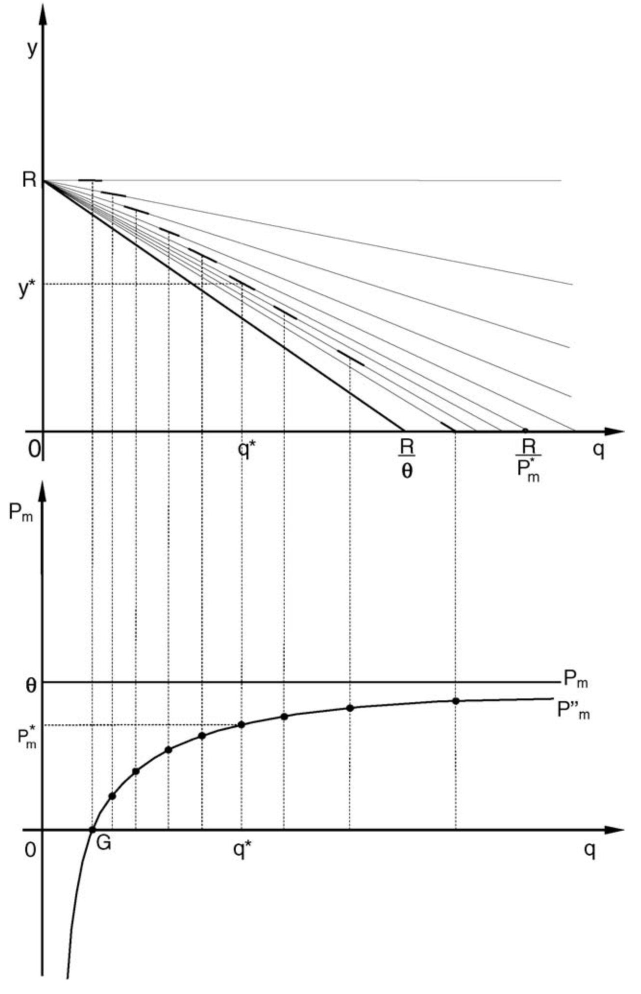

Fig. 2. Price effect induced by a lump-sum transfer.

Due to (1), the difficulty in having precise information at low costs about the way local expenditures are financed, and to (3), the easiness in concealing the real cost of the public good provided, the median voter budget constraint coincides with that of the local government. The local government gains this result by disguising a lump-sum transfer as a conditional grant destined to reduce the tax price of the locally provided good. In fact, this is the only effect the local taxpayer perceives.

Fig. 2 illustrates how a lump-sum transfer can result in a price effect. Part (b) of the figure draws on the graphic representation of Fig. 1 concerning the reduction in average price due to the introduction of a lump-sum transfer (a proportional transfer has been omitted here). If a budget constraint, based on the average price rather than on the marginal cost, is introduced in this setting we have to add the average price P_m after the transfer in (3). It is soon evident that as the average price function has taken the shape of a curve, it is impossible to determine the exact slope of the budget constraint since it varies according to the quantity provided. In other terms, what happens

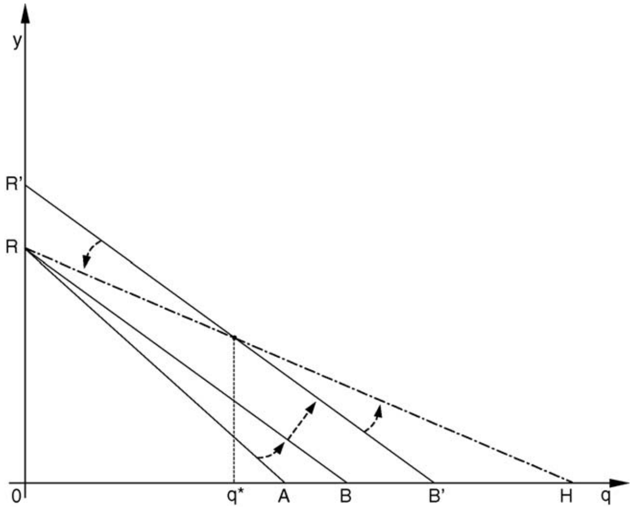

Fig. 3. Median voter's budget constraint with illusion: RH = Eq. (4) (with illusion); R′B′ = Eq. (3).

is described in part (a) of Fig. 2; each chosen level of q will modify the slope of the budget constraint such that the new constraint be valid only and exclusively in correspondence with q. By increasing the number of observations, there emerges a map of budget constraints with R as origin that depicts a sort of *compound* budget constraint through its relevant points (one point for each budget constraint).

