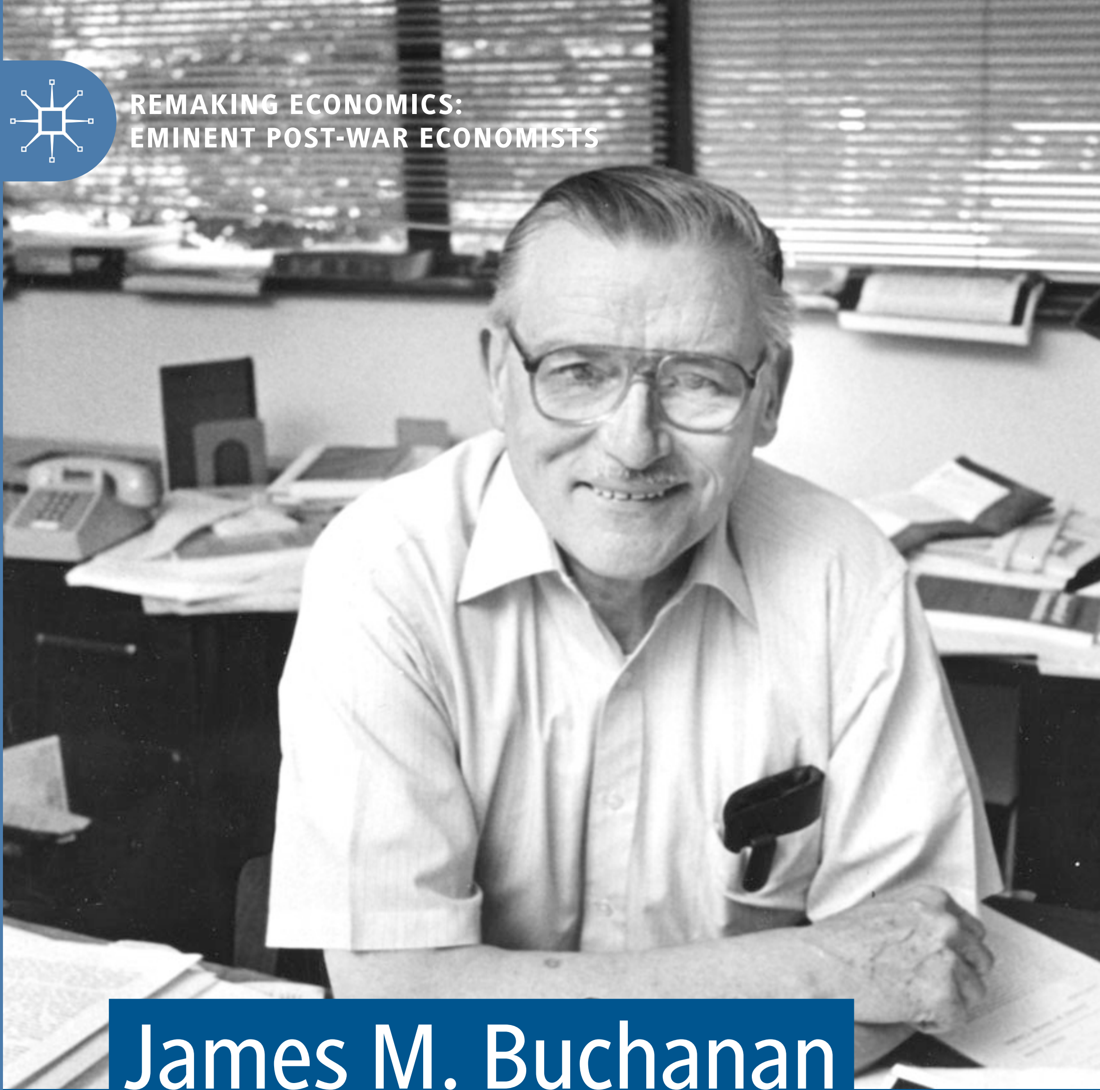
REMAKING ECONOMICS:
EMINENT POST-WAR ECONOMISTS



James M. Buchanan

A Theorist of Political Economy and Social Philosophy

Edited by
Richard E. Wagner

palgrave
macmillan

Remaking Economics: Eminent Post-War Economists

Series Editor
Robert A. Cord
Independent Researcher
London, UK

More information about this series at
http://www.palgrave.com/gp/series/14508

Richard E. Wagner
Editor

James M. Buchanan

A Theorist of Political Economy and Social Philosophy

palgrave
macmillan

Editor
Richard E. Wagner
Department of Economics
George Mason University
Fairfax, VA, USA

Remaking Economics: Eminent Post-War Economists
ISBN 978-3-030-03079-7 ISBN 978-3-030-03080-3 (eBook)
https://doi.org/10.1007/978-3-030-03080-3

Library of Congress Control Number: 2018959880

Cover credit: The Washington Post/Contributor

This Palgrave Macmillan imprint is published by the registered company Springer Nature Switzerland AG
The registered company address is: Gewerbestrasse 11, 6330 Cham, Switzerland

Introduction from the Series Editor

Economics has witnessed a dramatic transformation since the Second World War, both in terms of its depth and range. This series of volumes, entitled *Remaking Economics: Eminent Post-War Economists*, will examine the nature of this transformation through the work of those economists who have been responsible for the changes that have taken place. In some cases, relatively little has been written about these transformative figures in terms of single edited volumes dedicated to examining their work and influence. The series hopes to fill this gap with volumes edited by important economists in their own right, with contributions in each volume not only from some of the most prestigious scholars currently working in economics but also from promising younger economists. By addressing key themes and retaining a focus on originality, each volume will give the reader new and valuable insights. The series will also strengthen economists' knowledge of the history of their subject and hopefully inspire future research.

Robert A. Cord
Managing Editor

Preface

Economic theory underwent a substantial transformation in the aftermath of the Second World War, both in its methods and in substance to which those methods were applied. This volume is the third in a series that examine the ideas of the main figures who led that transformation. This volume is devoted to James M. Buchanan, who received his Ph.D. from the University of Chicago in 1948 and who was awarded the Nobel Memorial Prize in Economics in 1986. The 50 essays in this volume are organized into seven parts, with the titles of those parts reflecting the breadth of Buchanan's body of scholar work. In turn, these parts are dedicated to "subjectivism and the methodology of political economy," "public finance and the theory of the state," "collective action and constitutional political economy," "ethics, social philosophy, and liberal political economy," "economic theory as social theory," "money, debt, and the rule of law," and "Buchanan in relation to other prominent scholars."

While Buchanan is now a historical figure, these essays are not hagiographic in nature. To the contrary, they mostly focus on the potential contemporary relevance of Buchanan's ideas. The achievement of that potential relevance will require the application of a theorist's imagination to topics that Buchanan explored, and the authors of these essays are mostly concerned with exploring how one or another of Buchanan's many lines of inquiry might be carried productively into contemporary scholarly inquiry.

Fairfax, USA Richard E. Wagner

Contents

List of Figures

List of Tables

1

Who Was James M. Buchanan and Why Is He Significant?

Richard E. Wagner

This collection of essays exemplifies both the breadth and the depth of James M. Buchanan's (1919–2013) contributions to economics in the post-war period. He received the Ph.D. in economics from the University of Chicago in 1948, writing a dissertation on fiscal issues within federal systems of government.[1] Buchanan started his career as a public finance economist who wanted to take the theory of public finance in a starkly different direction, as Marianne Johnson (2014) illustrates through archival research.

The public finance that Buchanan encountered, throughout the western world and not just at Chicago, was public finance construed as applied statecraft. Public finance theorists focused on providing recipes for governments to pursue in doing good things for their subjects.

[1]Some book-length treatments of Buchanan's scholarship are David A. Reisman (1990), John Meadowcroft (2011), and Richard E. Wagner (2017).

R. E. Wagner (✉)
George Mason University, Fairfax, VA, USA
e-mail: rwagner@gmu.edu

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_1

The two main exemplars of this orientation toward public finance during Buchanan's student days were Francis Edgeworth (1897) and A. C. Pigou (1928). Edgeworth posed the central problem of public finance as one of how a ruler who wanted to minimize the burdens that his tax extractions imposed on his subjects should impose those extractions. A half-century later, Edgeworth's formulation had morphed into the theory of optimal taxation, which construed the fiscal problem as one of how the state should impose taxes and confer subsidies to maximize some notion of happiness or well-being for a society.

In contrast to Edgeworth's macro-level orientation, Pigou approached public finance from a micro-level orientation. That alternative orientation, however, was employed to the same effect of articulating what fiscal actions a state should employ assuming that it operated with a single-minded devotion to promoting social welfare. What resulted in Pigou (1928) was a menu of taxes and subsidies designed to promote beneficial activities and restrict harmful activities. Within the Edgeworth-Pigou orientation that dominated public finance, the state was treated as a benevolent despot and public finance economists were regarded as instructing that despot in how to promote the public good.

Buchanan began his scholarly career by wanting to transform the theory of public finance in two ways. First, he wanted to place the theory of public finance on an explanatory and not a hortatory footing. Rather than seeking to offer instruction to governments about the merits of different fiscal programs, Buchanan sought to orient public finance toward explanatory questions. Rather than seeking to set forth maxims about how progressive an income tax should be, Buchanan sought to explain how progressive an actual tax system is (Buchanan 1967) as that system is constructed through some political process. Second, Buchanan took substantively and not just formally the commonplace assertion that democracy is a system of "self-governance." Democracy might be a system where people govern themselves, but it could also be a system where an elite few govern the numerous masses (Michels 1962; Mosca 1939).

For instance, within a market system the pattern of production might be directed by corporate managers or it might be directed by consumers. As a formal matter, production is always directed by managers, for it is they who direct corporate affairs. As a substantive matter, sufficiently intense competition among corporations can transform managers into servants of consumers. The economic theory of free and open competition describes how this transformation takes place. In contrast, the economic theory of regulation explains how regulation can transform managers from servants into masters. In similar fashion, democracy might be a system of government that transforms politicians and bureaucrats into servants of the citizenry or it might be one that enables them to act as masters over the citizenry. Which is the case in both markets and politics depends significantly on the openness and the competitiveness of any system of democratic political economy, as Buchanan was to uncover and elaborate throughout his career.

In his rational reconstruction of Buchanan's body of scholarly work, Richard Wagner (2017) described Buchanan at the end of his scholarly career as a giant oak tree whose scholarly oeuvre sprang from a sapling he planted in 1949 with his first scholarly paper, "The Pure Theory of Public Finance," which he published in the *Journal of Political Economy*. In that paper Buchanan explained that a theory of public finance must rest on some form of political theory, for which he saw two options. One option was the prevailing organismic theory that treated the state as some action-taking entity, and with the democratic version of this theory being grounded in benevolent despotism. The other option, the uncovering and exposition of which Buchanan dedicated his scholarly career, was an individualistic theory of democratic political economy.

By this individualistic theory, Buchanan took substantively and not just formally the assertion in the American Declaration of Independence that governments derive their just powers from the consent of the governed. As a purely formal matter, any democratic form with universal franchise must reflect the consent of the governed, for consent *ipso facto* resides in the democratic form. As a substantive matter, however, democracies can entail a good deal of duress and force, like the ability of regulation to transform corporate managers from servants of consumers into masters. In his initial scholarly paper, Buchanan (1949) planted the sapling from which his entire body of scholarly work was to spring.

Buchanan sought to place public finance on an explanatory footing, and to do so in a way that was substantively consonant with the image of democracy as a political system where people truly governed themselves. The first of the several scholarly challenges he faced was how to move theoretically speaking from individual desires to collective actions. Democratic actions entail transformation of a "you" and "me" into a "we." A kidnapper and his victim are a plurality, but they do not comprise a "we." They remain a "you" and a "me." To become a "we" requires consent among the people included within that designation. This recognition led Buchanan to explore the properties of different institutional arrangements for taking collective action, with those various arrangements differing in their ability to reflect consensus among the governed. The theory of public choice thus emerged as one major scholarly branch within Buchanan's oak tree.

Without some framework of rules to constitute a group, a group is but a mob (Munger and Munger 2015). This recognition led Buchanan to emphasize the constitutional framework by which some collection of people govern themselves. The field of inquiry now known as constitutional political economy emerged out of Buchanan's explorations into alternative rules by which groups might be constituted. It should be noted that constitution does not refer only to some national level of government. It refers to any group that must operate through formal procedures. The people who comprise a legislative assembly are likewise just a mob until they acquire organization, rules of procedure, and the like. Constitutional political economy thus emerged as another major branch within Buchanan's scholarly oeuvre.

Starting with his doctoral dissertation, federalism was of especial interest throughout Buchanan's career. Most people live inside the territory occupied by several governments and not just one government. One line of thought presents federalism as a system of government that preserves liberty when compared with a system where people face only a single government. An alternative line of thought leads one to wonder just how it might be beneficial, or to whom it might be beneficial, to face a multitude of governments rather than facing just one government. Throughout his career, Buchanan recurred to federalism as a constitutional arrangement of governments and did so with enough verve and energy to render federalism another major branch of inquiry on his scholarly tree.

A person at an advanced age can rationally invest in planting a forest even if he or she cannot reasonably expect to be around when the trees are harvested. What makes this action rational is the existence of private ownership over the trees. A person who fails to maintain the forest will find the value of the forest falling even if that loss rests with heirs. Most economic action entails acting today with consequences borne tomorrow or the day after tomorrow. Private property is an institutional arrangement that effectively collapses time, meaning that bad decisions today that don't manifest until later will rest on the person who made the decision. Public debt raises similar issues within democracies, and this was a recurring theme throughout Buchanan's career. It is easily understandable why politicians like to spend more than the like to tax. That public debt enables politicians to do this by shifting costs from present to future taxpayers was a recurring theme in Buchanan's work.

Buchanan was an energetic and articulate proponent of the classical liberalism that informed the American constitutional founding. According to the Declaration of Independence, Americans were entitled to life, liberty, and the pursuit of happiness. The concept of entitlement has undergone enormous transformation since the late eighteenth century. As an economic-theoretic proposition, any statement that can be made about the product side of the market entails a complementary statement about the factor side of the market. The Herbert Hoover aphorism about guaranteeing a chicken in every pot was a product-market statement that in turn would require some such factor market statement as a requirement that able-bodied people be conscripted one day per month to work on chicken farms. Most theorists of liberty emphasize liberty, as did Buchanan, but Buchanan also paid considerable attention to personal responsibility. The relationship among liberty, responsibility, and entitlement formed another major branch on Buchanan's scholarly oak tree.

The relationship among liberty, responsibility, and entitlement led Buchanan into exploring a variety of topics in ethics, social philosophy, and political economy. A good deal of this work concerned the several faces of equality. For the moist part these days, equality is understood in simple materialist terms of how much income or wealth different people have. Buchanan's approach to equality was more nuanced than simple measures of income or wealth would allow, for it also entailed considerations regarding how people attained their positions. Buchanan had no objection to people enjoying great commercial success. One of the virtues of liberally organized societies was the scope it gave for people to pursue their dreams in ways that captured their imaginations, and which led many of them into commerce and industry. For Buchanan, equality was more about opportunity than about outcome. In this respect, Buchanan was opposed to unlimited inheritance, while also supporting some measure of progressive taxation. The framework inside of which he did this, however, was one that sought to secure consensus among participants, as against some set of rulers imposing their vision on everyone else. On this as on everything else, Buchanan was a genuine democrat in that he took the ideology of democratic self-governance as substantive and not just formal.

The essays in this volume reflect the breadth and the depth of Buchanan's contributions to political economy and social philosophy. Buchanan started with a simple question: what would be the contours of a theory of public finance that was written to reflect a self-governing republic? In wrestling with his animating question, Buchanan penned a vast body of work that originated in developing an alternative orientation toward public finance, leading to the development of public choice theory during the latter part of the twentieth century.[2] Buchanan's approach to democratic governance led to his recognition of the vital significance of the institutional and constitutional frameworks that governed human interaction.

The essays in this book are presented in seven parts, and with the variety of these parts reflecting the wide-ranging character of Buchanan's thought. While these essays are written by people who admired and learned from Buchanan's work, these are not essays in hagiography.

[2]Between 1999 and 2002, Liberty Fund collected and published Buchanan's work in 20 volumes. While that collection included most though not all of Buchanan's published work to that time, Buchanan continued to publish after 2002, and even had several items published after his death in 2013.

They are essays that explore various questions and topics that interested Buchanan. A good number of these explorations have critical overtones, but most significantly they build upon lines of inquiry to which Buchanan contributed.

The volume starts with five essays that treat subjectivism and the methodology of political economy. The significance of methodology should not be underappreciated. In political economy we refer repeatedly to such objects as "market" and "state." These are objects that no one has seen or can see. To the contrary, these are objects that we construct through our theories. Sure, we can see a place of business or an executive mansion. In doing that we see only a piece of our object of interest. The only way we can see the entire object is through prior theoretical construction, which renders methodology a vital and not an ancillary aspect of scholarship in political economy.

Part II contains eight essays that explore aspects of Buchanan's recognition that an explanatory theory of public finance must connect with some theory of the state. There is a rhyme and a reason to the actions that political entities undertake, and it is the understanding and the explaining of those actions that is the object of the explanatory theory of public finance that represented the sapling Buchanan planted in 1949.

The ten essays in the third section recognize that collectives cannot act as such, because action is a property of the individuals who constitute a collectivity. For collective action to occur, the relevant collection of persons must be constituted through some set of rules that specify and limit the types of actions that different participants can undertake. Five hundred people might comprise a parliamentary assembly, but that assembly cannot act as if it were a person. It can act only through institutionally-governed interaction among members of the assembly.

The eight essays in the fourth section treat ethics and social philosophy in relation to a liberal scheme of political economy. Buchanan was clearly liberal in his normative orientation. This orientation might be thought to entail recognition that social relations should be among equals and not among masters and servants. This dichotomy, however, is not a simple one to maintain. The leader-follower relationship is alive in society, which means in turn that authority exists within societies.

Recognition of authority raises some vexing questions that attracted Buchanan and also the authors in this section.

Buchanan was at his core an economic theorist. But there are different forms of economic theory and so different ways of being an economic theorist. Perhaps the pithiest piece in Buchanan's oeuvre was a one-pager titled "Order Defined in the Process of its Emergence." This is subjectivist to the core. The eight essays in the fifth section contrast economics as social theory with economics as a science of rational action. Perhaps nowhere is Buchanan's subjectivist orientation toward economic theory more evident than in *Cost and Choice*, published in 1969.

The five essays in the sixth section reflect Buchanan's interests in money and debt in relation to liberal presumptions in favor of a rule of law. Buchanan's concern with money and debt has little connection with macroeconomic theory and policy. Buchanan did not view money and debt as instruments for macroeconomic management. To the contrary, Buchanan viewed money and debt as part of the constitutional background of a liberal political order. This orientation toward money and debt hearkens back to the American Constitution where the monetary power of the federal government was located as a facet of maintaining the system of weights and measures that are vital to a system grounded in a genuine rule of law.

The five essays in the seventh and final section explore Buchanan's thought in relation to some other significant figures within Buchanan's extended present (Boulding 1971). To be sure, several of the preceding essays also examine historical figures, but those examinations are woven into narratives that are not focused directly on those figures. Two of these five essays examine the Italian influence on Buchanan, and two examine the relationship between Buchanan's work and that of Vincent Ostrom, whose own body of work mirrored that of Buchanan in many ways. The final essay probes the place of Frank Knight within Buchanan's scholarly orientation.

The authors of these essays are a mixture of established and beginning scholars. Most of the established scholars knew Buchanan, some well, during his lifetime. Most of the beginning scholars knew Buchanan only through his writing, though some of them had brief contact with him late in his life. In any case, my effort to assemble this collection of old and new thinkers aims to convey both a sense of the significance Buchanan's work provided for scholars during the primes of their scholarly careers and of the inspiration that his work provides to young scholars now seeking to make their way in the scholarly world.

References

Boulding, K. E. (1971). After Samuelson, Who Needs Adam Smith? *History of Political Economy, 3,* 225–237.
Buchanan, J. M. (1949). The Pure Theory of Government Finance: A Suggested Approach. *Journal of Political Economy, 57,* 496–505.
Buchanan, J. M. (1967). *Public Finance in Democratic Process*. Chapel Hill: University of North Carolina Press.
Buchanan, J. M. (1969). *Cost and Choice*. Chicago: Markham.
Edgeworth, F. A. (1897). The Pure Theory of Taxation. *Economic Journal, 7,* 100–122.
Johnson, M. (2014). James M. Buchanan, Chicago, and Post War Public Finance. *Journal of the History of Economic Thought, 28,* 57–79.
Meadowcroft, J. (2011). *James M. Buchanan*. London: Continuum.
Michels, R. (1962). *Political Parties: A Sociological Study of the Oligarchical Tendencies of Modern Democracy*. New York: Collier Books.
Mosca, G. (1939). *The Ruling Class*. New York: McGraw-Hill.
Munger, M., & Munger, K. M. (2015). *Choosing in Groups*. Cambridge: Cambridge University Press.
Pigou, A. C. (1928). *A Study in Public Finance*. London: Macmillan.
Reisman, D. A. (1990). *The Political Economy of James Buchanan*. Basingstoke: Macmillan.
Wagner, R. E. (2017). *James M. Buchanan and Liberal Political Economy: A Rational Reconstruction*. Lanham, MD: Lexington Books.

Part I

Subjectivism and the Methodology of Political Economy

2

What Should Economists Do Now?

Robert Sugden

'What should economists do?' is the title of the 1962 presidential address given by James Buchanan to the Southern Economic Association (Buchanan 1964). It is a combative critique of what was then the prevailing understanding of economics—that economics is the science of constrained maximization, or of rational choice. Buchanan defends an alternative view of the discipline in which individual freedom and voluntary exchange are central concepts. In Buchanan's framework, the concept of preference is redundant: there is no useful sense in which individuals have preferences, independently of their actual choices. Conventional welfare economics, in which the normative criterion is the satisfaction of preferences, is therefore fundamentally misguided. My essay revisits Buchanan's arguments in the light of

Some of the ideas presented in this essay were developed in discussions with Malte Dold, Alan Hamlin, Shaun Hargreaves Heap, and Christian Schubert. My work is part of a project that has received funding from the European Research Council (ERC) under the European Union's Horizon 2020 research and innovation programme, grant agreement No. 670103.

R. Sugden (✉)
School of Economics, University of East Anglia, Norwich, UK
e-mail: r.sugden@uea.ac.uk

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_2

subsequent developments in behavioural economics, particularly the normative analysis that most behavioural economists have favoured and my own attempts to develop an alternative approach.

My work as an economist has been deeply influenced by Buchanan ever since I met him in 1977. I was then a very junior summer visitor to the Center for Study of Public Choice at Virginia Polytechnic Institute. Buchanan had invited me after reading and liking a paper I had written, criticizing Amartya Sen's formalization of the concept of individual liberty.[1] During my stay at the Public Choice Center, I came to see how my critique of Sen's theoretical framework fitted into Buchanan's *contractarian* conception of normative economics. Ever since that visit, I have thought of my own work in normative and philosophical economics as contractarian in the sense that Buchanan expresses in 'What should economists do?'

Since the early 1980s, I have also seen myself as working in what has come to be called 'behavioural economics'. The distinguishing feature of behavioural economics is that, in explaining economic behaviour, it draws on ideas and research methods from cognitive psychology. I have never seen any tension between these two aspects of my work. To the contrary, I have come to see David Hume's *Treatise of Human Nature* (1739–1740/1978), which I first read on Buchanan's recommendation, not only as one of the greatest works in the liberal tradition of social thought, but also as a founding contribution to cognitive psychology.[2] However, I have been increasingly disturbed by the tendency for behavioural economists to present their empirical findings as supporting, or even as necessitating, a paternalistic form of normative economics. I will say more about this tendency later.

There can be no doubt that behavioural research sets a serious challenge for neoclassical welfare economics. In neoclassical welfare economics, the normative criterion is the satisfaction of individuals' preferences. Each individual's preferences are assumed to be reasonably stable over time and to be independent of 'irrelevant' contextual

[1]The ideas in that paper appear in a more fully worked-out form in Sugden (1985).

[2]I defend this view of Hume's *Treatise* in Sugden (2006).

features of the decision problems in which they are revealed. By virtue of these assumed properties, preferences are taken to be indicators of the individual's settled judgements about the value to her of alternative consumption options, or about the contributions those options would make to her well-being. But a large body of evidence shows that individuals' economic decisions often vary according to contextual cues that have no plausible relevance for welfare, but whose influence on decision-making can be explained by well-established psychological principles.

This evidence makes it difficult to defend (or even to use) preference-satisfaction as a normative criterion. But does it force economics to be paternalistic? I have spent much of the last fifteen years developing a form of normative economics that is compatible with the findings of behavioural economics, but is contractarian rather than paternalistic. Crucially, preference-satisfaction is not used as a normative criterion; instead, the criterion is the availability of opportunities for voluntary transactions.[3] I have claimed that my approach is broadly in continuity with Buchanan's. In this paper, I try to flesh out this claim by going back to Buchanan's texts.

Buchanan's Vision of Economic Order

In 'What should economists do?', Buchanan's chosen adversary is Lionel Robbins. Buchanan takes issue with Robbins's famous definition of the 'economic problem'—the central subject-matter of economics—as the allocation of scarce means among alternative or competing ends. Buchanan points out that this definition says nothing about *whose* ends are relevant for economics. The implication is that economics is about constrained maximization or rational choice, considered in general. Buchanan's response is that concern with allocation problems per se 'is not a legitimate activity for practitioners of economics, as I want to

[3] This work is brought together in Sugden (2018).

define the discipline'; it is 'applied mathematics' or 'managerial science', not economics (1964, pp. 32–33).

As I read him, Buchanan is not saying that models of optimization should have no place in economics. On any plausible account of what we economists should do, our job description includes trying to understand the workings of resource-allocation systems in general, and of the price system in particular. Buchanan has certainly seen his own work in this way. He has described how, as a graduate student at the University of Chicago, he was 'converted into strong advocacy of the market' by Frank Knight's price theory lectures, and how his work at the University of Virginia between 1957 and 1968 focused on promoting 'understanding of the price system' (1986a, pp. 3, 10). There are many areas of economic life where the immediate problems faced by individuals can usefully be modelled as the maximization of given objective functions subject to known constraints. It would be unreasonable to deny that neoclassical models of rational choice can throw light on significant features of human behaviour in markets.

Buchanan seems to acknowledge this in his discussion of the model of perfect competition. He says that this model has a 'basic flaw'—its 'conversion of individual choice behaviour from a social-institutional context to a physical-computational one' (1964, p. 36). I think that what Buchanan has in mind is that, in the model of perfect competition, there is no direct interaction between economic agents. Each individual's decision problem can be represented as that of maximizing a utility function subject to constraints imposed by technology and by market prices. The decision problems of different individuals are connected only through prices which, although endogenous to the model as a whole, are taken as given by each individual. As a modelling device, this representation enormously simplifies the analysis of a complex network of economic interactions. Buchanan is perhaps recognizing the legitimacy of this kind of modelling when he says that what is wrong with the model of perfect competition 'is not its lack of correspondence with observed reality; no model of predictive value exhibits this' (1964, p. 36). His objection is that the model provides a misleading framework for thinking about how markets work and what they do. It encourages the thought that a competitive market *just is* a solution to a set of equations—that we can understand the market without considering the actual process by which equilibrium is reached.[4] For Buchanan (as for Friedrich Hayek [1948], who makes a similar argument as part of his analysis of the limitations of central planning), that process is fundamental:

> A market is not competitive by assumption or construction. … [An equilibrium] solution, if there is one, *emerges* as a result of a whole network of evolving exchanges, bargains, trade, side payments, agreements, contracts which finally at some point, ceases to renew itself. At each stage in this evolution towards solution, there are *gains* to be made, there are exchanges possible, and this being true, the direction of movement is modified. (1964, pp. 36–37)

This is a picture of the market as a process in which individuals are free to engage in mutually beneficial interactions. Competitive equilibrium is understood as a state in which all opportunities for such interactions have been exhausted.

Buchanan's fundamental opposition to Robbins is not about the kinds of models that we economists should or should not use. In this sense, it is not really about what we should *do*. It is about how we should understand what we are doing. What, ultimately, is economics *about*?

Buchanan's answer is that economics is about exchange rather than choice. The 'idea that should be central to our discipline' is that of exchange as 'a unique sort of relationship, that which involves the cooperative association of individuals, one with another, even when individual interests are different' (1964, p. 35). Or, as he puts it in another paper, economics provides 'an understanding of the social process through which a society of free persons can be organized without overt conflict while at the same time using resources with tolerable efficiency' (1986a, p. 15). Notice how the second quotation suggests an alternative

[4]A similar thought is implicit in David Gauthier's (1986, pp. 83–112) account of the market as a 'morally free zone'. Gauthier's contractarian theory treats a competitive market as morally equivalent to an archipelago of mutually isolated one-person island economies: 'Each person is thus a Robinson Crusoe, even in the market' (p. 91).

definition of the 'economic problem', as a problem of institutional or constitutional choice for the members of a free society.

There is a delicate balance here between normative and descriptive argument. Buchanan has a conception of an economy based on relations of voluntary cooperation between individuals who recognize both the separateness of their interests and the existence of opportunities for them to realise mutual benefit. He clearly believes that this is a desirable form of economic order, but (as I understand him) he sees the role of economics as to help us understand how, as a matter of empirical fact, such a system works. For my part, I would not go so far as to say that this is how *all* economists ought to understand their subject matter, but it is a large part of how *I* understand it.

Buchanan *Versus* Robbins

If we accept Buchanan's idea that economics is about exchange, how exactly does Robbins's definition lead us astray?

Most obviously, economics goes astray if it treats the combined outcome of the decisions made in a society of interacting individuals as if it were the solution to a single maximization problem. This thought is the core of Buchanan's (1954) early and under-appreciated critique of Kenneth Arrow's Impossibility Theorem. Arrow's theorem is about the construction of a 'social' ranking of possible outcomes for society, using data about individuals' preferences over those outcomes. It is crucial to the impossibility result that the social ranking of outcomes is required to have 'collective rationality' properties that are formally similar to those that neoclassical economics attributes to individuals' preferences. Buchanan argues that there is no good justification for that requirement:

> Social rationality [for Arrow] appears to imply that the choice-making process produce results which are indicated to be 'rational' by the ordering relation, that is, the social welfare function. But why should this sort of rationality be expected? … Rationality or irrationality of the social group implies the imputation to the group of an organic existence apart from that of its individual components. (1954, p. 92)

My critique of Sen's analysis of individual liberty—the critique that won Buchanan's approval back in 1977—followed a similar logic: Sen was trying to formulate the idea that society should respect individual liberty, using a conceptual framework that included requirements of collective rationality.

To require that 'social choice' is collectively rational is to treat the combined outcome of many individual choices as if it were the choice of a single agent. As Buchanan has often said (usually citing Knut Wicksell as the originator of this critique), economists characteristically address their recommendations to some imagined single agent who takes decisions on behalf of society—the 'social planner', the 'policy-maker', the 'government'. Since the recommendations themselves are supposed to maximize social welfare, the agent to whom they are addressed must be assumed to have both the desire and the power to do whatever is necessary to maximize welfare. In other words, the imagined addressee is a benevolent despot (Buchanan 1986a, p. 23). If one's conception of society is of voluntary interaction between free individuals, the idea that it ought to work as if were under the control of a benevolent despot is deeply anomalous.

To use the model of the benevolent despot when making a normative appraisal of the market is to think of the market as a mechanism for solving an 'economic problem' in Robbins's sense—as the means by which some independently specified social objective might be achieved. For Buchanan, this way of thinking is fundamentally mistaken:

> The 'market' or market organization is not a *means* toward the accomplishment of anything. It is, instead, the institutional embodiment of the voluntary exchange processes that are entered into by individuals in their several capacities. That is all there is to it. (1964, p. 38)

But there is more to Buchanan's objection to Robbins's definition of economics than a rejection of the fiction of the social planner. The most basic normative principle in neoclassical welfare economics is the Pareto principle—that if, for some pair of social states x and y, every member of society weakly prefers x to y and at least one member strictly prefers x, then x is better for society than y. It is not self-evident that 'better for society' should be read as 'better, as judged by a social planner'. Might it not instead be read as 'better, as agreed by all members of society'? On this reading, one might think, the Pareto principle uses the idea that *individuals* have rational preferences without presupposing anything about *social* rationality. Extending this idea, one might think of the concept of individual preference as one of the basic building blocks of any liberal form of normative economics. This thought becomes particularly plausible if, moving beyond the kind of mathematics used by Robbins, one considers the role of (non-cooperative) game theory in present-day economists' models of human interaction. Game theory is based on maximizing principles of *individual* rationality that are stronger than the ordinal principles invoked by Robbins: the concept of 'payoff' used in game theory presupposes that individuals' preferences satisfy the axioms of expected utility theory. (Thus, utility is assumed to be cardinal, but there is no assumption of interpersonal comparability.) But the 'solution concepts' used in game theory are intended to represent the players' common knowledge of each other's individual rationality; there is no assumption that the solution to a game is *collectively* rational in Arrow's sense. Think of the Prisoner's Dilemma. Defection by both players is normally understood to be the uniquely correct solution to this game—the only combination of strategies that is consistent with common knowledge of rationality—even though it is clearly suboptimal from a social point of view.

Nevertheless, 'What should economists do?' is written as an objection to the maximizing perspective *in general*, and not merely to the idea of maximizing a social welfare function. Buchanan is more explicit about this in a later work, in which he argues that economics took a wrong turn after Alfred Marshall. As in the 1964 paper, that wrong turn is characterized as the search for 'maximizing or optimizing solutions within the constraints of specific wants, resources and technology', which Buchanan now calls the 'mathematical perspective'. Explaining what is wrong with this perspective, he says:

> I suggest that the mathematical perspective takes hold once we so much as define persons as utility or preference functions and implicitly presume that these functions exist independently of the processes

> within which persons make actual choices… By postulating such functions independently, and by imposing the resource constraints, it then becomes possible to define, at least conceptually, the 'efficient' allocation of resources, quite apart from any voluntary process of agreement among trading parties. This formalization of the efficiency norm then allows the market to be conceptualized as merely a means, a mechanism, one among others, to be tested or evaluated in terms of its efficacy in attaining desired results in the utilization of resources. (1986a, pp. 16–17)

What Buchanan is objecting to here is an assumption that he takes to be implicit in most forms of neoclassical economics—the assumption that an individual's preferences can be identified prior to decision problems in which they can be expected to be revealed.

An economist who takes the 'mathematical perspective' might question whether economics *does* assume this. She might point out that the economic concept of preference is understood in relation to choice. According to one common account of the relationship between preference and choice, a preference for *x* over *y* is a prevailing disposition to choose *x* rather than *y*. Alternatively, according to a strict revealed-reference account, to say that a person prefers *x* to *y* is to say that she would not choose *y* from an opportunity set that contained *x*. On either account, the economist's claim to knowledge about a person's preferences at any given time is based on evidence about what that person has chosen in the past, or on other information that is relevant for predicting how she will choose in the future. Nevertheless, Buchanan's claim is correct. Whenever economists use propositions about preference to explain or predict individuals' choices, they are endorsing a conceptual distinction between preference and choice—the distinction between what justifies one in making a prediction and what makes that prediction true or false.

If I am reading Buchanan rightly, he does not deny the potential usefulness of preference-based models as aids to predicting individual behaviour. But when what is at issue is the normative evaluation of institutions, he sees the separation of preference and choice as inconsistent with his favoured conception of individual liberty. This alleged inconsistency has two sources, which I will consider in turn.

Liberty as Individual Sovereignty

When Buchanan (1986a, b) writes about his own intellectual development, he describes his political position before going to the University of Chicago in 1945 as 'libertarian socialist' or 'populist'. Explaining the libertarian component of this position, he says:

> The person who shares this perspective places a primary value on *liberty*, as such. He personally disputes, rejects, resents, opposes attempts by others to exercise control or power over his own choice behaviour. He does not like harness. There is an exhilaration in simply being free. (1986a, p. 4)

This attitude to liberty, he says, is encapsulated in the words 'Don't tread on me' on the rattlesnake banner flown in the American War of Independence (1986a, p. 5). Socialism and populism enter the picture through the young Buchanan's identification of those who might exercise power over him as 'robber barons' (people who, he says, seemed very real to him in 1945) and the 'Eastern establishment' (with which even the later Buchanan was never quite able to reconcile himself). The point of the story is that Buchanan's socialism was short-lived, but his commitment to libertarianism continued throughout his life.

'Don't tread on me' expresses a first-person conception of liberty. Liberty is something that I can *demand*. I do not need to give reasons why my having liberty is fitting for me as a human being, or why this is good for society as a whole, or even why it is good for me. No one has the standing to ask me for reasons. It is enough that I want liberty and am entitled to have it. In more philosophical vein, Buchanan describes this position as 'normative individualism':

> The justificatory foundation for a liberal social order lies… in the normative premise that individuals are the ultimate *sovereigns* in matters of social organization, that individuals are the beings who are entitled to choose the organizational-institutional structures under which they will live… If individuals are considered the ultimate sovereigns, it follows directly that they are the *addressees* of all proposals and arguments concerning constitutional-institutional issues'. (1991, p. 288)

The sentence about addressees expresses what I take to be the fundamental principle of Buchanan's contractarianism—that normative analysis is addressed to individual citizens as potential parties to mutually beneficial agreements. The relationship of citizen to government is not that of passive subject to benevolent ruler; it is that of principal to agent.

If one thinks in terms of a principal–agent relationship, it is easy to understand why an individual citizen might be reluctant to allow public decisions to be justified in terms of claims about what he and his fellow-citizens prefer. For a citizen to allow this would be for him to transfer normative authority from himself as sovereign chooser to someone else (let us call her the 'social planner') who acts as the judge of what he prefers. It opens up the possibility that the planner might use her own judgements about the citizen's true preferences to overrule his actual choices. Buchanan characterizes the standard approach to normative economics as a construction in which there is an 'ontological assumption that there is "something"—whether called a utility function or not—that exists and can, at least conceptually, be objectified and separated from individual choice'. If this assumption is made:

> [The] relationship between an individual's choice behaviour and his or her utility function becomes a matter of fact. That is, there arises a factual question open to investigation concerning the correspondence between the choices made and the change in the individual's position as measured on the independent scalar… [And then it makes sense] to raise the question as to whether the individual or some third party or parties can most reliably identify the choices that are defined as 'best' in terms of the given utility function. (1991, p. 283)

Buchanan is committed to a different assumption: 'My own ontological presuppositions do not allow any conceptual separation or distinction between an individual's choice behaviour and his or her utility function… All there is are individual choices' (1991, p. 286).

Thus, for Buchanan, an individual's liberty should not be understood in terms of his getting what he prefers, with 'preferring' defined independently of 'getting'. His liberty should be understood in terms of *what he is free to choose*. This is a property of his choice set—the set of options between which he is able to choose. Crucially, an individual's choice set is defined without reference to his preferences. This line of thought leads Buchanan to the conclusion that it is in each person's interest that his choice set is 'as open as is naturally possible' (1979, pp. 258–259).

Taking the first-person view of liberty, you can demand that you are not prevented from choosing a certain option, say *x*, without having to give any reason for that demand, other than that *x* is something that you *might* want to choose. You can say that without actually having any current desire to have *x*. Thus, your demand cannot be countered by a social planner who judges, perhaps on the best possible evidence of your previous behaviour, that you have no current preference for *x* and are unlikely to have such a preference in the future. Notice that, in making this demand, you are asserting your sovereignty *now* to act on behalf of your future self, and the principle on which you are acting is that of trying to ensure that, in the future, you will be able to get what you *then* want—even if you do not yet know what that will be. You now want it to be the case that if, in the future, you want *x*, you will be able get *x*.[5] That seems to me to be an uncomplicated application of the principle of 'Don't tread on me'.

In some of his writing, however, Buchanan seems to want to connect the demand for freedom of choice to philosophically deeper notions of ontology and to morally deeper ideas about what it means to be human. I believe that these moves are not necessary for Buchanan's contractarian approach, and are liable to undermine it. Let me explain.

Liberty as Autonomy

In 'What should economists do', Buchanan objects to the conception of human agency that he sees as built into the theory of rational choice:

[5]This is a conception of individual agency as a *continuing locus of responsibility*. I say more about this in Sugden (2004).

> In one sense, the theory of choice presents a paradox. If the utility function of the choosing agent is fully defined in advance, choice becomes purely mechanical. No "decision", as such, is required; there is no weighing of alternatives. On the other hand, if the utility function is not wholly defined, choice becomes real, and decisions become unpredictable mental events. (1964, p. 34)

The idea seems to be that, because choice theory represents decisions as predictable (given data about preferences), it is modelling human agents as mere mechanisms, lacking in autonomy. The decisions of an autonomous agent, it is implied, would necessarily be unpredictable.

These thoughts are developed much further in Buchanan's 1979 paper 'Natural and artifactual man'. This paper has a more Austrian flavour than most of Buchanan's other work; he says that it was influenced by the work of George Shackle, which he had been reading at the time (Buchanan 1979, p. 251). Buchanan wants to contrast 'natural man', understood as a being whose behaviour can be predicted and explained naturalistically, with 'artifactual man', understood as an actor whose decisions are autonomous and thereby unpredictable, and who views his future self as his own construction (1979, pp. 246–248).

As in his 1964 paper, Buchanan argues that rational choice theory represents individuals as non-autonomous:

> The rational ideal eliminates choice, as Shackle emphasizes. Choice requires the presence of uncertainty for its very meaning. But choice also implies a moral responsibility for action. To rationalize or to explain choices in terms of either genetic endowment or social environment removes the elements of choice and responsibility. (1979, p. 257)

Notice that Buchanan is classifying rational choice theory together with other branches of natural and social science that claim to give empirical explanations of human behaviour. Such explanations, he claims, treat human beings as if *Homo sapiens* were just a 'natural animal', one animal species among many. But it is intrinsic to the nature of human beings that their behaviour cannot be fully predicted; and unpredictability is an essential part of moral responsibility:

> If individual man is to be free, he is to be held accountable, he is to be deemed responsible for his actions. But at the same time he is allowed to take credit for his achievement. Who can claim credit for results that could have been predicted from nature? From a knowledge of his genetic endowment or his social environment, or both? But once man is conceived in the image of an artifact, who constructs himself through his own choices, he sheds the animalistically determined path of existence laid out for him by the orthodox economists' model. (1979, pp. 257–258)

On this view, the whole idea of a science of human behaviour is morally objectionable.

The aspect of autonomy that is central to Buchanan's 1979 paper is the possibility of deliberately choosing the kind of person that you will become. He gives the example of spending on education, characterized as 'investing in becoming'—investing in creating 'the person that we want to be rather than the one we think we might be if the spending is not made in this way'. Musical appreciation is another example: through study and practice, you can invest in a way that will shift your preferences towards being appreciative of certain kinds of music (1979, pp. 248–249). Buchanan's approval of self-creation extends to forms of 'investment in becoming' by which you voluntarily subject yourself to constraints that you cannot then reverse, or authorize other people to coerce your future self against acting on its desires (p. 253).[6]

As long as trying to influence your future preferences is understood as just one of the many ways in which you might use freedom of choice, there is perhaps no tension between this line of thought and 'Don't tread on me'. But Buchanan takes a further step: he presents his picture of artifactual man as *the reason why liberty is valuable*:

> [Man wants liberty] precisely because he does not know what man he will want to become in time. Let us remove once and for all the instrumental

[6]Approval of unilaterally self-imposed constraints is a recurring theme in Buchanan's work, aligned with his advocacy of constitutional rules to restrict day-to-day political decision-making. His analysis of the 'Samaritan's dilemma', for which the solution is a self-imposed rule against generosity to would-be 'parasites', is an example (Buchanan 1975a).

> defense of liberty, the only one that can possibly be derived directly from orthodox economic analysis. Man does not want liberty in order to maximize his utility, or that of the society of which he is a part. *He wants liberty to become the man he wants to become*. (1979, p. 259; italics in original)

And he tells us that we *ought* to want liberty for this reason: 'Individually, persons must recapture an ability to imagine themselves as "better" persons than they are' (1979, p. 254).

I think these are wrong moves for a contractarian who values liberty. A contractarian justification of liberty needs to show each and every individual that liberty is in his or her own interests, as he or she understands them. But if the value of liberty really is tied to the unpredictability of human choice, a person who believes that his own decisions are predictable will not be able to see why his own liberty is valuable to him. And if the true reason for wanting liberty is to act as an 'artifactual man', a person who does not think of his future self as his own artifact is left without a reason for wanting to be free. Remember that the addressees of a contractarian argument are individual citizens, viewed as sovereigns. Ultimately, the only reasons that matter are the reasons that those citizens actually accept. The greater the degree to which an argument depends on specific ontological claims or on specific ethical commitments, the less power that argument has. Viewed in this perspective, 'Don't tread on me' looks a more promising justification for liberty than self-creation.

Why might someone want liberty without subscribing either to the ontology or to the self-creation ethic of Buchanan's 1979 paper? With respect to the ontology, my answer is that predictability *is* compatible with autonomy. Autonomy, as I understand it, is a sense of volition. It is a person's subjective perception of herself as the cause of her own actions—her perception that she has the power to act in ways that in fact she chooses not to do. It is possible to have this sense about highly predictable decisions. Take a personal example. Over the last five years, I have faced hundreds of decision problems in which my choice set contained both coffee and Coke. In that time, I have chosen coffee hundreds of times and (I am fairly sure) never chosen Coke. This pattern of behaviour is consistent with the hypothesis that, with respect to those two drinks, I prefer coffee to Coke and make rational choices between them. The proximate explanation for this behaviour is that I like the taste of coffee and do not particularly like that of Coke (which I can remember from drinking it long ago). These tastes may well have physiological causes. But whatever the explanation, my choices between the two drinks feel autonomous to me. On any occasion on which I face this choice, I have no sense of compulsion to choose coffee: my internal sense is that I *could* choose Coke, I just don't want to. And because I can imagine wanting to choose Coke in future situations, I can want Coke to continue to be an option in my choice set. I can say to a social planner: Just because I haven't chosen Coke for five years, don't presume that I will never want to choose it in the future. Let me choose for myself. Don't tread on me.

What about the ethic of self-creation? I can accept that *some* people make conscious efforts to shape their future preferences, but liberty also matters to those who don't. As far as I can recall, I never thought of my own educational choices as attempts to change my preferences. When I went to university at the age of eighteen, I had a strong sense of what Buchanan describes as exhilaration in being free—free from the oversight of parents and schoolteachers, free to try out new experiences. I looked forward to enjoying new intellectual challenges and having new opportunities to exercise my abilities. And, like most of my contemporaries, I expected that getting a university degree would be a stepping stone to some fulfilling career from which I would earn a comfortable income. Although I had only hazy ideas about what exactly these opportunities would be, I was excited about what might lie ahead. All this gave me good enough reasons to value my liberty. If someone had said to me that I ought also to have been trying to improve my preferences, I could reasonably have replied that it was up to me to decide whether or not my preferences were in need of improvement.[7] Don't tread on me.

---

[7]In fairness to Buchanan's adversary, I should add that I was fortunate in being able to go one of the 'new universities' established in Britain in the 1960s on the recommendation of a committee chaired by the then Lord Robbins. My education there had all the properties that tend to foster self-creation.

Treating unpredictability and self-creation as *the* reasons for valuing liberty reduces the constituency to which contractarian arguments for liberty can be addressed. It can also provide would-be social planners with arguments for restricting citizens' freedom of choice. From the idea that autonomy necessarily involves unpredictability, it is a short step to the idea that people whose choice behaviour is stable over time are not autonomous agents, but merely natural animals for whom liberty serves no purpose. From the idea that liberty has value precisely because it allows individuals to engage in self-creation, it is a short step to the idea that liberty has no value to individuals who make no effort to improve themselves. Dual-self models of self-constraint, in which a person's 'planning' self imposes constraints on his 'impulsive' self—the model that is implicit in the story of Odysseus and the Sirens—encourage would-be social planners to suppose that their fellow-citizens have latent desires for restrictions to be imposed on their choice sets. I do not want to claim that Buchanan's account of the connection between liberty, autonomy and self-creation directly justifies any constraints on choice other than those that each individual chooses to impose on herself. Still less do I want to claim that Buchanan favoured such constraints. But I do maintain that there is a tension between Buchanan's treatment of autonomy and his contractarianism.

It seems to me that the best way to resolve this tension is to distinguish between contractarian arguments and personal value judgements about a good society. When you write as a contractarian, your arguments are addressed to your fellow-citizens and are intended to engage with *their* judgements about *their* interests. But taking a contractarian perspective in your work as a normative economist does not debar you from expressing your own ideas about a good society—provided you acknowledge the distinction between the two activities. *In Buchanan's picture of a good society*, each person wants liberty to become the person he or she wants to become. And so, *in that imagined society*, each person wants its institutions to be structured so that each person has a rich range of opportunities for self-creation, including opportunities for Odysseus-like self-constraint. But unless actual people, here and now, want these things, all this just is a picture of an ideal world. There is a sense in which painting such pictures is what Buchanan

(1975b, pp. 1–2) has called 'play[ing] at being God'. That is not an intellectual crime, but it is not contractarianism.

What Should Economists Do with the Findings of Behavioural Science?

Buchanan's arguments about what economists should do were written in a period when almost all economists were content to assume that individuals' decisions revealed well-behaved context-independent preferences. In denying the usefulness of the concept of preference, Buchanan was opposing a central feature of received economic theory. His critique of the way the concept of preference was used in normative economics was taken up by only a tiny minority of economists (of whom I was one). But since then, there has been a huge change in economists' understanding of decision-making behaviour. How far individuals' choices reveal well-articulated preferences is one of the central topics of behavioural economics, and behavioural economics is at least well on the way to becoming mainstream.

One of the fundamental findings (or rediscoveries[8]) of behavioural economics is that individuals' choices are often *context-dependent*. That is, an individual's choices between what economics has normally understood as 'given' options vary according to features of the decision environment that seem to have little relevance to the individual's interests or welfare, but whose effects are psychologically explicable. To give just a few examples: choices from given sets of options are systematically influenced by which option is described as the status quo and by manipulations that direct the chooser's attention to particular features of those options; preferences between given pairs of options differ according to whether they are elicited directly in choices or inferred from monetary evaluations elicited for the two options separately;

[8]Many of these effects were known, to psychologists and to some economists, long before the explosion of interest in behavioural economics. (For example, Wicksteed's [1910] exposition of neoclassical economics includes psychologically acute discussions of many now-familiar 'anomalies'.) What is new is the widespread recognition of the economic significance of these effects.

preferences between 'smaller sooner' and 'larger later' payoffs reverse as the 'sooner' date approaches.[9]

On the most natural interpretation, this body of evidence confirms Buchanan's criticism of the 'mathematical perspective' of neoclassical economics—the criticism that it illegitimately assumes that preferences exist independently of the processes within which persons make actual choices. Ironically, however, the confirmation takes a form that Buchanan might not have welcomed. Recall that one of Buchanan's objections to the conventional theory of rational choice is that it treats human decision-making as predictable by the methods of empirical science; he thinks that this approach fails to recognize human choice as autonomous. Behavioural economics is much *more* empirical than rational choice theory. An advocate of rational-choice theory might claim that the reason why that theory can be expected to predict successfully is that human decision-makers really are autonomous rational agents: all that is being predicted about them is that their reasoning is consistent with the principles that define what is meant by 'rationality'. But if behavioural economics is grounded on empirical psychology (as its practitioners normally claim it is), it must use what Buchanan calls a model of 'natural man'. Given Buchanan's distrust of genetic and social-environmental explanations of choice behaviour, it is reasonable to guess that he would not have felt much sympathy for the programme of behavioural economics.[10]

For my purposes in this essay, what is particularly interesting about the way that behavioural economics has developed is its confirmation of one of Buchanan's criticisms of what his fellow-economists do. Recall his argument that if utility can be 'objectified and separated from individual choice', it becomes meaningful to ask 'whether the individual or some third party or parties can most reliably identify the choices that are defined as "best" in terms of the given utility function'

[9]There is far too much evidence about these and other 'anomalies' for specific citations to be useful. A representative sample of this evidence is collected in Kahneman and Tversky (2000).

[10]As far as I can recall, issues arising from behavioural economics did not feature in any of the many conferences at which Buchanan and I were co-participants. In his later years, I would have been reluctant to initiate discussion of topics on which I expected the two of us to have fundamental disagreements.

(1991, p. 283). To an economist who is confident in the predictive power of rational-choice theory, Buchanan's concern might seem misplaced. If an individual's utility function really can be constructed from observations of her previous choies, and if that function really can predict her future choices, why should she worried if the identification of what is best for her is made by a 'third party' who knows what that function is? Of course, Buchanan's starting point was scepticism about the predictive power of rational-choice theory, given the autonomy of human decision-makers. But behavioural economics gives further reason for that scepticism, and therefore further reason for concern about allowing social planners to judge what is best for an individual.

Among behavioural economists, there is now a broad consensus about how normative analysis should be conducted. The essential idea can be traced back to Cass Sunstein and Richard Thaler's (2003) well-known story of the (hypothetical) cafeteria in which customers' choices between food items are influenced by the relative positioning of the items on the cafeteria counter. Other things being equal, more prominently displayed items are more likely to be chosen. The cafeteria director can choose what display to use. Treating this example as a microcosm of the problem of how to do welfare economics when individuals' choices are context-dependent, Sunstein and Thaler ask how the director should make this choice. They conclude that, because individuals lack well-defined preferences that the director could try to respect, the idea that there are 'viable alternatives to paternalism' is a 'misconception'. They argue that the director should be a *libertarian paternalist*: she should not constrain the customers' opportunities for choice, but she should display the items in the way that results in their making the choices 'that she thinks would make the customers best off, all things considered' (Sunstein and Thaler 2003, pp. 1164–1165, 1182).

In their later book *Nudge*, Thaler and Sunstein (2008) are more explicit about the criterion that normative economics should use. They say that their recommendations are designed to 'make choosers better off, *as judged by themselves*'. Expanding on this, they say that behavioural economics has shown that 'in many cases, individuals make pretty bad decisions—decisions that they would not have made if they had paid full attention and possessed complete information, unlimited cognitive abilities, and complete self-control' (p. 5). The clear implication, confirmed over the subsequent course of the book, is that 'better off, as judged by themselves' is to be interpreted by reference to the preferences that the relevant individual would have revealed, had his decision-making not been impaired by limitations of attention, information, cognitive ability or self-control. In other words, normative analysis should try to reconstruct individuals' underlying or *latent* preferences by simulating what they would have chosen, had they not been subject to imperfections of reasoning and information. Notice the implicit assumption that latent preferences are not themselves context-dependent. (Remember that the point of using latent rather than revealed preferences is that revealed preferences are context-dependent.) As Gerardo Infante, Guilhem Lecouteux and I have argued, this method of analysis proceeds as if, inside each individual, there is an *inner rational agent* with neoclassical preferences; behavioural deviations from neoclassical theory are supposed to occur because of psychologically-induced 'errors' in the implementation of the agent's latent preferences (Infante et al. 2016).

In slightly different forms, this implicit model of an inner rational agent recurs in many attempts to derive normative conclusions from behavioural economics.[11] Some authors try to 'purify' revealed preferences by identifying and removing the alleged effects of errors of reasoning. Others try to identify the environments in which individuals' decisions are least prone to error and then infer individuals' preferences by using only data generated in those environments. Clearly, this strategy of *behavioural welfare economics* can work only if the concept of latent preference has an objective definition—if it is not just another word for the analyst's personal judgement about what is best for each individual—and only if latent preferences are context-independent. But the advocates of this strategy usually offer (at best) only rough sketches of how 'error' is to be defined operationally, and almost never try to justify the crucial assumption that, after the effects of error have been eliminated, preferences will be found to be context-independent.

[11]This paragraph contains sweeping claims that some behavioural economists might dispute. The evidence on which they are based is presented in Infante et al. (2016) and Sugden (2018).

Viewed in the perspective of empirical psychology, the whole concept of latent preference seems question-begging and redundant. (If actual choices can be explained as the result of known mental processes, why should we expect there to be other mental processes, as yet undiscovered, that generate preferences that are *not* used in decision-making but which happen to have the properties that correspond with the axioms of rational-choice theory?) Thus, whatever its advocates may intend, the strategy of behavioural welfare economists leaves the social planner or her adviser with a large amount of discretion in specifying individuals' latent preferences, and very little useful guidance about how that discretion should be used.

I conclude that Buchanan was right to be worried about the conceptual distinction in neoclassical economics between preference and choice, and about the practice of using preference rather than choice as the fundamental normative criterion. His worry was that this practice might license social planners (and economists who think of themselves as advisers to social planners) to set themselves up as the judges of what individuals 'truly' prefer, and to design social institutions to satisfy those supposed preferences. That is exactly what behavioural welfare economics is now doing.

How else might normative economics be done? Buchanan offers an obvious answer—obvious, that is, to anyone who shares his commitment to individual sovereignty:

> [Each person] has a clear interest in seeing that the choice set, the set of alternative imagined futures, remains as open as is naturally possible, and, if constrained, that the constraints be also of his own choosing. (1979, pp. 258–259)

In other words, the normative criterion should be one of *opportunity*. Roughly speaking, the aim should be to set up institutions that give individuals as much opportunity as possible to do whatever they want to do, both in their actions as separate individuals and in voluntary transactions with one another. In designing these institutions, there is no need to consider what individuals' preferences in fact are: the aim should be to ensure that individuals are able to act on *whatever* preferences they may happen to have in any particular context, at any particular time. Or, as Buchanan might put it, there is no need to talk about preferences at all; all that matters are opportunities *to choose*. Whether or not an individual's choices can be rationalized by context-independent preferences is beside the point.

This general strategy can be followed in at least two different ways. One way is arguably in the spirit of Buchanan's arguments about autonomy and self-creation. Its aim is to design and maintain institutions that individuals *would* want, were they to attach sufficient importance to being free to engage in self-creation. Or to put this another way, its aim is to create a society in which individuality and self-creation can flourish. Some ideas about how this approach to normative economics might be developed can be found in the work of Shaun Hargreaves Heap (2013, 2017), Christian Schubert (2015), and Malte Dold (2018).

The other way forward is the one that I have been developing, and which is summarized in my book *The Community of Advantage* (Sugden 2018). This way, I believe, is more faithful to the spirit of Buchanan's contractarianism and to the slogan of 'Don't tread on me'. It accepts that individuals' choices are often context-dependent in ways that psychological theories can predict and that neoclassical theory would classify as irrational, but does not interpret that fact as compromising individuals' autonomy as choosers or their claims to sovereignty. It views the market favourably, for the same reasons that Buchanan does when he says that the market is the institutional embodiment of voluntary exchange between individuals in their several capacities. The market, and civil society more generally, is not a means to the accomplishment of anything—not even a means to the flourishing of individuality. Voluntary interaction is, as Buchanan says, all there is to it.

References

Buchanan, J. (1954). Social Choice, Democracy, and Free Markets. *Journal of Political Economy, 62*, 114–123. Reprinted in Buchanan (1999).

Buchanan, J. (1964). What Should Economists Do? *Southern Economic Journal, 30*, 213–222. Page References to Reprint in Buchanan (1999).

Buchanan, J. (1975a). The Samaritan's Dilemma. In E. Phelps (Ed.), *Altruism, Morality and Economic Theory* (pp. 71–85). New York: Russell Sage. Reprinted in Buchanan (1999).

Buchanan, J. (1975b). *The Limits of Liberty: Between Anarchy and Leviathan*. Chicago: University of Chicago Press.

Buchanan, J. (1979). Natural and Artifactual Man. In J. Buchanan (Ed.), *What Should Economists Do?* (pp. 93–112). Indianapolis, IN: Liberty Fund. Page References to Reprint in Buchanan (1999).

Buchanan, J. (1986a). *Liberty, Market, and State*. Brighton: Wheatsheaf.

Buchanan, J. (1986b). Better Than Plowing. *Banco Nazionale del Lavoro Quarterly Review, 159*, 359–375. Page References to Reprint in Buchanan (1999).

Buchanan, J. (1991). The Foundations for Normative Individualism. In J. Buchanan (Ed.), *The Economics and the Ethics of Constitutional Order*. Ann Arbor: University of Michigan Press. Page References to Reprint in Buchanan (1999).

Buchanan, J. (1999). *The Collected Works of James M. Buchanan* (Vol. 1). Indianapolis, IN: Liberty Fund.

Dold, M. (2018). Back to Buchanan? Explorations of Welfare and Subjectivism in Behavioral Economics. *Journal of Economic Methodology, 25,* 160–178.

Gauthier, D. (1986). *Morals by Agreement*. Oxford: Oxford University Press.

Hargreaves Heap, S. (2013). What Is the Meaning of Behavioural Economics? *Cambridge Journal of Economics, 37*, 985–1000.

Hargreaves Heap, S. (2017). Behavioural Public Policy: The Constitutional Approach. *Behavioural Public Policy, 1*(2), 252–265. https://doi.org/10.1017/bpp.2016.8.

Hume, D. (1739–1740/1978). *A Treatise of Human Nature*. Oxford: Oxford University Press.

Infante, G., Lecouteux, G., & Sugden, R. (2016). Preference Purification and the Inner Rational Agent: A Critique of the Conventional Wisdom of Behavioural Welfare Economics. *Journal of Economic Methodology, 23,* 1–25.

Kahneman, D., & Tversky, A. (Eds.). (2000). *Choices, Values, and Frames*. Cambridge: Cambridge University Press and Russell Sage.

Schubert, C. (2015). Opportunity and Preference Learning. *Economics and Philosophy, 31,* 275–295.

Sugden, R. (1985). Liberty, Preference and Choice. *Economics and Philosophy, 1,* 213–229.

Sugden, R. (2004). The Opportunity Criterion: Consumer Sovereignty Without the Assumption of Coherent Preferences. *American Economic Review, 94,* 1014–1033.
Sugden, R. (2006). Hume's Non-instrumental and Non-propositional Decision Theory. *Economics and Philosophy, 22,* 365–391.
Sugden, R. (2018). *The Community of Advantage: A Behavioural Economist's Defence of the Market*. Oxford: Oxford University Press.
Sunstein, C., & Thaler, R. (2003). Libertarian Paternalism Is Not an Oxymoron. *University of Chicago Law Review, 70,* 1159–1202.
Thaler, R., & Sunstein, C. (2008). *Nudge: Improving Decisions About Health, Wealth, and Happiness*. New Haven, CT: Yale University Press.
von Hayek, F. (1948). *Individualism and Economic Order*. Chicago: University of Chicago Press.
Wicksteed, P. (1910). *The Common Sense of Political Economy*. London: Macmillan.

3

Starting from Where We Are: The Importance of the Status Quo in James Buchanan

Michael C. Munger

The uniqueness of the status quo lies in the simple fact of its existence. The rules and institutions of sociological order that are in being have an existential reality. No alternative set exists. This elementary distinction between the status quo and its idealized alternatives is often overlooked. Independent of existence, there may be many institutional legal structures that might be preferred, by some or many persons. But the choice is never carte blanche. The choice among alternative structures, insofar as one is presented at all, is between what is and what might be. *Any proposal for change involves the status quo as the necessary starting point*. "*We start from here*," and not from someplace else. (Buchanan 1999a, pp. 100–101; emphasis added)

M. C. Munger (✉)
Duke University, Durham, NC, USA
e-mail: munger@duke.edu

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_3

Introduction

There are three constructs crucial to James Buchanan's political philosophy. The first is the "relatively absolute absolutes" (RAA) ; the second is the status quo, requiring "we start from where we are" (SQ); and the third is his contractarianism, requiring that "values start with us" (C). A number of political philosophers have seen these three elements as being in tension, or perhaps even incoherent. I will argue that the three elements, while not articulating comfortably, are nonetheless necessary for Buchanan's system and can be coherently assembled. I will claim that the truly essential feature is SQ, because it constrains all other actions to the space of voluntary "politics as exchange" rather than coercion. And coercion is always that thing that, for Buchanan, had to be fully justified for the system to be legitimate.

This paper is organized as follows. The following section gives a cursory review of status quo, state of nature, or original position uses as analytic devices in political philosophy. Section "Buchanan's RAA, SQ, and C" describes Buchanan's use of each of the three devices, RAA, SQ, and C. Section "Connecting RAA, SQ, and C" combines the three devices and examines their implications, and limitations as a political philosophy. Section "Conclusion" concludes.

The Original Position

Justifying a State

If a constitution is an agreement, and people become members of the constituted group by consenting to the contract, then the "citizens" are agreeing to be coerced because they expect to be better off as a cooperating group than they were as non-cooperating individuals. Binding Odysseus to the mast, and then binding him even more tightly when he changes his mind (as he knew he would when he gave the orders to prevent his escape) is not coercion in the usual sense. Nonetheless, it is coercion: Odysseus really wants to be set free, at that moment, and his men disobey his orders and tie the knots more tightly.

Agreeing to suffer coercion at the hands of a group is potentially better for each individual in the group, compared to collections of individuals who cannot enforce agreements. The ability to enter into agreements, and to agree to be punished if the agreement is violated, is the essence of the constitution of groups. Rousseau's conception of this "constitutional moment" is illuminating:

> In order then that the social compact may not be an empty formula, it tacitly includes the undertaking, which alone can give force to the rest, that *whoever refuses to obey the general will shall be compelled to do so by the whole body*. This means nothing less than that *he will be forced to be free*; for this is the condition which, by *giving each citizen to his country, secures him against all personal dependence*. In this lies the key to the working of the political machine; this alone legitimizes civil undertakings, which, without it, would be absurd, tyrannical, and liable to the most frightful abuses. (Book 1, Chapter VII)

The "constitutional moment," when coercion is agreed to and therefore justified, could be an actual event at a real point in time. It could be, but it never is. Political philosophers substitute an analytic device for actual agreement. This device goes by many names: the "original position," the "state of nature," or "the natural condition." Of course, such devices are speculative, looking back across an event horizon where changes akin to the "Big Bang" in physics transformed everything in an instant.

The first clear use of this device is found in the writings of the Chinese writer Mo Tzu ("Master Mo," or "Micius," in Latinized form), around 400 BC. This body of work, possibly written by Mo Tzu and embellished and extended by his "Mohist" followers (Fraser 2015), contains this claim:

> Mo Tzu said: In the beginning of human life, when there was yet no law and government, the custom was "everybody according to his own idea." Accordingly each man had his own idea [moral intuition], two men had two different ideas and ten men had ten different ideas – the more people the more different notions. And everybody approved of his own view and disapproved the views of others, and so arose mutual disapproval

> among men. As a result, father and son and elder and younger brothers became enemies and were estranged from each other, *since they were unable to reach any agreement.* Everybody worked for the disadvantage of the others with water, fire, and poison. Surplus energy was not spent for mutual aid; surplus goods were allowed to rot without sharing; excellent teachings (Dao) were kept secret and not revealed. The disorder in the (human) world could be compared to that among birds and beasts. (Book 3, Chapter 11, "Identification with the Superior")

Mo Tzu's notion was that the "state of nature" was chaotic, because people were "unable to reach any agreement." It appears that the ambiguity in the English word "agreement," allowing either a consensus on moral intuitions about justice or an economic exchange or contract, is not present in the Chinese (which is closer to "discrete/conflicting moral views cannot match"). Nonetheless, this is an important ur-text for Buchanan's notion of "politics as exchange," because the fundamental constitutional moment is the setting of rules that allow "agreements" to take place on all other matters.

Mo Tzu suggested that the solution was the unification of all the discrete moral intuitions under one ruler, literally a *deus ex machina*. God chose a virtuous ruler who then also used virtue as the qualification for all his subordinate ministers and administrators.

> Yet all this disorder was due to the want of a ruler. Therefore (Heaven) chose the virtuous in the world and crowned him emperor. Feeling the insufficiency of his capacity, the emperor chose the virtuous in the world and installed them as the three ministers. The emperor and the three ministers, seeing the vastness of the empire and the difficulty of attending to matters of right and wrong and profit and harm among peoples of far countries, divided the empire into feudal states and assigned them to feudal lords. Feeling the insufficiency of their capacity, the feudal lords, in turn, chose the virtuous of their states and appointed them as their officials.

Thomas Hobbes, though likely unaware of Mo Tzu, used a very similar logic, justifying not just a ruler:

> …that a man be willing, when others are so too, as far forth as for peace and defence of himself he shall think it necessary, to lay down this right to all things; and be contented with so much liberty against other men as he would allow other men against himself. For as long as every man holdeth this right, of doing anything he liketh; so long are all men in the condition of war. But if other men will not lay down their right, as well as he, then there is no reason for anyone to divest himself of his…
>
> For he that performs first has no assurance the other will perform after; because the bonds of words are too weak to bridle men's ambition, avarice, anger, and other Passions, without the fear of some coercive Power. … But in a civil estate, where there is a Power set up to constrain those that would otherwise violate their faith, that fear is no more reasonable; and for that cause, he which by the Covenant is to perform first, is obliged so to do. (Chapter 14)

Hobbes was quite correct: the ability to sign binding contracts is necessary for human survival and group flourishing. But all he really established was to justify some kind of governance which would improve the welfare of citizens over an anarchic state of nature. He does not say how would the group select *among* all the many kinds of governance structures, some private and some involving direct state action, that might be constituted? As Hardin (1989) argued, what Hobbes showed was that almost *any* viable constituted group is better than his "state of nature." For a given group, however, the Hobbesian argument can provide no guidance about *which* constitution to select. That is, suppose ordered state A is possible, and ordered state B is possible. Hobbes used the "state of nature" to demonstrate that (1) A is better than the state of nature, and (2) B is better than the state of nature. But how might an actual group decide between state A and state B? As we will see, this was a problem that required Public Choice and a *Calculus of Consent* to solve fully.

The individuals constituting the group will use their moral intuitions in choosing the rules, and the rules become norms that guide moral intuitions. To be free, the group has to be free to choose its contract, and then be free to enforce that contract which limits the freedom of each member of the group.

After the group is constituted, of course, many people will look for ways to cheat, just as Odysseus did (and knew he would). After the agreement, people will try to escape the punishment they promised to accept. If they are caught, they will protest that the punishment is against their will, because they would prefer that everyone else is bound by the promise but that they can escape. But the consent, the *unanimous* consent, to the original contract means that the coercion was *voluntarily* agreed to. One way of understanding constitutions is that they can, in some circumstances, allow groups to solve collective action problems that otherwise would prevent the capture of substantial gains from cooperation.

Of course, if I did not agree to the contract, even if I am the *only* one who did not agree, then the coercion is not voluntary because I did not consent. This is why the condition of unanimity, even if it is hypothetical, is central to constitutive arguments.[1]

For other thinkers, such as John Locke, both morals and laws exist in the state of nature. Morality and the laws of behavior it implies have always been available to humans, simply by virtue of being human. The essential feature of humanity is the ability to use reason, in this view, and reason is quite sufficient to generate "agreement," contra Mo Tzu's view of eternal dispute. For Lockeans, the device of the state of nature is useful to illustrate how, in the absence of constituted state, rights are insecure, and laws cannot be enforced. But the justification for the state is to secure the rights and guard the morals that have existed since before the state was agreed into being.

[1]Some thinkers have been quite scornful of the idea of hypothetical consent. See, for example, Hume (1978), who says of tacit or implicit consent implied by residency:

> Can we seriously say, that a poor peasant or artisan has a free choice to leave his country, when he knows no foreign language or manners, and lives, from day to day, by the small wages which he acquires? We may as well assert that a man, by remaining in a vessel, freely consents to the dominion of the master; though he was carried on board while asleep, and must leap into the ocean and perish, the moment he leaves her. For some thinkers, the (hypothetical) agreement to a set of rules is actually the beginning of society itself, as in the case of Montesquieu, who conceived of humans as living timidly in the wild, fearful of having contact with other humans. For such theorists, the origins of society both causes, and is caused by, the agreement on how individuals will be governed.

One thinker who was important in the Scottish Enlightenment, serving as a bridge between John Locke and David Hume, was Lord Kames, or Henry Home, a solicitor and judge who lived from 1696, essentially the end of Locke's life, until 1782, living to see the publication of the Wealth of Nations in 1776. He largely agreed with Locke's conception of reason in the state of nature, but introduced the idea of evolved conventions that figured so prominently in the work of his protege, David Hume, and also sounds very much like the later work of James Buchanan in such writings as *The Reason of Rules*. Home wrote:

> The moral sense also, though rooted in the nature of man, admits of great refinements by culture and education. …The moral sense not only accompanies our other senses in their gradual refinement, but receives additional strength upon every occasion from these other senses. … Upon the whole, the operations of the moral sense in a savage, bear no proportion to its operations in a person possessed of all the advantages of which human nature is susceptible by refined education.
>
> I never was satisfied with the description given of the law of nations, commonly so called, That it is a law established among nations by common consent, for regulating their conduct with regard to each other. This foundation of the law of nations I take to be chimerical. For upon what occasion was this covenant made, and by whom? If it be said, that the sense of common good gradually brought this law into force; I answer, that the sense of common good is too complex and too remote an object to be a solid foundation for any positive law, if it have no other foundation. But there is no necessity to recur to so slender a foundation. What is just now observed, will lead us to a more rational account of these laws. They are no other but gradual refinements of the original law of nature, accommodating itself to the improved state of mankind. The law of nature, which is the law of our nature, cannot be stationary: it must vary with the nature of man, and consequently refine gradually as human nature refines. Putting an enemy to death in cold blood, raises at present distaste and horror, and therefore is immoral; though it was not always so in the same degree.…
>
> It is true, that these refinements of the law of nature gain strength and firmness from constant exercise. Hereby they acquire the additional support of common consent. And as every nation trusts that these laws will

> be observed, it is upon that account a breach of faith to transgress them. But this is not peculiar to these institutions which pass under the name of the law of nations. There is the same adventitious foundation for all the laws of nature, which every man trusts will be observed, and upon that faith directs his conduct. (Home 1779, Chapter VII)

The interaction between morals and formal rules was elaborated in Brennan and Buchanan (1985, p. 6):

> The notion that rules may substitute for morals has been familiar to economists and philosophers at least since Adam Smith. And, of course, the great intellectual discovery of the eighteenth century was the spontaneous order of the market, the discovery that within an appropriate structure of rules ("laws and institutions" in Adam Smith's phraseology), individuals in following their own interests can further the interests of others. The result is the great network of social coordination – refined and extended to the boundaries of the division of labor – that even after centuries defies the imagination when evaluated as a cooperative enterprise. The cooperation of agents in a market, however, requires neither that such agents understand the structure nor that they transcend ordinary precepts of morality in their behavior. What it does require is an appropriate "constitutional context" – a proper structure of rules, along with some arrangements for their enforcement.

Justice as Fairness: Impartiality

As was mentioned at the start of this section, there is a second advantage of the use of the device of the original position, with the added feature that knowledge of interests and privileges do not pass through the constitutional moment. Rousseau called this concern "particular" rather than "general" interest. Adam Smith contrasted "partial" and "impartial" motivation. Eventually, this opacity of the implication of rules for the state of interests was named the "veil of ignorance" by Rawls (1971). Rawls claimed that just rules were those chosen fairly, which amounts to requiring that decisions about rules be made in ignorance of particular consequences.

Buchanan and Tullock (1962) describe this kind of impartiality this way:

> Agreement seems more likely on general rules for collective choice than on the later choice to be made *within* the confines of certain agreed-on rules… Essential to the analysis is the presumption that the individual is *uncertain* as to what his own precise role will be in any one of the whole chain of later collective choices that will actually have to be made. … [T]he individual will not find it advantageous to vote for rules that may promote sectional, class, or group interests because, by supposition, he is unable to predict the role that he will be playing in the actual collective decision-making process at any particular time in the future. He cannot predict with any degree of certainty whether he is more likely to be in a winning or losing coalition on any specific issue. …His own self-interest will lead him to choose rules that will maximize the utility of an individual in a series of collective decisions with his own preferences on the separate issues being more or less randomly distributed. (Buchanan and Tullock 1962, p. 78; emphasis in original)

There is a striking difference between this conception of fairness and that defined by Rawls (1971, p. 61). The Rawlsian "distribution of primary goods" has a much more permanent and deterministic flavor. There are two steps: the liberty applies to choices about employment and production allocations, and then the difference principle in limiting, or justifying, distributions of income, wealth, and power.

Clearly Buchanan and Tullock are imagining a more dynamic and fluid process than what Rawls had in mind. The constitutive moment is a jumping off point for a set of rules that will guide a society through political conflict, with groups coalescing and dissolving over time, in both cases by voluntary consent. Buchanan and Tullock wanted to foster the capture of mutual gains from exchange and cooperation in a social, group setting, while minimizing conflict, and conferring legitimacy on outcomes even when people disagree.

Rawls is rightly credited with developing the "original position" in a way that gave him analytical purchase of the problem of justice as fairness. But there were important precursors. Tomasi (2011), for example, calls Rawls's use of the idea "the unoriginal position" and points to a passage in Hayek that takes much the same logic and applies it to fairness in laws.[2] But an even earlier "original position" can be found in Montesquieu.

> Every day one hears it said that it would be good if there were slaves among us. But, to judge this, one must not examine whether they would be useful to the small, rich, and voluptuous part of each nation; doubtless they would be useful to it; but, taking another point of view, *I do not believe that any one of those who make it up would want to draw lots to know who was to form the part of the nation that would be free and the one that would be enslaved.* Those who most speak in favor of slavery would hold it the most in horror, and the poorest of men would likewise find it horrible. Therefore, the cry for slavery is the cry of luxury and voluptuousness, and not that of the love of public felicity. Who can doubt that each man, individually, would not be quite content to be the master of the goods, the honor, and the life of others and that all his passions would not be awakened at once at this idea? Do you want to know whether the desires of each are legitimate in these things? Examine the desires of all. (Montesquieu 1750/1989, Book XV, Chapter 9, p. 253; emphasis added).

Regardless of whether Rawls' "original position" was original with him (it appears it was not), the Rawlsian emphasis on "justice as fairness" is important. If the institutions of society, or the rules of a group, are clearly chosen to benefit some members and harm others, that constitution will not be seen as legitimate.

Buchanan's RAA, SQ, and C

The previous section briefly outlined the use of the "state of nature" or "original position" as an analytic device in political philosophy. This introduction was superficial, because our real object is to consider

---

[2]Tomasi (2011), Chapter 5, quoting Hayek: "We should regard as the most desired order of society the one we would choose if we knew that our initial position in it would be determined purely by chance (such as the fact of our being born into a particular family)", Hayek (1979, footnote on p. 132).

Buchanan's use of the original position device. I did lay out a foundation, in Buchanan and Tullock's (1962) treatment of a kind of veil of ignorance, through which no one can see when agreements on rules are being made. This is more true at the level of rules about rules, or constitutions. And that is the core of Buchanan's political philosophy: coercion can be justified, but only by unanimous agreement on the rules about coercion and rules about changing the rules.

Relatively Absolute Absolutes (RAA)

The passage from *Limits of Liberty* (Buchanan 1999a) at the outset of this paper highlights Buchanan's focus on the status quo. Only by taking the status quo seriously as a starting point can a group ensure that all moves or changes are voluntary. As we will see in the next section, this privileging of the status quo can cause problems, but any system that ignores the status quo must in effect start with coercive redistribution of wealth and power.

But before moving to the status quo, it is useful to consider the RAA. This is a concept that Buchanan adapted from his mentor Frank Knight. The "we start from here" requirement interacts in a complicated fashion with RAA.

> We can move beyond economics while remaining in familiar territory if we shift attention from the personal to the political constitution. In constitutional democracy, and in the United States in particular, it is recognized that ordinary politics takes place within the constraints defined by the set of rules defined as the constitution. The very purpose of these rules is to constrain ordinary political choices. And these ordinary choices take existing constitutionl rules as relatively absolute absolutes. As they participate variously in ordinary politics… (Buchanan 1999b, p. 448)

In his two-part interview with Geoffrey Brennan (Buchanan and Brennan 2001), Buchanan describes his perception of the RAAs:

> I couldn't live without the Relatively Absolute Absolutes. It gets me out of lot of jams. It gets me off of lot of hooks, too! But it's a concept…that I picked up directly from Frank Knight and Henry Simons…. It prevents

> the necessity of taking a position either as a relativist in all respects or as an absolutist. I am neither…it's an in-between position… There are some moral values that have been in existence a long time, that have been proved by the test of history…[It] is best to live our ordinary lives by treating those as "relatively absolute absolutes" …
>
> [But] they are not beyond examination; nothing is sacrosanct. At one level of our existence you can evaluate those, you can say "Are they really as stable, authoritative, or unchallengeable as they might seem?" We can challenge them in the academy; that's the job of the academy…But at the same time that is not just going out and saying "anything goes," at all. So it gets you off that terrible problem of becoming [a relativist or an absolutist in moral theory]. I am neither. (Buchanan and Brennan interview 2001; Part II, at 27:00)

In fact, in some ways the relatively absolute absolutes summarizes much of what is overarching and unifying about Buchanan's whole world view. He was very sympathetic to natural rights theories, and persuaded that the libertarian philosophy was correct, while at the same insisting that groups are sovereign and that no outside force, be it revelation, law, or custom, could restrict what they could commit to collectively. It is tempting to think that he was a natural rights theorist, or a pure contractarian. But he was neither.

We Start from Where We Are (SQ)
As Brennan (2015, p. 8) puts it:

> Buchanan often insists that any normatively guided action—any attempt at improvement—must "start from where we are". At one level, this claim could be read as a simple analytical requirement: it is difficult to imagine how one could start from anywhere else! But in Buchanan's hands the requirement has a more normative cast. It is a feature of his contractarian approach that normative desirability is grounded in agreement—with the natural thought that individuals will not agree to changes that make them worse off. (all things considered)

That is, individuals must have the autonomy to be able to veto changes from the status quo, even if that change would make "everyone" better off, in a utilitarian sense. The simplest version of the SQ/voluntarism requirement is the requirement of unanimity in rule changes.

Take a simple example, one that is common in development economics. Suppose that everyone in a country knows that a move from institutions I_α to institutions I_β will increase GDP growth by 25% in the next five years. If current GDP is the equivalent of $1 billion U.S., and the current growth rate if 2%, a move to I_β will raise the growth rate to 2.5%. That means that after five year, a move to I_β will create a net surplus $25 million U.S.[3]

Should "we" do it? Well, who is this "we" you are talking about? Suppose that at present, under I_α, a select group of thugs control most power and resources. No one can pretend that the thugs in power are legitimately in power, or deserve the disproportionate share of wealth they are embezzling from the public treasury. But as a practical matter the nation needs the permission and cooperation of the thugs to move to I_β. There are two possibilities:

1. Citizens and reformers tell the thugs in charge that the thugs didn't deserve their wealth and power, and under I_β the thugs will simply be regular citizens, taking much smaller pieces of a larger social pie. Sure, the thugs will be worse off under I_β, but they will understand that's better for the nation, and so will support the change.
2. Citizens and reformers promise the thugs that their current shares of power and wealth will be retained, and in fact enlarged, because the surplus I_β creates allows everyone to be better off even with that side payment. Actually, the thugs will benefit the most from moving to I_β, because the nation will now have a legitimate government be able to participate in trade without sanctions. Being rich in such a nation will be great!

Now, under both of these possible "deals," it's true that the thugs will no longer be in charge, but the reformers promise that the thugs will

[3]Because ($1 billion * ($1.005^5$)) = $25 million. That's the difference between 2% growth rate and a 2.5% growth rate compounded over five years.

benefit, because the reformers want the thugs to consent. Possibility 1 is unlikely to happen, because the sort of people who are susceptible to such moral appeals are not likely to have murdered and stolen their way into power in the first place. Possibility 2 is unlikely also, though the reason is less obvious: there is a contracting problem, because the promise to leave the thugs alone to enjoy their stolen loot after power is transferred is not credible. Even if the reformers might mean it when they make the promise, after the transfer of power the new government will convene a "Truth and Reconciliation" commission, confiscate the stolen wealth, and have the thugs arrested and imprisoned, or worse.

