Private vs. Public Sector

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Abstract
Private and public sectors are often considered in a dichotomous way. However, it is important to note that the private and public sectors of modern societies progressed in a process of asymmetric and sometimes discontinuous co-evolution. Taking as a point of reference a pre-modern state of affairs where the private–public dichotomy is not yet developed, key issues and concepts relevant for this dichotomy are discussed. They are indispensable for distinguishing the modern public sector from other forms of non-market governance and considering the dynamism of individualist private market-mediated economy and the evolution of a distinctively modern public sector as two sides of the same coin. In that context, collective choice (related to the co-existence of individual values and ‘democratic’ procedures) and the distinction between public and private goods are of pivotal importance.

The co-evolution of private and public sectors 1700–1914
The two centuries between 1700 and 1914 saw a cluster of unique developments in European history, notably including the emergence of a public as well as a private sector in the modern sense. Those centuries are characterized by the evolution of individualist cultures of private capitalism complemented by the development of modern statehood. This is discussed in diverse strands of literature: Karl Polanyi (1944) argued that the development of the modern state went hand in hand with the development of modern market economies. More recently, Mazzucato (2013) invoked Polanyi’s emphasis on the role of the state in making and shaping markets in her attempt at ‘debunking private vs. public sector myths’. Discussions in political and legal philosophy show that individual autonomy developed along with publicly enforced norms of justice as two sides of the same coin (Schneewind 1998).

The bourgeois ‘culture of growth’ was accompanied by a co-evolution of public and private sectors, eventually leading to ‘the great divergence’ between Western(ized) and non-Western (ized) nations. By the eve of World War I, an unseen degree of European dominance in terms of economic prosperity and political-military power had developed. The general features of the historical setting explaining capitalist dynamism are inextricably related to the rules and institutions constitutive of specifically modern private sector and public sectors, including the development of a sharp distinction between the two. With regard to a specifically modern private sector, the rules and institutions of private property (securing a sufficient degree of economic freedom as non-interference) are a necessary condition for unleashing entrepreneurial activity: capitalist dynamism presupposes a private sphere of economic decisions which are nobody else’s business, thus minimizing the number of veto-players potentially obstructing entrepreneurial innovation. Moreover, financing private investment by credit requires mechanisms of accounting
and accountability, which meet the informational needs of private creditors, shareholders and public authorities seeking to rationalize the revenue side of the public budget.

As vividly described by Schumpeter (1918), private and public sectors underwent a joint process of modernization over centuries. In the first phase of this asymmetric co-evolution, the public sector and public finance was a major influence: more systematic taxation and the management of public debt had profound impacts on the rationalization of business practices. The expenditure side became more responsive to social needs, increasingly perceived as the needs of citizens, households or businesses best served by the public sector. In Britain, the private sector became the major force of change in the ‘years of wonder’ of the second half of the eighteenth century. During the subsequent industrial revolution the capitalist private sector was the main source of socio-economic dynamism, including state reliance on tax bases created by the dynamism of the private economy. All this went hand in hand with co-evolutionary changes of state institutions: while the development of state sovereignty was in the main a result of earlier developments, rationalization of modes and patterns of state activity progressed in various ways.

The American and French revolutions epitomize the fact that this progress was neither linear nor homogenous across different nations. The common core included two ideas: first, rationalization of the public sector presupposes some degree of decoupling state sovereignty from rigid forms of class privilege, thus promoting a sufficient degree of openness for private sector dynamism. Second, modern notions of public accountability referring to ideas of common good were strengthened, stressing (i) specifically public (or social) needs and wants as domain of state provision and (ii) explicit collective choice informed by democratic ideals as appropriate form of choice about public revenues and expenditures. Before discussing some coordinates and key concepts and theories that informed or accompanied decisive steps of an asymmetric, discontinuous and often asynchronic co-evolution of public and private sectors taking place 1700–1914, it is useful to consider Schumpeter’s (1918, 103) emphasis on the specificities of the modern private–public divide in contrast to the period preceding the evolution of modern statehood:

But it was not yet state power, for it did not rest on any general sovereignty, the representative and personification of which the prince might have felt himself to be and from the sanction of which the rights of the remaining powers which confronted the prince within the territory might have derived. The prince owned his sum of rights and positions of power for his own benefit, so that his phrases of public welfare then and much later had no other meaning than, for example, similar expressions uttered by a factory owner of today. The natural law distinction between the persona publica and the persona private of the prince did, therefore, not simply remain unrecognized at the time because of deficient legal or sociological analysis, but it had no factual basis and would have been meaningless. The prince did not look upon his territory then as a modern estate owner looks upon his cattle. All this came later. But he did look upon the sum of his rights precisely like this – as a patrimonium of which he could dispose in a manner which was nobody else’s business.