This *compound* constraint, although a line, has a different slope in every point; namely, it increases with the increase of the quantity provided due to the inverse relation in (3) linking P_m, and q.

Fig. 3 shows how this effect might be exploited to increase the level of local public expenditures.

The constraint RA depicts a situation where the local expenditure is financed only through local taxation. The well known effects due to the introduction of both a proportional transfer and a lump-sum transfer are obtained by pivoting the budget constraint about point R to RB and by *shifting* the line into R′B′, which represents both the budget constraint of the local government and that of the median voter. As mentioned above, the median voter perceives a lump-sum transfer as a simple reduction in price. In other words, once the quantity to be provided is q^*, the tax price the median voter is requested to pay is such that the budget constraint shifts to RH so that the median voter's choice will be q^*.

The equation of the RH constraint, including also the proportional transfer, is as follows:

$$y = R - \theta\left(1 - m - \frac{G}{q^*}\right)q. \tag{4}$$

The choice mechanism can be better visualised in Fig. 4 through the introduction of the utility function of the median voter.

Given the level of income R, the voter's choice changes with the changing in price along the Price–Consumption function denoted as P/C in the graph. It is exactly along the P/C function that the level of equilibrium of an illusion-seeking bureaucracy lies; the introduction of a lump-sum transfer is not perceived as an increase in disposable income (which would have had $\bar{\mathrm{E}}$ as an equilibrium point) but as a reduction in price so as to induce choosing E^*.

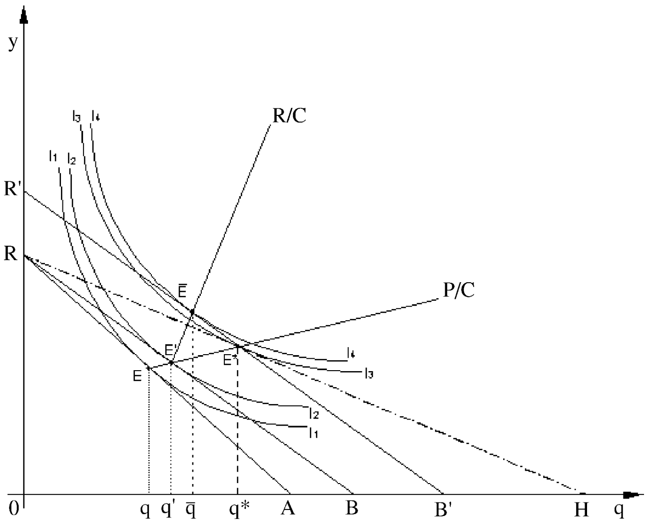

Fig. 4. Local expenditures increase under an active illusion-seeking bureaucracy: y = disposable income after taxes; q = perceived level of a locally provided service; R′B′ = budget constraint including a general lump-sum transfer as well as a specific proportional transfer; RH = budget constraint perceived by the voter; R/C = income consumption path; P/C = price–consumption path; $\overline{\mathrm{E}}$ = equilibrium with an illusion created by a centralised tax-system and an illusion created by an actively seeking bureaucracy; $\bar{q}q^*$ = increase in demand as a consequence of an active illusion-seeking bureaucracy.

Concluding, we can say that due to the two mentioned equilibrium points, the illusion-creating effect can be easily identified in the segment $\bar{q}q^*$ that represents the increase in the perceived level of production.

Let us look now at the second type of illusion, the one due to a centralised taxing power that also leads to an increase in local expenditure. Taking out the distorting effect that has led to E^*, we notice that the proportional transfer from central government to local government is equal to the quantity produced multiplied by the tax ratio m. In other words, as it appears from Fig. 5, the subsidy that the local government manages on behalf of the median voter is equal to:

$$UC = \theta m\bar{q}. \tag{5}$$

To understand the effect of this second kind of illusion, one wonders what the level of local expenditure would have been if the central government had chosen ad personam transfers instead of a proportional transfer managed by the local government. Assuming that redistribution equals zero, ad personam transfers may be seen as an unconditional reimbursement of central taxes.