For these reasons, the status quo takes on not just the moral significance of representing a benchmark against which to compare voluntary improvements, but also an Archimedean point against which the credibility of political commitments must be measures. Later work in constitutional political economy has not recognized the important Buchanan places on the status quote, and this work deserves recognition. One example of work that connects closely with this "start from where we are" idea is the "proportionality theorem" advanced by Cox et al. (2016). Cox, North, and Weingast ask a deceptively simple question:

> Violent contests over political power have been surprisingly common throughout the developing world, including the richest developing countries. This observation raises the question of resistance to political reform in a more precise form: Why do developing countries not adopt the institutional solution(s) to the problem of political violence that developed states have adopted? (p. 1)

If a credible commitment to control violence, both between antagonistic factions and misuses of state power to expropriate investment, is one of the keys to development and prosperity, why is that more nations do not simply adopt as templates the constitutions, rules, and policies of nations that have made the leap? The answer is that a set of rules that impose and protect distributions of wealth and power within a state that differ sharply from the de facto distribution on the ground will either be rejected in advance, or will be overturned by military action such as a coup or civil war.

Consequently, the problem of constitutional design must consider what Cox, North, and Weingast call "the proportionality theorem," or what James Buchanan called the requirement that "we start from where we are." But that means the problem is even more difficult than Cox, North, and Weingast make it out to be. If we have little understanding of emergent properties of rule systems, or the likely comparative statics of even small changes in rules, then it is hard to predict the consequence or even the direction of change. If this problem is combined with the difficulty of making credible commitments to compensate the "losers" in constitutional reform then the theory of constitutional politics in economics and political philosophy has simply failed to develop the tools that are required to address the problem adequately. The "veil of ignorance" means that credible commitments may be simply impossible, because the mapping from rule changes into future outcomes is just too opaque. In the earlier example, we are at least able to assume that everyone knew and agreed that there was a superior set of institutions available. In the absence of such knowledge, the status quo will always be decisively privileged in the attitudes of everyone who benefits from the current system.

Values Start with Us, in the Contract (C)
From the interview with Geoffrey Brennan (Buchanan and Brennan 2001; Part 1, at 14:10):

> [We need to go back to] the libertarian strand… There is no justification for anyone coercing anybody else. If you are not going to coerce someone, what can you do? You exchange with them, you engage in reciprocal relationships, one person with another person, and you build that up. You start getting more complex and more complex and ultimately you end up in a situation where we are participating in a big exchange, in which we are all sharing in a commonality of a government, of politics, and so forth.
>
> You start with the idea that coercion is never justified in advance, on any grounds. Unless you can bring in some transcendental purpose, how can you justify coercion? Unless God's rules, or "right reason," or [some a priori doctrine] justifies force, you can't have coercion. If you say, "No,

values start with us," start with the individuals, then how can one individual legitimately coerce another?

The core idea of constitutional political economy was to apply the notion of rational choice to two new domains. First, the feasible set of alternatives is consumption bundles, but rather is sets of rules. Second, the entity doing the choosing is a group of citizens, who by the act of choosing become a constituted group. While we often take this for granted now, the contribution by Buchanan and Tullock (1962) gathers the thought of many previous writers and creates something different, and important. In large measure, almost any choice or value settled on by consensus among all the members of the group is binding on the group.

This is made clear in the Brennan interview (Buchanan and Brennan 2001):

> Brennan: [But some agreements would require infringements on liberty]. Your interpretation of liberty and how liberty is to be structured seems to depend on getting constitutional consensus around it. So how does your libertarianism—which is undoubted—sit with the logic of contractarianism?
>
> Buchanan: I acknowledge that there is a tension—a possible contradiction—there. I could respond in part by saying that it's the constitutionalist that is primary, and the libertarianism is secondary. But that's not necessarily the case…in many cases my libertarianism might trump my constitutionalism.
>
> If you could observe a constitutional consensus developing on some restrictions on individual liberty that I might be very strongly opposed to…then I wouldn't be in the consensus but you might have an overwhelming [consensus] view.

Any discussion of Buchanan's own views of liberty or "correct" rules must be constrained by this overarching consideration: Buchanan had strong opinions about how rules should work. But he also maintained that either he might be wrong, or that others might disagree. If there is a conflict among these considerations, it is always the consensus that is more important, regardless of whether Buchanan himself was a member of that consensus.

Connecting RAA, SQ, and C

Proportionality as a General Application

In voluntary exchange, and also in the more abstract comparisons involved in Pareto improvement comparisons, the status quo position is highly privileged. If unanimous consent is required for change, then the status quo is the outside option for each individual's bargaining decision.

The problem this poses for constitutional political economy is that the status quo distribution of power and wealth may not be ethically defensible. And yet, as Buchanan notes, its importance "lies in the simple fact of its existence." A change that represents an "improvement" in the rules system, based on collective conceptions of justice, or efficiency, or aggregate conceptions such as levels of national prosperity, have little meaning compared to the tyranny of the status quo.

This factor has been ignored, or at a minimum under-recognized, in traditional theories of constitutionalism. Abstract, stand-alone notions of "good" constitutions have little place in a world where the constitutional project is to move from one (presumably inferior) basin of attraction to another (superior) basin of attraction. No one understands the interaction of rules and markets fully, and the unintended consequences of mistakes can be devastating.

But even holding that problem aside, reformers face an additional problem that is directly related to Buchanan's observation about the status quo, or "starting where we are." Suppose that we know that a move from institutions α to institutions β will cause GDP to increase by 25% in the next five years, a much faster growth rate than under α. Should "we" do it? Well, who is this "we" you are talking about? Suppose that at present, under α, a select group of thugs control most power and resources. There are two possibilities:

1. Citizens and reformers tell the thugs in charge that the thugs didn't deserve their wealth and power, and under β the thugs will simply be regular citizens, taking much smaller pieces of a larger social pie. Sure, the thugs will lose, but they will understand that's better for the nation, and so will support the change.
2. Citizens and reformers promise the thugs that their current shares of power and wealth will be retained, and they will benefit most from moving to β. It's true that the thugs will no longer be in charge, but the reformers promise that the thugs will benefit, because the reformers want the thugs to consent.

Under the first condition, it's possible that the thugs will go along. A sense of nationalism, patriotism, or personal duty may work in the favor of reform. But it may not. The fact that β is potentially Pareto superior just means that the total size of the benefits exceeds the total costs. But the costs will be born disproportionately by the thugs in charge under α. That's what the status quo means: under α, the status quo for the thugs is quite advantageous. The fact that it is not "deserved" may be important Rawlsian ideal theorists, but arguments from desert will likely fall on deaf ears in the colonels' quarters. Whether they deserve power or not, they *have* power. Why would they give it up?

Likewise, under the second condition, it's possible the thugs will go along. They may be easy-going, trusting sorts who just naturally think well of their fellow men and women. When the reformers promise that, after the thugs leave power, there will be no investigations, no truth and reconciliation committees convened to investigate atrocities, the thugs may accept the reformers at their word. But they probably won't. Once the thugs leave power, they can no longer protect themselves or retaliate for violation of the "contract" that promises no reprisals. Knowing that, the thugs either won't agree to the "contract" in the first place, or if it is imposed without their participation there will be a military coup or violent revolution.

This is essentially the "proportionality principle" laid out by Cox, North, and Weingast. As they put (p. 2):

> A key result that follows from the bargaining perspective on violence is the *proportionality principle*: Rents and privileges must be allocated in rough proportion to military power in order to keep the peace. Specifically, let Rj denote j's share of the rents. Then the proportionality principle says that peace can be maintained only if
>
> $$Rj > Pj(vj,v\text{-}j)\pi - cj \text{ for } j = A,B.$$
>
> [where π is the share of governance rents, P is the probability of winning a violent conflict, and c is the cost of fighting] This expression says that each player's rents must exceed their expected value of fighting. If this condition is not satisfied, then those groups with more power than rents prefer to fight for more, rather than play by the regime's rules.

The proportionality principle is a constraint on the set of equilibrium alternative institutions that can be imposed by reformers. Reformers who recognize this are likely to choose objectively "bad" constitutions that survive; reformers who fail to recognize this are likely to choose apparently "good" constitutions that are quickly deposed in bloody violence. But neither outcome is a surprise from the complex systems approach. The only surprise is that political philosophers think that ideal theory is even worth thinking about.

The Example of Chile

Chile had a military coup in 1973. The coup occurred on September 11, less than a month after a resolution was passed 81–47 by the Camara de Diputados (Chamber of Deputies) on August 22. The resolution was strongly worded; it asked that:

> the President of the Republic, Ministers of State, and members of the Armed and Police Forces…. put an immediate end…[to] breaches of the Constitution … with the goal of redirecting government activity toward the path of Law and ensuring the Constitutional order of our Nation,

> and the essential underpinnings of democratic co-existence among Chileans.
>
> The elected government, led by Salvador Allende, was accused of trying … to conquer absolute power with the obvious purpose of subjecting all citizens to the strictest political and economic control by the State … [with] the goal of establishing a totalitarian system…[where] violations of the Constitution [were now] a permanent system of conduct.

Most ominously, the resolution appeared to make a request of the armed forces, asking that Allende be forced to comply with the Constitution. The military was told:

> to present the President of the Republic, Ministers of State, and members of the Armed and Police Forces with the grave breakdown of the legal and constitutional order… it is their duty to put an immediate end to all situations herein referred to that breach the Constitution and the laws of the land with the aim of redirecting government activity toward the path of Law.

Now, Chile had had previous coups, and military coups were common in Latin America, so perhaps what happened next was predictable. Still, there was no Constitutional provision for the Chilean legislature requesting that the military depose the elected administration and kill the President. But three weeks later the military did depose the administration and kill Allende. The new military government was ultimately dominated by a *junta* (committee) controlled by Commander in Chief of the Army Augusto Pinochet.

While the coup itself had some (tenuous) claim to legitimacy, the governance of the *junta* was inexcusable. The new government was repressive, often murderous, and aggressive about rooting out any potential opposition figures around which an alternative government might organize. The new regime had certain goals, and chose economic and political measures in support of these goals.

To be fair, the Chilean people also had goals. These included transitioning away from a murderous military regime to a functioning democracy, and having their country be restored to its place among the free nations of the world. Interestingly, in some ways the goals of the regime and the goals of Chile's people coincided. Perhaps because of the long tradition of military deference to civilian authority in Chile, or perhaps to ease economic and other sanctions, the *junta* wanted to restore democracy.

The problem was that "too much" democracy, too fast, would almost certainly mean another military coup. In other words, everyone was constrained by the proportionality principle. If paper institutions, such as constitutions, attempt to create a de jure distribution of power that differs from the de facto distribution of power on the ground, there will be violence. And the resulting conflict is likely to be won by those who possess de facto power.

In the case of Chile, this meant that the military controlled actual power, regardless of what the constitution or the laws might say. Consequently, we are stuck with Buchanan's "start from Where We Are" maxim, because you can't start anywhere else. The Chilean problem was clear: if full power had been given by the new constitution to the new democratically elected government (which would be selected by a "Si o No" plebiscite in 1988, an election in 1989, and the installation of a new government in 1989), there would likely be an immediate move toward a "Truth Tribunal," with arrests and trials of military leaders and the middle-level officers who had carried out the murder, torture, and repression of 1973–1976, and in some cases beyond that date.

It's easy to argue, from the outside or from the perspective of decades later in time, that this is just what should have happened. But it wouldn't have happened. If Chile had had a "good" constitution, there would have been a coup, as military leaders protected themselves. Chile would not be a democracy. Munger himself first worked in Chile as a consultant in the 1989 presidential election, and saw firsthand while the *election* was for all practical purposes free and fair (it was won by moderate leftist Patricio Aylwin), the 1980 *constitution* under which the election was held was very much resented as being unfair. But if the constitution had been different, there would have been no election, or the election results would have been repudiated and a military junta immediately restored.

The provisions of the Constitution of 1980 were written so that even if Pinochet lost in 1988 (it appears he expected to win, but when he lost he did obey the constitutional requirement of scheduling the Presidential election in 1989), real power would not be transferred from the junta to the democratically elected government. The specific provisions of the Constitution of 1980 are interesting enough to deserve closer scrutiny.

There were 120 "permanent" articles, which were delayed until the transition to "constitutional government" in March 1990. There were also 34 "transitional" articles to govern the decade of transition, March 1980 to March 1990. The most important features of the transitional articles were the provisions for the plebiscite in 1988, the election of the legislature under the "binomial" system (all districts magnitude 2, with a large supermajority required to win both seats), and the contingent election of a new President in 1989. The most controversial and draconian of the transitional articles was #24, which for all practical purposes eliminated due process of law by giving the President (i.e., Pinochet) unilateral powers to curtail rights of assembly and speech and to arrest or exile any citizen without formal charges or appeal.

The "permanent" articles of the constitution claimed that their goal was a "modern and protected democracy," guaranteeing "national security" by severely circumscribing majority action. The Constitution vaguely (and ominously) established a role for the armed forces as "guarantors" of the nation's institutions, banned opposition political movements or (ironically) ideologies "hostile to democracy."

Most importantly, a formal institution of governance was created, the Council of National Security (Consejo de Seguridad Nacional—"COSENA"). The COSENA had thirteen members,[4] only seven of

[4] *Voting* members were (1) the president of the republic, (2) the president of the Senate, (3) the president of the Supreme Court, (4) the 3 commanders of the Army, Navy, and Air Force, and (5) the director general of the national police force (Carabineros de Chile). Consequently, the military had a large majority on any COSENA vote. Nonvoting members included the ministers of defense; economy, development and reconstruction; finance; foreign relations; and interior. For details, see Hudson (1994): http://countrystudies.us/chile/87.htm.

whom had formal voting rights, and only two of whom who were to be elected officials (Article 95).

Was this a good Constitution? It was a terrible Constitution, by any unimportant standard. We don't want to argue that justice and fairness are unimportant in general, or in the abstract. But when you must "start from where we are," you can't use general or abstract principles to evaluate institutions. The people of Chile needed help escaping from the military regime. A constitution must foster a move to democracy, and free and fair elections, but also avoid a military coup. It would serve no one to have had a constitution that allowed an immediate transfer of power, and a Truth Tribunal had been convened, followed by arrests of top military officers. That is frustrating, because those military officers clearly deserved it. But the only way to get from "where we are" (repressive military regime) to a functioning democracy was the way they did it. It is of course unjust that the killers and torturers of the regime escaped punishment. But politics is the art of the possible. Chile needed a way to move to free and fair elections, and stable democratic government. And it has done that.

Conclusion

The "status quo" notion in analytical political philosophy also has normative implications. James Buchanan recognized the importance of this positive-normative nexus in ways that have not been understood fully, even by some of his readers in economics and public choice. I think the reason is that Buchanan himself portrayed the problem as "politics as exchange" and used language that was not familiar to philosophers. I have tried to bridge this gap, to make Buchanan's conceptions of "relatively absolutely absolutes," "we start from where we are", and "constitutionalism" more general.

This essay focused on the importance of the "start from where we are" problem of Buchanan, as later elaborated in the proportionality principle of Cox et al. (2016). Attempts at reform, even if they are in some abstract sense efficient and just, may founder on the tendency of de jure power-sharing to snap back to the de facto, preexisting distribution of power and wealth. I sought to illustrate this problem, which also highlights its own solution, in evaluation of the Chilean Constitution of 1980. By any standard, the Constitution of 1980 was awful, violating standards of rule of law, democratic representation, and ethical fairness. Yet it may well have been an excellent constitution, in the sense that it recognized the problem of proportionality, and allowed Chile to escape from a repressive military dictatorship back to functioning democracy.

Bibliography

Brennan, G. (1999). *Notes on Buchanan and Methodological Individualism*. Research School in Social Sciences, Australian National University, Canberra. http://publicchoice.info/Buchanan/files/brennan.htm.

Brennan, G. (2015). Buchanan's Anti-Conservatism. *Public Choice, 163*, 7–13.

Brennan, G., & Buchanan, J. (1985). *Reason of Rules: Constitutional Political Economy*. New York: Cambridge University Press. Vol. 10 of *The Collected Works of James Buchanan*. Indianapolis, IN: Liberty Fund.

Buchanan, J. (1990). The Domain of Constitutional Economics. *Constitutional Political Economy, 1*(1), 13–14. Reprinted in *The Logical Foundations of Constitutional Liberty*, 1999. Vol. 1 of *The Collected Works of James Buchanan* (pp. 377–395). Indianapolis, IN: Liberty Fund.

Buchanan, J. (1991). The Foundations of Normative Individualism. In *The Economics and the Ethics of Constitutional Order*. Ann Arbor: University of Michigan Press. Reprinted in *The Logical Foundations of Constitutional Liberty*, 1999. Vol. 1 of *The Collected Works of James Buchanan*, 281–292. Indianapolis, IN: Liberty Fund.

Buchanan, J. (1999a). The Limits of Liberty: Between Anarchy and Leviathan. In G. Brennan, H. Kliemt, & R. Tollison (Ed.), *Collected Works of James Buchanan* (Vol. 7). Indianapolis, IN: Liberty Fund.

Buchanan, J. (1999b). The Relatively Absolute Absolutes. In G. Brennan, H. Kliemt, & R. Tollison (Ed.), *Collected Works of James Buchanan, The Logical Foundation of Constitutional Liberty* (Vol. 1, pp. 442–454). Indianapolis, IN: Liberty Fund.

Buchanan, J., & Brennan, G. (2001). *The Intellectual Portrait Series: A Conversation with James M. Buchanan*. Indianapolis, IN: Liberty Fund. http://oll.libertyfund.org/titles/buchanan-the-intellectual-portrait-series-a-conversation-with-james-m-buchanan-part-1 and http://oll.libertyfund.org/titles/buchanan-the-intellectual-portrait-series-a-conversation-with-james-m-buchanan-part-2.

Buchanan, J., & Tullock, G. (1962). *The Calculus of Consent*. Ann Arbor: University of Michigan Press.

Campbell, B. (2005). Economic Causes of Progressivism. *Journal of the Gilded Age and Progressive Era, 4*(1), 7–22.

Cooter, R. D., & Siegel, N. (2010). Collective Action Federalism: A General Theory of Article I, Section 8. *Stanford Law Review, 63,* 115–143.

Cox, G. W., North, D., & Weingast, B. (2016, December). *The Violence Trap: A Political-Economic Approach to the Problems of Development* (Working Paper). Hoover Institution, Stanford University.

Fraser, C. (2015). Mohism. In Edward N. Zalta (Ed.), *The Stanford Encyclopedia of Philosophy* (Winter 2015 Edition). https://plato.stanford.edu/archives/win2015/entries/mohism/.

Hardin, R. (1989). Rationally Justifying Political Coercion. *Journal of Philosophical Research., 15,* 79–91.

Hayek, F. A. (1979). *Law, Legislation and Liberty* (3 Vols.). Chicago: University of Chicago Press.

Home, H. (Lord Kames). (1779). *Essays on the Principles of Morality and Natural Religion, Corrected and Improved, in a Third Edition. Several Essays Added Concerning the Proof of a Deity*, Edited and with an Introduction by Mary Catherine Moran (Indianapolis, IN: Liberty Fund, 2005). June 19, 2018. http://oll.libertyfund.org/titles/1352.

Hudson, R. A. (Ed.). (1994). *Chile: A Country Study*. Washington, DC: GPO for the Library of Congress. http://countrystudies.us/chile/.

Hume, D. [1739–1740] (1978). In L. A. Selby-Bigge & P. H. Nidditch (Eds.), *A Treatise of Human Nature* (2nd ed.). Oxford: Oxford University Press.

Kliemt, H. (2004). Contractarianism as Liberal Conservatism: Buchanan's Unfinished Philosophical Agenda. *Constitutional Political Economy, 5*(2), 171–185.

Kliemt, H. (2011). Bukantianism: Buchanan's Philosophical Economics. *Journal of Economic Behavior & Organization, 80*(2), 275–279.

Mo, T. (n.d.). *Mozi Writings, Spring and Autumn—Warring States: 490 BC–221 BC* (English translation: W. P. Mei). https://ctext.org/mozi.

Montesquieu, C. S. B. (1989). *The Spirit of the Laws* (A. M. Cohler, B. C. Miller, & H. S. Stone, Trans.). Cambridge: Cambridge University Press.

Ostrom, E. (1990). *Governing the Commons: The Evolution of Institutions for Collective Action*. New York: Cambridge University Press.

Rawls, J. (1971). *A Theory of Justice*. Cambridge, MA: Harvard University Press.

Smith, A. (1976 [1776]). *An Inquiry into the Nature and Causes of the Wealth of Nations*. Chicago: University of Chicago Press.

Tomasi, J. (2011). *Free Market Fairness*. Princeton: Princeton University Press.

Wicksell, K. (1958 [1896]). Finanztheoretische *Untersuchungen*. Jena: Gustav Fischer Verlag. Partially Reprinted as Wicksell, K. (1958). A New Principle of Just Taxation. In R. A. Musgrave & A. T. Peacock (Ed.), *Classics in the Theory of Public Finance* Peacock (pp. 72–118) London: Macmillan.

4

James Buchanan and the Properly Trained Economist

Peter J. Boettke and Rosolino A. Candela

> [E]conomists forget the moral basis of their science and thereby miss the *raison d'être* of economics. The true purpose of the distinctive "science of political economy" is to design alternative legal structures and to evaluate their potentialities in enhancing efficiency in the exploitation of the mutuality of advantage. This means that the "science of political economy" is *categorically* distinct from the "science of economics." The former uses the knowledge of behavioural regularities, which the latter may discover, in order to allow the community of free individuals to make informed and institutional choices.
>
> James M. Buchanan (1987 [2001], p. 40, emphasis original)

P. J. Boettke (✉)
Department of Economics, George Mason University,
Fairfax, VA, USA
e-mail: pboettke@gmu.edu

R. A. Candela
F. A. Hayek Program for Advanced Study in Philosophy,
Politics, and Economics, Mercatus Center at George Mason University,
Fairfax, VA, USA
e-mail: rosolino_candela@brown.edu

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_4

Introduction

What is the role of the properly trained economist? James Buchanan often referred to Gordon Tullock as a "natural born" economist (1987 [2001]). Deirdre McCloskey (1992) has also written of the "natural," or those who "believe in economics". As she put it in that essay, the economic way of thinking can be summarized as (a) think about maximization, (b) think about equilibrium, and (c) think about the interaction of maximization and equilibrium. And, McCloskey gives as shining examples, Armen Alchian, Gary Becker, and Gordon Tullock. Historically contemplated, when we think of "natural born" economic thinkers, our mind turns to David Hume and Adam Smith, and to John Stuart Mill, and to early neoclassical economists such as Philip Wicksteed, Frank Knight, and Ludwig Mises. For these classical and early neoclassical economists, (a) was the analytical anchor to explain (b) via institutional variations that provide the framework for (c). The thoroughgoing subjectivism of Mises, however, makes the economic way of thinking a more subtle instrument of thought, while the philosophical musings of Knight make it more nuanced.[1] Part of the charm of Becker and Tullock[2] is their lack of subtlety and nuance as "natural economists," in which they oftentimes seem to conflate (a) and (b), which squeezes out (c), but as we argue, that is also part of their weakness in providing the appropriate foundations of, as Buchanan (1982 [2001]) put it, the distinct but related sciences of economics and political economy. Buchanan was trained in the classical and early neoclassical tradition of Knight and Mises, and so his work throughout his long career always

[1]As F. A. Hayek has written, "it is probably no exaggeration to say that every important advance in economic theory during the last hundred years was a further step in the consistent application of subjectivism" (1952, p. 31). "This is a development," Hayek argues further, "which has been carried out most consistently by L.v. Mises *and I believe that most peculiarities of his views which at first strike many readers as strange and unacceptable are due to the fact that in the consistent development of the subjectivist approach he has for a long time moved ahead of his contemporaries*" (1952, pp. 209–210, fn. 24, emphasis added; see also Knight 1940).

[2]Contrary to this standard interpretation, however, we have written elsewhere that Tullock's methodological and analytical understanding of economics fits more closely with Mises (see Boettke and Candela 2018).

reflected a subtlety and nuance in the application of the technical principles of economics to access how alternative institutional arrangements impact the ability of individuals to pursue productive specialization, and realize peaceful social cooperation through exchange. As prolific a writer Buchanan was, there is an underlying consistency that resonates throughout his work (see Wagner 2017),[3] and what we wish to emphasize in this chapter is that this consistency applies no less with regard to what he regarded as a properly trained economist.

The Science of Economics and Political Economy: Distinct, but Related

The role of the properly trained economist is not only to understand the "science" of economics under given institutional frameworks. He or she must also use economic science to explore opportunities for institutional change. As Buchanan argued, "the economist must hope that his simple truths, as extended, can lead to 'improvement' in the structure of these institutions, through the ability of institutions to modify the conditions of human choice" (1966 [1979], p. 140), but, "the final choices in a free society rest with individuals who participate in that society" (1966 [1979], p. 140).

For Buchanan, economic science is not simply the pure logic of choice (Buchanan 1969 [1979]). Rather, the pure logic of choice is the analytic anchor from which institutions emerge and guide the coordination of maximizing individuals *towards* equilibrium. Economic science, therefore, explains how the "institutions of exchange, of markets, are derived, therefore, from the mutual interactions of individuals who are

[3]As Wagner argues in his latest book, *James Buchanan and Liberal Political Economy: A Rational Reconstruction*, Buchanan's unique contributions to public finance, and political economy more broadly, can be traced back to his 1949 paper, "The Pure Theory of Government Finance: A Suggested Approach," in which he rejects what he refers to as an "organismic theory the state" as a single decision-making unit acting for society as a whole, seeking to maximize some conceptually quantifiable social welfare function. This rejection of preexisting social welfare function, existing "out there" and independent of human choice and valuation, is what resonates throughout Buchanan's work.

continuously engaged in making ordinary choices for more rather than less" (Buchanan 1966 [1979], p. 120). "Choice exercised by an individual," as Buchanan puts it, "involves self-creation along with the creation of constraints imposed on the choices of others. This *reciprocal interaction* takes place over a whole temporal sequence" (Buchanan, 1991, p. 226, emphasis added). Therefore, there exists, a bi-directionality between choice and institutions (Wagner 2010), and the distinct, yet related sciences of economics and political economy each help us understand the emergence and modification of institutions, respectively, as a result of human choice (see Runst and Wagner 2011).

Proper economic training requires an understanding that such reciprocal interaction is one of "adjustment, of coordinated conflict, of *mutual gains*," (Buchanan 1966 [1979], p. 118, emphasis original) and for that we need the subtlety and the nuance provided by Mises and Knight to transform the "natural born" economist into the "properly trained" economist. In sports, the motivating phrase is "hard work beats talent, when talent fails to work hard." In economics, we believe it should be, "proper training beats the natural born, when the natural born forgets the lessons of proper training." And, proper training relates not to the cognitive capacities we imbue our agents in our models with, nor does it relate to their base motivational content, but instead relates to the economist's ability to address how alternative institutional configurations impact human behavior, and vice versa, and thus the performance of social systems.

In his essay on "Economics and its Scientific Neighbors," Buchanan (1966 [1979]) argues that the properly trained economist must have the principles of the discipline always by their side. The task of the political economist is to use the technical principles to assess how alternative institutional arrangements encourage or hinder the ability of individuals to realize the gains from production specialization and peaceful social cooperation. "As a 'social' scientist," Buchanan argued, "the primary function of the economist is to explain the workings of these institutions and to predict the effects of changes in their structures. As the interaction process that he examines becomes more complex, it is but natural that the task of the economic scientists becomes more intricate. But his central principle remains the same, and he can, through its use, unravel the most tangled sets of structural relationships among human beings" (1966 [1979], p. 120).

Economics properly understood makes sense out the complex web of human relations that constitute reality. "The Economist," Buchanan continues, "is able to do this because he possesses this central principle—an underlying theory of human behavior. And because he does so, he qualifies as a scientist and his discipline as a science. What a science does, or should do, is simply to allow the average man, through professional specialization, to command the heights of genius. The basic tools are the simple principles, and these are chained forever to the properly disciplined professional. Without them, he is as a jibbering idiot, who makes only noise under an illusion of speech" (1966 [1979], p. 120).

So, the first task of the properly trained economist is to avoid becoming a jibbering idiot! (Boettke 2017). Since nobody knowingly strives to be a jibbering idiot in science, we must ask: What might lead someone astray in the discipline of economics and lead us not to enlightenment, but to mistaking noise for sense? Buchanan's consistent answer from the beginning of his career was a *methodological one*, and is best exemplified in "What Should Economists Do?" (1964) when he worries about the practice of nonsensical social science when the pure logic of choice and the allocation of resources is given the primary place in economics as opposed to exchange and the institutions within which exchange takes place.

For Buchanan, the properly trained economist occupies a dual, yet overlapping role. There is one as an economic scientist who understands institutional emergence and change arising a result of human choice, and how changes in such institutions generate alternative patterns of interaction. Based on their theoretical knowledge of economic science, properly trained economists also apply such knowledge in their role as a political economist, who *suggests* that there a multiple margins of improvement on existing institutions, *discovered* through democratic deliberation, in order to better facilitate the mutually shared goals among free and responsible individuals (1959, p. 131). The fact that we live in a non-ideal world provides hope for change, but change through improved institutions, not an improved man.

The properly trained economist is provided a non-normative basis for their role as a scientist as well as a reformer, which can "be summed up in the familiar statement: *There exist mutual gains from trade*" (Buchanan 1959, p. 137, emphasis original). That is, utilizing the tools of economics, the political economist can submit proposals for institutional reform for the purpose of securing greater gains from trade in the economy. The properly trained economist never acts as a social engineer, but as a social entrepreneur: "His task is that of locating possible flaws in the existing social structure and in *presenting possible* 'improvements'" (1959, p. 137, emphasis added). The idea in Buchanan's framework that best reveals this distinct relationship between the science of economics and the science of political economy is his discussion of the compensation principle (1959).

According to Buchanan, compensation is defined as "that set of payments required to secure the agreement of all parties to the proposed change;" it is not to be confused with an objectively measurable quantity independent of choice. Compensation "must be defined in terms of the individual choice process, and it becomes measurable only through an observation of choices" (1959, p. 128, fn. 6) arrived at through deliberation. In suggesting alternative institutional changes for reform, the political economist takes the status quo as a given, not as a normative evaluation, but as a positive benchmark from which to assess "which one from among the many possible social policy changes does, in fact, satisfy the genuine Pareto rule. Compensation is the only device available to the political economist for this purpose" (1959, p. 129).

Because changes in the rules of the game will change the nature of the payoffs in the game, compensation is necessary for those who benefit from the existing status quo, not because the losers have any normative claim to their existing benefits, but because without compensation, the beneficiaries of the status quo will fight to defeat any proposed changes in the structure of rules (see also Tollison and Wagner 1991). "Compensation is desirable here because only through the compensation device can appropriate criteria for 'improvement' be discovered" (Buchanan 1959, p. 131). Moreover, because individual valuation can only be demonstrated through choice, and therefore cannot be aggregated into a social welfare function that exists independent of choice, consensus must be discovered in order to "test" whether such institutional reform via compensation is mutually beneficial.

The political economist is able to submit such tests for evaluation and "predict" the responses to such proposed policy changes by utilizing economic science as a necessary input into the science of political economy. As Buchanan argues, the "predictive 'science of economics' is positively valuable to governmental agents, business firms, and private individuals. Persons can 'play better games' if they can predict their opponents' strategy more accurately" (1982 [2001], p. 47). This requires the modelling of agents as *homo economicus*, "as if they do not voluntarily restrict their behavior to the limits defined by the mutuality of gains" (1982 [2001], p. 50). In doing so, Buchanan is not arguing that this behavioral assumption is representative of flesh and blood human beings (see Boettke and Candela 2017b). As he states, "to model persons as *Homo economicus* terms for this purpose of deriving constitutional structure is *not* the same thing at all as advancing predictions that persons will necessarily behave as *Homo economicus* (Buchanan 1982 [2001], p. 50, emphasis original) Rather, this behavioral assumption is used by the political economist for the purpose of making "informed and sophisticated choices among alternative institutional constraints, constraints that are mutually acknowledged and accepted by all parties, and which are to be *externally enforced* by the sovereign" (Buchanan 1982 [2001], p. 50).

The "science of economics," which "predicts" how individuals will respond to proposed institutional changes *within given institutional constraints* is distinct, though related, to the "science of political economy," which tests proposed *institutional changes* via compensation. Once the properly trained economist understands this distinction, he "should not be content with postulating models and then working within such models. His task includes the derivation of the institutional order itself from the set of elementary behavioral hypotheses with which he commences. In this manner, genuine institutional economics becomes a significant and an important part of fundamental economic theory" (1968 [1999], p. 5).

Common Knowledge Consistently Applied by the Properly Trained Economist: A Perusal Through Buchanan's Archives

As we have been processing the Buchanan archives at GMU, it has been fascinating to get a window into Buchanan's world. This collection—which now runs 192 linear feet—reveals a surprising consistency in Buchanan's writings, his academic entrepreneurship and his private correspondence.[4] To anyone paying attention, this consistency in Buchanan's scientific enterprise and his published work should not be a surprise since it was already evident in his 20 volume *Collected Works*. Please don't misunderstand us, Buchanan was an amazingly wide-ranging scholar whose work not only constantly drew from literatures in economics, politics, philosophy and law, but whose contributions within economics and political economy also addressed fields as diverse as public economics, price theory, collective choice, welfare economics, comparative systems, law-and-economics, industrial organization, economic growth and development, and the history of economic thought. So, there is something new to learn about the man and his works with each visit to the archive, and something new to learn with each reading of the works contained inside the pages of those 20 volumes. But there is also a remarkable consistency, as Richard Wagner (2017) has argued, from Buchanan's first paper (1949) and throughout his career.

Critical to understanding Buchanan's system is that he is a liberal political economist in the tradition of Hume-Smith and Knight-Mises-Hayek, he is a methodological individualist in the tradition of Knight-Mises, he is price theorist in the tradition of Marshall-Knight, and he is public finance theorist in the tradition of Wicksell. All these elements are wrapped up in his economics (see Boettke and Candela 2014, 2017a). Furthermore, he has a deep commitment to government through discourse, and perhaps an even deeper commitment to the "relatively absolute absolute" in matters of politics (and in all human

[4] See http://scrc.gmu.edu/finding_aids/buchanan.html.

endeavors). No one individual, or group of individuals, is privileged either by nature or through social position in deliberation over others. No one, and no group, has unique access to TRUTH. In fact, any claim in politics to TRUTH leads to tyranny plain and simple. All we can have in politics is consensus and compromise, and since there is no unified scale of values for society as a whole, all we can ever reasonably expect to get a consensus over is not ends, but the acceptable range of means by which we each pursue our separate and often desperate ends and how we relate to one another in our efforts to pursue those ends.

Wagner relays the story of his first classroom encounter with Buchanan back at University of Virginia in the fall of 1963. The class was public finance, and Wagner had read all summer in excited anticipation of taking this class. On the first day, Buchanan, Wagner reports, glanced at his roll sheet and then said, "Mr. Wagner, what's wrong with the American tax system?" As Wagner tells the story, with a great deal of excitement he began to relay all he had read that summer about simplifying the tax system, and when he finished Buchanan simply responded: "Mr. Wagner, you have no business answering a question like that. We are democrats here and not autocrats" (Wagner 2017, p. 178).

Public finance in Buchanan's hands was never a form of social engineering where the theorist determines the balancing between public and private through some idealized theoretical construction. Fiscal decisions should reflect the preferences of the citizens in the relevant collective decision-making group, and not merely the imposition of the preferences of either the ruler or the ruling class. Buchanan made this point in 1949, and he makes it within the first few paragraphs of his Nobel Lecture in 1986: "Economists should cease proffering policy advice as if they were employed by a benevolent despot, and they should look to the structure within which political decisions are made" (1987, p. 243). Economics in the hands of the properly trained economist is a tool of social understanding, and never a tool for social control. However, such understanding must also encompass institutional change emerging from purposive behavior, for if social understanding means understanding the passive response of individuals to given constraints, economics is nothing more than an exercise in the pure logic of choice.

Buchanan's approach is the antithesis of the dominant Samuelson-Musgrave approach to public economics and public finance, and harks back philosophically to the great puzzles associated with choosing in groups from Hobbes, Rousseau, Montesquieu, and Hume, and the technical economics of Smith, Mill, Wicksell and the Italian public finance theorists of the late nineteenth and early twentieth century. The theory of taxation and fiscal expenditures, in Buchanan's work, provides the answer to the institutional puzzles that the philosophical question of the good and just bring to the forefront. Institutional problems demand institutional solutions. But our ability to offer those solutions must be constrained by the "relatively absolute absolute" check that we mentioned above.

Buchanan's clearest statement of this is in his 1959 paper "Positive Economics, Welfare Economics and Political Economy", and this should be mandatory reading for all economists and political economists for several reasons. Again, the properly trained economist must focus on exchange and the institutions within which exchange takes place in their positive analysis. "Political economy," Buchanan states, "is concerned exclusively with the modifications of the rules of the game" (1959, p. 133, fn. 11), and such modifications emanate from the self-seeking behavior of individuals taking into account their respective constraints. Individuals do have purposes, and do strive to do the best that they can given their situation. But the individual pure logic of choice is restricted in a strict scientific sense to Crusoe type analysis. Once Friday enters the picture, and we have two beings trying to live together through mutual adjustment and ways of relating to one another. Their interaction is categorically different than their isolated pure logic of choice. But the interaction arises from the pursuit of their own purposes and plans for betterment. Learning how to study both the logic of choice mechanics against given constraints, *and* the interaction process of exchange within alternative institutional arrangements is what it means to become a properly trained economist.

The key to Buchanan's 1959 paper is what the implications of the training are for both the critique of textbook welfare economics, and the alternative conceptual apparatus of political economy. Like in his 1949 paper, Buchanan argues that the deployment of the assumptions of omniscience and benevolence in the welfare economics results in magical thinking, and such magical thinking is decidedly unhelpful in addressing the tough questions of collective action within a democratic process of decision-making. As he said to Wagner, "we are democrats here", and so in putting the properly trained economist *inside* the model, the economist becomes restricted to offering only recommendations of changes to the structural rules of the game per se, and only as hypotheses to be tested through the democratic process. No autocratic impulse can be appealed to by the economic "expert" within a democratic polity. This is why Buchanan's version of welfare economics requires a real compensation principle and not just a potential compensation scheme as in Hicks-Kaldor, and it does "privilege" the status-quo, but not for any normative reasons, but simply for the analytical purpose of "starting from the here and now". It is in this way, and only in this way, that Buchanan believes the properly trained economist can both maintain the scientific status of economics, and appeal to the social reformist zeal in political economy.

In the late 1970s, all these issues are brought out in an exchange of letters with one of his former students—Richard McKenzie. McKenzie had just recently published with Tullock, *The New World of Economics* (1975), which is a relentless application of the economic way of thinking to all walks of life. He is also working on a paper dealing with the constitutional moment in the US, which challenges the public-spirited interpretation and pursues instead a pure private interest explanation of the American Founding. This particular exchange of letters runs from May 29, 1979 to June 25, 1979 and consists of 2 letters from each party. McKenzie begins the conversation by asking for Buchanan's reaction on his work on constitutions. He references Charles Beard's economic interpretation of the constitution, and asks Buchanan the following: "I recognize that Beard may not be right in his analysis; but if he is, does my analysis follow?" (McKenzie 1979).

Buchanan's response is harsh, but also framed with a self-effacing "quasi-serious" quip and informing McKenzie that he probably needs to be constrained as a scholar to keep his very good talents "from running to excess." He informs McKenzie that he does not like his paper, and in fact considers his paper to be profoundly immoral as it violates the norms of the civic religion with the over-extension of the logic of economics. He then says that he "felt a bit the same way about some of your applications in 'New World.' "There are limits" to economics analysis, Buchanan insists, "beyond which it is inappropriate to do go, for to do so will undermine myths, sacrosanct objects, concepts, ideas, that have intrinsic value in their own rights." Buchanan ends that paragraph by informing McKenzie that the mythology that the founders were disinterested public servants "has served us very well for two centuries, and, quite literally, I think it is a sin to destroy this mythology" (Buchanan 1979). The reason is that the social order of the liberal society, its stability and its viability, is intimately connected to the maintenance of this civic religion. Destroy the civic religion, and you will destroy the social order.

Buchanan's argument is not a denial of an economic reason for the existence of such a civic religion. Constitutional rules are crucial in providing expectations about future political exchange, including the modification of rules. Indeed, Buchanan has argued elsewhere that the economic origins for the emergence of such ethical-moral constraints arise from pure logic of choice, but such constraints are not simply the aggregate outcome of, as Becker would put it, individuals consistently maximizing well-defined and independent utility functions (Becker 1971). "The methodological individualist," Buchanan writes, "must, it seems to me, acknowledge the *relationships between individual utility functions* and the socioeconomic-legal-political-cultural setting within which evaluations are made. But such acknowledgement carries with it, almost as a matter of course, the possible productivity of investment in the promulgation of moral norms" (Buchanan 1991, p. 186, emphasis added).

Buchanan ends his letter chiding McKenzie to be more reflective of his position, one that steers a path away from a strict interpretation of "New World" and more toward one that recognizes the ethical-moral cement of the social order. In other words, to keep in mind as he would later put it (Buchanan 1982 [2001]), the distinctions between the related disciplines of economics and political economy. McKenzie responds immediately, and says that while the comments from Buchanan were not totally unexpected, he pushes back or seeks to clarify his position, especially as it relates to *The New World*. He "defends" the extreme examples as a method to capture the imagination of the students, to shock them out of their complacency so they may see the power of the principle being illustrated. He ensures Buchanan that he is not completely serious in the choice of examples. And then he adds that he believes that students get this, but that perhaps some instructors don't.

Buchanan's response brings us back to our theme here. As he says to McKenzie in a letter dated June 25, 1979, "I think that you can appreciate my own position, which places very heavy weight on ethical-moral constraints, and on noneconomic explanations generally. But yet you can also see the power of the simplistic economic explanation, and you, like me, recognize that these explanations are, after all, our own stock in trade." Yet, Buchanan argues that our discipline must resist the scientistic urge. "Our raison d'etre is not to act like, or to ape the scientists at all. And we would not like the world of the economic scientists at all." Here Buchanan lays out his position, which has been developed throughout his writings, that our role as economists is "basically didactic." This is not a preacher, but the teacher that cultivates in their students an appreciation and understanding of the spontaneous ordering of the market economy (Boettke 2011).

But once he makes this standard claim of his, Buchanan stresses that there are multiple windows into the world through which one can look, and that "we should all come to accept the fact that politics involves talking pure and simple". Buchanan had with his own public choice analysis attempted to pierce the romantic veneer of modern democratic politics, but once the romance is no more, Buchanan fears that if we "become generally convinced that politics is pure transfer" then all that is left is fighting over each other's shares.

After Buchanan won the Nobel Prize, there was a debate about whether or not public choice theory was immoral by sowing a cynical view of public engagement in the democratic process. Buchanan and Brennan (1988) tell us in the acknowledgements of their paper that they had originally drafted the essay in 1982, but revised and published this version in response to Steven Kelman's paper in *The Public Interest* in 1987. Kelman basically argues that Buchanan and public choice are attributing a descriptive set of assumptions to those engaged in public service that questions their motivations and intentions. Rather than seeing individuals as publicly spirited and motivated for the common-good, everyone is *presumed* to be self-seeking and thus only using the common-good language as a cover for their true private interests.

We don't want to belabor the problems with what we see as Kelman's interpretation, or for that matter the recent resurrection of Kelman's claims in Nancy MacLean's *Democracy in Chains* (2017). We just will point out simply two things: (a) Buchanan and public choice were never making a descriptive claim about any particular political actor, and (b) the purpose of *homo economicus* in political economy was to basically provide a robustness check in institutional design. Just as Hume centuries earlier argued that as thinkers it will be helpful for us to assume that all men are knaves when designing our political institutions, Buchanan et al. were doing the same. It is not a description that all men are knaves, it is an analytical device to build in a check against self-interest with guile, or opportunistic behavior, when engaged in the political economy of institutional design. The rules of the game engender strategies. If the best response strategy given the rules undermine the game, then the rules that were designed perhaps are poorly designed rules! The great early twentieth century economic thinker, Dennis Robertson, once asked famously, what do economists economize? Robertson's answer was love, the most precious of all resources known to humanity. His reasoning, if our institutional designs require for their working that we all love one another, then we will exhaust that resource in very short time. Instead, better for us to seek institutional arrangements that do not require our love for one another for their operation, so that we can utilize our capacity for love in more appropriate situations.

The fact that thinkers from Kelman to MacLean misunderstand this analytical purpose of the *homo economicus* assumption does not excuse the misuse of the assumption by those more closely aligned with the public choice research program. In a 1986 letter responding to a query of whether public choice isn't a deterministic social science akin to a form of "right-wing" Marxism, Buchanan responds that the critique offered by the letter writer (one Mr. Paul D'Andrea of Illinois) perceptively "summarize a concern that has been of increasing importance to me as the subdiscipline develops." He continues: "In many of its empirical applications, public choice seems to take on characteristics of a strictly deterministic 'science,' in which actors do not initiate action but only respond in the directions that economic incentives dictate. There is little or no room for the genuine entrepreneur, to use this term broadly to include those who might initiate ideas as well as organize production." And he concludes that those of us who work the level of philosophical discussion "recognize the severe limits of any deterministic public choice" and "we do despair at the efforts of some of our colleagues in the subdiscipline, who do not seem to have any sense of the underlying foundations."

These sentiments can also be seen in Buchanan's exchange of letters with Vincent Ostrom (1977) on the constitutional political economy project and the future of public choice scholarship. In a letter dated March, 18 1977, Buchanan argues that the shared project between him and Ostrom is grounded on two fundamental propositions: (1) institutions matter, and (2) institutions can be constructed. "We face opposition on both these counts," he adds. Stigler and the modern Chicago School explicitly deny the first, and Hayek and the evolutionists deny the second. This discussion could go in a variety of directions, but for our purposes, we simply want to stress that Buchanan's 'solution' to these problems are to be found once again in his distinction between the related but separate scientific enterprises of economics and political economy. Economics begins with the logic of choice, and expands to the study of exchange and the institutions within which exchanges take place. Political economy studies the property of the rules themselves and the process by which they can be changed. One takes the constraints as given, the other seeks to study how the constraints can be changed.

The properly trained economist must understand the difference, and also appreciate the different scientific standards of assessment the two intellectual exercises are to be judged by. "The science of political economy requires more than the making and testing of predictions about behavior under an existing set of constraints, some given system of laws, although the latter 'science' [economics] will, of course, continue to be a necessary input in the exercise. The second 'science' [political economy], however, also requires some comparison of the results observed within an existing system of constraints and those that might be predicted to emerge under alternative systems. For the simple reason that it does not now exist, the results of an alternative set of constraints can never be observed. Alternative structures exist only as potentialities, as constraints that persons might *create* by their own choices, from the void as it were, and not some reality 'out there' waiting to be explored and discovered. At this level, the discovery metaphor which has proven useful in describing the search activity of ordinary science becomes positively misleading in application to the comparative analysis of alternative constraints structures" (Buchanan 1982 [2001], p. 47).

This argument led Buchanan to conclude that the failure to distinguish between the two distinct sciences of economics and political economy has led the modern economic profession to lose its *raison d'être*. And it potentially turns the discipline away from a tool of social understanding and human betterment through democratic discourse into a tool for social control and "inadvertently lend support to the efforts of the subset of persons who seek always to treat other persons as potential responders to control stimuli, support to those putative authoritarians who act on behalf of and as agents for the modern state apparatus" (1982 [2001], p. 48).

Conclusion

When Buchanan took up the task to describe what he and his colleagues were hoping to accomplish with the establishment of the Thomas Jefferson Center for Studies in Political Economy (Buchanan 1958). He argued that the idea was to continue in the grand and honorable tradition of political economy, and that the task of the political economist was first and foremost to utilize the technical principles of economics that are necessary to access how alternative institutional arrangements enable or hinder the pursuit of individuals to pursue productive specialization and peaceful social cooperation. However, the second aspect of the task of political economy is to bring into the open the moral and philosophical investigations of the questions dealing with the scale and scope government in all deliberations concerning public policy. This remains the task of the properly trained economist. Others that fall short in this task, are not evil or dim, but they perhaps just "lack training."

References

Becker, G. S. (1971). *Economic Theory*. New York: Alfred A. Knopf.

Boettke, P. J. (2011). Teaching Economics, Appreciating Spontaneous Order, and Economics as a Public Science. *Journal of Economic Behavior & Organization, 80*(2), 265–274.

Boettke, P. J. (2017). Don't Be a 'Jibbering Idiot': Economic Principles and the Properly Trained Economist. *The Journal of Private Enterprise, 32*(3), 9–15.

Boettke, P. J., & Candela, R. A. (2014). Alchian, Buchanan, and Coase: A Neglected Branch of Chicago Price Theory. *Man and the Economy, 1*(2), 189–208.

Boettke, P. J., & Candela, R. A. (2017a). Price Theory as Prophylactic Against Popular Fallacies. *Journal of Institutional Economics, 13*(3), 725–752.

Boettke, P. J., & Candela, R. A. (2017b). Rational Choice as If the Choosers Were Human. In M. Altman (Ed.), *Handbook of Behavioral Economics and Smart Decision-Making: Rational Decision-Making Within the Bounds of Reason* (pp. 68–85). Northampton: Edward Elgar.

Boettke, P. J., & Candela, R. A. (2018). Gordon Tullock, Praxeology, and the Qualities of a Natural Born Misesian. *The Independent Review: A Journal of Political Economy, 23*(2), 169–185.

Brennan, G., & Buchanan, J. M. (1988). Is Public Choice Immoral? The Case for the 'Nobel' Lie. *Virginia Law Review, 74,* 179–189.

Buchanan, J. M. (1949). The Pure Theory of Government Finance: A Suggested Approach. *Journal of Political Economy, 57*(6), 496–505.

Buchanan, J. M. (1958). The Thomas Jefferson Center for Studies in Political Economy. *The University of Virginia News Letter, 35*(2), 5–9.

Buchanan, J. M. (1959). Positive Economics, Welfare Economics, and Political Economy. *The Journal of Law and Economics, 2,* 124–138.

Buchanan, J. M. (1964). What Should Economists Do? *Southern Economic Journal, 30*(3), 213–222.

Buchanan, J. M. (1966 [1979]). Economics and Its Scientific Neighbors. In *What Should Economists Do?* (pp. 115–142). Indianapolis: Liberty Fund.
Buchanan, J. M. (1968 [1999]). *The Collected Works of James M. Buchanan Volume 5: The Demand and Supply of Public Goods*. Indianapolis: Liberty Fund.
Buchanan, J. M. (1969 [1979]). Is Economics the Science of Choice? In *What Should Economists Do?* (pp. 39–63). Indianapolis: Liberty Fund.
Buchanan, J. M. (1977, March 18). *Letter to Professor Vincent Ostrom*. Blacksburg: Virginia Polytechnic Institute and State University.
Buchanan, J. M. (1979, June 25). *Letter to Professor Richard McKenzie*. Blacksburg: Virginia Polytechnic Institute and State University.
Buchanan, J. M. (1982 [2001]). The Related But Distinct 'Sciences' of Economics and of Political Economy. In *The Collected Works of James M. Buchanan, Volume 17: Moral Science and Moral Order* (pp. 40–54). Indianapolis: Liberty Fund.
Buchanan, J. M. (1986, June 9). *Letter to Mr. Paul D'Andrea*. Fairfax: George Mason University.
Buchanan, J. M. (1987). The Constitution of Economic Policy. *The American Economic Review, 77*(3), 243–250.
Buchanan, J. M. (1987 [2001]). The Qualities of a Natural Economist. In *The Collected Works of James Buchanan Volume 19: Ideas, Persons, and Events* (pp. 95–107). Indianapolis: Liberty Fund.
Buchanan, J. M. (1991). *The Economics and Ethics of Constitutional Order*. Ann Arbor: The University of Michigan Press.
Hayek, F. A. (1952). *The Counter-Revolution of Science: Studies on the Abuse of Reason*. Glencoe: The Free Press.
Kelman, S. (1987). 'Public Choice' and Public Spirit. *Public Interest, 87,* 93–94.
Knight, F. H. (1940). 'What Is Truth' in Economics? *Journal of Political Economy 48*(1), 1–32.
MacLean, N. (2017). *Democracy in Chains: The Deep History of the Radical Right's Stealth Plan for America*. New York: Viking.
McCloskey, D. N. (1992). Other Things Equal: The Natural. *Eastern Economic Journal, 18*(2), 237–239.
Mckenzie, R. B. (1979, May 29). *Letter to Professor James Buchanan*. Clemson: Clemson University.
Mckenzie, R. B., & Tullock, G. (1975). *The New World of Economics: Explorations into the Human Experience*. Homewood: Richard D. Irwin.

Runst, P., & Wagner, R. E. (2011). Choice, Emergence, and Constitutional Process: A Framework for Positive Analysis. *Journal of Institutional Economics, 7*(1), 131–145.

Tollison, R. D., & Wagner, R. E. (1991). Romance, Realism and Economic Reform. *Kyklos, 44*(1), 57–70.

Wagner, R. E. (2010). *Mind, Society, and Human Action: Time and Knowledge in a Theory of Social Economy*. New York: Routledge.

Wagner, R. E. (2017). *James M. Buchanan and Liberal Political Economy: A Rational Reconstruction*. Lanham: Lexington.

5

James Buchanan and the "New Economics of Order" Research Program

Stefan Kolev

Introduction: The New Fragility of Western Order

"Order" is certainly among the most complex and most fundamental notions in Western social philosophy (Anter 2007). This essay is dedicated to a perspective in the social sciences which approaches issues of economy and society through the notion of order—a perspective with a long-standing tradition and a multitude of thinkers related to it. James Buchanan's Constitutional Political Economy is one of the most recent and most prominent twentieth-century examples, and in the latest presentations of his life, he repeatedly emphasized his intellectual affiliation to this tradition, as embodied in the systems of the "Old Chicago" School and the Freiburg School (Buchanan 2010, 2011,

S. Kolev (✉)
University of Applied Sciences Zwickau, Zwickau, Germany
Wilhelm Röpke Institute, Erfurt, Germany
e-mail: stefan.kolev@fh-zwickau.de

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_5

2012)—systems which share an astounding number of commonalities (Köhler and Kolev 2013). Following up on this self-characterization, the purpose of the essay is to embed and contextualize Buchanan's thought in the "thinking-in-orders" tradition. In an attempt to transpose this tradition into the twenty-first century, the essay builds upon current formulations of the "New Economics of Order" ("Neue Ordnungsökonomik") research program as the most recent example in the "thinking-in-orders" tradition (Goldschmidt et al. 2016; Zweynert et al. 2016).

Such an order-based perspective can prove crucial for understanding our world and its current issues: The development of the past years can be characterized as a process of cumulative implosions of order. Since Brexit and Donald Trump's election at the latest, the discourse of the financial crisis or the Eurozone crisis has shifted into even more profound debates about identity and culture. The topos of the Western socio-economic discourse seems to be moving away from issues of the economic order, and towards issues of other societal orders. Even "The Economist" put forward the thesis that the old dividing lines in economic policy will increasingly take a back seat, and that the future of the free order of the West will be decided along new categories, such as the openness of society (Economist 2016).

As I delineate in this essay, for economists in the "thinking-in-orders" tradition such a dichotomy between questions of the economic order and other societal orders is unnecessary and untenable. The emergence of this contrast shows, however, that our current debates challenge economics in a genuinely new way. Unlike earlier moments of economic shocks such as the dot-com crisis, the new fragility of our time—both in its causes and in its effects—is characterized by an interdependence of factors that stem from the economic, legal, political or even religious domains. Neither Donald Trump nor the fragility of the EU can be explained by the instruments that today's students of economics acquire during their studies. And even where genuinely economic issues are at stake—such as in the explanation of the Eurozone crisis—a discussion has recently emerged which requires a historical sensitivity that is seldom taught to economics students.

In this discussion, an intriguing set of questions has been raised, on the policy level but even more so regarding the theory of political economy: How can we grasp the different economic philosophies about the macroeconomic need for control that were revealed during the Eurozone crisis in Germany, France and the Anglo-Saxon world (Brunnermeier et al. 2016)? What is this "German oddity" called ordoliberalism that might have urged German policy makers to react differently to the challenges in fiscal and monetary policy than other Europeans (Blyth 2013; Beck and Kotz 2017; Biebricher and Vogelmann 2017; Hien and Joerges 2017; Kolev 2018a)? Is history of political economy, after all its marginalization in academia during recent decades, nevertheless a helpful tool for economists to understand and handle the issues of today and tomorrow? And above all: In such times of profound transformations in the economic order and the other societal orders and amid the correspondingly increasing demand of citizens for "order security" (Popitz 1992, pp. 35–36): How can the economist meet these new expectations if "the task for the constitutional political economist is to assist individuals, as citizens who ultimately control their own social order" (Buchanan 1987, p. 250)?

Intellectual Origins of the "Thinking-in-Orders" Tradition as Contextual Economics

What should economists do, as James Buchanan famously asked? And what is the domain of their expertise? A straightforward answer seems to be: studying the economic order. But does such an order universally exist, in any society across time and space? Can we always presuppose its existence, with clear-cut boundaries and a full-fledged logic of its own? According to Karl Polanyi, the functional differentiation of an economic order from the overall order of society cannot be taken for granted in an ahistorical, naturalistic manner (Polanyi 1944, pp. 178–191). This problem is as old as economic thought itself. Tensions between an economic and a political logic occupied already the economics of Plato and Aristotle: Especially Aristotle saw the distinction between the household-embedded "Oikonomia" with its cohesion-enhancing properties for the polis, and the art of accumulating wealth ("Chrematistics") which follows its own laws that are not subordinate to the objectives of the polis, so that "Chrematistics" endangers the cohesion of the polis and is therefore to be discarded.

The relationship of an economic "value sphere" (Max Weber) to the overall order of society has occupied a central position over much of the history of economic and political thought. Adam Smith's system can be seen primarily a response to Thomas Hobbes (Perlman and McCann 1998, pp. 35–72), and as for Hobbes, the "cohesion question" is central for Smith (Evensky 2005), that is the question of how order is created in society. At the same time—and this makes him a founder of modern economics—Smith realized that the question of order in a functionally differentiated society can only be answered in connection with the question of the ordering mechanisms which prevail in the various societal orders.

Smith addressed two questions on an equal footing: On the one hand the older one, which dominated the antiquity and the Middle Ages, about the (primarily normative) connection *between* the economic order and the other societal orders, and on the other hand the (primarily positive) quest for the laws and regularities *within* the economic order. These two questions can be seen respectively as the fundamental questions of "contextual economics" versus "isolating economics" (Goldschmidt et al. 2009; Kolev 2018b). Contextual economics is primarily concerned with the processes at the interfaces between the economic order and the other societal orders, while isolating economics focuses on the processes within the economic order, so that for certain purposes the latter can be modeled isolated from the rest of society. Apart from the fact that isolating economics dominates today's economics, it is by no means true that all economists do either the one or the other. However, very few economists—classics like Smith, Alfred Marshall, Joseph Alois Schumpeter, John Maynard Keynes and Friedrich August von Hayek—have made groundbreaking contributions to both contextual and isolating economics. James Buchanan's "Old Chicago" School teacher Frank Knight is another prominent example of a twentieth century economist who contributed to both contextual and isolating economics.

The development of the mainstream in economic theory, from classical political economy over neoclassical economics to Samuelson's neoclassical synthesis, has been shaped by an ever-increasing focus on the processes occurring within the economic order and an ever greater outsourcing of the contextual issues—especially into sociology and later economic sociology. Consequently, the main focus of modern economics is currently the domain of isolating economics. There is nothing wrong with such a focus, or with a narrowing per se. The suggestion, for example, that this would mean "losing sight of the whole", is problematic—after all, as discussed above, already Smith realized that one cannot understand functionally differentiated societies without specifically analyzing their sub-orders. The issue is not about an "either-or", but rather about balancing the two questions.

This analysis also means that the relationship between isolating and contextual economics is not carved in stone, but that this relationship varies or should vary when economic reality changes. Since the market for (economic) ideas is usually structured in an oligopolistic manner and is characterized by corresponding positions of power, there can be considerable delays in the adjustment mechanism towards a new balance. Today's economics seems to be in this very position: The core objection to the extent to which isolating economics is currently dominating contextual economics is that it does not do justice to recent changes in economic reality.

To justify this claim, we have to move back a little in history: It is far from a coincidence that the protest against isolating economics of the middle of the nineteenth century originated in Germany: Germany was the first country to carry out a "catch-up industrialization" compared to Western Europe. This finding can be interpreted in the sense that in most countries Polanyi's "Great Transformation" (Polanyi 1944) only unfolded since the middle of the nineteenth century, and it was within the framework of this transformation that the economic order functionally differentiated itself within society. However, only when this process of functional differentiation is largely completed can scientific issues aimed at the processes within this order be addressed in a meaningful way. In other words, the isolating economics of David Ricardo implicitly predated what was still in the process of emerging in Germany and most other countries. Therefore isolating economics has little or nothing to say on the topic of "catch-up development". This disability was the indispensable background against which historicist economics emerged. The contextual economics produced by the sequence of Historical Schools in Germany turned out to be a real export hit—not quite surprisingly, this economics was intensively received especially in countries facing the problem of "catch-up development", such as Japan, Italy, Russia and the US. Thus, historicism in economics was by no means an intellectual "German exceptionalism" (Grimmer-Solem and Romani 1998; Pearson 1999; Caldwell 2001; Hodgson 2001), but rather a pan-European phenomenon that started in Germany as the first "latecomer" and became closely linked to economic reality in a large number of countries and the issues there. This economic reality was characterized by problems of structural change, upheavals and ruptures at the interface between economy and society.

And it is precisely these problems where contextual economics has its comparative advantage. One can say: Contextual economics is above all research of transition and transformation, a perspective on economics which has its comparative advantage where it is necessary to understand profound structural change. Conversely, where the economic order has differentiated itself from society and/or where the relationship between economy and society is reasonably stable, isolating economics has an advantage. This very simple consideration not only illuminates why contextual approaches in the nineteenth and early twentieth centuries were dominant in many countries of continental Europe, it also explains the triumph of isolating economics after the end of World War II. Today we know that the period from 1945 to about 1990, relative to the periods before and after, was a phase of globalization that was progressing slowly and above all rather steadily (Giersch 1986; Verde 2017, pp. 5–11). The balance of competing political orders slowed down the pace of institutional change worldwide and made sure that there was little change in the relationship between economy and society even in the developed industrialized countries. In short: In the economic reality of the Cold War, all the prerequisites were given that would grant an advantage to isolating economics. This has fundamentally changed with the collapse of socialism, and it is far from a coincidence that the deficiencies of isolating economics came to light for the first time when an analysis of post-socialist reform in Central and Eastern Europe became necessary. Here it also became apparent that almost all economists implicitly assumed something as given which was still only in the process of emergence: a differentiated economic order distinct from the rest of society. As these economists misjudged that their models reflected a reality which was simply not (yet) given in the countries to be analyzed, their economic policy recommendations were also partly inadequate. The emergence of so-called "oligarchs" in the course of a "state capture" in many countries of the post-Soviet area can certainly not be attributed directly to the recommendations of Western economic advisors. But it is strikingly a phenomenon involving the co-evolution of economics and politics (Weizsäcker 2017), which is a blind spot in isolating economics. And the post-socialist transformation in Eastern Europe was only the starting point for a renewed wave of fundamental changes in the institutional structure, especially of developing and emerging countries, but increasingly also of developed industrialized countries—again, the phenomena in the US and EU mentioned at the beginning of this essay are illuminating examples. Sooner or later the realization of these processes of structural change will lead to a shift within economics—and at the interfaces to its neighboring disciplines—between isolating and contextual economics. In fact, this process has already started. Before delving into the newer contextual approaches, the German ordoliberal tradition should first be located in the grid of contextual and isolating economics, since its varying success is particularly illuminating about the relationship between economics and economic reality.

Rise and Decline of German Ordoliberalism

For the reasons outlined above, the German reception of classical political economy was latently skeptical, and German economists of the nineteenth century turned towards a historical-ethical research program (Pribram 1983, pp. 200–206). In any case, it seems obvious that Gustav Schmoller did not contribute to economic theory—but only if one narrows the concept of economic theory to what was described above as isolating economics (Rieter and Zweynert 2006). The Younger Historical School—and this must be seen against the background of a fundamentally changing society in the late nineteenth and early twentieth century—radically shifted the focus of its research and teaching towards contextual issues and initiated passionate epistemological debates about the tasks of political economy. Ultimately, however, this led it to neglect the main task of economics. In the 1920s, a number of younger economists—among them the later ordoliberals Walter Eucken, Wilhelm Röpke and Alexander Rüstow—entered the scene, quite tellingly calling themselves "Ricardians" (Janssen 2009, pp. 34–50; Köster 2011, pp. 222–233). Their aim was to blaze a trail back to theoretical analysis for German economics and, in doing so, to reconnect it to the international mainstream of economic discussion and literature. However, as hard as Eucken, Röpke and Rüstow attacked the historicists, it was not their intention to banish those questions from economics. In a sense, ordoliberalism can rather be understood as the most recent historical school (Schefold 2003; Peukert 2000). Their concern was, firstly, to place the questions of historicism on epistemologically sound foundations (Gander et al. 2009); secondly, to mediate between the heritage of German contextual economics and the rapidly evolving insights of modern (isolating) economics; and thirdly, to show that economic policy recommendations should be understood not primarily as political volitions but rather as a scientific task in the domain of policy consulting. In 1938, Eucken clearly identified the questions about the economic process and those about the economic order as the two main problems of economics (Eucken 1938 [2005], pp. 30–54).

Within the different contextual domains, there was an implicit division of labor within German ordoliberalism. Franz Böhm and Walter Eucken were primarily concerned with the interfaces of the economic order to the legal order and political order, and here in particular with the problem of power in a free society. Wilhelm Röpke and Alexander Rüstow, sometimes referred to as the "sociological" or "communitarian" branch of ordoliberalism (Renner 2002, pp. 250–255; Zweynert 2013, pp. 116–120; Kolev 2015, pp. 424–431), focused more on the issues of social cohesion in modern market societies. In addition to these ramifications of original ordoliberalism, over the past seven decades the "thinking-in-orders" tradition received significant additional input by several other approaches. Doubtlessly the work of Friedrich August von Hayek played a very special role here (Hayek 1983 [1992]; Streit and Wohlgemuth 2000; Kolev et al. 2014): His presence in Germany from the 1960s onwards and his impact on the neoliberal debates well into the 1980s produced a transformation within ordoliberalism: Quite a few later-generation self-perceived ordoliberals actually qualified better as Hayekians than as descendants of the Eucken tradition, so that the original ordoliberal approach of the Freiburg School moved more and more into an impasse.

Thus the question is more than straightforward: Was ordoliberalism simply a moment in history and thus, as seen from today, only an artefact for historians of political economy?

An assessment of the contribution of ordoliberalism as seen from history, and an evaluation of its potential for research programs today, provides some intriguing answers. To a certain extent, the obvious loss of importance of ordoliberalism can also be attributed to the later-generation ordoliberal economists themselves. In times of a more or less static system competition in the twentieth century, a number of representatives of the "thinking-in-orders" tradition confined themselves to "praising" the quality of the original program of Eucken, Böhm, Röpke and Rüstow. In terms of economic policy recommendation, these later-generation ordoliberals often argued in a pragmatic and intuitively liberal manner. Their contributions to theoretical discussions seldom had an explicit connection to the core of the "thinking-in-orders" tradition. Even more importantly for this essay, a search for connectivity between their ordoliberal approach and the more recent developments in Anglo-Saxon academia was pursued only seldom and unsystematically (Feld and Köhler 2016, pp. 71–76). In a critique of this impasse-like intellectual climate, the later-generation ordoliberals have been depicted as behaving like "islanders" who "isolated themselves from international discussion" (Bachmann in Braunberger 2014).

In this perspective it is understandable that observers today draw a rather sober record for ordoliberalism. In the course of the most recent "Methodenstreit" around 2009–2010 (Caspari and Schefold 2011), the historical mission of the ordoliberals was portrayed as helping German interwar and early post-war economics its way out of the historicist impasse and back to theory (Ritschl 2009). However, in the course of the post-war decades, the ordoliberals all too quickly lost the connection to the development of modern theory: After World War II, the priority in Germany was the reception of the missed Anglo-Saxon literature and particularly of Keynesianism (Hesse 2010).

The assessment that the contribution of ordoliberalism exhausted itself in regaining a place for economic theory in German economics is again acceptable under two conditions: Firstly, if under "theory" one understands only isolating economics, and, secondly and decisively, if one focuses on the problems of a world with relative low connectivity and dynamics, as the one of the second half of the twentieth century. In contrast, what makes "thinking-in-orders" so topical for twenty-first century economics is that its early twentieth-century representatives understood how the two main problems of economics can only be understood as being interdependent, and that those representatives focused their attention especially on the relationship between isolating and contextual issues.

As indicated above, this necessity is increasingly evident in the course of the recent globalization wave as well as in the most recent ruptures in the US and the EU. Profound structural change is all over the place, and it affects both the economic order and its interfaces to the other societal orders. This raises questions about the "interdependence of orders"—above all about the relationship of the economic order to the political order and the legal order—as well as about the importance of informal institutions for economic development processes, a set of issues which deeply occupied Röpke's and Rüstow's attention.

Despite the evident revival of contextual problems, a decline of modern isolating economics is neither to be expected nor would it be desirable. But it may well be that future historians of economics will identify the partial failure of today's economics to understand the contextual problem of post-socialist change and to make meaningful recommendations as the starting point for a re-adjustment of the relationship between contextual and isolating approaches, leading to a significant appreciation and "revaluation" of the former. This would most likely not be the case if the processes that took place in the former Eastern Bloc in the 1990s were a singular phenomenon, a kind of "accident of history" for which the dominant strands of economic theory were not conceived. Today, we already know that these transformation processes were just the beginning of a new wave of profound structural change in a large number of countries. The current instability in the Middle East and North Africa and the associated migration flows show impressively that these are not abstract processes, but have very concrete points of contact with economic and social reality in the increasingly fragile order of the West.

In such a world, the "thinking-in-orders" tradition could soon emerge as a "hidden champion". If one understands ordoliberalism as a contribution to explaining the co-evolution of economic and social phenomena, then the dust of history flees from the ordoliberal writings. Superficially, ordoliberalism plays no role today, especially in the international discourse outside of Europe. However, the "thinking-in-orders" approach addresses issues and possible solutions that can prove essential for today's research in political economy. For if one interprets ordoliberalism not merely as a tool of economic policy leading to ultimately (neo-)liberal positions, but as a contextual access to the social sciences, a new "value added" becomes obvious: Current economic research—if it aims to explain processes in the real world—must face the same questions which the first-generation ordoliberals faced in the 1930s. As indicated above, these were and still are the questions of the epistemological foundations of economics, the relationship between contextual and isolating economics, and the content of economic policy recommendations, which—in Eucken's terms—should simultaneously be "effective" and also "do justice to the dignity of man" (Eucken 1940 [1992], pp. 313–317).

Revitalizing Impulses from Across the Atlantic: Buchanan's Virginia School and the Ostroms' Bloomington School

To be sure, revitalizing the ordoliberal tradition cannot confine itself to revisiting the "grand masters" of ordoliberalism. The rise and decline of ordoliberalism described in the section above can be matched to contemporaneous as well as to later developments in other strands of political economy in the “thinking-in-orders” tradition as embodied in contextual economics. This section focuses on the opposite side of the Atlantic, more specifically on two of the key paradigms in the renaissance of political economy in the US during the second half of the twentieth century, both clearly in the “thinking-in-orders” tradition: the Virginia School around James Buchanan, and the Bloomington School around Elinor and Vincent Ostrom. The exposition certainly does not aim at a comprehensive overview as conducted in the extensive literature on these scholarly communities. Rather, for this analysis the legacy of Buchanan and the Ostroms functions as complements to the ordoliberal tradition, drawing primarily on reconstructions of these complementarities as conducted by Viktor Vanberg (on Buchanan) and Peter Boettke (on the Ostroms).

The ordoliberals’ understanding of democracy has given rise to an extensive literature debating whether they were adherents of an “authoritarian liberalism” (Haselbach 1991; Ptak 2009; Slobodian 2018). While some of the authors have initiated intriguing debates, like the proximity of Eucken’s notion of the “strong state” to Carl Schmitt’s homonymous concept, other parts of this literature are similar, in tone and depth, to Nancy MacLean’s tendentious misrepresentations (MacLean 2017). Notwithstanding the rather ahistorical question whether the ordoliberals were “good democrats”, it is certainly true that their notion of the political process in a democracy is not particularly elaborate (Nientiedt and Köhler 2016). This has been a common critique to ordoliberal political economy: From the perspective of Public Choice, ordoliberalism has been located as being proximate to “technocratic-elitist approaches” to political economy (Kirchgässner 1988, pp. 55–58; Frey and Kirchgässner 1994, pp. 340–348). Challenging this irreconcilability by showing how the Freiburg legacy can be complemented by Virginia School impulses has been at the heart of the attempts to revitalize ordoliberalism, as conducted especially by Viktor Vanberg. While Public Choice can “fill the gap” in ordoliberalism regarding the conceptualization of politicians and bureaucrats in the democratic process, Constitutional Political Economy adds more nuance to the key ordoliberal notion of the economic constitution, and especially to the embedded character of this constitution, its establishment and maintenance in the interdependence to the democratic process (Vanberg 1988, 1999, 2013, 2014, 2015). Understanding the intricate mechanisms of this embeddedness—also in the sense of the recent concept of "Entangled Political Economy" (Wagner 2016)—is crucial not only for fundamental questions like the complex of legitimacy. Equally important, taking a Constitutional Political Economy perspective sheds light on practical issues like the "reformability" of economic constitutions in a democracy—and it has been convincingly argued that this will be the decisive "litmus test" for democracies to cope with the multiple, overlapping crises of our times (Wohlgemuth 2005, pp. 9–12).

Another important critique of ordoliberalism is related to the emergence of rules. Apart from the questions addressed in Hayek's evolutionary theory, it is obviously important to ask to what extent the setting of rules must be seen as a prerogative of the state. In this respect there are differences between various proponents of ordoliberalism, with its "sociological" or "communitarian" branch represented by Wilhelm Röpke and Alexander Rüstow as discussed in section "Rise and Decline of German Ordoliberalism" being more willing than the Freiburg School to see a "division of labor" between formal rules-setting by the state and informal rules-setting within civil society (Kolev 2015, pp. 430–431; Giordano 2018, pp. 45–52; Goldschmidt and Dörr 2018, pp. 207–210). Nevertheless, the legacy of Elinor and Vincent Ostrom can add much nuance regarding the mechanisms of polycentric self-organization and informal rules-setting within civil society. While Vincent Ostrom's approach profited methodologically and epistemologically from Eucken's attempt to overcome the intricacies left behind by the "Methodenstreit" (Sproule-Jones et al. 2008, pp. 3–4; Kuhnert 2008, pp. 118–121; Boettke 2012a, pp. 148–156), Elinor Ostrom's conceptualizations of self-organization within civil society, beyond the stereotypical dichotomy of state vs. market, is very helpful to understand the rules-setting in a context free of formal statehood, or of pockets of self-organization within formal statehood, also highlighting the dynamic effects of such self-organization on the cultivation of the citizens' capability of self-governance (Boettke 2012b, pp. 164–171; Aligica et al. 2017, pp. ix–xi). As will be shown below, in the context of today's digitalization such a perspective can gain considerably in relevance, as compared to the pre-digital age when notions like Vaclav Hável's trust in the problem-solving capacity of civil society were commonly criticized as merely utopian.

"New Economics of Order" as a Research Program in Contextual Economics

"New Economics of Order" (NEO) (Goldschmidt et al. 2009; Goldschmidt et al. 2016; Zweynert et al. 2016; Kolev 2018b) is a very recent attempt at formulating a research program within the paradigm of contextual economics, and that with a twofold goal. Firstly, it starts with the Buchananite plea for searching for complementarities across research programs:

> The diverse approaches of the intersecting 'schools' must be the bases for conciliation, not conflict. We must marry the property-rights, law-and-economics, public-choice, Austrian subjectivist approaches. Buchanan (1979)

Thus the first goal of NEO is to explore the possible complementarities of the research programs in the "thinking-in-orders" tradition on both sides of the Atlantic discussed above, along the lines depicted in section "Revitalizing Impulses from Across the Atlantic: Buchanan's Virginia School and the Ostroms' Bloomington School" as to how the German ordoliberal tradition can profit from Virginia and Bloomington impulses. The second goal is to update this intellectual heritage to today's socio-economic reality, and exploring this second goal is at the core of this section.

As argued in section "Intellectual Origins of the "Thinking-in-Orders" Tradition as Contextual Economics", the marginalization of contextual economics within today's economics discipline appears unwarranted especially due to the current fundamental changes in economy and society. The challenges of this quickly and deeply transforming world can be caught with a term which featured at the beginning of this essay—fragility. For multiple reasons, the order of economy and society—in the West as well as elsewhere—appears to many citizens as far from robust, and the dynamics of this non-robust, fragile entity raises manifold fears. Heinrich Popitz's notion of "order security" (Popitz 1992, pp. 35–36) can help to show the way to go for NEO. We can define "chaos" as an order which is not (anymore) intelligible to the observer (Anter 2007, pp. 44–52), and it is a common finding in opinion polls that many citizens perceive today's socio-economic reality as chaotic. This is a highly dangerous sentiment for the political process, one that can easily lead to the rise of populisms and their simplistic solutions. A plausible diagnosis for this sense of chaos can be formulated in the following terms: The global-digital world brings for the citizen an extraordinarily high degree of dynamics and, at the same time, an extraordinarily low degree of statics (Kolev 2017, pp. 16–19). The sources of dynamics are global markets and digital technology, whereas the providers of statics are the state and the community (Kolev 2018c).

To formulate answers to these sentiments and "to assist individuals, as citizens who ultimately control their own social order" (Buchanan 1987, p. 250), NEO has to engage in scholarly dialogue on two platforms. The first platform is the "traditional" interdisciplinary dialogue, indispensable for all the strands of contextual economics in the "thinking-in-orders" tradition discussed above. A discourse between economists, lawyers, political scientists, philosophers and sociologists is necessary for understanding the fragility of our governance structures—in the democratic processes on the national level (e.g., the weakening of centrism by right-wing populism) and in the constitutional framework on the international level (e.g., the encroachment on WTO rules by anti-globalist trade wars). Providing answers to the multiple and overlapping crises of our times clearly indicates the indispensability of this dialogue: What are likely reactions within the political order, already strained today despite the favorable macroeconomic climate, to the next major recession? How could citizens react within the political order if a sizeable inflation emerges in the economic order, leading to a devaluation of the pension schemes of millions of citizens and to the corresponding disappointment of long-term expectations about old-age material security? And what are likely changes of the political attitude to migrants if unemployment rises and the fear for one's job is back as a mass sentiment in the economic order?

Next to this "traditional" platform of dialogue about the governance issues of globalization, a second—still nascent—platform of dialogue is needed, one focused on understanding the challenges of digitalization as the other major source of dynamics. Issues of natural monopolies, data protection or copyright, but also the impact of this fundamental process of "creative destruction" on the labor market (Eichhorst and Rinne 2017; Haucap and Heimeshoff 2018; Rolnik 2018) are ideally suited to be addressed from a contextual perspective: The process of "creative destruction" is by far not confined to the economic order—and as a consequence, a conceptual apparatus of interdependent orders can capture much better the causes and effects as located in different societal orders. What are the threats for the political order stemming from a labor market polarized between the winners (e.g., IT specialists) and losers (e.g., blue-collar workers) of digitalization? What are likely changes of the citizen's attitude to the political order stemming from the economic transformation of media markets, the possible loss of flagship media in the democratic discourse and the formation of "echo chambers" and "filter bubbles" in social media? Understanding these multiple—often intuitively unintelligible and frequently reinforcing—transmission and feedback effects of digitalization across societal orders as one source of the citizen's perception of economy and society as being chaotic, imperatively requires this contextual conceptual apparatus of interdependent orders.

NEO is thus a particularly adequate access to understanding today's dynamics within and across orders, as generated by globalization and digitalization. But it is also helpful to understand where the statics demanded by the citizen can come from. NEO analysis can show that, under certain conditions, the increase of abstractness and anonymity which goes along with the dynamics of globalization—in the sense of Ferdinand Tönnies' "Gesellschaft"—can at least partially be compensated by the opportunities provided by the dynamics of digitalization to set up or revitalize virtual communities in the sense of "Gemeinschaft" (Kolev 2018c, pp. 653–659). Thus the statics for the citizen in search of "order security" must not necessarily be provided only by the formal institutions of the state, but also by the informal mechanisms of the "digital commons". The ordering principles of these "digital commons"—including questions such as whether they favor large-scale players, or whether they have the potential to become a serious substitute for social welfare provision by the state—are still largely to be discovered, and it is within this process of discovery that NEO scholars will be able to assess the relative suitability and applicability of the ordoliberal, Virginia and Bloomington toolboxes. But it is already quite obvious that the questions raised by the phenomena in this section resonate more than well with the problem-solving capacity of the entirety of those toolboxes in the "thinking-in-orders" tradition—with the complementarities and updates identified as necessary by the NEO research program.

Conclusion: James Buchanan as Offspring of, Contributor to, and Revitalizer of Contextual Economics

This essay pursued one historical and one conceptual task. The sections dedicated to history of political economy aimed at reconstructing the distinction between the "thinking-in-orders" tradition as embodied in contextual approaches to socio-economic reality, and approaches classified as "isolating economics". While the former focus on the interfaces between the economic order and other societal orders, the latter concentrate on the processes within the economic order. When matching this distinction to different phases in economic history, the claim could be substantiated that contextual approaches—from classical political economy to ordoliberalism—have their comparative advantage in periods of transformation and transition, while isolating economics is particularly powerful in periods when the general order of society is fairly stable.

James Buchanan experienced his scholarly socialization in the "Old Chicago" School, a community which—very much parallel to German ordoliberalism—emerged in the 1930s in a period of fundamental transformation, especially in the long shadow of the Great Depression and the profound structural change during the New Deal. While "Old Chicagoans" Frank Knight and Henry Simons also contributed to domains of isolating economics like capital and taxation theory, they were equally interested in the contextual issues of the economic order amid the increasingly fragile overall order of society. The "New Chicago" School, as it emerged from the 1950s onwards, left the contextual focus of its predecessors behind and moved away from "laissez faire within rules" towards an unrestrained "laissez faire" (Buchanan 2010). In the diagnosis of the current essay, this development is anything but surprising, given the increasing stability in the Cold War order.

As it is widely known, Buchanan's life-long contributions concentrated on the interface between the political order and the economic order. Both Public Choice and Constitutional Political Economy are deeply contextual in their nature. The aim of the essay's conceptual sections was to show how Buchanan's politico-economic legacy—along with Bloomington School impulses—can prove vital for waking up the German ordoliberal tradition from a dormant state after its stagnation in recent decades. Apart from identifying complementarities in this attempt to "marry" Transatlantic contextual approaches (Buchanan 1979), the "New Economics of Order" research program targets primarily the specific challenges of today's socio-economic reality, may they be related to the politico-economic ruptures in the West or the general transformations due to globalization and digitalization. This "New Economics of Order" interdependent orders apparatus is constructed with the explicit goal to provide answers to today's pervasive fragility in economy and society. In a Buchananite attempt "to assist individuals, as citizens who ultimately control their own social order" (Buchanan 1987, p. 250), the "New Economics of Order" toolbox could help enable economists to be not only "students of civilization", but also its active defendants (Dekker 2016)—a task of ultimate importance amid today's order fragility.