Public sector vs. non-market governance

As shown by Schumpeter (1918), not all kinds of non-market-governance are part of a ‘public sector’, let alone a state: for instance, the provision of some form of public security may be a by-product of semi-private feudal governance. However, the emergence of market economies from the early modern era to the classical liberal capitalism of the nineteenth century was
supported by the development of a specifically modern public sector. Locating modern statehood within the more general coordinates of nonmarket governance, as well as the development of modern private economy, requires a three-dimensional coordinate system.

1 **Degree of marketization.** This reflects the share of socio-economic interdependences that are mediated by competitive prices, viz. by voluntary exchange between individuals and private contract. Considering this axis, a residual becomes visible which is reflecting the limits of market mediation: interactions that are not mediated by the price system and either remain unmediated or are dealt with by non-market institutions/mechanisms (non-market governance). It should be obvious that this residual account of gaps in market coordination does not provide a satisfactory starting point for studying the properties of specific versions of non-market governance, which may be either public or private to different degrees. Given some particular degree of marketization, one may still have different options as to the degree and mode in which (i) the functional properties of markets are complemented by suitable institutions and (ii) to the direction in which such institutions can be improved by different kinds of public policies. In order to capture relevant differences and locate the interdependence between them, two further coordinates are useful, locating different modes of non-market regulation.

2 **Degree of centralization.** There is broad agreement that the specific difference of modern individualist societies is the extent to which they rely on a sufficiently strong central state (including bureaucratic organization and collective choice mechanisms) for regulation and the provision of public goods. However, strands of economic thought as well as public sectors of different countries differ substantially with regard to the role of intermediate institutions, the role of federalism and the desirable degree of centralization.

3 **Explicit vs. implicit collective choice.** Choices relating to issues of common concern come about in different ways. They may be based on explicit collective choices, as in the modern democratic state and in some modern intermediary institutions such as trade unions and business associations. However, non-market governance may also be brought about by ‘implicit’ collective choice. The latter is collective in the sense that the outcome (tax regimes, norms, regulatory mechanisms, levels of public good provision) cannot be individualized: all members of the collective have to live with it, even if it is not legitimized by explicit collective choice and concomitant notions of public accountability but implemented by either authoritarian fiat or some spontaneously established rule.

The history of the private–public divide between 1700 and 1914 can be described in terms of those three axes: the private sector progressed as markets for labour, capital and land evolved (increasing marketization), unleashing private entrepreneurship and a rationalization of economic behavior, while the public sector mainly progressed by rationalizing governance by way of (i) centralization and (ii) explicit collective choice – albeit not in a linear way, as illustrated not only by revolutions and reactionary backlashes but also by doctrines and developments suggesting that centralization should not be pushed too far and democracy may have functional limits and drawbacks, as analyzed by Schumpeter (1942).

**Public and private goods: the core economic concept of the private–public dichotomy**

Let us first summarize the main reasons why the technological distinction between private and public goods is of pivotal importance for drawing the line between private and public sectors. In economics, the concept of public goods is the core of positive and normative theories of
public sector institutions and public expenditure (see Sandmo 1987 and Sturn 1998). That is, public good theory answers the question of which kind of non-market governance does make sense under given empirical circumstances. Pure public goods are defined by (i) non-excludability and (ii) joint consumption, while pure private goods are characterized by excludability and rival consumption (if I consume a given pint of beer, it is impossible for you to consume this very same pint). In public economics, the concept of public goods is related to two kinds of concern:

1. the general justification of the public sector, including the determination of its tasks and its institutional boundaries vis-à-vis the private sector and
2. the analysis of choice procedures and mechanisms of provision specifically suitable for public goods.

At level 1, the concept of public goods makes available an individualist account of genuinely public phenomena such as the state. More generally, it delivers an individualist foundation of public sector institutions. However, it does not imply contractarian models of the state, even though it is compatible with them. The two constitutive characteristics of pure public goods, joint consumption (non-rivalry) and non-excludability may be considered as the co-ordinates of a two-dimensional map which is useful as a rough guide for the assessment of candidates for institutional solutions (state, private or ‘intermediate level’) of the allocation problems raised by various types of ‘mixed’ goods.