In this case, the median voter perceives what before was concealed to him, namely that he is not only *directly* but also *indirectly* financing the local expenditure; if the central government decided not to levy the amount of taxes that it gives back as transfers, the median voter's budget constraint would coincide with the line R″D in Fig. 5. The average price of the local public good for the median voter would be θ once again and the budget constraint would be the following:

$$y = [R + \theta(G + m\bar{q})] - \theta q. \tag{6}$$

In conclusion, under this budget constraint the equilibrium point E^0 is unaffected by the two kinds of illusion. Consequently, in E^0 the production of the local public good is not only lower, but as is shown in Fig. 6, which reproduces to the details the equilibrium points E^0, $\bar{\mathrm{E}}$, E^* seen in Fig. 5, implies also the highest level of utility.

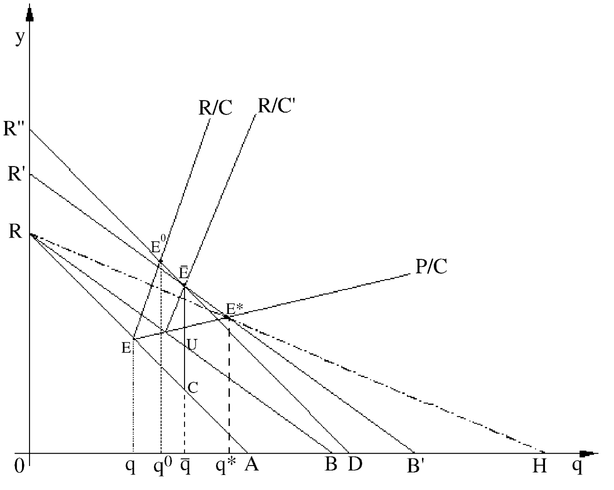

Fig. 5. Local choice free from an illusion-creating centralised tax-system: y = disposable income after taxes; q = perceived level of a locally provided service; R′B′ = budget constraint including a general lump-sum transfer as well as a specific proportional transfer; ĒC = total amount transferred from the central government to the local government, corresponding to $\bar{q}$; R″D = budget constraint including a lump-sum transfer equal to ĒC, allotted directly by the central government to the voters–taxpayers; E^0 = equilibrium free from both illusion created by a centralised tax-system and an illusion created by an actively seeking bureaucracy; $q^0\bar{q}$ = increase in demand as a consequence of an illusion created by a centralised tax-system.

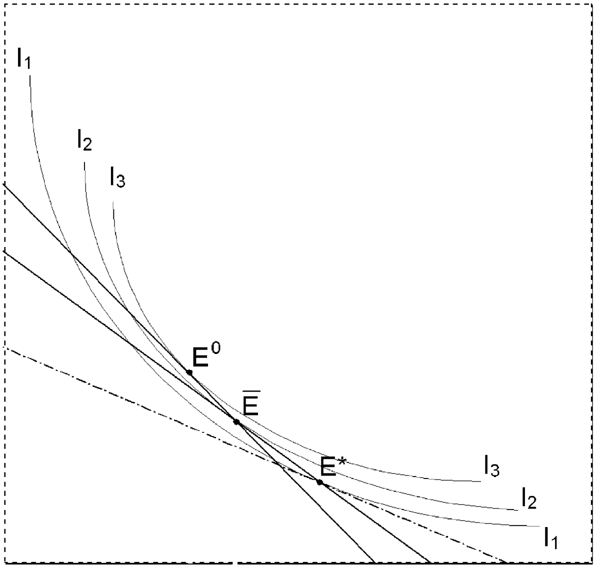

Fig. 6. The optimal choice free from the two kinds of illusion: E^* = equilibrium with both an active illusion-seeking bureaucracy and a centralised tax-system; Ē = equilibrium free from the effects of an active illusion-seeking bureaucracy; E^0 = equilibrium free from fiscal illusion.

In reality, the concept of equilibrium free from both types of illusion is incompatible with that of the real welfare state characterised, as it is, by ex post adjustments. One can deduce from it that this illusion free equilibrium can only be brought about within a contractarian constitutional framework where illusion-creating bureaucratic/political institutions are drastically reduced if not cancelled.