References

Aligica, P. D., Lewis, P., & Storr, V. H. (2017). Austrian Economics and the Bloomington School: An Introduction and Overview. In P. D. Aligica, P. Lewis, & V. H. Storr (Eds.), *The Austrian and Bloomington Schools of Political Economy* (pp. ix–xxi). Bingley: Emerald Publishing.

Anter, A. (2007). *Die Macht der Ordnung*. Tübingen: Mohr Siebeck.

Beck, T., & Kotz, H.-H. (Eds.). (2017). *Ordoliberalism: A German Oddity*? London: CEPR Press.

Biebricher, T., & Vogelmann, F. (Eds.). (2017). *The Birth of Austerity. German Ordoliberalism and Contemporary Neoliberalism*. London: Rowman & Littlefield.

Blyth, M. (2013). *Austerity. The History of a Dangerous Idea*. New York: Oxford University Press.

Boettke, P. J. (2012a). Methodological Individualism, Spontaneous Order, and the Research Program of the Workshop in Political Theory and Policy Analysis: Vincent and Elinor Ostrom. In *Living Economics. Yesterday, Today, and Tomorrow* (pp. 139–158). Oakland: Independent Institute.

Boettke, P. J. (2012b). Is the Only Form of "Reasonable Regulation" Self-Regulation? Elinor Ostrom. In *Living Economics. Yesterday, Today, and Tomorrow* (pp. 159–171). Oakland: Independent Institute.

Braunberger, G. (2014, November 23). *Deutsche und amerikanische Ökonomen leben nicht in getrennten Welten Gespräch mit Rüdiger Bachmann*, in: Fazit - das Wirtschaftsblog. http://blogs.faz.net/fazit/2014/11/23/xxx-3-4938.

Brunnermeier, M. K., James, H., & Landau, J.-P. (2016). *The Euro and the Battle of Ideas*. Princeton: Princeton University Press.

Buchanan, J. M. (1979). *Notes on Hayek* (Unpublished manuscript). Fairfax: Center for Study of Public Choice.

Buchanan, J. M. (1987). *Economics: Between Predictive Science and Moral Philosophy*. College Station: Texas A&M University Press.

Buchanan, J. M. (2010, June 2). *Chicago School Thinking: Old and New*. Presentation at the 2010 Summer Institute for the History of Economic Thought, Jepson School of Leadership Studies, University of Richmond. https://www.youtube.com/watch?v=7_atDse06r4.

Buchanan, J. M. (2011, June 24). *Economists and the Great Recession*. Presentation at the 2011 Summer Institute for the History of Economic Thought, Jepson School of Leadership Studies, University of Richmond. https://www.youtube.com/watch?v=7SXhW9ucEW8.

Buchanan, J. M. (2012, June 29). *Institutional Sources of America's Fiscal Tragedy*. Presentation at the 2012 Summer Institute for the History of Economic Thought, Jepson School of Leadership Studies, University of Richmond. https://www.youtube.com/watch?v=UAu1gUbE0uc.

Caldwell, B. (2001). There Really Was a German Historical School of Economics: A Comment on Heath Pearson. *History of Political Economy, 33,* 649–654.

Caspari, V., & Schefold, B. (Eds.). (2011). *Wohin steuert die ökonomische Wissenschaft? Ein Methodenstreit in der Volkswirtschaftslehre*. Frankfurt: Campus.

Dekker, E. (2016). *The Viennese Students of Civilization: The Meaning and Context of Austrian Economics Reconsidered*. New York: Cambridge University Press.

Economist. (2016, July 30). Globalisation and Politics: The New Political Divide, Editorial.

Eichhorst, W., & Rinne, U. (2017). *Digital Challenges for the Welfare State* (IZA Policy Paper 134). Bonn: IZA—Institute of Labor Economics.

Eucken, W. (1938 [2005]). *Nationalökonomie – wozu*? Stuttgart: Klett-Cotta.

Eucken, W. (1940 [1992]). *The Foundations of Economics. History and Theory in the Analysis of Economic Reality*. Berlin: Springer.

Evensky, J. (2005). *Adam Smith's Moral Philosophy. A Historical and Contemporary Perspective on Markets, Law, Ethics, and the Culture*. Cambridge: Cambridge University Press.

Feld, L. P., & Köhler, E. A. (2016). Ist die Ordnungsökonomik zukunftsfähig? In J. Zweynert, S. Kolev, & N. Goldschmidt (Eds.), *Neue Ordnungsökonomik* (pp. 69–95). Tübingen: Mohr Siebeck.

Frey, B., & Kirchgässner, G. (1994). *Demokratische Wirtschaftspolitik*. Munich: Franz Vahlen.

Gander, H.-H., Goldschmidt, N., & Dathe, U. (2009). *Phänomenologie und die Ordnung der Wirtschaft*. Würzburg: Ergon.

Giersch, H. (1986). Weltwirtschaftliches Wachstum durch Liberalisierung. *Kyklos, 39,* 518–536.

Giordano, A. (2018). The Making of the "Third Way": Wilhelm Röpke, Luigi Einaudi, and the Identity of Neoliberalism. In P. Commun & S. Kolev (Eds.), *Wilhelm Röpke (1899–1966): A Liberal Political Economist and Conservative Social Philosopher* (pp. 41–64). Cham: Springer.

Goldschmidt, N., & Dörr, J. (2018). Wilhelm Röpke on Liberalism, Culture, and Economic Development. In P. Commun & S. Kolev (Eds.), *Wilhelm*

Röpke (1899–1966): A Liberal Political Economist and Conservative Social Philosopher (pp. 203–217). Cham: Springer.

Goldschmidt, N., Grimmer-Solem, E., & Zweynert, J. (2016). On the Purpose and Aims of the Journal of Contextual Economics. *Schmollers Jahrbuch, 136,* 1–14.

Goldschmidt, N., Wegner, G., Wohlgemuth, M., & Zweynert, J. (2009, June 19). Was ist und was kann Ordnungsökonomik? *Frankfurter Allgemeine Zeitung*, 12.

Grimmer-Solem, E., & Romani, R. (1998). The Historical School, 1870–1900: A Cross-National Reassessment. *History of Economic Ideas, 24,* 267–299.

Haselbach, D. (1991). *Autoritärer Liberalismus und soziale Marktwirtschaft. Gesellschaft und Politik im Ordoliberalismus*. Baden-Baden: Nomos.

Haucap, J., & Heimeshoff, U. (2018). Ordnungspolitik in der digitalen Welt. In H. J. Thieme & J. Haucap (Eds.), *Wirtschaftspolitik im Wandel: Ordnungsdefizite und Lösungsansätze* (pp. 79–132). Berlin: De Gruyter.

Hayek, F. A. (1983 [1992]). The Rediscovery of Freedom: Personal Recollections. In *The Fortunes of Liberalism. Essays on Austrian Economics and the Ideal of Freedom* (pp. 185–195). Chicago: University of Chicago Press.

Hesse, J. O. (2010). *Wirtschaft als Wissenschaft. Die Volkswirtschaftslehre in der frühen Bundesrepublik*. Frankfurt: Campus.

Hien, J., & Joerges, C. (Eds.). (2017). *Ordoliberalism, Law and the Rule of Economics*. Oxford: Hart Publishing.

Hodgson, G. M. (2001). *How Economics Forgot History: The Problem of Historical Specificity in Social Science*. London: Routledge.

Janssen, H. (2009). *Nationalökonomie und Nationalsozialismus. Die deutsche Volkswirtschaftslehre in den dreißiger Jahren des 20. Jahrhunderts*. Marburg: Metropolis.

Kirchgässner, G. (1988). Wirtschaftspolitik und Politiksystem: Zur Kritik der traditionellen Ordnungstheorie aus der Sicht der Neuen Politischen Ökonomie. In D. Cassel, B.-T. Ramb, & H. J. Thieme (Eds.), *Ordnungspolitik* (pp. 53–75). Munich: Franz Vahlen.

Köhler, E. A., & Kolev, S. (2013). The Conjoint Quest for a Liberal Positive Program: "Old Chicago", Freiburg, and Hayek. In S. J. Peart & D. M. Levy (Eds.), *F. A. Hayek and the Modern Economy* (pp. 211–228). New York: Palgrave Macmillan.

Kolev, S. (2015). Ordoliberalism and the Austrian School. In P. J. Boettke & C. J. Coyne (Eds.), *The Oxford Handbook of Austrian Economics* (pp. 419–444). New York: Oxford University Press.

Kolev, S. (2017). *Neoliberale Staatsverständnisse im Vergleich*. Berlin: De Gruyter.

Kolev, S. (2018a, April 16). Freiburger Austerität? Der Ordoliberalismus und die Euro-Krise. *Frankfurter Allgemeine Zeitung*, 16.

Kolev, S. (2018b). Zur Einführung: Was ist und was kann Ordnungsökonomik? In N. Goldschmidt & M. Wohlgemuth (Eds.), *Soziale Marktwirtschaft. Grundtexte zur Ordnungsökonomik*. Tübingen: Mohr Siebeck.

Kolev, S. (2018c). Gemeinschaft und Gesellschaft im Zeitalter von Globalisierung und Digitalisierung. In G. Kubon-Gilke (Ed.), *Gestalten der Sozialpolitik. Theoretische Gundlegungen und Anwendungsbeispiele* (pp. 646–659). Marburg: Metropolis.

Kolev, S., Goldschmidt, N., & Hesse, J.-O. (2014). *Walter Eucken's Role in the Early History of the Mont Pèlerin Society* (Discussion Paper 14/02). Freiburg: Walter Eucken Institut.

Köster, R. (2011). *Die Wissenschaft der Außenseiter. Die Krise der Nationalökonomie in der Weimarer Republik*. Göttingen: Vandenhoeck & Ruprecht.

Kuhnert, S. (2008). The Man Who Heated Up Economic Discussion with a Stove: Walter Eucken's Method of Institutional Design. In M. Sproule-Jones, B. Allen, & F. Sabetti (Eds.), *The Struggle to Constitute and Sustain Productive Orders: Vincent Ostrom's Quest to Understand Human Affairs* (pp. 111–121). Lanham, MD: Lexington Books.

MacLean, N. (2017). *Democracy in Chains: The Deep History of the Radical Right's Stealth Plan for America*. Melbourne: Scribe.

Nientiedt, D., & Köhler, E. A. (2016). Liberalism and Democracy—A Comparative Reading of Eucken and Hayek. *Cambridge Journal of Economics, 40,* 1743–1760.

Pearson, H. (1999). Was There Really a German Historical School of Economics? *History of Political Economy, 31,* 547–562.

Perlman, M., & McCann, C. R., Jr. (1998). *The Pillars of Economic Understanding. Ideas and Traditions*. Ann Arbor: University of Michigan Press.

Peukert, H. (2000). Walter Eucken (1891–1950) and the Historical School. In P. Koslowski (Ed.), *The Theory of Capitalism in the German Economic Tradition* (pp. 93–146). Berlin: Springer.

Polanyi, K. (1944). *The Great Transformation. The Political and Economic Origins of Our Time*. New York: Farrar & Rinehart.

Popitz, H. (1992). *Phänomene der Macht*. Tübingen: Mohr Siebeck.

Pribram, K. (1983). *A History of Economic Reasoning*. Baltimore: Johns Hopkins University Press.

Ptak, R. (2009). Neoliberalism in Germany: Revisiting the Ordoliberal Foundations of the Social Market Economy. In P. Mirowski & D. Plehwe (Eds.), *The Road from Mont Pèlerin. The Making of the Neoliberal Thought Collective* (pp. 98–138). Cambridge, MA: Harvard University Press.

Renner, A. (2002). *Jenseits von Kommunitarismus und Neoliberalismus. Eine Neuinterpretation der Sozialen Marktwirtschaft*. Grafschaft: Vektor.

Rieter, H., & Zweynert, J. (2006). Gustav Schmoller and Globalisation. *Schmollers Jahrbuch, 126,* 225–250.

Ritschl, A. (2009, March 16). Am Ende eines Sonderwegs. *Frankfurter Allgemeine Zeitung*, 12.

Rolnik, G. (Ed.). (2018). *Digital Platforms and Concentration. 2018 Antitrust and Competition Conference E-Book of the Stigler Center for the Study of the Economy and the State*. Chicago: University of Chicago Booth School of Business.

Schefold, B. (2003). Die deutsche Historische Schule als Quelle des Ordoliberalismus. In P. Commun (Ed.), *L'ordolibéralisme allemand. Aux sources de l'Économie sociale de marché* (pp. 101–117). Cergy-Pontoise: CIRAC.

Slobodian, Q. (2018). *Globalists: The End of Empire and the Birth of Neoliberalism*. Cambridge, MA: Harvard University Press.

Sproule-Jones, M., Allen, B., & Sabetti, F. (2008). Normative and Empirical Inquiries into Systems of Governance. In M. Sproule-Jones, B. Allen, & F. Sabetti (Eds.), *The Struggle to Constitute and Sustain Productive Orders: Vincent Ostrom's Quest to Understand Human Affairs* (pp. 3–9). Lanham, MD: Lexington Books.

Streit, M. E. & Wohlgemuth, M. (2000). The Market Economy and the State: Hayekian and Ordoliberal Conceptions. In P. Koslowski (Ed.), *The Theory of Capitalism in the German Economic Tradition* (pp. 224–271). Berlin: Springer.

Vanberg, V. J. (1988). "Ordnungstheorie" as Constitutional Economics: The German Conception of a "Social Market Economy". *ORDO Jahrbuch für die Ordnung von Wirtschaft und Gesellschaft, 39,* 17–31.

Vanberg, V. J. (1999). Markets and Regulation: On the Contrast Between Free-Market Liberalism and Constitutional Liberalism. *Constitutional Political Economy, 10,* 219–243.

Vanberg, V. J. (2013). James M. Buchanan und der Ordoliberalismus. *Orientierungen zur Wirtschafts- und Gesellschaftspolitik, 135,* 57–61.

Vanberg, V. J. (2014). Liberalismus und Demokratie: Zu einer vernachlässigten Seite der liberalen Denktradition. *ORDO Jahrbuch für die Ordnung von Wirtschaft und Gesellschaft, 65,* 345–374.

Vanberg, V. J. (2015). Ordoliberalism, Ordnungspolitik, and the Reason of Rules. *European Review of International Studies, 2,* 27–36.

Verde, A. (2017). *Is Globalisation Doomed? The Economic and Political Threats to the Future of Globalisation*. London: Palgrave Macmillan.

Wagner, R. E. (2016). *Politics as a Peculiar Business. Insights from a Theory of Entangled Political Economy*. Cheltenham: Edward Elgar.

Weizsäcker, C. C. V. (2017). Die normative Ko-Evolution von Marktwirtschaft und Demokratie. *ORDO Jahrbuch für die Ordnung von Wirtschaft und Gesellschaft 65*, 13–43.

Wohlgemuth, M. (2005). Vorwort. In M. Wohlgemuth (Ed.), *Spielregeln für eine bessere Politik* (pp. 9–13). Freiburg: Herder.

Zweynert, J. (2013). How German is German Neo-Liberalism? *Review of Austrian Economics, 26,* 109–125.

Zweynert, J., Kolev, S., & Goldschmidt, N. (2016). Neue Ordnungsökonomik. Zur Aktualität eines kontextualen Forschungsprogramms. In J. Zweynert, S. Kolev, & N. Goldschmidt (Eds.), *Neue Ordnungsökonomik* (pp. 1–17). Tübingen: Mohr Siebeck.

6

Emergence, Equilibrium, and Agent-Based Modeling: Updating James Buchanan's Democratic Political Economy

Abigail N. Devereaux and Richard E. Wagner

James M. Buchanan's *Collected Works* required 20 volumes to hold them when they were published in 1999–2002. His *Collected Works* were incomplete even at the time of their publication, confounded by the fact that he continued to publish more books and articles thereafter. Given this massive body of work, it might reasonably be wondered what we think we are doing in referring to "updating" Buchanan's political economy. With more than 20 volumes of writings on the record, it would seem as though Buchanan's political economy can speak for itself. That it can surely do, though a discerning reader might be excused for thinking that more than one kind of Buchanan must have generated the

A. N. Devereaux (✉) · R. E. Wagner
George Mason University, Fairfax, VA, USA
e-mail: anussey@gmu.edu

R. E. Wagner
e-mail: rwagner@gmu.edu

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_6

corpus of his *Collected Works*. It is these different Buchanans we wish to address, presently, and to bring forward the Buchanan more concerned with social processes of continual emergence than with the solutions of equilibrium problems.

Buchanan was a thinker whose thoughts turned mainly to economic theory, political economy, and social philosophy. Much thought can be expressed in the ordinary language of the speaker. For some areas of discourse, however, specialized and technical languages are needed to carry thought forward in a way that facilitates discourse among the speakers. For instance, starting in the late-nineteenth century, economists started to embrace calculus as a language of discourse, which led to the adoption of constrained maximization as the near-universal language of economic discourse. William Stanley Jevons's "pleasure calculus" was, in his estimation, the culmination of earlier French thought rooted in Condillac's recognition of a connection between value and utility in 1776, and brought forward formally by the engineer Dupuit in 1849 (Jevons 1957 [1871]; Condillac 1776; Dupuit 1849). Francis Edgeworth, an admirer of the accomplished physicists Lagrange, Hamilton, and Maxwell, imported wholecloth the field-theoretic maximization problems that had revolutionized physics in the nineteenth century into economics (Edgeworth 1881).

While this specialized language has made a certain kind of communication of ideas possible, it has also restricted possible avenues of discourse. In the language of field theoretic physics, where calculus is the ultimate tool of analysis, humans and firms become particles in fields, indifference and isoprofit maps the contour lines of vector fields, potential energy-minimizing equilibria the solutions to problems of choice and production. Though it is always possible to impose a constrained maximization framework on any observed situation, not all situations consumers or business owners face are genuinely problems of constrained maximization whereby the use of such methods is appropriate. The imposition of such a framework might distort the observed situation more than it provides clarity and understanding. The ability of the mathematics of constrained optimization to aid understanding of some situations must be balanced by a recognition that it can distort understanding of other situations.

As an analytical point of departure, constrained optimization requires the specification of an objective to be sought along with specification of the instruments and their properties that can be deployed in achieving that objective. Hence, a consumer is construed as possessing a given utility function along with given prices for the objects that provide utility. It is essentially the same for a business firm. Without doubt, there are situations of a relatively routine character for which constrained optimization yields useful insight. Equally without doubt, however, is the existence of situations for which constrained optimization does not provide useful insight, but instead creates a caricature. For instance, all economizing action entails a bridging of time: a plan to act is formed today, but the result of that planned action doesn't manifest until tomorrow or even the day after tomorrow, proverbially speaking. In other words, constrained optimization is not a universally valid description of rational action without invoking a caricature whereby the domain of human imagination of future possibilities is treated as being calculable in today's prices. What economists have construed as optimizing choices since the importation of calculus into economics does not reflect the calculations that are truly amenable to constrained optimizations, but rather reflects beliefs or desires regarding future conditions that do not have the same real plane of reference for everyone (for instance, in today's prices). Constrained optimization entails some common objectivity; however, action aimed at future conditions enters the realm of subjectivity, as Buchanan (1969) recognized clearly in *Cost and Choice*. All economic action entails forming plans and acting to achieve them, and so have entrepreneurial quality. In the pursuit of analytical simplicity, however, economists have typically invoked the presumption of stable equilibriums and steady states, not because they think such presumptions are accurate but because they allow importation of the definitiveness of the calculus into economics. Thus, our models have a Janus-faced character, as Buchanan recognized in *Cost and Choice*. On the one hand, they allow us to probe more deeply the contours of our intuitions; on the other hand, they can lead us to what Paul Samuelson (1947, p. ix) ironically described as "shadow boxing with reality" where the theorist creates an imaginary reality and theorizes about it, pretending that the theorizing has captured the essence of reality when it has not.

Equilibrium and Emergence in Buchanan's Thought

Without doubt, Buchanan used both equilibrium-grounded and process- or emergence-based concepts throughout his body of work. It is possible for a theorist to employ both sets of concepts, only not at the same instant to make the same point. An equilibrium model seeks to explain a consistent set of observations a some instant t_1; a process model seeks to give an account of some internally-generated change over some interval $|t_1 - t_2|$. Buchanan shifted between these modes of theorizing across his works throughout his career.

For instance, his 1968 book *The Demand and Supply of Public Goods* was devoted to presenting equilibrium models regarding the voluntary organization of the provision of public goods, thus countering Paul Samuelson's (1954, 1955) claims that the search for market-like fiscal catallactics was an impossible quest because producers could not exclude consumers from consuming the service once it had been supplied. Hence, standard market arrangements were insufficient for organizing the provision of public goods. About this claim of Samuelson's, Buchanan (1968) concurred; however, Buchanan did not regard institutional arrangements as data. To the contrary, he regarded those arrangements as products of the search by interested participants to capture mutual gains from profitable interaction. Buchanan recognized that what Samuelson described as catallactical failures would be failures only under one particular institutional context, one where producers produced services and then waited for consumers to offer to pay for those services.

But the central theme of Buchanan (1968) was that institutional arrangements were variables that emerged through interaction as people sought to construct arrangements that enabled them to improve various aspects of their lives. After the fashion of Samuelson, someone who built a lighthouse and waited for shipowners to offer payments as they passed nearby was operating under a business model that was doomed to failure. But people who had their wits about them would never employ this kind of business model. They might sell ice cream at a corner stand in this fashion, but they would not try to provide lighthouses in this manner. In one fashion or another, lighthouses would have to operate on some basis that gave potential producers reasonable grounds for thinking that consumers would support their construction. In one fashion or another, this would involve potential consumers in making reliable pledges to producers in response to those producers supplying appropriate services. Evidence from an historical study on market-provided lightships—floating lighthouses—suggests that provision of these services was possible without the need for intervention into or nationalization of the sector (Candela and Geloso 2018).

Indeed, Buchanan's treatment of *The Demand and Supply of Public Goods* is precursory to Elinor Ostrom's (1990) *Governing the Commons*. Ostrom recognized that Garrett Hardin's (1968) "Tragedy of the Commons" described a possible but not a necessary outcome of common property settings. Hardin, like Samuelson, advanced a possible source of failure in the ability of some set of people to secure the mutual gains that lay latent before them. The postulated failure, however, was a product of making an assumption about a governing institutional arrangement that precluded the ability of participants to secure the gains from trade that lay latent in their situation. Neither Samuelson nor Hardin considered the ability of people to create or alter the institutional arrangements that governed their interactions. In contrast, both Buchanan and Ostrom treated those institutional arrangements as emergent variables, and with the impetus for emergence being the search for mutual gain by participants.

In Buchanan's case, no person gains by having ships crash on rocks, so we can reasonably expect people to seek ways of enabling lighthouses to be established. Within this setting, a process where someone built a lighthouse and solicited contributions after the lighthouse was working would lead quickly to commercial failure. Yet there are numerous other processes that could lead to the successful establishment of lighthouses, and we should expect interested participants to pursue one of these processes. One such process could entail creation of a tax-financed Bureau of Lighthouses. An alternative process could entail the acquisition of ownership over harbors, along with associated docking rights at those harbors. The owners of harbors would sponsor the construction of lighthouses and tie the sale of harbor dockage to the use of lighthouses, much as hotels tie the rental of rooms to the provision of such amenities as pools and exercise rooms. In Ostrom's case, all farmers gain by the creation and operation of an irrigation project, and all have good reason to work out arrangements of mutual benefit. Both Ostrom and Buchanan explain the emergence of what resemble market arrangements, only with those arrangements adapted to situations that require some modicum of collective interaction.

That it was emergence and not equilibrium that provided the core of Buchanan's intuition about collective action is readily apparent in his 1964 paper "What Should Economists Do?" There, Buchanan argued forcibly that markets are not competitive by assumption, contrary to standard theories of competitive equilibrium or its absence. To the contrary, Buchanan argued that markets become competitive through the continual search for gain and the generation of institutional arrangements that promote acquisition of such gains. This centrality of process over equilibrium was intensified in Buchanan's (1982) one-page paper "Order defined in the process of its emergence," which showed in stark relief the dominant position of emergence and process in Buchanan's thinking.

If Hayek Was an "Ace," so Was Buchanan

In his early work on monetary theory and macroeconomics, Friedrich Hayek (1933, 1935) took the Walrasian conception of general equilibrium as his analytical point of departure for theorizing about economic instability. Starting from the presumption of an economic system in general equilibrium, Hayek sought to explain instability as stemming from monetary-induced disruption to an equilibrium set of prices. Hayek subsequently abandoned his initial Walrasian point of departure and focused instead on how it would ever be possible for equilibrium to be established once it is recognized that no person possesses the knowledge necessary to establish an equilibrium for society. Each person in society possesses only a tiny portion of the knowledge that would be necessary to create a societal equilibrium Hayek (1937, 1945). This alternative point of analytical departure replaced the stipulative character of general equilibrium theorizing with an emergent or generative orientation where the analytical challenge was to explain how orderliness might emerge through interaction without pre-supposing orderliness at the start.

To date, economic theory has proceeded mostly within a stipulative mode of analysis using fixed points and comparative statics. Different economists and their models are thus "Experts" who compete for public attention. This theoretical approach generates tractable models that often produce reasonably accurate results, but not always. There is, of course, a good deal of permanence in human activity and social life. That permanence could well be represented by the claim that theoretical propositions are generally though not always 95% accurate. Permanence, moreover, pertains to such macro-level observations as rates of aggregate growth or employment. While those aggregate variables are constructed from observations on individual actions that lie beneath that aggregate, orthodox theory makes no serious effort to generate aggregative observations from prior micro-level interactions among the participants who are subsumed within the aggregate variables (Wagner 2012a). To do this requires a *generative* and not a *stipulative* mode of analysis (Latour 2005; Epstein 2006). We must be able to generate social-level observations from micro-level interactions, as against simply assuming the existence of social-level observations. It is human interactions that form our analytical primitives; social-level observations are derivative and not primitive variables.

Nicholas Vriend (2002) asks whether Hayek was an "ace," by which he was referring to someone who worked with agent-based computational economics. Obviously, Hayek could not have been an "ace" in any literal sense of the term because neither the hardware nor the software to support this approach to theorizing was available when Hayek formed his ideas about the assembly of distributed and incomplete knowledge. Of necessity, Hayek had to argue in what appeared to be a stipulative mode even though his analytical intuitions called for generative or emergent modes of analysis. For this reason, Vriend argued that

Hayek could have made good use of agent-based computational modeling had those tools been available.

Buchanan's intuitions were similar to Hayek's, as Wagner (2017) explains in his rational reconstruction of Buchanan's body of work, and as noted above in his early work on public goods (Buchanan 1968). Buchanan's intuition on public goods called for a generative mode of theorizing where people crafted institutional and organizational arrangements as a consequence of their desire to secure the mutual gains they thought could be captured through rightly arranged interaction. Later, Elinor Ostrom treated common property situations based on similar intuitions with a combination of game theory, field-based experimentation, and agent-based modeling. The real Buchanan was surely a generative and not an equilibrium theorist, as was Hayek. The reason neither was an "ace" is only because both came to scholarly maturity before those modeling platforms were in play.

Agent-based modeling is an excellent tool for theorizing about non-equilibrium settings comprised of interactions among numerous creative agents who are only incompletely coordinated at any instant. Agent-based modeling entails methodological recognition that reality works through distributed and incomplete knowledge. Economists of all methodological stripes are faced with a significant analytical challenge in truly exploring how interaction generates knowledge or belief through transactions. The field theoretic maximization calculus has no room in its assumptions and derivations thereof for interaction between agents, and suffers little true difference between them (Kirman 1992; Clower 1994; Potts 2000). Incompleteness is thus caricatured by methodological failure as an individual or systemic failure, depending on the level of analysis queried. Interaction becomes non-interaction, outcomes become unentangled and independent from one another, intervention is insulated from the perversion of feedbacks, and the formation of expectations is protected from unknown changes uncovered by the forward flow of time and therefore amenable to simple search. Incompleteness, and difference, are not simply complexifications whose general nature can be approximated through completeness, and sameness. Subjective value and the perception of one's world do not approximate market prices and a limited-yet-predictable subset of the given data. The world acquires its shape through complex patterns of interaction among people who know or believe different things.

> Individuals do not act so as to maximize utilities described in *independently existing functions*. They confront genuine choices, and the sequence of decisions taken may be conceptualized, *ex post* (after the choices), in terms of "as if" functions that are maximized. But these "as if" functions are, themselves, generated in the choosing process, not separately from such process…The potential participants *do not know until they enter the process* what their own choices will be. (Buchanan 1982; emphasis in original)

Outcomes and plans are entangled with one another, which can generate conflict as easily as coherence. This is part of social reality that Buchanan thought we should seek to understand rather than to ignore the difficulty of securing such understanding by stipulating the existence of societal equilibrium instead of seeking to generate it. Stipulated equilibrium was anathema to Buchanan's conception of how economists should understand and theorize about the market order, certainly with respect to policy advice meant to intervene upon an unplanned order in the name of teleological orderliness. The point Buchanan wished to make on his short note referenced above, "…reduces to the distinction between end-state and process criteria, between *consequentialist* and *nonconsequentialist*, *teleological* and *deontological* principles" (Buchanan, ibid.).

Agent-based modeling gives us the ability to start asking deontological rather than telelogical questions, in particular, about *becoming*. In his (1979) "Natural and Artifactual Man," Buchanan differentiates between spending on education as an investment in "becoming" and, say, the kind of life-cycle calculations we engage in when deciding how much to save for retirement given an expected average interest rate, retirement age, and life expectancy (p. 248). Buchanan suggests that we spend on "becoming" to become something different; we have a sense that keeping on in what we are doing won't exploit our potential the way investing in education would. But our future is a canvas on which we, others, and time paint. Our sense for the difference signifies perhaps a direction in which we wish to go, and is not precise or even approximately so. Perhaps we think about an average person post-degree and say, "I wouldn't mind living like that," but it is our *imagination* of that person's condition and their happiness that carries us forward. And *forward* is where we are carried, invariably; we are *changed*, invariably, and we are okay with that.

Becoming, in the sense of Buchanan, harkens to what Henri Bergson called *durée*, the inextricability of continual difference as a result of moving through time with the thing that moves through time (Bergson 1911). In contrast, classically, the billiard ball at time $t + 1$ is reducible to the billiard ball at time t plus a smooth, continuously differentiable spatial translation. Similarly, field-theoretic economics treats people as particles who are at time $t + 1$ reducible to what they were at time t plus a smooth, continuously differentiable function describing the transition of some set of relevant characteristics. People cannot be said to be invariant in any general sense with respect to time, both because they themselves are continually becoming, and because the very social fabric in which they become is also becoming. Buchanan differentiates between life-cycle decision-making, where we calculate what we need in retirement, the expected interest rate, and save accordingly, and spending on becoming. While we do engage in some life-cycle-like calculations, these are not sufficient to explain the full extent of human planning because that planning also entails activities directed at becoming, as Ross Emmett (2006) explains in contrasting Frank Knight's orientation toward human action which emphasized becoming to George Stigler and Gary Becker's (1977) formulation which treated becoming as irrelevant to human action.

The question remains, what do we lose when we approximate all planning as life-cycle-like calculations? Without doubt, and as Buchanan suspected, we will end up caricaturing some spending-on-becoming as irrational when framed as life-cycle calculations. For instance, the consensus of behavioral economics, whose conclusions about maximal possible individual and social welfare are based on the field theoretic conception of people reducible to some core set of preferences plus a smoothly differentiable translation through time, is that young people tend to under-save for old age (Benartzi and Thaler 2013). It is not only possible but quite likely that applying life-cycle calculations as if people were squirrels saving nuts for winter does not correctly capture the tradeoffs we make between *becoming* through time and saving for retirement. The life-cycle model might work for some kinds of stable jobs held in the long-term with a certain kind of set of stable expectations, but clearly fails for individuals who deviate from the model. Models with heterogeneous agents, evolving through time, have already shed light on the matter, showing that agents who appear to be acting sub-optimally as individuals can, when sufficiently modeled as agents who act and plan in a society over time, attain an optimal social distribution (Axtell and Epstein 2006).

Agent-Based Modeling as Quintessential Tool of Democratic Political Economy

Normatively, there is a question of the relation between experts and ordinary citizens within a system of democratic political economy. Closed-form modeling with its semblance of solvability construes economic theory as a game reserved for experts versed in economic theory. Theorists become shepherds guiding sheep, with any theoretical controversy being a controversy concerning which destination for guidance is superior and never over whether guidance is desirable or necessary in the first place. The mass of sheep is left to stand outside this conversation among experts in any case, often bringing about what Koppl (2018) describes as expert failure. Analytical tractability in this conversation presupposes that correctness resides with one of the theorists, with competition among theorists being the means of selecting among the solutions to various closed-form models of the problem.

In contrast, the open-endedness associated with agent-based modeling effectively transforms lectures among experts into conversations among everyone. This recognition recurs to Frank Knight's (1960) distinction between debate and discussion, with discussion and not debate reflecting the genuine spirit of democratic as distinct from autocratic governance. Debate entails a contest among pre-established positions, producing a form of deductive, eristic discourse. Discussion opens discourse to the injection of creativity, due to its open-ended, inductive quality.

Agent-based modeling can explain whether coherence, or the extent of such coherence, is a possible feature of societal life under the conditions presented within the model, whereas orthodox modeling stipulates coherence as a property of the model. It should be noted, though, that the prime virtue of agent-based modeling does not reside in giving more accurate answers to old questions. Rather, it resides in posing different questions, including more nuanced versions of old questions. For instance, equilibrium thinking centered on comparative statics frames the crisis of 2008 as a shock to an equilibrated system, and asks whether that shock stemmed from too much or too little regulation? Ignored by this framing is possible recognition that variable turbulence might be a working property of a system of political economy. Agent-based modeling can enable exploration of more nuanced questions regarding how different types of contractual forms and different frameworks for the organization of regulatory agencies might entail some degree of variable volatility as systemic properties (Wagner 2012b). To be sure, open-systems modeling butts more quickly against the concerns of analytical tractability than does closed-form modeling (Bookstaber 2017). For instance, a great deal of evidence has accumulated for the existence of cascade effects in financial networks, which require financial agents to make decisions in a contextually-aware manner (Tedeschi et al. 2012). Contextually-aware agents are the bread-and-butter of agent-based modeling, while field-theoretic equilibrium modeling has difficulty handling agents who cannot or do not cleanly access and react to system-wide indicators. Agent-based modeling is a superior tool for analyzing economic problems in which context is a large part of the explanatory content.

Furthermore, agent-based modeling offers a superior framework for theorizing about creative social systems (Bertalanffy 1968; Bergson 1998 [1911]), in contrast to the presumption of automatic systems that characterizes equilibrium modeling. This alternative orientation leads to the pursuit of new opportunities for social-level theorizing. Of course, any model is deterministic in that the outcomes of the model are baked into the construction of the model. The outcomes of agent-based models are governed by the assumptions with which those models are constructed; however, agent-based models lead into an examination of social processes, whereas equilibrium theorizing enervates any concern with institutional arrangements and social processes.

Open vs. Closed Frameworks for Social Theorizing

While Buchanan worked with both closed and open theoretical frameworks, his analytical basing point surely rested with open frameworks. In contrast, the profession-wide attempt to derive processes from equilibrium theory has led to a concept of expert-led "perfectly" rational human behavior that has little basis in reality (Easterly 2014, Koppl 2018), spinning off entire subfields that list deviations from rationality and prescribe policy curatives to nudge agents to find the "solution" that increases some measure of individual and social welfare (Kahneman and Egan 2011; Thaler 2012; Thaler and Sunstein 2008). As soon as we peek beneath the veil of analytical solutions, however, we discover processes which are suggestive of an evolutionary or creative logic (Gigerenzer et al. 2000; Simon 1972; Smith 2003). Agent-based modeling gives us a tool to go beyond our analytical intuition, for it enables us to explicate processes that appear irrational, but which promote coordinative outcomes all the same (Wilhite 2001).

The definition of simulation as involving a "material technical device" demonstrates one of the methodological differences between simulation and a thought experiment based on comparative statics: the constructive nature of simulation. Making a computer program equivalent to a simulation indicates the most desirable property of a simulation, namely, its computability. We can better contextualize historical definitions of simulation by considering them in relation to the constructivity versus nonconstructivity of their results (Bridges 1999).

The contrast between stipulative and constructive thinking is present even in what is arguably the core model of economics: exchange. The stipulative approach posits a situation where gains from trade are recognized by both participants. In contrast, a constructive or generative approach would need to explain the emergence of exchange from a situation where it was absent. To do this moves into territory occupied by leadership and entrepreneurship (Sterpan and Wagner 2017) and opens into analytical territory that lies beyond the vision of orthodox thinking. We must be able to generate social-level observations from micro-level interactions, as against simply assuming the existence of those observations. Human interactions form our analytical primitives; social-level observations are derivative and not primitive variables.

Constructedness as a Virtue; Stipulation as a Vice

Theorists often remark that such devices as agent-based modeling are defective because they are to a variety of answers to questions, depending on the models used. Without doubt, this is true. This is also true, however, for stipulative modeling, for the answers given likewise depend on particular stipulations. Using simulations instead of close-ended mathematical analysis must confront the illusion of precision and certainty in deducing results that accompany a closed and consistent set of axioms. Despite pejoratives about "black boxes," simulations have no less a mathematical basis; for instance, the outcomes of agent-based models are reducible to some set of interactions between the generating algorithms of agent behavior and agent environment. Leigh Tesfatsion (2017) explains that agent-based models are mathematically reducible to sequential games on networks.

Simulation's primary methodological strength is in *constructing* outcomes, instead of *deriving* them. That is, when an outcome is realized in a simulation, its existence has been proved a result of the agent characteristics and model conditions, a no less rigorous test than proving the existence of a fixed point in general equilibrium theory.

The theorist then must argue for the realism of relationships, behaviors, and assumptions made to construct the model environment and its evolution through time, but this is the ever-challenging side of theory, no less challenging to the equilibrium theorist. The simulation theorist isn't at a methodological disadvantage relative to the mathematical analyst. In fact, it is likely that the constructive approach taken by the simulation theorist is more appropriate given the complex and open-ended evolutionary nature of social relationships and their dynamic progression through time.

Indefiniteness as a Virtue; Definitiveness as a Vice

The indefiniteness that surrounds simulation is a virtue of the method, not a defect. One of the biggest unsolved problems in economic theory is our inability as theorists to properly account for the generating processes of growth, in that our static-stochastic modeling schemes stipulate final resting states and are silent on the pressing question of *how* to attain these states. There are no *hows* in our present theoretical language because there are no *processes*. Social processes are particularly anathema to analytic models whose unique equilibrium predictions are foiled by the time we've added the third person (as demonstrated by Condorcet (2014 [1885]); Arrow 1950).

On the other hand, subjectivity and an embrace of open-ended evolution is sometimes conflated with the absence of theory altogether, and as an abdication of method. We contend that the very fact that simulation is untethered from more constrictive axioms frees it as a tool of exploration into the murkiness of social complexity. That is, subjectivity and change are inescapable realities of the social condition that cannot be assumed or approximated away, and simulation for the first time has given us tools to embrace these realities instead of cloister ourselves in the comfortable lie of a consistent axiom system.

The black box of simulation with its apparent indefiniteness is an expression of complex, unpre-statable contextual relationships among agents and systems as these emerge through time. In the desire to avoid the meaningless chaos that is mistakenly thought to accompany indefiniteness and subjectivity, economists have ignored the social analogy of organized-but-not-planned Prigoginian dissipative structures (as in Prigogine and Lefever 1973), opting instead for smooth and doubly-differentiable trendlines. That is, given some suite of simple and intuitive micro-behaviors, a simple and intuitive social network, and an evolutionary progression of the system through time, we may see structures and patterns form that are not analytically pre-statable given those same agents, networks, and evolution. Those patterns are of course stateable after-the-fact in some algorithmic format, but perhaps not in a way that is useful or interesting to policy-makers, for whom many economic models are created. We must of course note that theories have end-users, and products are created to suit the needs of end-users. It is possible that simulations, in their embrace of complex relationships, cannot match the apparent demonstrative power of Keynesian crosses. But just as the allure of the simple and elegant in physics may have to yield to the reality of a 10-dimensional world derived from obscure octonion math and actualized as vibrating discrete strings, the social theorist must go where the science of the subject leads.

Debate, Discussion, and Normative Political Economy

Democracy is widely characterized as a political system where people govern themselves, in contrast to political systems where some people govern others. Buchanan embraced this normative vision of democracy at the start of his scholarly career, with his scholarly oeuvre taking shape over the following six decades mostly as a product of his effort to explore deeply what might be entailed in constructing a self-governing republic. Vincent Ostrom (1997) pursued a similar line of inquiry. Both discovered that to pursue this line of inquiry requires first of all rejection of any facile identification of the democratic form with self-governance. A century ago such thinkers as Robert Michaels (1962) and Gaetano Mosca (1939) explained that the democratic form could easily operate in oligarchic fashion. In this respect the Italian theorist Antonio de Viti de Marco (1888, 1936) recognized this oligarchic possibility by distinguishing between cooperative and monopolistic models of democracy. For de Viti, the cooperative model conveyed the ideal of self-governance while the monopolistic model conveyed the idea that democracy operated for the benefit of some people at the expense of others.

Knowledge is necessarily distributed among people. As Roger Koppl (2018) explains this divides the world on any question between experts and novices. A world where experts govern novices can easily become a form of democratic oligarchy. Much depends on how experts are selected, and the place that novices have in the selection and maintenance of experts. Nearly all human interactions conform to the expert-novice template. In many such settings, it is novices who hire experts and who have the ability to retain or dismiss the experts they have hired. This is less the case when we come to politically-grounded interactions due to the prevalence of what Pareto (1935) described as non-logical action, which has nothing to do with irrational action and refers instead to the ability of different action environments the influence the substance of action.

Pareto described his methodology as logico-experimental. By this, he meant that you can observe what people do and how they explain what they do, but you can't observe why they truly do what they do. Market environments place people in the position of conducting a form of scientific experiment. Both consumers and investors conduct forms of experiment: they form hypotheses about the probable courses of action, and then bet on the results. This environmental setting is the domain of logical action. In contrast, politics and religion are mostly the domain of non-logical action. In this environment there is no testing of actions against experience, in contrast to market environments.

Pareto's distinction between logical and non-logical action pertains to the relation between experts and novices, with novices being ordinary citizens within a system of democratic political economy. Closed-form modeling construes economic theory as a game reserved for experts versed in economic theory. This situation maps onto a world of shepherds guiding sheep, with theoretical controversy concerning which destination for guidance is superior—and with the sheep standing outside this conversation in any case. Analytical tractability thus refers to the presumption that correctness resides with one of the theorists, and with competition among theorists being the means of selecting among competing experts.

In contrast, the open-endedness associated with agent-based modeling effectively transforms lectures among experts into conversations among everyone. This recognition recurs to Frank Knight's (1960) distinction between debate and discussion, with it being discussion and not debate that reflects the genuine spirit of democratic as distinct from autocratic governance within Buchanan's scheme of thought. Debate entails a contest among pre-established positions, producing a form of eristic discourse. With discussion, the situation is open to the injection of creativity into discourse due to the open-ended quality of the situation. Buchanan's original embrace of Knut Wicksell's consensual approach to collective action, which in its ideal form required unanimity, was grounded in democratic discussion with actions being approved through the emergence of consensus.

References

Arrow, K. J. (1950). A Difficulty in the Concept of Social Welfare. *Journal of Political Economy, 58*(4), 328–346.

Axtell, R. L. & Epstein, J. M. (2006). Coordination in Transient Social Networks: An Agent-based Computational Model of the Timing of Retirement. In J. M. Epstein (Ed.), *Generative Social Science: Studies in Agent-based Computational Modeling* (p. 146). Princeton, NJ: Princeton University Press.

Benartzi, S., & Thaler, R. H. (2013). Behavioral Economics and the Retirement Savings Crisis. *Science, 339*(6124), 1152–1153.

Bergson, H. (1998 [1911]). *Creative Evolution*. (A. Mitchell, Trans.). New York: Dover.

Bookstaber, R. (2017). Agent-Based Models for Financial Crises. *Annual Review of Financial Economics, 9,* 85–100.

Bridges, D. S. (1999). Constructive Mathematics: A Foundation for Computable Analysis. *Theoretical Computer Science, 219*(1–2), 95–109.

Buchanan, J. M. (1964). What Should Economists Do? *Southern Economic Journal, 30,* 213–222.

Buchanan, J. M. (1968). *The Demand and Supply of Public Goods*. Chicago: Rand McNally.

Buchanan, J. M. (1969). *Cost and Choice: An Inquiry in Economic Theory*. Chicago: Markham.

Buchanan, J. M. (1979). Natural and Artifactual Man. In *The Logical Foundations of Constitutional Liberty: The Collected Works of James M. Buchanan* (Vol. 1). Indianapolis: Liberty Fund.

Buchanan, J. M. (1982). Order Defined in the Process of Its Emergence. *Literature of Liberty, 5,* 5.

Candela, R. A., & Geloso, V. J. (2018). The Lightship in Economics. *Public Choice, 176*(3–4), 479–506.

Clower, R. W. (1994). Economics as an Inductive Science. *Southern Economic Journal, 60*(4), 805–814.

Condillac, E. B. (1776). *Le Commerce et le gouvernement: Considérés rélativement l'un à l'autre ouvrage elementaire* (Vol. 1). Amsterdam: Chez Jombert & Cellot.

Condorcet, N. (2014 [1885]). *Essai sur l'application de l'analyse à la probabilité des décisions rendues à la pluralité des voix*. Cambridge: Cambridge University Press.

De Viti de Marco, A. (1888). *Il carattere teorico dell'economia finanziaria*. Rome: Pasqualucci.

De Viti de Marco, A. (1936). *First Principles of Public Finance*. London: Jonathan Cape.

Dupuit, J. (1933 [1849]). De l'influence des peages sur l'utilitee des voies de communication' [1849]. *De l'utilite et de sa mesure, Torino: La Riforma Sociale*, 97–162.

Easterly, W. (2014). *The Tyranny of Experts: Economists, Dictators, and the Forgotten Rights of the Poor*. New York: Basic Books.

Edgeworth, F. Y. (1881). *Mathematical Psychics: An Essay on the Application of Mathematics to the Moral Sciences.* London: Kegan Paul.

Emmett, R. B. (2006). Die Gustibus Est Disputandum: Frank Knight's Response to George Stigler and Gary Becker's 'Die Gustibus Est Disputandum'. *Journal of Economic Methodology, 13,* 97–111.

Epstein, J. M. (2006). *Generative Social Science: Studies in Agent-Based Computational Modeling*. Princeton: Princeton University Press.

Gigerenzer, G., Todd, P. M., & ABC Research Group. (2000). *Simple Heuristics That Make Us Smart*. Oxford: Oxford University Press.

Hayek, F. H. (1933). *Monetary Theory and the Trade Cycle*. London: Jonathan Cape.

Hayek, F. H. (1935). *Prices and Production*. London: Routledge and Kegan Paul.

Hayek, F. H. (1937). Economics and Knowledge. *Economica, 4,* 33–54.

Hayek, F. H. (1945). The Use of Knowledge in Society. *American Economic Review, 35,* 519–530.

Jevons, W. S. (1957 [1871]). *The Theory of Political Economy.* New York: Sentry Press.

Kahneman, D., & Egan, P. (2011). *Thinking, Fast and Slow* (Vol. 1). New York: Farrar, Straus and Giroux.

Kirman, A. P. (1992). Whom or What Does the Representative Individual Represent? *Journal of Economic Perspectives, 6*(2), 117–136.

Knight, F. H. (1960). *Intelligence and Democratic Action*. Cambridge, MA: Harvard University Press.

Koppl, R. (2018). *Expert Failure*. Cambridge: Cambridge University Press.

Latour, B. (2005). *Reassembling the Social: An Introduction to Actor-Network-Theory*. Oxford: Oxford University Press.

Michels, R. (1962). *Political Parties: A Sociological Study of the Oligarchical Tendencies of Modern Democracies*. New York: Collier Books.

Mosca, G. (1939). *The Ruling Class*. New York: McGraw-Hill.

Ostrom, V. (1997). *The Meaning of Democracy and the Vulnerability of Societies: A Response to Tocquevill's Challenge*. Ann Arbor: University of Michigan Press.

Pareto, V. (1935). *The Mind and Society*. New York: Harcourt Brace.

Potts, J. (2000). *The New Evolutionary Microeconomics: Complexity, Competence and Adaptive Behaviour*. Cheltenham, UK: Edward Elgar Publishing.

Prigogine, I., & Lefever, R. (1973). Theory of Dissipative Structures. In *Synergetics* (pp. 124–135). Wiesbaden: Vieweg + Teubner Verlag.

Samuelson, P. A. (1947). *Foundations of Economic Analysis*. Cambridge, MA: Harvard University Press.

Samuelson, P. A. (1954). The Pure Theory of Public Expenditure. *Review of Economics and Statistics, 36,* 387–389.

Samuelson, P. A. (1955). Diagrammatic Exposition of a Theory of Public Expenditure. *Review of Economics and Statistics, 37,* 350–356.

Simon, H. A. (1972). Theories of Bounded Rationality. *Decision and Organization, 1,* 161–176.

Smith, V. L. (2003). Constructivist and Ecological Rationality in Economics. *American Economic Review, 93,* 465–508.

Sterpan, I., & Wagner, R. E. (2017). The Autonomy of the Political in Political Economy. *Advances in Austrian Economics, 22*, 133–157.

Stigler, G. J., & Becker, G. S. (1977). Die Gustibus Non Est Disputandum. *American Economic Review, 67,* 76–90.

Tedeschi, G., Mazloumian, A., Gallegati, M., & Helbing, D. (2012). Bankruptcy Cascades in Interbank Markets. *PloS One, 12,* 527–549.

Tesfatsion, L. (2017). Modeling Economic Systems as Locally-Constructive Sequential Games. *Journal of Economic Methodology, 24,* 384–409.

Thaler, R. H. (2012). *The Winner's Curse: Paradoxes and Anomalies of Economic Life*. New York: Simon & Schuster.

Thaler, R. H., & Sunstein, C. (2008). *Nudge: Improving Decisions About Health, Wealth, and Happiness*. New Haven, CT: Yale University Press.

Von Bertalanffy, L. (1968). *General System Theory*. New York: George Braziller, 41973(1968), 40.

Vriend, N. J. (2002). Was Hayek and Ace? *Southern Economic Journal, 68,* 811–840.

Wagner, R. E. (2012a). A Macro Economy as an Ecology of Plans. *Journal of Economic Behavior and Organization, 82,* 433–444.

Wagner, R. E. (2012b). Viennese Kaleidics: Why It's Liberty More Than Policy that Calms Turbulence. *Review of Austrian Economics, 25,* 283–297.

Wagner, R. E. (2017). *James M. Buchanan and Liberal Political Economy: A Rational Reconstruction*. Lanham, MD: Lexington Books.

Wilhite, A. (2001). Bilateral Trade and 'Small-World' Networks. *Computational Economics, 18,* 49–64.

Part II

Public Finance and the Theory of the State

7

The Conflict Between Constitutionally Constraining the State and Empowering the State to Provide Public Goods

Lawrence H. White

James M. Buchanan, especially in the early part of in his career, contributed to elaborating the Samuelsonian theory of public goods and the associated theory of externalities, and defended that theory (qua theory) against critics. In its most common normative application, public-goods (or externality) theory the tax-financed provision (or subsidization) of services wherever the market may fail to achieve Pareto efficiency. Buchanan (1962) noted that without equivalent scrutiny of government allocation processes, warts and all, the advocate of public provision on the grounds of market imperfection commits a *non sequitur*. Government provision cannot be counted on to improve matters where government is subject to similar imperfection. Buchanan advocated constitutional constraints on the scope of taxation and tax-funded state activity to limit its use for non-Pareto-improving purposes.

When Buchanan questioned the "naïve" normative application of public goods theory, he questioned it mostly on the grounds of the

L. H. White (✉)
George Mason University, Fairfax, VA, USA
e-mail: lwhite11@gmu.edu

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_7

problem of interests, i.e. the divergence of the advocate's or administrator's interest from the general interest. Thus Buchanan (1962, p. 21) emphasized that free-riding in the market is matched by rent-seeking in majoritarian politics. Both involve readiness to benefit at others' expense. Geoffrey Brennan and Buchanan (1980) emphasized that legislators and bureaucrats empowered to spend tax revenues presumably will—being human and not saintly—pursue their own welfare and not purely the general public's welfare unless properly constrained by constitutional rules.

Buchanan also recognized, but arguably underemphasized, the *inbuilt knowledge problem* in public goods provision and externality correction. Namely: even the most benevolent government agents cannot improve on imperfect market outcomes in the presence of free-rider or demand-revelation problems because—being human and not omniscient—they cannot know the public's true but necessarily unobserved willingness to pay for unpriced services. The claim that "x is a worthwhile public good" for taxes to finance, i.e. that project x's expenses will be exceeded by the value the public places on its services, can never be falsified given the free-rider or demand-revelation problem built into the Samuelsonian concept of a public good. It follows that to give a human bureaucracy the constitutional mandate to provide only "genuinely 'public goods' of the pure Samuelsonian type," as Brennan and Buchanan (1980, p. 191) proposed, is to sign over a blank check. The constitutional limits that Brennan and Buchanan recommended would provide no barrier to the proliferation of claimed public goods and therefore no barrier to the scope of government.

Buchanan as Public Goods Theorist

In their classic clarification of the concept of externality, Buchanan and Craig Stubblebine (1962, p. 383) noted the affinity of their formal analysis to Samuelson's analysis of public goods. The Pareto equilibrium conditions for internalizing externalities are the same as those for efficiently providing public goods: "The summed marginal rates of substitution (marginal evaluation) must be equal to marginal costs." The authors did not consider the problem of knowledge or the problem of interest in institutional arrangements for applying the theory.

Buchanan and Stubblebine importantly distinguished *Pareto-relevant* externalities (where the benefits from modifying the scale of the interaction would exceed the costs of doing so) from externalities in general, some of which it would be non-economical to modify. In the same vein we can distinguish worthwhile or Pareto-relevant public goods (providing non-rival benefits in excess of production costs) from public goods in general, some of which would be non-economical to provide.

Buchanan's 1967 book *Public Finance in Democratic Process: Fiscal Institutions and Individual Choice* discussed Samuelsonian public goods with only slightly more attention to knowledge and interest problems in collective provision. There Buchanan (1967b, p. 225) noted that "the traditional approach" to public goods relies on "imputing" benefits to consumers who do not demonstrate a willingness to pay for them (but rather find services simply showering down on them at zero prices). He acknowledged that "the traditional approach contains few attempts to justify the empirical relevance of any of the benefit imputations required to legitimatize its methodology." Nonetheless he ran with the theory, offering the specific hypothesis of equal benefits to all consumers, and later of benefits proportional to consumer incomes, as useful assumptions for fiscal model-building that may not be too far from the truth. In the absence of a way to measure rather than to "impute" benefits by hypothesis, however, the analyst has no way of knowing how far from the truth such benefit imputations are.

In *The Supply and Demand for Public Goods*, published a year later, Buchanan sought to frame public goods theory as a positive analysis for understanding which services *are* tax-financed, rather than a normative analysis of which should be. He warned (Buchanan 1968b, pp. 161–162) that although it "is understandable that organizational-institutional implications were read into the theory of public goods from the outset," the ascription of publicness (non-rivalrous benefits) to a good does not imply that its provision should be financed by taxes. "Some comparative analysis of alternative institutions" is necessary to reach an informed decision. Buchanan noted that while tax-financed collective provision of a "polar public good" at a zero price may eliminate the *distributional* inefficiency of a price above the marginal cost of serving another household, it gives rise to *financing* inefficiencies from the deadweight losses created by distorting taxes and likely *allocational* inefficiencies from provision of too many or too few units to everyone. The possibility of too many or too few units, relative to aggregate willingness to pay, suggests the presence of the public-goods knowledge problem (irremediable ignorance of the aggregate willingness to pay for various quantities) or a bureaucratic interest problem (the bureaucratic provider's interest lies in over-provision), but the book did not explore these problems.

Minasian, Samuelson, Buchanan, and Broadcast Television as a Public Good

In 1967 Buchanan inserted himself into an important debate over the normative application of public goods theory. In an early discussion of his theory Paul Samuelson (1958, p. 335) observed that in the case of a good with external effects "we can by logic know that ordinary pricing will be non-optimal unless it happens to be able to pick up each indirect external marginal utility." Commenting specifically on broadcast television because "in a way" it was a "perfect example of my public good" for which any one household's consumption is non-rival with another's, Samuelson seemed to disparage the enterprise of subscription television. (Like satellite television today, but using ground-based antennas, the enterprise under discussion would scramble its broadcast signals and rent descramblers to households.) Samuelson reckoned that a paid subscription system would *inefficiently* exclude some consumers because it would impose a positive price on access to the signal being provided despite a zero cost of allowing additional households within any given signal area to tune in. Wrote Samuelson (1958, p. 335):

> Here is a contemporary instance. The Federal Communications Commission is now trying to make up its mind about permitting subscription television. …
>
> Being able to limit a public good's consumption does not make it a true-blue private good. For what, after all, are the true marginal costs of

> having one extra family tune in on the program? They are literally zero. Why then prevent any family which would receive positive pleasure from tuning in on the program from doing so? Upon reflection, you will realize that our well-known optimum principle that goods should be priced at their marginal costs would not be realized in the case of subscription broadcasting.

Jora Minasian (1964) criticized this passage for leaving out many factors relevant to an economical choice among advertiser-, subscriber-, and tax-financed broadcasting. Minasian made the important point that pricing *elicits information* on willingness to pay, which is essential to avoid providing services that users value less (as measured by willingness to pay) than alternative uses of the resources expended in provision: "As in the case of television, the [Samuelsonian public goods] theory ignores the effect of different signaling and control systems (alternative institutional arrangements) in revealing alternative values of the used resources."[1]

Samuelson (1964) expressed outrage at Minasian's uncharitable interpretation of his remarks on television, but in his initial response he neglected to acknowledge the demand-revelation problem.[2]

Buchanan's (1967a) commentary on the Minasian-Samelson exchange attempted to clarify what "Samuelson initially had in mind in his reference to TV signals as an application of his theory of public goods." Buchanan sketched an "ideal-type situation" of a single relay antenna on an island, whose owner-operator has no choice about which mainland channel to re-broadcast (only one channel reaches the antenna) but has the choice of how many hours to operate per day. Buchanan noted that the marginal conditions for Pareto optimality in provision do not

[1]No party to the discussion made the point that the FCC could not make the public worse off by *allowing* subscription television services to enter a market that already had advertiser-financed television, thus giving the public an additional option but foreclosing no existing option.

[2]Contrast Samuelson (1967, p. 200), where he observed: "For ideal private goods, people are motivated to 'reveal' their tastes," whereas (p. 202) "God-like powers" would be necessary for an official body "to determine the … utilities of different users" for a public good provided monopolistically.

themselves determine whether provision should be public or private, because those conditions could be satisfied under either arrangement *if* (Buchanan left this implicit) we assume in both cases that the provider already has all the needed knowledge about consumer demands. An optimizing government provider could charge perfectly calibrated taxes (such that no household pays more than it is willing to pay for the broadcasting service) with a uniformly zero access price to households. A private monopoly provider could likewise engage in perfect price discrimination, charging positive prices to inframarginal households but a near-zero price to any household with near-zero willingness to pay.

Should the antenna owner face a choice among alternative mainland channels to re-broadcast, however, Buchanan endorsed Minasian's point that the marginal conditions for Pareto Optimality in provision of a *given* product are insufficient to make the choice. In the new case information is needed about consumers' dollar willingness to pay (consumer surplus at any given price) for each of the alternative channels. If that information is not already in hand, charging prices provides informative feedback to the private owner that the non-price-charging government authority would lack. Buchanan commented:

> The theory of public goods, in this limited sense, is of no assistance in determining which one, from among a set of mutually-exclusive alternatives, should be provided. This decision requires a consideration of the total conditions, some conceptual or actual measurement of consumers' surplus. There is, as such, no means of measuring this, and Minasian's point is well taken when he suggests that the ordinary profitability criterion, whether applied by a private or a public monopolist, would be a more instructive guide than the opinions of a governmental authority. The monopolist owner of the antenna, seeking out his highest net revenue, will tend to select that signal (or that mix of signals) which most closely satisfies consumer demand.

Buchanan's next sentence suggested, however, that he was more concerned with the equi-marginal conditions that with the need to elicit willingness to pay:

> If by necessity, by convention, or by law, the monopolist is prevented from discriminating and is, instead, required to charge uniform prices, his profitability criterion will no longer serve as an appropriate guide for aggregative allocative decisions.

While it can of course be shown that a single-price monopolist will produce a sub-optimal quantity of any output by contrast to a perfectly price-discriminating monopolist, the profit-or-loss criterion plays an informative role even for a single-price monopolist who does not begin with complete relevant knowledge: It tells the producer when expenses exceed revealed consumer benefits. It also prevents the producer from continuing a non-worthwhile project indefinitely. A tax-financed authority that distributes at a zero price receives no such information, therefore cannot use (or be held to) an informed benefit-cost standard, and may persist indefinitely in a wasteful project.

Buchanan the public-goods theorist faulted Minasian for going too far in suggesting "that the allocative norms contained within the theory are incorrect, within properly constrained models. His demonstration that other considerations may be dominant in certain real-world circumstances has little relevance to the validity or invalidity of the theory of public goods." A theory can be logically valid (its propositions follow from its premises), however, without being useful or even true, if it begins from false premises. A theory sheds little useful light on choices among alternative institutions if it gives normative guidance only "within properly constrained models" that assume away problems of knowledge and interest. Such a theory is indeed likely to be more misleading than illuminating. Minansian (1967, p. 207) made essentially this point in his response to Buchanan:

> My criticism of the [Samuelsonian public goods] models was not based on their logical merits, but on the grounds of their relevance. Their being theoretical rather than empirical models, the allocative norms must be judged by the relevant economic data the models contain. A model of public goods which does not incorporate the cost of exclusion and the value of the information generated by different signaling and incentive systems, is not properly "constrained" for the purpose of solving real

> world problems. Indeed, without the two elements, the model altogether defines away the problem of resource allocation with which I was concerned in my article.

Samuelson's (1967, p. 199) response to Buchanan's comment commendably highlighted the problem of demand revelation. Samuelson noted that "we can summarize all the information of Buchanan's example by the shapes of the marginal-utility curve of the public good to each man." He then added: "Each man knows this function for himself. But only God knows them for all men. Buchanan does not; I do not; the government does not; monopolists and competitors do not."[3]

Samuelson (1967, p. 200) went on to recognize a difference in demand revelation between priced private provision and unpriced public provision, although his recognition was too limited:

> If the unknown marginal-utility functions appertained to *private* goods, this lack of knowledge would not matter. *Laissez faire* would introduce and police perfect competi[ti]on. It would be to each man's interest to act along his MU function as an observable demand function. The "organizers" of this society could rely on the anonymous market to (1) reach equilibrium, [and] (2) achieve Pareto-optimality …. Summary: For ideal private goods, people are motivated to "reveal" their tastes.

People are in fact motivated to reveal their willingness to pay for *any* priced goods whether or not they are "ideal private goods" in Samuelson's sense of exhibiting constant or rising marginal costs. It is essential for avoiding wasteful projects to have markets test willingness to pay, even if informational or institutional factors block achievement of what would be the unconstrained Pareto optimum.

Despite his paying more explicit attention to the knowledge problem than Buchanan had, Samuelson (1967, p. 203) was skeptical about the

[3]Questionnaires won't reveal demand curves for a public good if one's tax bill depends on one's answers. Samuelson (1958, p. 336) noted the "game- theory reasons that compel rational men to hide their desires for public goods."

epistemic benefit of charging a price to marginal consumers of a non-rival ("public" in Samuelson's usage) good such as broadcast television. Much as he had in 1958, he emphasized the consumer surplus lost by charging any price for access above the zero cost associated with an additional household tuning in an existing broadcast signal. The informational benefit from pricing an excludable but non-rival good was less clear to him:

> Let us now examine some of the costs of getting information through use of excluder devices and use prices. In the case of truly private goods, there are no such costs[4]; since, in the case of public goods, there do exist such costs, one cannot apply the analogy of private good pricing to deduce cogently the advisability of use prices for public goods. Here it may become a case of digging up the plants to see whether their roots are healthy, a destructive test. … [E]xcluding consumption by use of any price in excess of true social marginal cost involves deadweight loss. Whether such inefficiency involves benefits in knowledge so great that pricing brings more net benefits than can be obtained from feasible alternative methods is a question quite incapable of being answered on a priori or general grounds. Depending upon institutions and cases, I can recognize no presumption one way or another. Therefore, I cannot agree with Buchanan that "Minasian's point is well taken when he suggests that [the] ordinary profitability criterion, whether applied by a private or a public monopolist would be a more instructive guide than opinions of a governmental authority."

Samuelson here recognized no presumption in favor of private provision in part because he imagined that there exist (unspecified) "feasible alternative methods" for obtaining willingness to pay information, a fact not in evidence. He furthermore did not consider the problem of tax-funded provision of services that provide total benefits (measured by willingness to pay, as known to God) smaller than their total production costs, yet persist due to the interests of bureaucrat-providers and the lack of a profitability test.

[4]Exclusion costs are zero for truly private goods? This would seem to suggest that shops can costlessly prevent shoplifting, and theme parks need no costly fences.

Brennan and Buchanan's Constitutional Political Economy

In *The Power to Tax*, Brennan and Buchanan (1980, p. 59) introduced a "revenue-maximizing model of government" and used it to illuminate the benefits (p. 46) of "possible tax-base and tax-rate constraints that will serve to keep fiscal excesses within tolerable limits." Fiscal excesses are theoretically defined as tax-financed expenditures with marginal benefits less than marginal burdens, i.e. public expenditures beyond the levels that taxpayers would consider worthwhile given the private consumption that they must sacrifice. The authors (p. 46) recognized that the potential for fiscal excesses arises in part from the government's inescapable ignorance about what taxpayers would be willing to pay for unpriced government services: "Taxes are coercive instruments that allow governments to levy charges on persons without any corresponding expression of current willingness to pay." In this statement the authors suggested, although they did not go on to emphasize, that the knowledge problem provides a reason for limiting the scope and height of taxes.

In contractarian fashion, Brennan and Buchanan (p. 46) imagined a constitutional setting in which participants consent to some tax system in order to get the valued programs they expect it to finance: "As Knut Wicksell noted, no persons would approve the imposition of taxes, either at a constitutional or a postconstitutional stage of decision, unless they anticipate securing some benefits from the goods and services that they expect government to finance with the tax revenues collected." In the constitutional setting, then, citizens who consent to be taxed in certain ways or to a certain extent do express a certain overall willingness to pay. But these citizens face (p. 59) a "danger of allowing government access to revenue-raising instruments that generate budgets in excess of those necessary for financing some roughly efficient levels of public goods and services." The citizens' prudent strategy at the constitutional level is then to insist that (p. 153) "tax instruments are chosen that will generate an approximately efficient level of public-goods supply when exploited to their maximum revenue potential."

In speaking of "an approximately efficient level of public-goods supply" as though the attainment of such a level could be empirically confirmed or disconfirmed, Brennan and Buchanan understated the danger of fiscal excesses by neglecting the demand-revelation problem. Citizens' consent to an overall tax structure would not itself reveal *what* government services the citizens consider worth financing, unless the constitution strictly limits tax-financed spending to a explicitly enumerated list (rather than an elastically characterized type) of programs. Nor does it reveal *how much* they value any particular program, unless the constitution strictly specifies spending ranges for each of the enumerated programs. The demand-revelation problem will make it epistemically impossible to identify "an approximately efficient level of public-goods supply" in the post-constitutional setting and thus make it impossible to limit expenditures to programs providing benefits greater than costs. Decision-makers at the constitutional stage should thus be doubly wary of leaving spending decisions to the future decisions of legislators or bureaucrats.

Brennan and Buchanan imagined citizens in the constitutional setting taking into account their own demands for public goods when choosing the tax system. But doing so does not suffice to reveal their demands. Instructing the post-constitutional government to "provide Pareto-relevant public goods" would provide no enforceable constraint on the direction of future spending programs. *Any* program favored by post-constitutional political interests (rent-seekers) can be couched as the provision of a worthwhile public good, and the absence of demand revelation means that there is no way to demonstrate (to a Supreme Court, say) that it does not meet the test. There is no test. The demand-revelation problem makes it inherently impossible to identify whether a claimed public good is a Pareto-relevant public good.

If this epistemic point is accepted, then little merit can be seen Brennan and Buchanan's proposal (p. 191) of a "requirement that the spending activities of government be restricted to the provision of genuinely 'public goods' of the pure Samuelsonian type." Constitutional language restricting government spending to "genuinely 'public goods'" is pointless when *any* program can be rationalized as providing a public good, and when genuine or Pareto-relevant public goods cannot be distinguished in practice from spurious or Pareto-irrelevant public goods. What Brennan and Buchanan aimed at in this proposal was a generality norm or non-favoritism rule, in order to block "the possibility of a majority redistributing resources in its own favor." An explicit generality norm might do this job, but "limit expenditures to public goods" is not a generality norm and won't do it. Nothing in the concept of a public good requires that its benefits be equal for all citizens.

Even explicitly redistributive income-transfer programs (clearly failing a generality test, at least at the post-constitutional level) can be and have been advocated as providing genuine public goods. Lester Thurow (1971), like Hochman and Rodgers (1969), proposed that individuals in a society may be willing to pay for a change in the society's distribution of income either for its indirect benefits (lower crime, less social unrest) or because "individuals may simply want to live in societies with particular distributions of income."[5] Thurow had in mind more egalitarian distributions, but a distribution that favors farmers (for example) is not excluded by the form of the argument. Thurow argued that individuals cannot bring out the desired change in the distribution of income except by collective action. Especially when the posited benefit to the public is the psychic benefit of *observing* a preferred distribution, the benefit is non-rival and non-excludable, and a free-rider problem prevails. Lacking a demand-revelation mechanism as we do, a proposition like Thurow's cannot be falsified.

Buchanan (1968a, p. 433) objected (in advance) to the idea that the public has a hidden willingness to pay for redistributive programs, declaring: "The evidence seems to indicate that general redistribution of purchasing power, or even general change in relative levels of well-being, is not widely desired. … The mere fact that some members of the community are poor does not, in and of itself, normally impose an external diseconomy on many of the remaining members. … Ordinary citizens are probably quite unwilling to finance substantial transfers of general purchasing power to the poor in their communities." But these

[5]For criticism of the argument see Lawrence H. White (2017, pp. 353–355).

judgments (the "evidence" remaining unspecified) cannot be tested against the contrary Hochman-Rodgers-Thurow judgment that people *are* willing to pay enough for a program to redistribute income to make it a Pareto-relevant public good. Measures of genuine willingness to pay for a substantial redistribution of wealth, as for other proposed public goods, are humanly unobtainable. If constitution-writers want to rule out redistributive policies, they will have to do it directly, not by adopting a "requirement that the spending activities of government be restricted to the provision of genuinely 'public goods' of the pure Samuelsonian type."

Conclusion

In his work on public goods we can see the uneasy interplay between James M. Buchanan the formalist scientific economist and James M. Buchanan the subjectivist political economist. Buchanan accepted the Samuelsonian theory of public goods and externalities, yet he also wanted to contest the naïve policy application of those constructions. He sometimes regarded public goods as a class of really existing phenomena, while warning against treating any concrete real-world cases as examples.

What I have argued here is not that formal public goods theory is incoherent on its own terms, or that Pareto-relevant public goods are inconceivable. It is rather that we should not forget, in moving our attention from blackboard constructions to the phenomena of the world outside the classroom, that the benefits of any proposed public good are no more than hypothetical. They are, by the premises of the theory, unobservable. Public goods theory thus does not provide an objective standard to guide public policy-making. It is epistemically impracticable. Although Buchanan set this aside in some writings, he clearly recognized it in others.

References

Brennan, G., & Buchanan, J. M. (1980). *The Power to Tax: Analytical Foundations of a Fiscal Constitution*. Vol. 9 of *Collected Works of James Buchanan*. Indianapolis, IN: Liberty Fund, 2000.

Buchanan, J. M. (1962). Politics, Policy, and the Pigovian Margins. *Economica, 29* (February), 17–28. Reprinted in Buchanan, *The Logical Foundations of Constitutional Liberty*. Vol. 1 of *Collected Works of James Buchanan*. Indianapolis, IN: Liberty Fund, 1999.

Buchanan, J. M. (1967a, October). Public Goods in Theory and Practice: A Note on the Minasian-Samuelson Discussion, *Journal of Law and Economics, 10*, 193–197. Reprinted in Buchanan (2001).

Buchanan, J. M. (1967b). *Public Finance in Democratic Process: Fiscal Institutions and Individual Choice*. Vol. 4 of *Collected Works of James Buchanan*. Indianapolis, IN: Liberty Fund, 1999.

Buchanan, J. M. (1968a). What Kind of Redistribution Do We Want? *Economica, 35*, 185–190.

Buchanan, J. M. (1968b). *The Demand and Supply of Public Goods*. Vol. 5 of *Collected Works of James Buchanan*. Indianapolis, IN: Liberty Fund, 1999.

Buchanan, J. M. (2001). *Externalities and Public Expenditure Theory*. Vol. 15 of *Collected Works of James Buchanan*. Indianapolis, IN: Liberty Fund.

Buchanan, J. M., & Stubblebine, W. C. (1962). Externality. *Economica, N.S., 29*, 371–384. Reprinted in Buchanan (2001).

Hochman, H. M., & Rodgers, J. D. (1969). Pareto Optimal Redistribution. *American Economic Review, 59,* 542–557.

Minasian, J. R. (1964). Television Pricing and the Theory of Public Goods. *Journal of Law and Economics, 7,* 71–80.

Minasian, J. R. (1967). Public Goods in Theory and Practice Revisited. *Journal of Law and Economics, 10,* 205–207.

Samuelson, P. A. (1958). Aspects of Public Expenditure Theories. *Review of Economics and Statistics, 40,* 332–338.

Samuelson, P. A. (1964). Public Goods and Subscription TV: Correction of the Record. *Journal of Law and Economics, 7,* 81–83.

Samuelson, P. A. (1967). Pitfalls in the Analysis of Public Goods. *Journal of Law and Economics, 10*, 199–204.

Thurow, L. C. (1971). The Income Distribution as a Pure Public Good. *Quarterly Journal of Economics, 85,* 327–336.

White, L. H. (2017). What Economics Can and Cannot Say About Egalitarian Redistribution. *Social Philosophy and Policy, 34,* 56–78.

8

Fiscal Constitutions, Institutional Congruence, and the Organization of Governments

Charles B. Blankart and David C. Ehmke

Introduction

Is the government servant or master of its citizens? The premise of democracy is that the citizens choose, and that the government executes their choice as a loyal servant.

This contribution is the product of a fruitful collaboration of both authors. It is based on the PhD thesis in economics of Dr. David Ehmke supervised by Prof. Dr. Charles Blankart. The analysis of institutional congruence and the country- and EMU-analysis presented in this contribution will focus on the most distinct features of fiscal organization. For a comprehensive analysis with further bibliographic references see David Ehmke, *Institutional Congruence: The Riddle of Leviathan and Hydra (Nomos* 2019*)*, especially Chapters III, IV, and V. See also Charles Blankart (2017), Chapters 26, 27, 28, 29, and 30, and Charles Blankart and David Ehmke (2015). We are very grateful to Prof. Dr. Richard Wagner for helpful comments on an earlier draft.

C. B. Blankart (✉)
Humboldt-University of Berlin, Berlin, Germany
e-mail: charles@blankart.net

D. C. Ehmke
Berlin, Germany

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_8

The economists Geoffrey Brennan and James Buchanan (1980), however, claim that the majority principle in representative democracies is not strong enough to enforce the democratic rule. The government would soon turn into the beast Leviathan, which excessively collects revenues and maximizes expenditures to build an empire at the costs of its citizens.

In order to tame Leviathan, constitutional principles should be established, and as far as the fiscal organization of various (sub-national) governments in relation to each other is concerned, federalism and decentralisation of the power to tax and to decide about expenditures is the solution to free the taxpayers from unreasonable demands, according to Brennan and Buchanan. Five years later, in 1985, Wallace Oates called Buchanan and Brennan's Leviathan a mystical beast. Other scholars would follow up. Some confirmed the Leviathan-hypothesis while others rejected the very same (see section "Leviathan: A Mythical Beast?").

The main proposition of our contribution to this book is that governments have to be organized institutionally congruent. The circles of decision-makers, tax payers, and beneficiaries have to overlap to the highest possible degree in each constituency so that each constituency spends only its own money. For this purpose, burden-shifting via bailout transfers must be credibly excluded so that Leviathan finds no way to sneak in through the back door and to exploit the taxpayers in form of (delayed) taxation; a burden which the distressed local government could try to shift to other sub-national governments or to the central government. We argue that while a consequently decentralized fiscal architecture is likely to achieve the best financial performance, a consequently centralized fiscal architecture works still better than an incompletely and institutionally incongruent federation.

This contribution is organized as follows. In section "Free Choice and Public Goods", we investigate the dilemma of free choice when public goods are subject to exploitation. In section "Calculus of Consent", we present Buchanan and Brennan's concept of choice and rule-making on a constitutional level, applied to the fiscal and federal organization of government in section "Buchanan and Brennan: Leviathan". In section "Leviathan: A Mythical Beast?", we discuss the empirical challenges to the Leviathan-hypothesis, before we present the theory of institutional congruence as the missing piece in the puzzle of fiscal organization in section "The Concept of Institutional Congruence: Three Models". As part of the analysis in this section, we explain the institutionally congruent integration model, the institutionally congruent autonomy model, and the institutionally incongruent mixed model. The integration, the autonomy, and the mixed models will be further illustrated and developed in practical application in sections "The United States of America: The Autonomy Model of Fiscal Organization", "France: The Integration Model of Fiscal Organization", "Germany: The Mixed Model of Fiscal Organization", and "The European Monetary Union: A Many-Headed Beast".

Free Choice and Public Goods

Individuals choose because choice promotes their personal interests. According to Adam Smith, individuals do not need a master who tells them what they have to do so that they will find happiness. Everyone shall be his or her own master. Choice is also the tenet of James Buchanan. Free choice is the way how traders can mutually improve their wellbeing. Choice can be organized between two as well as between many participants. Among many participants, choice becomes the principle of demand and supply. The formal proof of the advantage of demand and supply in the subjective valuation of goods was provided a hundred years after Adam Smith, around 1870, by the economists Carl Menger, William St. Jevons and Leon Walras. The authors have shown that free choice can generate an efficient resource allocation in a competitive market economy in which individuals adjust themselves to supply and demand. No one can be made better off without someone else being made worse off. The outcome is Pareto-optimal. All resources are used up. There is no need for state intervention.

The theorem of Pareto optimality holds, however, only in an economy of private goods. Paul Samuelson has shown that the theorem fails in the allocation of public goods which are non-excludable. Without exclusion, individuals can benefit of a good even if they do not pay the price for the good to be provided. Therefore, they have an incentive to disguise their preferences and to give false signals. Free choice is not anymore Pareto-optimal. A person's wellbeing is disconnected from the market process of demand and supply. Samuelson concludes: "it is in the selfish interest of each person to give false signals to pretend to have less interest in collective consumption activity than he really has" (Samuelson 1954, p. 388). Individuals hesitate to reveal their true preferences. Therefore, the market process stops before the Pareto optimal output is achieved.

Conceptually, however, the Pareto optimum still exists and can be calculated under the counterfactual assumption that the individuals reveal their preferences honestly. Since, however, the revelation of preference is no more in the individual's interest, individuals will fail to say the truth and, thus, to reach Pareto optimality. The theorem of individual choice is in danger. Individuals have lost their capacity to find mutual advantages by choice. They do not know what to do. They are eventually instructed to adjust their choice according to the will of a benevolent government who chooses in lieu of the individuals. This, in fact, is the end of free choice. Individuals are nothing but chessmen in the game of government decision-making.

Calculus of Consent

It was Buchanan's endeavor to liberate the economics of public goods from the chains of the benevolent government and to re-establish free choice as a fundamental principle of free men. Buchanan asked the question: Is it possible to organize a society according to the principle of free choice in the presence of public goods? Buchanan's answer was yes: he referred to the Swedish economist Knut Wicksell who wrote in 1896 that taxes can be organized in a way to reflect the individuals' preferences. Individuals with high interests pay more and individuals with less interests pay less. The key to understand taxation according to interest is the unanimity principle.

Assume the Swedish government proposes to raise a tax to acquire a new vessel for the Swedish navy. Poor individuals with small property obtain only a small benefit from the vessel and therefore are only willing to pay little. Wealthy individuals pay more according to their expected interest because they wish to protect their wealth. Eventually, all people pay according to their interest—the poor people pay less than the rich people. Should unanimity not be reached, the vessel will not be acquired, which is neither in the interests of the rich nor the poor. Therefore both, the rich and the poor have an incentive to tell the truth.

Knut Wicksell criticized the Swedish law of his time for imposing regressive taxes. To avoid such inequality, Wicksell said that the public good shall only be provided if and insofar as unanimity can be arranged. Under unanimity, the free rider problem disappears. A simple extension of the franchise to the poor would not be enough. It would only reverse the distribution of power compared to the status quo. The majority of the poor would now be able to exploit the rich who would become a minority without effective voting power under majority rule. Wicksell explained: "It is not the purpose of this movement and indeed it would be contradictory to its guiding spirit, to have wholly or partially shaken off the yoke of reactionary and obscurantist oligarchies only to replace it by the scarcely less oppressive tyranny of accidental parliamentary majorities" (1896/1958, p. 88).

Buchanan is a realist. He does not believe that it is possible to achieve Wicksellian unanimity on every issue in everyday politics. But he believes that it is possible to design a decision-making procedure on the constitutional level which shall allow individuals to make efficient decisions. Such a procedure shall tilt the right balance between external costs of the decisions taken and the decision-making costs of the procedure itself.

The easier it is to outvote a minority, i.e., the lower the threshold is, the higher is the risk that a majority outvotes the dissenting minority and imposes costs on them (external costs). A high threshold or unanimity, on the other hand, causes high costs for collective decision-making which may outweigh the reduction of external costs. On the constitutional level, individuals evaluate external costs against decision-making costs. The community makes an unanimous decision on the optimal decision-making rule which promises the lowest possible costs as a sum of external costs and decision-making costs (Buchanan and Tullock 1962) (Fig. 8.1).

Buchanan and Brennan: Leviathan

Buchanan developed the constitutional decision-making rule in cooperation with Gordon Tullock (1962). But throughout time Buchanan became increasingly skeptical about the stability and enforceability of the constitutional contract. He doubted that the constitutional contract will hold and that it will be enforced in the post-constitutional world.

Brennan and Buchanan (1980) predict in their last great work that the constitutional contract will be eroded and will fall prey to the Leviathan under a representative government. In Fig. 8.2, the government announces a tax ABFG on the private good X in order to finance the costs of a public good. But instead of raising ABFG, the Leviathan collects the maximum revenue potential ACDH. Brennan and Buchanan conclude that the constitutional rule must be as rigid as possible. For only the constitution can resist the Leviathan to increase taxes further and further.