With regard to level 2, joint consumption is the basis for studying choice procedures and provision mechanisms for public goods. In analogy to the modern analysis of competitive markets for private goods, public choice theorists are interested in issues such as the conditions for existence, stability, efficiency and other properties of voting equilibria.

It is widely recognized that the Scottish philosopher David Hume (1739/40 [1992], III.ii.7) stands out in anticipating public good analysis. Hume’s pertinent discussion is presented in the context of deriving the foundations of private property and contract. This is complemented by Adam Smith’s more detailed account of the ‘duties of the sovereign’ in Book V of the Wealth of Nations: they are related to activities not ‘sufficiently’ induced by spontaneous market processes. Smith (1776, IV.ix.51) gives the rationale for ‘publck works and publck institutions’ in these terms: ‘the proft could never repay the expence of any individual or small number of individuals, though it may frequently do much more than repay it to a great society’. As shown by Gilbert Faccarello (2006), French sensationist thinkers (notably Turgot and Condorcet) developed sophisticated theories of public expenditure based on public goods. While stressing the case for an integrated treatment of public revenues and expenditures, their reasoning included an optimal balance of public expenditure, tax burdens and private economic activity.

After Hume and Smith, the theory of public expenditure did not make major progress in Anglo-Saxon economics for quite a while. Paul Samuelson (1954, 387) stated that ‘except for Sax, Wicksell, Lindahl, Musgrave, and Bowen, economists have rather neglected the theory of optimal public expenditure, spending most of their energy on the theory of taxation’. In the same spirit, Musgrave (1959, 68) commented on Ricardo: ‘Ricardo, who considered taxation of suficient importance to entitle his book The Principles of Political Economy and Taxation, evidently found public expenditures so wasteful that he did not feel it necessary to discuss them. He was satisfied to endorse “the golden maxim of M. Say, that the very best of plans of finance is to spend little …”’.

The long stagnation of the market failure perspective on public goods referred to by Musgrave and Samuelson is related to the fact that theorists such as Hume and Smith, while
being aware of the free-rider problem occasioned by non-excludability, failed to develop concepts capturing the aspect of non-rival (‘joint’) consumption and, as a consequence, failed to grasp systematically the specific implications of non-rivalry, i.e. the existence of a category of public goods where the concept of optimal provision (formalized by Samuelson 1954) does make sense. The market failure approach based merely on non-excludability makes for an appealing explanation of the public sector, but this explanation has two drawbacks:

1. It provides only a fragmentary account of the economic reasons and forces determining the scope of the public sector;
2. The logical basis and rationale for a systematic approach to the study of mechanisms of public provision connoting explicit collective choice is weak.

Moreover, it is compatible with a simple rule cutting off further analysis: tax-financed provision of public goods is a necessary evil that should be kept to a minimum. All this contributed to developments in political economy in which tax incidence remained an area of fertile research, but the expenditures side as well as the public choice mechanisms potentially supporting it were to a large extent neglected. As Fritz Karl Mann (1937, chs 11–13) shows, this was followed by various kinds of attempt to couch the working of the public sector in terms of the institutional logic of the private sector (the state as joint-stock company, taxation as insurance premium, other versions of the benefit principle and so forth), as well as in discussions regarding whether taxation should be dispensed with altogether and substituted by voluntary contributions. For a discussion of pertinent French liberal traditions in the nineteenth century, see Faccarello (2010). By contrast, Kolm (2010) summarizes French public sector traditions with a specific focus on public infrastructure.

The complementarity of private and public sector: political theory and economics

Things were somewhat different in the German-language tradition inspired by thinkers such as Kant. Pertinent developments culminated in Knut Wicksell’s (1896) seminal contribution to public goods in a democratic polity (Sturm 2010). Equally important, the co-evolutionary views of Schumpeter and Polanyi owe much to this tradition, which made sense of the private vs. public dichotomy while at the same time stressing complementarities between the two sectors.