Conversely, the illusion component in the welfare state implies that individuals feel political-bureaucratic coercive acts to be Lindahl's prices. It should be added, on the other hand, that the political-bureaucratic regime has to invest directly in illusion-creating activities to win consent in order to precommit the demand for bureaucratic services. Moreover, it is *noteworthy* to underline that with regard to *illusion creation*, the salient linkage is that between top level bureaucrats and the majority if the latter prefers an expansionary budget; it becomes instead one between top level bureaucrats and the minority if the majority offers a budget that top level bureaucrats consider too restrictive. Since in the real welfare state the government has no budget constraints and is characterised by a "long chain" or Niskanenian model, the decisive linkage is that between bureaucracy and majority, unless the minority behaves strategically by promising even larger budgets and has a high probability of becoming a majority.[12]

If public opinion were well informed and acted rationally in its own interest towards its representatives and bureaucrats, the illusion-creating activity would probably have decreasing returns and bureaucrats' and politicians' advantages would be lowered. Since, as has been shown, the welfare state lacks stringent fiscal institutions, the creation of fiscal illusion is complementary to and coexists with the presuppositions of the ex post adjustment theory.

The theoretical analysis and the stylised graphic schemes may give an answer also to Musgrave's question concerning the optimal size of the public sector in a "good society". On this issue, Musgrave gave unsatisfactory answers. This is not, in fact, as Musgrave (1983) seems to maintain, a matter of defining the "normal" dimension of the public sector so as to contrast it with an oversized–undersized one. (Deviations in both cases!) Due to its illusion-creating bureaucracy, the real welfare state necessarily involves an oversized public sector. Musgrave argues that Lindahl's fiscal prices are not at the basis of the decisions of the majorities, which, in fact, might approve proposals not able to pass the efficiency test and, by contrast, reject others able to pass it. Such reasoning does not prove at all that Lindahl's test is erroneous; it simply shows that the efficiency criterion is not the basis of the welfare states. My scheme, based on the two kinds of *illusion*, visualises the deviations from Lindahl's equilibrium of the real welfare state. This, however, does not amount to say that the Value–Countervalue or benefit principle is unimportant per se; it only means that in the real welfare states, decisions are not taken on an efficiency basis. This conclusion would be impossible to derive under Musgrave's reasoning. My analysis suggests that an oversized bureaucracy is wholly compatible with a shortage in the provision of public services because it favours both inefficiencies and misallocation of resources.

This situation reveals the existence of a conflict between an oversized bureaucracy, which provides bureaucratic goods, and citizens who demand genuine public goods. However, the conflict is hidden since bureaucracy has an illusion-creating power. If my analysis actually seizes the essential determinants of the real welfare state, what seems to be certain is that the real welfare state is destined to disregard taxpayers and citizens' preferences and what follows from them. If some sort of welfare state is to fulfill its purpose a new setting free from political and bureaucratic

[12] In a proportional voting system, this would not require a new election, so that the likelihood of the text is not a pure abstraction.

illusions has to be created. The first question in many people's minds when confronted with this issue is how to set limits. To put the question differently, can we prefigure a welfare state that, working under uncertainty, guarantees that there is no room for illusion-creating institutions? This calls for an explanation of the different role uncertainty and illusion play in economics. While uncertainty simply involves incomplete information and is inborn in democratic choices, illusion necessarily involves the systematic distortion of information. This does, of course, end up by being a deceitful limit to a democratic public choice. Perhaps the key to the survival of some kind of welfare state is in the introduction of constitutional limitations.

4. Towards a constitutional welfare state

In the logic of contractarian constitutionalism, Wicksell's theory of just taxation is the most outstanding antecedent of fiscal justice. As is well known, the peculiar character of a democratic fiscal system is determined by the fact that it fixes a method or decision-making procedure based on the individual *willingness-to-pay principle,* which is the opposite of the *ability-to-pay* one.

This conflict solution gives an answer also to the problem adumbrated in Section 3 as to which elements of the real welfare state should be kept and which should be rejected. The following consideration may explicitate this point. If government were to pass an expenditure exceeding the individuals' willingness to pay, that government would be ipso facto the advocate of a welfare state. But this event is intrinsically incompatible with the contractarian constitutionalism. In no case, this could mean that in the contractarian fiscal constitution, grounded on the benefit principle, there is no room for redistribution. As is well known, the traditional welfare state theorists, following the Marshallian logic, justify subsidies that create either positive externalities or stop negative ones.