The immediate way to limit the number of taxes is the constitution. For once a good has been declared taxable, the government will be tempted to increase taxes further and further. The most spectacular

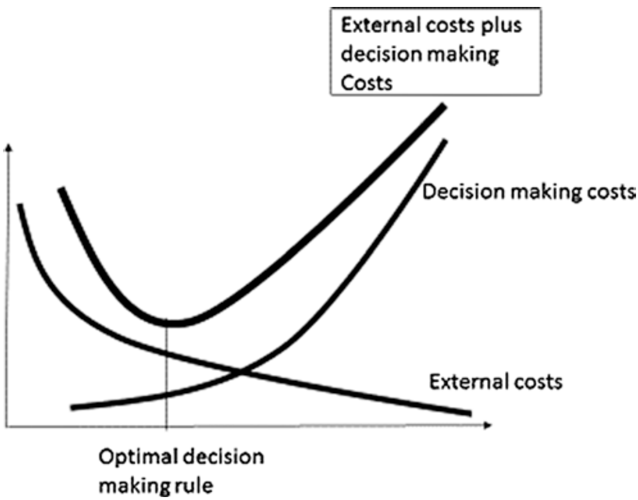


Fig. 8.1 External and decision making costs

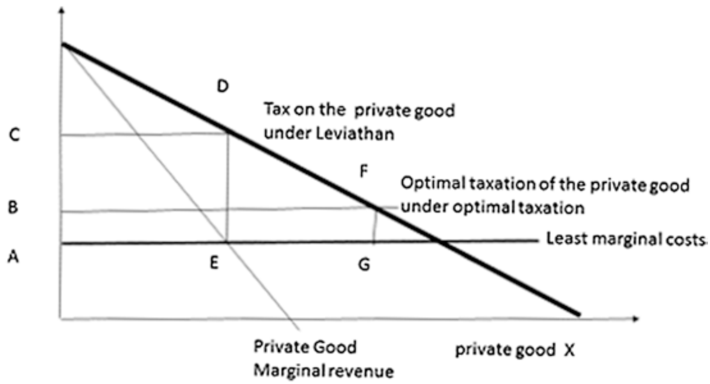


Fig. 8.2 Leviathan

example of Leviathan's hunger is the tax on cigarettes which has been increased by 250% in Germany between 1906 and 2017. Conversely, goods which are exempt from taxation by the constitution cannot be exploited by Leviathan.

Often, the fiscal constitution is not strong enough to withhold Leviathan. What are the remaining options? A substitute to an outright prohibition of taxation in the constitution is tax competition among regional governments, as Buchanan and Brennan demonstrate in Chapter 9 of *The Power to Tax*: If a government is fractioned in small jurisdictions, individuals may migrate and choose their preferred government. If the individuals are mobile, Leviathan will have no hold on them. They cannot be taxed. Only immobile individuals are exposed to the excessive demands of Leviathan. A car driver who drives around Italy remains tax free as long as he has gasoline in his tank. As soon as he runs out of gas, he becomes immobile and a victim of Leviathan. A similar example is housing. An individual living in jurisdiction A becomes a victim of the local Leviathan as long as he remains immobile. But if he chooses a house in jurisdiction B, he escapes taxation from the Leviathan in jurisdiction A. Tax maximization of A's government would not harm the individual, as long as he is mobile and as long as he can migrate to jurisdiction B, C, and so on. This phenomenon has been studied under the title of Yardstick Competition. The local taxpayers can estimate the price of the public good to be paid in taxes and compare the performance of their government with that of neighboring governments. They can, eventually, migrate to a different fiscal unit (see, e.g., Maarten and Allers 2005).

It is important to see that the power to tax does not primarily depend on the ability to pay, but on the tangibility and immobility of the subjects to taxation. Brennan and Buchanan conclude that the monopoly power inherent in the economy must be considered too. Under a decentralized government, individuals can escape taxation by migration. A tax maximizing government is confronted with a more price elastic demand under fiscal federalism. Therefore, taxation cannot be that exploitative in a decentralized state as in a unitary state in which individuals cannot escape its imposition. The loss of utility due to taxation is smaller in a decentralized state where individuals can escape taxation than it is in a in a centralized state where individuals cannot escape taxation by a revenue maximizing government. Leviathan is less powerful in a decentralized state than in a centralized state. Total intrusion of the central government into the economy should be larger the more concentrated (and hence) monopolistic the fiscal organization of government is, and should be smaller, the more decentralized and (hence competitive) it is. Insofar as the tax and spending authority is decentralized, tax competition may limit the overall burden of taxation.

Leviathan: A Mythical Beast?

In 1985, Wallace Oates published a much-noticed study in which he called Buchanan and Brennan's Leviathan nothing but a "mythical beast". He could not find a relation between the size of government in form of public spending and taxation and the degree of centralisation and decentralisation. Different empirical studies in the following years would show mixed results: While some authors found the Leviathan hypothesis confirmed (e.g. Marlow 1988), others rejected Leviathan as a fabulous creature the same as Oates did (e.g. Stein 1999).

Jonathan Rodden, eventually, presented a solution to the puzzle. Brennan and Buchanan had focused on the centralisation and decentralisation of taxation and expenditures in theory, and consequently, those who would find proof or disproof of the Leviathan-hypothesis had focused on the centralisation and decentralisation of taxation and expenditures empirically. While it is quite intuitive that accountability, comparability, and control and, as a consequence thereof, financial performance would increase with decentralisation, Rodden pointed out that Leviathan could trick the taxpayers if the back door of inter-governmental transfers and bailouts remains open. Rodden (2002) showed that decentralisation would actually cause higher spending in countries where the budget was largely funded by shared taxes and inter-governmental transfers while he found the Leviathan hypothesis confirmed where each decentralized unit had to fund its expenditures from 'own taxes' without a realistic chance of burden-shifting. Notably, Rodden—different from Oates—qualified shared taxes, i.e., taxes which cannot be individually adjusted, as transfers. In his widely-recognized criticism of the Leviathan-hypothesis, Oates (1985) took the share of taxes received by the sub-national governments as an indicator of decentralisation, which is misleading; as especially the case of Germany illustrates. Rodden, moreover, found that the combination of borrowing and tax autonomy or, conversely, of a centralized tax authority with strict borrowing constraints for sub-national governments would be crucial to keep spending and taxation at bay, while expenditures would be excessive in case that sub-national units could spend and borrow as they like without a possibility and responsibility to fund their expenditures from own taxes (Rodden 2003).

The findings of Rodden might be best understood as a clarification or extension of the Leviathan model as it was presented by Brennan and Buchanan. The underlying assumption of Brennan and Buchanan's model is that if the size of government shall not grow without limitation, the taxpayers must have information about the government's financial performance and they must have a chance to choose, to exit, and to migrate to the local unit which promises them a reasonable taxation for the public good offered. Decentralization would increase that chance of information and control with each sub-national unit having the possibility and responsibility to master its own fate. Precisely in order to strengthen that link between power and responsibility, not only the power to spend and tax has to be decentralized but also the responsibility to fund one's own expenditures and repay one's own debts. If the government can shift the burden of current expenditures by way of inter-governmental transfers or bailouts, Leviathan will prevail. If decentralisation is incomplete, the accountability, comparability, and even the taxpayers/voters' interest in a sustainable budget will fade in the dust of a common pool budget. To put it differently, decentralisation may only yield a surplus to centralisation if those who order and enjoy the lunch eventually pay the bill.

The Concept of Institutional Congruence: Three Models

The unity of power over and the responsibility for expenditures, taxation, and debt translates into the idea of institutional congruence. Institutional congruence is achieved once the circles of decision-makers, beneficiaries, and payers perfectly overlap. Any approximation to the ideal standard of institutional congruence, thus, should be a step towards a better financial performance. In this section, we will present three distinct models of fiscal organization in the taxonomy of institutional congruence. In the subsequent section, the theory of institutional congruence will be applied to the USA, France, Germany, and the European Union so as to showcase the functioning of the autonomy, integration, and mixed model.

Autonomy model: The autonomy model represents the ideal model of fiscal organization according to the Leviathan hypothesis. In the autonomy model, fiscal organization is consequently decentralized. Local units of an otherwise politically connected federation perform important duties on their own responsibility. Centralisation has to be justified, not decentralisation, i.e., the principle of subsidiarity applies. The local governments decide about their own expenditures. Similarly, they have the power to raise taxes in order to fund their expenditures. They may decide to raise debt instead of taxes. Nonetheless, they remain solely responsible for their own debts, i.e., debts have to be repaid with future taxes. In case of financial distress, the local governments may not expect any help from other governments. They will have to consolidate, to raise taxes, to cut spending, or to approach their creditors and negotiate about a debt restructuring. Since their creditors cannot expect that a distressed debtor will be bailed out, they have to monitor each individual debtor and price them by their distinct risk level. The incremental risk rate development mirrors the government's financial performance. Market discipline is the rule.

Integration model: The integration model is quite the opposite of what Brennan and Buchanan envisaged as the ideal fiscal organization for government. In the integration model, the central government decides top-down about expenditures, taxation, and debt. The local governments can decide about expenditures, taxation, and debt only within the limits which are at the discretion of the superior central government. One may compare the integration model to the idea of a multinational firm. The managers of local branches may act more or less independently, but the ultimate responsibility is with the board of directors or the bank which has provided the loans. The board of directors holds the reins in its hands, which they may tighten or loosen as it deems fit. Market control is replaced by top-down central government control. Certainly, the integration model does not offer the same degree of accountability, comparability, and control as the autonomy model. However, the integration model of a consequently centralized fiscal organization provides a way more effective design for the purpose of financial performance than an incompletely decentralized mixed model.

Mixed model: Many federations around the world have been falsely identified as 'decentralized' while they are actually stuck in between the stools. They are hybrids in their fiscal constitution. Essentially, the power and responsibility to decide about expenditures, taxation, and debt has been disconnected. Often, each public entity can decide about their own expenditures (and sometimes even about their taxes), but the final responsibility to pay for their expenditures is shared in regular transfers or bailouts. In the mixed model, the markets perceive a federation of debtors as one. The risk rate is calculated in a pooling equilibrium. Burden-shifting becomes the rule. While in the autonomy model, the taxpayers have high quality information to hold their local government accountable and realize their preferences by voice and exit, and while in the integration model, the taxpayers have the same interest with inferior information and less power to make themselves heard, the taxpayers in the mixed model do not even have an interest to keep Leviathan in check. They should have a rational interest to urge their local government to spend more on the local public good while they bet on burden-shifting in (equalisation) transfers and—most importantly—bailouts from other members of the federation.

The United States of America: The Autonomy Model of Fiscal Organization

The fiscal organization of the United States of America provides the perfect example for the autonomy model. Each of the three distinct levels of government, i.e., federal government, state/territorial government, and municipal government, has its own/original rights and responsibilities to decide about spending, taxation, and debt.

In the relation of federal and state governments, the principle of subsidiarity applies. The federal government has only those rights and responsibilities explicitly delegated to the federal government by the US constitution. All remaining duties of legislation and administration are to be fulfilled by the states if not delegated to the municipalities. The federal government may levy taxes only as far as it is empowered by the constitution. The states levy their own taxes so as to fund their expenses. They are not dependent on federal shared or delegated tax transfers. Similarly, the relation between the state and the municipal governments is regularly fashioned according to the principle of subsidiarity. The municipalities may impose their own taxes and fees so as to fund their expenditures. A particularity of the US system is that so-called special purpose districts co-exist at the municipal level. Such special purpose-districts are entrusted with a specific task, e.g., school districts, as well as they are empowered to raise taxes/fees so as to acquire funds for the performance of their respective task.

While the federal government (generally) raises taxes uniform across the country, the states and municipalities set their tax rates to reflect their public service offer. The taxpayers may decide where to live and where to pay taxes depending on the combination of the public good provided and the 'tax price' to be paid. In line with Buchanan and Brennan's Leviathan hypothesis, the differentiation and competition in taxes allows the taxpayers to make an informed and independent decision. Leviathan is held accountable.

Key to the functioning of the US autonomy model in fiscal organization, however, is the strict and credible application of the no-bailout principle. Since 1840, when the US Congress rejected the request for a bailout of several financially distressed states, there has not been any major bailout of a US state or municipality. Over time, the enforcement of the no-bailout principle itself has become a valuable 'credence capital good'. Creditors and debtors know that they cannot expect a bailout. Therefore, they have to price each official debtor by its distinct risk. Conversely, the individual debtors have an incentive to improve on their fiscal performance so as to benefit from lower debt capital costs. The risk rate, eventually, signals the fiscal performance as perceived by the markets to the debtor's taxpayers and voters. Holding the creditors responsible to their investment decision translates into a disciplinary effect for the debtor.

The credibility of the no-bailout principle is strengthened by the availability of a crisis resolution mechanism in distress. If a municipality—a general- or a special-purpose district—has acquired an unsustainable debt burden, it may enter an orderly restructuring procedure under Chapter 9. Under Chapter 9, most importantly, the creditors vote on a restructuring plan which will become binding if creditors holding two-thirds of the outstanding debt claims per creditor class vote in favour of the plan. A court may cram-down dissenting classes if the court finds the plan to be 'fair and equitable'.

The strong commitment of the USA to the principle of institutional congruence and the no-bailout principle was just recently confirmed with the enactment of PROMESA as a response to the Puerto Rico debt crisis. Since Puerto Rico had reached unsustainable debt levels and defaulted on its creditors' debt claims, the US Congress tailored a restructuring regime for the US territory modelled after the municipal insolvency procedure of Chapter 9. In spring 2017, Puerto Rico officially filled for insolvency after a consensual arrangement with its creditors had failed out-of-court.

While there are certainly some (more or less harmful) deviations from the pure autonomy model and perfect institutional congruence in the US, in particular the increasing importance of intergovernmental grants or the absence of an insolvency law for troubled states, the USA remains the most prominent example for the autonomy model today.

France: The Integration Model of Fiscal Organization

Traditionally, France has been the example par excellence of the integration model. Decentralization reforms starting in the 1980s have done little to weaken the institutional congruence of the French fiscal organization. The meta-rule remains: Paris holds the reins in its hands. At times, Paris may loosen its grip and give the sub-national governments of regions (second level), départements (third level), and municipalities (fourth level) more or less leeway in making fiscal decisions. The principle, however, is clear: The central government has the final responsibility.

The fiscal integration finds its expression in the concentration of legislative authority on the national level. Laws are being made in Paris and the sub-national governments may only make administrative decisions within the legal framework set in Paris. This way, the central government already influences the spending decisions of the sub-national governments. The spending budget for sub-national governments, importantly, is defined by the revenue, on which the sub-national governments have relatively little influence. The sub-national budgets are funded from delegated and shared taxes and transfers. Especially, the sub-national governments have no constitutional or original right to specific taxes. Only if and insofar as the legislator in Paris is willing to loosen the strings, the sub-national governments may levy and adjust taxes to balance their expenditures.

The door to burden-shifting and excessive spending on the sub-national level by debt financing is closed. The sub-national governments may only acquire debt for capital investments, the same as they are required to present a balanced budget. If they decide to borrow for the purpose of capital investments, the debt capital costs are to be accounted for in the annual budget, i.e., the debt repayment tightens the budget for regular expenses. Deficit financing is no option. The local government may only raise taxes and fees or cut spending. The option to adjust the tax income stream is limited by the tax authority as it is delegated from Paris.

In order to enforce fiscal discipline, the French fiscal architecture is equipped with a quite strict supervisory and control system: For each transaction of a sub-national entity, a personally liable public accountant has to check as to whether the transaction is authorized by the approved budget. If not, the public accountant rejects the payment. While the public accountant may be overruled by the local government representative (e.g. the mayor), the local government representative assumes personal liability for this case. The annual budget itself has to be reviewed and approved by the prefect, a central government representative. If the prefect finds that the budget does not confirm with the central budget rules, importantly, the balanced budget rule, the case is referred to the Regional Chamber of Accounts and the budget may be revised.

The French fiscal architecture is designed to strike a balance between control and flexibility. The central government is aware that it has to bear the final responsibility for the fiscal health of its sub-national regions, départements, and municipalities. The sub-national governments are not equipped with sufficient tax authority to master their own fate independently. They receive funds primarily from delegated/shared taxes and transfers. With the decentralization reforms of the 1980s, however, it was decided that Paris should loosen its reins and give the sub-national governments some leeway to make spending decisions according to local preferences. This could have easily gone out of hand if not Paris had—at the same time—established strict and enforceable rules to contain indebtedness.

Germany: The Mixed Model of Fiscal Organization

Although often referred to as a federal state, Germany is more like a cross-bread stuck in-between decentralisation and centralisation with a tendency towards integration. 16 German Länder can decide independently about their expenditures while they have very little flexibility to adjust their tax rates to fund their own expenditures. All major taxes are decided upon in Berlin. While the Bundesrat, as the representation of the German Länder, participates in the decision making process, there is but one final decision about the uniform taxation across the country. No German Land may levy a higher or lower personal income, business income, or sales tax. Tax competition does not exist. Only rather insignificant taxes are available for the individual adjustment of the German Länder governments. The most important taxes by volume are shared between the central government and the Länder according to a fixed key.

The German sub-national governments are in a tricky situation. The tax income stream is mostly out of their control. They can neither lower their taxes to attract personal and business taxpayers for growth nor are they able to raise taxes for a better public good or to balance their current and past expenditures. If they spend more than they receive from shared taxes and transfers, they have to acquire debt. Deficits, as they may occur, have to be paid from debts. The problem gets worse when the central governments with vast legislative and executive powers makes decisions with lasting financial effect for the Länder without their participation. The recent refugee crisis provides a good example. While the decision to open the borders to more than a million refugees was taken by the Chancellor, the Länder and the municipalities had to carry much of the financial burden.

The German sub-national governments are almost inevitable pulled into a spiral of indebtedness. The temptation of debt financing is high because German sub-national governments have easy access to debt capital. Since it is explicitly ruled out that any sub-national government may be put into an insolvency procedure as well as the creditors hold an established and confirmed bailout expectation, the interest rates for German sub-national governments are determined in a pooling equilibrium, which favours especially those debtors with a weak financial performance. While it is subject of debate at what level of indebtedness a distressed debtor has to be bailed out, i.e., how much effort a debtor has to show itself before the central government steps in, the bailout is confirmed as an ultima ratio-solution to distress. A debt brake was instituted in order to keep the previously excessive indebtedness of many of the German sub-national governments at bay, but it is questionable as to whether it will hold against the strong temptation of debt financing. It is, at least, not fortified by a similar supervision and control system as the French fiscal organization.

A paradigm of German fiscal organization is the equalisation of the financial endowment and the realization of 'equal living conditions' across the federal union (Art. 72 II Basic Law). For this purpose, a complex equalisation scheme is established. In a first step, the sales tax is distributed according to a formula which favours the Länder governments which have collected relatively less taxes within their territory than other Länder governments. In a second step, the Länder with more income have to contribute to an equalisation pool from which the Länder with less income receive transfers. In a third step, the central government transfers funds to the Länder which are still at a (relatively small) financial disadvantage. While there would exist quite visible differences in the financial endowment of the Länder without the equalisation scheme, the equalisation scheme pulls all Länder very close to the mean average. With 2020, a new equalisation scheme will start. Most importantly, the second step of horizontal transfers will be cancelled while the first and third step of the present equalisation scheme will increase in volume. The Länder have sold some of their regulatory powers of tax enforcement to the federal government for which they were promised federal transfers to pay for their deficits. But this is singular action which will dry out in some years.

The German fiscal organization should be a warning example for the perils of incomplete decentralisation. While the sub-national governments are free to spend and borrow, they have little influence on their tax income. The temptation to serve oneself a free lunch from common pool financing is high. Similarly, the central government may be tempted to burden the sub-national governments with new tasks and responsibilities without appropriate compensation in order to window-dress the central government accounts. The German case shows how incomplete decentralisation, i.e., the decentralisation of spending and debt authority, but the centralisation of tax authority and debt responsibility, can create a beast hungry for spending and debt which is way more dangerous than Leviathan in a consequently centralized fiscal organization.

The European Monetary Union: A Many-Headed Beast

Even though not a country but a union of sovereign members, the European Monetary Union shows many of the characteristics of a mixed model. The sovereign members can decide independently about expenditures and taxation. Similarly, they have an independent debt authority. The Stability and Growth Pact has proven to be a toothless tiger. Most countries have violated the debt level ceiling and the deficit limits. However, if each and every sovereign member was responsible for its own debt, competition amongst the member states should tilt the right balance and the markets would discipline those countries with a weak financial performance. Market discipline should promote solid public finances.

The story went different as it is well known: With the onset of the sovereign debt crisis, the EMU member states established various transfer channels to bailout distressed EMU member states, amongst them the Greek Loan Facility, the European Financial Stability Facility, the European Financial Stability Mechanism, the European Stability Mechanism (as a permanent bailout fund), the Security Market Programme, and the Asset Purchase Programme (for the massive acquisition of sovereign bonds). Interestingly, the markets predicted the bailout quite accurately while politicians denied the possibility of such a bailout for many years when they emphasized the self-responsibility of each and every member as inscribed in the no-bailout provisions of the European Treaties (Art. 125 and 126 TFEU). While the spreads of EMU member state's bonds had differed very significantly for many years, the introduction of the euro as a common currency was accompanied by an almost miraculous alignment of interest rates with the blink of an eye. Greece and Germany paid the same risk premium. (Sinn 2016). The only rational explanation is that the markets had a firm expectation of a future bailout to come. And except for a partial bail-in of creditors of Greece in 2012, after many creditors have already been paid out in full and debt had been transferred from private to official creditors, the creditors were quite successful to shift their burden to the taxpayers of the financially sound EMU member states.

While the bailout transfers—arguably—benefitted mostly the creditors, the bailout expectation was nothing than a permanent equalisation scheme across the EMU. The weaker EMU members could acquire cheap debt capital without restrain. This way, they had little incentive to improve their financial performance by cutting expenses or by reforming their economy. The lesson to be learnt from the EMU debt crisis is that in the presence of a bailout expectation, each government of the bailout and transfer union will form the head of a many-headed beast with a ravenous hunger to grow. And different from the Leviathan-hypothesis of Buchanan and Brennan where the taxpayers and voters will have an incentive to compare and choose so as to restrain Leviathan, the citizens of the EMU member states are—rationally and without blame—accomplices of the government when it comes to the race for the largest share from the common pool in the mixed model of fiscal organization.

Conclusion

A multilevel government is viable as long as it is constructed according to the principle of institutional congruence. This requires that the central government imposes strict limits on sub-central spending and debt or that the sub-central governments are self-responsible for their revenue in debt and taxation. A bailout has to be credibly excluded for decentralisation to function.

In contrast, a mixed system in which the sub-central government can speculate a priori that some of their debts or all their debts can be shifted to other governments is non-viable. In such an environment, loans will be non-sustainable, and interest rates will be calculated in a pooling equilibrium, because lenders anticipate the bailout. Once the back door for common pool financing via excessive debts and bailouts opens, loans are likely to explode and taxpayers themselves have an opportunistic interest to support spending and debt acquisition in the hope to shift the burden to other local units and taxpayers. Leviathan can act without limitations. In order to reinforce Buchanan and Brennan's decentralisation hypothesis, decentralisation has to be organized institutionally congruent, so that each local units is being empowered to decide about and be responsible for their taxes, debts, and expenditures.

Bibliography

Blankart, C. (2017). *Öffentliche Finanzen in der Demokratie* (9th ed.). München: Vahlen.

Blankart, C., & Ehmke, D. (2015). Collective Decisions on Public Debts. *CESifo DICE Report, 14*(3), 43–51.

Brennan, G., & Buchanan, J. (1980). *The Power to Tax: Analytical Foundations of a Fiscal Constitution*. Cambridge: Cambridge University Press.

Buchanan, J., & Tullock, G. (1962). *The Calculus of Consent: Logical Foundations of Constitutional Democracy*. Indianapolis: Liberty Funds.

Ehmke, D. (2019). *Institutional Congruence: The Riddle of Leviathan and Hydra*. Baden-Baden: Nomos, forthcoming.

Maarten, S., & Allers, M. A. (2005, August). Tax Mimicking and Yardstick Competition Among Local Governments. *International Tax and Public Finance, 12*(4), 493–513.

Marlow, M. (1988). Fiscal Decentralization and Government Size. *Public Choice, 56*(3), 259–269.

Oates, W. (1985). Searching for Leviathan: An Empirical Study. *The American Economic Review, 75*(4), 748–757.

Rodden, J. (2002). The Dilemma of Fiscal Federalism: Grants and Fiscal Performance Around the World. *American Journal of Political Science, 46*(3), 670–687.

Rodden, J. (2003). Reviving Leviathan: Fiscal Federalism and the Growth of Government. *International Organization, 57,* 695–729.
Samuelson, P. (1954). The Pure Theory of Public Expenditures. *The Review of Economics and Statistics, 36*(4), 387–389.
Sinn, H. W. (2016). *Der schwarze Juni*. Freiburg: Herder.
Stein, E. (1999). Fiscal Decentralisation and Government Size in Latin America. *Journal of Applied Economics, 2*(2), 357–391.
Wicksell, K. (1896/1958), Finanztheoretische Untersuchungen, Jena: Gustav Fischer 1896 and English Trans.: A New Principle of Just Taxation. In R. Musgrave and A. T. Peacock (Eds.), *Classics in the Theory of Public Finance* (pp. 72–118). New York: St. Martin's Press.

9

The Irrelevance of Balanced Budget Amendments

David J. Hebert

You cannot make a fat man skinny by tightening his belt.

–John Maynard Keynes

Introduction

Balanced budget requirements are often heralded as a panacea for public debt. The goal of such a proposed amendment (or any other form of requirement that public budgets be balanced) is laudable: preventing rampant public deficits and stemming the tide of public debt. The fear is that without such a policy solution, a financial collapse can be the only outcome. Whether this is true remains to be seen and is an important question, of which Salsman (2017) provides an excellent exploration. This paper, however, asks a different question: are balanced budget requirements likely to succeed in their stated goal? Looking through

D. J. Hebert (✉)
Aquinas College, Grand Rapids, MI, USA
e-mail: david.hebert@aquinas.edu

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_9

individual states in the U.S., the answer would appear to be a resounding "no" as forty-nine of the fifty states have at least some form of balanced budget rule, either at the state-constitutional level or legislatively, yet all fifty states are currently running deficits.

This is surprising for several reasons. First, the political arena is populated by individual people who, for the most part, seem quite capable of balancing their own personal budgets, as we very rarely hear of politicians who have persistent financial difficulties (Wagner 2012). Thus, we can confidently say that even though living within a budget can be challenging at times, the overwhelming majority of the people involved in determining political budgets are able to do so in their own lives. Second, the problem with political budgets cannot be due to the fact that a group is making a collective choice, as other groups throughout society are able to do so.[1] Finally, the problem cannot be one of difficulty. The amount of debt, whether done by an individual or a group, is determined by subtracting expenditures from revenues. If keeping these two numbers roughly similar were merely difficult, we would expect errors to be made on both sides of "zero," with some years seeing revenues exceeding expenditures and others vice versa. That we persistently see error in the form of expenditures exceeding revenues points to the existence of some sort of systematic bias towards debt.

The general logic behind the support of a balanced budget requirement is that requiring revenues to equal expenditures will automatically cause this to be true without affecting revenues. But to presume this is to misapply notions that are relevant for private debt to public debt. Specifically, it conflates the process by which public debt is determined with that of private debt. While on the surface, both are determined by the difference between revenues and expenditures over a period of time, there are substantial structural differences which lie beneath the surface. These differences are conventionally ignored by traditional

[1]Wagner (2012) points to "clubs, churches, and other groups" which are able to balance their budgets despite their group-decision-making nature, at least over a sufficiently long period of time.

public finance theorists, who concern themselves with examining aggregate figures rather than the processes and institutions through which these aggregate statistics are determined. Instead, problems with balancing public budgets are imagined to be the result of a lack of e.g. political will and it is here where a written requirement that revenues equal expenditures gains its acceptance in the sense that willpower and formal requirements are viewed as substitutes. To put this another way, there is no need for a rule requiring something when there exists sufficient will to do it. Where there is a lack of willpower, formal rules are imagined to be a near-perfect substitute.

Of course, there are problems with this. Most obviously, a legislative body can always decide to grant exceptions for particular circumstances. For example, even during the golden age of "that old time fiscal religion" (Buchanan and Wagner 1977), where public debts were avoided as a matter of principle, wartime spending was understood to be an acceptable exception to the principle. In today's world, where governments are (rightly or wrongly) expected to provide financial assistance in times of disaster or hardship, unforeseen circumstances can give rise to situations where such exceptions could be granted.

Setting this aside, there are two related problems that a balanced budget requirement faces. The first is the process by which revenues and expenditures are determined in a political arena. The second is the substitutability of public spending and regulation. Taken together, these two problems provide a myriad of possible strategies for would-be politicians to accomplish the stated goal of equalizing public revenues and public expenditures while having little to no effect on actual revenues and expenditures from the perspective of the taxpayer.

This paper contributes to the growing body of literature that considers public finance to be an explanatory, rather than a hortatory, discipline. Rather than take the approach of providing advice and counsel, this paper seeks to generate understanding. In this respect, it is most similar to Hebert and Wagner (2013) and Hebert (forthcoming, a), which explain the source of tax code complexity in democratic societies and Hebert (forthcoming, b) which explains the trifurcation within the U.S. Federal budget process among committees related to authorization, appropriation, and revenue generation.

This paper will proceed as follows. Section "Private Debt vs. Public Debt" describes some of the differences between private debt and public debt and the incentives faced when making forecasts. Section "Budgetary Chicanery" describes different means of manipulating federal budget numbers that are commonly used. Section "Spending vs. Regulation" discusses the substitutability of expenditures and regulation and in doing so introduces the ability to move implicit expenditures off-budget. Section "Conclusion" concludes.

Private Debt vs. Public Debt

In all cases of debt, the surface-level calculation is identical: debt is determined by the difference between an entity's revenues and expenditures over a given period of time. This entity can be an individual person, a group of people, a business, or a government—it makes no difference, at least at this surface level of analysis. For example, if a household has annual revenues equal to $100,000 and annual expenditures equal to $75,000, we can surmise that this household has an extra $25,000 left at the end of the year. This money can be carried forward into the next year, which allows the household to spend more money in this second year. Alternatively, if the household has $100,000 in annual revenue and expenditures equal to $125,000 per year, this household must borrow $25,000 in order to finance their operations. The same type of analysis can be performed with respect to public budgets, albeit typically with much larger numbers.

This analysis, however, skips over two important realities. The first is the category mistake that is made when comparing private and public debt. The second, which derives from the first, is to examine how revenues and expenditures are determined in the public setting and how this differs from how they are determined in the private setting.

As Wagner (2017, p. 118) points out, democratic governments around the world do in fact incur debts in their name. However, it would be erroneous to describe a government as indebted because there is no explicit relationship created between a debtor and a creditor created. At first blush, this should sound strange. But if we consider government as a financial intermediary which connects people who wish to save currently by purchasing public debt and everyone else in society, the notion of indebtedness breaks down. This breakdown is not caused by some ambiguous relationship between bondholders and the parliamentary assembly, as we could accurately describe saving money with a private bank in much the same way. Instead, the difference between the two stems from the idea that the bank, its employees, own the value consequences of their actions, whether they be positive or negative, and bear ultimate responsibility. In parliamentary assemblies, this is simply not the case as individual members of a parliamentary body do not gain from creating value through debts nor do they lose from destroying value from debts. In fact, in line with Buchanan and Tullock (1962) and Tullock (2005), it may even be the case that individual members stand to reap private rewards from apparent fiscal irresponsibility. Such irresponsibility is unlikely to garner sufficient support if explicitly stated and so individual members will seek to justify any proposed change in policy that affects expenditures or revenues. To understand this, it is necessary to examine the process by which these figures are determined in the public sector. This is not to say that individual members are intentionally trying to hide nefarious deeds. Often, the goals are laudable and include such language as helping to reduce, e.g. poverty.

The determination of revenues and expenditures in the private and public spheres is markedly different in several ways. Suppose for simplicity that the time period under consideration is one calendar year, beginning in January first and ending December thirty-first. Both private and public institutions engage (at least implicitly) in some form of forecasting about the upcoming year's revenues and expenditures. For simplicity, suppose that the private household's income is earned by one person and that this person's annual salary is $120,000, payable on the first of every month. This household's expected budget every month would therefore be equal to $10,000 multiplied by the probability that the person maintains employment. Perhaps, as Clark Griswold does in the 1989 classic, *National Lampoon's Christmas Vacation*, this worker has also receives an annual bonus check at the end of the year. Thus, this person's annual revenues for the upcoming year may exceed their salary and they may choose, as Clark Griswold did, to purchase an expensive purchase at the end of the year with the expected bonus check. If that bonus check were to not show up, or if it was in an amount less than expected, debt would be incurred and the responsibility for reconciling this debt would fall squarely on the shoulders of the household, which has identifiable people in it.

Government revenues at the beginning of a fiscal year are determined in a similar way. Congress determines some aggregate dollar figure of taxable activity (the tax base) and multiplies it by some aggregate figure of a tax rate and thus arrives at a figure for total revenue. Like the private household example, this involves a significant amount of forecasting. Unlike the private realm, however, should actual revenues fall short of the actual expenditures, it is not at all clear who is to blame for the resulting deficit. To be sure, blame will be cast. Congressional Democrats, for example, will likely point to a proposed tax increase that was blocked or a loophole that was created by Congressional Republicans as the culprit while Congressional Republicans will likely point to a program that Congressional Democrats supported which cost more than anticipated. In either case, determining which specific members of Congress are at fault is an impossible task just as it's impossible to determine which specific members of Congress are at fault for a nigh-incomprehensible tax code (Hebert and Wagner 2013; Hebert, forthcoming, b).

The above analysis, like Wagner (2012), points to issues surrounding errors made in forecasting. While individuals in both the private and public spheres may have some general sense of what the future will hold, it is impossible to predict the future with certainty and thus, error is a feature of the world, not a flaw. However, the above analysis could easily describe particular instantiations of normally distributed error, which would offset itself over a sufficiently long time horizon. In thinking about this, it is necessary to describe the incentives that individual people face in different institutional settings when making such forecasts.

In the private realm characterized by individuals or individual households, prudence would seem to be likely. A household may reasonably be expected to underestimate revenues and overestimate expenditures over a given year in order to avoid finding themselves in unanticipated debt. In other word, of the myriad methods by which revenues and expenditures may be forecasted, a private household can be reasonably expected to select the forecasting method that produces a set of estimates biased downward with respect to revenues and upward with respect to expenditures.

This is not the case in the public realm, for here the coin of the realm is the ability to sell voters and constituents on the efficacy of a proposed piece of legislation. Thus, proponents of a new tax scheme are likely to select the methodology that produces the most lavish of estimates for projected revenues. Likewise, proponents of a new spending plan will likely select the methodology that produces the lowest total cost. In other words, where the private realm could be characterized by "hope for the best but plan for the worst," the public realm could be characterized by "assert the best."

Budgetary Chicanery

As Block (2008) notes, "one pesky reality of [government] budgeting is that it requires the use of numbers." In an ideal world, these numbers would bear some semblance on reality. The problem with this is that in order to accurately forecast the future, one must know, precisely, what the effect of a bill would be on the citizenry. Increased sophistication of modeling techniques has done little to resolve the difficulties of predicting the future accurately but have given us what Graetz (1995) refers to as the "illusion of precision." However, if getting the numbers required for balancing the budget were merely difficult, then all we would be concerned with would be error.

As it turns out, the error in forecasting revenues and expenditures are almost entirely one-sided. In the case of U.S. Federal revenues, each and every year for the last ten years has fallen short of projections. Likewise, actual expenditures exceed projected expenditures over this time period. The challenge, then, becomes one of explaining these systematic biases.

In order to assess the financial impact of any proposed change in legislation, two numbers must be established. The first number that must be established is a sort of base for purposes of comparison. This number, appropriately called the "baseline," is a projection of what will happen under current legislation if nothing changes in current law. The second number is an estimation of revenue that would be generated or costs that would be imposed if the proposed legislation were to pass. This number is referred to as the "score." Taken together, these numbers provide Congress with an estimation of where they are currently heading financially and how the proposed legislation will affect that trajectory. While both are highly important numbers, the baseline is perhaps the more important of the two as a high baseline would reduce the apparent cost of any proposed legislation.

These numbers became particularly important after the 1990 Budget Enforcement Act. This act imposed two restrictions on Congress: First, Congress was not to adopt spending legislation that would cause annual appropriations on discretionary spending to exceed caps established in the budget resolution. Second, all new tax legislation or changes to entitlement programs must be revenue neutral, meaning that decreases in revenue or increases in spending had to be offset by increases in revenue or decreases in spending elsewhere in the budget.

In an ideal world, the economic assumptions and methodologies used to construct these numbers would not matter. Unfortunately, this is not the case. As Block (2008) describes, "in the imprecise world of budgetary mathematics, even seemingly small changes in estimation methodologies and economic or behavioral assumptions can lead to significantly different scores." There will always be legitimate differences of opinion over which assumptions to make or which estimation methodologies to use, however it would be foolish not to also acknowledge that particular assumptions and methodologies that best suit a particular ideology will be used in order to advance a particular agenda.

To add a further complication to this, the task of classifying an item as taxation or spending is not as straightforward as one would intuitively believe. Both Reagan and Clinton, for example, have argued that increases in Social Security benefit taxes should be scored as spending cuts rather than tax increases since the tax increases would effectively reduce the amount of benefit that the recipients actually received.

Beyond this, Congress is able to manipulate each year's budget through selectively timing when revenues or expenditures occur. For example, this can be accomplish through inconsistent uses of a budget window. Budgets are, after all, tied to a specific amount of time. Every household has its own daily budgets, but also weekly, monthly, yearly, and perhaps even lifetime budgets. In setting these budgets, households set aside a certain amount of money that can be spent over the course of a specified amount of time. The same applies to any committee or office that makes budget projections and recommendations—they must put forth a plan that sets aside a certain amount of money that is available to be spent over a certain amount of time.

In the past, Congress used a short, one-year basis for budgeting purposes. While this provided Congress with the flexibility to amend the budget resolution each year, it also meant that individual Congresses were not taking into account the long-run costs of any proposed legislation, instead only taking into account the current-year costs.

In 1990, Congress passed the Budget Enforcement Act as a means of resolving this by moving to a statutory five-year minimum window for purposes of budget resolutions. In 1997, Congress began requesting ten year budget information from the Congressional Budget Office (CBO) and the President's Office of Management and Budget (OMB) followed suit, similarly supplying 10 year budget information. The important thing here is that both the legislative and the executive branches both used the same budget window, the same scoring practices, etc. in their evaluations. Doing so allows for a more fruitful comparison between the two branches' budget proposals.

The challenge, however, is that there are no formal rules governing the budget window that must be used other than the five-year minimum. In 2004, for example, the OMB began using a ten year window in some instances and a five-year window in others in the same budget proposal. This made meaningful comparisons and calculations difficult and resulted in charges that the President's administration was using selective changes in the budget window solely to advance the president's legislative agenda.

Another source of timing difficulty comes from the use of various accounting gimmicks. These can range from the relatively simple to the complex. An example of a simple accounting gimmick comes from the inconsistent use of cash versus accrual accounting. Briefly, cash accounting is a type of accounting practice that records revenues in the period in which they are received and expenses in the period in which they are paid. It does not include revenues that are to be collected in the future nor does it include expenses that are to be paid in the future in any way. In contrast, accrual accounting records incomes and expenses when the right to receive or obligation to pay them arises regardless of whether funds have been received or paid. In the private sector, the accrual method dominates due to its forward-looking nature and is even required based on generally accepted accounting principles established by the Financial Accounting Standards Board. Congress, however, does not have such a requirement. In general, Congress uses the cash accounting method (though there are exceptions) and OMB/CBO reports are calculated using this method as well. This method affords legislators with several tools of budget chicanery.

Perhaps the easiest tool is to simply delay payments or receipts by one day and into the subsequent fiscal year. Any budget must be a budget over a period of time, as one collects revenues at one point in time and expends those revenues at another. This can be over the course of a day, a month, a year, or even a lifetime. In private lives, this poses no real challenge. For example, knowing that an inheritance check is coming next month, a private person can reasonably account for the additional funds in their current budget and adjust spending habits accordingly. It would be inaccurate, however, to consider this as "current income" on one's monthly budget.

In Congress, this is most apparent by recognizing that the fiscal year begins on October first while many spending programs are based on calendar years. Because of this, revenues and expenditures can be reported as occurring in different parts of the calendar year which correspond to different fiscal years. In the event that a spending program will put an appropriations committee over its cap, this committee can simply report the spending as occurring at a different part of the calendar year and avoid being punished for going over its limit during the current fiscal year. Delaying revenues or expenditures by one day can easily be employed to move billions of dollars from one budget year to another. Advance appropriations are similar to this in that an appropriations bill can be passed in one fiscal year while the authorization bill (and thus the actual spending) can be passed in the subsequent year, again shifting the spending from one fiscal year and into another. While these budget gimmicks are powerful, they are limited in that they can only move payments and receipts from one year to the next. In order to move budget items over longer periods, more sophisticated and complex variations need to be employed.

The easiest way to move budget items across longer periods is to phase programs in over time. In doing so, legislators commit to spending over much longer periods of time than the year in which they are legislating while simultaneously tying the hands of future Congresses (unless the future Congress takes action to repeal said program). Alternatively, rather than paying the full cost upfront to, say, construct a building, Congress can contract with a private contractor to build the building, giving the contractor the title to the building at the end of construction, subsequently paying rent to occupy the space created.[2] Again, using the cash accounting method, these allow the current Congress to commit to spending programs while only reporting a fraction of that spending in the current year. Under the accrual method, the full cost would be reported immediately regardless of when the money would actually be paid.

Another, slightly more complicated version of this is to pass legislation with a fixed expiration date or sunset even if the full expectation is that the legislation will be extended beyond this sunset or perhaps even made permanent. This “trick” works because of the methodology that the CBO uses when scoring any proposals. The CBO must, when scoring any proposals, consider them in light of existing law without taking into account future statutory changes to the law. As a result, if a proposal that will reduce revenue includes a sunset provision of three years, the CBO will score it only as existing for those three years and

[2] Thus, this contracting-out method can appear advantageous even if it ultimately costs significantly more than Congress simply building/buying the building themselves.

its score will be improved.[3] Block (2008) calls the temporary R&D tax credit as the most notorious offender of this sunsetting game. Despite widespread bipartisan support, a permanent tax credit for R&D has not been passed, instead the temporary credit first passed in 1981 has been extended several times such that it is now viewed as "virtually a political given."

As a result, the cash accounting method, for all its merits of keeping an accurate accounting of levels of funds currently in the accounts of the government agencies, also provides these agencies with significant scope to engage in budget gimmicks by slightly altering the timing of the spending or revenue collection. Doing so can make it appear as if Congress as a whole is saving significant money on a year-by-year basis while simultaneously increasing long-term spending obligations. Regardless of Congress's ability to kick the can further down the road, that road will eventually end eventually become so massive that it simply cannot be kicked any longer.

Spending vs. Regulation

At first blush, it is important to note that any parliamentary assembly is not in the business of producing any sort of economic good whatsoever. Rather, governments are merely the bridge between people who have money and people who want money. As is pointed out in Wagner (2016, pp. 136–162), we can view parliaments as a peculiar form of an investment bank. Like a private bank, parliaments connect people who have money with people who want money to perform some task. Unlike a private bank, with parliamentary assemblies there is no guarantee that the people contributing the money (i.e. taxpayers) are contributing their monies voluntarily (Podemska-Mikluch and Wagner 2013). In this sense, taxes can be viewed as akin to a forced loan by the taxpayer to the recipient of government expenditures.

[3] To be sure, sunsets are not always used to play budgetary games. The Byrd Rule, among other things, makes it necessary to sunset certain bills in the event that a 60 vote majority in the Senate cannot be achieved.

Fig. 9.1 Money flow with government intermediation

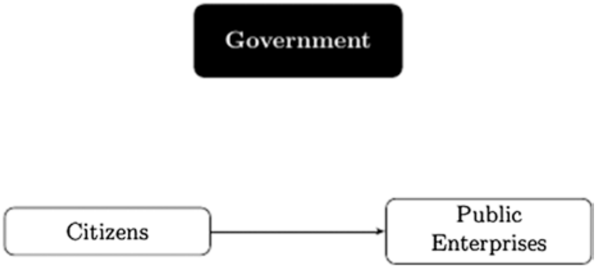


Fig. 9.2 Money flow without government intermediation

Figure 9.1 illustrates this, showing the flow of dollars from citizens to the providers of public enterprises through the apparatus of government. In this scenario, the public enterprise is funded entirely by dollars received from the government which, in turn, receives its dollars from citizens in the form of taxes.

Because money is received by the government from citizens, it would count as revenue received and would show up on their budget. Likewise, money would flow out of the government's coffers to finance the public enterprise and would show up as an expense. However, this is not the only way in which parliaments can direct spending and, in doing so, move money from citizens to public enterprises. Instead, governments could simply regulate the behavior of citizens and, in doing so, force payment from citizens to public enterprises directly (Fig. 9.2).

Here, rather than receiving and distributing funds, the parliamentary assembly merely directs citizens to purchase some good or service that is provided by the public enterprise. From the perspective of the citizen, the effect is identical: money has been moved from their accounts to the accounts of the public enterprise. However from the perspective of the parliamentary assembly's budget, the effect is wholly different, as this would not be recorded as either a revenue or an expenditure at all.

These are also not mutually exclusive, as some enterprises are financed through both tax dollars and regulations. For example, in principle there is no reason why public transportation couldn't be financed entirely through taxation, with riders paying zero price to get on or off the bus/subway regardless of how frequently they ride, how many transitions they make, or the total distance traveled. As a matter of practice, public transportation is typically financed through both regulatory means and through some sort of use-fee. For example, in the greater Washington, DC area, there is an extensive metrorail system that is used to bring people to, from, and around the District. During the rush-hour times, driving on the freeway is regulated in the sense that the road is reserved for vehicles carrying two or more passengers. In effect, what this does is raise the cost of driving oneself into the district in the morning and out of the district in the evening. The funds to provide the metrorail service are provided through a combination of tax dollars and the fees collected from riders.

This type of shared-cost arrangement does not guarantee that the funds collected from citizens paying directly for public enterprises will be sufficient to meet its expenditures, nor does it guarantee that this is the least-cost way to provide a metrorail system. In the event that user fees are insufficient to finance the operation of the DC Metro, supplemental tax dollars may be provided, however this would require far fewer dollars flowing from Congress to the DC Metro under this shared-cost arrangement than would be were the metrorail system funded entirely by tax dollars. Similarly, it may be more costly from the point of view of society as a whole to have this shared-cost arrangement, and analyzing to the extent to which this is true or false would an interesting exercise. However, it is certainly less costly from the perspective of government budgetary authorities to have a shared-cost arrangement aided through regulation than it is to have a metrorail system financed entirely by taxes.

The use of regulation in this capacity is tantamount to taking what would have been on-budget activities and removing them from the budget. The overall effect on citizens, however, remains the same. As a result, one concrete prediction that can be made and explored is that a balanced budget amendment would have little to no effect on the operation of parliamentary assemblies other than to shift some activities that are currently financed through taxation to providing them through regulation, effectively forcing citizens to finance their operation out of their own pockets. This was explored in Bennett and DiLorenzo (1982), who found a significant increase in the use of off-budget enterprises as a result of changes in state tax laws in the 1970s, and more recently in Bowler and Donovan (2004) and Mullins (2004).

Conclusion

This chapter has presented an overview of how federal budget numbers are determined in the United States Congress. To be sure, this is but a brief and simplistic overview that glosses over many details.[4] Nonetheless, it provides evidence of a sobering conclusion: the figures determined for public revenues and public expenditures can be manipulated with relative ease. Because of this, it is difficult to imagine a balanced budget requirement having a meaningful impact on the day-to-day operations of any type of parliamentary assembly. Today's budget rules allow for Congress to include deficit spending in their budgetary outlook and so deficit spending is included in the budget proposals and resolutions. If it were no longer allowed, then it would not be included in the budget. Were deficit spending to become necessary over the course of the year, then one of the several forms of budgetary chicanery described above or a shift from using government expenditures to regulation would be used to reconcile any accounting differences.

Acknowledgements The author wishes to thank participants at the 2018 Public Choice Society meetings for helpful feedback and discussion. All remaining errors are my own.

[4]Schick (2007), especially Chapters 4 and 6, provides a much more thorough investigation.

References

Bennet, J., & DiLorenzo, T. (1982). Off-Budget Activities of Local Governments: The Bane of the Tax Revolt. *Public Choice, 39,* 333–342.

Block, C. (2008). Budget Gimmicks. In E. Garrett, E. Graddy, & H. E. Jackson (Eds.), *Fiscal Challenges: An Interdisciplinary Approach to Budget Policy*. Cambridge, MA: Cambridge University Press.

Bowler, S., & Donovan, T. (2004). Evolution in State Governance Structures: Unintended Consequences of State Tax and Expenditure Limitations. *Political Research Quarterly, 59,* 189–196.

Buchanan, J., & Tullock, G. (1962). *The Calculus of Consent: Logical Foundations of Constitutional Democracy*. Vol. 6 of *The Collected Works of James M. Buchanan*. Indianapolis, IN: Liberty Fund.

Buchanan, J., & Wagner, R. (1977). *Democracy in Deficit: The Political Legacy of Lord Keynes*. Vol. 8 of *The Collected Works of James M. Buchanan*. Indianapolis, IN: Liberty Fund.

Graetz, M. (1995). Paint by Numbers Tax Lawmaking. *Columbia Law Review, 95,* 609–613.

Hebert, D. (forthcoming, a). The Spontaneous Order of Politics. *The Quarterly Journal of Austrian Economics.*

Hebert, D. (forthcoming, b). Politics as a Polycentric Order in Practice: The U.S. Federal Budget System. *Journal of Public Finance and Public Choice*.

Hebert, D., & Wagner, R. (2013). Taxation as a Quasi-Market Process: Explanation, Exhortation, and the Choice of Analytical Windows. *Journal of Public Finance and Public Choice, 31,* 163–177.

Mullins, D. (2004). Tax and Expenditure Limitations and the Fiscal Response of Local Government: Asymmetric Intra-local Fiscal Challenges. *Public Budgeting and Finance, 24,* 111–147.

Podemska-Mikluch, M., & Wagner, R. (2013). Dyads, Triads, and the Theory of Exchange: Between Liberty and Coercion. *Review of Austrian Economics, 26,* 171–182.

Salsman, R. (2017). *The Political Economy of Public Debt: Three Centuries of Theory and Evidence*. Cheltenham: Edward Elgar.

Schick, A. (2007). *The Federal Budget: Politics, Policy, Process*. Washington, DC: The Brookings Institution Press.

Tullock, G. (2005). *The Economics of Politics*. Vol. 4 of *The Selected Works of Gordon Tullock*. Indianapolis, IN: Liberty Fund.

Wagner, R. (2012). *Deficits, Debt and Democracy: Wrestling with the Tragedy of the Fiscal Commons*. Northampton, MA: Edward Elgar.

Wagner, R. (2016). *Politics as a Peculiar Business: Insights from a Theory of Entangled Political Economy*. Northampton, MA: Edward Elgar.

Wagner, R. (2017). *James M. Buchanan and Liberal Political Economy: A Rational Reconstruction*. Lanham, MD: Lexington Books.

10

Subsidizing Health Insurance: Tax Illusion and Public Choice for a Mostly Private Good

Mark Pauly

Introduction

The Affordable Care Act (commonly termed Obamacare) has and continues to experience substantial political and economic challenges to the "Exchange" market for individual (non-job-related) insurance it is trying to build to cover the uninsured. One of the law's most popular features by far is the promise to make insurance available to those who have already become above-average risks, given age. The challenge to this feature is where to find the money to pay the difference between the average premium charged and the much higher expected value of benefits for high risks, for any nominal insurance policy. The mechanism built into the law, so-called "modified community rating" in which the same premiums are charged to below average risks has become the most serious flaw in the ACA framework, as defections by

M. Pauly (✉)
The Wharton School, University of Pennsylvania, Philadelphia, PA, USA
e-mail: pauly@wharton.upenn.edu

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_10

lower risks from insurance markets have resulted in high and growing premiums for Exchange coverage.

Another feature of Obamacare, which is less popular because it is perceived to be weak, is its efforts to control the rate of growth of medical spending. While it did make some apparently successful efforts to slow the growth of government payments for Medicare, it has not managed to bring private sector spending growth down to the level of GDP growth, and specifically been ineffective in curtailing the feature most commonly agreed to cause excessive private spending growth, the tax subsidy to employment-based premiums.

Finally, the cost of subsidies to the formerly uninsured has provoked taxpayer backlash to such an extent that repeal of the entire program almost succeeded. Is there a way to redesign subsidies and the distribution of methods to pay for them that might have had a different effect? James Buchanan's work offers insights on each of these three issues. We focus here on his contribution to "positive political economy," first outlined in 1949 (Buchanan 1949), especially the idea of "fiscal illusion" treated masterfully in Chapter 7 in *Public Finance in Democratic Process* (Buchanan 1967).

For the first problem, Buchanan's thoughts can explain why there is concern for insurance coverage and premiums for people who are not poor but who happen to be above average risks, why Obamacare selected the politically expedient but flawed solution of modified community rating, and what alternatives might repair that flaw but still have political challenges. It can also help to explain why the most effective cost containment device—closing the tax loophole that provides high benefits to the rich while encouraging the use of expensive low value medical care has proven so politically durable. Finally, it can suggest alterations in the design of subsidies and taxes to increase the number of citizens who obtain net benefit from the program and thus improve its future political prospects.

Individual insurance markets before Obamacare generally operated in ways consistent with competitive insurance markets: premiums for a given policy with given coverage varied across buyers depending on insurer estimates of their health risk and other determinants of use of high priced care. Adverse selection did occur but was limited by insurance provisions that asked applicants about all prior use of medical care or medical conditions for up to 5 years, and rescinded coverage in the case of fraud. Among highest observable risks (say, the top 2%) there was more danger of adverse selection since the very high premiums they would have to be charged would only be paid by those who were likely to use care–so such persons were typically rejected for coverage. The great bulk of applicants including those at much-above-average risk could obtain coverage at some premium if they searched (Pauly 2010). This was less true in a small minority of states that required insurers to charge the same premiums to all risks (termed "community rating"), where either many more applicants were rejected for coverage (if that was permitted) or individual insurance markets virtually disappeared.

One of the major goals of the ACA, with support across the political spectrum, was to prevent this discrimination in favor of low risks and against high risks by requiring insurers to cover everyone buying an individual policy at community rated premiums that could vary only by age, location, and smoking status. Why was there support for this provision (which has gone on to cause so much mischief in the operation of Obamacare), especially since risk rated markets had extended coverage to many high risks, to such an extent that, controlling for income, there was very little relationship between risk level and being insured? After all, because of the shared nature of the distribution of risks, there were many more low risks who stood to lose a little and relatively few high risks who would gain a lot.

Buchanan's work offers several insights which, when combined, help to explain the peculiar political economy of this policy. There was an intense minority (of chronic illness advocacy groups) lobbying for high risks, but no one to speak for non-poor lower risks (who were not all young) who were being grossly overcharged relative to the benefits they could expect to collect. However, the stronger argument focuses on the rest of the population. It seems to have been the case that many people who would not be affected by these changes in the individual insurance market (those on Medicare or obtaining insurance through an employment-based group) favored doing something about this "unfairness" (of possibly actuarially fair premiums). They were moved by stories of families with a high-risk member who suffered either from higher than average premiums or higher than average out of pocket bills, depending on whether they bought insurance or remained uninsured. At one level, the concern of these members of the community for others in the community who were either under consuming medical care or under consuming other key items of consumption was a kind of "externality per se in consumption" that Buchanan had identified, even though both health insurance and medical care (except for care for contagious conditions) appear to be pure private goods (see Buchanan 1968). More deeply, they may have felt that the "rules of the game" that they would have chosen behind a veil of ignorance might have embodied at least some transfers from the lucky who stay healthy to the unlucky who are hit with a chronic condition. Probably their willingness to pay more taxes to finance these transfers (even taxes on their insurance premiums that were part of the ACA since repealed) was modest, but they would prefer that high risks be covered by insurance compared to the situation with unsubsidized and largely unregulated individual insurance markets.

The other feature that doubtless contributed to the popularity of this provision was uncertainty—ranging up to total ignorance about who would pay to make up the difference between the average premiums and the much-above-average medical claims of the high risks. Some people, it is clear, thought it both likely and desirable that rich insurance companies should pay for the high risks they were forced to cover. Other more reflective people may have believed that premiums would need to be increased (compared to risk rated premiums) for low risks buying individual insurance, a small and diffuse minority of all citizens. This phenomenon too was anticipated by Buchanan in *Cost and Choice* (1969), where he notes that "cost" is only meaningful if agents have a choice that they understand.

Thus even in a simple majority rule model one has all the ingredients to combine both fiscal illusion with an influential intense minority. Those bearing the bulk of the cost of this increased generosity and fairness were a tiny misinformed and disorganized group while the great majority both mildly favored it and did not expect to pay.

As is often the case, the aftermath of putting this provision into action did not exactly match the rosy scenario envisioned by its supporters. For one thing, the increase in premium required an increase in taxpayer support for subsidies to lower income people so they could afford and be willing to buy insurance—so the rest of the population did pay, along with the small number of high income lower risks that kept buying. For another thing, though this widespread pattern of subsidies did to some extent diminish adverse selection, there apparently were enough non-poor low risks who realized they were facing a bad deal and so did not take individual coverage. Insurers initially had difficulty in covering their claims—and so many of them pulled out.

The so-called "individual mandate" in the ACA (really a modest penalty for failure to purchase coverage by the middle class and above) was not very effective at keeping low risks in the ACA pool (despite having had some earlier success in Massachusetts)—many unsubsidized low risk buyers apparently dropped or avoided overpriced coverage even at the cost of the penalty, and others sought coverage through employment groups of mostly low risk well off workers for whom premiums were allowed to be low.

Here again, there was a public choice puzzle. Apparently, there was little support for a large penalty that would have stabilized the community rated market covering high risks that so many claimed to favor. "Policy" illusion, a failure to connect the dots and therefore to blame insurance companies, rather than the policies they themselves had chosen, probably contributed to this behavior by an "irrational majority." The problems associated with defection of low risks continue to bedevil individual insurance markets; the premiums charged by the remaining firms have now gotten high enough to cover claims, but the abolition of the individual mandate may destabilize those markets for purchases by the remaining unsubsidized buyers whose current behavior is not well understood and whose future behavior is unpredictable.

For the record, there are alternative ways to generate stable subsides to low and middle income high risks if that is what externality-affected voters want to do. One could make the penalty attached to a mandate high enough to guarantee coverage, require individuals who are low risk to purchase guaranteed renewable coverage at moderately higher premiums that will keep premiums down should they become high risk as long as they have maintained continuous coverage, or simply fund a high-risk pool with general revenue financing. Yet none of these has as yet garnered political support.

We still have a puzzle then. The low risks in individual markets who are not poor have dodged much of the burden for paying for the high risks. Instead, once one unpeels the complex structure in Obamacare, it turns out that much of the payment to help high risk was actually being made by the general taxpayers who are funding the subsidies to lower income average and low risks in exchanges. Wouldn't they prefer to pay the subsidy directly to high risks rather than go through the channels of first subsidizing exchanges in order to subsidize middle and upper class high risks? Perhaps the explanation is precisely that the subsidy is so filtered through so many channels that taxpayers cannot see the tax price of their support and distinguish it from the subsidy they might want to pay to lower income average and lower risks on externality grounds; they cannot change what they cannot unravel—and a promise to lower exchange premiums for other risks if high risks could be skimmed off into a well-supported high risk pool is just not credible. The confusion caused by complexity benefits politicians who can point with pride to benefits from Obamacare—reasonably priced coverage for high risks, insurance at no cost for children up to age 26 whether dependents or not—and claim that no identified group has to pay for this.

The Loophole That Refuses to Close, and Spending Growth That Refuses to Stop

The recent tax reform legislation has been controversial, but there is considerable support for its successful effort to curtail at least some of the tax loopholes that provide poorly designed tax subsidies to some activities, such as high state and local taxes and home mortgages for second homes. What is perhaps surprising is that reform failed to tackle (or even mention) what is in the opinion of many tax experts the most troubling loophole of them all: the exclusion from taxation of insurance premiums arranged as part of employment-based group insurance. Indeed, the new law further postponed a poorly designed partial limit on this subsidy—the Cadillac tax.

The original Obamacare design (and subsequent Congressional follow-up) did have another feature designed to limit growth in government spending on the Medicare program, perhaps because (as will be discussed in more detail below) the bulk of the direct funding for subsidies to insurance for uninsured under 65 was to come from "savings" on Medicare. Specifically, the ACA put ad hoc limits on the growth in reimbursements for hospital care under Medicare, some motivated by an expectation that fewer uninsured would reduce the charity care burden on hospitals and some motivated by a hope that hospitals would find new "productivity improvements" that would allow them to survive lower prices. This strategy was extended to physician services in the Medicare physician payment reforms enacted in 2016: a lower growth of payments (especially after 2025 or so), linked to incentives to maintain quality and yet reduce the volume of services.

Things have not worked out perfectly—the failure of many states to expand Medicaid coverage left their hospitals with the same charity care burden but lower Medicare payments, and hospital financial status on average has worsened somewhat—but the slower growth of Medicare outlays has materialized without obvious reductions in quality or access, at least for the moment. The government's ability to cut payments without doing much harm implies that pre-reform payments were higher than they needed to be, but the main message for voter choice is that lower payments to providers generate little objection from the majority of voters—only those tied to or employed in the health care industry potentially suffer, and lower wage growth and job growth has yet to materialize.

However, much of the burden for cost containment in the private sector was to come from changing the tax treatment of employment based health insurance. Previous research had shown that the generosity of health insurance chosen responded to the price of insurance, and that more generous insurance led even non-poor consumers to use substantially more medical care and to make less effort to find low priced sellers. Whether spending growth would be higher with more generous coverage once any effect of expanding coverage wore off was less definitively established, but there was some evidence in support of an effect on long run growth of spending. Insurance obtained as a work-related group benefit was excluded from most federal, state and local taxes, so the consequence was to lead to more generous coverage than would have been the case had compensation received in the form of partial payment of premiums been taxable and had any explicit worker premium not also been tax shielded under a cafeteria plan.

Phelps and Parente (2018) have recently produced updated estimates of the effect of the tax subsidy on amount of insurance demanded and the subsequent effect of more coverage on medical care spending; they find that the short run effect of removing the tax exclusion at the margin would be to reduce spending on insured services by about 20%, with the lower spending (or sacrificed wages) going for insurance offset by higher money income spendable on other goods and services of value.

However, as with any tax advantage, those who are benefitted by that advantage—compared to its removal and other taxes remaining the same—will resist attempts to constrain or eliminate it. Obamacare did surprisingly include an awkward attempt to offset the exclusion, through a provision that would impose a 40% sales tax (to be paid by insurers, or employers in the case of self-insurance) on premiums in excess of some target amount at some future date. This Cadillac tax probably survived into law because the revenue it would generate (either from the tax itself or from higher income taxes if money wages rose as employer-paid premiums were cut back) helped to finance the subsidies to lower income individual insurance, and because the primary beneficiaries of the subsidy were higher income workers (with high marginal tax rates). However, fierce opposition from unions (who generally negotiated for benefits-rich compensation packages) and from people living in areas where medical costs were high has led to postponement of implementation of the tax until 2024. Over the longer term, the tax provision would have eventually hit a large number of households (Herring and Lentz 2011).

So the median person (whatever that would mean in this context) might be worse off if the exclusion disappeared and nothing else was changed. No voter was fooled by the delusion that the additional tax collections would come out of insurer or employer profits; in this case, workers and their unions pierced the cloud of fiscal illusion to register a definite "no." However, the fact that the exclusion leads to a non-(Pareto) optimal outcome means that it should still be possible to find an alternative arrangement which could be beneficial to many, even to those who use the exclusion. Phelps and Parente have suggested one: the simple idea of eliminating the exclusion entirely but then using the proceeds to lower marginal income tax rates, with the reductions roughly proportional to the average value of the exclusion by income bracket and possibly other demographic characteristics. Given that the self-interested taxpayer-voter who is at the core of Buchanan's theory of public choice would have preferred the exclusion to its removal without side payments, would this proposed exchange of one way of taxing for another that raises about the same amount from almost everyone but allows a dividend of higher spending on other types of consumption (rather than low value spending on health insurance) be accepted by a majority?

Practical political economy suggests some potential impediments. Since tax rate reductions cannot be perfectly tailored to prior tax benefits, some people who had very large benefits from the subsidy may object—either because *their* former tax subsidy is much in excess of their prospective tax reduction, or because it seemed unfair to them that they should get less net benefit than others. Moreover, one of the other efficiency dividends from the exchange—less deterrence of work effort because of lower marginal tax rates—may not be realized if previously workers had counted on high excluded spending when their incomes rose. Finally, there is an ideological constituency in the medical care sector that views with alarm any attempt to reduce insurance coverage of medical care, for fear that some may go without "needed" care (Gladwell 2005). Nevertheless, my conclusion is that public choice theory argues for eventual removal of this long-standing unfair and inefficient stimulus to medical spending as a likely outcome. One possibility might be to allow workers (individually or as the workforce of a firm) to choose voluntarily whether they want to trade in the exclusion for lower tax rates. There would be some bias in this choice (workers who got a lower than average tax exclusion would be more likely to volunteer), but it might break the political logjam.

The final feature of Obamacare that might usefully be viewed through the lens of Buchanan's insights was the signature feature of reform: making subsidized insurance available on an individual basis to lower and middle-income people on Exchanges. This attempt to nationalize the insurance broker business for people who do not get job-based insurance was not very successful, and led to a rocky start in signing up customers, which has remained somewhat unstable. And the number of people who actually bought insurance through these exchanges remains well below initial projections even from the Congressional Budget Office. Although that has meant a lower level of government spending on subsidies, it is fair to say that, after the law squeaked through Congress, it has not achieved strong support from a majority of voters or a majority of taxpayers ever since and is still in political jeopardy.

What does Buchanan's political economy theory tell us about the reason for lukewarm support and likely future developments of subsidized insurance for the non-poor? The policy goal of many economist commentators on the uninsured and medical care use and spending envisions "trading in" the pro-rich and cost-increasing tax exclusion for subsidies to those mostly lower income individuals who are likely to be uninsured and suspected of failing to use beneficial care. I have already commented on the political impediments to getting rid of the tax loophole, but what about the subsidy program present in Obamacare? That program rejected a uniform universal public program for health insurance for under-65 people at all income and wealth levels (in the form of original Medicare and Social Security) in favor of subsidies based on "need," and hence much more generous for relatively lower income people given risk and at higher risk given income. The qualitative outlines of this subsidy program I have argued can be based on Buchanan's notion of "consumption externalities per se," and fit the pattern I suggested in my doctoral work done under his direction (Pauly 1971). That approach began with the idea that persons other than the direct consumer may get utility benefits from assuring that beneficial care that might be worth less than its cost to the direct consumer but worth something positive at the margin to other concerned persons should be encouraged. Per unit subsidies to medical care consumption are de facto insurance benefits (given the stochastic nature of illness), and so provide both health- and wealth-protection features. But totally covering the cost of care may lead to use of care worth less than its cost to everyone because of moral hazard (Pauly 1970). So the ideal would be a pattern of subsidies to insurance intended to move consumption from the individually optimal level to the socially optimal level—and because both insurance and health appear to be normal goods, would require generous subsidies to generous coverage for the poor, and then phasing down both subsidies and required coverage generosity as income rose.

That was the pattern incorporated into law in Obamacare for the modest share of the population not already covered by employment-based health insurance. However, the theoretical mutual welfare gains to recipients of subsidies (from more care and less risk) and to taxpayers who are concerned about the medical and financial health of that population have thus far failed to assure majority support. The simple public choice model involving voter comparison of marginal utility benefits from a public program with marginal tax cost can, I believe, explain the current opposition and suggest a way to think about how to determine whether this program should be stabilized and how to do so.

There were several serious flaws in the support for and design of the program as it was (barely) passed into law. The first is that, to my knowledge, neither the pattern of subsidies to insurance (proportion of premium covered) or subsidies to care (proportion of unit prices of care covered) were based on defensible empirical evidence. Three key and knowable but currently unknown pieces of empirical information never came up in the discussion of the design of the program: how subsidies at different levels for people at different incomes would affect their take up of insurance, how insurance coverage of different degrees of generosity would influence the use of additional care, and how much of an improvement in population health might be expected based on enhanced coverage. Moreover, the more fundamental question of how much improvements in health were worth to those covered and to those subsidizing the coverage was not asked. It is true that measures of demand responsiveness for insurance and care did figure prominently in estimating the cost implications of coverage chosen, and some recent research has tried to estimate the value of coverage to those subsidized (and found, unsurprisingly, that is worth less to them than the full premium cost and often less than the subsidized cost (Finkelstein et al. 2017).

But the key design parameters of the plan—subsidies up to 400% of poverty line incomes, minimum coverage at least 60% of average expected health spending, seem to have been selected on an ad hoc basis involving consideration of what was done in Massachusetts' prior plan, concern for the fairness of distribution of subsidies across income levels, and the need to hit some spending impact targets. In particular, there was no attempt either to demonstrate what health improvements might accrue along the income distribution or that the premiums and cost sharing of the Affordable Care Act actually were affordable (meaning able to motivate purchase, with or without complaints).

The other sketchy aspect of the law was its financing. There was not an earmarked addition to taxes that each person could estimate—except for a modest share of financing to be generated by higher Medicare taxes imposed on higher income taxpayers of all ages. As already noted, the largest share of financing was to come from lower growth of payments for hospital and related care for Medicare beneficiaries, the Cadillac tax (eventually) and a grab bag of excise taxes on insurance, medical devices, and (believe it or not) tanning salons. There were also mandates on employers and the uninsured that would return revenues from the tax penalties imposed on those who did not comply.

For the recipients of subsidies, deciding in favor of the program was generally an easy call. But what about a kindly and concerned insured middle-class taxpayer, asked to support a program with no rigorous evidence of the health improvement it might generate with financing whose eventual impact (if any) on that taxpayer was impossible to guess? Buchanan's public choice model would not predict that such persons (not to mention those higher up on the income scale) would support the program on benefit cost grounds. If "uncertain personal cost" could be translated into "no personal cost," small whiffs of benefit from the program (covering 25-year-old slacker "children," guaranteeing coverage to high risks under 65) would generate positive sentiments, but uncertainty about effects on taxes and private premiums would lead to second thoughts. And polls suggest that a large slice of the population is in this uncertain swing group, opposed to almost everything they hear whether it is continuation or canceling of the program.

What needs to be established to help to make progress? The key thing is whether there is some way of distributing the actual cost of the program over taxpayers in such a way that their perceived benefits from the program (compared to some alternative) are higher than their incremental tax cost. That leads to a big but important "to-do" list for researchers and politicians.

One is to produce conclusive evidence to establish that insurance coverage does cause improved health. A randomized controlled trial of Medicaid expansion to poor able-bodied adults in Oregon found no major effects on health but some benefit in terms of reducing high medical bills; a less-robust study found positive effects on health in Massachusetts. This was coverage expansion for the least well off, and presumably, effects of coverage on health would be smaller for those who have higher incomes. Suffice it to say that there is no unequivocal evidence of consistently large magnitude effects of insurance on health outcomes that might persuade a kindly but skeptical taxpayer to be eager to pay higher taxes for such a program.

The other unknowns involve taxes. One is how the final tax payments to cover the uninsured under Obamacare actually are distributed. The other is how values of improvements in health for subsidy recipients (assuming such increments can be demonstrated) are distributed across the population based on characteristics that might plausibly be used in a tax system. (Buchanan attributes this idea to Knut Wicksell.) There is for example evidence in cross state analysis of Medicaid programs that higher taxpayer income promotes more generosity to a given poor population. If the "income elasticity of demand for subsidies for health insurance" by non-recipients of the subsidy could be known, taxes could be made to vary with income in the same fashion, potentially increasing support for the program if it is of enough value in the first instance. Some other characteristics will be harder to incorporate: we know that Southern taxpayers are less supportive of public programs but more generous with private charity, but there is no obvious way to build such regional differences in preferences into the tax system.

About a third of the financing for the subsidies newly extended to purchasers on exchanges and states expanding Medicaid eligibility were to be financed by "cuts in Medicare." That did not literally mean year over year reductions in spending, but rather slowing the rate of growth in spending below what had previously been forecast. What insights might Buchanan's work offer for this method of financing?

For Medicare beneficiaries, this change literally meant that some of the money that would have been spent on care for them would now be spent on other groups in the population. While they were reassured that hospitals and to some extent physicians would be able to continue to provide the same access to care and quality of care by "productivity improvements," reducing prior technical inefficiency in the face of reimbursement constraints, beneficiaries then and now are concerned about impacts of these cuts, with provider organizations predicting potential adverse consequences in terms of access to care and hospital closure.

Beneficiaries (or their self-appointed lobbyists, such as AARP) could have argued that they would have preferred any improvements in technical efficiency to go toward higher quality care for themselves or lower beneficiary cost sharing, but they did not. They might also have argued, and a few did, that any slowdown in Medicare spending growth should go toward paying forward some of the future costs of Medicare which were forecasted by the government actuary to run ahead of Medicare payroll taxes and the growth of GDP; they could have argued that the savings should have been used for the benefit of future Medicare beneficiaries who would otherwise get less or have to pay more.

Transparency of this process was impeded by the fiscal accounting by the Medicare trust fund that pays for hospital (Part A) benefits for all seniors regardless of income; the slowdown in spending growth (relative to what had been forecasted) actually improved the "health" of the trust fund in that it delayed the date at which it would achieve zero balance, even though it meant that some of the proceeds from the payroll tax earmarked for hospital care were being diverted to paying subsidies to others (in place of the higher taxes or greater budget deficits that would otherwise have been required). The best explanation of this apparent paradox is to note two points: (1) slowing growth of benefits payments always delays exhaustion of the trust fund but (2) taking all of the excess tax collections over benefits cost to buy bonds for the trust fund postpones this date further than diverting some of those funds to other purposes. So beneficiaries were not harmed compared to no reduction in spending growth, but diversion of funds to others harmed them relative to how well off they would have been with lower spending growth and no diversion. All of this assumes, of course, that providers were able to absorb lower payments over the long term without changing access or quality.

An aspect of this Medicare change in the ACA, and Medicare in general, may deserve comment. There is a view that passage of the original Medicare legislation in 1965 along with its trust fund financing of the then-dominant hospital spending represented a promise to current and future elderly that the benefits then described—no limits on access, no interference in provider-patient relationships—were to be perpetual. Economists have taken great glee in pointing out that, despite appearances of piling up assets to buttress such promises, there actually is no trust fund and the great bulk of Medicare (and Social Security) taxes go out to pay for current federal spending of all kinds. People who believe in the "promise" model have been duped.

However, Buchanan's notion of constitutional rules limiting current short-term government behavior may have an application here. The application is different from those he typically made, where tax rules were put in place in part to simplify political bargaining and in part to constrain politicians and bureaucrats who want to spend more. The stability over time of the rate structure in the personal income tax was the usual example of a "quasi-constitutional" rule. Admitting that determining empirically what is "constitutional" or not is a much more complex and deeper problem than can be covered here, one might imagine that Medicare (and Social Security) embody a longstanding constitutional rule that promises not to spend less on the elderly—and certainly not to spend less on this program in order to divert funds for programs that benefit others. In effect, the ACA violated a long-standing policy on which people may have relied in planning retirement and living in retirement; it violated what many perceived as rules of the game—and it did so based on a single Congressional bill passed with a razor thin margin. We do not want to go too far here: we have no definitive basis for deciding which types of government actions have constitutional protection, and what sanctions are implied if such rules are broken. It is probably fair to say that nothing obviously terrible has yet happened to Medicare beneficiaries (who have yet to experience the access problems associated with low physician payments in Medicaid) but many of the consequences will only take place more than a decade after the legislation. Still, both the future trajectories of Social Security and Medicare spending relative to federal tax collections (both earmarked and total) are so dire that circumstances at some point may force a constitutional convention in which decades-long promises to seniors are reconsidered—probably with delayed application behind a veil of ignorance. The unpredictability and plasticity of Medicare spending will press the issue.

Conclusion

At this point using a public choice model largely raises unanswered questions about the problems it identifies, and does not provide an immediate recipe for what "we" should do. But that phenomenon was very much part of Buchanan's intellectual style, seeking first to identify and then begin to address the fundamental questions of what individual preferences are for collective action and how they might be translated (or mistranslated) into government efforts. "Looking through a new window" and "analyzing before action" were two bedrock characteristics of his approach. It is as much needed in this field as ever.

References

Buchanan, J. (1949). The Pure Theory of Government Finance: A Suggested Approach. *Journal of Political Economy, 57,* 496–505.
Buchanan, J. (1967). *Public Finance in Democratic Process*. Chapel Hill, NC: University of North Carolina Press.
Buchanan, J. (1968). Pure and Impure Goods. *The Demand and Supply of Public Goods* (Chapter 4). Carmel, IN: Liberty Fund.
Buchanan, J. (1969). *Cost and Choice*. Chicago: Markham Publishing.
Finkelstein, A., Hendren, N., & Shepard, M. (2017). Subsidizing Health Insurance for Low-Income Adults: Evidence from Massachusetts?

(NBER Working Paper 23668). National Bureau of Economic Research: Cambridge, MA.

Gladwell, M. (2005, August 29). The Moral-Hazard Myth. *The New Yorker*. Available at https://www.newyorker.com/magazine/2005/08/29/the-moral-hazard-myth.

Herring, B., & Lentz, L. K. (2011). What Can We Expect from the "Cadillac Tax" in 2018 and Beyond? *Inquiry, 48,* 322–327.

Pauly, M. (1970). Optimality, 'Public' Goods, and Local Governments: A General Theoretical Analysis. *Journal of Political Economy, 78,* 572–585.

Pauly, M. (1971). *Medical Care at Public Expense*. New York and London: Praeger.

Pauly, M. (2010). *Health Reform Without Side Effects: Making Markets Work for Individual Health Insurance*. Stanford, CA: Hoover Institution Press.

Phelps, C., & Parente, S. (2018). *The Economics of US Health Care Policy*. New York and London: Routledge.

11

Inconsistencies in the Finance of Public Services: Government Responses to Excess Demand

Andrew Abbott and Philip Jones

Introduction

Buchanan (1965) highlighted inconsistencies in the finance of public services when services are provided 'free of charge' at the point of delivery. Citizens' incentive, as 'consumers', is to increase demand. However, citizens' incentive (as 'voters') is to reject the required increase in general taxation. Buchanan argued that "*If the price elasticity of individual demand … is significantly higher than zero over the applicable range, government cannot efficiently 'give away' goods or services*" (p. 5). Focusing on the provision of health care in the UK National Health Service, he concluded that the "*…observed failures of the NHS…*" can be explained with reference to these inconsistencies (p. 4).

A. Abbott (✉)
Hull University Business School, University of Hull, Hull, UK
e-mail: a.abbott@hull.ac.uk

P. Jones
Department of Economics, University of Bath, Bath, UK
e-mail: p.r.jones@bath.ac.uk

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_11

Inconsistencies arise because "*…individuals make choices in two separate capacities, as buyers-sellers on ordinary markets for* <u>*private*</u> *goods and services and as buyers-sellers of public goods and services in the political process*" (author's emphasis, p. 11). In markets, citizens make choices as individuals, but in political processes "*…a choice implies…a willingness to finance stated quantities of a good or service for all members of the group through appropriately chosen taxes…*" (p. 11).

As 'voters', citizens are conscious that taxation is required to finance many services (e.g. education, social security). Wagner (2007) emphasises that there is no clear link between voting to increase general taxation and voting to finance a specific service. As 'taxpayers', citizens question the likelihood that they will require health care in the coming fiscal year and, as 'taxpayers', they are not as willing to spend as much on the provision of health care for others as they are to spend on provision for themselves.

Buchanan predicted severe shortages, but critics argued that the crises in the NHS have never been as severe as implied by Buchanan's analysis (Bosanquet 1986). They argued that cost containment measures and a growing affinity amongst voters for this form of government intervention averted the severity of NHS crises.

Buchanan emphasised that his objective was to highlight the inconsistencies that arise when there is a difference between 'consumers' incentives and 'taxpayers' incentives. In this chapter, the objective is to consider the way in which a divorce between receipt and payment for services is likely to influence governments' incentives. Buchanan invited readers to explore this question. He argued that: "*Alternative hypotheses concerning the behaviour of politicians can of course be advanced, and some of them might be of explanatory value*" (p. 15).

In section "Inconsistencies When Vote Maximising Governments Manage Excess Demand" attention focuses on the way that vote maximising governments are likely to respond when there is excess demand. With reference to the characteristics that scholars have attributed to vote maximising governments, the objective is to predict the way in which vote maximising governments are likely to respond. In later sections of the chapter the objective is to test the predictions formed in section "Inconsistencies When Vote Maximising Governments Manage

Excess Demand" of the chapter. As Buchanan focused on the National Health Service in the UK to illustrate his arguments, predictions are tested with reference to changes in the NHS.

The NHS was established in 1948 to provide health care to all citizens of the UK. It is funded by general taxation, with only a small supplementation from National Insurance Contributions and user charges (e.g. for prescriptions and dental treatment). Services are usually described as 'free at the point of delivery' because the proportion of income derived from user charges is very low.[1] Section "The Model and Data" of the chapter describes the data and the model used to test predictions. Section "Estimation Results" presents the results. Section "Conclusions" concludes by focusing on policy implications.

One of the most obvious indicators of excess demand in the NHS is the waiting list for non-urgent treatment. In the UK, every citizen must register with a general medical practitioner. The general practitioner acts as a 'gatekeeper'. When appropriate, the general practitioner refers a patient to a hospital consultant. After the consultant has made an assessment, the patient is likely to appear on a waiting lists for non-urgent admission to hospital. Figure 11.1 illustrates the waiting lists in the NHS between 1970 and 2007.

This list rose steadily (from 532,806 persons, rising to a peak of 745,980 persons in 1990) and fell progressively in the following two decades (to reach 226,893 persons in 2007). It is impossible to dismiss the importance of increases in government health expenditure. Government health spending increased from 3.4% of GDP in 1970 to 4.8% in 1996. Thereafter, spending increased rapidly in the remainder of the 1990s and rose to 6.9% of GDP in 2007. It continued to increase to 7.9% of GDP in 2015.[2] Figure 11.2 illustrates the size of the UK health sector compared to the rest of the OECD. Public current

---

[1]For example, 1.2% of income between 2007 and 2011 (Hawe and Cockroft 2013). Other countries (Australia, Canada, New Zealand and the Nordic countries) also rely heavily on general taxation (Mckenna et al. 2017).

[2]The average annual change in the spending ratio was 0.2% of GDP (1997–2015). Over the same period private expenditure on health also grew but not at the same rate, increasing from 0.5% of GDP in 1970 to 2.0% of GDP in 2015.