Much of Kant’s political and legal philosophy can be understood in the context of problems and achievements in the oeuvres of Hobbes, Locke and Hume. This particularly applies to his theory of property and the state, which elaborates on the private–public dichotomy as two sides of the same coin in a way hugely influential in various strands of nineteenth century thought. In order to get an idea of the relation between public and private spheres as conceived of by German thought in the wake of Kant, consider the main differences between Hobbes, Locke and Kant. For Hobbes (1651), private property and market exchange is an instrument in the political project of securing peace. For Locke (1690), private property is a pre-political concept: the state is an instrument for enforcing private property rights (whose scope and distributional patterns are data for the political process) more efficiently than in the state of nature. For Kant (e.g. 1964), the institution of full-fledged modern property and the state are more intimately connected than for either Hobbes or Locke. The political and legal procedures of the state are a precondition for ‘peremptory property’. However, the formation of the modern state itself presupposes individuals endowed with ‘provisional possession’. The state is an institution complementing private property, as it enforces rational procedural constraints channelling the self-interested behaviour of private individuals in a way such that its destructive potential is neutralized.
As the modern state and the market economy are complementary, it does not make sense to construe one of them in terms of the logic of the other. Rather than being a mere enforcement agency for pre-political private rights, the legal order of the state necessarily superimposes additional norms which inter alia may require a change of the historical pattern of rights and duties emerging as ‘provisional possession’. For Kant, norms of procedural rationality are constraining the admissible procedures in order to ensure the overall acceptability of public sector activities, including the patterns of private possession guaranteed by it. Put another way, these norms can be understood as universal requirements for the rational working of the public sector. Speculations concerning a private property exchange economy without a state are misleading according to this view. The patterns of public activity and the politico-legal procedures of the state are determined by norms and concerns that cannot be fully understood in terms of the private interest-driven logic of transactions in the market. The purpose of the public sphere is to create institutions supporting individual freedom. If this freedom is to be understood not as a privilege but as a universal norm, the public sphere must be based on principles of rationality accommodating requirements of universality.

Kant’s conception of the public sphere set the agenda for economists such as Jakob and Hermann: to provide an adequate socio-economic account of ‘joint purposes’ (Jakob 1805, §22). In that context, ‘collective needs’ were a heuristically fertile concept. Hermann (1832, 5) emphasized that ‘economics does not deal exclusively with exchange value, but with goods that have exchange value’. Economic analysis of the public sector expenditure side is useful insofar as collective needs are satisfied by means of economic goods: even if no price is charged by the state, public establishments are not free goods. Hermann suggests self-preservation as the basic motivational assumption and source of needs: there are social conditions of self-preservation that generate collective needs. The most basic social condition of self-preservation is the family. The ‘isolated family of settlers’ is the basic social unit used by Hermann (1870, 7) for certain theoretical thought experiments. It is described as a sphere of family-specific needs, motivations and activities, which are linked to jointly consumed family-specific public goods. The exclusion principle (which is regarded as the pivotal organizing principle of the private economy) does not make sense in the case of such goods.

Whereas British thinkers from Smith onwards invoked non-excludability as the first cause of market failure, Hermann (1870, 19) positively emphasized excludability as a necessary condition for the functioning of the private market economy. Non-exclusion is associated with different levels of the public economy, typically coinciding with collective needs and joint consumption. Note the differences: first, the degree of excludability is influenced by the normative and institutional framework prevalent in a community. Moreover, it depends on the effectiveness of the public order and the cost of private exclusion technologies. Excludability is more of a contingent and artificial than a natural property of goods. Second, this reasoning suggests that the core of certain collective institutions such as the family or the state is the joint consumption of benefits, making exclusion economically inefficient or politically/morally unacceptable, even if technically feasible.

The process of civilization widens the scope of the socio-economic conditions for self-preservation, developing new types of needs going beyond the level of the individual and the family. ‘New’ collective needs are conditioned by the overall socio-economic dynamism and satisfied by the existence of collective institutions. As Hermann (1870, 3) explains, the need for protection of personal spheres and property does not emerge in a social vacuum. The endogeneity of the system of needs amounts to the development of needs in an individual and social learning process. Put another way, needs and valuations co-evolve with the conditions of social interaction, production and consumption: privacy-enhancing effects of increased material wealth coincide with increasing importance of public goods. Hermann emphasizes...
the simultaneous usefulness of public goods for *many individuals*: ‘These public goods ought to be useful too; not for single individuals in an exclusive way, but for many or all simultaneously’ (Hermann 1832, 14; my translation). Regarding the provision of the goods satisfying collective needs, many authors in the German tradition believe that ‘public spirit’ may play a motivational role. However, the provision problem (as it necessarily implies economic goods) remains an economic problem for which alternative institutional solutions are considered: the state to some extent must rely on institutional coercion.