But they fail to see that also in this case such a decision would be taken behind the veil of ignorance precisely because the subsidy would benefit all consumers in the polity. It would thus pass the constitutional efficiency test based on the unanimity rule. It is also worth keeping in mind that the issue of redistribution/no redistribution should not cause divisiveness between the supporters of the welfare state and those of the contractarian constitutional welfare state. The distinctive element lies, in fact, in the kind of maximisation. At a constitutional level transfers are genuine and general so that there is no reason why the expenditures should not meet the constitutional efficiency test, while in the real welfare state the maximising function does not take into account individual preferences and discriminates against future generations (Buchanan, 1993, 1997).

Again, this is a different way of saying that the real welfare state can be seen as congenial to the flourishing of politicians and bureaucrats' welfare function. By contrast, what could a constitutional welfare state really maximise? The fact that the Constitution fixes budget rules can be seen as a force that might enhance individuals or their representatives to make choices on the political market by confronting alternative expenditure–taxation proposals. This choosing procedure would no doubt be in the direction of ensuring fiscal justice, which passes the efficiency test based on unanimity or approximate unanimity. As the real welfare states shun the constitutional test and adopt ex post adjustments, the results determined by the government are unavoidably assessed as being optimal by the government itself.[13] This optimality, however, may at the most, reflect citizens' evaluations as manipulated by the two kinds of illusion, and never their genuine opportunity costs (Wagner, 1988). To state the matter shortly, the distinction between real welfare

[13] The text overlooks the extreme case of an organic state in which the omniscient benevolent despot unduly claims to be entitled to know all his subjects' unrevealed preferences.

states and constitutional welfare states can be synthesised with the passage or path going from the optimal taxation to the optimal rule in public choices.

Although this topic would be completely out of place in the benevolent despot hypothesis that is behind the real welfare state, let us nevertheless suppose that a benevolent despot is in power, say, by God's will, but he is to be reconfirmed through elections. Would this benevolent despot be willing to maintain his behaviour unaltered in both alternatives[14] and would it really be the same welfare functions to be maximised in either case? The answer is unequivocally in the negative. The contractarian logic, seen as an agency relationship, involves that the principal sets limits to his agent.[15] Namely, should the principal-taxpayer evaluate that the benefits he receives as Countervalue of his tax-bill are lower than those he would receive from the alternative private use, the taxpayer would give the government an amount of his income corresponding to a certain quota of GNP. Hence, the government would be *entitled* to levy only within those limits.[16]

Needless to say, if the government levied higher taxes it would ipso facto disregard the limits imposed by the constitution and would violate the agency relationship (although both the taxpayer and the government could accuse each other of rule breaking).[17]

In a non-constitutional welfare logic, decisions are led by the politico-bureaucratic power that plays a major part in taming the decision power of the governed. The key issue is whether there can be institutions that authoritatively fix redistribution while meeting the equal treatment criterion that underlies the constitutional state. In answering in the affirmative, I shall define the body of those institutions as an ex ante welfare state or, simply, a constitutional welfare state. From this point of view, it is possible to define some rights as inalienable, and I mean by this that all individuals have the guarantee to be "entitled to", such as, the lexicographical priority of the equal liberty principle as well as of the difference principle in Rawls's terms.

It follows that only in the event that a welfare state assigned obligations to meet those rights, one could say that the constitutional logic is met. This, in no way, means, however, that all rights created by the rules of the real welfare states may find their justification behind this concealment. When we move to the institutions of real welfare states, there emerges dramatically the problem of rights-creation. Rights created by the law violate the equality principle, which is the skeleton upon which the welfare state should be based in order to be defined as constitutional. One effect of this is that in the non-constitutional welfare state the coercive power is not used in defence of the individual entitled to receive transfers because of the difference principle, and against the violation of this right by other individuals[18]; in this context, in fact, the coercive power would be wholly legitimate. It is used, instead, as a rent-seeking device by pressure groups, especially bureaucracy, as shown in Section 2.