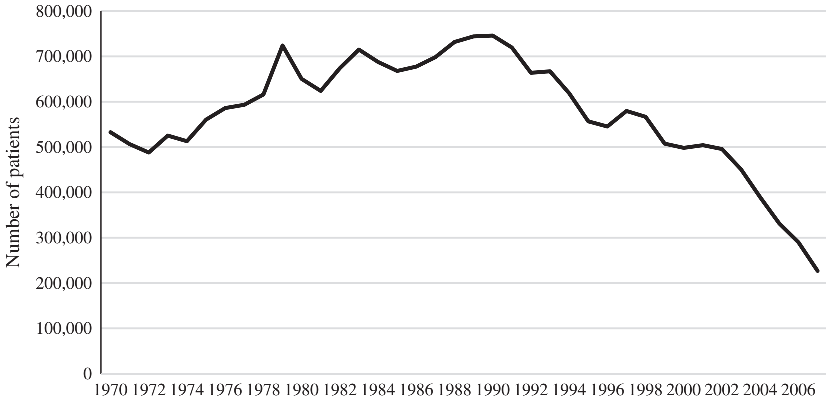


Fig. 11.1 Ordinary waiting list in the UK NHS, 1970–2008 (*Source* Department of Health UK)

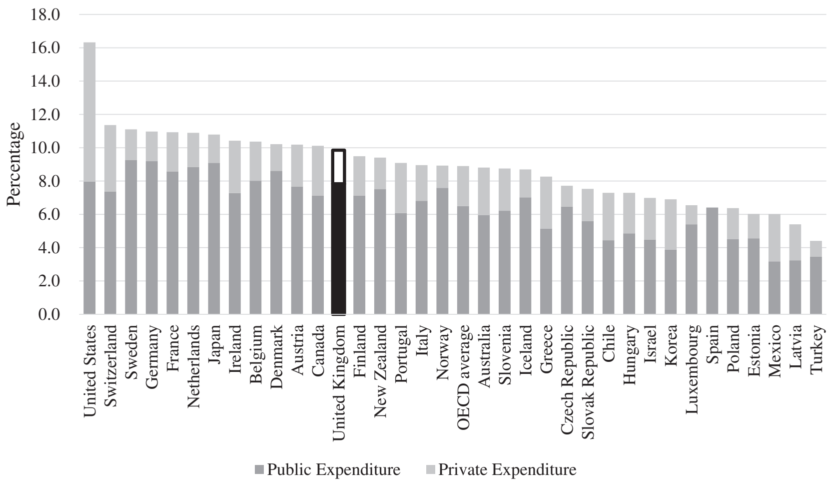


Fig. 11.2 Current health spending as a percentage of GDP: UK versus the OECD, 2013 (*Source* OECD Health Statistics)

expenditure on health services is 7.8% of GDP in 2013 compared to an average of 6.5% across the OECD, while private expenditure is only 2.0% of GDP, compared to an OECD average of 2.4%.

As Buchanan predicted, waiting lists have been endemic. However, Buchanan (1965, p. 22) also explained that "*…if we look at the* *experience of the NHS in the framework of theoretical welfare economics, we can infer nothing at all concerning the 'correctness' or 'incorrectness' of the collective decisions that have been made as regards overall or aggregate levels of provision*". In some countries, the absence of waiting lists might simply reflect the observation that large sections of the community are unable to afford health insurance (Culyer 1982). Other indicators of morbidity and mortality are likely to be relevant when comparing the performance of different institutional arrangements (Cullis and West 1979). While the waiting list is an indicator of excess demand, it is not easy to assess the welfare effects of changes in waiting lists in the absence of a clear estimate of the 'optimal' waiting list, and this might well differ from zero (Cullis and Jones 1983, 1985).[3] Buchanan focused on the 'weakness of the NHS' in terms of inconsistency; inconsistency between collective decisions "*…and the private or individual decisions on the demand side*" (p. 22).

Inconsistencies When Vote Maximising Governments Manage Excess Demand

In this section, the '*alternative hypothesis of politicians*' (Buchanan 1965) is that governments focus on maximising votes. Downs (1957) argued that governments win electoral support when they increase government spending and lose electoral support when they increase taxation. Buchanan identifies inconsistencies when the finance of public services increases demand without a commensurate increase in willingness to increase taxation. As vote maximising governments face the dichotomy that increased expenditure will win votes and increased taxation will lose votes, are vote maximising governments more likely to be adept in reconciling the inconsistencies that Buchanan identifies in the finance of public sector services?

[3]While changes in waiting times are also indicators of change in excess demand, changes in waiting lists are used in this paper because this data is available over a longer period.

Consider the characteristics of vote maximising governments and their implications when predicting responses to excess demand:

1. For vote maximising governments, the 'holy grail' is the opportunity to increase health expenditures without alerting taxpayers to an increase in taxation. With evidence of excess demand, there is an even stronger incentive to achieve this goal and rely on 'fiscal illusion'. Voters experience 'fiscal illusion' when they systematically under-estimate the costs of taxation (Puviani 1903). If excess demand exists (in part) because governments are unable to win taxpayer approval to increase taxation (and, if governments feel that they are likely to alienate taxpayers if they ask for approval), governments are likely to be attracted to measures that increase taxation without voters' approval.

   With reference to policy designed to manage waiting lists for health care in the UK, it is clear that revenue (available to increase expenditure) is extremely important if governments are to introduce initiatives to reduce excess demand. While governments in the UK have introduced demand-side reforms to reduce waiting lists in the UK, e.g. by providing patients with a wider choice of health care provider (in the public and private sector), it is impossible to dismiss the relevance of increased expenditure. When Smith and Sutton (2013, p. 307) assessed government policies, they concluded that "*…addressing supply side constraints was an especially important requirement for achieving the waiting time target…*".

   With this incentive to increase tax revenue, *how* are governments likely to rely on fiscal illusion when services are financed by general taxation? An established literature describes the circumstances in which voters systematically under-estimate taxation. In the literature on 'fiscal illusion' (see Oates 1988; Dollery and Worthington 1996; Dell'Anno and Mourao 2012 for surveys), voters are not likely to be as aware of general taxation when national income is increasing. In economic upturns, tax revenues increase automatically. There is no need to announce new taxes, or to announce new tax rates (e.g. Oates 1988; Abbott and Jones 2013). With progressive taxation, voters underestimate taxation when national income is increasing

(Craig and Heins 1980). In economic upturns, voters are more likely to underestimate taxation the higher the income elasticity of tax revenue (Abbott and Jones 2016). When national income is increasing it is easier to sustain (and even increase) government health expenditure. In economic downturns the reverse is true; voters are more sensitive to taxation and to the prospect of increases in taxation. Andersen and Nielsen (2008, p. 34) demonstrate that, in the OECD, a "*…lack of fiscal transparency…*" is more prevalent in economic upturns than in economic downturns.

With an even greater incentive to rely on 'fiscal illusion' (to address supply side constraints), vote maximising governments are likely to rely on procyclical tax revenues (on revenues that increase in economic upturns and decrease in economic downturns). With this characteristic of a vote maximising government, the first prediction is that:

(i) *Government tax revenues in the UK are likely to have been procyclical.*

2. A second characteristic of vote maximising governments is a tendency to focus more heavily on increasing expenditures on specific public sector programs. Downs (1960) argued that voters will prioritise expenditures on public sector programs that yield tangible and immediate benefits in their day-to-day lives. The implication is that voters prioritise expenditure on domestic services (such as health care and education). Voters are less likely to prioritise overseas expenditures (such as international aid and defence). When focusing on the likelihood that voters will undervalue public spending, Downs (1960, p. 541) noted that "*…this tendency is most obvious in international affairs, where economic and technical progress…spread a web of interdependency over the whole world…*".

   Questionnaire surveys have shed insight into voters' priorities. As Downs predicted, voters attach priority to domestic expenditures that might yield tangible, short term results (e.g. social security, health care, and education) rather than to intangible international expenditures that might yield long term results (e.g. international aid, international affairs) (see Jones (2006) for further analysis).

Focusing explicitly on health care, voters in the UK have consistently given priority to increasing spending on the National Health Service. Since 1983, the *British Social Attitudes Survey* has annually reported voters' first, or second, priority across a range of different public sector programs: Health; Education; Housing; Help for Industry; Police and Prisons; Defence; Public Transport; Roads; Social Security Benefits; Overseas Aid. By 2013, in "*…every year since 1983 the public put health at the top of its priority list for extra government spending…*" and "*…since 1985 at least 70 per cent of the public had prioritised the NHS (as either their first, or second, choice)…*" (Appleby and Roberts 2013, p. 99). Figure 11.3 describes a selection of the reported responses over the period. Far more voters attached priority to domestic expenditure (e.g. health care and education) than to overseas expenditures (e.g. international aid). More voters attached 'priority' to increased expenditure on health care than to any other programme.[4]

Vote maximising governments have a stronger incentive to increase expenditure when there is evidence of excess demand and when there is a large majority of voters calling for greater expenditure. This influences changes in the portfolio of government expenditures. There is an even greater likelihood that the distribution of public expenditures will reflect the 'tyranny of the majority' (de Tocqueville 1835).

The second prediction is that revenue-constrained vote maximising governments are likely to manage excess demand for health care by diverting expenditures from other services to increase expenditures on health care. When services are financed by general taxation, the second prediction is that:

[4]In the *British Social Attitudes Survey*, respondents sometimes indicate a preference for increased expenditure on health care even if this implies an increase in taxation (as an example, see Park et al. 2013). However, as Brook et al. (1998) have noted, *apparent* willingness to increase taxation is difficult to interpret. They demonstrate that in some questionnaire studies respondents have indicated that they are willing to increase taxation in order to increase public expenditure but, with closer analysis, when voters *appear* willing to increase taxation, they are willing to increase other citizens' taxes.

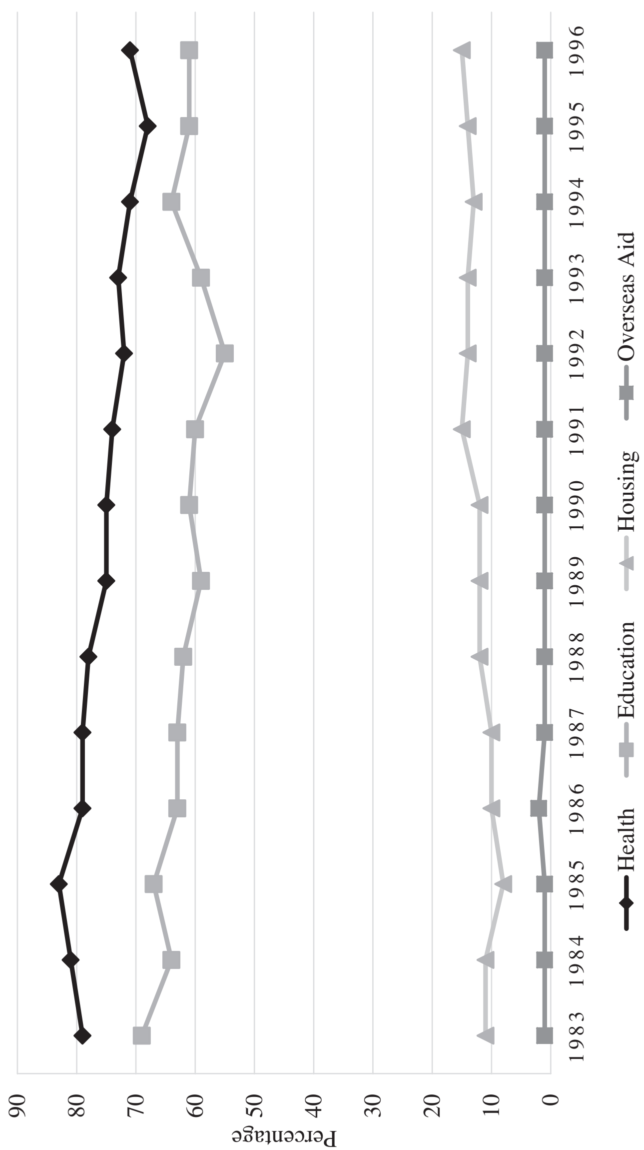


Fig. 11.3 First or second priorities for extra government spending in the UK, 1983–2012 (*Source* Park et al. 2013)

(ii) *Governments are likely to increase health expenditure at the expense of non-health expenditure.*

3. A third characteristic of vote maximising governments is that they operate with a very short time horizon. Their time horizon is, at most, the four- or five-year period that they are in office. Downs (1957, p. 174) argued that, if politicians focus on maximising votes, "…*governing parties are never interested* per se *in future return from actions; they are always concerned only about the next election and the vote they receive therein*".

   As political myopia is relevant when vote maximising governments make decisions concerning changes in taxation (Buchanan and Lee 1982a, b), political myopia is also likely to be relevant when focusing on the *way* vote maximising governments make changes to increase health expenditure. The proposition in this chapter is that there are specific occasions when vote maximising governments are likely to be particularly responsive to voters' concerns.

   Vote maximising governments are likely to be particularly wary of perceptions of excess demand in economic recessions. They are likely to be particularly wary of the prospect that excess demand might *increase* in an economic recession. As it is likely that both mental and physical health will deteriorate in recessions (see Artizumi and Schirle [2012] and Modrek et al. [2006] for literature reviews), vote maximising governments have an even greater incentive to increase expenditure in economic downturns.[5] With political myopia, they have an incentive to respond more urgently if they anticipate that there will be an increase in excess demand in a recession.

   In recessions the evidence, once again, suggests that voters' priorities are for the provision of health care. Figure 11.4 indicates that preferences to retain expenditures on health care are greater than preferences to retain any other public expenditure.

   A vote maximising government, wary of an *increase* in excess demand for health care in a recession, is more likely to spend

[5] Artizumi and Schirle (2012) review the literature and offer further insight based on experience in Canada. While Ruhm (2003) argues that mortality rates are lower during recessions, studies have usually referred to the harm created by recessions.

countercyclically on health care than on non-health programs. The third and fourth predictions are that:

(iii) *Government health expenditures are likely to be countercyclical in economic downturns.*
(iv) *Government health expenditures are more likely to be countercyclical in economic downturns than non-health expenditure.*

4. The fourth characteristic of a vote maximising government is that they are more willing to accommodate pressures from producer groups when the costs to consumers are not obvious (Peltzman 1976). If governments are vote maximising, they are more likely to respond to pressures from producer groups (to increase capital expenditures) when consumers of health care appear sanguine.

   Producer groups (as 'small' groups) are more effective lobbyists than consumer groups (e.g. Olson 1971; Becker 1983, 1985) and they are more interested in capital expenditures than consumer groups. Both consumers and producers might press for increases in *current* expenditures, but producers are more likely (than consumers) to press for increases in *capital* expenditures.[6]

   The implication is that, vote maximising governments are more likely to increase capital expenditure in economic upturns (when tax revenues are increasing), *as long as* consumers are not exercised by the excess demand that they are facing. While governments are more likely to increase capital expenditures in economic upturns, this tendency is likely to depend on the waiting list that consumers face. The higher the waiting list the greater the pressure to increase current health expenditures and the more obvious the cost to consumers (if governments increase capital expenditures at the expense of current expenditures). The fifth prediction is that:

[6]Producer groups are interested in increases in remuneration and increases in remuneration increase current expenditures. However, producers are relatively more likely to be interested in capital expenditures. With evidence that "*….individual voters…care most about public consumption goods or transfers… (and) business interests… (care most about) …the infrastructure….*" (Lane 2003, p. 2665), producers are likely to be *relatively* more effective, pressing (in economic upturns) for increases in capital expenditures.

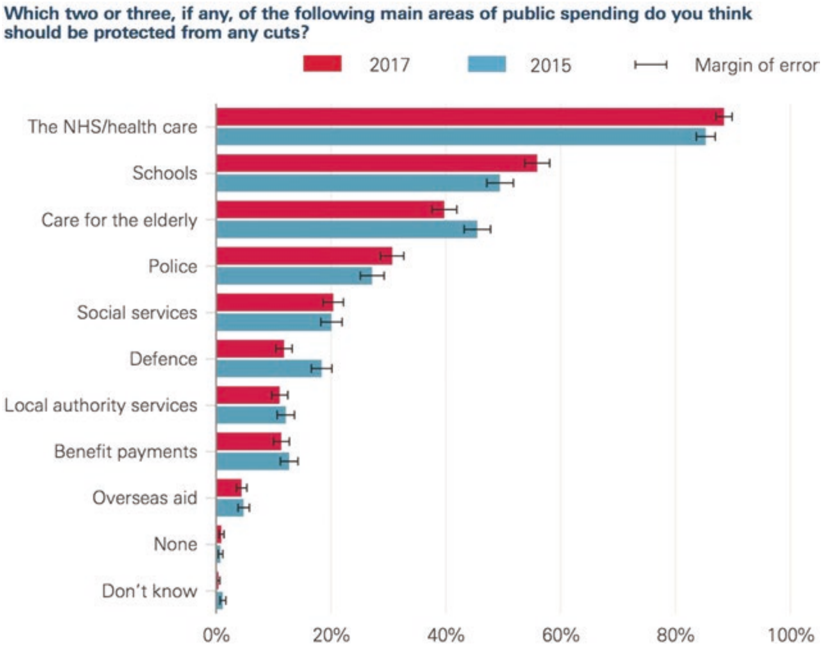


Fig. 11.4 Voters' priorities to retain expenditures in recessions (*Source* Health Foundation analysis of Ipsos MORI survey of 1985 adults in Great Britain 15 and over, May 2017, and Ipsos MORI survey of 1792 adults in Great Britain aged 15 and over, March 2015)

(v) *Capital expenditures are more likely to be lower in economic upturns the longer the waiting list.*

5. The final characteristic to be considered is the importance that vote maximising governments attach to the *timing* of elections. McNutt (2003, p. 9) argues that: "*The Downsian vote-maximising model of governments has found its greatest expression in the public choice literature of the political business cycle*".

In an endeavour to produce a 'feel good' factor, incumbents focus on improving short-term indicators of wellbeing when voters are able to express their preferences at the voting booth. A political business cycle is produced because, with the advent of an election, vote-maximising governments have an incentive to increase expenditure as a part of their election strategy, and "… *in the aftermath of* *an election ...(to) emphasise the need for fiscal rectitude...*" (McNutt 2003, p. 9).

The literature (e.g. Nordhaus 1975) that has explored vote-maximising governments' tendency to manipulate expenditures to win elections has focused on short-term macroeconomic indicators, e.g. "... *the level of inflation, unemployment changes, promotion of growth and income distribution objectives...*" (McNutt 2003, p. 9). This chapter is the first (to our knowledge) to question the extent to which incumbent vote maximising governments have an incentive to manipulate *excess demand* in election years.

Yates (1991) has emphasised the relevance of the promises (concerning waiting list and waiting times) that political parties have made in their electoral manifestoes. A promise to reduce waiting times featured in the Labour Party's 'pledge card' in the 1997 election (Appleby and Roberts 2013, p. 91) and when the party came to office in 1997 a reduction of the waiting list was "... *a high political priority*" (Smith and Sutton 2013, p. 299). However, in this chapter attention focuses on a vote maximising incumbent's incentive to increase government health expenditure. If vote maximising incumbents are likely to be even more wary that excess demand might increase in a recession, they are even more wary in election years. The final prediction is that:

(vi) *Health expenditures are even more likely to increase in economic downturns in election years.*

A vote maximising governments' incentive is to minimise the electoral damage experienced if an electorate were aware of the costs (in terms of taxation and in terms of reductions in other public sector expenditures) required to offset the emergence of severe excess demand. A vote maximising government's incentive is to minimise the electoral costs when accommodating pressures from producer groups and when facing the prospects of excess demand increasing in recessions. Vote maximising government have an incentive to reduce the likelihood of severe excess demand, especially in election years!

In sections "The Model and Data" and "Estimation Results" the objective is to test the relevance of predictions premised on received characteristics of vote maximising governments. The proposition is that these characteristics are relevant when explaining the way governments have managed excess demand in the National Health Service.

The Model and Data

Our first hypothesis is that UK government tax revenues will be procyclical. Adapting Akitoby et al. (2006) to investigate the cyclical properties of UK tax receipts, we estimate the following equation:

$$\Delta tr_t = \alpha_0 + \alpha_1 \Delta tr_{t-1} + \alpha_2 \Delta y_t + \alpha_3 tr_{t-1} + \alpha_4 y_{t-1} + \varepsilon_t \quad (11.1)$$

where tr denotes the log of total UK tax revenue, presented in millions of Pounds Sterling and based in constant 2010 prices, while y is the log of real GDP, also in millions of pounds, using the 2010 base year.

Data on tax revenues (again in constant prices) are collected from the OECD's Tax Statistics, while GDP data comes from the OECD's National Account Statistics. This Error Correction Model (ECM) allows the simultaneous estimation of both the short-run adjustment process as well as the long-run relationship. We add the lagged dependent variable Δtr_{t-1} to account for potential persistence in the growth of tax revenues, while Δy_t is included to estimate the cyclical relationship between GDP and tax revenues. The coefficient α_2 indicates the cyclicality of government revenues: if $\alpha_2 > 0$ then government revenues are found to be procyclical, while $\alpha_2 < 0$ indicates countercyclical government revenues. If Δy_t is statistically insignificant then tax revenues are acyclical. The above model can be estimated by Ordinary Least Squares using data that is available from 1970 to 2012.

The above specification can be adapted to also consider the cyclical properties of government expenditure on health, as well as the other functions of government spending. The following two equations enable us to test hypotheses (iii) and (iv):

$$\begin{aligned}\Delta h_t = \beta_0 + \beta_1 \Delta h_{t-1} + \beta_2 \Delta y_t^{+} \\ + \beta_3 \Delta y_t^{-} + \beta_4 h_{t-1} + \beta_5 y_{t-1} + \varepsilon_t\end{aligned} \quad (11.2)$$

$$\Delta nh_t = \delta_0 + \delta_1 \Delta nh_{t-1} + \delta_2 \Delta y_t^+ + \delta_3 \Delta y_t^- + \delta_4 nh_{t-1} + \delta_5 y_{t-1} + \varepsilon_t \quad (11.3)$$

where h denotes the current government expenditure on health services, while nh denotes current spending on all other functions of government than health services i.e. non-health expenditure. Data on total government expenditure is taken from the OECD National Accounts and used to calculate the series for non-health spending, from the difference between total spending and health expenditure, which we take from the OECD Health Statistics. The specifications of (11.2) and (11.3) differ from (11.1) through the inclusion of Δy_t^+ and Δy_t^-, which account for potential asymmetric responses of government spending over the business cycle.[7] We therefore test for differences in the cyclical response of spending between upturns and downturns. Upturns are defined as those periods when the actual level of output is above the trend level i.e. a positive output gap $\left(\Delta y_t^+\right)$, whereas downturns are those periods when the actual output is below trend $\left(\Delta y_t^-\right)$. So $\Delta y_t^+ \neq 0$ and equals Δy_t, when Δy_t takes a positive value and zero otherwise, while $\Delta y_t^- \neq 0$ (and equals Δy_t) when Δy_t takes a negative value and zero otherwise. Hypothesis (iii) suggests that health expenditures should be countercyclical in economic downturns, implying that Δy_t^- should be statistically significant and $\beta_3 < 0$. We can test hypothesis (iv) by comparing the statistical significance of Δy_t^- from (11.3) with the same variable in (11.2), as well as the sign of the estimated coefficient δ_3 relative to β_3.

To consider the cyclical properties of capital expenditure and particularly the influence of waiting lists on cyclicality during economic upturns from hypothesis (v), we adapt (11.2) to estimate the following:

$$\Delta kh_t = \theta_0 + \theta_1 \Delta kh_{t-1} + \theta_2 \Delta y_t^+ + \theta_3 \Delta y_t^- + \theta_4 \left(\Delta y^+ \times wl\right)_t + \theta_5 \left(\Delta y^- \times wl\right)_t + \theta_6 kh_{t-1} + \theta_7 y_{t-1} + \varepsilon_t \quad (11.4)$$

[7] Gavin and Perotti (1997) found fiscal policy responds asymmetrically in industrial countries but not in developing countries. Arena and Revilla (2009) find for the state governments of Brazil that fiscal expenditures were more procyclical during economic downturns than upturns, though the degree of procyclicality is broadly similar for government revenues.

where kh_t refers to the gross fixed capital formation (all types of assets) in the health sector, expressed in constant Pounds Sterling, using the 2010 base year. We utilise the available data from the OECD Health Statistics, where capital formation is defined for the whole health sector, which is 80% accounted for by the public sector in the UK. The variable wl refers to the Ordinary Waiting List, which is the total number of patients waiting for treatment coming from the Inpatient Waiting List dataset of the UK's Department of Health. This dataset is calculated from information given by health care providers and refers to patients who are waiting for treatment in hospital but excludes day cases. The annual series is calculated from an average of the four quarterly observations provided. The interaction terms $(\Delta y^{+} \times wl)_t$ and $(\Delta y^{-} \times wl)_t$ show the influence of the waiting list on the cyclicality of capital expenditure during upturns and downturns. Support for our hypothesis '*capital expenditures are more likely to be lower in economic upturns the higher the waiting list*', arises provided $(\Delta y^{+} \times wl)_t$ is statistically significant and $\theta_4 < 0$.

Our final hypothesis considers the consequences of elections on the cyclicality of UK government health expenditure. We focus our attention on general elections for the UK national government only, since the UK has a highly centralised system of government. For example, the OECD's General Government Accounts indicate that in 2012, 77% of UK government expenditure is concentrated in the central government sector, while 74% of all revenue raised flows to central government. By contrast, the OECD averages 43% of all expenditure at central government level in 2012 and 37% of all revenue raised. The influence of elections on the cyclicality of UK government current health expenditure can be estimated by amending (11.2) to estimate the following:

$$\begin{aligned}\Delta h_t = \lambda_0 + \lambda_1 \Delta h_{t-1} + \lambda_2 \Delta y_t^{+} + \lambda_3 \Delta y_t^{-} + \lambda_4 (\Delta y^{+} \times elec)_t \\ + \lambda_5 (\Delta y^{-} \times elec)_t + \lambda_6 h_{t-1} + \lambda_7 y_{t-1} + \varepsilon_t\end{aligned} \tag{11.5}$$

where elec is a dummy variable that equals one during a general election year and zero otherwise. The interaction terms $(\Delta y^{+} \times elec)_t$ and $(\Delta y^{-} \times elec)_t$ allow us to test whether cyclicality of government current health expenditure differs during election years compared to all periods in the sample. While this is done separately for both upturns and downturns, the proposition is that elections are particularly relevant in economic downturns. If vote maximising governments are likely to increase government expenditures in economic downturns, governments increase spending in election years if the coefficient λ_5 on the interaction term $\left(\Delta y^{-} \times \text{elec}\right)$ will be even more negative than the coefficient λ_3 on Δy_t^{-}.

Estimation Results

Around 80% of UK health expenditure is funded through the public sector, compared to 73% in the OECD. Supported by voters' preferences for higher health spending over and above other functions of government, spending on health care grew from 4.2% of GDP in 1970 to 9.1% of GDP in 2012 (see Fig. 11.5). The growth in government expenditure in other functions has fallen from 14.1% in 1970 to 12.8% in 2012. As a result, health's share of overall government spending has risen from 22.7% in 1970 to 41.7% in 2012. This finding is consistent with our second hypothesis that '*governments are likely to increase health expenditure at the expense of non-health* expenditure'. This additional spending resulted in more capacity for health services, resulting in a falling waiting list (see Fig. 11.1).

As a pre-cursor to the estimation of the cyclicality equations, to test our hypotheses it is necessary to investigate the time series properties of the variables used. Specifically, to consider the order of integration of the variables used for estimation and to ensure the level of each series has a unit root as well as being first difference stationary. Table 11.1 presents unit root test statistics based on the Phillips-Perron test (Phillips and Perron 1988) for the order of integration. The Phillips-Perron statistics are the same as Dickey-Fuller (Fuller 1996) regressions but with a non-parametric correction made to the t-statistics (unit root tests), making them robust to serial correlation. Results are presented assuming two forms of deterministic components: (i) a constant only and (ii) a constant plus trend. For all series in levels we cannot reject the null hypothesis of a unit root while also finding them to be first-difference stationary.

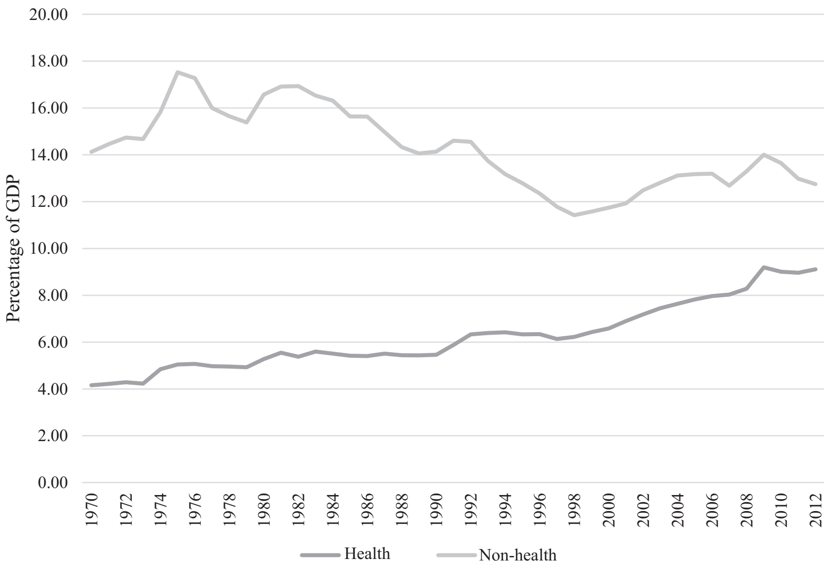


Fig. 11.5 UK Health versus non-health spending, 1970–2012 (*Source* OECD Health Statistics and National Accounts)

We can therefore proceed to the estimation of the relevant Error Correction Models presented in (11.1) to (11.4).

The results of estimating (11.1) by OLS are presented in Table 11.2. We find that Δy_t is statistically significant and α_2 is positively signed as expected. This implies that tax revenues in the UK are procyclical, consistent with our first hypothesis. The diagnostic tests also suggest an absence of residual serial correlation up to 1st and 2nd order serial correlation. Evidence of procyclical tax revenues is also supported by Talvi and Vegh (2005) and Arena and Revilla (2009).

To consider the cyclical properties of current health expenditure, we estimate (11.2) using data on UK government health consumption. The inclusion of Δy_t^+ and Δy_t^- allows us to estimate separately the cyclical responses of health spending during both upturns and downturns. The results presented in Table 11.3 indicate that current health expenditure is procyclical, but only during periods of economic downturns. We find that Δy_t^- is statistically significant and the estimated coefficient (β_3 from 11.2) is negatively signed, with an estimate of -0.624.

Table 11.1 Philips-Perron unit root tests

Variable	Z_t test statistic	
	Constant only	Constant plus trend
tr	−0.382	−2.594
Δtr	−4.967*	−4.898*
h	0.512	−1.686
Δh	−4.797*	−4.697*
nh	−2.379	−1.842
Δnh	−2.621**	−3.147*
kh	−1.664	−2.708
Δkh	−6.843*	−6.841*
y	−0.756	−1.646
Δy	−4.235*	−4.226*

Notes Phillips-Perron unit root tests (Phillips and Perron 1988) are calculated for all series over the 1970–2012 estimation period, assuming two forms of deterministic components: (1) Where the unit root regression includes a constant only; (2) Where both a constant and trend are included. In all cases, a maximum of three lags were chosen to undertake the Newey-West non-parametric correction that controls for serial correlation. The interpolated Dickey-Fuller (Fuller 1996) critical values at the 5% level are −2.95 and −3.53 respectively for models including a constant only or constant plus trend. The equivalent 10% values are −2.61 and −3.20
*Indicates significance at the 5% level; and **indicates 10% significance

Table 11.2 The procyclicality of UK tax revenues

Variable	
Constant	−0.344 (−1.41)
Δtr_{t-1}	0.346* (2.29)
Δy_t	0.632* (2.23)
tr_{t-1}	−0.332* (−2.80)
y_{t-1}	0.332* (2.82)
Serial correlation tests	
$\chi^2(1)$	0.06
$\chi^2(2)$	3.21

Notes Estimates are derived from Ordinary Least Squares (OLS) estimation using data from 1970 to 2012. T-ratios are presented in parentheses, calculated from robust standard errors. Durbin's alternative test for serial correlation is presented for up to 1st and 2rd order serial correlation
*Indicates significance at the 5% level

Table 11.3 The procyclicality of UK current health expenditure

Variable	
Constant	−1.989* (−3.64)
Δh_{t-1}	0.143 (1.13)
Δy_t^+	−0.035 (−0.12)
Δy_t^-	−0.624* (−2.28)
h_{t-1}	−0.202* (−3.80)
y_{t-1}	0.308* (3.78)
Serial correlation tests	
$\chi^2(1)$	1.05
$\chi^2(2)$	1.65

Note See Table 11.1

Negative output shocks cause governments to stimulate health expenditure. This might be, for example, in response to a deterioration in mental or physical health during recessions. We can therefore support our third hypothesis that '*government health expenditures are likely to be countercyclical in economic downturns*'. By comparison, Δy_t^+ is statistically insignificant, implying that health expenditure is acyclical during economic upturns.

The results of estimating (11.3) for non-health expenditure are presented in Table 11.4. Consistent with health expenditures, we find that Δy_t^+ is statistically insignificant, implying acyclicality during economic upturns. In contrast, Δy_t^- is statistically significant and the estimated δ_3 coefficient positively signed, with a magnitude of 0.484. Negative economic shocks are consistent with a fall in government expenditures that are not health related. Interestingly, these results imply a substitution effect, whereby during economic downturns governments increase spending on health at the expense of non-health sectors. Indeed, as the evidence presented in Fig. 11.5 suggests, following the financial crisis in 2007/2008, UK health expenditures have been sustained at around 9% of GDP, while the non-health expenditure-GDP ratio fell from 14% in 2009 to 12.75% in 2012.

The influence of waiting lists on the cyclicality of current health expenditure, through the estimation of (11.4), is considered in Table 11.5. In light of our hypothesis that '*capital expenditures are more likely to be lower in economic upturns the longer the waiting list*',

Table 11.4 The procyclicality of UK current non-health expenditure

Variable	
Constant	1.493* (3.01)
Δnh_{t-1}	0.327* (2.65)
Δy_t^+	−0.359 (−1.38)
Δy_t^-	0.484* (2.30)
nh_{t-1}	−0.186* (−3.32)
y_{t-1}	0.056* (3.11)
Serial correlation tests	
$\chi^2(1)$	1.60
$\chi^2(2)$	1.83

Note See Table 11.1

Table 11.5 The procyclicality of UK health capital formation

Variable	
Constant	−0.499 (−0.34)
Δkh_{t-1}	−0.398** (−1.89)
Δy_t^+	7.317** (1.98)
Δy_t^-	8.856 (1.32)
$(\Delta y^+ \times wl)_t$	−0.00001* (−2.02)
$(\Delta y^- \times wl)_t$	−0.000008 (−0.99)
kh_{t-1}	−0.234 (−1.08)
y_{t-1}	0.178 (0.81)
Serial correlation tests	
$\chi^2(1)$	3.27
$\chi^2(2)$	4.50

Notes See Table 11.1
*Indicates significance at the 5% level
**Indicates significance at the 10% level

our interest rests on the statistical significance of the interaction term $\left(\Delta y^+ \times wl\right)_t$ and the sign of the estimated coefficient θ_4. Consistent with our maintained hypothesis, we find that $\left(\Delta y^- \times wl\right)_t$ is statistically significant and the estimated coefficient negatively signed, albeit with a small magnitude of −0.00001.

Finally, our sixth hypothesis implies that the cyclicality of current health expenditure should be influenced by the electoral cycle. Specifically, a larger cyclical response should be expected during the election years. Therefore, the focus of our analysis is on the interaction terms $\left(\Delta y^+ \times elec\right)_t$ and $\left(\Delta y^- \times elec\right)_t$ in (11.5). The results

Table 11.6 The procyclicality of UK current health expenditure and the influence of elections

Variable	
Constant	-1.703^{*} (−3.25)
Δh_{t-1}	0.163 (1.72)
Δy_t^+	0.055 (0.22)
Δy_t^-	-0.606^{*} (−2.96)
$(\Delta y^+ \times \text{elec})_t$	0.440 (0.94)
$(\Delta y^- \times \text{elec})_t$	-3.461^{*} (−5.47)
h_{t-1}	-0.165^{*} (−3.36)
y_{t-1}	0.257^{*} (3.35)
Serial correlation tests	
$\chi^2(1)$	1.11
$\chi^2(2)$	2.50

Note See Table 11.1

from this estimation are presented in Table 11.6 for UK current health expenditures. Consistent with the findings presented in Table 11.3 we find that Δy^- is statistically significant and the estimated λ_3 coefficient is negatively signed, with a magnitude of −0.606. The associated interaction term $(\Delta y^- \times \text{elec})_t$ is also statistically significant and the estimated λ_5 coefficient negatively signed, with a larger than anticipated magnitude of 3.461. This result implies a very much larger cyclical response during general election years compared to all other years in the sample period. Interestingly, consistent with the results presented in Table 11.3, Δy_t^+ is statistically insignificant, implying the cyclical response during economic upturns is not affected by the electoral cycle.

Conclusions

In response to Buchanan's suggestion (that his analysis might be considered with reference to different assumptions of the way that governments behave), this chapter has focussed on the way that vote maximising governments are likely to manage excess demand for public-sector services. Buchanan (1965) focused on the way that the divorce between 'receipt' and 'payment' for public sector services influences 'consumers' and 'taxpayers' incentives. This chapter has focused on the way that excess demand (created by the divorce between 'receipt' and 'payment' for public-sector services) influences governments' incentives.

With reference to characteristics attributed to vote maximising governments, the evidence in this chapter is consistent with the prediction that governments' incentive is to minimise voters' awareness of increases in taxation and redistribution across public expenditure programmes required to manage excess demand:

(i) Vote maximising governments have an even greater incentive to rely on 'fiscal illusion' (to reduce supply-side constraints). Taxonomies of government failure (e.g. Wolf 1989) are helpful, but the analysis in this chapter highlights the relevance of the relationships *between* government failures. Some government failures (e.g. fiscal illusion) are likely to complement other failures (e.g. the divorce between receipt and payment for government services).

(ii) As vote maximising governments are unlikely to raise sufficient tax revenue to resolve the problem of excess demand, they have an incentive to divert expenditure from less popular expenditures to more popular expenditures. A beneficent government would address the merits of different expenditure programmes. A vote maximising government focuses on electoral returns (the votes they might win by increasing the provision of health care at the expense of expenditure on non-health care programmes). For voters, the link between revenue raised as general taxation and the provision of specific public expenditure programmes is not likely to be obvious (Buchanan 1965; Wagner 2007). However, vote maximising governments have an incentive to rely on mechanisms that will divert expenditures from voters' low priority programs to reduce excess demand in voters' high priority programs.

(iii) In an attempt to minimise loss of electoral support, myopic governments (with, at most, a four- or five-year electoral horizon) act with urgency in economic recessions to mitigate the fear that excess demand might *increase*. Governments have increased expenditure on health care counter cyclically (to divert resources from non-health expenditure programs).

(iv) Vote maximising governments have also been more willing to accommodate producer group pressure to increase capital expenditure when voters are not likely to be as aware of any diversion of current expenditure (Peltzman 1976). They have been more likely to increase capital expenditure in economic upturns, when waiting lists are falling.

(v) In economic downturns governments have increased health expenditures to manipulate waiting lists in election years.

Vote maximising governments manage excess demand to minimise voters' awareness of the severity of shortages. With the assumption that governments are vote maximising, Buchanan's analysis does not imply the same severity of shortage in the NHS as implied by Buchanan's critics.

When vote maximising governments compete for votes, they minimise voters' awareness of the costs of supporting policies that increase the affordability of health care, to reduce the likelihood that voters might feel that they are acting 'irrationally'. Patrick and Wagner (2015) consider Pareto's (1935 [1923]) distinction between 'logical' and 'non-logical action': Individuals rely on logical action when "… there is a clear connection between the action someone takes and the consequence that the chooser experiences" (Patrick and Wagner 2015, p. 114). They rely on non-logical action when this connection is not obvious and, when this connection is not obvious, Brennan and Lomasky (1993) argue that citizens vote expressively (e.g. to 'feel good about themselves').

Patrick and Wagner (2015, p. 110) also note that: "Pareto recognised a universal desire of people to feel good about themselves and their actions". However, Pareto argued that individuals feel good about themselves when they feel they have also acted rationally. If voters support policies that increase the affordability of health care, it is also important that they are able to persuade themselves, and others, that their decision is premised on "…rational sounding statements…" (Patrick and Wagner 2015, p. 110). In this context, political "…

competition…consists of seeking to *articulate* programs and actions that resonate with the sentiments that govern action" (pp. 110–111, our emphasis). The evidence in this chapter is consistent with the proposition that governments engaged in this form of political competition. When managing excess demand, they engage in competition by relying on measures that minimise voter awareness of the costs of the policy that voters have supported.

Pauly (2002) notes that the inconsistencies that Buchanan identified are a reflection of the 'moral hazard' that exists when individuals are able to consume health care 'free' at the point of delivery. In 1965 and later in 1990 (when addressing the problem of containing the costs of health care), Buchanan proposed a process that might limit the availability of public provision of health care. In 1990 he focused on the more general problem that is created if the demand for health care is lexicographic. When demand is lexicographic it is difficult to contain costs because, "*…whatever is necessary (for health care)… does not compete with other outlays*" (p. 6). As in 1965, he called for cost containment behind a 'veil of uncertainty'. Behind the 'veil', citizens would agree on the limits of publicly-provided health care that should apply to members of the community. After noting the irony in this "*… interesting argument for government or socialised decision making*" (p. 13), Buchanan highlighted the difficulties inherent in putting this into practice. When assessing whether governments are likely to meet the challenge of containing health care costs, the evidence in this chapter suggests that vote maximising governments are unlikely to 'grasp the nettle'. Even if Buchanan's prescription were feasible, they would not have the incentive to introduce this process.

The overarching conclusion in this chapter is that assumptions concerning the way that governments behave are of paramount importance when analysing governments' response to excess demand for public services. Vote maximising governments are unlikely to address the *essence* of the problem of excess demand. Vote maximising governments are more likely to rely on measures intended to reduce voters' awareness of the problem of excess demand.

References

Abbott, A., & Jones, P. (2013). Procyclical Government Spending: A Public Choice Analysis. *Public Choice, 154,* 243–258.

Abbott, A., & Jones, P. (2016). Fiscal Illusion and Cyclical Government Expenditure: State Government Expenditure in the United States. *Scottish Journal of Political Economy, 63,* 177–193.

Akitoby, B., Clements, B., Gupta, S., & Inchauste, G. (2006). Public Spending, Voracity and Wagner's Law in Developing Countries. *European Journal of Political Economy, 22,* 908–924.

Andersen, A. L., & Nielsen, L. H. W. (2008). *Fiscal Transparency and Procyclical Fiscal Policy*. University of Copenhagen. Available at http://www.econ.ku.dk/eprn_epru/Workings_Papers/wp-10-01.pdf.

Appleby, J., & Roberts, C. (2013). Health: How Have the Public's Views of the NHS Changed Over the Last 30 Years. In A. Park, C. Bryson, E. Clery, J. Curtice, & M. Phillips (Eds.), *British Social Attitudes: The 30th Report* (pp. 87–114), London: NatCen Social Research.

Arena, M., & Revilla, J. (2009). *Pro-cyclical Fiscal Policy in Brazil: Evidence from the States* (World Bank, Policy Research Working Paper No. 5144).

Artizumi, H., & Schirle, T. (2012). Are Recessions Really Good for Your Health? Evidence from Canada. *Social Sciences and Medicine, 74,* 1224–1231.

Becker, G. S. (1983). A Theory of Competition Among Pressure Groups for Political Influence. *Quarterly Journal of Economics, 98,* 371–400.

Becker, G. S. (1985). Public Policies, Pressure Groups and Deadweight Costs. *Journal of Public Economics, 28,* 329–347.

Bosanquet, N. (1986). Inconsistencies of the NHS: Buchanan Revisited. In A. Culyer & B. Jőnsson (Eds.), *Public and Private Health Services: Complementarities and Conflict* (pp. 101–111). Oxford: Basil Blackwell.

Brook, L., Preston, I., & Hall J. (1998). *What Drives Support for Higher Public Spending?* (Institute for Fiscal Studies Working Paper No. W97/16).

Brennan, G., & Lomasky, L. (1993). *Democracy and Decision: The Pure Theory of Electoral Preference*. Cambridge: Cambridge University Press.

Buchanan, J. M. (1965). *The Inconsistencies of the National Health Service*. London: Institute of Economic Affairs.

Buchanan, J. M. (1990). *Technological Determinism Despite the Reality of Scarcity*. Little Rock: University of Arkansas for Medical Sciences.

Buchanan, J. M., & Lee, D. R. (1982a). Tax Rates and Tax Revenues in Political Equilibrium. *Economic Inquiry, 20,* 344–354.
Buchanan, J. M., & Lee, D. R. (1982b). Politics, Time and the Laffer Curve. *Journal of Political Economy, 90,* 816–819.
Craig, E. D., & Heins, J. A. (1980). The Effect of Tax Elasticity on Government Spending. *Public Choice 35*, 267–275.
Cullis, J. G., & Jones, P. R. (1983). In-patient Waiting: A Discussion and a Policy Proposal. *British Medical Journal, 287*, 1483–1486.
Cullis, J. G., & Jones, P. R. (1985). National Health Service Waiting Lists: A Discussion of Competing Explanations and a Policy Proposal. *Journal of Health Economics, 4*, 199–235.
Cullis, J. G., & West, P. A. (1979). *The Economics of Health: An Introduction*. Oxford: Martin Robertson.
Culyer, A. (1982). Health Care and the Market: A British Lament. *Journal of Health Economics, 1*(3), 299–303.
de Tocqueville, A. (1835). *Democracy in America* (Reprint ed.). Oxford: Oxford University Press.
Dell'Anno, R., & Mourao, P. (2012). Fiscal Illusion Around the World: An Analysis Using the Structural Equation Approach. *Public Finance Review, 40,* 270–299.
Dollery, B. E., & Worthington, A. (1996). The Empirical Analysis of Fiscal Illusion. *Journal of Economic Surveys, 10*, 261–297.
Downs, A. (1957). *An Economic Theory of Democracy*. New York: Harper Row.
Downs, A. (1960). Why the Government Budget Is Too Small in a Democracy. *World Politics, 12,* 541–563.
Fuller, W. A. (1996). Introduction to Statistical Time Series (2nd ed.). New York: Wiley.
Gavin, M., & Perotti, R. (1997). Fiscal Policy in Latin America. In B. S. Bernanke & J. J. Rotemberg (Eds.), *NBER Macroeconomics Annual* 1997 (pp. 11–72). Cambridge: MIT Press.
Hawe E., & Cockroft, L. (2013). *OHE Guide to UK Heath Care Statistics* (2nd ed.). London: Office of Health Economics. Available at https://www.ohe.org/news/updated-ohe-guide-uk-health-and-health-care-statistics. Accessed August 18, 2017.
Health Foundation. (2017). *What Does the Public Think About NHS and Social Care Services?* Results from an Ipsos Mori Poll Commissioned by the Health Foundation, Longacre, London. Available at https://www.health.org.uk/sites/health/files/Polling2017_web.pdf.

Jones, P. (2006). Taking Self-Interest into Account: A Public Choice Analysis of International Cooperation. In I. Kaul & P. Conceição (Eds.), *The New Public Finance Responding to Global Challenges* (pp. 304–324). Oxford: Oxford University Press.

Lane, P. (2003). The Cyclical Behaviour of Fiscal Policy: Evidence from the OECD. *Journal of Public Economics, 87,* 2661–2775.

McKenna, H., Dunn, P., Northern, E., & Buckley, T. (2017). *How Health Care Is Funded*. London: The Kings Fund.

McNutt, P. (2003). *The Economics of Public Choice* (2nd ed.). Cheltenham: Edward Elgar.

Modrek, S., Stuckler, D., McKee, M., Mark, C., & Basu, S. (2006). A Review of Health Consequences of Recessions Internationally and a Synthesis of the US Response During the Great Recession. *Public Health Review, 35,* 1–33.

Nordhaus, W. (1975). The Political Business Cycle. *Review of Economic Studies, 42,* 169–190.

Oates, W. (1988). On the Nature and Measurement of Fiscal Illusion: A Survey. In G. Brennan, B. S. Grewel, & P. Groenewegn (Eds.), *Taxation and Fiscal Federalism: Essays in Honour of Russell Matthews* (pp. 65–82). Sydney: ANU Press.

Olson, M. Jr. (1971). *The Logic of Collective Action: Public Goods and the Theory of Groups*. Cambridge, MA: Harvard University Press.

Pareto, V. (1935 [1923]). *The Mind and Society: A Treatise on General Sociology*. New York: Harcourt Brace.

Park, A., Bryson, C., Clery, E., Curtice, J., & Phillips, M. (Eds.). (2013). *British Social Attitudes: The 30th Report*. London: NatCen Social Research. Access online at www.bsa-30.natcen.ac.uk.

Patrick, M., & Richard, W. (2015). From Mixed Economy to Entangled Economy: A Paretian Social-Theoretic Orientation. *Public Choice, 164,* 103–116.

Pauly, M. V. (2002). James Buchanan as a Health Economist. In G. Brennan, H. Kliemt, & R. D. Tollison (Eds.), *Method and Morals in Constitutional Economics: Essays in Honor of James M. Buchanan* (pp. 401–409). Berlin and Heidelberg: Springer-Verlag.

Peltzman, S. (1976). Toward a More General Theory of Regulation. *Journal of Law and Economics, 19,* 211–240.

Phillips, P. C. B., & Perron, P. (1988). Testing for a Unit Root in Time Series Regression. *Biometrika, 75*, 335–346.

Puviani, A. (1903). *Teoria della illusione finanziaria*. Palermo: Sandron.
Ruhm, C. J. (2003). Good Times Make You Sick. *Journal of Health Economics, 24*, 637–658.
Smith, P. C., & Sutton, M. (2013). United Kingdom. In S. Luigi, B. Michael, & M. Valerie (Eds.), *Waiting Time Policies in the Health Sector: What Works? OECD Health Policy Studies* (pp. 293–323). Paris: OECD.
Talvi, E., & Végh, C. A. (2005). Tax Base Variability and Procyclical Fiscal Policy in Developing Countries. *Journal of Development Economics, 78*, 156–190.
Wagner, R. E. (2007). *Fiscal Sociology and the Theory of Public Finance: An Exploratory Essay*. Cheltenham: Edward Elgar.
Wolf, C. (1989). *Markets or Governments: Choosing Between Imperfect Alternatives*. Cambridge: MIT Press.
Yates. J. (1991). Lies, Damned Lies and Waiting Lists. *British Medical Journal, 303*, 800–802.

12

The Unproductive Protective State: The U.S. Defense Sector as a Fiscal Commons

Christopher J. Coyne and Thomas K. Duncan

Introduction

In *The Limits of Liberty*, James Buchanan (1975) set up the juxtaposition of the "protective state" and the "productive state." In doing so, he expounded upon the paradox of governance (1975, pp. 91–106), citing the confusion that arises when the state crosses the bounds of the

Earlier versions of this paper were presented at the Southern Economic Association Annual Meeting in New Orleans, LA, November 23, 2015, Washington, DC, November 20, 2016, and at the Association of Private Enterprise Education Annual Meeting in Las Vegas, NV on April 4, 2018. We would like to thank participants for their comments and suggestions. We would also like to thank the College of Business and Economics at Radford University for its generous support.

C. J. Coyne (✉)
Department of Economics, George Mason University, Fairfax, VA, USA
e-mail: ccoyne3@gmu.edu

T. K. Duncan
Department of Economics, Radford University, Radford, VA, USA
e-mail: tduncan13@radford.edu

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_12

analytically separated roles. These roles are, indeed, analytically separate. As described by Buchanan, the "task or role of the protective state is to insure that the terms of the conceptual contractual agreement are honored, that rights are 'protected'" (1975, p. 95). The purpose of the productive state, in contrast, "is the constitutional process through which citizens accomplish jointly desired objectives, a means of facilitating complex exchanges *among* separate citizens…" (1975, p. 97, emphasis original). In the former, the state "ideally must be external to and divorced from the individuals or groups whose rights are involved" (1975, p. 95) yet in the latter, "government is *internal* to the community, and meaningful political decisions can only be derived from individual values as expressed at the time of decision or choice" (1975, p. 97, emphasis original). While it is true that these roles can be clearly distinguished for the purposes of academic exercises in the study of ideal governance, when these concepts become operationalized in practice the distinctions can quickly become a quagmire of confusion in constitutional political economy.

For the state to have protective capabilities, it must have the means of enforcing contracts and protecting the rights of its citizens. This necessity indicates that the protective state cannot exist within a vacuum. Rather, it must carry out some of the role of the productive state or be unable to function in the other role (see Buchanan 1975, p. 98). The analytical separation quickly erodes as the state must take on both roles, but the risk of the state performing both is that there is an opportunity for it to perform neither function effectively. When the shifting roles force the state to leave behind its "external" nature and become "internal to the community" there is an inherent risk of the state slipping into a third category: the unproductive or predatory state. Nowhere is this risk more apparent than in the state's role of providing for the national defense, an area where the roles of protective and productive state directly overlap. It is in this space, and the resulting military-industrial complex, that this chapter focuses. Specifically, we craft an institutional explanation for why scarce public resources are squandered on a large scale to produce outputs that do not contribute to the public good of national security. To highlight the importance that the institutional arrangement has on incentives in the defense sector, we will utilize Buchanan's (1949, 1967, 1975) insights into the theory of public finance in conjunction with Ostrom's (1990) insights regarding the commons. We also draw on insights from the American military sector to illustrate the core theoretical points.

Our argument consists of two central parts. The first is an appreciation of the incompleteness and inaccuracy of the widely accepted view that state-provided defense is everywhere an economic good that is produced in value-added quantities and qualities (see Dunne 1995; Smith 1995; Fischer and Brauer 2003; Coyne 2015). The "standard neoclassical model of the demand for military expenditures assumes that there is a national state that maximizes welfare..." (Smith 1995, p. 71). This approach is "based on the notion of a state with a well-defined social welfare function, reflecting some form of social democratic consensus, recognizing some well-defined national interest, and threatened by some real or apparent potential enemy" (Dunne 1995, p. 409). The standard defense expenditure models, however, are a poor representation of reality.

The problem with the purely value-added approach is that increases in defense spending do not automatically create the economic value that the models typically portray. As constituted, these value-added models do not take account of the economic trade-off between the private sector and the defense sector with given increases in military expenditures (Higgs 2006; Duncan and Coyne 2013b). Nor do these models account for the largess and waste found within defense budgets. Waste is prevalent in the U.S. Department of Defense budget and has been well documented (see, for example, Fitzgerald 1972; Higgs 1988b; McNaugher 1989; Reed 2011; Leo and Ehly 2015). Some significant problems that arise from this waste are that the benefits of largess accrue to narrow interested within the military-industrial complex (Melman 1985; Higgs 1987, 2006; Hartung 2011; Duncan and Coyne 2013a, b, 2015b; Coyne 2015) and that individual instances of waste, which may seem small in comparison to overall defense budgets, sum to a far more wasteful picture in the aggregate (Higgs 1988a).

Second, we establish that economic waste in the provision of defense is not simply a comedy of errors, but is a systemic, perpetual occurrence. Specifically, economic waste accrues due to the lack of fundamental property rights and residual claimants within the defense sector. As will be described, once the funds are filtered through the complex budgetary process, these funds take on the nature of a common pool resource. The nature of the "budgetary process results in the creation of a common pool of funds from which to finance a large variety of programs, including income transfers to individuals and businesses as well as the direct provision of goods and services. The process converts privately generated income and wealth into common property to be allocated among potentially unlimited alternative uses" (Brubaker 1997, p. 355). Once the funds are entered into the common pool, the system operates under the dynamics of any other common pool resource (see Hardin 1968), and, as such, economic actors within the system are not incentivized to make responsible budgeting decisions over non-privately owned funds. This fundamental disconnect between earners and spenders leads to perpetual waste.

Our contribution is twofold. First, our analysis contributes to the literature that blends the aforementioned insights of Buchanan and Ostrom to study the dynamics of the "fiscal commons" (Wagner 1992, 2002, 2004, 2012, 2016; Jakee and Turner 2002). We advance this literature by extending the insights of these authors to understand the dynamics of national defense and military spending.[1]

Second, we contribute to unpacking the "black box" of state-provided defense. As noted, economists typically treat national defense as public good that can be provided by the state in optimal qualities and quantities. This view pervades undergraduate textbooks (see Coyne and Lucas 2016) and economic models of the state. The process underpinning the security-related activities of the state has been underexplored. Indeed, even Buchanan failed to provide a consideration of how the protective state would operate and, in doing so, neglected to address some of the potential downsides of these state activities (see Coyne 2018). In contrast to the view that state-provided defense is always and everywhere value-added, we argue that it is the result of a complex

[1]The use of the terms "national defense" and "military spending" may seem redundant here. However, as we intend to show, these terms are not synonymous, though they are often used as such. In fact, a great deal of military spending has no relation to the defense of the nation.

institutional arrangement prone to commons-esque overutilization of resources.

We proceed as follows. The next section, "Foundations: The Fiscal Brain vs. the Individualistic Theory," provides the foundation for the analysis by exploring Buchanan's treatment of alternative approaches to public finance. A theory of state-provided defense requires a grounding in institutions and methodological individualism. The next two sections begin to develop this theory. "Common Pools and Common Problems" discusses the budget of the defense sector as a common pool resource while "For the Commons Defense" discusses the resulting issues with this arrangement. The final section concludes.

Foundations: The Fiscal Brain vs. the Individualistic Theory

In a 1949 article that served as the foundation for the rest of his research program (see Wagner 2017), James Buchanan described two approaches to public finance. In the first approach, what he termed the "organismic theory" or "fiscal brain," the "state is considered as a single decision-making unit acting for society as a whole" (1949, p. 496). Under the second approach, the "individualistic theory," in contrast, the "individual replaces the state as the basic structural unit" and the "state has no ends other than those of its individual members and is not a separate decision-making unit" (1949, p. 498). Depending on the approach adopted, the outcomes of the analytical exercise will be substantially different.

The current neoclassical literature regarding national defense and military spending is firmly grounded in the fiscal brain approach to public finance (Coyne 2015). From this standpoint, military spending is a purely technical, allocative issue where the fiscal brain of the state will "select the values of these many [taxation and expenditure] variables which will maximize social utility," through a straightforward, known maximization process that "consists of a simultaneous determination of all variables on both sides" to achieve equilibrium (Buchanan 1949, p. 497). The fiscal brain approach to public finance yields neatly calculated results that are easily managed by those in positions of political power.

The issue is that the blackboard economics of pure maximization is not consistent with political reality which is characterized not by a single omniscient "brain," but by an emergent process of multiple components involved in the allocative and budgeting process (Wagner 2009, 2016). Once the blackboard is left behind, it quickly becomes apparent that the "theoretical steps in the maximizing of social utility offer little to no direct guidance to government fiscal authorities" (Buchanan 1949, p. 498). In the absence of a static and known social welfare function allowing "the state" to maximize social utility, the practical application of public finance is one that must include the inherent messiness of collective action. Individuals must come together to decide upon the levels of both taxation and expenditure. This goes for all state activities, including the provision of security and defense.

Once one appreciates that political decisions do not rely upon a single omniscient and benevolent mind to conduct state operations, the individualistic approach alludes to two practical issues that the organismic approach assumes away. First, there is no specific guarantee that taxation and expenditure variables are known or viewed at the same moment (Wagner 2012). Secondly, the individualistic approach does not yield neat, predetermined conclusions as the "ends to be served by the fiscal system are determined by political decisions" (Buchanan 1949, p. 504). Herein lies the true challenge inherent in the state moving towards an active participant in productive activities which increase the utility of the citizenry. As Buchanan (1975, p. 97) notes, in "providing and financing national defense, for example, the governmental process represents an adjustment among conflicting demands and generates some median level of budgeted outlay…The outcomes of the institutional processes of the productive state are not 'scientific.' These outcomes are derived from individual behavior, not from some objectifiable empirical reality."

These insights serve as the foundation for alternative, but more accurate, understanding of state-provided defense. Rather than a single unit maximizing social welfare, the situation is far more convoluted. If a theory of a "defense brain" maximizing social utility is no longer a viable option, a more satisfactory theory for the study of military spending must be constructed (Coyne 2015). Instead of treating the decision process as a black box of efficiency maximization, the institutional environment, and the subsequent individual incentives created by those institutions, must be analyzed. This analysis does not yield any particular hope of collective social utility maximization. In fact, we may even call the outcome a tragedy as we will discuss.

Common Pools and Common Problems

The importance of an individualistic approach to the study of military spending lies in the numerous moving and entangled components involved in defense budgeting. Buchanan (1975, p. 103) warns that with any state budgeting process, "as the total size and complexity of the budget increases, the individual [citizen] may become increasingly disappointed with governmental performance, even if all functions are carried out efficiently in the small." The U.S. defense budget is large—the Department of Defense is the largest recipient of discretionary federal funds—and the process of its determination is not a simple one. The size and complexity inherent in the defense budget lends itself to significant waste in the aggregate. The reasons for this outcome stems from the numerous parties in play, each with distinct goals and interests that must be adjudicated through the budgetary process. As with any budgeting process where interests must be coordinated, there will necessarily be some give and take amongst the competing ends and means. How this coordination problem is satisfied, however, tends to increase rather than reduce the overall size of the budget (see Buchanan 1975, pp. 100–101).

Budgets and the Fiscal Commons

The convoluted nature of the budgetary process, financed through a system of generalized taxation, erodes the link between decision-making and those who bear the full costs of the decision. Once project proposals are entered into the bureaucratic structure, "[n]othing links a particular public program with the private sacrifices required for its operation. Assessing the personal distributions of benefits and costs associated with the various programs is impractical, and likely to remain so" (Brubaker 1997, p. 355). As Wagner (2012, p. 42) notes, "there is a basic distinction between private property budgeting and common property budgeting…A corporation that is considering expanding its manufacturing capacity but lacks the cash to do so must choose between borrowing to do so and postponing or forgoing the expansion…The consequences of that choice will be reflected in the corporation's earnings and, hence, value, thereby creating a link between choice and consequence." Simply put, if an overabundance of funds is allocated to projects in the context of private property budgeting, the company will see a loss of value for its mishandling of resources.

The U.S. Defense budget does not function in this manner. Rather than having a direct stakeholder to whom public programs must remain beholden, the "general budget represents potential profit to those in the defense industry and can be viewed as a 'fiscal commons'" (Coyne et al. 2016, p. 225). In essence, the defense budget functions as a common pool of funds, otherwise known as a common-pool resource,[2] from which branches of the military and their affiliated contractors draw financial resources. As funds are moved into the fiscal commons through taxation and bureaucratic processes, "the public budgetary process creates its own form of tragedy. Mainstream public microeconomics indicates that the common fund should be allocated to the creation of 'public goods'…In practice, however, the common fund becomes the object of attempted alienation by interest groups striving to secure allocations of benefit mainly to themselves" (Brubaker 1997, p. 356).

Rather than performing as a purely value-added contribution to the public good assumed under the organismic approach, the "common fund most often finances…the proverbial all-too-depletable pie to be divided among competing claimants" (Brubaker 1997, p. 356)

[2]As Ostrom (1990, p. 30) defines it, a "common-pool resource refers to a natural or man-made resource system that is sufficiently large as to make it costly (but not impossible) to exclude potential beneficiaries from obtaining benefits from its use."

whereby "[a]gent-representatives have an incentive to enlarge the pool of common funds" (Brubaker 1997, p. 360). Instead of facing liability for funds at the time of borrowing, public funding "liability is left to be determined at the time the debt is amortized. It is the tax system in place, along with its various exemptions and exclusions that determines the liability" (Wagner 2012, p. 43).

With the link between borrower and lender severed, the incentive structure is not one that generates concern for current company revenue stream-to-value calculations, but instead encourages the enlargement of the common fund in order to increase the share of the pie each interest group may receive. Political actors within the bureaucratic structure of budgeting have significant incentives to overgraze the fiscal commons (see Wagner 1992, 2002, 2012; Raudla 2010; Lipford and Yandle 2014), provided they are able to disburse the costs over the general public and concentrate the benefits amongst their constituents (see Weingast et al. 1981, p. 658; Lipford and Yandle 2014, p. 468).[3]

Specific Complexities of the Defense Commons

The inefficiencies of common pool resource distribution are only exacerbated when one considers the particular nature of the U.S. defense budgeting process. It is important when addressing the commons to note its specific nature, as the larger and more complex the system becomes, the more issues arise with attempts to develop successful "institutions for ensuring fair access and sustained availability to them. Some experience from smaller systems transfers directly to global

[3]Weingast et al. (1981) note that "[s]ince political representation is geographic, legislators care about who gains and who loses in proportion to their geographic locations" (648) creating a system where "locally targeted expenditures are counted by the local constituency as benefits…[and] the districting mechanism in conjunction with the taxation system provides incentives to increase project size beyond the efficient point by attenuating the relationship between beneficiaries and revenue sources" (658). Brubaker (1997, pp. 360–361) furthers this point noting that when it comes to overgrazing, "[a]lthough the hostile reactions of voters temper this incentive somewhat, the representatives' discretion in allocating from the common fund provides them with a source of power, influence, and a potentially decisive advantage in retaining their offices. They tax opponents and reward supporters, all in the name of public purposes."

systems, but global commons introduce a range of new issues, due largely to extreme size and complexity" (Ostrom et al. 1999, p. 278).

The determination of the U.S. military budget, which runs on an 18–24 month cycle, is a multi-step process involving numerous parties and can be understood as follows (Kaufman 2009, pp. 55–56; see also, see Yarmolinsky 1971, p. 261; Higgs 2006; Thorpe 2014; Duncan and Coyne 2015a). In the first, planning, stage the president communicates their defense priorities and strategies to the defense secretary. These priorities are important for influencing the overall size of the defense budget. The secretary of defense then produces a Defense Policy Guidance memo which outlines the president's military strategies. This document, which is aimed at the military services—army, navy, air force—is the end of the planning phase of the budget.

The second, programming, stage commences as each of the military services must prepare a Program Objective Memorandum in response to the Defense Policy Guidance document. In this memo each service must demonstrate how their activities—past and future—align with the Defense Policy Guidance document. Producing this Program Objective Memorandum is itself a complex task.

The first step involves each service providing a report that indicates a requirement[4] or "capability that needs to exist for the conduct of combat operations…be it training equipment, uniforms, rifles, airplanes, naval vessels, tanks, missiles, mess kits, boots, or any of a myriad of items" (Kambrod 2007, p. 2). As noted in the Department of Defense (2015, p. 4) instructions for acquisition, "Acquisition, requirements, and budgeting, are closely related and must operate simultaneously with full cooperation and in close coordination."

Validated "Capability Requirements" provide the basis for defining the products that will be acquired through the acquisition system and the budgeting process determines Department priorities and resource allocations and provides the funds necessary to execute planned programs. A capability must be validated by the specific services through a

[4]The term requirement is no longer the official language of the budgeting process. "Capability" and "requirement" are interchangeable terms that bridge the official language time gap.

"complex and a very lengthy process" (Kambrod 2007, p. 3) that must account for the purpose of the proposed item, its impact on the existing or other proposed items, the staffing levels required to utilize the item, relevant alternatives that may be available, and a strategy for obtaining access to any required components for the item (Kambrod 2007, pp. 4–6). These decisions must be made in coordination with the Joint Chiefs of Staff and leadership "of the acquisition and budget process… as advisors to the validation authority during consideration of initial or adjusted validation of capability requirements to ensure coordination across the three processes" (Department of Defense 2015, p. 4).

Even this original validation is not done in a vacuum of decision-making by the service and its leadership. Each service plays a role in determining its own capabilities, but it does so with involvement by industry and its lobbying representatives (Kambrod 2007, pp. 26–27) and the occasional member of Congress who may have a vested interest in a particular program (Kambrod 2007, pp. 40–41). The input of these various sources leads to an increasing lack of oversight as the acquisition system becomes more complex with more players involved. These types of close-knit decision-making arrangements lead to the ability of military program managers who have ties to certain defense industries and Congressional contacts to press for capabilities that are not strictly necessary. This feedback loop does not have to be just in this direction either. The more people who have input, the more points there are to interject information for political reasons rather than technological or strategic importance (Duncan and Coyne 2015a, pp. 400–403).

Only after this initial process of validation is completed can the service issue its Program Objective Memorandum. The defense secretary must then reconcile the Program Objective Memoranda with the president's policy aims as spelled out in the Defense Policy Guidance document. This process involves constant negotiations between all parties involved as certain decisions need to be made about what to include in the budget request. This ends the programming phase of the budget. The budgeting stage is the third, and final, phase of the process. Analysts in the Pentagon and in the White House review the budget and make any changes necessary to obtain the president's approval.

Once approved, the budget is sent to congress for review and approval (Kaufman 2009, pp. 57–58). This review process takes about a year and involves numerous committees through private and public meetings and hearings. The members of each of these committees have their own interests and goals which influence the trajectory of the budget. In many cases members of Congress will ask for "add-ons" to the budget submitted by the president. This phase of the process concludes with congressional authorization and approval by the president which enacts the budget into law.

Not all validated capabilities are funded. When this occurs the service, or an industry that has an interest in a particular program, can rely upon a lobbying effort to get "plus up funds," or "funding that is recommended by a Member of Congress or delegation to be added to the Defense budget but not formally requested by a Service" (Kambrod 2007, p. 11). These funds can be gathered either by making a strong case for the services' needs of the program or by securing the political backing of the appropriate Congressional member regardless of service needs. The lobbyist's job is to coordinate the efforts of industry and service to get Congress to approve the additional funding for the previously unfunded capability.[5] They are basically complex marketers (but on policy too which may help industry get their programs funded). This process, which would seem to be somewhat straightforward even if it opens the door for potential misuse of funds, is still not the end of the budgeting.

Once Congress has agreed to an initial capability or introduced additional funding for a previously unfunded capability, there are still supplemental budget requests that are used to fund continued operations and maintenance of programs. These supplemental budgets come independently of the budget cycle and are utilized to increase the amount of

[5]The lobbyist operates as a complex marketer, attempting to place the unfunded capability in front of the most likely source of backing. This source may be a direct Congressional contact or a military contact who has the power or reputation to gain Congressional support. In these attempts, it should be noted that convincing either Congress or the military to accept a program may also include lobbying for a change in policy in order to gain support for the program. So, in essence, the lobbyist is an active participant in both budgeting and policy formation (Kambrod 2007, p. 56; Duncan and Coyne 2015a).

available funds through "contingency operations" above that allotted in the actual budget (Kambrod 2007, p. 9). These supplemental funds are not included in the original budgets for the year, but tend to add substantially to the overall levels of military spending. The overseas operations funds amounted to an additional $64 billion in defense spending in 2015 and an additional $59 billion in 2016 (National Priorities Project 2016). The Department of Defense gained an additional $70 billion in 2017 with another $65 billion requested for 2018 despite the base budget rising by $25 billion before the contingency operations ask (Towell and Williams 2017, p. 2).

The pressure on the budget at each of the stages described—three-phase budgetary process, plus-up, and overseas contingencies—leads to increased consumption and overutilization of the fiscal commons, increasing the overall level of spending and resulting in activities that have nothing to do with advancing the "public interest."

For the Commons Defense

Once resources are filtered through the budgetary process there is an inherent bias towards spending by parties who are able to first secure a piece of the budgetary pie (Adams and Adams 1972; Melman 1985; Duncan and Coyne 2015a). If there is any hope of channeling these funds to uses that serve the citizenry it is imperative that there are institutional mechanisms to manage the commons. In order to prevent "destructive patterns of overutilization" there are "four institutional factors that appear to be essential…: (1) a broad consensus on sustainable levels of overall use, (2) agreement on criteria for determining individual access to the commons, (3) effective monitoring systems to detect when established use levels are exceeded, and (4) effective sanctions against violations of established use levels" (Jakee and Turner 2002, p. 485; see also Ostrom 1990, pp. 88–102). How well the defense sector incorporates workable solutions to these factors determines the extent to which overgrazing the fiscal commons occurs. It is useful at this point to analyze features of the defense sector to explore whether these mechanisms are suitable for dealing with fiscal commons problems.

What Is the Proper Level of Defense Spending?

The notion of an agreed upon benchmark for the proper level of defense spending is difficult to fathom. This difficulty reflects the fact that "no one knows the production function for national security" (Higgs 2006, p. 133) and that the optimal level of defense is not fixed and given to political decision makers. Rather, "the level of security is determined administratively" (Duncan and Coyne 2013b, p. 422) through the bureaucratic budgetary process described in the previous sub-section, and with the input of the same actors, determines the size of the common pool of funds (see Yarmolinsky 1971, p. 261; Kambrod 2007). Due to the bureaucratic nature of both the security-level determination and the appropriations process, along with the unique structure of the defense sector,[6] agencies within the sector face perverse incentives regarding the assessment of their own resource use. Specifically, distribution of resources takes place through a process where,

> allocation becomes determined by spending levels. If the bureau spends less than its complete budget, the additional funds are considered unnecessary during the next term's budget decisions. This process of resource determination establishes the incentive that a bureau should always spend its complete budget to ensure that it maintains its level of resources over time… To sustain the bureau, or agency, especially in the climate of political competition, is to continuously spend and to continuously seek to increase the agencies' access to funding (Duncan and Coyne 2015b, p. 691).

When combined with the idea that political entrepreneurs "will be motivated to search out and to propose other spending schemes which are personally preferred and which promise to yield benefits in excess of the allocable tax costs" (Buchanan 1975, p. 101), the spend-it-all

[6]The difficulty in optimal defense spending determination is further established by the unique nature of the defense market, where "the federal government comprises the entire, or nearly the entire, consumptive portion of the defense market" (Duncan and Coyne (2015a, pp. 396–397) and, as such, "there is no guarantee that market operation will reveal the technological information the monopsonist needs in order to buy rationally, even if such information exists" (Adams and Adams 1972, p. 281).

mentality that comes from the budgetary allotment system ensures that the "winners" of the political competition are those who see their budgets expand (Coyne 2011, pp. 10–11; 2013, p. 110; see also Brubaker 1997, pp. 360–361).

One criticism of using a spend-it-all mentality to discuss bureaucratic processes, as done here, comes from Thompson (1973, pp. 952–953), where he argues that trustees, or legislatures, are ultimately responsible for the levels of spending and not the bureaucrats. Thompson (1973, p. 953) notes the "rational bureaucrat who will not be working in the subsequent period will not take [an] economical opportunity [if] it lowers his current budget. But this decision is a decision…determined by the elected representatives, not the bureaucrats." From this perspective the elected representatives act as a check on the behavior of overzealous bureaucrats, mitigating the ability to increase budgets by overspending. The issue for the defense sector, however, is that these legislatures are an integral, but not separate, part of the process of deciding both the overall size of the military budget and the levels of spending within the budget. This weakens their ability to serve as a check against overutilization. The result is that for the defense sector there is not currently a consensus on the "optimal" level of resource use which is critical for preventing overutilization.

Who Can Swim in the Defense Pool?

The second institutional constraint on common resource overutilization arises from the determination of who can access the resource. To aid in the efficient management of the common pool resource, involved parties must "be able to determine which set of actors or which production technique best uses the CPR [common-pool resource] (in the sense of maximizing returns at the lowest cost while sustaining the resource). If sustainability is important to our community, the obvious conclusion is that the community will want to limit access to those more productive technologies" (Jakee and Turner 2002, p. 491).

While the idea of allowing access to those who are the most productive seems a straightforward concept, the solution to this problem in the defense sector is not so easy. Solutions to "this issue will depend on the complexity of the pool itself. If the rules of access are not absolutely clear and widely understood, we can expect not only problems rooted in bounded rationality but also those rooted in opportunism, as some intentionally seek to exploit the ambiguity itself" (Jakee and Turner 2002, p. 493). As alluded to in the description of the budgeting process above, in the case of military budgeting there is a lack of simplicity. Also, there are legislative and executive gatekeepers who may bar or grant access for reasons other than matters of efficiency.

In determining who has access to the pool of military funds, decisions "turn not on price, but on technical and scientific capabilities, size, experience, and established reputations as a military supplier – vaguer attributes that are easier to fudge for one's friends" (Higgs 2007, p. 308). The criteria of reputation is one that has severe implications for how access is determined, as "firms compete with each other, but, in their race for fresh contract and capital grants from the Pentagon managers, they do not vie for who can achieve a lower product price and cost but rather who can compete best in terms of a display of 'competence'"[7] (Melman 1985, p. 35). To demonstrate their reputation and competence, military services desiring a program and defense firms will invest resources in developing and maintaining political connections through a variety of channels, including the revolving door between the private and public sectors (Duncan and Coyne 2015a).

There are a few possible ways for a service or defense firm to access funds. The service may insert a fully validated capability into the President's budget request as discussed above (see "Specific Complexities of the Defense Commons"). A firm with a product may employ a lobbyist with military contacts (Duncan and Coyne 2015a, p. 395) who knows "the right military staff officer in the Pentagon who handles [their] sort of product" (Kambrod 2007, p. 18) or civilian counterpart

[7] Melman (1985, p. 35) defines competence as "the readiness and ability of the particular firm to satisfy the Pentagon's requirements in the judgment of its top management. It means its ability to collaborate with the Pentagon-level administrators to turn out the sort of product that the Pentagon wants with regard to details of product designing, testing, producing and servicing" (See also Duncan and Coyne 2013b, p. 426).

to attempt to validate the product as a capability. The lobbyist is encouraged to "[p]ick the military over the civilian" to ensure the product is reviewed by someone with "fire in their belly for developing combat systems" rather than too narrow a focus on cost effectiveness (Kambrod 2007, pp. 18–19). A firm may also have a lobbyist with connections to Congress (Duncan and Coyne 2015a, p. 403) allowing them to circumvent the military services by appealing directly to a Congressman, or more successfully an Appropriations Committee member. If successful, the product will be funded regardless of service desire, and every "Defense Bill has a number of such wasted programs, catering not to the Military Departments but rather—and at great expense to the overall Defense Budget—to local 'most-favored' industries" (Kambrod 2007, p. 41). Also, a service who sees a validated capability that is currently unfunded may utilize similar mechanisms in conjunction with industry to get the unfunded capability into either the President's budget or the plus up and supplemental budget requests presented to Congress (Kambrod 2007, p. 47).

The use of close ties and political maneuvering to ensure access to the pool of funds weakens the original productivity criteria to maximize the return on the scarce resource. Products pushed onto the military that are not considered capabilities by the services lead to a reduction in overall efficiency. Similarly, services who use political mechanisms to overcome cost-effectiveness analyses, or who press its desired product into a budget instead of (or even along with) another more efficient product also weaken the constraints on resource use. Any combination of this scenario reduces the ability to limit access to commons resources and leads to further overutilization.

Blind Watchers on the Wall

The third institutional constraint necessary for restraining overutilization is the creation of effective monitoring systems of resource usage. The defense sector faces specific challenges in satisfying this constraint. The first and most easily recognized issue is that the sheer size of the bureaucratic structure of the defense sector makes oversight difficult.

With such a vast number of ongoing processes and programs for upper-level bureaucrats to focus on, "the acquisition process…have been pushed downward in command structure so that senior executives…are mostly unaware of relatively large contracts awarded at two and three levels removed from the Pentagon. This delegation of responsibility… puts the decision-making process in the hands of junior officers or civilians…" (Kambrod 2007, p. 48).

Difficulties in monitoring are not simply a function of size, however; again, the complexity of the system matters. In his review of the processes involved in decision-making, then-Secretary of Defense Robert Gates (2011) noted "the current apparatus for managing people and money across the DoD enterprise is woefully inadequate. The agencies, field activities, joint headquarters, and support staff functions of the department operate as a semi-feudal system – an amalgam of fiefdoms without centralized mechanisms to allocate resources, track expenditures, and measure results relative to the department's overall priorities." With each party operating independently and the monitoring system being one of self-reporting, there should be little confusion as to why the results are "woefully inadequate."

Of particular note is the lack of overall information regarding resource allocation and expenditures. If this basic data is unavailable, there is a clear inability to make determinations regarding whether those resources were used efficiently (or even legally). One only has to remember that "at least $31 billion, and possibly as much as $60 billion" was lost due to waste during the wars in Iraq and Afghanistan (Commission on Wartime Contracting in Iraq and Afghanistan 2011, p. 5) to see the problems that may arise. Even in that detailed study conducted by a full commission, there is a $29 billion gap in the ability to track funds. In 2016 it was reported that the Department of Defense purposefully hid an internal report showing $125 billion in management waste out of fear that Congress would reduce its budget (Whitlock and Woodward 2016).

While the first two monitoring issues revolve around the ability to monitor resource usages, another concern arises from the incentives to track the information as well. As noted above in reference to the Thompson (1973) critique (see "What Is the Proper Level of Defense

Spending?" above), the interplay between Congress, the military, and the defense industry leads to a break-down of the incentives to check resource overutilization. Each party is an active participant in the decision-making process rather than a true overseer of defense-related decisions. Defense acquisition processes allow the legislature to benefit from overspending because they can direct the additional funds to their own district at taxpayer expense.

Add to this dynamic that decisions about military spending are made at the national, rather than local levels, and the incentive compatibility issues become ever more problematic. As Buchanan (1975, p. 103) notes, "it has long been recognized that the individual's sense of participation in collective choice is relatively greater in localized jurisdictions" as the "tax-budgetary exploitation of the individual are reached more quickly in local governmental units than in central governments." Simply put, the legislative agent overutilizing resources to benefit his or her own district at the expense of the average taxpayer will find little voter backlash to correct the behavior. Thus, the legislative check against bureaucratic behavior gets weakened more than in other potential bureaucracies where that dynamic and distance from the voter does not exist.

The incentive to effectively monitor resource usage is reduced further when one considers the entanglement among the various parties involved. The current "feedback mechanisms in the military economy allow for, and encourage, the practice of what has become known as the 'revolving door,' where personnel rotates between Congress, the military, and the defense industry" (Duncan and Coyne 2015a, p. 392). The existence of the revolving door ensures "the necessity of maintaining political connections and remaining on friendly terms with defense industries" (Duncan and Coyne 2015a, p. 408) to maintain lucrative relationships beyond a person's current service or legislative position. The maintenance-of-reputation effect further ensures "the incentive to identify and remove waste and inefficiencies resource is drastically reduced, if not altogether absent" (Duncan and Coyne 2015a, p. 409). The combination of the inabilities and motivational lapses suggest a resulting overall lack of monitoring effectiveness, reducing constraints on resource overutilization.

The Great Axe Is Missing

The final constraint necessary to prevent overuse is a clear system of penalties sanctioning those who violate the rules. In the defense sector, the enforcement of such sanctions is lacking. If there is little incentive to monitor resource usage, there is also little incentive to sanction bad behaviors in the use of resources. Extreme and notable circumstances that may cause public outcry, particularly from one's own constituency, may be an ultimate check, but there are many gradations of bad behavior in resource utilization prior to reaching such a threshold.

As noted above, the legislative bodies responsible for oversight are also those who are active participants in the determination of resource usage. While expert advice is considered necessary to alleviate problems with waste in the acquisition programs (Kambrod 2007, pp. 48–49), an important issue that arises is that "this oversight by experts simply pushes the problem up a level … Given the dynamics of the revolving door, the use of experts for oversight may be either ineffective or exacerbate the issue as the overseers also become subject to the conforming tendencies inherent in the system" (Duncan and Coyne 2015a, p. 409). Oversight becomes a challenge when the incentive issues remain relevant at all levels of the structure rather than simply at the lowest level.

A further challenge in sanctioning violations in the defense sector is that the Department of Defense is sufficiently influential in domestic politics as to ignore rules with no repercussions. The military holds an elevated status in American society (see Bacevich 2005) such that there tends to be bi-partisan support for the services irrespective of numerous cases of blatant waste, fraud, and abuse. Examples abound.

The Department of Defense has refused to comply with reporting requests regarding the revolving door from its own Inspector General (Davenport 2014; U.S. Department of Defense Inspector General 2014). The U.S. Government Accountability Office (2006, p. 4) has also issued "many acquisition-related reports over the years [that] raise serious questions about the reasonableness, appropriateness, and affordability of DoD's current investment plans; the soundness of the acquisition process which implements those plans; and the effectiveness of the practices DoD uses to manage its contractors, including the use of award and incentive fees."