To summarize:

1. Along the lines of a broadly Kantian conceptualization of the public sphere, the theoretical basis for the analysis of the public sector is *not market failure but institutional complementarity*. Public institutions taking care of collective needs typically use as inputs tradable goods with exchange value.

2. The policy implications are well expressed in Hermann (1832, 13): ‘Presupposing all the social means of securing and enhancing industry and trade, and assuming moreover sufficiently educated citizens, one may well admit that, as a rule, the individual’s own advantage is the best guide to the kind and method of his industry, whereas constraints of it are rather harmful than useful’ (my translation, emphasis by Hermann). That is, laissez-faire is not ‘the general rule’ (as John Stuart Mill, 1848, would have it) but a rule conditional on the existence of suitable public institutions.

### Determinants of modern public budgeting: collective choice and individual values

Richard Musgrave called Lorenz von Stein (1815–90), Adolph Wagner (1835–1917), and Albert E. Schäffle (1831–1903) the ‘triad of German public finance in its golden age’. (English translations of relevant texts by Italian and German-language authors quoted in this section are collected in Musgrave/Peacock 1958). As Musgrave (1997, 152) observes, ‘their aim was to create self-contained systems showing the fiscal role of the state from general principles down to institutional detail and their changing patterns’. Stein stresses the need for developing a ‘systematic’ theory of the fiscal process. The state economy cannot be adequately dealt with by modelling the public sector just as an appendix to the economics of competitive markets. It rather has to be based on a theory of the state and the historical stage of the development of the polity and its governmental organization (see also Schäffle 1880, 19).

This strand of thought is particularly concerned to show how the fiscal process of the public economy is located within the framework of explicit collective choice and the constraints of public law, thereby stressing the interdependence with individualism (Stein 1875, 62–81). This is particularly relevant for the constitutional framework of taxation:

> All this changes with the ascendancy of the idea of the state as a free association of equal citizens. Once individuals cease to be subordinate to the domination of the social order, their contributions to the community are conditioned by … personal freedom and the equality before the law … . Taxation is not yet present when the exaction of contributions is based merely on the needs of an autocratic state; we can speak of taxation only when these levies come to be based on the needs of the life of the community.

(Stein 1875, transl. in Musgrave/Peacock 1958, 30)

Moreover, mechanisms of budget approval in constitutional monarchies were discussed. The writers of the triad, though not the first, were some of the most forceful advocates of an *integrated treatment of taxes and public expenditures*. They emphasized the need to compare
the benefit of public expenditures with the burden imposed by taxation on individuals and to bring them into a balanced proportion. These economic requirements can only be implemented by a rational budget process. This includes legal, political and bureaucratic mechanisms, aspects that in contemporary France were stressed by Paul Leroy-Beaulieu. Emil Sax (1887) provides one of the most extensive critical surveys of the pertinent literature of the nineteenth century. His declared goal is to establish a unified framework for public economics (Sax 1887, 3): in a marginal-utility framework, he conceptualized taxation as a collective process of individual valuation. Musgrave/Peacock (1958, xiv) remarked that, ‘shorn of certain complications and confusing distinctions, the systems of Mazzola and Sax already contained the essentials of the later doctrine.’ Indeed, Sax and Mazzola (1890) provided the essentials in that they combine three ideas: (i) the economic determination of the efficient amount of public goods by the principle of marginal utility, (ii) linking the pattern of taxation to the private utilities generated by the consumption of public goods (benefit principle; see also Pantaleoni 1883), and (iii) the idea of a politico-economic equilibrium reflected in the overall pattern including allocation of public goods as well as distribution of tax burdens. However, like other authors writing before Wicksell (1896), they dealt with the last two of those ideas in a rather vague manner. Wicksell (1896) developed a model-mechanism of political approval of expenditures. He made the point that the reconstruction of the benefit principle aided by marginalist economic theory could provide a superior framework for public expenditures in the context of a ‘democratic’ political mechanism, further developed by Lindahl (1919). While not applicable in a mechanistic way, the reasoning of those Swedish authors is a key to the understanding of public sector in markedly individualist democratic societies. Providing an individualist account of a genuinely public sector, they are explaining democratic processes of public good provision in a society guided by individualist values and private entrepreneurship. This is a major contribution to understanding the basic conditions of modern society, where privacy and marketization enhances the importance of public goods, which are often best provided on the basis of collective decision processes giving a say to private individuals, but in a more or less centralized way.

References