5. Rights and obligations: behind the veil of ignorance

It is hardly surprising that in real welfare states there is a systematic conflict between right and duties. The reason for this is embodied in the particular way of assigning rights or titles to

[14] For the debate between Wicksell and Kuylistierna, which is within the logic of the text, see Jonung (1996).

[15] On the delegation limits, see Blankart (1994).

[16] The reader will note that I am simply adopting here Mazzola's criterion which is wholly coincident with that of Wicksell, at least as far as the discourse in the text is conceived. See Mazzola (1890), Chapter 9, especially Sections 6, 7, 9 and 10. See also the English translation in Musgrave and Peacock (1958).

[17] This may be imputed to an abuse by the governors, an error by the governed, or, finally, defects of representativeness. Though important these arguments may be, I cannot dwell upon them here.

[18] On this point, see Kliemt (1993).

receive transfers. The analysis carried out up to this point has tried to show that, with the exception of the Mazzola–Wicksell approach, the two sides of the fiscal account have been kept separate. Only under the heroic assumption that all property is at the disposal of the fiscal authority can a rights-creating law omit to designate the obligations. But in this case, the taxpayer is left without any valid obligations to finance the growing needs of the fiscal authority, and this fact raises the question of where democracy leads us.

Hence, the real welfare state should be crafted to include the obligations–entitlements–rights circuit as the constitutional boundary. The constitutional analysis, however, due to the manner it has been introduced, has evidenced that the equal opportunities of the liberal theory are not an outcome spontaneously achievable and that the equal opportunity principle is a *built* or *artificial* dimension. From this perspective, the distributive component, especially in terms of ad personam transfers, is an explicit part of the constitutional contract as is clear in (Buchanan and Tullock, 1962; also Buchanan, 1975), as well as in Rawls (1971).

So even while limiting my analysis to transfers, I do need to emphasize that also on this point the constitutional approach drastically differs from that used in real welfare states. In fact, the supply of goods and services is handled by bureaucracy as an alternative to ad personam transfers. Adopting this latter state of things should be an instrument for preventing fiscal obligations from being directed to the maintenance of an oversized bureaucracy as a high powered pressure group (see Borcherding et al., 1977).

From this we might reasonably be led to expect that this situation might develop, even ignoring that in the presence of a "bribe market" the demand by bureaucracy could increase. Yet though this public attitude to bribery is not justified by welfare states, it is nevertheless the point round which they eddy, as demonstrated in the graphic scheme.

The analysis developed here suggests also that the political sponsor's neutrality towards his bureaucratic agent is not convincing at all. In fact, politicians and bureaucrats together make up a single pressure group with the power of creating both political and "optimistic-like" fiscal illusion[19] among taxpayers–voters. Clearly, fiscal limits to the welfare state, like the classical equal opportunity principle or the newer Rawlsian principle, should be put at constitutional level. The Rawlsian difference principle seems to have a more marked redistributive impact than the liberal postulate of equality in the initial position that was requested, more or less explicitly by the theory of the minimal state.[20]

In the remaining part of this work much light is thrown on the difference principle, and it is shown that it is covered by the constitution as long as the principle is weak, but it may lose such a coverage if it is robust. Rawls's difference principle is, of course, weak and does not hinge on a liberal logic stricto sensu. The justice it refers to is one of the procedural or ex ante kind, and as such, cannot be discriminatory. Wicksell had brilliantly noticed that if the *real status quo* were unjust, the correct procedure would give rise to a result that should be defined still unjust (see Jonung, 1996).

Thus an unjust *status quo* is not compatible with the contractarian constitutional logic, no matter whether in the unanimity version or in that of the veil of ignorance, at least in the version I

[19] See Puviani (1897, 1903). Due to the role fiscal illusion plays in the real welfare states of Western democracies, Puviani's contribution has an explanatory power that goes well beyond that of the ruling class and should rather represent the litmus paper to separate errors from imperfect information (which are unavoidable) from errors coming from systematically falsified information, (which, instead, would be inconsistent with the constitutional welfare state sketched here).

[20] This is a different manner of maintaining that Kliemt thesis, on the grounds of which the minimal state included a redistributive component, is correct. See Kliemt (1993).

call *weak*. Clearly, no one would be interested in approving rules that could systematically harm someone else. Behind the veil of ignorance or within an ex ante logic, in fact, the individual cannot know whom the "anyone" will correspond to.