In 2016, the Defense Inspector General noted that "the Army made $2.8 trillion in wrongful adjustments to accounting entries in one quarter alone in 2015, and $6.5 trillion for the year. Yet the Army lacked receipts and invoices to support those numbers or simply made them up" (Paltrow 2016; see also U.S. Department of Defense Inspector General 2016a). The report specified the responsible party "did not prioritize correcting the system deficiencies that caused errors" and that "DoD and Army managers could not rely on the data in their accounting systems when making management and resource decisions" (U.S. Department of Defense Inspector General 2016a, n.p.). Another U.S. Department of Defense Inspector General (2016b, n.p.) report noted the Air Force "inaccurately represented Air Force OIR costs in the third quarter FY 2015 [Cost of War] reports by underreporting $237.9 million in obligations and $209.9 million in disbursements." A third report in the same year suggested the Air Force "did not promote cost-effectiveness on the Total System Support Responsibility contract for sustainment support of the E-8C JSTARS aircraft" and "paid unallowable award fees totaling $7.6 million, which could have been put to better use" (U.S. Department of Defense Inspector General 2016c). Yet the Department of Defense has seen little in the way of true sanctioning for such actions.

Finally, consider that it took two decades for the Department of Defense to meet federal law requiring the provision of audit-ready financial statements (see Hedges 2017). As per the Government Management Reform Act of 1994, starting in 1997 the Government Accountability Office (GAO) has been legally required to audit financial statements of federal agencies which are then submitted to the President and Congress. Despite this requirement, the GAO was unable to audit the Department of Defense until 2017 (the audit is still in process at the time of writing) because of dysfunctional accounting processes. Despite numerous threats from members of Congress over those two decades no one has been punished for violating federal law. The institutionalization of these types of blatant violations of established rules contributes to overutilization of the fiscal commons.

Conclusion

Our analysis has three implications. First, the standard treatment of state-provided defense by economists is too simplistic. This treatment of defense as a "public good" provided in optimal quantities and qualities by a benevolent state to maximize social welfare does not comport with reality. James Buchanan's emphasis on the individualistic approach to public finance provides an alternative means of opening the "black box" of defense to understand the process through which defense is provided.

A second implication deals with the issue of constitutional political economy and Buchanan's distinction between the protective, productive, and unproductive state. In order to operate the protective state must draw resources from the economy. It cannot be assumed that the state can effectively combine and maintain its protective and productive capacities. That is, there is reason to believe that in undertaking its protective functions the state may also engage in unproductive activities. If the state's resource usage in the defense sector is overextended, the result may be that the unproductive state moves further into the predatory state in terms of its taking of resource from prosperous uses and redirecting them towards unproductive or destructive activities. More theoretical and empirical work on the nature of protective-state activities is necessary to explore the nuances between these different types of activities.

Finally, the issues inherent in the defense sector are institutional in nature and require institutional solutions rather than simply a renegotiation of the existing defense budget. As Gates (2011) noted in his review of the acquisition processes, "I have always believed inspired leadership can overcome deficient organization charts. But in this case, it may be time to consider new governance structures and arrangements." The changes necessary for resolving a tragedy of the commons are those that affect incentives and the rules of the game. In emphasizing the importance of rules for political outcomes, James Buchanan's research program provides unique insight into not only how the defense sector operates, but what is necessary for change and reform.

References

Adams, W., & Adams, W. J. (1972). The Military-Industrial Complex: A Market Structure Analysis. *The American Economic Review, 62,* 279–287.

Bacevich, A. J. (2005). *The New American Militarism: How Americans Are Seduced by War*. New York, NY: Oxford University Press.

Brubaker, E. R. (1997). The Tragedy of the Public Budgetary Commons. *The Independent Review: A Journal of Political Economy, 1,* 353–370.

Buchanan, J. M. (1949). The Pure Theory of Government Finance: A Suggested Approach. *Journal of Political Economy, 57,* 496–505.

Buchanan, J. M. (1967 [1999]). *The Collected Works of James M. Buchanan, Vol. 4. Public Finance in Democratic Process: Fiscal Institutions and Individual Choice*. Indianapolis, IN: Liberty Fund.

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

Commission on Wartime Contracting in Iraq and Afghanistan. (2011). *Transforming Wartime Contracting: Controlling Costs, Reducing Risks*. Final Report to Congress.

Coyne, C. J. (2011). The Political Economy of the Creeping Militarization of U.S. Foreign Policy. *Peace Economics, Peace Science & Public Policy, 17,* 1–25.

Coyne, C. J. (2013). *Doing Bad by Doing Good: Why Humanitarian Action Fails*. Stanford, CA: Stanford University Press.

Coyne, C. J. (2015). Lobotomizing the Defense Brain. *Review of Austrian Economics, 28*, 371–396.

Coyne, C. J. (2018). The Protective State: A Grave Threat to Liberty. In P. J. Boettke & S. Stein (Eds.), *Buchanan's Tensions: Reexamining the Political Economy and Philosophy of James M. Buchanan*. Arlington, VA: Mercatus Center at George Mason University.

Coyne, C. J., & Lucas, D. (2016). Economists Have No Defense: A Critical Review of National Defense in Economics Textbooks. *Journal of Private Enterprise, 31,* 65–83.

Coyne, C. J., Michaluk, C., & Reese, R. (2016). Unproductive Entrepreneurship in U.S. Military Contracting. *Journal of Entrepreneurship and Public Policy, 5,* 221–239.

Davenport, C. (2014). Pentagon Not Properly Tracking 'Revolving Door' Data, Report Says. *The Washington Post*. Available at http://www.washingtonpost.com/business/economy/pentagon-not-properly-maintaining-revolving-door-datareport-says/2014/04/07/c65f27bc-be7f-11e3-b195-dd0c1174052c_story.html.

Department of Defense. (2015). *Operation of the Defense Acquisition*. Department of Defense Instruction. No: 5000.02.

Duncan, T. K., & Coyne, C. J. (2013a). The Origins of the Permanent War Economy. *The Independent Review: A Journal of Political Economy, 18,* 219–240.

Duncan, T. K., & Coyne, C. J. (2013b). The Overlooked Costs of the Permanent War Economy: A Market Process Approach. *The Review of Austrian Economics, 26*, 413–431.

Duncan, T. K., & Coyne, C. J. (2015a). The Revolving Door and the Entrenchment of the Permanent War Economy. *Peace Economics, Peace Science & Public Policy, 21*, 391–413.

Duncan, T. K., & Coyne, C. J. (2015b). The Political Economy of Foreign Intervention. In P. J. Boettke & C. J. Coyne (Eds.), *The Oxford Handbook on Austrian Economics* (Vol. 1, pp. 678–697). Oxford, UK: Oxford University Press.

Dunne, J. P. (1995). The Defense Industrial Base. In K. Hartley & T. Sandler (Eds.), *Handbook of Defense Economics* (Vol. 1, pp. 399–430). New York, NY: Elsevier.

Fischer, D., & Brauer, J. (2003). Twenty Questions for Peace Economics: A Research Agenda. *Defence and Peace Economics, 14,* 223–236.

Fitzgerald, A. E. (1972). *The High Priests of Waste*. New York, NY: W.W. Norton.

Gates, R. M. (2011, May 24). *Speech Given to American Enterprise Institute*. Available at http://archive.defense.gov/Speeches/Speech.aspx?SpeechID=1570.

Hardin, G. (1968). The Tragedy of the Commons. *Science, 162,* 1243–1248.

Hartung, W. D. (2011). *Prophets of War: Lockheed Martin and the Making of the Military-Industrial Complex*. New York, NY: Nation Books.

Hedges, T. (2017). The Pentagon Has Never Been Audited. That's Astonishing. *The Guardian*. Available at https://www.theguardian.com/commentisfree/2017/mar/20/pentagon-never-audited-astonishing-military-spending.

Higgs, R. (1987). *Crisis and Leviathan: Critical Episodes in the Growth of American Government*. New York: Oxford University Press.

Higgs, R. (1988a). Hard Coals Make Bad Laws: Congressional Parochialism Versus National Defense. *Cato Journal, 8,* 79–106.

Higgs, R. (1988b). *U.S. Military Spending in the Cold War Era: Opportunity Costs, Foreign Crises, and Domestic Constraints*. Cato Policy Analysis No. 114. Washington, DC: Cato Institute.

Higgs, R. (2006). *Depression, War, and Cold War: Studies in Political Economy*. New York, NY: Oxford University Press for the Independent Institute.

Higgs, R. (2007). Military-Economic Fascism: How Business Corrupts Government, and Vice Versa. *The Independent Review: A Journal of Political Economy, 12*, 299–316.

Jakee, K., & Turner, S. (2002). The Welfare State as a Fiscal Commons: Problems of Incentives Versus Problems of Cognition. *Public Finance Review, 30,* 481–508.

Kambrod, M. R. (2007). *Lobbying for Defense*. Annapolis, MD: Naval Institute Press.

Kaufman, R. F. (2009). The Defense Budget Process. In J. K. Galbraith, J. Brauer, & L. L. Webster (Eds.), *Economics of Peace and Security* (pp. 53–60). Oxford, UK: EOLSS Publishers.

Leo, J., & Ehly, B. (2015). With $8.5 Trillion Unaccounted for, Why Should Congress Increase the Defense Budget? *The Fiscal Times*. Available at http://www.thefiscaltimes.com/2015/03/19/85-Trillion-Unaccounted-Should-Congress-Increase-Defense-Budget.

Lipford, J. W., & Yandle, B. (2014). Grazing the State and Local Fiscal Commons: Do Different Tax Prices Lead to More or Less Grazing? *Public Finance Review, 42,* 466–486.

McNaugher, T. L. (1989). *New Weapons, Old Politics: America's Military Procurement Muddle*. Washington, DC: Brookings Institution Press.

Melman, S. (1985). *The Permanent War Economy: American Capitalism in Decline*. New York, NY: Simon & Schuster.

National Priorities Project. (2016). *Overseas Contingency Operations: The Pentagon Slush Fund*. Available at https://www.nationalpriorities.org/campaigns/overseas-contingency-operations/.

Ostrom, E. (1990). *Governing the Commons: The Evolution of Institutions for Collective Action*. New York, NY: Cambridge University Press.

Ostrom, E., Burger, J., Field, C. B., Norgaard, R. B., & Policansky, D. (1999). Revisiting the Commons: Local Lessons, Global Challenges. *Science's Compass Review, 284,* 278–282.

Paltrow, S. (2016). U.S. Army Fudged Its Accounts by Trillions of Dollars, Auditor Finds. *Reuters*. Available at https://www.reuters.com/article/us-usa-audit-army/u-s-army-fudged-its-accounts-by-trillions-of-dollars-auditor-finds-idUSKCN10U1IG.

Raudla, R. (2010). Governing Budgetary Commons: What Can We Learn from Elinor Ostrom? *European Journal of Law and Economics, 30,* 201–221.

Reed, J. (2011). $46 Billion Worth of Cancelled Programs. *Military.Com*. Available at https://www.military.com/defensetech/2011/07/19/46-billion-worth-of-cancelled-programs.

Smith, R. (1995). The Demand for Military Expenditures. In K. Hartley & T. Sandler (Eds.), *Handbook of Defense Economics* (Vol. 1, pp. 69–88). New York, NY: Elsevier.

Thompson, E. (1973). Review of Niskanen's Bureaucracy and Representative Government. *Journal of Economic Literature, 11,* 950–953.

Thorpe, R. U. (2014). *The American Warfare State: The Domestic Politics of Military Spending*. Chicago, IL: University of Chicago Press.

Towell, P., & Williams, L. M. (2017). *The Trump Administration's March 2017 Defense Budget Proposals: Frequently Asked Questions*. Washington, DC: Congressional Research Service.

U.S. Department of Defense Inspector General. (2014). *Section 847 Ethics Requirements for Senior Defense Officials Seeking Employment with Defense Contractors*. DODIG-2014-050. Available at http://www.dodig.mil/pubs/documents/DODIG-2014-050.pdf.

U.S. Department of Defense Inspector General. (2016a). *Army General Fund Adjustments Not Adequately Documented or Supported*. DODIG-2016-113. Available at http://www.dodig.mil/DesktopModules/ArticleCS/Print.aspx?PortalId=48&ModuleId=2973&Article=1119298.

U.S. Department of Defense Inspector General. (2016b). *Additional Controls Needed to Issue Reliable DoD Costs of War Reports that Accurately Reflect the Status of Air Force Operation Inherent Resolve Funds*. DODIG-2016-102. Available at http://www.dodig.mil/reports.html/Article/1119290/additional-controls-needed-to-issue-reliable-dod-cost-of-war-reports-that-accur/.

U.S. Department of Defense Inspector General. (2016c). *The Air Force Needs to Improve Cost-Effectiveness and Availability of the Joint Surveillance Target Attack Radar System*. DODIG-2017-003. Available at http://www.dodig.mil/reports.html/Article/1119323/the-air-force-needs-to-improve-cost-effectiveness-and-availability-of-the-joint/.

U.S. Government Accountability Office. (2006). *Defense Acquisitions: DOD Wastes Billions of Dollars through Poorly Structured Incentives*. GAO-06-409T. Available at http://www.gao.gov/products/GAO-06-409T.

Wagner, R. E. (1992). Grazing the Federal Budget Commons: The Rational Politics of Budgetary Irresponsibility. *Journal of Law and Politics, 9,* 105–119.

Wagner, R. E. (2002). Property, Taxation, and the Budgetary Commons. In D. P. Racheter & R. E. Wagner (Eds.), *Property, Taxation, and the Rule of Law* (Vol. 1, pp. 33–47). Norwell, MA: Kluwer Academic.

Wagner, R. E. (2004). Debt, Money, and Public Finance. In J. G. Backhaus & R. E. Wagner (Eds.), *Handbook of Public Finance* (Vol. 1, pp. 195–215). New York, NY: Springer.

Wagner, R. E. (2009). *Fiscal Sociology and the Theory of Public Finance: An Exploratory Essay*. Cheltenham, UK: Edward Elgar.
Wagner, R. E. (2012). *Deficits, Debt, and Democracy: Wrestling with Tragedy on the Fiscal Commons*. Cheltenham, UK: Edward Elgar.
Wagner, R. E. (2016). *Politics as a Peculiar Business: Insights from a Theory of Entangled Political Economy*. Cheltenham, UK: Edward Elgar.
Wagner, R. E. (2017). *James M. Buchanan and Liberal Political Economy: A Rational Reconstruction*. Lanham, MD: Lexington Books.
Weingast, B. R., Shepsle, K. A., & Johnsen, C. (1981). The Political Economy of Benefits and Costs: A Neoclassical Approach to Distributive Politics. *Journal of Political Economy, 89,* 642–664.
Whitlock, C., & Woodward, B. (2016). Pentagon Buries Evidence of $125 Billion in Bureaucratic Waste. *The Washington Post*. Available at https://www.washingtonpost.com/investigations/pentagon-buries-evidence-of-125-billion-in-bureaucratic-waste/2016/12/05/e0668c76-9af6-11e6-a0ed-ab0774c1eaa5_story.html?utm_term=.7149251e735e.
Yarmolinsky, A. (1971). *The Military Establishment: Its Impacts on American Society*. New York, NY: Harper and Row.

13

Contraception Without Romance: The Entangled Political Economy of State and Federal Contraceptive Insurance Mandates

Marta Podemska-Mikluch

Introduction

The sale of the first hormonal oral contraceptive pill was approved by the Food and Drug Administration in 1960. The pill became an immediate success and a driving force of a social and cultural revolution. Between 1965 and 1973, the share of married women of reproductive age using traditional methods of contraception declined from 40 to 20%. In the same period, the percentage of women using any form of contraception increased from 63 to 68%. These changes are sometimes referred to as the Contraceptive Revolution to mark the tremendous transformation that occurred when birth control pill became widely available (Westoff and Ryder 2015). Undoubtedly, access to reliable contraception gave women unprecedented control over their reproductive choices, reducing the rate of unintended and mistimed births. The invention of oral contraceptive is often credited with the increase

M. Podemska-Mikluch (✉)
Gustavus Adolphus College, St. Peter, MN, USA
e-mail: mpodemsk@gustavus.edu

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_13

in the number of women entering professional programs (Goldin and Katz 2002). Freedom to plan childbearing also led to an increase in the number of women in the paid labor force and increased number of annual hours worked (Bailey 2006). Greater educational attainment and increased labor force participation created a lasting social change.

In 1966, an article published in Time argued that "No previous medical phenomenon has ever quite matched the headlong U.S. rush to use the oral contraceptives now universally known as "the pills" (Time 1966)." The key reason for why oral contraception rapidly generated this tremendous social change was its relative affordability. When it was first approved, Enovid cost about $10 per month, which would be equivalent to about $80 today. But the price was quickly decreased to $3.50, about $32 per month today. By the end of the decade numerous competitors obtained FDA approval for oral contraception, which further contributed to the decline in prices. The trend continued as patents on oral birth control begun to expire in the 1980s and generic competitors entered the market.

And yet, in the early 1990s, affordability of contraception became a subject of political controversy, followed by a push for contraceptive insurance mandates. In 1998, Maryland became the first state to mandate comprehensive contraceptive coverage. By 2012, 29 states adopted similar policies. These state-level efforts were reinforced by the Patient Protection Affordable Care Act (PPACA), which mandated private insurance plans to cover women's preventative health services, without cost-sharing. These were then ruled by the Health Resources and Services Administration (HRSA) to include all FDA-approved contraceptives and contraceptive services prescribed by health care providers.

Given that contraception was already relatively affordable, there was a limited opportunity for any major changes in contraceptive use. However, policy advocates argued that mandates would increase access to more reliable Long Acting Reversible Contraception (LARC), for example, an Intrauterine Device (IUDs). While that has in fact happened, population level research suggests that the path to reduction in the rate of unintended pregnancies lies in inducing non-contraceptors to use contraception, not in inducing contraceptors to use LARCs (Thomas and Karpilow 2016). In any case, contraceptive mandates did impact the form of contraception being used. By equalizing the price of all forms of prescription contraception, the federal mandate increased the demand for the otherwise more expensive products. Incidentally, manufacturers of these products were heavily involved in lobbying for the federal contraceptive mandate, as will be explored below.

This paper analyses the emergence of contraceptive insurance mandates in the context of Virginia Political Economy, focusing on James M. Buchanan's distinction between a productive and a redistributive state. Buchanan would surely view insurance mandates as an expansion of a welfare state and an activity indicative of constitutional anarchy. Any explanation of societal coordination within constitutional anarchy must involve an explanation of coordinated patterns of interactions between political and market enterprises, the tools for which can be found in Richard E. Wagner's framework of Entangled Political Economy. The paper starts with a brief overview of the history of modern contraceptives in the U.S., followed by an overview of the push for state and federal involvement. I then summarize the main features of Buchanan's integrative approach of treating political and market interactions in terms of voluntary exchange and its relation to Wagner's Entangled Political Economy. The second to last section applies the framework of Entangled Political Economy to the emergence of contraceptive mandates. I conclude that the push for state and federal contraceptive mandates was driven by a rent-seeking effort oriented at increasing the demand for the more profitable forms of contraception.

Affordability of Contraception in the U.S.

Enovid, the oral birth control pill, was first approved by the FDA for the purpose of menstrual regulation in 1957. Approval for contraceptive use followed in 1960. Another popular reversible contraceptive method, an IUDs, was approved by the FDA in 1967. These developments were accompanied by other legal changes. In 1965, in *Griswold v. Connecticut*, the Supreme Court declared that married couples have the constitutional right to use contraception. In 1972, in *Baird v. Eisenstadt*, the Supreme Court legalized birth control for all, irrespective of marital status (Chesler 2007). The Contraceptive Revolution ensued.

Responses collected in the National Survey of Family Growth (NSFG) suggest that between 1965 and 1973, the share of married[1] women aged 15–44 who used traditional methods of contraception declined from 40 to 20%. This change was an outcome of an increase in the popularity of sterilization, oral contraception, and IUDs. In that period, use of sterilization increased from 7.8 to 18.6%, oral contraception from 15.1 to 22.5, and IUDs from 0.8 to 6.3%. As a result, the share of married women using any form of contraception increased from 63 to 68%. A majority of non-users cited pregnancy, being post-partum, seeking pregnancy, or infertility as reasons for not using contraception. Only 9.7% in 1965 and 7.6 in 1976, reported "other reasons" (Mosher 1982).

Marking a cultural change, by 1982, the NSFG survey expanded the pool of respondents from "married women" to "women who ever had sexual intercourse" (Mosher and Jones 2010). In this group, in the 1982 survey, 76.3% of women confirmed having used oral contraception at some point in their life. This number grew to 82.3% in 2002 and remained at that level in the period between 2006 and 2008. In 1982, 15.6% were using the pill, with the number growing to 18.9% in 2002 and then slightly declining to 17.3% in the 2006–2008 survey. By 1982, only about 4% of women used traditional, relatively ineffective, methods of contraception. Their share did not change much in the following years.

Similar to the findings from the surveys conducted between 1965 and 1976, subsequent surveys showed that less than 10% of respondents reported "other reasons" for not using contraception. 7.4% in 1982, 5.2 in 1995, 7.4 in 2002 and 7.3 in 2006–2008 (Mosher and Jones 2010). These are the women who are considered to be at risk for an unplanned pregnancy. And according to findings from

[1]While the survey focused only on married women, it's worth remembering that in the 1960s and 1970s, the share of women age 25 or older who never been married was significantly smaller than today, at about 8%.

population-level research, this is the group that should be targeted if a reduction in the rate of unintended pregnancies were the actual objective, as opposed to encouraging women who already use condoms or oral birth control to switch to IUDs (Thomas and Karpilow 2016).

There is no reliable way to assess what share of women in the "other reasons" group were prevented from using effective contraception by financial concerns. Based on revealed preferences we need to assume that if a woman is using a particular form of contraception, she can afford it. Of course, the reverse is not true. There are many reasons for why a woman would not use contraception, affordability might be just one of many concerns. The NSFG data captures the rapid spread of contraception in the United States which suggests that contraception had been relatively affordable and easily accessible for the majority of women. Moreover, it is important to keep in mind that contraceptive insurance mandates were not designed for low-income women. In order to benefit from the contraceptive mandate, a woman must be eligible for a private insurance plan, a benefit usually associated with full-time, professional, positions.

As stated in the introduction, when Searle's Enovid was first approved, its price was about $10 per month, which would be equivalent to about $80 today. But the price was quickly lowered to about $3.5 a month, or about $32 per month today. This price decrease was due in part to FDA approval of a lower dosage as sufficiently effective, and in part due to competition. By 1970 Searle's competitors, Ortho, Syntex, Parke-Davis, Eli Lilly, Upjohn, Wyeth, and Mead Johnson received patent protection and FDA approval for their formulations of oral birth control. With so many substitutes, a downward pressure on prices ensued. This pressure was intensified when these patents begun to expire and generic formulations became available in the early 1990s. By 2007, of the 90 oral contraceptives available on the market, 83 had generic equivalents (Food and Drug Administration 2008). Today, those buying oral birth control without an insurance plan pay between $20 and $50 per month. At Walmart, 9 types of birth control can be bought for as little as $9 per month, with no insurance coverage needed (Walmart 2017).

One often cited weakness of oral birth control is the need for the daily intake. Forgetting to take the pill even for one day might reduce its effectiveness. More convenient alternatives became available since the 1990s: the implant, the three-month injectable shot, the skin patch, and the vaginal ring. These new products were not scientific breakthroughs but just more convenient methods for the delivery of the same chemical formulations as the ones that can be found in oral birth control (Watkins 2012). And just like the oral birth control pills, these new products prevent pregnancy by preventing ovulation. However, the novel delivery mechanisms allow the hormones to enter the bloodstream directly and eliminate the need for the daily intake.

Intrauterine devices (IUDs) are another alternative to oral birth control and have been available in the U.S. almost as long. IUDs provide protection from unintended pregnancy for up to 10 years and are therefore classified as Long Acting Reversible Contraceptives. IUDs lost popularity in the 1980s in the fallout from the Dalkon Shield scandal (Mintz 1985). In response, the FDA begun to treat them as pharmaceuticals, not medical devices. Treatment of IUDs as pharmaceuticals results in a longer approval process and more stringent testing requirements, which discourages European and Canadian companies from bringing their products to the U.S. and protects U.S. companies from competition. It also explains why IUDs are so expensive in the U.S., at about $1000, an absurd price for a simple, small t-shaped device, and five times the price of IUDs in the United Kingdom and Canada.

Clearly, given the affordability of birth control, insurance coverage is not necessary in order for contraception to be affordable. In fact, since the purpose of obtaining health insurance is to eliminate uncertainty and the possibility of incurring a large medical expense, we should not expect such coverage to be commonly offered if at all. Moreover, since the ratio of administrative charge to insurance premium is larger for smaller claims, we also should not expect much demand for such coverage. However, in the U.S., the tax-free status of the employer-purchased health insurance provides strong incentive to purchase insurance coverage that includes small claims (Feldstein 2011). Given the combination of market forces and tax incentives, it should come as no surprise then that majority of private plans offered some contraceptive coverage well before the introduction of the first state contraceptive mandate in 1998. For example, in 1993, 72% of private plans covered at least one of the leading methods of contraception: diaphragm fitting, three-month injectable, IUD insertion, and oral contraceptives (The Guttmacher Institute 1994). 59% of all plans covered oral contraceptives. Among the four different forms of health care plans (Indemnity, HMO, PPO, POS), HMOs offered most coverage with 84% of plans offering oral contraceptive coverage and 86% paying for IUD insertion (though only 47% also covered the device). Only 7% of all HMO plans provided no coverage for any of the leading methods of contraception.

Reproductive Health Movement and the Push for Mandates

Despite the relative affordability and easy access to contraception, advocacy for mandated contraceptive coverage began to emerge in the early 1990s. The signals of its advent can be found in the 1990 report by the National Research Council produced in cooperation with government and industry leaders, researchers, and advocacy groups (National Research Council 1990). The report documented the withdrawal of pharmaceutical companies from contraceptive research and the obstacles to the development of new contraceptives. According to the report, no new methods of contraception have been developed since the 1960s and only one major American company was still involved in research. The report focused on product liability laws as the main factor discouraging private investment. The report echoed the concerns raised previously by Carl Djerassi, a chemist credited with synthesizing a key ingredient of the oral contraceptive. Djerassi argued that there would be no new developments in contraceptive research unless the incentive structure was altered so that pharmaceutical manufacturers were encouraged to continue investing in contraceptive research and development (Djerassi 1970, 1989).

To say that there is a lack of research into some matter suggests an expectation of unmet demand. But that was not the case here. As the authors of the 1990 report write “Despite the widespread practice of modern contraception and the overall favorable attitudes toward fertility control, there is no broad public demand for the development of new contraceptives." Despite that, the report argued for increased government funding, suggested that the FDA give more weight to contraceptive effectiveness and convenience of use, and insisted on significant changes in product liability laws. These recommendations were made even though the report acknowledged that contraceptive research was still being carried out by nonprofits and smaller entrepreneurial firms.

In the fall of 1993, Bill Clinton brought to Congress a bill which, if enacted, would introduce a universal healthcare system. The heated debate that ensued in the following months provided an opportunity for those interested in shaping the new health care policy landscape, including reproductive rights groups. The Clinton proposal was built on the assumption that contraceptive drug coverage would be ensured as long as prescription drug benefits were required by the proposed legislation (Dailard 2004). This assumption was immediately questioned. The Guttmacher Institute, a think tank focused on advancing sexual and reproductive health, conducted a nationwide survey of private health insurers (The Guttmacher Institute 1994). Some of the report findings were discussed in the previous section, however, the report had presented them in a very different light. The authors argued that the survey provided evidence of insufficient private plan coverage of contraceptives, highlighting inequality in access and marginalization of women's health needs. Highly publicized, the report launched a campaign for mandating comprehensive insurance coverage of contraceptives and in March 1994, the president of the Guttmacher Institute was invited to testify to Congress, at a Senate hearing entitled "Women's Health Care in the President's Health Care Plan" (Dailard 2004). While the Clinton initiative failed that same year, the push for contraceptive mandates continued. The survey of health insurance plans turned out to be a huge success for the Guttmacher Institute and for the contraceptive advocacy movement in general. In a publication highlighting the 50 years of the institute's impact, the 1994 survey is credited with galvanizing broad support for "change at the federal and state levels and set off a chain of litigation and progressive legislation, including laws in 27 states mandating private insurance coverage of contraceptives" (The Guttmacher Institute 2018). Many of the claims from the Guttmacher 1994 report were repeated in the 1995 publication from the Institute

Of Medicine (Brown and Eisenberg 1995). Similar to the Guttmacher report, this was a landmark publication for the contraceptive rights movement. It was the first publication to recommend the mandated coverage of contraceptive services and supplies without cost-sharing.

A push for legislative changes also ensued at the state level. That very same year legislators in Hawaii, California, and New York proposed bills mandating contraceptive insurance coverage but these were not enacted (Sollom 1995). During the 1995–1996 legislative term contraceptive insurance mandates were proposed again in Hawaii, California, and New York, and similar measures were brought up by legislators in Illinois, Oregon, Virginia, and Wisconsin (Sollom 1997). By the end of 1997, legislators in 10 different states followed with similar bills but none of these attempts were successful. It was not until the spring of 1998 that Maryland became the first state to adopt the contraceptive coverage mandate. Within six years, a total of 20 states added similar laws. By the time of Obamacare, 28 states had their own mandates that required health insurance coverage of prescription contraceptives. It is worth noting that state mandates come with some serious limitations, for example, employers who self-insure are not bound by state mandates.

At the federal level, a seemingly unrelated legislation provided a framework for the contraceptive mandate. The Health Insurance Portability and Accountability Act of 1996 (HIPAA) was the first federal foray into health insurance regulation which until this point was left entirely to the states. With HIPPA, the reproductive health movement was given a framework for addressing deficiencies in contraceptive coverage (Dailard 2004). It was now possible for the health insurance to be regulated at the federal level. In 1997 the Equity in Prescription Insurance and Contraceptive Coverage Act (EPICC) was introduced to Congress by a bipartisan coalition (S. 743 105th Congress). If approved, it would mandate health insurance plans to provide the same level of coverage for prescription contraceptives and contraceptive services that they provide for other prescription drugs and outpatient health services. In practice, prescription drug benefits would need to cover all contraceptive drugs and devices, such as the birth control pills, IUDs, Norplant, Depo-Provera, diaphragms, and emergency contraception. While it was not successful in 1997, the bill was reintroduced in 1999 (S. 1200 106th Congress), 2001 (S. 104 107th Congress), 2003 (S. 1396 108th Congress), 2005 (S. 1214 109th Congress), and in 2008 (S. 3068 110th Congress). EPICC also became a part of a 2005 proposal, entitled Prevention First Act (S. 20 109th Congress) that was later reintroduced in 2007 (S. 21 110th Congress), and in 2009 (S. 21 111th Congress).

The original EPICC bill gained significant attention in 1998 when FDA approved Viagra and its coverage by private insurance plans was broadly reported in the media, raising gender fairness concerns (Kindell 1999). The effort was further fueled by a new report from the Guttmacher Institute, which featured an analysis concluding that adding full contraceptive coverage to a prescription drug benefit would have minimal impact on health plan premiums, increasing them by only about $21.40 per worker (Gold 1998).

The first significant federal-level victory for the reproductive health movement came in 2000 when the Equal Employment Opportunity Commission ruled that companies providing prescription drug benefits to their employees that did not include birth control were in violation of Title VII of the 1964 Civil Rights Act (Equal Employment Opportunity Commission 2000). The commission mandated that employers must not only cover “drugs, devices, and preventive care” related to contraceptives, but must also include visits to doctors to prescribe and monitor their use. This policy is still in effect and it applies to all employers with 15 or more employees. In fact, the policy even applies to religious employers because, while they might discriminate on the basis of religion, they are not allowed to discriminate on the basis of sex. The ruling was confirmed in subsequent lawsuits.

It would be almost a decade before another great victory at the federal level, this time in the form of a Senate amendment to the Section 2713 of the Patient Protection and Affordable Care Act, entitled Coverage of Preventive Health Services. The Women Preventative Health Amendment was proposed by Senator Barbara Mikulski and it was approved by the Senate on December 3rd 2009. Before the amendment, language in the Coverage of Preventive Health Services section of the PPACA required all private health plans to provide coverage for a range of preventive services and forbid imposition of any cost-sharing such as copayments, deductibles, or co-insurance. The exact scope of coverage was to match the latest recommendations of the United States Preventative Services Task Force (USPSTF).

It is worth noting that there was no mention of contraceptives in the Mikulski amendment. In fact, contraceptives do not appear once in the 906 pages of the PPACA bill. The amendment only specified that in addition to the preventative services recommended by the USPSTF, private health plans must cover womens' preventative care and screenings. Guidelines and detailed requirements for womens' preventative coverage were left to be determined at a future date by the Health Resources and Services Administration (HRSA). Before making the recommendation, the HRSA solicited feedback from the Institute of Medicine. In response, the IOM recommended mandated coverage of well-woman visits, all FDA-approved contraceptives and related services, broader screening and counseling for STIs and HIV, breastfeeding support and supplies, and the domestic violence screening. The HRSA adopted these guidelines on August 1, 2011, less than two weeks after the release of the IOM findings (Institute of Medicine 2011).

Advocates of insurance mandates argued that by increasing access and affordability, these policies would reduce the rate of unintended pregnancies. So far state insurance mandates were found to have a modest, and to some extent uncertain, impact on utilization of contraception and birth rates. For example Raissian and Lopoo find that state contraceptive mandates increased prescription contraception use among women with low educational attainment, but their results are not robust to a variety of specifications (Raissian and Lopoo 2015). In terms of birth rates, Dills and Grecu find that among Hispanic women 19 years old or younger there was a 4% decrease in births (Dills and Grecu 2017). They do not find any impact on birth rates among other demographic groups. Interestingly, researchers also find that enactment of state contraceptive mandates have an immediate effect, before the law becomes effective (Mulligan 2015). This might suggest that the impact of the mandates, at least partially, is generated by the discussion surrounding the enactment (Dills and Grecu 2017).

The federal contraceptive mandate did cause a decline in women's out-of-pocket spending, with the savings estimated to be about $248 a year for the intrauterine device and $255 for the pill (Becker and Polsky 2015; Cox et al. 2016). $20 per month seems to be a rather insignificant share of income for women enrolled in the employer-provided insurance plans. Despite the fact that the proportion of American women with no cost-sharing for contraceptives rose in 2013 from 20 to 50%, number of prescriptions written for contraceptive medications increased only by 4.6% (IMS Institute for Healthcare Informatics 2014).

Significant effort was also invested in publicizing the benefits of Long Acting Reversible Contraception (LARCs) as a more reliable form of contraception than oral birth control. It was argued that switching to LARCs will significantly contribute to a decrease in unintended births. By 2014 there was a significant uptake in the usage of IUDs. It is questionable, however, whether the increased utilization of LARCs will lead to a decrease in unintended births. Population level research suggests that the non-marital pregnancy rate would not be substantially different whether noncontraceptors adopted LARCs or if they began to use oral contraception. The path to a lower rate of unintendent pregnancies is through converting noncontraceptors to contraceptors, not through having users of birth control switch to LARCs (Thomas and Karpilow 2016; Karpilow and Thomas 2017).

Politics Without Romance

Most public policy analysis is conducted in terms of its impact on social welfare. The focus is on social costs and benefits with the goal of finding and fostering a more efficient allocation of resources. This approach allows economists to play the role of wise advisors to benevolent political leaders, which in turn lends legitimacy to the political process. But this approach becomes deeply questionable upon a closer inspection. The preceding sections offered a brief overview of access to contraception in the United States in the last six decades, followed by a summary of findings from the research on the impact of contraceptive insurance mandates on the rate of unintended pregnancies and on out-of-pocket spending. What emerges from these overviews is a startling incongruence between the stated intentions of policy advocates, the severity of the problem they sought to address, and the changes brought about by the policy. We are faced with the challenge of explaining a two-decade long effort to solve a problem that did not exist. Why invest so much time and effort pushing for state and federal policy change if the supposed beneficiaries of the bill were barely affected by it? Was it really worth to invest all this research and effort in saving middle-class women $240 a year?

Any attempt to answer these questions calls into question the public interest theory of government and the allocative approach of welfare economics. In light of the repeated adoption of outwardly ineffective public policies, to accept the public interest theory of government, we would need to accept the unfettered incompetence of political leadership. Otherwise, we need a different analytical framework. Public Choice, described by James Buchanan as *Politics Without Romance*, was developed to serve as such an alternative. Buchanan, and his colleagues at University of Virginia, rejected the public interest approach and set out to develop a uniform framework for the analysis of market and political processes. Markets had long been understood in terms of spontaneous order processes, with observable outcomes being traced back to the interactions of individuals in the pursuit of their diverse, often conflicting, goals. Buchanan sought to develop a framework that would expand this approach to include the explanation of political outcomes and processes. Doing so required breaking apart from neoclassical economics (Johnson 2014). Instead of focusing on allocation and efficiency, Buchanan envisioned a research program that would explain social phenomena as an outcome of interactions between individuals.

Despite Buchanan's intention, Public Choice insights became incorporated into the neoclassical economics, and the field evolved away from the Buchanan's core ideas. Today, Public Choice is understood more as a study of the relative efficiency of different voting rules and legislative processes than a study of politics as exchange. It no longer serves as an alternative to the allocative approach of neoclassical economics. However, Buchanan's remarkable contributions live on through the Virginia Political Economy (VPE) research program. VPE is a distinct research program that builds on the Smith-Menger line of analysis, centered on the institutions of human governance, as Richard Wagner points out in his effort to identify the core insights of VPE (Wagner 2016) and as will be explored below.

One of the key distinguishing features of Virginia Political Economy is its rejection of social aggregates and the adherence to methodological individualism. In fact, Buchanan described his approach as profoundly individualistic (Buchanan 1975). In response to Arrow's (1951) attempt to find a rule for aggregating individual preferences into rational social outcomes, Buchanan pointed out that such exercise involves assigning individual characteristics to a collective (Buchanan 1954). Yet, to Buchanan, there are two, mutually excludable possibilities: either the individual is the only entity that possess ends and values, or the collective is an independent entity with its own value ordering. Consistent with this assertion, Arrow shows that there is no rule that would allow for a derivation of a social welfare function from individual orderings; that no rule allows for an aggregation of individual preferences into social preferences. To Arrow, this implies that there is no rational social choice mechanism. Buchanan, however, draws a stern distinction between a rule and a process. Buchanan does agree with Arrow that there is no rule that would allow for a derivation of a social welfare function from individual orderings. That, however, does not imply that the decision-making processes are incapable of producing social outcomes consistent with individual preferences. In contrast to majority rule, markets do translate individual preferences into consistent choice, precisely because market outcomes originate from the individual choice process.

Adherence to methodological individualism requires that group level outcomes be explained in terms of choices made by individuals in the interactions with other group members. When the notion of welfare maximization is rejected, policy can no longer be considered an object of direct choice. From the perspective of methodological individualism, policy must be explained as an emergent phenomena, which Podemska-Mikluch explores with respect to the adoption of the Medical Reimbursement Act in Poland (Podemska-Mikluch 2014).

Closely related to the notion of methodological individualism is Buchanan's commitment to subjectivism, as he demonstrates in his in-depth study of cost theory (Buchanan 1978). As economists often remark, any choice comes with an opportunity cost. What is less widely acknowledged but critically important is the fact that opportunity cost can only be known to the decision maker, nobody else. This insight puts into question the research on cost neutrality of contraceptive mandates. Any sort of calculation as to whether insurance companies or taxpayers save money by providing contraception is a pointless exercise once we recognize the subjective nature of cost. We do not know the actual opportunity cost of providing contraceptive coverage, only those who make these decisions can know. Recognition of the subjective nature of cost suggests that any attempt to estimate other entities' cost involves an arbitrary selection of what to include and what not to include in the estimate. For example, cost neutrality studies do not usually include the increased cost of providing healthcare services during a geriatric pregnancy. Moreover, there is also the puzzle of why insurance companies would leave money on the table by not providing contraceptive coverage. Buchanan's elucidation of the tight connection between cost and choice exposes the grossly misleading nature of public interest approach. Any pronouncement of public interest must involve one's subjective perception of what that interest might be. So even if the leaders are saints, they are going to pursue goals according to their own moral preferences.

In place of public interest theory of government, Buchanan argued for behavioral symmetry—behavior of political actors should be conceptualized in the same manner as that of market actors (Buchanan and Tullock 1962; Brennan and Buchanan 1980). Methodological individualism is neutral with respect to the motivation of involved individuals. Nevertheless, Buchanan suggests that the economic models of man be expanded to include political actors. In economic models, individuals are thought to seek to maximize their own utility, or more generally, to increase their own well-being. No assumptions are made regarding the ends individuals pursue, only that they pursue ends they themselves conceive. Buchanan argued that if these models of man works well enough in economics, they should be a starting point for politics. In defending the notion of behavioral symmetry, Buchanan repeatedly asserted that "the burden of proof should rest with those who suggest that wholly different models of man apply in the political and the economic realms of behavior" (Buchanan 1999).

Once we acknowledge that all individuals are engaged in the pursuit of self-conceived goals, we must recognize that the propensity to engage in mutually beneficial exchange is independent of institutional environment. This leads Buchanan to the analysis of politics as exchange (Buchanan 1987). Just as market outcomes are explained as resulting from interactions among individuals, same must be done for political outcomes. Buchanan distinguished two levels of exchange in politics: constitutional and post-constitutional (Buchanan 1999). Exchange at the constitutional level is an agreement to accept some level of exploitation in exchange for protection. The state that emerges at the constitutional level plays a protective role, its only responsibility is to enforce the agreed-on laws. Once the constitutional level is established, there is still significant room for mutually benefitial exchange. For one, there might be a demand for the state to produce public goods, or to supply goods as if they were public. Allowing the state to take on a productive role is one possible form for escaping the problems of free-riding (Buchanan 1968). In order for that to happen the state must be enabled to coerce payments. However, this provides the state with the ability to benefit some groups at a cost to others. In other words, enabling the state to provide public goods creates opportunities for rent-seeking. What emerges is a redistributive state, a return to the Hobbesian world of a war of all against all, but with conflict occurring at the institutional level (Buchanan and Congleton 1998). Emergence of a redistributive state places individuals at the mercy of bureaucrats and politicians and erodes constitutional protections of individual liberty, resulting in a system that Buchanan describes as a "constitutional anarchy" (Buchanan 1975).

Contraceptive Politics as a Peculiar Business

Building on the tradition of Virginia Political Economy, Wagner developed a framework of Entangled Political Economy (Wagner 2009, 2016). Entangled Political Economy might be described as an effort to understand societal coordination within constitutional anarchy. One of the key distinguishing features of the Entangled Political Economy is the placement of political actors within the same sphere of activity as market actors, where they are entwined in complex exchange relations.

Wagner postulates that the shared characteristics of political and market enterprises are the reason for why we should think of political enterprises as peculiar forms of business (Wagner 2016). For both types of enterprises, the fundamental objective is to infuse novelty. Doing so entails a cost, at the very least there is the opportunity cost of time spent on developing and testing the idea. So to be successful in either market or politics, entrepreneurs require investor support.

Market enterprises attract investors with a promise of financial returns. But what attracts investors to a political enterprise? Even in this regard, political enterprises are not that different from market enterprises. Buchanan and Tullock argue that special-interest group activity is a direct function of expected gains (Buchanan and Tullock 1962). Similarly, Wagner suggests that at the most fundamental level investment in political enterprises occurs when it offers higher returns than other forms of investment (Wagner 2016). However, the relationships with investors will differ depending on whether the enterprise operates in the environment of alienable or inalienable property. Working with alienable property, market enterprises engage in reciprocal, mutually beneficial exchange. In contrast, the value of a political enterprise to an investor lies in its ability to alter the relative prices of various market offerings. In order for that to happen, others must face a worsening in the terms of exchange. Wagner identifies this group as forced investors (Wagner 2016). The very purpose of investing in a political enterprise is to redistribute resources of forced investors to serve the desires of voluntary investors. The presence of forced investors gives political interactions its triadic character (Podemska-Mikluch and Wagner 2013).

Forced Investors

Using the simple logic of supply and demand, federal contraceptive mandates can be analyzed as a subsidy. Doing so suggests that at least two groups benefited from the federal contraceptive mandate:

producers and consumers. Even though the mandate did not provide a direct subsidy, it forced insurance companies to give up any copayments or deductibles they would otherwise continue to collect, and to pay for all approved contraceptive products, irrespective of their price. Since insurance companies typically pass premium increases onto the insured in the form of increased contributions or premiums, effectively the insured paid for the subsidy. As for the benefits to the producers, the subsidy drives up demand, leading to higher prices and greater quantity sold. What could be more beneficial to a market enterprise than a third party being forced to provide its products free of charge?

To analyze the impact of contraceptive mandates on the revenue of pharmaceutical manufacturers, it is necessary to note that not all forms of contraceptives are equally profitable. As with any other pharmaceutical products, patents are the key determinant of profitability. However, the majority of oral birth control patents expired in the late 1980s and generic substitutes became available. In order to be profitable, any new product would need to fight for market share with generic oral birth control. Attempting to win a share of the market through market competition was not a risk pharmaceutical companies wanted to take as evidenced by their withdrawal from contraceptive research, discussed above. However, market competition is not the only method of winning a share of the market. Mandating private insurance coverage of contraception so that women paid $0 regardless of type, increased the attractiveness of new products.

Four companies, producers of brand name contraceptives, were among the key winners of the federal mandate: Merck (producer of NuvaRing and Implanon/Nexplanon, a subdermal contraceptive implant, Pfizer (producer of Depo-Provera injection shot), Johnson and Johnson (producer of diaphragms and birth control pills), and Teva (producer of ParaGard T-380A, the only copper-containing IUD approved for use in the U.S.). Stocks of these four companies had a high forward price-to-earnings ratio in late 2011, a clear indication that investors were expecting higher future earnings. They did not end up disappointed. For example, U.S. NuvaRing sales increased from $367 million in 2012 to $564 million in 2017 while sales of Merck's Implanon/Nexplanon, a subdermal contraceptive implant, also increased in that period, from $348 million to $496 million in 2017 (Merck 2018).

As mentioned previously, mandates contributed to an uptake in the usage of IUDs (Snyder et al. 2018). The shift from oral contraceptives to IUDs offered tangible benefits not only to IUD manufacturers but also to the prescribing physicians and outpatient clinics. The physician payment for an IUD insertion is $600–$1000. Only OBGYNs, some trained midwifes, and some family physicians have the necessary skills to insert an IUD. In contrast, a growing number of apps and websites allows women to get oral birth control without seeing a physician, and some argue that oral birth control should be sold over the counter (it would no longer be covered by the mandate). Some states already allow pharmacies to dispense contraceptives with no physician involvement. No wonder then that the American College of Obstetricians and Gynecologists (ACOG) had advocated for, and fully endorsed, IUDs as a primary form of birth control. ACOG also encouraged physicians to discuss IUDs with patients and issued a guide on how to bill for IUDs, immediately after the IOM report was published (ACOG 2011). The American Academy of Pediatrics soon followed by endorsing IUDs as a first-line contraceptive choice for teenage girls (Ott and Sucato 2014).

Bootleggers, Baptists, and Credence Goods

Undeniably, the pharmaceutical industry was heavily involved in lobbying for the contraceptive mandate, and for Obamacare in general (Schweizer 2012). The health sector lobbying has reached its highest point in 2009, during the Obamacare debate, spending $552 million and deploying 3526 lobbyists in D.C. (OpenSecrets 2018b). About half of the health sector annual lobbying comes from the pharmaceutical and health products industry. The pharmaceutical and health products industry lobbying ramped up in 2008 when the industry spent $239 million dollars in Washington, followed by $272 during the Obamacare lobbying. In 2009, the largest industry contributor was its trade association Parent Pharmaceutical Research and Manufacturers of America, with contraceptive manufactures (Pfizer, Merck, Johnson and Johnson, and Teva) also high on the list. Other major spenders in the health sector included the American Hospital Association and the American Medical Association, each spent $20 million in 2009.

Since there were numerous attempts to enact the federal contraceptive bill, an easy way to assess which groups were most involved in direct lobbying for this particular initiative comes from looking at the lobbying filings, available from OpenSecrets.org from 2006 to present. In that period, the word 'contraceptive' was mentioned in lobbying filings from 58 organizations. America's Health Insurance Plans mention contraceptives 48 times in its filings, followed by Planned Parenthood, Alan Guttmacher Institute, American Association of University Women, League of Women Voters of the US, and NARAL-Pro Choice America. American Academy of Family Physicians, American College of Ob/Gynecologists, and the American Academy of Pediatrics are also among the 58 organizations (OpenSecrets 2018a).

At first glance womens' advocacy groups, pharmaceutical companies, and physician associations seem to be strange bedfellows. However, close ties between pharmaceutical manufacturers and patient advocacy groups are well documented (Rose 2013; Rothman et al. 2011). Advocacy groups turn public attention to the popular aspects of a lobbied policy while hiding from view its rent-seeking aspects. Within the framework of Entangled Political Economy, the work of advocacy groups can be viewed as a an entrepreneurial solution to coordination problems between private and public entities, which Podemska-Mikluch and Wagner explore (2017). Since public organizations do not respond to the market mechanism of profit and loss, advocacy groups provide a service of transforming market signals into political signals.

The close ties between pharmaceutical companies and women advocacy groups are captured by the Bootleggers and Baptists metaphor. As Yandle argues, opportunistic rent-seekers often frame their programs in a manner designed to attract support from idealists (Yandle 1983). Bootleggers and Baptists come together to support the same goals, often for unrelated reasons. Baptists argue that the particular programs will enhance child safety, promote energy independence, save family farms, or some other widely popular and supported goal. But looking below the surface, one discovers that these programs are about government favoritism for well-organized special interest groups.

Since the strategy of Bootleggers and Baptists is deceptive in nature, their business model should have a low chance of repeated success. Once voters learn that the actual impact of a particular policy is far from what the Baptists promised, the party is over. But that is usually not the case. As Wagner notes, public policy is more of a credence good than an experience good (Wagner 2016). Consumption of experience goods reveals quality and helps decide on future consumption. In contrast, the impact of credence goods on utility is difficult or impossible for consumers to ascertain, even after consumption (Emons 1997). Since public policy shares the characteristics of credence goods, enactment of policy does not influence future consumption decisions. Any aggregate observations on the impact of contraceptive mandates is subject to interpretation, it is not a matter of direct experience. As Wagner notes, such shell games misdirect an observer's attention away from where the action is truly located. In the case of the federal contraceptive mandate, the use of aggregate notions of social cost and benefit was supported by the controversy on whether the mandate infringed on religious freedoms of employers who opposed birth control.

Forced Investors Redux

When successful, politically induced changes in relative prices benefit voluntary investors. In order for that to happen, some group must face a worsening in the terms of exchange. Wagner identifies this group as forced investors (Wagner 2016). Forced investors are coerced to support the political enterprise through changes in regulatory or fiscal policy. There are endless examples of regulatory policies that accomplish this goal, such as increased safety standards that benefit incumbent firms and discourage entry of competitors. Subsidies are an even more direct form of generating returns for voluntary investors at the expense of forced investors. Since it is not always easy to identify the cause for the worsening in the terms of trade, forced investors are often ignorant of the support they provide.

Insurance mandates are a straightforward example of a political enterprise that relies on the support of forced investors. In general, an insurance benefit mandate causes a substantial (0.85–0.89%) increase in premiums (Bailey and Blascak 2016). These increases are largely passed onto the insured in the form of increased premiums, but the nontaxable status of employer-provided health insurance insulates employees from experiencing the full impact of premium increase. As far as the impact of contraceptive mandates on premiums is considered, the findings are conflicting and inconclusive. Policy proponents argued that contraceptive mandates would be cost neutral for insurance companies or even that they would result in savings, due to averted mistimed and unwanted pregnancies. However, when an insurer is forced to cover contraception, it usually has no reason to anticipate any savings because the majority of unwanted or mistimed pregnancies would be averted anyway due to their high private cost (Finley 2012; Liebman 2014).

Another group of forced investors are those who pay the market price for contraceptives. Since mandated insurance coverage is equivalent to a subsidy, we should anticipate that the market price would increase after the mandate. This would adversely affect women who pay out-of-pocket for contraceptives, either because they do not have health insurance or because they do not want to use it for this purpose. Medicaid must also now pay higher prices for contraceptives, transferring the burden onto taxpayers. For example, data collected in Medicaid's National Average Drug Acquisition Cost shows that while in August 2013 Medicaid paid $86 for NuvaRing, by February 2018 the price of NuvaRing has increased to $149.

Conclusion

The push for contraceptive mandates succeeded in turning a right into an entitlement. The rhetoric of gender equality and reproductive justice, combined with the religious freedom debate, hid from view the redistributive aspects of the policy, in particular the expected payoffs of the pharmaceutical manufacturers. The success of the federal contraceptive mandate illustrates that there are many ways in which collectivization of medicine can occur. It is not necessary to institute a single payer system in order to achieve socialized care. Regulation can play the redistributive role just as well, if not better. The growth of the redistributive state makes it all the more important that we adopt the uniform approach to the study of political economy, one that helps foster an understanding of entanglement between political and market enterprises. Any framework that portrays government intervention as exogenous, or as an object of choice, hides the erosion of individual liberty brought about by growing entanglement. While estimating the impact on contraceptive mandates on premiums has its merit, it is not the approach with much potential for reversing the constitutional drift (Figs. 13.1 and 13.2).

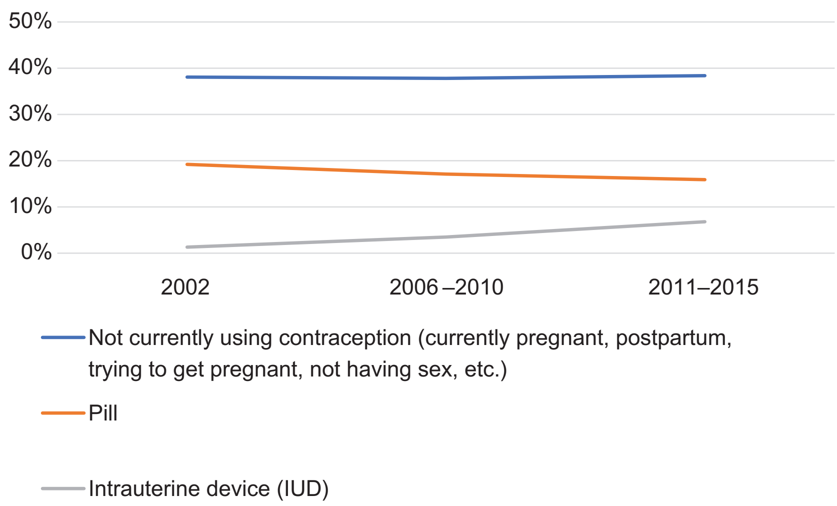


Fig. 13.1 Form of used contraception (Based on Mosher and Jones 2010)

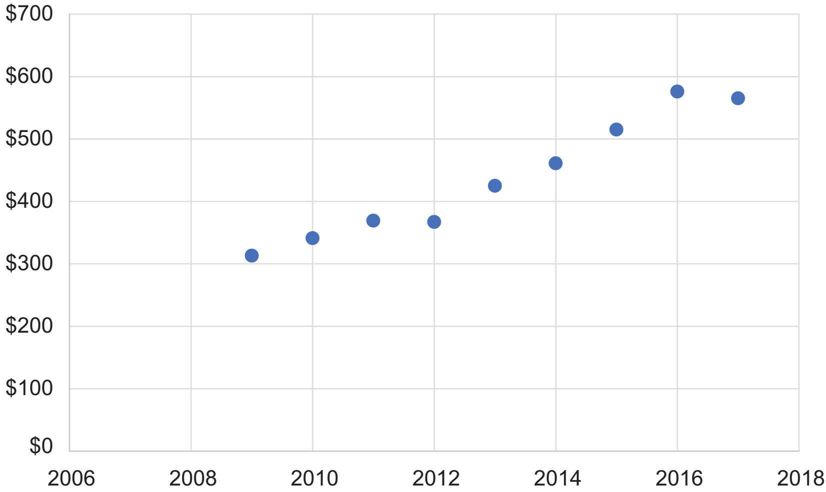


Fig. 13.2 U.S. NuvaRing sales in millions of dollars (Based on Merck's annual reports)

References

American College of Obstetricians and Gynecologists (ACOG). (2011). ACOG Practice Bulletin No. 121: Long-Acting Reversible Contraception: Implants and Intrauterine Devices. *Obstetrics and Gynecology, 118*(1), 184.

Arrow, K. J. (1951). *Social Choice and Individual Values*. New York: Wiley.

Bailey, M. J. (2006). More Power to the Pill: The Impact of Contraceptive Freedom on Women's Life Cycle Labor Supply. *The Quarterly Journal of Economics, 121*(1), 289–320. https://doi.org/10.1093/qje/121.1.289.

Bailey, J., & Blascak, N. (2016). The Effect of State Health Insurance Benefit Mandates on Premiums and Employee Contributions. *Applied Economics Letters, 23*(14), 1042–1046. https://doi.org/10.1080/13504851.2015.1130786.

Becker, N. V., & Polsky, D. (2015). Women Saw Large Decrease in Out-of-Pocket Spending for Contraceptives After ACA Mandate Removed Cost Sharing. *Health Affairs, 34*(7), 1204–1211. https://doi.org/10.1377/hlthaff.2015.0127.

Brennan, G., & Buchanan, J. M. (1980). *The Power to Tax: Analytic Foundations of a Fiscal Constitution*. Cambridge: Cambridge University Press.

Brown, S. S., & Eisenberg, L. (1995). *The Best Intentions: Unintended Pregnancy and the Well-Being of Children and Families*. Washington, DC: National Academies Press.

Buchanan, J. M. (1954). Social Choice, Democracy, and Free Markets. *Journal of Political Economy, 62*(2), 114–123.

Buchanan, J. M. (1968). *The Demand and Supply of Public Goods*. Chicago, IL: Rand McNally.

Buchanan, J. M. (1975). *The Limits of Liberty: Between Anarchy and Leviathan* (Vol. 714). Chicago: University of Chicago Press.

Buchanan, J. M. (1978). *Cost and Choice: An Inquiry in Economic Theory*. Chicago: University of Chicago Press.

Buchanan, J. M. (1987). The Constitution of Economic Policy. *The American Economic Review, 77*(3), 243–250.

Buchanan, J. M. (1999). Politics Without Romance: A Sketch of Positive Public Choice Theory and Its Normative Implications. In *The Logical Foundation of Constitutional Liberty, Vol. 1*. The Collected Works of James M. Buchanan. Indianapolis, IN: Liberty Fund.

Buchanan, J. M., & Congleton, R. D. (1998). *Politics by Principle, Not Interest: Towards Nondiscriminatory Democracy*. Cambridge: Cambridge University Press.

Buchanan, J. M., & Tullock, G. (1962). *The Calculus of Consent: Logical Foundations of Constitutional Democracy*. Ann Arbor: University of Michigan Press.

Chesler, E. (2007). *Woman of Valor: Margaret Sanger and the Birth Control Movement in America*. New York: Simon & Schuster.

Cox, C., Damico, A., Claxton, G., & Levitt, L. (2016, October). Examining High Prescription Drug Spending for People with Employer Sponsored Health Insurance. *Kaiser Family Foundation*. Available at https://www.healthsystemtracker.org/brief/examining-high-prescription-drug-spending-for-people-with-employer-sponsored-health-insurance/.

Dailard, C. (2004). Contraceptive Coverage: A 10-Year Retrospective. *Guttmacher Report on Public Policy, 7*(2), 6–9.

Dills, A. K., & Grecu, A. M. (2017, February). Effects of State Contraceptive Insurance Mandates. *Economics and Human Biology, 24*, 30–42. https://doi.org/10.1016/j.ehb.2016.11.004.

Djerassi, C. (1970). Birth Control After 1984. *Science, 169*(3949), 941–951. https://doi.org/10.1126/science.169.3949.941.

Djerassi, C. (1989). The Bitter Pill. *Science, 245*(4916), 356–361. https://doi.org/10.1126/science.2667135.

Emons, W. (1997). Credence Goods and Fraudulent Experts. *The RAND Journal of Economics, 28*(1), 107–119. https://www.jstor.org/stable/2555942?seq=1#metadata_info_tab_contents.
Equal Employment Opportunity Commission. (2000). *Decision on Coverage of Contraception*. Available at https://www.eeoc.gov/policy/docs/decision-contraception.html.
Feldstein, P. J. (2011). *Health Policy Issues: An Economic Perspective*. Chicago and Arlington, VA: Health Administration Press; Association of University Programs in Health Administration (AUPHA).
Finley, B. (2012, February 24). Cloudy Contraception Costs. FactCheck.org. Available at https://www.factcheck.org/2012/02/cloudy-contraception-costs/.
Food and Drug Administration. (2008). *Therapeutic Equivalence of Generic Drugs. Letter to Health Practitioners*. Rockville, MD: Food and Drug Administration.
Gold, R. B. (1998). The Need for and Cost of Mandating Private Insurance Coverage of Contraception. *Guttmacher Report on Public Policy, 1*(4), 5–7.
Goldin, C., & Katz, L. F. (2002). The Power of the Pill: Oral Contraceptives and Women's Career and Marriage Decisions. *Journal of Political Economy, 110*(4), 730–770.
IMS Institute for Healthcare Informatics. (2014). "Medicine Use and Shifting Costs of Healthcare".
Institute of Medicine. (2011). *Clinical Preventive Services for Women: Closing the Gaps*. Washington, DC: The National Academies Press. https://doi.org/10.17226/13181.
Johnson, M. (2014). James M. Buchanan, Chicago, and Post-War Public Finance. *Journal of the History of Economic Thought, 36*(4), 479–497. https://doi.org/10.1017/S1053837214000571.
Karpilow, Q. C., & Thomas, A. T. (2017). Reassessing the Importance of Long-Acting Contraception. *American Journal of Obstetrics and Gynecology, 216*(2), 148.e1–148.e14. https://doi.org/10.1016/j.ajog.2016.10.012.
Kindell, K. (1999). Prescription for Fairness: Health Insurance Reimbursement for Viagra and Contraceptives. *Tulsa Law Journal, 35,* 399.
Liebman, D. (2014, July 9). Does Contraceptive Coverage Pay for Itself? A Review of the Evidence. *The Incidental Economist*. Available at https://theincidentaleconomist.com/wordpress/does-contraceptive-coverage-pay-for-itself-a-review-of-the-evidence/.
Merck. (2018). *2017 Annual Report*.
Mintz, M. (1985). *At Any Cost: Corporate Greed, Women, and the Dalkon Shield*. New York: Pantheon Books.

Mosher, W. D. (1982). *Trends in Contraceptive Practice: United States, 1965–76. Vital & Health Statistics*. Data from the National Survey of Family Growth, Series 23, No. 10. Superintendent of Documents, U. https://eric.ed.gov/?id=ED292000.

Mosher, W. D., & Jones, J. (2010). Use of Contraception in the United States: 1982–2008. *Vital and Health Statistics, 29*, 1–44.

Mulligan, K. (2015). Contraception Use, Abortions, and Births: The Effect of Insurance Mandates. *Demography, 52*(4), 1195–1217. https://doi.org/10.1007/s13524-015-0412-3.

National Research Council. (1990). *Developing New Contraceptives: Obstacles and Opportunities*. Washington, DC: National Academies Press.

OpenSecrets. (2018a). Lobbying Spending Database. OpenSecrets.org. https://www.opensecrets.org/lobby/lookup.php.

OpenSecrets. (2018b). Lobbying Spending Database: Health. OpenSecrets.org. https://www.opensecrets.org/lobby/indus.php?id=H&year=2018.

Ott, M. A., & Sucato, G. S. (2014). Contraception for Adolescents. *Pediatrics, 134*(4), e1257–e1281. https://doi.org/10.1542/peds.2014-2300.

Podemska-Mikluch, M. (2014). Public Policy: Object of Choice or Emergent Phenomena? Lessons from the Polish Medical Reimbursement Act. In S. Horwitz & R. Koppl (Eds.), *Entangled Political Economy* (Advances in Austrian Economics, Vol. 18). Bingley: Emerald Group Publishing.

Podemska-Mikluch, M., & Wagner, R. E. (2013). Dyads, Triads, and the Theory of Exchange: Between Liberty and Coercion. *The Review of Austrian Economics, 26*(2), 171–182. https://doi.org/10.1007/s11138-012-0180-x.

Podemska-Mikluch, M., & Wagner, R. E. (2017). Economic Coordination Across Divergent Institutional Frameworks: Dissolving a Theoretical Antinomy. *Review of Political Economy, 29*(2), 249–266.

Raissian, K. M., & Lopoo, L. M. (2015). Mandating Prescription Contraception Coverage: Effects on Contraception Consumption and Preventive Health Services. *Population Research and Policy Review, 34*(4), 481–510. https://doi.org/10.1007/s11113-014-9353-6.

Rose, S. L. (2013). Patient Advocacy Organizations: Institutional Conflicts of Interest, Trust, and Trustworthiness. *The Journal of Law, Medicine, and Ethics: A Journal of the American Society of Law, Medicine & Ethics, 41*(3), 680–687. https://doi.org/10.1111/jlme.12078.

Rothman, S. M., Raveis, V. H., Friedman, A., & Rothman, D. J. (2011). Health Advocacy Organizations and the Pharmaceutical Industry: An Analysis of Disclosure Practices. *American Journal of Public Health, 101*(4), 602–609. https://doi.org/10.2105/AJPH.2010.300027.

Schweizer, P. (2012, March 2). *Big Pharma's Role in the Contraception Debate*. https://www.thedailybeast.com/peter-schweizer-big-pharmas-role-in-the-contraception-debate?fb_ref=article&fb_source=home_multiline.
Snyder, A. H., Weisman, C. S., Liu, G., Leslie, D., & Chuang, C. H. (2018). The Impact of the Affordable Care Act on Contraceptive Use and Costs among Privately Insured Women. *Women's Health Issues: Official Publication of the Jacobs Institute of Women's Health, 28*(3), 219–223. https://doi.org/10.1016/j.whi.2018.01.005.
Sollom, T. (1995). State Actions on Reproductive Health Issues in 1994. *Family Planning Perspectives, 27*(2), 83–87.
Sollom, T. (1997). State Actions on Reproductive Health Issues in 1996. *Family Planning Perspectives, 29*(1), 35–40.
The Guttmacher Institute. (1994). *Uneven & Unequal: Insurance Coverage and Reproductive Health Services*. New York: AGI.
The Guttmacher Institute. (2018, March 14). *Guttmacher 50th Timeline*. Guttmacher Institute. https://www.guttmacher.org/about/guttmacher-50th-timeline.
Thomas, A., & Karpilow, Q. (2016). The Intensive and Extensive Margins of Contraceptive Use: Comparing the Effects of Method Choice and Method Initiation. *Contraception, 94*(2), 160–167. https://doi.org/10.1016/j.contraception.2016.03.014.
Time. (1966, August 19). *Contraception: The Safe and Effective Pills*. http://content.time.com/time/magazine/0,9263,7601660819,00.html.
Wagner, R. E. (2009). Property, State, and Entangled Political Economy. In W. Schafer, A. Schneider, & T. Thomas (Eds.), *Markets and Politics: Insights from a Political Economy Perspective* (pp. 37–49). Marburg: Metropolis.
Wagner, R. E. (2016). *Politics as a Peculiar Business: Public Choice in a System of Entangled Political Economy*. Cheltenham: Edward Elgar.
Walmart. (2017). *Retail Prescription Program Drug List*.
Watkins, E. S. (2012). How the Pill Became a Lifestyle Drug: The Pharmaceutical Industry and Birth Control in the United States Since 1960. *American Journal of Public Health, 102*(8), 1462–1472. https://doi.org/10.2105/AJPH.2012.300706.
Westoff, C. F., & Ryder, N. B. (2015). *The Contraceptive Revolution*. Princeton, NJ: Princeton University Press.
Yandle, B. (1983). Bootleggers and Baptists – The Education of a Regulatory Economists. *Regulation, 7,* 12.

14

Samaritan's Dilemmas, Wealth Redistribution, and Polycentricity

Meg Patrick Tuszynski and Richard E. Wagner

Introduction

In the United States, it is estimated that one in three individuals are currently receiving aid from some type of federally administered welfare program (Eberstadt 2015). The federal government provides funding for 126 different programs specifically for low-income people, with 72 of these programs providing either cash or in-kind benefits directly to individuals (Tanner and Hughes 2013, p. 3). Since President Johnson declared the War on Poverty in 1964, the US has spent more than $19 trillion on anti-poverty programs, with essentially no change in the officially measured poverty level (Tanner and Hughes 2014). Certainly, the lives of the vast majority of those counted as "poor" by official statistics have improved, as Tanner and Hughes (2014) and

M. P. Tuszynski
Southern Methodoxt University, Dallas, TX, USA

R. E. Wagner (✉)
George Mason University, Fairfax, VA, USA
e-mail: rwagner@gmu.edu

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_14

Rector and Sheffield (2011) document. Yet despite unprecedented economic growth throughout the developed world over the past century, more and more people have been turning to government programs in order to make a living. This situation would seem to indicate either (1) not everyone has shared in the massive increase in aggregate wealth this economic growth has generated, or (2) the increasing attractiveness of government-sponsored aid programs has created a situation whereby rational individuals have increasingly chosen aid over work despite their low incomes.

Despite claims that the rich are getting richer while the poor are getting poorer, available evidence suggests that among developed nations, as the rich get richer, the poor get richer too (Winship 2014). However those increases in wealth are distributed, everyone gains from increasing aggregate wealth. This means that the growing presence of public aid in the U.S. is more likely due to the creation of institutional rules that expand the demand for aid than to any deterioration in standards of living among those classified as poor. In this paper, we explore the disconnect between the recipients and the providers of public aid, given the incentive problems facing both. We explain how this disconnect is exacerbated by the largely centralized nature of our system for organizing the supply of public aid, and also illuminate some facets of how this could be alleviated by moving to a more localized, polycentric system for supplying aid.

Federal expenditures on programs that target low-income individuals amounted to $848 billion in 2015 (Spar and Falk 2016).[1] Putting aside federal expenditures, state and local expenditures on public welfare programs were $610 billion in 2015, or about one-fifth of direct general expenditures.[2] Yet the indiscriminate extension of aid to those in need often induces moral hazard; that is to say, it entices individuals to act differently than they would in the absence of the transfer. This situation is illustrated clearly by Buchanan's (1977) examination

[1]This figure does not include spending social insurance programs (Social Security, Medicare, or Unemployment Compensation), since these are targeted toward a broader population.

[2]This figure comes from the regularly-updated "Public Welfare Expenditures" page from the Urban Institute, part of the "State and Local Backgrounders" project.

of the Samaritan's dilemma, and with Gibson et al. (2005) examining how this plays out in an international context of development aid. Buchanan builds on the biblical narrative of the Good Samaritan, who finds a poor traveler beaten and left to die on the side of the road. In the biblical story, the Samaritan comes to the man's rescue, nursing him back to health before heading on his way. According to Buchanan, this illustration is incomplete. If the Samaritan acts non-strategically, he may achieve a result that is undesirable from his point of view. While the Samaritan may sustain great personal benefit from helping the poor traveler, that giving of aid might set in motion unintended consequences that could negate the Samaritan's personal benefit through the promotion of moral hazard. If the beaten Samaritan were an isolated instance that would never recur, there would be no moral hazard. But if there are other travelers who are also beaten and who are aided by Samaritans, moral hazard is likely to arise as Samaritans come to take less care in choosing their routes and times of travel. By aiding beaten travelers, the Samaritans might lead travelers to be less cautious in choosing their routes and times of travel. According to Buchanan, 'we may simply be too compassionate for our own well-being or for that of an orderly and productive free society' (1977, p. 71). Like the biblical Samaritan, many involved in the government provision of public aid are genuinely caring individuals. However, the problem of moral hazard is baked into our current system, and only a radical rethinking of the way we provide aid can begin to alleviate these serious institutional problems.

In the traditional theory of public finance set forth in canonical fashion by Musgrave (1959), it has been nearly universally claimed that redistribution can only be carried out effectively by national-level governments. Public finance theorists are concerned with how government uses real resources—how it allocates them, and the utility impact this has on citizens (see Rosen and Gayer 2008 for an extended discussion). While the individual is the focus of examination, it is the construct of the 'representative individual' that occupies the foreground of this type of analysis. Redistribution, in this context, is often justified on the presumption that it is a public good, as illustrated by Hochman and Rogers (1969). Theirs is a analytical construct of Pareto optimal redistribution, in which high income individuals receive utility from alleviating the low consumption opportunities that low-income individuals face. Within this analytical construction, donors supply aid so long as the marginal value they place on offering aid exceeds the marginal loss that results from the resulting diminution in their consumption opportunities. Within this analytical framework, raising the utility of those with low-incomes is the end of the story. It is simply assumed that monetary transfers will result in a better standard of living for the poor. Yet once we move beyond the analytical environment of traditional public finance, we are forced to confront the reality of the different responses individuals have to the receipt of aid, the unintended consequences of this receipt, and the question of how aid might plausibly be provided without inducing these types of unintended consequences.

Musgrave's assertion that redistribution can effectively be provided only at the central level follows from the logic of collective action. If redistribution to the poor and downtrodden is provided at the local level, it is plausible to expect that some localities will offer higher levels of aid than will other localities. It doesn't matter whether this higher aid is induced by higher income in those localities or stems from greater generosity among the high earners of those localities. Either way, some localities will offer higher aid than others. However, this may induce some aid-seeking individuals to move from low-aid to high-aid places. This situation might be overcome if redistribution is carried out at the national level of government, for the only escape would entail international migration.

Yet the disconnect between the givers of aid and the receivers of aid is a serious problem in centralized provision of aid. Current reform proposals seek to work within the existing system to improve the incentives of the receivers of aid through, for example, imposing work requirements as a condition for receiving aid. While the political attractiveness of marginal reforms is understandable, we choose instead to look at the organization of aid through a different analytical window, to recall one of Buchanan's favorite images from Friedrich Nietzsche. Instead of examining how the incentives contained within the *current system might be revised*, we explore the possibility that some alternative *system* for organizing the provision of aid might create higher incentive compatibility between providers and receivers of aid. To do this, we introduce two concepts that are not generally present in these discussions: polycentricity and co-production. Though we will explore the terms more fully below, we offer a brief description here. A polycentric system is one in which multiple, often overlapping, autonomous service providers exist within a given area. Though these systems may seem messy and chaotic, competition among service providers typically expands the extent to which customers are efficiently and effectively served. Co-production is simply the idea that much effective service provision requires input from both the provider and the receiver of the service. Teachers, for example, will be most effective if they can create conditions in which students actively desire to improve their understanding of what the teacher is seeking to teach. In our context, the supply of aid will be more effective when it induces recipients to change their behavior to increase their future income prospects, which means in turn that aid promotes an increased supply of effort by recipients and not an increased supply of leisure.

We explore the various ways in which monocentric and polycentric arrangements alternately discourage or promote coproduction in social welfare programs. Monocentric systems, as contrasted to polycentric systems, are those that concentrate decision-making power in the hands of a single, centralized authority. With monocentric arrangements, whether they are administratively centralized or decentralized, there is a person or office that has the final word in offering or withholding aid.[3] This is the world of national redistribution. In contrast, polycentric arrangements have no position of a last resort provider of aid. If there is no aid provider of last resort, then no individual provider is responsible

[3]This is an important point to highlight. Polycentricity and administrative decentralization are not synonymous, nor are monocentricity and administrative centralization. It is where the locus of decision-making power lies that distinguishes a monocentric from a polycentric order. Any particular polycentric system might also be administratively centralized if the optimum scale of service provision requires this type of administrative centralization. An organization like Catholic Charities might be thought to be administratively centralized, but still exist in a polycentric order of charitable service providers. Likewise, the network of local governments across any particular state might be considered administratively decentralized, but many will act as monocentric service providers within their jurisdiction.

for making what can be a life-or-death decision for potential recipients. With respect to co-production, we explain how polycentricity will more effectively elicit co-production by the recipients of aid than will monocentricity. Interaction among the Samaritan's dilemma, co-production, and polycentricity can reverse the implication of the standard analysis of redistribution by showing how aid may successfully be provided at the local level. Not only can aid effectively be provided through a polycentric system, but doing so may be able to overcome some of the most serious negative consequences associated with our current system of administratively centralized aid provision. After we explore these concepts and their relevance for 'social policy,' we shall examine some illustrations and applications of our thesis.

Charity, Futurity, and Redistribution

The Samaritan and his dilemma can be generalized or universalized by recognizing that it speaks to a widespread quality of human nature for people to render assistance when they come across instances of need. While need is typically objectified through such measures as percentages of median income and indexes of poverty, it ultimately resides in the affective sentiments held by some people toward the observed situation of others in society. A needy person is thus someone whose observed situation activates sympathetic feelings from other people. It is doubtful, however, that "charity" is a useful description of those feelings because they pertain to the instant of observation and do not extend to possibilities beyond the moment of observation. The surface sentiment is activated by observation at some point in time t_1, but beneath that superficial observation lies some notion of future prospects for the subjects of observation. These future prospects are expressed by the notion of futurity. While purely charitable impulses may be activated at particular moments and lead a donor to give aid without any expectation of a behavioral change on the part of the recipient, generally donors surely prefer that their assistance help the recipient achieve a better trajectory for his or her life. That is to say, the donor wants to enhance the recipient's future prospects; this is what we mean by 'futurity'.

Hayek, in volume two of *Law, Legislation, and Liberty* (1976), describes how life outcomes are determined in part by skill and hard work, and part by luck. It is this element of luck that leads him to justify a minimal welfare state in order to ensure that those who are plagued by bad luck don't fall into destitution. With the right set of incentives in place, a minimal safety net can encourage individuals to rely on aid only when needed, and for only as long as needed. Yet this set of incentives is difficult to design. While donors may want to assist those who are temporarily disadvantaged due to an unfortunate set of circumstances, it is nearly impossible *ex ante* to distinguish between those individuals who will use the extension of aid to improve their future prospects and those who will use it to reduce their efforts to support themselves. Even if the actual distribution of empathy in society varies widely, it is undeniable that the sight of people in need often invokes sympathetic responses to render comfort and assistance in some degree. Few donors would want to see their donations transformed into increased leisure for recipients, yet many might support donations that promoted a strengthened effort by recipients to contribute to their human capital.

Though donors surely hope that recipients will have a different future in consequence of receiving aid, our public redistribution system has created a situation whereby donors and their interests are totally separated from the actions of recipients. In the US, as in most developed nations, social welfare programs are funded through taxes and operated by specialized bureaus. Those bureaus are then allocated a specified amount of money to spend on their respective programs. While there may be a great many people working in these bureaus who are genuinely concerned about the futures of the individuals they are assisting, they are trapped in a situation where by law they must provide assistance to all individuals who meet a specified set of criteria. Indeed, because a large bureau lacks the knowledge necessary to understand the particular situation each aid recipient faces, the only set of criteria they can use when doling out aid is the simple set of one-size-fits-all benchmarks they are given. It is thought worse to commit a type I error—to fail to grant aid that is warranted—than a type II error—to grant aid that should not have been granted. This pattern of errors and their avoidance means that the granting of aid is biased in the direction of supporting those who will squander it, relative to those who will use it to get back on their feet. This pattern of bias emerges through institutional arrangements that have divorced the interests of donors from those who administer aid programs.

Donors have not always been so far removed from the recipients of aid. As Olasky (1992) documents, the early American model of compassion held that giving indiscriminate aid was as damaging as was turning a blind eye toward the poor. Indeed, prior to the late-1800s the very word 'compassion' had a different meaning than it does today.[4] Originally, compassion meant 'suffering with', and required that any person trying to help the poor must be intimately acquainted with the particulars of that person's condition. These early providers of relief believed that the key to helping people out of destitution required an examination of the whole person. This meant that moral shortcomings needed to be addressed along with physical and economic shortcomings. This theme is also explored by Himmelflarb (1991). Without using the term, the narratives Olasky and Himmelflarb tell about early forms of relief provision support our contention that successful aid provision requires some level of co-production between donors and recipients.

Co-production in the context of the early American model of aid provision meant that both givers and recipients were required to play an active role. It was not merely that the giver and receiver had some influence on the outcome; rather, it required active participation by both giver and receiver in order to produce a mutually beneficial outcome. The early Americans realized that the causes of poverty are multifaceted, so simple solutions would likely be inadequate. Only by working closely with aid recipients and understanding their circumstances and motivations could aid providers hope to create solutions that would have some chance of actually working.

[4]As Olasky (1992) documents, the late 1800s saw the rise in social work as a profession, in contrast to what is now described as social work being a volunteer activity or even a calling.

Coproduction and the Avoidance of Accidents

It seems often to be assumed that people are naturally provident and hard-working, so being in positions of need is a result of chance or limited capacity, and not a product of choice (Friedman 1953). The offer of aid, however, can increase the number of people in a position to need aid. This is a simple consequence of moral hazard. Further, if the institutional environment is structured correctly, it matters little whether people are naturally provident and hardworking or not. As long as the structure of incentives entices people to be hardworking, their natural proclivities are of little consequence. An institutional environment that is both polycentric and encourages relationships of coproduction may allow providers of aid to determine *ex ante* which potential recipients will use the aid to invest in their futures, versus those who will use it merely to increase their leisure time.

There is a well-developed economic theory of accidents (for instance, Shavell 1987) that is directly relevant for relating co-production to these questions of charity, futurity, and polycentricity. This theory notes that there are not only direct costs to accidents, but also costs to avoiding accidents. While there is controversy over whether automobile accidents rise with increases in vehicle speed per se or rise with increases in the variance of the speed at which cars are traveling (Lave 1985), there is no doubt that automobile fatalities could be nearly avoided if everyone were to drive at no speed higher than, say, 20 miles per hour. That no one wants to drive so slowly involves an acceptance of risk to be able to arrive at destinations more quickly. Regardless of the relation between speed and accidents, there are also various actions drivers and carmakers can take that would increase or reduce the risk of accidents. A manufacturer can produce a car with such features as air bags and shatter-resistant windshields. Highways can be built in various ways with different safety qualities engineered into their construction. For instance, four lane roads are safer than two lane roads, though they are also more expensive. Whatever forms of safety is embedded in those cars and highways, safety is nonetheless a matter of co-production between drivers and the builders of cars and highways. It is well recognized that the construction of cars with more safety features will reduce the care that drivers take because these features allow people to feel safer when they are driving more recklessly (Peltzman 1975). Cars do not harm people; people driving recklessly in cars harm people. If the incentives are appropriately aligned to encourage people to drive more safely, fewer accidents will result. This is what we mean when we say that safety is a matter of coproduction.[5]

Being in a position of need is similar to being in an accident. While both destitution and accidents may be partially attributable to unforeseeable, random circumstances, to a significant extent they are also products of choice. Henry Fawcett's (1871) tale of Robinson and Smith in *Pauperism* helps to illustrate this point. In Fawcett's story, both gentlemen were blue-collar workers who entered adulthood with similar skills and in similar occupations. From that common point of departure, their lives diverged due to different choices they made and actions they took. Robinson performed his job conscientiously, was frugal in his spending, and spent time studying to become eligible for higher-paying positions. In contrast, Smith performed his job in so-so fashion, did not devote time to preparing to secure higher-paying positions, and instead spent all of his earnings, much of it on amusement. By the time both reached retirement age, Robinson was well-to-do and had accumulated a good sum of capital through his saving during his working years. Smith had accumulated no capital through saving and retired at a similar earnings level to where he began.

Though Fawcett's story focuses on the life choices each man made, it is possible to incorporate some degree of chance into the narrative. We can imagine a scenario in which an economic downturn hits and both men lose their jobs due to layoffs unrelated to their performance. However, as with the literature on the economic theory of accidents, there are steps that each man can take to minimize the chance that serious economic harm befalls him in this circumstance. For example, immediately after being laid off, we can imagine Robinson actively trying to find a new job, perhaps studying for a new certification so he can shift into another, less-vulnerable occupation. We can imagine Smith

[5]While it is probably more accurate to declare that accidents are jointly caused than to describe them co-produced, the *avoidance* of accidents is a matter of co-production all the same.

taking the job hunt less seriously, sending out a few resumes, but spending much of his time enjoying his newly-found leisure. Though both men were laid off through no fault of their own, it is highly likely that the steps Robinson takes will allow him to find a new job before Smith.

An outside observer, or a strict follower of the orthodox approach to public finance, who is unfamiliar with these details may conclude that Smith was a candidate for aid and that Robinson was someone who reasonably could provide such aid. To be sure, Smith's utility could have been raised by reallocating some of Robinson's earnings to him. Yet by the very structure of the story, Smith could have achieved a similar outcome had he been willing to act similarly to Robinson. Indeed, one major problem with the orthodox theory is that it evaluates the need for aid at some instant in time, where some genuinely dynamic approach would be more informative. Only through a holistic understanding of the circumstances surrounding Robinson and Smith's relative circumstances could a person determine an appropriate course of action. Monocentric systems by their very nature reduce these complex sets of circumstances into easily-manageable options and associated statistics, upon which proposed policy actions are based.

This simple story powerfully illustrates why co-production must be taken into account if we expect aid meaningfully to change a recipient's future options. Robinson and Smith were both eligible for unemployment benefits when they were laid off, but only Robinson used them as they are meant to be used—as short-term measures to help a person avoid destitution while looking for a new job. The provision of aid *by itself* cannot change a person's future. Yet the provision of aid coupled with a sincere desire to succeed can result in a positive outcome. For the most part, public assistance programs operate by giving what are effectively gifts to recipients. It is easy for governments to spend money. This is something they do well, meaning that account balances are emptied by the end of the fiscal year. In contrast to this setting for redistribution, co-production would enlist participation by the recipient of aid in developing capacities that would obviate the need for aid in future years. But how might co-production be activated? Our thesis is that the prospects for its activation are stronger when aid is organized in polycentric fashion than when it is organized in monocentric fashion.

Polycentricity, Monocentricity, and the Problem of the Helper of Last Resort

A national system of support is monocentric. With a monocentric arrangement, there is a 'helper of last resort'. Normal human sentiments being what they are, someone in the position choosing between offering aid and letting someone starve (or suffer a similar fate), is highly likely to offer aid. In this respect, it is reasonable to conceptualize a representative Samaritan as facing three options in relation to a potential recipient of aid, recognizing that the Samaritan is thinking in terms of present values over some relevant future. A reasonable preference ordering for the Samaritan is as follows: (1) the recipient becomes self-supporting, (2) the recipient subsists on aid, and (3) the recipient starves or suffers a similar fate. The Samaritan would dearly love (1) to result while having no stomach for being responsible for (3). The outcome of this situation will be (2), unless the recipient has a strong desire to achieve (1) and avoid (2). In this situation, though, it is the recipient and not the Samaritan who controls the recipient's future state.

This preference ordering, and the tendency for outcome (2) to prevail, can easily be seen in the current fight to reform the U.S. Supplemental Nutrition Assistance Program (SNAP). The current bill attempts to overcome the problem of increasing reliance on food assistance among Americans by instituting stronger requirements for receiving aid. Critics of the bill, including the Catholic Bishops of America, claim that it "could cause as many as 2 million individuals to lose their benefits, and potentially remove state flexibility in 42 states".[6] Though critics and proponents alike recognize the perverse incentives built into the current system, if reforming it in an attempt to achieve outcome (1) results in a situation whereby there is potential for outcome (3) to emerge, then sticking with the current system is perfectly reasonable, despite its tendency toward outcome (2).

[6] http://www.usccb.org/issues-and-action/human-life-and-dignity/agriculture-nutrition-rural-issues/joint-letter-to-congress-on-2018-farm-bill-2018-04-18.cfm.

Why can't the Samaritan induce unwilling recipients (perhaps call them Slackers) to become self-supporting rather than subsisting on aid? The answer is that the monocentric Samaritan cannot make a credible commitment that would induce the Slacker to pursue a self-supporting way of life. The Samaritan might wish the Smiths he faces would act like Robinsons, but he has no tools to bring this outcome about. The only tool he has for accomplishing this is to let some of the Slackers starve, which would induce the other Slackers to change their pattern of activity. Misery, in this case, would have both a didactic purpose and a clear social function. We may doubt, however, whether the Samaritan's sensibilities would allow such action. The mere existence of a position of aider of last resort places responsibility for what are effectively life-or-death decisions on the holders of that position. Normal human sympathies are surely likely to choose life, thereby leading Slackers to subsist on aid rather than becoming self-supporting.

With polycentric arrangements, however, there is no helper of last resort. With localized, overlapping jurisdictions of assistance, there are many sources of assistance but no single helper of last resort. Polycentricity reduces the ability of Slackers to game the system because the Samaritans are no longer makers of life-or-death decisions. For instance, a local aid office can tell the Smiths in the locality that to receive aid they must show up for work punctually and be suitably dressed. Moreover, they must exhibit courteous demeanor toward co-workers and customers. The imposition of such requirements when pursued over some duration of time might even convert some Smith-types into Robinson-types. Those requirements would in any case appear to be credible to the Slackers because the local group of Samaritans is not responsible for the Slacker's fate. Polycentricity accommodates the imposition of conditions on aid which promotes co-production. Hence, the Samaritan's dilemma can explain how redistribution can be carried out effectively only at local levels of government, contrary to what Musgrave and subsequent public finance theorists have tended to hold.

A polycentric system of aid provision, it should be noted, would improve outcomes for both recipients and donors. If a potential recipient is unwilling or unable to meet the conditions imposed by one provider, he can choose to apply for aid with a different provider. Let's say the donor agency in the first system requires its recipients to work 40 hours a week and provides access to a list of service-sector jobs to help them achieve these goals if they are unable to find a job. Continuing the illustration, let's say the donor agency in the second system requires its recipients to work only 30 hours per week, but provides access to a list of manual labor jobs. In this case, the potential recipient can choose which option is most attractive to himself, and each donor agency can encourage coproduction under the terms it finds most attractive. Furthermore, and most significantly, there is no donor whose action appears to the donor to determine the fate of the recipient. Within a polycentric system with, say, 1000 donors, each donor's action has a negligible impact on how the recipient ultimately fares.

Illustration and Application

Co-production has been shown to be a successful way to overcome collective action problems in a variety of areas. In Nigeria, the creation of urban infrastructure is guided by the people who will be using it, thereby ensuring it will be useful to those it is intended to benefit (Ostrom 1996). In many areas, the cooperation of the community with the public police force has yielded a higher level of protection than policing without community involvement. In this case, instances that may have been conflictual in the past turned into situations of cooperation (Ostrom et al. 1978). The delivery of health services, too, has been shown to benefit from a higher level of participant involvement (Dunston et al. 2009). If participant involvement in both private and public affairs has been shown to produce broadly beneficial outcomes, then there is reason to believe that co-production in aid to the disadvantaged will yield similar results.

Ultimately, however, whether co-production in the provision of public aid will yield beneficial results is an empirical question. Consequently, we find it useful in this section to examine an example of a set of private programs that employ extensive use of co-production in their anti-poverty efforts, as compared to federal programs that do not aim to use this tool. It should be mentioned at the outset that understanding the success of private initiatives is somewhat complicated, given that private initiatives exist within the same ecology that includes public alternatives. Consequently, it might be the case that the individuals who select themselves into these private programs already have an active desire to improve their socioeconomic situations, as compared to those who opt for the public alternative. In the context of our illustration, however, this seeming difficulty has some advantages. For one, it helps us understand the necessity of co-production in improving life outcomes among the economically disadvantaged. If it really is the case that those who are most eager to change their lives enroll in the private alternatives, and if these private programs do actually help encourage upward mobility, then we have some evidence for our claim that encouraging co-production can help overcome Samaritan's dilemmas. Secondly, because these private organizations do not have to act as helpers of last resort, but instead operate within an ecology of aid-providing enterprises, this helps us to understand how imposing conditions on the receipt of aid can be beneficial for both the donor and the recipient.

The problem with many centrally-administered programs is that they are often by necessity (due to resource constraints) one-size-fits-all in nature. The Temporary Assistance for Needy Families (TANF) program, for example, provides monetary aid to anyone who meets a pre-specified set of criteria. Yet the reasons any individual can give for being down on his luck differ from person to person. A program that is able to understand on a fundamental level why an individual is poor to begin with can muster a fuller set of tools to help him get back on his feet. This is what the nonprofit Nurse-Family Partnership program aims to do.[7]

The Nurse-Family Partnership was founded in 1977 by David Olds, who had recently received his Ph.D. from the Cornell School of Human Ecology. Olds was intensely interested in how understanding the networks within which an individual resides are important for understanding both their internal constitutions and life outcomes. He understood

[7]The information on the Nurse-Family Partnership is pulled primarily from two sources. Goodman (2006) provides much of the historical information. A comprehensive literature review by the Coalition for Evidence-Based Policy (2014) provides much of the statistical information.

that breaking the cycle of intergenerational poverty and dependency on aid programs required a holistic approach which got to the root of what made these individuals poor in the first place. Olds decided to recruit 400 low-income families in Elmira, NY to test his method, assigning half to his treatment group and half to a control group. Families in the treatment group (which consisted mainly of single mothers and their children) were visited on a regular basis by trained nurses, who would help disentangle the socioeconomic challenges facing these young mothers, and work to determine a plan for building a better future. The control group received transportation to a local center and were given free screening services, prenatal care, and well-child care, but were not visited by nurses, and were not assisted with determining a better path forward. Olds and his research team were careful to ensure that the demographic characteristics and socioeconomic statuses were similar between the two groups.

The effects of the program were evaluated in 1986, then again once the first-born child of the women in the study reached age 15–19. In the first round of evaluation, the incidence of child neglect was significantly lower in the treatment group than in the control group. Mothers in the treatment group were also more likely to have given up smoking cigarettes and were less likely to have pre-term deliveries than mothers in the control group. The long-term effects, however, show the real power of this holistic approach. Mothers who received nurse visits spent 20% less time on welfare than women in the control group, were 19% less likely to have unplanned subsequent children, reported 61% fewer arrests, and 72% fewer convictions than women in the control group. The effects on the first-born children of these women were also startling; they were 48% less likely to abuse their own children, 57% less likely to be arrested, and 66% less likely to have been convicted of a crime than children born to control group mothers (as of age 19). While there were no discernable effects on educational or work outcomes in the Elmira group, subsequent repetitions of this controlled experiment in Memphis and Denver did find positive long-term impacts on performance in school, along with the development of beneficial lifetime skills that was particularly pronounced among children born to mothers with low cognitive abilities and/or mental health.

Certainly, the mothers who chose to enroll in these experiments did so because they actively wanted to improve their prospects for achieving a better life. Yet this is surely the case for mothers in both the treatment and control groups. The two sets of mothers must surely be regarded as being identical with respect to wishing to improve the prospects for their children's futures. What differs is the institutional frameworks that confronted the different groups. Participants in the treatment group were faced with an arrangement that enlisted the mothers in a relationship of co-production with the visiting nurses, which led these mothers act so as to create better lives for themselves and their children. The mothers in the control group, by contrast, were not drawn into any framework of co-production.

This program can be sharply contrasted with the experience of most states under the TANF program mentioned above. With the passage of the Personal Responsibility and Work Opportunity Reconciliation Act (PRWORA) by President Clinton in 1996, TANF replaced the Aid to Families with Dependent Children program, which had provided cash grants to low-income families since it was put into place as part of the 1935 Social Security Act.[8] TANF did impose conditions on the receipt of aid that had not previously existed, including work requirements and five-year total lifetime limits for recipients. It also ceased the reimbursement structure that had operated during the AFDC years, and instead gave block grants to the states to encourage them to economize on their anti-poverty spending. Within this framework, states were granted wide latitude to design their own programs, so long as they met the criteria imposed upon them at the federal level.

Though the PROWRA did encourage states to design their own welfare systems within the boundaries set by Congress, ultimately the welfare system still operated within a monocentric arrangement of bureaus and agencies whose programs generally were not incentivized to experiment with any sort of co-production. Since funding was contingent

---

[8]Originally, the Aid to Families with Dependent Children program was called the Aid to Dependent Children program. The name was changed in 1962 to reflect the changed focus of the program.

on hitting specified performance targets and incorporating federally-determined provisions, states were incentivized to design their systems to maximize their federal funding. Further, states were disincentivized to push responsibility for running these aid programs down to lower levels of government, since they would risk losing federal funding if some localities failed to meet these prespecified goals.

This reorganization of the welfare system under the PRWORA was based on states' earlier experience with obtaining waivers out of the federal welfare system throughout the late 1980s and early 1990s. This was a period in which the welfare rolls had swollen to an unprecedented level, and states were granted wide latitude by the Department of Health and Human Services (DHHS) to conduct experimental, demonstration, or pilot programs, so long as these programs were subject to rigorous evaluation.[9] By the time the PRWORA was passed in 1996, the DHHS had approved waivers for 45 states for both state and local pilot programs. However, incorporating the success of these smaller-level programs into a centralized scheme removed the flexibility that had made many of these pilot programs successful in the first place.

Throughout the late-1990s, it appeared that the 1996 welfare reforms had achieved great success. The number of families receiving benefits fell, as did the number of unemployed single mothers—and this took place without any commensurate rise in the number of people living in poverty. This led many to declare that welfare reform had been a success. Yet when the economy began contracting in the early 2000s, many of these positive trends began modestly reversing course. It continues to be an open debate as to whether the positive trends of the late 1990s are primarily attributable to the strong economy or to welfare reform.

This debate, however, is misguided. Though the reforms allowed the states some latitude to design their own programs, the overall system of aid still had a monocentric structure, with the federal government

[9]The 1962 amendments to the Social Security Act allowed states to apply to the DHHS for an exemption from the AFDC rules in order to conduct pilot programs. However, these waivers were not widely used until the late 1980s.

occupying the apex of that system. While the particular details of the welfare programs differed among states, those programs were nonetheless constrained by what the federal government proscribed. More significantly, states were disincentivized to allow competing jurisdictions to emerge at the local level, so they could not effectively encourage co-production between givers and recipients of aid.

Yet co-production is occurring regularly between private, small-scale providers of aid and local recipients. Both secular and religious organizations work closely with those to whom they provide aid to ensure that recipients' futures are better than their pasts. The problem, however, is that many recipients would prefer to seek aid from organizations that simply hand out funds with no strings attached. Because these small-scale organizations exist in the same social ecology as government aid programs, many recipients find the latter to be more attractive options to alleviate their current wants. With the right incentive structure, many who currently subsist on aid would be willing to become productive members of society. The current structure simply does not encourage self-sufficiency in the same way that a polycentric system would.

Conclusion

Wagner (2010) distinguishes between raising and leveling as alternative conceptual frameworks for thinking about issues of social welfare. The distinction lies in how it is that the general welfare of the population is promoted. A system of taxation and redistribution necessarily aims at leveling; the implicit assumption is that the welfare of the population can be improved by ensuring that incomes significantly higher than the mean are redistributed to those with incomes significantly below the mean. Our alternative framework aims to raise the position of the least well off without altering the position of those who are already relatively well off. To do this requires recognition that doing this entails a system based on co-production between suppliers of aid and recipients. Such a system, moreover, is sustainable only if it is polycentric, for then there is no single supplier of aid who faces ultimate responsibility for what the aid supplier would regard as a life-or-death choice.

References

Buchanan, J. M. (1977). The Samaritan's Dilemma. In E. Phelps (Ed.), *Altruism, Morality, and Economic Theory* (pp. 71–86). New York: Russell Sage Foundation.

Coalition for Evidence Based Policy. (2014). *Top-Tier Evidence Initiative: Evidence for the Nurse-Family Partnership*. Available at http://evidencebased-programs.org/1366-2/nurse-family-partnership.

Dunston, R., Lee, A., Boud, D., Brodie, P., & Chiarella, M. (2009). Co-Production and Health System Reform—From Re-Imagining to Re-Making. *The Australian Journal of Public Administration, 68*(1), 39–52.

Eberstadt, N. (2015). American Exceptionalism and the Entitlement State. *National Affairs,* 22. Available at http://www.nationalaffairs.com/publications/detail/american-exceptionalism-and-the-entitlement-state.

Fawcett, H. (1871). *Pauperism: Its Causes and Remedies, by Henry Fawcett*. New York: Macmillan Publishers.

Friedman, M. (1953). *Essays in Positive Economics*. Chicago: University of Chicago Press.

Gibson, C. C., Andersson, K., Ostrom, E., & Shivakumar, S. (2005). *The Samaritan's Dilemma: The Political Economy of Development Aid*. New York: Oxford University Press.

Goodman, A. (2006). The Story of David Olds and the Nurse Home Visiting Program. *Robert Wood Johnson Foundation, Grants Results Special Report.*

Hayek, F. A. (1976). *Law, Legislation and Liberty, Volume 2: The Mirage of Social Justice*. Chicago: University of Chicago Press.

Himmelfarb, G. (1991). *Poverty and Compassion: The Moral Imagination of the Late Victorians*. New York: Knopf.

Hochman, H. M., & Rogers, J. D. (1969). Pareto Optimal Redistribution. *The American Economic Review, 59*(4), 542–557.

Lave, C. A. (1985). Speeding, Coordination, and the 55-MPH Limit. *American Economic Review, 75,* 1159–1164.

Musgrave, R. A. (1959). *The Theory of Public Finance*. New York: McGraw-Hill.

Olasky, M. (1992). *The Tragedy of American Compassion*. Wheaton, IL: Crossway Books.

Ostrom, E. (1996). Crossing the Great Divide: Coproduction, Synergy, and Development. *World Development, 24*(6), 1073–1087.

Ostrom, E., Parks, R. B., Whitaker, G. P., & Percy, S. L. (1978). The Public Service Production Process: A Framework for Analyzing Police Services. *Policy Studies Journal, 7*(s1), 381–389.

Peltzman, S. (1975). The Effects of Automobile Safety Regulation. *Journal of Political Economy, 83,* 677–726.

Rector, R., & Sheffield, R. (2011). *Understanding Poverty in the United States: Surprising Facts About America's Poor*. Heritage Foundation Backgrounder on Poverty and Inequality No. 2607.

Rosen, H. S., & Gayer, T. (2008). *Public Finance*, 9th ed. New York: McGraw-Hill.

Shavell, S. (1987). *Economic Analysis of Accident Law*. Cambridge, MA: Harvard University Press.

Spar, K., & Falk, G. (2016, July 29). *Federal Benefits and Services for People with Low Income: Overview of Spending Trends, FY2008-FY2015* (Congressional Research Service Report No. 7-5700). Available at https://fas.org/sgp/crs/misc/R44574.pdf.

Tanner, M., & Hughes, C. (2013, August). *The Work Versus Welfare Tradeoff: 2013*. Cato Institute White Paper. Available at http://www.cato.org/publications/white-paper/work-versus-welfare-trade.

Tanner, M., & Hughes, C. (2014, October). *War on Poverty Turns 50: Are We Winning Yet?* (Cato Institute Policy Analysis No. 761). Available at http://www.cato.org/publications/policy-analysis/war-poverty-turns-50-are-we-winning.-yet.

Wagner, R. E. (2010). Raising vs. Leveling in the Social Organization of Welfare. *Review of Law & Economics, 6*(3), 421–439.

Winship, S. (2014, October 2014). *Inequality Does Not Reduce Prosperity: A Compilation of the Evidence Across Countries* (e21 Report No. 1). Available at https://www.manhattan-institute.org/html/inequality-does-not-reduce-prosperity.-compilation-evidence-across-countries-6032.html#.VFDPb_nF-Sr.

Part III

Collective Action and Constitutional Political Economy

15

Constitutional Reform: Promise and Reality

Dennis C. Mueller

In 1962, James M. Buchanan and Gordon Tullock published *The Calculus of Consent*, It contained numerous important analyses of and insights into the properties of voting rules and political institutions. Arguably its most long lasting contribution, however, was to introduce into the public choice literature and more broadly political science the view that politics is a two stage process in which the rules of the political game are first written at a constitutional stage, and the political game then played under these rules at a later stage, which we might call the parliamentary stage.

Throughout his long and productive subsequent career, James Buchanan laid great stress upon the important role constitutions can play in the political process, both facilitating collective action by citizens, and constraining the State. He clearly thought of constitutions as an essential part of the political process, and when discussing how this process might be improved, he often recommended changes in the

D. C. Mueller (✉)
University of Vienna, Vienna, Austria
e-mail: dennis.mueller@univie.ac.at

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_15

constitution. In this essay, I review some of his analyses and recommendations for constitutional reform. Buchanan's oeuvre is so vast that it would be impossible to review all of his suggestions for constitutional reform. I shall, therefore, limit my discussion to a handful of what I regard to be his most important and representative recommendations. Following this review, I shall examine the need for and possibility of major constitutional reforms in the United States and the European Union.

The structure of the essay is a follows. I begin appropriately enough with *The Calculus of Consent* (1962), Section "The Calculus of Consent". In Section "The Limits of Liberty", I discuss what I regard as Buchanan's most important analysis of constitutions following *The Calculus, The Limits of Liberty* (1975). Section "Further Recommendations for Constitutional Changes" looks briefly at several later works, which deal with constitutional issues. In Sections "Constitutional Change in the United States" and "Constitutional Change in the European Union", I turn to the questions of constitutional reform in the United States and the European Union, viewed from the perspective of Buchanan's work. Conclusions are drawn in the final section.

The Calculus of Consent

The Calculus of Consent was James Buchanan's first, extensive exercise in what would later be called "constitutional political economy." The stated objective of the book was to describe "what *we think* a State ought to be" (Buchanan and Tullock 1962, p. 3, italics in original). Thus, unlike most of public choice, the book can be regarded as a largely normative exercise to show both how the institutions of the State can be better understood using the methodology of the economist, and how they can be better designed for making collective decisions.

As noted above, *The Calculus* is built around a two-stage depiction of the political process in which the rules of the polity—voting rules, electoral rules, etc.—are chosen at the constitutional stage of the process. Early in the book they confront the infinite regress problem. What voting rule should be used at the constitutional stage to choose voting rules for the subsequent stage? They circumvent this infinite regress by assuming that unanimity can be reached on the features of the original constitution, and any changes to it (Buchanan and Tullock 1962, p. 6). Although individuals are likely to have different views or preferences concerning the policies they would like to see the State implement, the long-run nature of the decisions to be made at the constitutional stage introduces considerable uncertainty about the consequences of different voting rules and institutions in the minds of those writing the constitution. Buchanan and Tullock (1962, pp. 78–79) claim that this uncertainty will suffice to produce unanimity at the constitutional stage thereby resolving the infinite regress problem.

The use of uncertainty by Buchanan and Tullock to achieve unanimous agreement on the constitution resembles John Rawls's introduction of a *veil of ignorance* to achieve unanimity on the content of a social contract (Rawls 1972, p. 136 ff.). Indeed, although the original addition of *The Calculus* contained no index, a reprint of the book by the Liberty Fund in 1999 added an index and refers to the discussion of uncertainty on pp. 78 and 79 as "the veil of uncertainty," even though the word "veil" appears nowhere in the text. Rawls's treatise constituted a major revival of the contractarian approach in philosophy, and *The Calculus* is very much in the contractarian tradition. In later works Buchanan championed and defended Rawls' work (e.g., Buchanan 1976).

In an appendix to *The Calculus* Buchanan defends the contractarian nature of the analysis in the book against the oft made criticism that states do not in reality emerge from a state of anarchy through a social contract. "The relevance of the contract theory must lie, however, not in its explanation of the origin of government, but in its potential aid in perfecting existing institutions of government" Buchanan and Tullock 1962, p. 319). And a bit later, "Discussion must be concentrated on the 'margins' of variation in political institutions, not on the 'totality' of such institutions, and the relevant question becomes one of the criteria through which the several possible marginal adjustments may be arrayed" (p. 320). Thus, circa 1962 James Buchanan clearly believed that constitutions were an important, indeed, fundamental component of the political process, and that they could be changed, at the margin at least, to improve the working of this process.

The Limits of Liberty

Following the rather calm "Eisenhower years" of the 1950s, the United States entered into a rather turbulent period in the 1960s. John F. Kennedy, Martin Luther King Jr., and Robert Kennedy were all assassinated. Civil rights demonstrations led to violent confrontations in the South, opposition to the expanding war in Vietnam brought protests across the country. By the late 1960s this unrest had spread to college campuses. Buchanan became personally caught up in the turbulence in 1968 when he left the University of Virginia and moved to UCLA. Shortly after his arrival, UCLA students demonstrated and occupied buildings on campus. Buchanan was not pleased by the university administration's response, and quickly departed for what was then called the Virginia Polytechnic Institute (VPI) in Blacksburg, Virginia, where he and Gordon Tullock founded the Center for the Study of Public Choice.

Buchanan's 1975 book, *The Limits of Liberty*, is a reflection upon and reaction to the events of the late 1960s and early 1970s. In the book he contrasts the "orderly anarchy" that existed on university campuses in the relatively tranquil 1950s with the atmosphere in the early '70s.

> Consider the situation in the orderly anarchy that was the university community in the late 1950s. Although there may have been a few notable exceptions, most university communities were then characterized by relatively pure standards of free expression. Almost any student or faculty group could invite almost any speaker on almost any subject in the assurance that the event would be allowed to take place without disruption. The intellectual environment of the university embodied free expression, and expectations were made on the basis of this fact. In the 1960s, much was changed…Can anyone seriously dispute the statement that the quality of the intellectual environment was lower in 1970 than it was in 1960? And, once commenced, how can erosion be stopped? How can behavioral standards, which allowed the university community to remain an ordered anarchy for so long, be recovered once they are lost? (Buchanan 1975, pp. 122–123)

Alas, free expression on American university campuses is, if anything, more restricted today than it 1970.

In the appendix to the *Calculus*, Buchanan sole authored, he cites Immanuel Kant's social contract theory as an influence on his thinking (p. 316). Later Buchanan would remark that he and Tulloock more or less consciously had the U.S. Constitution in the back of their minds when they wrote the *Calculus*. Kant was one of the greatest, and most optimistic of the Enlightenment thinkers, and some of this optimism is visible in the *Calculus*. The events enfolding in the United States after its publication altered Buchanan's views about both the United States and the role a constitution must play in the political process. Immanuel Kant gives way to Thomas Hobbes.

> I have come to be increasingly disturbed by this basic optimistic ontology [in *The Calculus*]….I have found myself describing what I observe as "constitutional anarchy" rather than any institutional translation of individual values into collective outcomes. In the 1970s much to be explained does not seem amendable to analysis that incorporates positive-sum institutional processes. Zero-sum and negative-sum analogues yield better explanatory results in many areas of modern politics… (Buchanan 1975, p. 7).

Thus, in contrast to *The Calculus, The Limits of Liberty* is much more concerned with understanding why states may *fail* to advance the interests of their citizens, why they may provide *bads*. Where the *Calculus* focused on the *productive* State providing public goods that benefitted all, *The Limits of Liberty* concentrated on the *protective* State, a state that shielded individuals from their fellow citizens and indeed the State itself (1975, pp. 68–70). Where *The Calculus* analyzed voting rules and other democratic procedures, *The Limits of Liberty* proposes specific constitutional constraints on what the State can do.

On page 47 of *The Calculus* a section appears entitled, Minimal Collectivization—The Definition of Human and Property Rights. The section consists of two paragraphs and in fact contains no definitions of rights. Instead, the authors explain why "it will be useful to 'jump over' the minimal collectivization of activity that is involved in the initial definition of human and property rights…". The contrast with *The Limits* could not be greater. While much of *The Calculus* is concerned with the choice and properties of various voting rules, the focus in *The Limits* is on the selection of rights to be written into the constitution. Although Buchanan's concept of rights can be construed broadly, the analysis and examples provided seem most appropriate for property rights.

Buchanan envisaged individuals negotiating a constitutional contract from a state of anarchy in which some well-defined, primitive property rights already existed. Each individual has an endowment of goods to consume or to trade with others, or more broadly, each individual possesses a set of preferences and capacities he or she can use to acquire goods. Each individual is unique and "owns" herself. Over the course of several chapters, Buchanan describes how and why rational individuals would agree to establish contractual rights that would lift them out of anarchy.

In the appendix to *The Calculus* cited above, Buchanan defended the contractarian approach from the criticism that its adherents actually believed that states came into existence through some unanimous agreement on a social contract. Much of the discussion in *The Limits* of the move from anarchy to a constitutional democracy, however, seems to suggest that such moves would not only be desirable, but feasible. For example, Buchanan cites with favor Harold Demsetz's (1967) account of how Canadian Indians moved from an anarchy in which beaver-skins were regarded as common property to a state in which private property rights over beavers were established (pp. 22–23). Thus, Buchanan seems to want to legitimize the protective state by a prior unanimous agreement that created it.

Here it is perhaps useful to highlight another important difference between *The Calculus* and *The Limits*. In the former, uncertainty at the constitutional stage was crucial for getting unanimity on, say, the optimal voting rule. No uncertainty need be assumed in the state of anarchy described in *The Limits* to get people to agree to a set of rights that will make everyone better off in the future. This point was first formally pointed out by Christian Müller (1998). Buchanan, however, seems to have been aware of it.

> I have tried to examine the prospects for genuine contractual renegotiation among persons who are not equals at the stage of deliberation and who are not artificially made to behave as if they are, either through

> general adherence to internal ethical norms or through the introduction of uncertainty about post-contract positions. It is for this reason that a return to the conceptual emergence of contract from Hobbesian anarchy has been necessary to develop my argument. (Buchanan 1975, pp. 175–176)

The protective State consists of a set of rights and rules that protect individual citizens from one another, and all citizens from the State. The existence of rights and rules is a form of social or legal capital. With time individuals learn to abide by the rules, respect others' rights, and exercise their own rights. It is the existence of these legal institutions and the behavior they foster that distinguishes life in civil society from life in Hobbsian anarchy, and explains why life in a civil society is superior to life in anarchy. Abiding by the rules and respecting others' rights constitutes a form of n-person prisoners' dilemma, however. If all individuals believe they are better off in the long run by abiding by the rules, the cooperative solution to the dilemma will be sustained. Economic developments, technological change, and changes in underlying preferences may, however, distance the prevailing rights and rules from the set which would emerge from a new constitutional bargain. Individuals, who feel disadvantaged by the current rules, will be tempted to break them. As more and more people break the rules, a community's legal capital erodes and it slides back toward a state of anarchy. This is what Buchanan thought he saw happening in the United States in the 1970s.

How can a community respond to such a loss of social and legal capital?

> There are two ways a community can respond to an increasing "distance" between the status quo and the set of renegotiation expectations for a large number of its members. It may, first of all, increase resource commitments to enforcement…Second the community may attempt to renegotiate the basic agreement, the constitutional contract itself, so as to bring this distance back to acceptable limits…In practice, the only alternative may be that of attempting to renegotiate the basic constitutional contract, at least along some of the margins of possible adjustment. (Buchanan 1975, p. 77).

In Chapter 10 Buchanan elaborates upon what is needed to rectify the sorry situation in the United States in the early 1970s. Here the focus is not so much on rowdy college students and Vietnam protesters, but on "the threat of Leviathan," discussed at greater length in Chapter 9. Buchanan attributes many of the problems he has identified in the United States of the 1970s to the great expansion of the size of the state that began under Roosevelt in the 1930s, and the overreach by the Supreme Court. What was needed was a "constitutional revolution." By this Buchanan meant

> …basic non-incremental changes in the structural order of the community, changes in the complex set of rules that enable men to live with one another, changes that are sufficiently dramatic to warrant the label "revolutionary"…
>
> A central hypothesis of this book is that basic constitutional reform, even revolution, may be needed. The existing legal order may have lost its claim to efficiency, or, in a somewhat different sense, to legitimacy. At the very least, it seems time that genuine constitutional change be considered seriously. (Buchanan 1975, pp. 168–169)

Thus, I think it can be safely said that in the book, *The Limits of Liberty*, James Buchanan both thought that significant reforms were desperately needed in the United States, and that they were also feasible.

Further Recommendations for Constitutional Changes

In this section I briefly discuss a few later contributions by Buchanan that offered suggestions for constitutional reforms.

The Power to Tax

In *The Power to Tax* the State (Leviathan) is modeled as a monopolist (Brennan and Buchanan 1980). This Leviathan seeks to maximize its revenues from taxation. They admit that this assumption is somewhat unrealistic, but defend it on the basis of the analytic insights it produces. Because of the distortions and disincentive effects of taxation, tax revenue can be assumed to be a concave function of the tax rate, R(t), a function made famous by Arthur Laffer. A revenue-maximizing Leviathan chooses the tax rate corresponding to the peak of the Laffer curve.

Substituting the assumption of a revenue-maximizing dictator for a benevolent dictator leads to many striking differences with conventional models of taxation and the State. A typical exercise in optimal taxation usually would, for example, begin with the assumption that an exogenously given fixed amount of revenue must be raised. It then proceeds to analyze how this revenue can be raised with the least amount of dead weight loss. Lump sum taxes are ideal, since they produce no distortions in behavior, but are rather rare. Broad-base taxes are better than narrow-base ones, because a given amount of revenue can be raised with a lower tax rate through a broad-base tax causing fewer distortions. This conclusion gets "stood on its head" once the State is viewed as a revenue maximizer. Narrow-base taxes are now superior, because they limit the amount of revenue the State can extract from the citizens. Definitions of income, which exclude some potential components like the implicit rents earned by homeowners, are superior to broad definitions (Chap. 3). Taxes on individual commodities are superior to general sales or value-added taxes (Chap. 4). One explanation for the relatively small size of the federal government over the nineteenth century might simply be that it was constrained to a fairly small set of revenue sources.

Where the last chapter of *The Limits of Liberty* was fairly short on specific proposals for a new constitution, *The Power to Tax* is replete with them. Constitutional rules regarding money expansion or inflation targets appear, as do limitations on public deficits (Chap. 6). Earmarked taxes are better than general taxes, because they force the state to provide a public good in exchange for more tax revenue. More generally, Knut Wicksell's (1896) proposal that each expenditure item in the state's budget be tied to a specific tax to finance it, combined with a requirement of a super majority (5/6ths) to authorize any expenditure would be desirable (Chap. 7).

In Chapter 9, Brennan and Buchanan extol the advantages of federalist states over unitary states, because with federalism the threat of citizen exits at lower levels of government constrains regional and local Leviathans' abilities to tax without providing corresponding public goods. The importance of federalist institutions in constraining Leviathan and, more generally, in promoting individual liberty was stressed by Buchanan many times. "I suggest that a coherent classical liberal must be generally supportive of federal political structures, because any division of authority must, necessarily, tend to limit the potential range of political coercion" (Buchanan 1995 [1996], p. 259). Upon the collapse of communism in East Europe, Buchanan also expressed hope that Europe would develop a set of federalist structures that would protect individual liberties (Buchanan 1990).

The Power to Tax constitutes Buchanan's fullest statement of how Leviathan might be constrained. All of the work in forging these constraints must be done at the constitutional stage. As with Hobbes's monarch, in the model of Brennan and Buchanan once the social contract cum constitution is signed, Leviathan is essentially unfettered except for the constraints written into the constitution.

The Reason of Rules

The Reason of Rules (Brennan and Buchanan 1985), is to a large extent a methodological treatise. The authors wish to demonstrate the superiority of a constitutionalist/contractarian approach to the study of politics over a non-contractarian approach. Thus, the book takes up and extends the arguments Buchanan put forward in the appendix to the *Calculus of Consent* and in *The Limits of Liberty*.

A noncontractarian is portrayed as believing that some ideal set of outcomes from the political process, a definition of the "public good," is "out there" and the task of the social scientist or social engineer is to discover what this "public good" is, and then bring it about. In contrast, the contractarian starts with the individual and his/her preferences and desires. Political outcomes emerge from the interactions of individuals in the political process, just as allocations of private goods emerge from the interactions of individuals in markets. If all citizens have agreed on what the rules of the political game are, then the outcomes of the political process might be judged as good, because they emerged from a mutually agreed upon set of rules. It is the *means* by which the political outcomes are obtained that gives them normative value, not some externally imposed definition of the public good.

As its title suggests, the book is much concerned with the existence of rules and their effects on social outcomes. Rules can improve social outcomes by eliminating uncertainty about the actions of others. In much of *The Reason of Rules* the authors appear to be referring to rules imbedded in a constitution. Their notion of rules is much broader than this, however, and includes things like rules of the road (1985, pp. 7–12).

The authors discuss how and why an individual's decision in a private market differs from the same individual's decision when voting (1985, Chap. 5). Both authors have written on this topic several times elsewhere. Here the emphasis is on inter-temporal problems. An individual who takes out a loan to start a business faces uncertainty about future demand, costs and so forth. She knows, however, that she will be in charge of the business, and thus can react to developments in an optimal way. A voter contemplating whether the government should issue debt to finance a given project has much less, indeed, essentially no control over what the government will do in the future. In particular, he cannot assume that the government will make optimal choices in the future. This introduces a kind of myopia in individuals as voters.

This myopia produces several undesirable outcomes from democratic processes—a high-tax trap, an inflation trap, a public-debt trap, and still others (1985, Chap. 6). The high-tax trap takes the form of governments adopting policies, which lead them past the peak of the Laffer curve. Today's government increases expenditures and taxes to win votes. Over time citizens adjust to the higher taxes with behavior that reduces their tax obligations. If the tax increase is on income, they may take longer vacations, or early retirement. The self-employed may work fewer hours. Thus, in the long run the tax increase produces less revenue than it did in the short run. A cut in the tax rate might even lead to an *increase* in revenue—*in the long run*. Because this increase would not immediately occur, in the short run the government is trapped with its high tax rates. Voter myopia also leads in fairly predictable ways to the government printing too much money (inflation), and running too big of deficits.

As in *The Limits of Liberty* and *The Power to Tax*, the proposed solutions to these problems take the form of constitutional provisions dealing with tax rates, increases in the money supply, and a balanced budget constraint. The authors also propose that redistribution to the poor be dealt with in the constitution (1985, pp. 127–131).

In the closing chapter, Brennan and Buchanan pose the same question that Buchanan answered positively in the closing chapter of *The Limits of Liberty*. "Is constitutional revolution possible in a democracy?" They answer yes, but recognize the obstacles to achieving such a revolution. Three things work in favor of such a revolution taking place—the undesirability of the status quo, the uncertainty surrounding the effects of constitutional choices on particular individuals' welfare, and the possibility with a complete constitutional overhaul of making side payments to compensate those who think they will lose as a result of some changes. More than two decades after the publication of *The Calculus* Buchanan still believed constitutions could be changed to improve individual welfare.

Politics by Principle, Not Reason

The Calculus contains an extended discussion of the simple majority rule. Some of it is positive, as the analysis of logrolling (Chaps. 10 and 11), but most of it is critical, and Buchanan criticized this rule on many other occasions. By the end of the twentieth century, however, he seems to have decided to accept the fact that the simple majority rule will continue to be the universal choice of legislative bodies. *Politics by Principle, Not Reason* (Buchanan and Congleton 1998), discusses how majoritarian democracy might be constrained so as to produce better outcomes. While much of the public choice literature criticizing the majority rule focuses on the problem of cycling, Buchanan and Congleton are more concerned about the tendency for the majority rule to induce redistribution.

To see the problem, consider a simple prisoners' dilemma situation involving, say, the provision of a public good with all row players having identical payoffs, and all column players having identical payoffs. The bottom right-hand box contains the Pareto-inferior Nash equilibrium with the two groups free riding and receiving payoffs of, say, 5 and 4 per person. The cooperative solution appears in the upper left-hand box with payoffs of, say, 12 and 10. As Buchanan often stressed neither the initial positions of the players nor the gains from cooperation need be ones of equality. If the community uses the simple majority rule, and the column group is larger, the column players will gain even more, if they vote to provide the public good *and* combine its provision with a tax that redistributes income from the row group resulting in an outcome in the upper right-hand box and payoffs, say of 2 and 13. The community's use of the simple majority rule gives majority coalitions the legal right to steal (redistribute) from the minority. Buchanan and Congleton (1998, pp. 23–24) point out an important difference between the provision of a public good using the simple majority rule and classical prisoners' dilemma situations. In the latter, each player *independently* chooses a strategy and the outcome emerges from their separate choices. With majoritarian democracy, a majority coalition can choose any of the four boxes in the matrix. It could choose to tax its own members the same as members of the minority, or even choose the opposite off-diagonal box and tax its own members more than the minority. Self-interest, of course, leads a majority coalition to choose the off-diagonal box that is most advantageous to it.

The solution to this problem is to remove the off-diagonal options from the domain of choice. Buchanan and Congleton (1998) propose to do this by enshrining a *generality principle* in the constitution. Application of the principle to taxation might take the form of a comprehensive, common tax base for all citizens, and a proportional tax to pay for a public good that all consume.

As in his earlier works, in this book Buchanan seeks to correct a perceived failure in the functioning of democracy with a constitutional change, a constitutional constraint on the democratic process. Presumably, he would not have written the book, if he did not think that such a change in the constitution was feasible. Unlike in some of his earlier works, however, the final chapter of *Politics by Principle, Not Reason* is not so much a call for a constitutional revolution, but an expression of hope that such a change might come into being.

Competitive Federalism by Default

In 1990, almost immediately after Communism had collapsed across much of Europe, Buchanan gave a lecture in Paris addressing the dramatic events taking place in Europe at that time (Buchanan 1990). In it he "suggested that the time was ripe for the Europeanization that was already in progress to be directed toward the organization of a genuine competitive federalism, with a strong, but quite limited, central authority, and with the competing nation-state regulatory regimes all operating within an enforced open and integrated economy" (Buchanan 2003, p. 25). He soon, however, realized that his "argument was quite naive" ibid. He also claimed to be surprised by the vehement criticisms the suggestion elicited. Some years later, I published an article in which I tried to sketch how a European federalism might look (Mueller 1997). It, too, elicited serious criticism (Aroney 2000).

The suggestion put forward in 1990 seemed to be calling for a constitutional moment in Europe, a conscious and presumably explicit creation of institutions that would constitute a competitive federalism of nation states. Thus, circa 1990, Buchanan's faith in the possibility of meaningful and substantive constitutional change seemed to still burn bright. Thirteen years later, the glow had substantially dimmed. Now constitutional change was seen as *emerging* through an evolutionary process much in the spirit of Frederich Hayek (Buchanan, 2003, pp. 26–27).

Toward the end of this essay, Buchanan asserted that the "effective constitution for the Europe of this century will not be 'laid on'… by some explicitly constructed special assembly operating under well-defined rules" (Buchanan 2003, p. 34). In fact, such an assembly had already been constituted, and charged with the task of writing a constitution for the European Union. This effort is discussed below.

Constitutional Change in the United States

If there was a need for a constitutional revolution in the United States in 1975, 1985, and still in 1998 as Buchanan seemed to suggest, then in the year 2017 there is a *desperate* need. The federal budget deficit has grown to an unsustainable level, fiscal crises loom in the state provision of health care and pensions, Congress is incapable of passing legislation to provide basic public goods like highway and bridge maintenance. The word "dysfunctional" often appears in discussions of the efficacy of the federal and several state governments.

The poor performance of Congress in recent years has not gone unnoticed by Americans. A Gallup poll in 2017 found 47% of those polled had little or no trust in Congress. Only 12% had a great deal or quite a lot of trust, a rather low figure but higher that the 7% recorded in a 2014 poll.[1]

James Buchanan often remarked that the ideal form of government took a federalist form. The United States has one of the strongest set of federalist institutions in the world. Elected representatives at the federal, state and local levels of government have the authority to both determine spending at their respective levels, and to levy the taxes needed to cover these expenses. In many so-called federalist states like Austria and Germany, the latter authority is largely lacking. In an ideal federalist system, legislative bodies at each level of government would largely confine their attention to providing public goods and services that benefitted all citizens within this governmental unit. At the national level, parties would compete for votes by offering platforms containing the bundles of public goods and services they thought should be provided at the national level, similar competitions would take place at state and local levels, with the choices in local elections often being among *persons* instead of parties. This is not how politics works in the United States, however. All of the Republican candidates for seats in the House of representatives do not promise their constituents the identical set of national policies. The same is true for the Democratic candidates.

[1]See, http://www.gallup.com/poll/1597/confidence-institutions.aspx, accessed 28 August 2017.

Incumbents running for the House emphasize all of the benefits (pork) that he or she was able to obtain for the district. The challengers make promises of what they will do for their constituents if elected. In office, representatives often provide ombudsman services for their districts, e.g., help getting a son or daughter of a major campaign contributor into West Point (Fiorina 1977, p. 41). Geographic representation in the United States often results in local concerns taking precedence over the national interest. Since state legislatures are structured in much the same way as Congress is, similar problems arise at this level.

A fundamental principle underlying a fair set of democratic institutions is one man one vote. Each citizen's vote should carry the same weight in determining the outcomes of elections and ultimately of the policies the state adopts. This principle is grievously violated in the United States. In 2016, the population of California was 39.25 million. North Dakota's was 757,952. Thus, the vote of a citizen of North Dakota has roughly *50 times* the weight in the Senate as a vote of a Californian has. I can think of no country in the European Union where the one man one vote principle is violated as dramatically as in the U.S. Senate. Gerrymandering has existed in the United States throughout its history. Since state legislatures draw the lines for their Congressional districts, each party has an incentive to draw the lines in such a way as to maximize the number of representatives who will be elected from their party. In recent years, the Republicans have controlled a large fraction of state legislatures, and it is they who have benefitted the most from gerrymandering. In 2016, Republican candidates for the House got 50.4% of the votes cast for either a Republican or a Democrat, which gave them 55.4% of the seats at the beginning of the 115th Congress in 2017.[2] Similar disproportionate outcomes occurred in the 2010, 2012, and 2014 elections (Reynolds 2016). Then there is the anachronistic institution, the College of Electors, which allows the person who comes in second in the voting across the entire country to

[2]See, http://history.house.gov/Institution/Election-Statistics/Election-Statistics/, accessed 28 August 2017.

win the office of president, an event which has occurred twice in the last five presidential elections.

American politicians often refer to the United States as the "greatest democracy in the world." The above discussion suggests that this statement is a gross exaggeration. This judgment is supported by the data gathered by institutions that rank countries by the quality of their democratic institutions. The United States has *never* been at the top of the list in recent years, nor even in the top ten. One recent ranking placed it 16th.[3] Clearly, there is much room for improvement in the quality of the democratic institutions in the United States.

What to do? I shall offer a couple of answers to this question by taking up the constitutional reform gauntlet that Buchanan often threw down.

Two reforms are simple—abolish the Electoral College and the Senate, and declare the candidate with the most votes in a presidential election the winner. One could consider adding seats to the Senate and basing the number of senators per state on population, but this would only make the Senate look like the House and be more or less redundant.[4]

The best way to get parties in the legislature to focus on national issues is to have each party compete for votes across the entire nation. There are essentially two variants of such a system—multiparty and two-party systems.[5] Given the past dominance of two parties in the United States, if it were to adopt one of these systems, I am sure it would opt for the two-party variant. Briefly it would work as follows. Each party draws up a list of candidates it proposes for the legislature. The parties compete across the nation for votes. An initial allocation of seats is determined by the number of votes each party gets in the election. If one party receives a majority of the votes, it is allocated a majority of the seats in the legislature and can implement its proposed

[3]See, http://democracyranking.org/wordpress/, accessed 29 August 2017.

[4]For further criticism of bicameralism see Mueller (1996, Chap. 13).

[5]I discuss ideal variants of these systems in Mueller (1996, Chaps. 8–10).

program. If no party receives a majority of the votes, a second, run-off election is held with only the two largest parties from the first election taking part, as in French presidential elections. Unlike the so-called two-party systems in Britain and Canada, where parties can win a majority of the seats in parliament with less than 50% of the votes, this system would ensure that the party with a majority of seats had won a majority of the votes in at least one election. Under certain assumptions, the competition for votes in such a two-party system would maximize a social welfare function (Mueller 2003, Chap. 12). Given this property, such a two-party system should not be coupled with an executive branch in which a president can wield a veto. Either no president should exist or a very weak one as in Germany and Austria.

Constitutional amendments in the United States have come about through the first route defined in Article 5 of the Constitution. The proposed Amendment is first approved by at least two thirds of both the House and the Senate. It is then handed over to the states and becomes part of the constitution, once three fourths of the state legislatures have approved it. There is no chance of a system such as sketched above being adopted using this procedure. The Senate would never vote to abolish itself, and the 400+ members of the House with relatively safe seats would not vote to put their safety at risk.

The second route to a constitutional amendment contained in Article 5 is through a national convention, which can be convened if two thirds of the state legislatures petition Congress to do so. Proposals to hold another constitutional convention have passed in numerous state legislatures down through the years, but the two thirds requirement has never been reached. At the time of this writing (October, 2017), a lobbying effort by the Balanced Budget Amendment Task Force has induced 27 state legislatures to pass resolutions calling for a convention. Other efforts are also afoot. Like the movement for a balanced budget amendment, these other efforts also have rather narrow and conservative objectives (*Economist* 2017). Nevertheless, the possibility that another constitutional assembly will meet in the United States cannot be ruled out. Once convened, the assembly might confine itself to the narrow objectives of the groups lobbying for the convention, but it might alternatively choose to expand its options and morph into a “runaway” convention. Its seems unlikely even in this event, that the convention would be able to agree to the kinds of structural changes needed to make the United States a truly great and responsive democracy. If the composition of the convention reflected the range of views that exists in the country, the polarization eating away at American society would simply be carried over into the convention and no consensus could be reached. If the composition of the convention was heavily weighted towards those of a particular ideological persuasion, the result might even further polarize the country. In *The Calculus* and other writings, Buchanan relied heavily in claiming a normative underpinning for the constitution on it being written behind a veil of ignorance or uncertainty. If a constitutional assembly were convened in the United States today, it is difficult to believe that its participants would step behind any such veil.

Constitutional Change in the European Union

The European Union had constituted a constitutional convention before James Buchanan predicted in 2003 that it would never do so. This was a great opportunity to close the much lamented “democratic deficit” in the European Union, and to decide whether the EU was to be structured as a confederation of nation states or a federation as Buchanan had recommended, and to eliminate the hodgepodge between the two that existed at that time. One possibility for choosing delegates to the convention that would have involved EU citizens from the start would have been for the citizens of each country to *elect* the delegates based on the views of the candidates about what the scope and structure of the European Union should be. This was not the way the convention was formed, however. As with all of the treaties that underscore the EU, the political elite in the EU decided who the delegates should be. The European Commission, the European Parliament, and each of the member states governments were all represented. The composition of the convention ensured that the question of whether the EU should be a confederation, thereby abolishing the EU parliament, or a federation, thereby abolishing the European Council in which the national governments are represented, would not be resolved. The unwieldy 350 page document that the convention produced read more like a procedural manual for the bureaucrats in Brussels than a social contract joining the citizens of the European Union.

Having left the citizens out of the process of writing the EU constitution, the political elite of the EU still had the opportunity to involve the citizenry in the ratification process. When the citizens of France and Holland voted to reject the draft constitution, this option was closed. The constitution's rejection by the citizens of two of the founding countries of the EU might have caused its leadership to conclude that the constitution needed to be rethought. This was not the reaction, however. Instead, modest changes were made, the constitution was renamed a treaty and adopted without the consent of the citizenry of the European Union. Instead of closing the democratic deficit in the European Union, the process of writing and adopting the constitution/treaty only widened it.

Conclusions

Although James Buchanan placed heavy weight on the importance of constitutions in the democratic process, he *never* discussed how the constitutional reforms he advocated would come into being. Should one of the movements for a new constitutional convention succeed, a host of questions need to be addressed, for which Article V provides no guidance. How would delegates be chosen? Would the voting rule used at the convention be a 2/3rds majority, as stipulated in the Constitution, or should the convention strive for unanimity, as Buchanan clearly preferred? By not addressing questions such as these, Buchanan might be accused of wishful thinking.[6]

When discussing the constitutional stage of the democratic process, as say in *The Calculus*, Buchanan often seemed to assume that the

[6] I took some of these questions up in the final chapter of *Constitutional Democracy* (Mueller 1996).

citizens of the polity would themselves meet to decide on what voting rule to use in the future, whether to have a bicameral or unicameral legislature, and so on. In any community larger than a small town, such a procedure would be clearly infeasible. On the other hand, the experience in the European Union illustrates the costs of drafting a new Constitution *without* heavy citizen involvement. It also reveals just how difficult meaningful constitutional revolutions are. Thus, in closing, I conclude that Buchanan's many contributions to the broad area of constitutional political economy inform us about what constitution can and ought to accomplish, but, alas, give us little guidance about how those wished for constitutional changes can be made to come about.

References

Aroney, N. (2000). Mueller on European Federation: A Reply from the Perspective of Australian Federalism. *Public Choice, 105*(3–4), 255–272.

Brennan, G., & Buchanan, J. M. (1980). *The Power to Tax: Analytical Foundations of a Fiscal Constitution*. Cambridge: Cambridge University Press.

Brennan, G., & Buchanan, J. M. (1985). *The Reason of Rules*. Cambridge: Cambridge University Press.

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

Buchanan, J. M. (1976). A Hobbesian Interpretation of the Rawlsian Difference Principle. *Kyklos, 29*(1), 5–25.

Buchanan, J. M. (1990). Europe's Constitutional Opportunity. In *Europe's Constitutional Future* (pp. 1–20). London: Institute for Economic Affairs.

Buchanan, J. M. (1995 [1996], Fall/Winter). Federalism and Individual Sovereignty. *Cato Journal, 15*(2), 259–278.

Buchanan, J. M. (2003). Competitive Federalism by Default. In C. B. Blankart & D. C. Mueller (Eds.), *A Constitution for the European Union* (pp. 25–35). Cambridge, MA: MIT Press.

Buchanan, J. M., & Congleton, R. D. (1998). *Politics by Principle, Not Reason*. Cambridge: Cambridge University Press.

Buchanan, J. M., & Tullock, G. (1962). *The Calculus of Consent*. Ann Arbor, MI: University of Michigan Press.

Demsetz, H. (1967). Toward a Theory of Property Rights. *American Economic Review, 67*(2), 347–359.

Economist. (2017, September 30). Conventional Follies, 21–23.
Fiorina, M. P. (1977). *Congress: Keystone of the Washington Establishment*. New Haven, CT: Yale University Press.
Mueller, D. C. (1996). *Constitutional Democracy*. Oxford: Oxford University Press.
Mueller, D. C. (1997, March). Federalism and the European Union: A Constitutional Perspective. *Public Choice, 90*(1–4), 255–280.
Mueller, D. C. (2003). *Public Choice III*. Cambridge: Cambridge University Press.
Müller, C. (1998). The Veil of Uncertainty Unveiled. *Constitutional Political Economy, 9*(1), 5–17.
Rawls, J. A. (1972). *A Theory of Justice*. Cambridge, MA: Belknap Press.
Reynolds, M. E. (2016, November 22). *Republicans in Congress Got a 'Seat Bonus' This Election (Again)*. Washington, DC: FIXGOV, Brookings Institution. http://democracyranking.org/. Accessed 28 August 2017.
Wicksell, K. (1896/1967). A New Principle of Just Taxation, Finanztheoretische Untersuchungen, Jena. Reprinted in R. A. Musgrave & A. T. Peacock (Eds.), *Classics in the Theory of Public Finance* (pp. 72–118). New York: St. Martin's Press.

16

Constitutional, Political and Behavioral Feasibility

Alan Hamlin

Introduction

One of the many points of entry into the work of James Buchanan is the essay *Politics Without Romance* originally published in 1979.[1] That essay identifies, perhaps more clearly than any other single essay, several key themes of Buchanan's approach to political economy: a critique of the prevailing orthodoxy in economics in which Buchanan targets the idealization of Government as a benevolent despot motivated by some idea of the public interest; a proposal for an alternative that moves away from idealism in the direction of practicality by modelling Government

[1]Buchanan (1979b) (1). In providing citations to Buchanan's work I will refer to the original publication, however most of the cited works are conveniently collected in Buchanan (1999) and I will also provide an indicator of the relevant volume in that collection, so a citation might read Buchanan (X) (Y) where X is the date of the original publication as listed in the list of references and Y is the number of the volume of the collected works in which the relevant piece appears.

A. Hamlin (✉)
University of Manchester, Manchester, UK
e-mail: Alan.Hamlin@manchester.ac.uk

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_16

as a set of institutions populated and operated by individuals whose motivations are essentially similar to those of all other individuals in society; a separation of the domain of political economy into the constitutional and the political. The proposed more realistic approach, it is often said, abandons the romantic image of politics and takes feasibility seriously.

But what does it mean to take feasibility seriously? Given that this idea can be identified as one of the foundational themes of Buchanan's approach it is perhaps surprising that, to my knowledge, no systematic or detailed discussion of the idea of feasibility itself exists in Buchanan's work. The word 'feasibility' does not appear in *Politics Without Romance*, where Buchanan prefers to use variations on 'realism' and the idea that public choice theory embodies more 'skepticism' about what Governments can and will do. Indeed, only one of Buchanan's published articles carries the word 'feasibility' in its title, and 'feasibility' appears only once in the indices of all the volumes of Buchanan's collected works—and then the reference is to the editors' forward rather than to anything written by Buchanan himself.[2]

Buchanan's reticence in discussing the concept of feasibility more directly needs some explanation, and I will offer some suggestions towards such an explanation in what follows, but I should be clear from the outset that I do take the idea of feasibility—appropriately understood—to be important to any adequate reading of Buchanan's work. It might be said that feasibility issues are so deeply woven into the fabric of Buchanan's argument that they form part of the background rather than the foreground. It is partly for this reason that a primary objective of this essay is to reconstruct and make explicit what I take to be largely implicit in Buchanan's work on the issues of feasibility as it arises at the constitutional, political and individual levels,. A second objective is to

[2]The relevant article is Buchanan (1995) (16), to be discussed below. In the relevant section of their forward to the collected works, the editors are discussing the idea of 'politics without romance'; the relevant text reads: "…normative analysis must be mediated by a proper sense of the feasible – with 'feasibility' understood both in terms of plausible assumptions about human motivations and behavior and in terms of the ways in which different institutional forms structure human interactions to produce social outcomes." (Buchanan [1999, Vol. 1, p. xv1])

connect what I identify as the Buchanan approach to feasibility with the more recent debate on the concept of feasibility in the more general political philosophy literature.

Before approaching these objectives directly, I will say something about Buchanan's use of 'feasibility' in the 1995 article, and some potential explanations for his avoidance of any more extended discussion of the concept of feasibility.

Behavioral Feasibility and the Political Nexus

In *Individual rights, emergent social states and behavioral feasibility* Buchanan returns to the theme of his earlier critique of Arrow's analysis of the relationship between social choice and individual values.[3] Buchanan's basic point is that if, as he insists, choices are necessarily made by individuals, and at least a significant number of individuals have the right to make at least some choices, social outcomes (or social states in Arrow's terminology) must be seen as emergent states—that is, states that emerge from the complex interplay of a large number of individual choices—rather than states that are themselves directly chosen. For this reason, social outcomes have to be 'behaviorally feasible' in the sense that they have to be feasible given the behavior of individuals, so that they can emerge from a set of choices made by those individuals exercising their rights. This insistence on behavioral feasibility is key to recognizing the distinction between the set of social states that can be imagined and ranked by political actors constrained only by their physical and logical feasibility, and the set that can actually be attained. Behavioral feasibility bites by constraining the set of socially accessible social outcomes.

Under Buchanan's analysis, we see distinct levels of activity which, taken together, identify the social and political nexus. At the higher, constitutional, level we have the allocation of a set of individual rights including the specification of institutional structures within which those

[3] Arrow (1951) and Buchanan (1954) (1).

rights may be exercised. For example, the individual right to vote makes sense only in the context of some outline of the institutional arrangements within which voting occurs. At the lower, political, level those individual rights are exercised and a social outcome emerges. But the key feature is that the set of individual rights determined at the higher level and exercised at the lower level determines the set of behaviorally feasible social outcomes. Only in the extreme limiting case in which the set of individual rights is empty, will the set of social outcomes be the set of all physically and logically feasible social states. In this way a constitution which identifies individual rights and institutional structures adds further constraints to determine the set of politically and behaviorally feasible social states.

Now, given this reading of Buchanan's position, it would seem natural to extend and make explicit this feasibility based analysis so as to provide both a detailed account of the constraints that limit the scope of political or constitutional design and an account of the relevant concept of feasibility itself. But, as already noted, Buchanan did not take this route; and before we set off on that path, it is worthwhile to ask why he did not. I offer several suggestions that might provide some clues, and which will also inform my later discussion.

The first suggestion is that the Buchanan project seems to require a rather non-standard approach to the relationship between desirability and feasibility, between objective and constraint. For Buchanan, it is important that at least some constraints are self-imposed. This is so both in the personal domain and in the political.[4] Given Buchanan's broadly contractarian account, constitutional provisions are both chosen and constraining. At first sight this is puzzling. There is an immediate apparent tension in the idea of a chosen constraint. If constitutional rules are artifactual, then any actions that they prohibit might still be considered 'feasible' if we take 'feasible' to mean something close to 'possible'. Just as a law prohibiting murder does not make murder infeasible, so, one

[4]While most of Buchanan's work relates to the political domain, a significant minority relate to the personal, see, for example, Buchanan (1979a) (1), Buchanan (1991a) (12), and Buchanan (1991b) (17).

might argue, a constitutional rule prohibiting, say, unfair electoral practices, does not render such practices infeasible. The basic issue is, how can the language of desirability and feasibility, objective and constraint, be re-purposed to fit with the Buchanan's project?

A second suggestion is that Buchanan was not inclined to characterize economics, even in its standard domain, by reference to the idea of rational choice seen as constrained maximization, preferring to view the most basic idea as that of exchange.[5] This more catallactic approach shifts attention from the apparently isolated individual making choices under constraints dictated largely by nature, to the more socially embedded individual engaged with others in a network of economic and political relationships. Of course, this does not imply that Buchanan completely rejected the usefulness of the analysis of constrained maximization in particular circumstances, but rather that he did not see it as foundational. The idea of exchange and its implications will be key in the argument to be developed below.

A third suggestion involves the possibility that Buchanan's notion of feasibility is sometimes tied up with the notion of legitimacy—at both the political and the constitutional level. So that something (including constitutional reform) is 'politically feasible' if it can be done given existing constitutional arrangements; that is, within the rules. But at the same time some outcome or policy is legitimate if it emerges from due process; that is, from the appropriate operation of the rules. So a constitution acts both to limit political feasibility and to ground the relevant notion of legitimacy, and these two things are deeply linked. Of course, revolution, rebellion or overthrow of the rules may be 'feasible' in some wider sense, but may not be legitimate.

A fourth suggestion relates to Buchanan's familiar insistence that 'we start from here and now' so that the status quo provides a relevant datum in considering political action and constitutional reform.[6] Here, it seems that whatever the relevant facts are at any moment may be expected to have at least some constraining effect on action.

---

[5]See, for example, Buchanan (1964) (1) and Buchanan (1989) (17).

[6]See, for example, Buchanan (2004b).

The question here, then, is exactly which facts are relevant and how do they constrain?

These four suggestions interact. For Buchanan, constraints on individual and political action derive from a variety of sources: some are externally imposed, some emerge from collective action, some are chosen by those who are subject to them, and some are merely circumstantial. We should expect different types of constraint to operate differently: some may be absolute and inviolable, others may depend upon the acceptance of those who are subject to them and operate via internalized norms of compliance, and others may operate via shared beliefs or otherwise. In this way, the idea of feasibility is revealed as being significantly more complex than might be imagined.

The Idea of Feasibility

The appropriate conceptualization of the basic idea of feasibility has attracted considerable attention in recent years.[7] There are two broad strands to this literature, one identifying feasibility with some notion of conditional probability, the other identifying feasibility with some notion of restricted possibility.[8] It is clear that neither a simple probability account of feasibility nor a simple possibility account will be satisfactory. An outcome being improbable (my winning the lottery) does not render it infeasible, and many outcomes that are logically possible (me discovering a cure for cancer) are nevertheless infeasible. Clearly, much depends upon how probability is *conditioned*, or how possibility is *restricted*. The details here can be complex. Conditional probability accounts tend to see a state as feasible if that state could be realized with

[7]See, for example, Räikkä (1998), Brennan and Pettit (2005), Brennan and Southwood (2007), Estlund (2011), Gilabert and Lawford Smith (2012), Lawford-Smith (2013), Wiens (2015), Southwood (2016), Wiens (2016), Stemplowska (2016), Estlund (2016), Hamlin (2017), Gilabert (2017), and Southwood (2018).

[8]Hamlin (2017) and Southwood (2018) broadly agree on this characterization although Southwood also considers (but rejects) a conceptualization of feasibility identified in terms of cost.

reasonable probability by an actor or set of actors who try to realize that state. This shifts the focus of attention onto exactly how to interpret 'reasonable probability' and 'try'. Restricted possibility accounts tend to see a state as feasible if it is possible for that state to be brought about given our current stock of resources, where 'resources' are interpreted widely to include human and social resources as well as the physical and technological, a central analogy here is with a generalized version of the standard economist's production possibility frontier.[9]

Note that both of these accounts tend to focus on the feasibility of states, rather than, say, the feasibility of particular actions. I will return to this point. Note also that while the restricted possibility account tends to favour a binary distinction between the feasible and the infeasible, the conditional probability account tends to operate in terms of degrees of feasibility. Finally, note that there is no requirement in either account that all feasibility constraints be objectively defined or socially exogenous. Consider, for example the standard economist's notion of an individual budget constraint. Such a constraint is formed by the set of prices facing the individual, requiring that income generated by sale of some commodities (typically, labour) is sufficient to finance the purchase of other commodities. But it is clear that these prices are endogenous to the system as a whole, with prices emerging from the interaction of all buying and selling decisions. It is, of course, important for the standard notion of a feasibility constraint to hold that it is outside the immediate unilateral control of any individual who is seen to be under the constraint, but this does not require such constraints to be exogenous in any more general sense.

In a recent article,[10] I have suggested that the distinction between the conditional probability approach and the restricted possibility approach is less clear than is sometimes claimed and that it is useful to move beyond the formal conceptualization of feasibility in terms of either conditional possibility or restricted possibility to focus of a number of

---

[9]For a leading example of the conditional probability approach see Gilabert and Lawford Smith (2012), for a leading example of the restricted possibility approach see Wiens (2015).

[10]Hamlin (2017).

inter-related aspects of feasibility that raise rather different issues. In particular, I distinguish between resource feasibility, value feasibility, human feasibility and institutional feasibility. Here I focus on human and institutional feasibility and their interconnections, so as to bring out the connection to the idea of feasibility in Buchanan's work.[11]

In outline, the idea of human feasibility is to track those aspects of feasibility that arise from the fact that specifically human decision making (whether by individuals or groups) is important in determining outcomes. I focus on two major area of concern, one associated with human motivation, the other associated with human interaction. The motivational concern, discussed extensively in the literature, arises from the basic thought that it is surely inappropriate to claim that some state is infeasible just because the relevant individual does not want to bring it about. Lack of motivation, by itself, cannot ground infeasibility. On the other hand, it seems extreme to argue that motivation is entirely irrelevant to feasibility. If some outcome will come about if and only if all individuals act perfectly morally (on some particular definition of morality), and we have good reason to believe that such universal moral compliance does not exist, it seems reasonable to class that outcome as infeasible, at least in present circumstances.

The interaction concern arises from a similarly basic tension. Some outcomes are feasible if and only if a number of individuals act together. Even if all relevant individuals are appropriately motivated, there are reasons why we might expect that the outcome will not necessarily arise. The problems of collective action are numerous and varied, and require no detailed rehearsal here.[12] The point is simply to question whether such problems constrain the set of outcomes and so provide grounds for claims of infeasibility.

The issue of institutional feasibility then relates to the role of institutions in determining social outcomes. Institutions surely matter, but

[11]Resource feasibility is the least controversial element of the idea of feasibility since it relates to the physical and technical limitations imposed by generalised scarcity. Value feasibility is of little relevance here since it relates to the relationship between distinct values and identifies an explicitly normative aspect of feasibility. See Hamlin (2017) for details.

[12]For classic discussions see Olson (1965), Hardin (1982), Sandler (1995), and Ostrom (2000).

exactly how do they work in promoting some outcomes or reducing the likelihood of others? One line of thought is that institutions can both empower and constrain: empower in the sense that they help to overcome collective action problems and so render (more) feasible outcomes that might otherwise have been infeasible (or less feasible); constrain in the sense that they restrict forms of antisocial behavior and so render some undesirable outcomes less feasible. But, of course, institutions can also repress and enslave, and it is by no means trivial to understand the distinctions separating positive from negative institutional arrangements. Which institutional arrangements are both desirable and feasible, and how they influence the feasibility of actions within their structures, are among the most basic questions addressed by the Buchanan project.

It should be clear that the issues of human and institutional feasibility are intimately connected, institutions are, inter alia, the mechanisms that govern human interaction and provide a framework for individual action, and so it is appropriate to raise the question of how institutions constrain individual behavior in tandem with the deeper question of the feasibility of desirable institutions.

Buchanan certainly does see institutions as providing constraints on individual behavior. In an explicit discussion of the structure of constraints Buchanan writes:

> If we adopt the methodological imperative that all choice analysis be reduced to inquiry into individual behavior, the importance of *institutional* constraints becomes evident. The feasible choice options open to the individual are, in part, determined by the institutional setting. (Buchanan [1989] (17), p. 42, emphasis in original).

At one level this is consistent with the standard economist's idea of feasibility. Recall the earlier discussion of the individual budget constraint, where the individual is effectively constrained by prices that themselves emerge from the overall market process. That is, it is the institution of the market that generates the individual budget constraint, and the budget constraint should be seen as internal to that institutional structure. The more general claim that institutions constrain individuals might be seen to operate analogously. This requires some explanation.

It might appear that a budget constraint is a good example of a feasibility constraint that operates on a binary level, either a plan is feasible or it is not, and the options available to the individual are exhausted by the set of feasible budget plans. But this appearance is less firmly grounded that it seems. The individual is bound by her budget constraint only to the extent that she (and others) are committed to the institution of the market and its various rules. Seen in a broader context all sorts of other options, such as theft and fraud, are at least possible and so 'feasible' in strictly possibilist understanding of feasibility. Of course, such alternatives may be prohibited by other laws and institutional rules, but this merely serves to reinforce the thought that the budget constraint is best understood as a part of a network of institutional rules that serves to identify the market system in the context of an overall economic and political structure. Such rules may be accepted or rejected by an individual on a case by case, opportunistic, basis or may be internalized into the decision making of the individual.[13] More generally, institutional constraints constrain only insofar as the individuals who are subject to them accept, in broad terms, the set of institutional arrangements in which they are embedded. Such constraints operate effectively insofar as they are accepted by a sufficiently large proportion of the population, just as the budget constraint is effective insofar as most individuals accept the general market order.

But what does 'accept the institutional arrangements' mean? It could mean no more than recognizing the fact of the prevailing order without in anyway supporting or approving of that order; or it could mean a clearer acknowledgement that the order offers benefits, even if it is in some ways imperfect. It is this distinction between 'recognition of fact' and 'conditional approval' that is key to the link from the role of institutions as constraints on individual behavior and the grounding of those institutional constraints in individual consent. Later in the same article quoted above, Buchanan turns to the topic of the choice of institutional constraints:

---

[13]For a discussion, see Hamlin (2014) and references therein.

> Once it is acknowledged that institutions enter as constraints on individual choice behavior, and once we allow institutions to be treated as variables subject to reform or change the potential for selection among alternative sets of institutions seems to follow. In expressing a preference for a *general rule*, one that will equally constrain the behavior of all persons in a community, the individual is, effectively, trading of the possible negative value of losing his own freedom of action (of having his choice set constrained) in exchange for the positive value that he expects to secure from the constraints imposed upon the behavior of others. (Buchanan [1989] (17), p. 46, emphasis in original).

Here Buchanan clearly states the basic idea of an individual supporting a general rule that would constrain all individuals in the relevant community, including herself. But such support is a long way from the individual actually choosing such an institutional constraint.

As Buchanan stresses, only a dictator could choose to impose institutional constraints and, if there were such a dictator the set of individual constraints that he might choose to impose might be expected to be very different from those that would be supported by a large proportion of the population. In less dictatorial settings, constitutional orders emerge from a complex mix of evolutionary pressures and individual political actions. If constitutional choice and the choice of institutional arrangements is to be grounded in individualism as is required by the Buchanan project, the feasibility of constitutional control must be demonstrated.

Constitutional Feasibility

Just as Buchanan criticizes the idea of 'social choice' by reference to the essentially individual nature of choice and the emergent characteristic of social outcomes, so we must accept that the idea of 'constitutional choice' is open to the same line of argument. Constitutions are not 'chosen' (except is dictatorships) but rather emerge from the complex interplay of history and individual action.[14] So what constitutions are feasible?

---

[14] See, for example, Buchanan (1967) (1), Buchanan (2004a), and Voigt (1999).

Two of the themes identified above as providing suggestions as to why Buchanan may have avoided explicit discussion of the concept of feasibility are particularly important here: the centrality of the idea of political exchange and the idea that 'we start from here and now'. These two themes point to the idea that we are typically concerned with constitutional reform, rather than de novo constitutional design.[15] They also point to the identification of the forces relevant to determining the direction of any reform. In any given situation, individuals have certain rights that may be exercised within the specified institutional structure that we identify as the status quo; within that set of rights is the right to bargain with each other about changes in those rights allocations and institutional structures that form the status quo. While no individual can choose constitutional reform, constitutional reform can emerge from the political exchange involved in such a bargain.[16]

In the quotation given above, Buchanan emphasizes the reason that any individual might have to enter into such a political exchange. Any individual might believe that she can identify a general rule that would, on balance, benefit them. But only if this general rule receives general support is it a genuine contender as an addition to (or replacement of) the set of rules that form the status quo. So, the key constraint in Buchanan's system of contractarian constitutionalism is the need to secure the agreement of others against the background of the prevailing status quo. It is the emphasis on exchange that highlights the idea that a major constraint on any individual lies in the behavior of others.

[15]Brennan and Eusepi (2013) make the distinction between the 'marginal' and the 'total' versions of Buchanan's contractarian constitutionalism. They argue that the marginal version (represented by Buchanan and Tullock (1962) (3) assumes that we start from a position in which we already have well-established rules and institutions and are asking about reform. The total version (represented by Buchanan [1975] (7)) tackles the task of how a set of rules and political institutions might be established de novo.

[16]Of course, constitutional reform might arise by other means—without explicit political exchange among the citizens—for example, through a process of evolution or revolution or by re-interpretation by a constitutional court that might depend on the agreement of only a small number of individuals identified by the current constitution.

Of course, the constraint imposed by the necessity of the agreement of others is explicitly recognized in *The Calculus of Consent*.[17] But that discussion is concerned specifically with identifying the costs of decision making as the size of the political group increases, and so forms part of the individual's process of evaluating alternative voting rules that might be adopted. The point I want to stress here is that exactly the same point is relevant more generally across the full range of issues at the constitutional level. The existing allocation of rights, rules and institutions forms a status quo point from which each individual can identify the set of alternative arrangements that offer some additional benefit. The intersection of all such sets then identifies the feasible set of agreed constitutional reforms. Note that the status quo plays an important part here. Imagine a situation in which the prevailing allocation of rights and institutional arrangements are largely imposed (perhaps by some essentially dictatorial clique) and widely unpopular. In such a situation there should be considerable scope for widely supported constitutional reform, the set of feasible constitutional reforms will be large. By contrast, imagine a society with a long history of broadly democratic governance where the status quo constitution (whether written or not) has emerged over many iterations of reform. In such a situation there may be very limited scope for further widely supported constitutional reform, the set of feasible constitutional reforms will be small and in the limit may be empty.

If it is the interaction between the status quo and the dynamic of political exchange and agreement that defines the idea of constitutional feasibility, we should also note the link to a third of the suggestions made in relation to Buchanan's lack of explicit discussion of feasibility: the role of the idea of legitimacy. To address this link we need to consider the idea of legitimacy in slightly more detail.[18] On the one hand legitimacy might be considered an essentially descriptive concept, or it might be considered to be essentially normative. On the other hand

---

[17]See the text relating to figures 8 and 9 in Chapter 8 of Buchanan and Tullock (1962) (3).

[18]For more detailed discussion and references see, Buchanan (2007), Peter (2008), and Estlund (2009).

legitimacy might be considered to be an essentially procedural property, or it might be considered to be essentially substantive.

A descriptive concept of legitimacy (in the tradition of, for example, Weber) involves a political regime being legitimate if its population holds certain beliefs about it, beliefs that grant it authority. A normative concept of legitimacy (in the tradition of, for example, Rawls) requires that the power of the regime is justified. A procedural approach to legitimacy would stress that legitimate actions are those that emerge from due process. A substantive approach to legitimacy would stress that the legitimacy of actions depends upon their impact or outcome. Within these distinctions there are many possible positions on legitimacy and its role in political theory. What is important here is that we can see Buchanan's view of legitimacy as falling into what might be termed the normative, procedural, consent based tradition. Normative both because legitimate laws are justified and because legitimate laws and rules carry significant normative implications for individuals; they are action directing, they constrain. Procedural because the mark of a legitimate rule or law is that it has emerged from a particular, constitutional, process of decision making. Consent based because the constitutional rules that bestow legitimacy on the laws and rules that flow from the operation of the constitution are themselves ultimately justified by appeal to a form of consent.

Buchanan's contractarian constitutionalism provides a model of legitimate government. Buchanan fleshes out the likely content of a consensual constitution in liberal and procedural terms. Terms that are concerned with the protection of individual liberties and the specification of collective decision making procedures that broadly limit the power of government, rather than the pursuit of particular policies or particular end states. But the detailed content of the constitution are not what makes it legitimate; rather it is the consent provided by the contractarian formulation that justifies, and would justify whatever constitutional details might emerge. Buchanan is well known for his privileging political process over policy—arguing repeatedly that political economists should shift their attention from individual policies to the level of policy-making processes. The point here is that he is equally committed to privileging the contractarian approach to constitutions over particular constitutional arrangements. All of his arguments for this or that constitutional arrangement are ultimately grounded in what he believes a typical individual would agree to in an appropriately constitutional setting. Constitutional arrangements are legitimate because agreed, rather than agreed because legitimate.

So, what is the relationship, in Buchanan's work, between feasibility and legitimacy? As we has seen, feasibility at the constitutional level is largely a matter of respecting the constraint of voluntary agreement, and legitimacy attaches to that which is agreed—whatever its detailed content. In this way, all feasible constitutions are potentially legitimate.

Feasibility and Desirability

The interaction between desirability and feasibility lies at the heart of many approaches to political economy and certainly that of James Buchanan. On desirability Buchanan is clear and explicit in his adoption of a form of normative individualism. In Buchanan (1991c) (1) he explicitly distinguishes between ontological individualism, which he rejects, and normative individualism, which he embraces. Epistemic individualism is the position which holds that individuals are each the best judge of their own interests and wider objectives; they have epistemically privileged access to their own interests. Normative individualism adopts the more subjectivist stance that an individual's interests or wider objectives do not exist as independent features which can be known or discovered, all that exists are the choices and behaviors made by the individual in specific circumstances, so that it is the act of choice or, more generally, the behavior of the individual in specific circumstances that creates value. Put in other words, the individual is the source of all value in the sense that her choices or behavior creates value rather than merely revealing some underlying utility function. Providing individuals with choice and the scope for interpersonal agreement therefore allows them to be individuals in the full sense. Adopting the position of normative individualism, as Buchanan does, commits one to respecting the outcomes of such individual choice or interpersonal agreement without questioning whether they are 'best for' the individual's concerned in terms of some utility or welfare function.

If Buchanan's deep position on desirability is the broadly subjectivist normative individualism sketched in the last paragraph this does not prevent him from writing in a manner that is suggestive of the more traditional ontological individualism that he explicitly rejects. Buchanan's work is full of instances in which he seems to make use of the idea of an individual's objectives or interests even in the absence of any specific choice or behavior. But my suggestion is that these instances are best understood as a shorthand for the deeper normative individualistic position that actually underlies the analysis.

On the feasibility side of the interaction between desirability and feasibility, Buchanan is, as I have noted, less explicit about his deep position. However in working within a contractarian constitutionalist framework he is essentially committing to an understanding of feasibility that is adapted to that framework; one that treats exchange and agreement as foundational to the understanding of constitutional politics. In line with his commitment to normative individualism, the earlier discussion suggests that his distinctive take on feasibility is one that emphasizes the role of the choices and behavior of others acting as constraints on each individual. To overdramatize, Buchanan takes the Hobbesian 'war of all against all' and transforms it into a more peaceful case of 'all constraining all' alongside an equally important 'each accepting the constraint of others'. This human and institutional aspect of feasibility, which sits alongside the more standard ideas of physical feasibility that arise out of the logic of scarcity and of the limitations of technology, operates at a number of levels; the constitutional, the political, and the behavioral.

At the constitutional level where the issue is the reform of existing institutional structures and practices including the allocation of individual rights, there are, as already argued, two major sources of feasibility constraint that go beyond the physical and the technological. One is the prevailing set of institutions—the status quo—that which is to be subject to potential reform. The second is the necessity of agreement. This requires individuals to accept that the constitutional voices of others act as constraints on the legitimate pattern of reform. In line with his normative individualism, the behavior of others should not be reduced to some formulation of their interests or their welfare, but rather should respect their actual behavior in the relevant constitutional setting. It is no coincidence that Buchanan identifies the relevance of 'constitutional moments' in the life of communities; moments when particular circumstances align in such a way as to make particular constitutional options salient.

At the political level I have argued that the key ingredient of Buchanan's view of feasibility is the emphasis on the constraining force exerted by institutions. That institutions constrain is fundamental to any understanding of Buchanan's work and yet would seem to be controversial in at least some parts of the more general debate on feasibility. There are at least two lines of argument that might suggest that institutions do not constrain. On the one hand institutional rules (or their enforcement) do not force compliance, they may make non-compliance more costly but that is not the same as making non-compliance infeasible. On the other hand, institutions could be otherwise, and the fact that institutions can change might be taken to mean that feasibility cannot be defined in terms of the specific current arrangement of institutional rules. These two arguments deserve at least some response.

In response to the argument that rules do not render non-compliance infeasible, we might point to the probabilist rather than the possibilist account of feasibility and argue that if, in fact, institutions and rules do condition the behavior of most of the people most of the time, so that the probability of outcomes is heavily influenced by the set of institutions and rules in place, then realism requires us to recognize this fact. Here we see that Buchanan's understanding of feasibility surely lies in the conditional probability camp, but is distinctly more realist and more subjectivist than many in that camp. In particular, there is little in Buchanan's work that we might relate to the debate on the role of individual motivation in the analysis of feasibility. In the recent literature, this debate has often revolved around the understanding of what it means for an individual to 'try' to bring about some state.[19] My reading

[19]See Hamlin (2017) and Southwood (2018) for discussion and further references.

of Buchanan's likely position on this debate is that it operates in the context of too mechanical a model of individual motivation in which motivations exist independently of the individual. Buchanan's subjectivist normative individualism with its focus on situated behavior sidesteps the debate of 'trying'. Of course Buchanan accepts that individual behavior is malleable, both in response to circumstances and in response to individual action itself, so that individuals influence their future selves through their actions. Certainly 'motivations' are not fixed across time or circumstance, but this does not imply that current individual behavior is not a significant source of constraint on feasibility.