The welfare state based on a constitutional perspective cannot legitimate an unjust *status quo* since this could be equal to empowering a rule which would never pass the conceptual unanimity test required for entering the Constitution.

The reading of the difference principle in terms of equality in results may originate, however, bizarre this may appear, from its being a constitutional principle that cannot be circumvented. This change in the meaning of the difference principle stems from the creation of *robust* distributive rights.

When the compulsoriness of the difference principle is combined with a quantitatively large redistribution, the difference principle is, as it were, a device to determine a just result rather than a just procedure. In this light, the difference principle would generate equality in results, the individuals being endowed with *primary goods* quite independently of their individual merit.

The hypothesis of a quantitatively *robust* difference principle may lead to a lower growth path than the potential one due to the fall in incentives to invest. Results would, in fact, be *politicised* while risks would remain with *privates*.

In a sense, a *robust* version of the difference principle finds its upper limit precisely in the relation obligations/rights. In this way, legitimating redistributive entitlements may arise on condition that an agreement on fiscal obligations has been reached in advance. Even so the coercive element is not the legitimating procedure of fiscal obligations here; such legitimating procedure, in fact, is a *voluntary* choice behind the veil of uncertainty; the coercive element appears only at a post-constitutional level to restrain people from free-riding. The coercive element, then, emerges only with the implementation, while the choice is free, although within the Wicksellian version of a conceptual agreement.

There is, however, an important consideration still left. The difference principle can be explained with the concept of negative liberty and automatically ceases with the end of the motivation that originated it. Hence, the individual's entitlement to the difference principle lies in his being a *disadvantaged guiltless* individual. Yet, the difference principle cannot cover all future disadvantages of individuals since behind the veil of ignorance constituents necessarily reason within a scarcity context. That is why the problem of fiscal justice arises at a constitutional level.

If, instead, the law creates rights to receive transfers independently of fiscal obligations as is the case of the real welfare state, conflicts between fiscal obligations and fiscal rights become blatant and do not emerge only because an impression of abundance is surreptitiously created through debt illusion and money creation, and by definition, abundance is "beyond distributive justice".

Clearly, in this context, the Rawlsian difference principle would violate intergenerational equality before the law, because through debt financing government precommits unjustified constraints to the choice set available to future individuals, including those who would benefit from the difference principle. One cannot say that this would be the result of the difference principle per se. It is just a consequence of its incorrect use, as happens in the real welfare states.

6. Conclusions

The purpose of this paper was neither to sketch some alternative profiles of welfare offered by different national doctrines of public finance nor to supply the recipe or a corrective to the creation of a constitutional welfare state. Main emphasis has been rather placed on the contemporary welfare state outlining the differences among the various schools, namely Italian, German, Swedish and English. This may have induced me to overemphasise differences rather than underline similarities, yet different as these schools are, a paternalistic element is ever present in all the versions except that of Mazzola and Wicksell.

The core of the paper is an extension of Puviani's theory of fiscal illusion that was designed for non-democratic institutions to the democratic institutions such as those of the welfare state. It is fairly evident that the related illusion mechanism allows the welfare state to have discriminatory powers. The overcoming of these discriminatory powers, as suggested in the paper, leads almost by necessity towards constitutional political economy.

In particular, the work has emphasised the linkage between fiscal rights and fiscal obligations. The last part of the paper has suggested a solution to some possible ambiguities that may be prima facie improperly ascribed to the Rawlsian difference principle.

References

Atkinson, A.B., Stiglitz, L.E., 1980. Lectures on Public Economics. McGraw Hill, Maidenhead.

Blankart, C.B., 1994. Club governments versus representative governments. Constitutional Political Economy 5, 273–283.

Borcherding, T.E., Bush, W.C., Spann, R.M., 1977. The effects on public spending of the divisibility of public outputs in consumption, bureaucratic power and the size of the tax sharing group. In: Borcherding, T.E. (Ed.), Budgets and Bureaucrats: The Sources of Government Growth. Duke University Press, Durham, NC, pp. 211–228.

Buchanan, J.M., 1960. 'La scienza delle finanze': the Italian tradition in fiscal theory. In: Fiscal Theory and Political Economy. North Carolina University Press, Chapel Hill.

Buchanan, J.M., 1969. Cost and Choice: An Inquiry in Economic Theory. Markham Publishing Company, Chicago.

Buchanan, J.M., 1975. The Limits of Liberty: Between Anarchy and Leviathan. University of Chicago Press, Chicago.

Buchanan, J.M., 1993. How can constitutions be designed so that politicians who seek to serve 'public interest' can survive and prosper. Constitutional Political Economy 4, 1–6.

Buchanan, J.M., 1997. Le crisi nelle democrazie del 'welfare'. In: Arcelli, M. (Ed.), Globalizzazione dei Mercati e Orizzonti del Capitalismo. Laterza, Bari, Roma.

Buchanan, J.M., Tullock, G., 1962. The Calculus of Consent. University of Michigan Press, Ann Arbour.

Eusepi, G., 1998. Mercati istituzionali alternativi: un modello burocratico 'a catena breve' come superamento dei modelli 'a catena lunga' Rivista di Politica Economica. Anno LXXXVIII, 117–142.

Jonung, L., 1996. Knut Wicksell: the principles of just taxation an unpublished manuscript by Knut Wicksell, translated into English for the Liberty Fund Colloquium "Public Finance in a Free Society" celebrating the centennial of Finanztheoretische Untersuchungen, Potsdam, September 5–8.

Kliemt, H., 1993. On justifying a minimum welfare state. Constitutional Political Economy 4, 159–172.

Lindahl, E., 1919. Die Gerechtigkeit der Besteuerung. Eine Analyse der Steuerprinzipen auf Grundlage der Grentznutzentheorie. Lund, Gleerups.

Mazzola, U., 1890. I Dati Scientifici Della Finanza Pubblica. Loescher, Roma.

Mazzola, U., 1958. The formation of the prices of public goods. In: Musgrave, R.A., Peacock, A.T. (Eds.), Classics in the Theory of Public Finance. Macmillan, London.

Mill, J.S., 1970. Principles of Political Economy with Some of Their Applications to Social Philosophy. Penguin books, Alesburg, Bucks.

Musgrave, R.A., 1939. The voluntary exchange theory of public economy. Quarterly Journal of Economics 53, 213–237.

Musgrave, R.A., 1966. Principles of budget determination. In: Scherer, J., Papke, J.A. (Eds.), Public Finance and Fiscal Policy. Houghton Mifflin Company, Boston, pp. 3–12.

Musgrave, R.A., 1983. When is the public sector too large? In: Taylor, C.L. (Ed.), Why Governments Grow. Measuring Public Sector Size. Sage Publications, Beverly Hills, pp. 50–58.

Musgrave, R.A., Peacock, A.T., 1958. Classics in the Theory of Public Finance. Macmillan, London.

Pigou, A.C., 1920. The Economics of Welfare. Macmillan, London.

Puviani, A., 1896. Il problema edonistico nella scienza delle finanze. Riforma Sociale VI, 297–309.

Puviani, A., 1897. Teoria della Illusione nelle Entrate Pubbliche, vol. VII. Annali dell'Università di Perugia, Perugia.

Puviani, A., 1903. Teoria Della Illusione Finanziaria. Sandron, Palermo.

Rawls, J., 1971. A Theory of Justice. Harvard University Press, Harvard.

Seligman, E.R., 1908. Progressive Taxation in Theory and Practice. Princeton University Press, New York.
Söderstrom, L., 1986. The Wicksellian alternative, Skandinaviska Enskilda Banken Quarterly Review 3, 88–96.
Von Stein, L., 1958. On taxation. In: Musgrave, R.A., Peacock, A.T. (Eds.), Classics in the Theory of Public Finance. Macmillan, London, pp. 28–36.
Wagner, A., 1958. Three extracts on public finance. In: Musgrave, R.A., Peacock, A.T. (Eds.), Classics in the Theory of Public Finance. Macmillan, London, pp. 1–15.
Wagner, R.E., 1988. The calculus of consent: a Wicksellian retrospective. Public Choice 56, 153–166.
Wicksell, K., 1958. A new principle of just taxation. In: Musgrave, R.A., Peacock, A.T. (Eds.), Classics in the Theory of Public Finance. Macmillan, London, pp. 72–118.