In response to the argument that institutions are malleable and so should not be seen as forming part of the set of constraints on feasibility, in parallel with the discussion of individual 'motivation', Buchanan would again welcome the point that institutions are at least somewhat malleable, given his commitment to the idea that institutional and constitutional reform should be the focus of our attention, but would emphasize that the institutional rules that we currently have nevertheless act as constraints both at the political level of everyday behavior and at the constitutional level of what reforms might themselves be seen to be feasible.

In both of these responses, the emphasis is on a probabilist, realist, and subjectivist reading of feasibility in which the feasibility of an action is heavily conditioned by the individual's institutional and social context. This shows through most clearly at the behavioral level. As a thoroughgoing individualist—both methodologically and normatively—Buchanan places individuals at the heart of the idea of feasibility. From the starting point of our discussion of Buchanan (1995) where the idea that individual rights constrain the set of socially accessible social states, to the emphasis on the constraints imposed by the emphasis on exchange where the feasible set is identified in terms of the set of outcomes that can be agreed, we find that while individuals are constrained by a variety of factors, it is no less true that the recognition of individuals as individuals provides some of the most significant constraints on feasibility.

Both the conditional probability account of feasibility and the restricted possibility account tend to focus on the feasibility of states.

This or that state of the world is declared to be feasible, or not, or to have a certain degree of feasibility, depending on the details of the specific account. I believe that the Buchanan approach shifts primary attention to the feasibility of actions, rather than states. Now, this might seem like a minor matter if we take the relationship between actions and states as simple and unproblematic, but this is a big if. The shift of attention to the feasibility of actions seems to me to be entirely consistent with Buchanan's thoroughgoing individualism and the clear idea that social states are to be seem as emergent. As already noted, this message comes through clearly in the explicit discussion of feasibility in Buchanan (1995), where it is the extent of individual action that constrains the set of socially accessible states of the world.

Once attention is focused on the individual level, the next step is to recognize that, at that level, the major sources of constraint on any individual include the institutions under which she lives and the behavior of others, as well as the more standard sources of resource scarcity and technology. This focus on human and institutional aspects of the ideas of constraint and feasibility is what marks Buchanan's approach (as reconstructed here) out from many of the more recent contributions to the literature which, partly because of their focus on the feasibility of states, tend to downplay the role of institutions as constraints and focus on human constraints only to the extent to which they are concerned with motivational questions. In my view, it is this more human and institutional aspect of the Buchanan approach that makes it a more realistic account of feasibility; that is, an account that sets out to recognize the constraints that actually operate in the world.

But it might also be argued that the approach I attribute to Buchanan is more normative than might be expected of an account of feasibility, if it is intended to view feasibility and desirability as forming two independent forces that interact in the standard manner. Certainly the idea of constitutional feasibility is ultimately based on a contractarian approach that elevates agreement to a normative stance, and as such tends to conflate feasibility with potential legitimacy. This objection might claim that in tailoring the idea of feasibility too closely to a normative position, it risks declaring actions and states that are regarded as normatively inferior as infeasible.

I do not claim that the reconstruction of Buchanan's approach to feasibility that I offer here is the last word on Buchanan's understanding of feasibility. Nor do I claim that Buchanan's approach to feasibility deals satisfactorily with all of the issues raised in the recent debate on feasibility. But I do claim both that closer attention to the concept of feasibility and its deployment will add to our understanding of Buchanan's economic and social philosophy and that the more individualist, more subjectivist, and more realist account of feasibility at the constitutional, political and behavioral levels that I find in reading Buchanan's work sheds a distinctive light on the concept of feasibility that challenges at least some of the current debate. If we recognize that a primary source of the constraints on political and social feasibility that individuals face is to be found in the behavior of other individuals, as realized in a particular institutional and constitutional setting, while also recognizing that the particular institutional and constitutional setting may be open to at least some feasible and legitimate reform, we see the idea of feasibility in a relatively practical setting, and can genuinely be said to be taking feasibility seriously.

References

Arrow, K. J. (1951). *Individual Values and Social Choice*. New York: Wiley.

Brennan, G., & Eusepi, G. (2013). Buchanan, Hobbes and Contractarianism: The Supply of Rules? In F. Cabrillo & M. Puchades-Navarro (Eds.), *Constituional Economis and Public Instituions* (pp. 17–34). Cheltenham: Edward Elgar.

Brennan, G., & Pettit, P. (2005). The Feasibility Issue. In F. Jackson & M. Smith (Eds.), *The Oxford Handbook of Contemporary Philosophy* (pp. 258–279). Oxford: Oxford University Press.

Brennan, G., & Southwood, N. (2007). Feasibility in Action and Attitude. In *Hommage à Wlodek. Philosophical Papers Dedicated to Wlodek Rabinowicz*, http://www.fil.lu.se/hommageawlodek/index.htm. Lund, Sweden.

Buchanan, A. E. (2007). *Justice, Legitimacy, and Self-Determination: Moral Foundations for International Law*. Oxford: University Press on Demand.

Buchanan, J. M. (1954). Individual Choice in Voting and the Market. *Journal of Political Economy, 62,* 334–343.

Buchanan, J. M. (1964). What Should Economists Do? *Southern Economic Journal, 30*, 213–222.
Buchanan, J. M. (1967). Politics and Science: Reflections on Knight's Critique of Polany. *Ethics, 77*, 303–310.
Buchanan, J. M. (1975). *The Limits of Liberty: Between Anarchy and Leviathan*. Chicago: University of Chicago Press.
Buchanan, J. M. (1979a). Natural and Artifactual Man. In J. M. Buchanan (Ed.), *What Should Economists Do* (pp. 93–112). Indianapolis: Liberty Press.
Buchanan, J. M. (1979b). Politics Without Romance: A Sketch of Positive Public Choice Theory and Its Normative Implications. *IHS Journal, Zeitschrift des Instituts für Höhere Studien, Wien, 3*, B1–B11.
Buchanan, J. M. (1989). Rational Choice Models in the Social Sciences. In R. D. Tollison & V. J. Vanberg (Ed.), *Explorations into Constitutional Economics* (pp. 37–50). College Station: Texas A&M University Press.
Buchanan, J. M. (1991a). Economic Interdependence and the Work Ethic. In *The Economics and the Ethics of Constitutional Order* (pp. 159–178). Ann Arbor: University of Michigan Press.
Buchanan, J. M. (1991b). Economic Origins of Ethical Constraints. In *The Economics and the Ethics of Constitutional Order* (pp. 179–193). Ann Arbor: University of Michigan Press.
Buchanan, J. M. (1991c). The Foundations of Normative Individualism. In *The Economics and the Ethics of Constitutional Order* (pp. 221–229). Ann Arbor: University of Michigan Press.
Buchanan, J. M. (1995). Individual Rights, Emergent Social States, and Behavioral Feasibility. *Rationality and Society, 7*, 141–150.
Buchanan, J. M. (1999). *The Collected Works of James M. Buchanan* (H. Geoffrey Brennan, H. Kliemt, & R. D. Tollison, Eds.). Indianapolis: Liberty Fund.
Buchanan, J. M. (2004a). Competitive Federalism by Default. In C. Blankart & D. Mueller (Eds.), *A Constitution For The European Union*. Cambridge: MIT Press.
Buchanan, J. M. (2004b). The Status of the Status Quo. *Constitutional Political Economy, 15*, 133–144.
Buchanan, J. M., & Tullock, G. (1962). *The Calculus of Consent*. Ann Arbor: University of Michigan Press.
Estlund, D. (2011). Human Nature and the Limits (If Any) of Political Philosophy. *Philosophy & Public Affairs, 39*, 207–237.
Estlund, D. (2016). Reply to Wiens. *European Journal of Political Theory, 15*, 353–362.

Estlund, D. M. (2009). *Democratic Authority: A Philosophical Framework*. Princeton, NJ: Princeton University Press.
Gilabert, P. (2017). Justice and Feasibility: A Dynamic Approach. In K. Vallier & M. Weber (Eds.), *Political Utopias: Contemporary Debates* (pp. 95–126). Oxford: Oxford University Press.
Gilabert, P., & Lawford Smith, H. (2012). Political Feasibility: A Conceptual Exploration. *Political Studies, 60*, 809–825.
Hamlin, A. (2014). Reasoning About Rules. *Constitutional Politcal Economy, 25,* 68–87.
Hamlin, A. (2017). Feasibility Four Ways. *Social Philosophy and Policy, 34*, 209–231.
Hardin, R. (1982). *Collective Action*. Baltimore and London: Johns Hopkins University Press.
Lawford-Smith, H. (2013). Understanding Political Feasibility. *Journal of Political Philosophy, 21,* 243–259.
Olson, M. (1965). *The Logic of Collective Action*. Cambridge, MA: Harvard University Press.
Ostrom, E. (2000). Collective Action and the Evolution of Social Norms. *The Journal of Economic Perspectives, 14,* 137–158.
Peter, F. (2008). *Democratic Legitimacy*. New York: Routledge.
Räikkä, J. (1998). The Feasibility Condition in Political Theory. *Journal of Political Philosophy, 6,* 27–40.
Sandler, T. (1995). *Collective Action—Theory and Applications*. Ann Arbor: University of Michigan Press.
Southwood, N. (2016). Does "Ought" Imply "Feasible"? *Philosophy & Public Affairs, 44,* 7–45.
Southwood, N. (2018). The Feasibility Issue. *Philosophy Compass, 13*, e12509.
Stemplowska, Z. (2016). Feasibility: Individual and Collective. *Social Philosophy and Policy, 33,* 273–291.
Voigt, S. (1999). *Explaining Constitutional Change: A Positive Economic Approach*. Cheltenham: Edward Elgar.
Wiens, D. (2015). Political Ideals and the Feasibility Frontier. *Economics and Philosophy, 31,* 447–477.
Wiens, D. (2016). Motivational Limitations on the Demands of Justice. *European Journal of Political Theory, 15*, 333–352.

17

Blockchain and Buchanan: Code as Constitution

Shruti Rajagopalan

Introduction

This chapter discusses Blockchain, a technology that was invented and publicly released in 2008 under the pseudonym Satoshi Nakamoto as the platform underpinning *bitcoin*, a cryptocurrency. Bitcoin is a decentralized, stable, and transparent time-stamped public ledger resolving the double-spending problem[1] by using blockchain technology combined with the benefits of cryptography with a peer-to-peer network using the internet, to create a tamper-proof record of transactions (Nakamoto 2008).

Blockchain is referred to as a distributed ledger technology or a trustless consensus engine (Swanston 2014). The technological novelty of a blockchain is that it can create consensus about the true state of a

[1]Double-spending is the act of using the same digital currency for more than one transaction.

S. Rajagopalan (✉)
State University of New York, Purchase College, Purchase, NY, USA

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_17

ledger (that might record, for instance, exchanges, contracts, ownership, identity, data) without participants required to trust any centralized authority, or an intermediary (like an auditor, government, or an exchange). Consequently, there is much to evaluate and learn from the institutional structure that the technology and its various applications provide, especially within the constitutional political economy and public choice literature, wrestling with designing collective action rules that are robust to capture by interest groups.

Blockchain has been described as a as disruptive force that can disrupt *any* centralized system, that coordinates valuable information (Wright and De Filippi 2015), reduce the size of government by increasing cooperative efficacy (Nair and Sutter 2018), and as a system of institutional evolution that leads to many kinds of entrepreneurial actions (Davidson et al. 2018).

As an extension of this literature on blockchain as a new institutional and governance platform, this article argues that one can conceptualize computer code as constitutional rules and constraints in blockchain technology and governance. The Bitcoin protocol is essentially a set of rules written in computer code, governing what is, and what is not, allowed by the participants in the Bitcoin network. No single participant can change the rules, and even when new rules (in the form of upgrades to the open source software) are advanced by different participants, the key to understanding Bitcoin is through understanding consensus. In this context, Buchanan's scholarship is relevant to this new technology.

There are two aspects of Buchanan's scholarship that can be extended by studying blockchain; in particular, cryptocurrencies like Bitcoin. First, as a currency, Bitcoin fits Buchanan's vision of an automatic and not a managed monetary system (Buchanan 1962). Second, if the Bitcoin currency is an automatic system, operating without any centralized direction, it is useful to understand the rules governing the decentralized network, that actually make it a predictable monetary system, as desired by Buchanan. In particular, Buchanan's scholarship on consent and unanimity is quite illustrative (Buchanan and Tullock 1962). For this analysis, I argue that it is useful to think of computer code as rules, and as constitutional rules, or the rules for rule-making (Buchanan 1990).

One mark of long lasting scholarship is when its fundamental insights can explain the world decades later, even when the world looks unrecognizable through technological transformation. James Buchanan's scholarship can be used to both understand and analyze Blockchain technology as a governance platform. Though Bitcoin is a harbinger of the future of technology and governance, the building blocks of the classic literature in constitutional political economy have much to contribute.

This chapter is organized as follows. Section "Bitcoin" describes the basic functioning of the Bitcoin system. In section "Code as Constitutional Constraints", I introduce the idea of conceptualizing computer code as constitutional rules. Section "Mining Bitcoin: Consensus and Verification" discussing the process of mining Bitcoin—or to find an analogous idea in Buchanan's terms—the level of choice and actions within rules. Section "Forking: The Calculus of Crypto Consent" discusses the process of Forking, or in Buchanan's terms—the choice of rules. Section "Conclusion" concludes.

Bitcoin

Blockchain technology was first used in the development of the digital cryptocurrency, Bitcoin (Nakamoto 2008). Though the Blockchain structure extends past the application of Bitcoin to other kinds of cryptocurrencies and kinds of ledgers, it is useful to understand its origins through Bitcoin.

Bitcoin is a completely decentralized cryptocurrency, that is not issued, controlled, or distributed by any centralized authority. As a decentralized currency, Bitcoin started as a publicly available ledger of all trades or transfers of Bitcoin among its users anywhere in the world. The ledger file is not stored any central institution. It is distributed across the world via a network of private computers that are both storing data and executing computations. Each of these computers represents a "node" of the blockchain network and has a copy of the ledger file. The interesting thing about Bitcoin as a currency, and blockchain as a technology for keeping ledgers, is that the idea of not centralizing power to prevent capture, is inherent in its core design, and therefore it is constitutionally more robust to capture by special interests or coordinated attacks by small and powerful groups.

Bitcoin is an excellent illustration of Buchanan's idea of a monetary constitution where Buchanan argued that the appropriate standard is monetary predictability (instead of monetary stability). Buchanan distinguishes a managed monetary system—"that embodies the instrumental use of price-level predictability as a norm of policy, either loosely by discretionary authorities possessing wide latitude for independent decision-making powers, or closely in the form of specific rules constraining discretionary authorities within narrow limits" from an automatic monetary system "which does not, at any stage, involve the absolute price level, the price index, or any other macroeconomic variable, in guiding monetary policy" (Buchanan 1962, pp. 164–165).

Leaning towards the latter, Buchanan argues that automatic systems are characterized by an organization "of the institutions of private decision-making in such a way that the desired monetary predictability will emerge spontaneously from the ordinary operations of the system" (Ibid., p. 164, footnote omitted).

In reality, Bitcoin does not fit the commodity standard as described by Buchanan's illustration of an automatic system consisting "solely of the designation of a single commodity or service as the basis for the monetary unit, as the standard, and the firm fixing of the future course of the price, in monetary units, of this commodity" (Ibid.). The automatic nature of a non-commodity-based currency implies that a group requires no monetary authority to either manage the monetary base or monetary rule using discretion.

Although Buchanan perceived money with some features of a public good, requiring strictly controlled government provision, Bitcoin, a completely decentralized cryptocurrency, is an excellent illustration of such an automatic system that will result in monetary predictability.

The total supply of Bitcoin is capped by its code at 21 million. This essentially ensures scarcity with an absolute limit on the supply of this currency. In 2018, about 17 million Bitcoin have been mined and are in circulation.[2] Developers expect another three million Bitcoin to be mined over the next 5–10 years. And, it is expected to take close to a century (at current computing speeds and capacity) to mine the last one million of Bitcoin. The Bitcoin code issues new currency to miners for verifying transactions. This is done at a controlled pace, and the verification process also becomes more complex as more Bitcoin are generated and traded (Antonopoulos 2014). So, the process of getting new Bitcoin through verification increases at a decreasing rate. In this aspect, the process of increasing Bitcoin supply mimics the increase in the supply of gold, it increases only at a decreasing rate (Nair and Sutter 2018).

The foundation of Bitcoin is cryptography. Its protocol uses a public-private key to store and spend money and allow cryptographic validation of transactions. Standard cryptography allows any individual to create a public key (designed to be shared widely) and an associated private key.[3]

Encrypted messages with a public key can only be unscrambled by the holder of the associated private key. This allows individuals in a large network to encrypt messages that only the specified recipient can access and read. Messages encrypted with the private key can only be unscrambled with the associated public key, allowing messages to be confirmed as authentic from a given sender.

For instance, Sender 'A' publishes a message in the Bitcoin network announcing her plan to transfer 10 of her bitcoins to receiver 'B'. This announcement includes a reference to the transaction on

[2]See https://www.blockchain.com/charts/total-bitcoins.

[3]Every public key is 256 bits long and the resulting hash from the public key is 160 bits long. The public key is used to indicate the ownership of an address to receive funds. *A private key* is a randomly generated string (numbers and letters), allowing bitcoins to be spent. A *private* key is always mathematically related to public key or the wallet address, but only known to the owner and not required to be shared for transactions. The public key is mathematically derived from the corresponding private key, but the beauty and benefit of cryptography is that it would be nearly impossible to use the public key to derive the private key, requiring about a trillion years for a supercomputer to crack the reverse mathematics solution.

how she acquired or received those Bitcoin. Part of this message is encrypted by sender A's private key to demonstrate that this message was sent by Sender A. Once receiver B has the Bitcoin and wishes to engage in a new transaction, he becomes the Sender. Now Sender B, in order to conduct a transaction with receiver 'C' announces his intention encrypted with the private key, and also with a reference to the transaction with A, from whom he received these Bitcoin. A, B, and C are all identified on the network through their public keys for these transactions.

The network does not need to know the private key. All that the network requires is to know if the private key corresponds to the public key, and then the transaction is validated. And since the public key is known, the network can check if the Bitcoin was spent previously, since all the previous transactions are on a public ledger.

These transactions are secured through participating nodes on the network algorithmically generating hashes that are periodically added as a new block. A hash is a string of data of consistent length that acts as a unique identifier that can validate the transactions that were recorded in making it. For instance, the following string of data generate the following SHA256 hashes.

String	Hash
James Buchanan	e806362b5be794dbb9c81162c4a8dcf-3864c81082004ee536f98a8fd8326de50
James M Buchanan	0a1489e8f1a881ccec84ee7ba3fab435c59a2b-e184b121b90289b0adf8319016
James McGill Buchanan	8a2612d6e8b70697fefa83cfa5749d1076be-0911b0e42e4403f788469aa19110

Hash functions are deterministic, i.e. a particular input through a hash function will always lead to the same result. Further, even a small change in the input, there is a big difference in the hash. Each of these hashes is then added to a block. And the block of transactions is linked to previous blocks or chain of transactions, hence blockchain. The result is that, unlike other shared ledgers, transactions recorded on a blockchain are extremely difficult to manipulate or reverse by any authority.

Code as Constitutional Constraints

My main argument is that for governing the decentralized network of nodes, the code of the Bitcoin protocol can act as both rules and as constitutional rules.[4] By 'constitution' I mean 'rules for rule-making' as defined by Buchanan. While the code has a technical aspect, much of it is intended to constrain what individual nodes can and cannot do. And in this sense, it is a rulebook for computing, but the nodes or computers act out the intentions of individuals who participate in the Bitcoin network, and therefore the code, in essence, constraints the individual participants. The constitutional rules governing the interactions in the Bitcoin network are through the computer code in the Bitcoin Core software and its upgrades. The code determines how the different nodes or computers within the network interact with one another.

One of Buchanan's most important contributions is to distinguish between two levels of choice—the choice of rules, and the choice within rules (Buchanan 1990). This way, constitutional politics places boundaries over the realm of ordinary politics. One can think about the Bitcoin code as a constitution and the Bitcoin network engaging in both the choice of rules and choice within rules.

The original Bitcoin constitution was coded or written by Satoshi Nakamoto and was not a set of rules and protocols that was collectively decided by the participants in the Bitcoin network. But Nakamoto adopted an open source system and the source code was publically available. In addition, coders and developers could write changes to the code or upgrades to the Bitcoin Core software. However, all the software upgrades and changes to protocol need to be accepted by the group, and are adopted only if the participants can agree on the rule/code change. The choice of rules since the creation of Bitcoin, is really an emergent

[4]A similar argument has been made for cyberspace and other technologies by Lessig (1999). Lawrence Lessig famously described the code that regulates cyberspace as law, in that this code, or architecture, sets the terms on which life in cyberspace is experienced. If code is the law that regulates behavior or the individual participants, then the changes in code also lead to changes in the behavior of the participants.

process within an open source network. Various proposals for a new set of rules, or changes to the existing set of Bitcoin Core rules, need to be accepted by the nodes within the network.

These rule changes are governed by consensus requirements to create and change the code that governs Bitcoin, i.e. at the constitutional level. This is described in detail in section "Forking: The Calculus of Crypto Consent" while discussing forks in the Bitcoin network. An example of choosing the rules of the game is increasing the size of the block of transactions. Since Satoshi Nakamoto capped the block size at 1 MB, the network requires a change to the existing code (akin to amending the constitution) to increase block size. An increase in the block size will affect the choice within rules, i.e. the process of verifying transactions and adding them to the public distributed ledger.

At the level of choice within rules or constraints, is the everyday business of Bitcoin participants interacting with one another within the network, mainly to verify transactions (which is the process to mine or issue new Bitcoin). For instance, mining new Bitcoin will take on different forms depending on what is the allowed block size. At a block size of 1 MB, most computers can effectively participate and use their computing power to produce proof-of-work or the verification for transactions that mines new Bitcoin. An increase in the block size to 4 MB, automatically favors larger processing power, which means that the verification system will have fewer and more powerful participants—those with access to higher processing power. This has significant consequences, for the nature of the network, the concentration of hashing power, and therefore making the public ledger more vulnerable to attack or capture.

The 'original constitution' by Satoshi Nakamoto (2008) created a set of rules governing the network, the most important of which was the supply of the currency. Unlike most fiat currencies, Bitcoin is constitutionally capped. i.e. the total supply of Bitcoin is capped at by its code at 21 million. Bitcoin can be bought, sold, and spent in fractions, with the smallest fraction called Satoshi (1 Satoshi = 0.00000001 Bitcoin). So even with the absolute limit on Bitcoin, and its increasing value, it is easy to use as a medium. Therefore, even if the network gets close to mining almost all the Bitcoin, there is no incentive for current Bitcoin holders to change the code and increase the total cap from 21 million to a larger number, because doing so will reduce the value of their holdings.

Bitcoin, as a version of the Buchanan's automatic system, is far less vulnerable to manipulation or political capture than the typical forms of ordinary automatic system backed by physical commodities. Given that the process of verifying transactions is an increasingly complex mathematics puzzle, the process of getting new Bitcoin increases at a decreasing rate. Both these aspects, the limited supply, and the slow increase in the new supply, are constitutionally enforced, and cannot be changed, and are the main reasons for the value of Bitcoin as a cryptocurrency.

Given that the network is completely decentralized and relies on consensus for collective action, there is the question of who is allowed to participate and to vote in the Bitcoin governance system. There are two types of participants in the Bitcoin network. The first group is the miners, who actually verify transactions on the blockchain and the second is every participant on the network—Bitcoin owners, exchanges, nodes maintaining the public ledger etc. When it comes to having a "vote" or a say in either verifying transactions or changing the protocol, only miners have a vote. However, there are no barriers to entry and anyone can become a Bitcoin miner. The software is open source, and anyone can download Bitcoin Core, and download and maintain the complete blockchain on their computer and participate in verifying transactions in exchange for new Bitcoin. In 2018, the number of computers storing the Bitcoin ledger is estimated at close to 10,000.[5] And each of these nodes has low barriers to entry, as well as the ability to exit the system, and the voice to accept or reject any rule changes.[6] If the default rule in

[5]This is only an estimate. No one knows how many nodes there in the Bitcoin network since all are not reachable. Some website like https://bitnodes.earn.com update the number of reachable nodes frequently.

[6]At this point it is important to understand the difference between nodes and miners. Full nodes are the computers have a complete record of the blockchain and verify all the transactions in the system and enforce consensus rules using Bitcoin Core. There are also nodes that are not full nodes, which only have a small portion of the blockchain and are mainly used to transact and can be used to connect with full nodes for transactions. Miners are full nodes, but in addition to maintaining the complete blockchain, they also perform proof-of-work to mine new Bitcoin.

democracy is 'one individual one vote' one can say that in Bitcoin, it is "one processor one vote." And because the decision-making or voting is done through nodes participating in the Bitcoin network, there must be rules governing this kind of democratic decision-making.

There are two levels of choices—the choice that takes place within those rules in order to mine, verify, and exchange Bitcoin, and the choice of rules or software upgrades that change the Bitcoin protocol. Therefore, there are two types of consensus required for Bitcoin.

The first is the consensus over any transaction—falling within the category of choice within rules. This consensus, as discussed above, is based on the proof-of-work by miners, and once such consensus is achieved, then the transactions cannot be changed later. In the cases where there is a failure to achieve consensus, there is a split in the blockchain. This means that temporarily, there is more than one blockchain in the network. But the chain that is the first to find or connect to the next block of transactions becomes the longest chain, and therefore other chains that form temporarily are abandoned. While there is no specific voting or majority rule, at the core of the decentralized decision-making is the idea of consensus. The greater the consensus around a given chain, that chain will be adopted by the network as "the" chain. Part of this is informed or governed by some informal norms emerging from the network. Currently, transactions are considered final, if they are six blocks deep in the blockchain, because given current hash power and its concentration, it would be almost impossible to manipulate change the ledger once it is six blocks deep. If the hashing power concentrations increase, the norm may also increase from six blocks to a higher number of blocks before a transaction is accepted as final in the network.

A second type of consensus is required at the level of the code or protocol—or the choice of rules. As the technology is used over time, many of the developers and coders find bugs or wish to eliminate certain problems and propose changes to the code. However, for changes to be adopted there is consensus required within the network.

Like any constitutional framework, it is impossible to expect that the original set of rules adopted will always be relevant. Rules change and evolve over time, either by changing the text of the rule, or its interpretation/meaning. So, an important question arises when we compare code as constitutional rules. How does any change in the code or protocol compare to constitutional rules? And in a decentralized network, who decides how to change the rules? The simple answer is that no single individual decides these rules changes, and even when a single individual writes the updated set of rules, a very large majority must agree. This emergent aspect of Bitcoin and block chain technology has made it an extremely fertile experimental space for different rules and systems.

Vitalik Buterin has described the immense flexibility to change the rules within blockchain. "Blockchains are not about bringing to the world any one particular ruleset, they're about creating the freedom to create a new mechanism with a new ruleset extremely quickly and pushing it out. They're Lego Mindstorms for building economic and social institutions" Buterin (2015).

Furthermore, the code that runs the Bitcoin network is a hard constraint and cannot be overcome by manipulation or interpretation. The only way of getting around a given set of rules or constraints is to upgrade the software which requires the consent of the nodes present in the network. In this sense, unlike the modern-day constitutions, whose custodians are elected representatives and unelected judges, and changes can be made and implemented without the explicit consent of citizens or voters; Bitcoin requires consent of the individual nodes, since these nodes have to upgrade to the new set of rules before the computer can perform the requisite function.

Second, unlike modern constitutions, often executed by bureaucrats and interpreted by judges, there is no room for interpretation of the Bitcoin code. Any action is either permitted or not permitted by the code governing that particular protocol. And if there is more than one set of rules in operation (as may be the case since it is an open source system), then the Bitcoin protocol will either allow both sets of rules to exist simultaneously or invalidate transactions of one of the sets of rules.

Mining Bitcoin: Consensus and Verification

The process of issuing new Bitcoin is completely decentralized. New Bitcoin are generated as a reward for mining—a process that verifies the transactions within the decentralized peer system. The process of mining is essentially solving a very difficult mathematic puzzle using computing power. Finding the solution requires trying all possible combinations and the speed of success is determined by the availability of computing power. The one with the access to the most computing power will most likely solve the problem first.

Since Bitcoin lacks a central auditor, every transaction must be verified and agreed upon by the decentralized network. There are many ways to achieve this like majority voting on transactions, having randomly selected parties within the network verify transactions, etc. Bitcoin however, uses a costly and robust system called the proof-of work.

The core idea of Bitcoin is that for voting on any transaction, the miners must solve a problem, or a mathematical puzzle, that is difficult to solve, but easy to verify by the nodes once solved. Each and every node adds to the layer of security or protection from capture by storing the ledger in this decentralized way. Miners take on the costs of supplying this service of adding security to the decentralized ledger. For supplying this costly and valuable service, miners are rewarded with newly created Bitcoin.

Given the absence of a trusted centralized authority, the value of Bitcoin emerges from the system of a public decentralized transparent ledger. However, it takes time to verify each transaction because each transaction must be verified by multiple nodes.

As mentioned before, solving the puzzle, or proof-of-work, makes Bitcoin a highly democratic system where each computation cycle equals one vote. If the network simply required some kind of consensus on the correct or authentic record of transactions, then such a system could be rigged by creating multiple identities and therefore voting many times and capturing the system. However, requiring proof-of-work, is a very costly method of participating or voting (for which miners are rewarded with Bitcoin). Therefore, it fosters authenticity, discourages fake identities and provides the right incentives to the participants within the network to verify transactions (Bohme et al. 2015).

Once this mathematical puzzle is solved, proving proof of the authenticity of the transaction, the miner will publish the proof-of-work in a block. This proof-of-work shows the solution and then other miners and nodes can verify the solution. Nodes can add a block only if the block follows all the rules in the consensus mechanism. Therefore, the software running on each node checks the validity of a block and will reject any block with an invalid transaction. One example of an invalid transaction, and therefore an invalid block, is someone sending Bitcoins that they have not received from someone else in a transaction, or not received from mining a block. After the solution is verified, the miners start working on the new block of pending transactions (Ibid.).

The process comprises mining and verifying the blocks, and comparing the block to the most recent blocks, such that the entire network agrees on the historical ordering or chain. No transaction will clear or become final, until it has been added to the consensus blockchain i.e. there is consensus among the nodes over a transaction. And consensus means that most of the nodes in the Bitcoin network have the same block in their locally validated best blockchain. It takes time because it takes time to provide proof-of-work and then verify the solution using consensus rules of the network (Ibid.).

The system is coded such that blocks are added approximately every 10 minutes, though there have been times when the congestion in the Bitcoin network takes hours for transactions to clear. Because of this time lag—there are times when a transaction batch may be added to a blockchain, but it is changed because the miners reached a different consensus on the solution. To ensure that there is no problem of double-spending, the informal consensus in the network is to wait for a transaction to be 6 blocks deep before the transaction is confirmed. While this provides greater validity and assurance for the transaction, it also increases the time taken to confirm a transaction. The more transactions in the network, the greater the delay. Transactions are processed in the order in which they are received by the network, though there are mechanisms to move up in the line by paying fees.

Like in any system requiring consensus, Bitcoin transactions are costly, and take time to verify. Sometimes it may take up to an hour to verify a transaction as final. Compared to other systems like credit card networks that take mere seconds to verify and vet a transaction, Bitcoin has high decision-making costs. However, it is precisely this high degree of consensus for verification of transactions that fosters trust within the network and provides robustness to Bitcoin, and therefore provides value as a currency.

The Calculus of Consent (Buchanan and Tullock 1962) highlights the tradeoff between external costs and decision costs arising from any given voting rule within a group. This is also true for the consensus rules governing Bitcoin. The lower the consensus requirement, the higher the chance of an attack compromising the blockchain. And the higher the consensus requirement, the greater the time taken to verify transactions. Given this tradeoff, it is quite obvious that as the network evolves, a different rule will minimize total costs of arriving at consensus over a transaction. However, this changing these rules also requires a high level of consensus, as discussed in the following section.

Forking: The Calculus of Crypto Consent

In the Bitcoin network, consensus means that most of the nodes in the Bitcoin network have the same block in their locally validated best blockchain. However, to maintain consensus, it is important that all the nodes in the network follow the same consensus rules, or the same block validation rules. Since Bitcoin software is open source, developers and participants in the network often propose new rules and features that they believe will improve Bitcoin.

Within the blockchain technology, any time there is a change in the code, there is the potential for a fork. Because the technology is open source, every single Bitcoin node must be compatible with the rest of the network. Any node that is not compatible with the version of the software that all the other participants in the network are using, could face two possibilities. First, even though there are differences in the versions being used, these different versions are compatible, and lead to mining the same blockchain (because consensus is required at that level). A second possibility is that the two different versions are incompatible, and this leads to the nodes mining different blockchains.

When new rules are introduced and implemented, there is the question before all the nodes on whether they choose to upgrade to the new set of rules or follow the old set of rules. And this choice is similar to a constitutional choice, or in modern terms voting on a constitutional amendment. Except, in the Bitcoin network these changes require a high degree of consensus that is near unanimity. The argument in *The Calculus of Consent*, is that behind the veil of uncertainty, in the absence of decision-making costs, the unanimity rule will be chosen, because when the costs of decision-making are absent the external costs are minimized only at the point of unanimity. The rule of unanimity makes every single acceptance of rule change a voluntary one. All exchanges will be efficient, as every single member in the network consents (Buchanan and Tullock 1962).

The Bitcoin network however has learnt first-hand, the difficulty with the unanimity requirement. In practice, rules have evolved which are similar to super majority rules, and not unanimity rules. Unanimity is achieved eventually, once the high threshold is reached, because the remaining nodes upgrade to the new set of rules.

When new rules are introduced, some nodes upgrade to follow the new set of rules while other nodes continue to follow the old set of rules. This creates a situation where the consensus over the blockchain can split. If a block of transactions is mined and accepted by the upgraded nodes but is rejected by the non-upgraded nodes, i.e. the old version of the rules and the new version of the rules are incompatible, this leads permanently divergent blockchains, one for the non-upgraded nodes following the old rules and the second for the upgraded nodes following the new rules. This is known as a hard fork. In theory, the only way to prevent a hard fork is if every single node upgrades to the new set of rules or every single node rejects the new set of rules i.e. unanimity. In practice, if a sufficiently large number of nodes upgrade to the new set of rules and that becomes the longest blockchain, then there is a greater incentive for the rest of the nodes to upgrade, since their fork will be the less valuable fork. Conversely, if too few nodes upgrade to the new set of rules, the new fork or upgrade will be abandoned since there are insufficient users/miners.

A second scenario is when a new set of rules is introduced, and the newly upgraded nodes reject a block violating the new rules (following the old rules), but the block is accepted by the non-upgraded nodes still using the old rules. In this case the new set of rules are backwards compatible, i.e. the non-upgraded nodes will accept all the blocks mined by the upgraded and the non-upgraded nodes as valid. But upgraded nodes will not accept transactions under the old set of rules. This is called a soft fork. In case of soft forks, it is possible to prevent a split if the upgraded nodes control more than 50% of the hash rate. Since the non-upgraded nodes accept all the blocks (by upgraded and non-upgraded nodes) as valid, if the upgraded nodes get the majority of the hash power, they can build the chain that non-upgraded nodes accept as the best blockchain.

The interesting thing about Bitcoin rule changes, especially hard forks, is that no one can impose a new set of rules on any node in the network without consent. If a sufficiently large number of nodes change or upgrade to the new set of rules, then that blockchain becomes more valuable, and there is a benefit in upgrading to the new set of rules. In both hard forks and soft forks, it is impossible for a minority to impose a new set of rules on the majority. At best, the minority can carve out a new set of rules for itself. This abstract splitting of hard forks and soft forks becomes clearer with actual examples from the recent history of the Bitcoin network.

On the issue of congestion of transactions in the Bitcoin network, there was a major disagreement within the Bitcoin community. The problem within the Bitcoin protocol was that it would get slower and more congested as it grew more popular. The original Bitcoin code by Satoshi Nakamoto placed a limit on the number of transactions that could be processed within the network every 10 minutes. The reason for the cap was to make sure that the individual computers processing the transactions within the network, could handle the cumulative global load of transactions. However, as the number of transactions in the overall network increase, this limit on the number of transactions created congestion and delays.

One solution suggested by Mike Hearn, one of the coders in the core group, was to upgrade the code for processing transactions. Hearn argued that the "Bitcoin Core has no code in it to handle a permanent and growing transaction backlog. Transactions just queue up in memory until the node runs out" (Hearn 2015). Consequently, each node might become very slow, or crash. Hearn's main argument was that these consequences would eventually harm users, and Bitcoin's reputation, leading to a loss in Bitcoin value. And the only way to preserve value was to raise the limit on the number of transactions processed in each block.

Hearn's main opposition for increasing the block size, Gregory Maxwell, talked about the various tradeoffs. One important consequence, he pointed out, was that larger blocks of transaction might overwhelm the small or ordinary individual computers. The result would be that only large companies, or miners within the network would process the claims (Popper 2016). The original point of creating the decentralized network was that both the transactions and the ledgers would be stored across a larger number of computers, and anyone could join the network and become a miner or node. This would change the barriers to entry to become a node within the network, with fears of capture by larger firms.

This point was more than just technology, but about a system that would fundamentally change the democratic nature of the Bitcoin network. If only very large processing capacity could solve the transactions, because of the increase in block size, then even with the one vote rule, only the elite and larger miners with extensive computing power get a vote in the system.

Within the Bitcoin community, there was the struggle between the classic external costs and decision-making costs on the question of who processes or "votes" on a transaction. The original code took on high decision-making costs, limited the size of the block, and allowed anyone to be a miner with the proof-of-work qualifying as a vote on a legitimate transaction. The new faction led by Hearn preferred lower decision-making costs in the same tradeoff. Because it was a question about changing the code of the Bitcoin protocol, it is similar to a constitutional question. There are two fundamental constitutional questions raised in this kind of issue—first, who should be allowed to vote within a system. And second, what should be the voting rule once the network agrees upon the participants.

In national boundaries, this question manifests itself as the decision over the voting rule—first past the post, primary system, etc. Or the distribution of authority between the legislature and executive decision-making.

The factions were not just about code, but more fundamental, about how the participants viewed Bitcoin. Some viewed Bitcoin as a currency primarily like gold, with a store value, that was preserved due to the decentralized nature of the network and the anonymity provided by the protocol. Others viewed Bitcoin as a medium of exchange, where the value would come from ability to support a large number of transactions very quickly, like MasterCard or Square. This division within the Bitcoin network also posed more basic questions, as there are often at the time of constitutional framing.

The issue of congestion of transactions in the Bitcoin network caused a lot of internal debate and turbulence within the Bitcoin network. One of the first few suggestions was to increase the block size (forwarded by Mike Hearn and Gavin Andersen, a lead maintainer of the bitcoin project) by introducing a software upgrade leading to a fork known as Bitcoin XT.

The main issue was increasing the block size would cause a change of rules that was not backwards compatible. If the block size limit were to be increased from 1 MB to say 4 MB, a 3 MB block would be accepted by nodes running the new version but rejected by nodes running the older version. Therefore, unless all the miners upgrade to the new protocol, there would be a split in the community, or a hard fork. Bitcoin XT was a split off the original Bitcoin Core.

To avoid a hard fork and still have the XT protocol to replace the Bitcoin Core protocol requires unanimity. i.e. in theory all nodes must accept the new protocol or exit the system. In practice, however, sufficiently high number of nodes should upgrade to the new XT protocol, to make the XT blockchain the longest and dominant blockchain after the hard fork. To this end, if a sufficient number of all the bitcoin node owners had chosen to adopt XT—75% to be precise—Bitcoin

Improvement Protocol 101 (BIP101) would have become active and the block size for those running that software would increase from 1 MB to a maximum of 8 MB, with a provision to double every two years. However, the Bitcoin XT protocol was never adopted by 75% of the nodes and at its maximum it had about 10% acceptance, which has since fallen. Bitcoin XT is considered a hard fork in the Bitcoin protocol that failed (Palmer 2016).

After the failure of Bitcoin XT, the same idea to increase the block size, but in a less drastic way from 1 to 2 MB was introduced with Bitcoin Classic. Unlike XT which was a result of a sharp divide within the community, Bitcoin Classic initially showed signs of reaching some consensus within the community, but like XT, this hard fork also failed.

An example of a successful hard fork is Bitcoin Cash, which was not an attempt to build close to unanimous consensus the traditional way. In August 2017, the blockchain forked at block 478558. This was done as a surprise announcement by a small group of miners, who instead of waiting for consensus within the Bitcoin community, simply performed a hard fork and used their hash power to trade the new cryptocurrency, Bitcoin Cash. Trading started after an hour of announcement, taking the Bitcoin community (which was debating a different user activated soft fork called Segwit) by surprise. While starting with only a few hundred nodes, at present Bitcoin Cash has over 2000 nodes processing transactions, and a block size limit of 32 MB.

Thus, multiple attempts to improve the original Bitcoin Core protocol and move to a faster network benefitting all the participants have consistently failed. One reason is the requirement for the very high level of consensus required to make these changes, and the consequent tendency to stick to the status quo. Hard forks impose a high bar. To prevent a split in the blockchain, all nodes must upgrade to the new rule and accept the new rule unanimously and almost in unison. This high bar makes hard forks or splits in the blockchain more likely. And splits in the blockchain can reduce the value of Bitcoin, which imposes a cost on all the participants in the network. So even when participants reject a new set of rules, the value of the Bitcoin Core may reduce depending on the kind of split within the network. Too many hard forks do not bode well for the network as a whole or the individual Bitcoin holder.

And therefore, there has to be a mechanism to bring about agreement upon the new set of rules.

Aside from the issue of decision-making costs, which can make unanimous decisions inefficient, Buchanan also accepts other limits of using the unanimity rule. “In effect, a unanimity rule allows the status quo values of all existing entitlements to be preserved against any unpredictable possible intrusions from the special effects of new and untried ventures, with distinction between physical (technological) and financial (pecuniary) effects” (Buchanan and Faith 1981, p. 108).

In this sense, there is a lot of turmoil within decentralized communities, choosing and voting on rules. In particular, there is a strong tendency to maintain the status quo rules. However, unlike closed communities, the Bitcoin network has a high level of entry and exit of miners, coders, and developers. This churn of individuals and ideas is the source of new and better rules. And usually rules improving the system are adopted by the network or will split off into a new blockchain creating value with a new variant of the currency.

To prevent splits and to ensure that the Bitcoin Core currency does not lose its value because of frequent changes, many of the upgrades are announced in advance with a flag day. If sufficient number of users or nodes have upgraded on the flag day, then they enforce the new rules after flag day. This is known as User Activated Soft Forks. Another innovation in this area is to rely on the acceptance miners with hash power to activate a new set of rules. This is known as Miner Activated Soft Forks where soft forks wait for the signal or acceptance of a super majority of miners (usually 75 or 95%) for the new set of rules. Once this super majority accepts the new rules, all the nodes operate under the new set of rules.

After the failure of Bitcoin XT and Bitcoin Classic, but before the introduction of Bitcoin Cash, there was an attempt to increase the block size, without splitting the community. This proposal, called Segwit (or segregated witness) was introduced into make a marginal improvement in technology and maintain consensus within the network. And the upgrade allowed all transactions mined under the new set of rules to be backwards compatible, i.e. compatible with the Bitcoin Core software.

It replaced the Bitcoin block size by a block weight limit, which would allow for blocks up to 4 MB in size, existing simultaneously with 1 MB blocks.

This would be accomplished through a soft fork, to avoid forcing everyone running Bitcoin Core to upgrade to the new software. Another interesting feature of the Segwit upgrade was that it was intended through a User Activated Soft Fork, which required 95% of the miners to upgrade in order to activate Segwit.

The intention was that after the activation of Segwit through a soft fork in August 2017, they would adopt an upgrade to increase the block size to 2 MB through a hard fork on November 16, 2017. The proposal for the hard fork split in the blockchain as abandoned in November 2017 due to lack of consensus. The introduction of the Segwit upgrade was not a success because of the high threshold for activation (95%) (Rizzo 2015).

Though these examples of the hard and soft forks, and the difficulty in achieving consensus in the Bitcoin network make it seem volatile and problematic, in fact this is the kind of emergent process that adds to the long-term robustness of Bitcoin. The Bitcoin network seems extremely robust, in this aspect, to any capture by minority or even the standard majority interests and requires a very high level of agreement. It simultaneously, due to its open source software system, experiences a lot of challenges to status quo and introduction and experimentation with new rules.

Conclusion

Bitcoin, as a cryptocurrency, may seem like the new frontier of technology and governance. However, studying the rule changes and debates within the Bitcoin community only shows that the debates and problems are age old problems of consensus.

Conceptualizing computer code as constitutional rules can be quite illuminating to create a framework to understand the issues affecting Bitcoin, other cryptocurrency, and blockchain as a technological platform. Any network, without a central auditor, relying on decentralized nodes and participants to create and maintain a valid ledger through consensus rules, is effectively grappling with the same problems as age old constitutional framing and constitutional maintenance debates. One commonality is to govern the actions of individuals within the network and prevent or mitigate opportunistic behavior. A second, is to navigate a fast-changing world, that requires the evolution of rules and constraints.

Buchanan's framework is particularly useful to understand the consensus problems of Bitcoin and other blockchain technology. Given that decentralized ledgers are worried about losing value due to capture and attack by minority and majority factions; the rules to achieve consensus are often geared to prevent such attacks. They face the classic tradeoff between external and decision costs and find voting or consensus rules that minimize the costs of collective action and maximize the value of the cryptocurrency.

References

Antonopoulos, A. M. (2014). *Mastering Bitcoin*. Sebastopol, CA: O'Reilly Media.

Böhme, R., Christin, N., Edelman, B., & Moore, T. (2015). Bitcoin: Economics, Technology, and Governance. *Journal of Economic Perspectives, 29*(2), 213–238.

Buchanan, J. M. (1962). Predictability: The Criterion of Monetary Constitutions. In L. Yeager (Ed.), *In Search of a Monetary Constitution* (pp. 155–183). Cambridge: Harvard University Press.

Buchanan, J. M. (1990). The Domain of Constitutional Economics. *Constitutional Political Economy, 1*(1), 1–18.

Buchanan, J. M., & Faith, R. L. (1981). Entrepreneurship and the Internalization of Externalities. *The Journal of Law and Economics, 24*(1), 95–111.

Buchanan, J. M., & Tullock, G. (1962). *The Calculus of Consent*. Ann Arbor: University of Michigan Press.

Buterin, V. (2015, April 12). Visions Part 1: The Value of Blockchain Technology. *Ethereum Blog*. Available at https://blog.ethereum.org/2015/04/13/visions-part-1-the-value-of-blockchain-technology/.

Davidson, S., De Filippi, P., & Potts, J. (2018). Blockchains and the Economic Institutions of Capitalism. *Journal of Institutional Economics, 14*(4), 639–658.

Hearn, M. (2015, May 7). Crash Landing. *Medium*. Available at https://medium.com/@octskyward/crash-landing-f5cc19908e32.

Lessig, L. (1999). *Code: and Other Laws of Cyberspace*. New York: Basic Books.

Nair, M., & Sutter, D. (2018). The Blockchain and Increasing Cooperative Efficacy. *Independent Review, 22*(4), 529–550.

Nakamoto, S. (2008). *Bitcoin: A Peer-to-Peer Electronic Cash System*. Available at https://bitcoin.org/bitcoin.pdf.

Palmer, D. (2016, January 11). Scalability Debate Continues as Bitcoin XT Proposal Stalls. *Coindesk*. Available at https://www.coindesk.com/scalability-debate-bitcoin-xt-proposal-stalls/.

Popper, N. (2016, January 14). A Bitcoin Believer's Crisis of Faith. *The New York Times*.

Rizzo, P. (2015, December 8). Is Segregated Witness the Answer to Bitcoin's Block Size Debate? *Coindesk*. Available at https://www.coindesk.com/segregated-witness-bitcoin-block-size-debate/.

Swanson, T. (2014). Great Chain of Numbers. *A Guide to Smart Contracts, Smart Property, and Trustless Asset Management*. Mountain View, CA: Creative Commons.

Wright, A., & De Filippi, P. (2015). *Decentralized Blockchain Technology and the Rise of Lex Cryptographia*. Available at http://dx.doi.org/10.2139/ssrn.2580664.

18

Blockchains as Constitutional Orders

Chris Berg, Sinclair Davidson and Jason Potts

Introduction

Blockchains are the distributed ledger technology underpinning cryptocurrencies such as Bitcoin and Ethereum. Blockchains facilitate exchange, provide public goods (security, property rights), map identities and provide a platform for contracting and the enforcement of contracts. Some applications of blockchains offer the possibility of new forms of 'corporate' organisation—such as distributed autonomous organisations firms. Other applications suggest the possibility of removing public good provision from states to networks—such as property titling and identity.

Chris Berg, Sinclair Davidson and Jason Potts are with the RMIT Blockchain Innovation Hub.
A version of this chapter was first presented at the Western Economic Association Conference 93rd Annual Conference, June 29, 2018 in Vancouver, BC, Canada.

C. Berg · S. Davidson · J. Potts (✉)
RMIT University, Melbourne, VIC, Australia
e-mail: jason.potts@rmit.edu.au

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_18

This chapter offers a constitutional political economy perspective on the development of the blockchain ecosystem. We argue that blockchains are constitutional orders—rule-systems in which individuals (or firms, or algorithms) can make economic and political exchanges (MacDonald et al. 2016). As a consequence, they offer a unique economic environment for institutional discovery and constitutional experimentation (Allen, Forthcoming). The process of experimentation and discovery in blockchains has some unique features for exploitation by researchers interested in the evolution of human institutions, some of which are inherent to the technology and others which come from the norms surrounding the technology's development.

James M. Buchanan's constitutional political economy makes a profound insight into the rules that govern economic behaviour and exchange (Buchanan 1986, 1990). A blockchain facilitating trade through the operation of smart contracts can be understood as a constitutional order. The rules of the game in blockchain applications are written into the code itself. Unconstitutional transactions simply will not execute. By contrast all trades that adhere to constitutional rules will execute. The constitutional framework is self-executing and self-monitoring. It is also possible within a blockchain framework to easily modify the existing constitution through secession without existing constitutional norms being violated and changed for those parties that do not wish to change the constitution.

Blockchain enabled exchange is a clear example of Buchanan's constitutional approach. The rules of the blockchain are determined before exchange can occur and must be chosen. How those rules are chosen may be an entrepreneurial discovery process, or bureaucratic choice. Only once those rules are articulated into code, will exchange occur.

Some key characteristics of blockchain institutional experimentation distinguish it from other processes of competitive institutional discovery: public discussion, highly iterative, low discovery costs, and high transparency. While not all instances share these features equally (permissioned blockchains and privacy coins, for instance, can be less transparent about their transactions that occur on their network) most current blockchains have each of these characteristics to a greater or lesser degree.

Public Discussion: Blockchains are (typically) open source software (OSS) and their development follows patters characterised by the OSS movement. Entrepreneurs and developers coordinate activity through public forums. This allows researchers to identify with a high degree of precision when and how entrepreneurial insights occur. The original Nakamoto (2008) White Paper appeared online as if out of nowhere, yet we can see through the early online discussions—particularly on the Cryptography Mailing List, and then through the Bitcoin Talk Forum—how the early stages of the technology evolved. For many blockchain forks however we can track in extreme detail the entrepreneurial conceptualisation and development of the new blockchain.

Highly Iterative: Blockchain innovation is iterative. Iterative innovation is a feature of open source software. Closed software licenses restricts the pool of those who can contribute towards development. Closed software innovation either occurs when the property rights holder allows modification, or entrepreneurs develop competing products from scratch—both 'in the blind' and being careful to avoid any intellectual property violations. OSS allows for 'tweaking' of code by a decentralised pool of developers, and for potential modifications to permeate up to official releases from not only a small number of developers but also users themselves (Kogut and Metiu 2001). Forking allows for the exact replication of existing codebases and the creation of new iterations.

Low Discovery Costs: The development of a new blockchain is relatively low cost. A number of services exist that can establish new cryptocurrencies, governed by unique rule sets, with extremely limited programming knowledge. While the technology is conceptually complex, the development of a blockchain is relatively straightforward, and the OSS nature of blockchain software makes it easy for developers to build new features on top of existing, functioning, blockchain software. Financing new blockchains is also relatively low cost. Initial coin offerings are (currently) low cost compared to their primary competing legal construct, the initial public offering.

High Transparency: Not only is the software OSS and therefore publicly visible, but the use of technology is also publicly visible. A critical dimension of the security in blockchain is provided by its publicly visible ledger of transactions stretching back to each blockchain's genesis block. (Some privacy focused coins limit the information available to observers.) This gives developers and entrepreneurs extremely fine-grained data about the use of blockchains in the real world. The economic layer of blockchains also offers exchange rate data which can be used to inform assessments about how the blockchain is being received by the market. While many other institutions have price data—governments can be monitored through bond and other interest rates, firms can be monitored through share prices, markets can be monitored through prices and velocity—no other human institution offers such detailed public empirical evidence about its use from the moment of its birth.

These features make blockchains a unique sandbox for observing the development of constitutional innovation—new mechanisms to deliver public goods and structure markets. The transaction costs of institutional discovery mean that we have much less opportunity to observe and experiment with constitutions in an iterative innovation framework.

Blockchains as an Institutional Technology

Institutional cryptoeconomics describes the study of blockchains as an institutional technology of governance. Using the schema of Williamson (1985) and Davidson et al. (2018) argue that blockchains are a new form of coordinating institution that complements and competes with firms, markets, relational contracting and commons. Institutional cryptoeconomics was first outlined in Davidson et al. (2018), and has since been explored in Allen et al. (2018), Berg (2017), Berg et al. (2017a, b, 2018a, b, Forthcoming), Markey-Towler (2018). Institutional cryptoeconomics is a field of study that applies the conjoined schemas of Friedrich Hayek (1945), Ronald Coase (1937, 1960), Douglass North (1981, 1990), Oliver Williamson (1985), and Elinor Ostrom (1990) to explore the institutional aspects of blockchain technology. Where 'cryptoeconomics' refers to the study of the game theoretic and mechanism design features of blockchain consensus mechanisms (see Buterin 2017), institutional cryptoeconomics looks at blockchains as an institutional feature set that complements, contrasts, and sometimes competes with other institutional technologies, such as firms, markets, relational contracting, governments and the commons. The use of this technology requires the writing of constitutions.

Tasca and Tessone (2018) provide a taxonomy of blockchain technologies that vary the purpose and rules under which blockchains operate. These technologies function as a field on which constitutional innovation can occur. They break these down into eight categories: (1) security and privacy, (2) extensibility, (3) native currency/tokenisation, (4) transaction capabilities, (5) consensus algorithms, (6) charging and rewarding systems, (7) identity management and (8) codebase. These blockchains can vary in their inflation rate, scripting capabilities, compliance with know-your-customer regulations, transaction throughput, privacy and permissioning systems, consensus mechanisms (such as proof-of-work, proof-of-stake, distributed byzantine fault tolerance etc.), and mining rewards, as an example. Tasca and Tessone identify at least 80 separate technological variations used by blockchains as of time of writing, although this is certainly an underestimate.

Blockchains provide ledgers which represent consensus over shared facts about relationships. Knowledge of shared facts is currently delivered by the human coordination mechanisms of markets, the public square, hierarchies (firms and governments) and the systems of knowledge production (journalism, the academy, freedom of expression). In Berg et al. (2017b) we argue that blockchains are capable of manufacturing trust in shared facts. In particular, proof of work blockchains convert energy (hashing power) into economically valuable trust. Blockchains organise this shared knowledge into a distributed ledger, held on nodes and devices using a shared protocol. Berg et al. (2018a) outlines the value of ledgers as an epistemic tool for the purposes of exchange. Ledgers (actual, written ledgers, or virtual, assumed or tacit ledgers) map the property rights on which exchanges can be made.

How do blockchain protocols develop? How do they evolve? Each sequential adaptation of a blockchain represents a new economic organisation. Dopfer and Potts (2015) identify three stages of entrepreneurial innovation, which can be straightforwardly applied to non-firm constitutions. In stage one the firm (government, market, commons, blockchain) is created—registered and formalised. Stage two involves the diffusion of the innovation. Stage three involves the institutionalisation of the innovation in the economy. Potts (Forthcoming) and Allen and Potts (2016) describe a 'zero-th' phase—the innovation commons—in which entrepreneurs freely share information which is combined to create entrepreneurial activity. (In Berg et al. 2018a we add an intermediate step between the zero-th and first state—the ledgerisation event where property rights over the firm are allocated.) For researchers seeking quantifiable information about most institutional innovations they are usually forced to wait for third stage, when the innovation shows up in macroeconomic data. By contrast, the public nature of blockchains mean we can observe the first and second stages with a high degree of precision, and even the zero-th phases—given practices in the open source community—is publicly visible. It is at this point that economic constitutions are written.

New categories of economic coordination institutions are rare—the invention of the joint stock company and representative democracy are separated by centuries. Even institutional innovations—are relative rare, due to their high cost. It is expensive to make changes to the shape of institutions, and typically significant changes are made over the space of decades. Here we might think about the shift in governance from public ownership to the regulatory state, made between the 1970s and 1990s across the Western developed world. Changes in shareholder democracy and directors' responsibilities also represent multi-decade long legislative processes. Constitutional natural experiments are even rarer again. Berg and Berg (2017) argues that Australia was a 'fork' of British governance, and contrast that experiment with a fork of Australia: the New Australia settlement in Paraguay. But these sorts of constitutional experiments are costly, typically violent, and disrupt or undermine the existing inhabitants of the new institutional settlement.

Despite these high costs, we can see constitutional innovation as a (slow) discovery process. Friedrich Hayek (1945) conceived of the market as a process of information discovery. Later in life he (along with Bruno Leoni) applied the same analytic lens to the common law, seeing in the

English legal system a mechanism for discovering distributed knowledge. As Stringham and Zywicki (2011) note Hayek could have easily made the same observation for governance structures: seeing in the problems of public goods provision and other services a need for institutions of competition and discovery. Our argument here is that we can see precisely that in blockchain innovation. Where blockchain innovations differ from previous constitutional innovations is that innovation is cheap. Rather than revolution or legislation, also that is required is a simple source-code fork. Forking allows secession movements to change the constitutional rules and go their own way without adversely affecting non-secessionists. Forking can be imagined as being a constitutional revolution—and a peaceful revolution at that (see Brennan and Buchanan 1985 [2000]).

Forking as Constitutional Discovery

Forking is an event that occurs in an open source project when the code base of a project is copied and changed, creating a new project. We can distinguish between a number of species of forks in the Bitcoin ecosystem:

- At the lowest level, the chain forks whenever two nodes broadcast new (equally valid) blocks near simultaneously. The Bitcoin gossip protocol means that different nodes will hear about different valid blocks at different times. The topologically uneven notification about each block results in two equally valid chains. Here we call this a *block fork*, and the Bitcoin system resolves the problem with the 'longest chain' principle (Nakamoto 2008), where miners converge on the chain which is most likely to accepted by other miners.
- *Upgrade Forks*: occur when developers build new features into the blockchain with no intention of creating a new underlying currency—that is, no intention to create a 'chainsplit'. (This definition is vulnerable to a Ship of Theseus paradox, but we park that problem by focusing on the intentions of the developers of the software upgrade.) Upgrade forks are usually described as 'soft' forks or 'hard'

forks.[1] The distinction pivots around whether transactions registered by new software are compatible with legacy versions of the software. Incomplete adoption of soft fork maintains the blockchain as a unitary entity. An incompletely adopted hard fork creates two separate blockchains. For the most part, upgrade forks represent a coordination failure, where all participants wish to see the network continued as a unitary chain but do not agree on potential upgrades.

- *Coin Forks*: occur when developers deliberately copy the codebase of an existing source code, modify it, and release a new blockchain under a new name, distinct from the original. These are often described as *altcoins*. Namecoin took the Bitcoin source code, added domain name management functionality and mined a new genesis block on April 17, 2011.[2] An intermediate position between hard software forks and coin forks occurs when new coins are released that piggy-back off existing blockchains, inheriting not only their source code but their history. One prominent instance was the creation of Bitcoin Cash, which implemented a block size increase upgrade in the full knowledge that it would fork the blockchain. Just as in an upgrade fork, at the instant of the fork, those who held Bitcoin now also held the equivalent amount of Bitcoin Cash. We distinguish here between hard forks in the process of an upgrade and coin forks such as Bitcoin Cash by their intentionality: Bitcoin Cash was a deliberate chainsplit, whereas a hard fork is not intended to split the chain.

Forking either resolves a coordination problem or instances a 'cryptosecession' (Berg et al. 2018b; MacDonald 2015; Markey-Towler 2018). The Bitcoin protocol has a built-in ('on-chain') coordination mechanism for resolving block forks. The need for software upgrades has induced the Bitcoin "governance crisis" (De Filippi and Loveluck 2016; Musiani et al. 2017) as groups have disputed the desirability of certain changes to the protocol. These are constitutional disputes that

[1]This terminology was first developed in https://gist.github.com/gavinandresen/2355445.
[2]https://bchain.info/NMC/block/0.

have occurred off-chain, necessitating political resolutions. One more dramatic instance of this was the so-called New York Agreement of May 2017, when 58 companies agreed to a controversial protocol upgrade to facilitate Bitcoin's scalability brokered by a major cryptocurrency and blockchain investment firm ('Bitcoin Scaling Agreement at Consensus 2017' 2017). Later blockchains have sought to build governance dispute resolution mechanisms into the protocol itself (see for instance Decred, Tezos, and EOS). Some consensus algorithms also build in dispute resolution mechanisms in order to choose validating nodes (the equivalent of Bitcoin miners). For example, EOS and NEO each use a form of delegated proof of stake or delegated byzantine fault tolerance (or dBFT, in which transaction validators are nominated by token holders) that utilises a voting protocol.

The governance of open source software (OSS) forking has been well-studied. Benkler (2006) describes peer production such as open source as an economic coordination institution that is separate to managed hierarchies and markets; a 'commons-based' model of production that relies on unpriced labour contributions (although a secondary effect of participation may be consulting or service contracts in the market). Most open source communities operate as commons, governed by strong social norms around the ownership and use of the software (Kogut and Metiu 2001; Raymond 2001; Stewart and Gosain 2006). In these communities forking is usually frowned upon, as forking divides labour that could otherwise be concentrated on a single project (Ågerfalk and Fitzgerald 2008).

While blockchains are (for the most part) open source software, some key institutional features of blockchains provide distinct dynamics from the OSS ecosystem. Tokens play a dual role in structuring the incentives to maintain cryptocurrencies. At the first instance, they provide the security for the network, rewarding desirable behaviour to achieve consensus (depending on the consensus mechanism deployed). In Bitcoin, rewards are given to miners for conducting the proof-of-work scheme and forming new blocks of transactions. In dBFT systems, elected validators ('block producers' in EOS) are rewarded for processing transactions and managing the gossip network. A secondary incentive mechanism is 'off-chain' (that is, not coded into the consensus system).

Owners of tokens have an incentive to add value to the network, therefore increasing the value of their holdings. Some cryptocurrencies have 'founders rewards' built into their network, which return a reward to the founders of the network. The recipients of the Zcash founders reward, for example, have taken a percentage of that money establish the Zcash Foundation, which provides grants for research (including software development), effectively subsidising network effects. The tokens that incentivise network maintenance and transaction validation are also an incentive mechanism for blockchain governance. After the ICO craze of 2017, rather than selling new tokens, a number of new cryptocurrencies have been 'airdropping' tokens in order to spark network effects.

Token holdings also provide some of the security of blockchains. This is the explicit intention behind proof of stake, dBFT and other mechanisms, but even 'traditional' proof of work algorithms draw some of their security from investment. Budish (2018) has shown how asset specific investment in cryptocurrency mining equipment (application specific integrated circuits, or ASICs) reduces the likelihood of a 51% attack on the blockchain. A successful attack would undermine the value of the cryptocurrency that the investment relies upon. While Budish concludes that this is contrary to the Nakamoto (2008) philosophy of one-CPU-one-vote only the most Bitcoin maximalist believes that cryptocurrency innovation began and ended with Satoshi. One key relevance of this finding is how it effects debates within blockchain communities about the desirability of so-called 'ASIC-resistant' PoW algorithms, which may not be a desirable feature.

However, consensus algorithms are not infinitely heterogenous. In a proof of work algorithm setting, security against a 51% attack means is a function of how many miners/validators are working on the token. One of the consequences of forking as an institutional innovation mechanism is that forked coins often use the consensus algorithm of their 'parent' but with a smaller userbase. ASICs can be redeployed from a large blockchain like Bitcoin to a smaller one that uses the same consensus algorithm, allowing a miner to dominate the hashing power of those chains (opportunistically exploiting the smaller chain while not undermining the value of the larger, thus protecting their specific investments).

What does this mean for the constitutional discovery? We can identify two potentially contradictory effects of ASIC redeployment. Cryptocurrencies are potentially subject to positive network effects, creating a winner-take-all situation (Gandal and Halaburda 2016). These security concerns provide further support for network effects. The availability of ASICs for a popular cryptocurrency such as Bitcoin is a potential security risk for smaller cryptocurrencies sharing the Bitcoin hashing algorithm (SHA256). This would suggest some consolidation around a few large cryptocurrencies.

However, innovation within a cryptocurrency protocol has proven to be major coordination challenge (as opposed to innovation on top of the protocol) and blockchain innovation has usually required the bootstrapping of a new cryptocurrency. Forking is a way to innovate without requiring the participation of all miners in the network. In addition, it provides for an iterative innovation process, allowing innovators to take proven protocols and make minor variations. Forking allows for low cost experimentation with institutional features that might be later adopted by more popular protocols. One early Bitcoin fork, Geistgeld, was announced by its creator in September 2011 in the following way (reflecting some of the earlier consensus around the desirability of OSS forks).

> **Why are you leeching on the Bitcoin community?**
>
> To the contrary, not only am I not leeching, I happen to think that, should GG survive it's [sic] launch, it can serve as guinea pig for various optimizations that can be later implemented in Bitcoin (assuming real programmers take interest, of course), thus benefiting community at large. (Lolcust 2011)

A competitive discovery process model around cryptocurrency technologies and institutions suggests that in the absence of innovation within the Bitcoin network, network effects will not dominate the incentive to create competing blockchains. For example, the risk of a

51% attack through redeployed ASICs provides an incentive for innovation around consensus algorithms. In this sense the existence of asset specific hardware ASICs drive heterogeneity. We would expect to see in innovation around proof-of-work: a diverse and growing range of hashing algorithms as developers seek (a) ASIC-resistance and (b) to reduce the likelihood of ASICs used for large networks being redeployed on smaller ones. As this suggests, the economic characteristics of blockchain forking are not straightforward, representing an interplay between the supply and demand for innovative entrepreneurship in tension and complementing both network effects and the security demands of the blockchain 'machine'.

Conclusion

Blockchains are constitutional technologies on which entrepreneurs can experiment with different institutional and constitutional frameworks. This is exciting from a research perspective as it gives researchers a window into every stage of the development of a constitution: its conception, creation, early stage adoption and ultimate institutionalisation in the economy. More critically, we can use blockchains to experiment with new forms of governance. Blockchains have features that should be of significant interest to scholars of constitutional orders and governance. On-chain governance systems (developed in part to deal with the upgrade/forking problems of Bitcoin) have complex voting rules and procedures. Smart contract protocols such as Ethereum raise questions about how disputes are arbitrated. Prior to the development of blockchain these issues and questions could only be investigated at a macro-level. Now researchers can explore the implications of constitutional development and change at a micro-level.

Here we have presented what can be seen as a methodological insight about how we can study of constitutional orders. The standard empirical approach to how constitutions are created and change has been to exploit natural experiments in the manner of North (1981, 1990), which uses historical instances of change and development to draw conclusions about the causes and consequences of those changes. Blockchains offer a different, potentially significant approach. Blockchain protocols evolve under variation, replication and selection conditions, and researchers have a near complete and comprehensive window into those changes.

References

Ågerfalk, P. J., & Fitzgerald, B. (2008). Outsourcing to an Unknown Workforce: Exploring Opensurcing as a Global Sourcing Strategy. *MIS Quarterly, 32*, 385–409.

Allen, D. W. E. (Forthcoming). Entrepreneurial Exit: Developing the Cryptoeconomy. In M. Swan, J. Potts, S. Takagi, P. Tasca, & F. Witte (Eds.), *Blockchain Economics: Implications of Distributed Ledger Technology*. Singapore: World Scientific.

Allen, D., & Potts, J. (2016). How Innovation Commons Contribute to Discovering and Developing New Technologies. *International Journal of the Commons, 10*(2), 1035–1054.

Allen, D. W. E., Berg, C., & Novak, M. (2018). Blockchain: An Entangled Political Economy Approach. *SSRN*.

Benkler, Y. (2006). *The Wealth of Networks: How Social Production Transforms Markets and Freedom*. New Haven: Yale University Press.

Berg, C. (2017). What Diplomacy in the Ancient Near East Can Tell Us About Blockchain Technology. *Ledger, 2,* 55–64.

Berg, C., & Berg, A. (2017). Exit, Voice and Forking. *SSRN.*

Berg, C., Davidson, S., & Potts, J. (2017a). The Blockchain Economy: A Beginner's Guide to Institutional Cryptoeconomics. *Medium*.

Berg, C., Davidson, S., & Potts, J. (2017b). Blockchains Industrialise Trust. *SSRN*.

Berg, C., Davidson, S., & Potts, J. (2018a). Ledgers. *SSRN*.

Berg, C., Markey-Towler, B., Novak, M., & Potts, J. (2018b). Blockchains Evolving: Institutional and Evolutionary Economics Perspectives. *SSRN*.

Berg, C., Davidson, S., & Potts, J. (Forthcoming). *Understanding the Blockchain Economy: An Introduction To Institutional Cryptoeconomics*. Cheltenham: Edward Elgar.

Bitcoin Scaling Agreement at Consensus 2017. (2017, May 23). *Digital Currency Group*.

Brennan, G., & Buchanan, J. M. (1985 [2000]). *The Reason of Rules: Constitutional Political Economy*. Indianapolis: Liberty Fund.

Buchanan, J. M. (1986). The Constitution of Economic Policy. In *The Logical Foundations of Constitutional Liberty*. Indianapolis: Liberty Fund.

Buchanan, J. M. (1990). The Domain of Constitutional Economics. *Constitutional Political Economy, 1,* 1–18.

Budish, E. (2018). *The Economic Limits of the Blockchain* (Working Paper). https://faculty.chicagobooth.edu/eric.budish/research/Economic-Limits-Bitcoin-Blockchain.pdf.

Buterin, V. (2017, February 23). *Introduction to Cryptoeconomics*. Paper Presented to Ethereum Foundation. https://www.youtube.com/watch?v=pKqdjaH1dRo.

Coase, R. H. (1937). The Nature of the Firm. *Economica, 4*(16), 386–405.

Coase, R. H. (1960). The Problem of Social Cost. *The Journal of Law and Economics, 56*(4), 837–877.

Davidson, S., de Filippi, P., & Potts, J. (2018). Blockchains and the Economic Institutions of Capitalism. *Journal of Institutional Economics*.

De Filippi, P., & Loveluck, B. (2016). The Invisible Politics of Bitcoin: Governance Crisis of a Decentralised Infrastructure. *Internet Policy Review, 5*(3). https://doi.org/10.14763/2016.3.427.

Dopfer, K., & Potts, J. (2015). *The General Theory of Economic Evolution*. London: Routledge.

Gandal, N., & Halaburda, H. (2016). Can We Predict the Winner in a Market with Network Effects? Competition in Cryptocurrency Market. *Games*, *7*(3), 1–21.

Hayek, F. (1945). The Use of Knowledge in Society. *The American Economic Review, 35*(4), 519–530.

Kogut, B., & Metiu, A. (2001). Open-Source Software Development and Distributed Innovation. *Oxford Review of Economic Policy, 17*(2), 248–264.

Lolcust. (2011). *[ANNOUNCE] New Alternate Cryptocurrency—Geist Geld*. https://bitcointalk.org/index.php?topic=42417.0.

MacDonald, T. (2015). *Theory of Unbundled and Non-Territorial Governance: Studies in Evolutionary Political Economy*. Melbourne, VIC: RMIT University.

MacDonald, T., Allen, D. W. E., & Potts, J. (2016). Blockchains and the Boundariesof Self-Organized Economies: Predictionsfor the Future of Banking. In P. Tasca, T. Aste, L. Pelizzon, & N. Perony (Eds.), *Banking Beyond Banks and Money: A Guide to Banking Services in the Twenty-First Century* (pp. 279–296). Cham: Springer.

Markey-Towler, B. (2018). Anarchy, Blockchain and Utopia: A Theory of Political-Socioeconomic Systems Organised Using Blockchain. *Journal of the British Blockchain Association, 1*(1), 1–14.

Musiani, F., Mallard, A., & Méadel, C. (2017). Governing What Wasn't Meant to Be Governed: A Controversy-Based Approach to the Study of Bitcoin Governance. In M. Campbell-Verduyn (Ed.), *Bitcoin and Beyond: Cryptocurrencies, Blockchains, and Global Governance*. New York: Taylor & Francis.

Nakamoto, S. (2008). *Bitcoin: A Peer-to-Peer Electronic Cash System*. https://bitcoin.org/bitcoin.pdf.

North, D. C. (1981). *Structure and Change in Economic History*. New York: W.W. Norton.

North, D. C. (1990). *Institutions, Institutional Change and Economic Performance*. Cambridge: Cambridge University Press.

Ostrom, E. (1990). *Governing the Commons: The Evolution of Institutions for Collective Action*. Cambridge and New York: Cambridge University Press.

Potts, J. (Forthcoming). *Innovation Commons: The Origin of Economic Growth*. Oxford: Oxford University Press.

Raymond, E. S. (2001). *The Cathedral & the Bazaar: Musings on Linux and Open Source by an Accidental Revolutionary*. Cambridge, MA: O'Reilly Media.

Stewart, K. J., & Gosain, S. (2006). The Impact of Ideology on Effectiveness in Open Source Software Development Teams. *MIS Quarterly, 30*(2), 291–314.

Stringham, E. P., & Zywicki, T. J. (2011). Hayekian Anarchism. *Journal of Economic Behavior & Organization, 78*(3), 290–301.

Tasca, P., & Tessone, C. J. (2018). *Taxonomy of Blockchain Technologies: Principles of Identification and Classification*.

Williamson, O. E. (1985). *The Economic Institutions of Capitalism*. New York, NY: Free Press.

Check for updates

19

The Questionable Morality of Compromising the Influence of Public Choice by Embracing a "Nobel" Lie

J. R. Clark and Dwight R. Lee

Introduction

Our paper is motivated by Brennan's and Buchanan's paper (2000 [1988]) "Is Public Choice Immoral? The Case for the 'Nobel' Lie." Their paper considers a controversy generated by the success of public choice that they say "goes well beyond the 'scientific' level." They summarized the controversy as resulting from (p. 80) a "conviction on the part of many commentators that the whole [public choice] enterprise is *immoral* in a basic sense" (emphasis in original). They conclude by agreeing (p. 88) "that there is cause for some concern with public choice interpreted as a predictive model of behavior in political roles …. that it

J. R. Clark (✉)
Probasco Distinguished Chair of Free Enterprise,
The University of Tennessee at Chattanooga, Chattanooga, TN, USA
e-mail: j-clark@utc.edu

D. R. Lee
O'Neil Center for Global Markets and Freedom, Southern Methodist University, Dallas, TX, USA

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_19

will indeed breed the [unfortunate] moral consequences previously discussed." What are those unfortunate moral consequences?

The basis for Brennan's and Buchanan's moral concern with predictive, or positive, public choice is that those ideas can change people's values and behavior. For example, the study of price theory can legitimate self-interested behavior that "in the context of a well-functioning market … may be of little normative concern" (p. 83). Yet, unfortunate moral consequences are the likely result if public choice models "legitimate such behavior for those who exercise discretionary power in political roles … [and] standards of public life will be eroded" (p. 84). They accept that preventing that erosion "may require a heroic vision of the 'stateman' or 'public servant,' because only by holding such a vision can the possibility of public-interested behavior on the part of political agents be increased …. Hence, so the argument would go, those who engage in the ideas of politics must preserve a calculated hypocrisy about the conduct of political affairs, and they must talk in terms of 'ideal types'" (p. 84). They continue, "[t]his argument deserves to be taken seriously, despite its vulnerability to caricature when viewed from the 'scientific' perspective" (p. 84). And finally, "[c]ynicism about the behavior of political agents, however empirically justified it may be, may wreak damage to the 'civic religion' …. we should recognize that the 'myths of democracy' may be essential to maintenance of an underlying popular consent of the citizenry to be governed, in the absence of which no tolerable stable political order is possible" (pp. 85–86).

These quoted statements are representative of the general view expressed in the article. We haven't cherry-picked them to make it easier for us to criticize Brennan's and Buchanan's concern that public choice is undermining the morality of the political process. Despite our doubts about their paper, we believe it serves at least one useful purpose by clearly undermining the criticism that Buchanan and his work are ideologically inflexible. In the section entitled "Buchanan Is Difficult to Pigeonhole," we contrast the "The Nobel Lie" and other work of Buchanan with a recent book by MacLean (2017) that claims his contributions to public choice are not only ideologically rigid but motivated by the evil intentions of crippling the democratic political process. This book is an extreme example of a scholar misrepresenting Buchanan as a right-wing ideologue;

but it is of particular interest because it is not only recent, but surely the most widely read example of such misrepresentation.[1] In the section entitled "The Importance of Noble Lies," we discuss the limited government in America that lasted well over 100 years and the noble lies that helped maintain effectiveness of constitutional restrictions on government expansion. This section begins with a discussion by Buchanan and Tullock (1999 [1962]) on the importance of moral principles to political scientists in their reluctance to accept economic analysis of the political process. In the section entitled "Does Buchanan Really Want Heroic Presidents?" we consider an article by Buchanan (2001 [1981]) that provides a plausible explanation for a plausible dynamic for the decline in the effectiveness of constitutional constraint on government. We see parallels between this dynamic and the discussion by Healy (2009) on the connection between the expansion of the federal government that began in earnest in the 1930s and the rise of "the heroic presidency." In the section entitled "Did Buchanan Change His Mind?" we focus on some interesting inconsistencies and consistencies in Buchanan's writing between 1979 and 1988. We offer remarks based on insights by Wagner (2017) in our concluding section. Wagner sees Buchanan's scholarship as based on a willingness to understand the world as it is (we start from where we are) while believing that such an understanding can be conducive to more harmonious and cooperative social orders. And instead of shying away from apparent conflicts and inconsistencies, Buchanan believed that grappling with them leads to more creative scholarship. Wagner's insights support our view that any attempt to put Buchanan into an ideological pigeonhole is to miss the essence of the man and his scholarship, and causes us to moderate our criticism of "The Nobel Lie," but only slightly.

Buchanan Is Difficult to Pigeonhole

It is difficult to believe than an intellectually honest scholar, such as Nancy MacLean (2017) was reported to have been, could have read "The Nobel Lie" and believed that Buchanan wanted restrictions on the

[1] The book was written by a scholar, but it is not a scholarly book, as will be discussed.

democratic process to empower an elite few to benefit at the expense of the general public.[2] Such a belief about Buchanan and his work would not have been made by any serious scholar who has "systematically worked [her] way through piles of [Buchanan's] papers … and … documents that revealed virtually every step in the evolution of his ideas and associations" as MacLean claims to have done (MacLean, pp. xx–xxi). In this section we point out that reading just "The Nobel Lie" raises red flags regarding either her honesty as a scholar or her claim about being familiar with Buchanan's work. A small sample of other clearly stated positions and arguments from some of Buchanan's other writing is also shown to be clearly at variance with MacLean's statements about him and his work.

Buchanan had plenty of scholarly opposition, as would be expected given his enormous output and willingness to challenge prevailing understandings in economics, political science, law, and philosophy. And the criticism of his work continues, reflecting the timelessness of his contributions to controversial issues. Though there are exceptions, most of those who disagree with Buchanan's work focus their arguments on responsible interpretations of narrow arguments he made. Any responsible critics of Buchanan's work who read "The Nobel Lie" would surely recognized that he wasn't as intellectually, or ideologically, rigid as he is sometimes claimed to be. But if their criticism focused on a narrow issue, then a general thought piece such as "The Nobel Lie" would unlikely be relevant to the narrow issue they are criticizing, and therefore ignored. This is not true when making broad claims and insinuations about the meaning and motivation behind Buchanan's work, as MacLean (2017) does. Our purpose in this section is not to detail the many distortions made by MacLean, but to briefly mention a couple clearly contradicted in "The Nobel Lie." We then consider a few

[2]This is our brief statement of MacLean's view of Buchanan's motivation for scholarly work. In her words (MacLean, p. xxii) "Buchanan believed in every fiber of his being that if what a group of people wanted from government could not, on its own merits, win the freely given backing of each individual citizen, including the very wealthiest among us, any attempt by that group to use its numbers to get what it wanted constituted not persuasion of the majority but coercion of the minority, a violation of the liberty of individual taxpayers."

other examples from a wide range of Buchanan's work, much of which MacLean should have encountered, that undermine her claims about Buchanan's work and motives.[3]

Consider MacLean's statement (p. xxx) that "Buchanan believed government failed because of bad faith: because activists, voters, and officials alike used talk of the public interest to mask the pursuit of their own personal self-interest at others' expense. His was a cynicism so toxic that, if widely believed, it would eat like acid at the foundation of civic life." How would MacLean reconcile this statement with Brennan's and Buchanan's previously expressed worry that "cynicism about the behavior of political agents …. may wreak damage to the 'civic religion'"? (pp. 85–86). Neither Brennan nor Buchanan believed people are any more subject to bad faith, or self-interest, when making political decisions than when making market decisions. Indeed, the theory of expressive voting that developed from key contributions by Buchanan (1954), Tullock (1971), and Brennan and Lomasky (1993) explained why voters commonly vote against their financial interest to support legislation and candidates they believe would best promote the public interest.

Another embarrassment for MacLean is her attempt to criticize Buchanan and public choice by quoting Steven Kelman saying Buchanan's ideas "threaten to become self-fulfilling," in that, by discrediting the aspirational behavioral norm of public spirit, "our society would look bleaker and our lives as individuals would be more impoverished" (endnote 31 referenced on p. xxx). MacLean's problem with using this quote to discredit Buchanan is that Brennan and Buchanan (2000 [1988], p. 79) quote the same passage in full at the beginning of "The Nobel Lie" (p. 79). Not only did they quote Kelman, they responded to him by acknowledging (p. 81) "we have to reckon with the moral implications [of public choice] … To do this properly … we shall take our critics seriously on their own terms, and examine the purely ethical case against public choice scholarship." Notice to MacLean—Buchanan is a difficult scholar to pigeonhole ideologically.

[3]For more thorough reviews of MacLean's book see Munger (2018), Carden and Magness (2017), and Horwitz (2017).

If "The Nobel Lie" failed to alert MacLean on the accuracy of her caricature of Buchanan, she would surely be immune to the effect other readings of his should have had on her understanding of him, assuming she bothered to glance at them. As an example, she states (p. 149) that Buchanan "believed that what was required to support an expansive public sector was profoundly unjust: a system of progressive taxation that would ask more of the wealthy." The trouble with this is that Brennan and Buchanan (2000 [1980], pp. 48–55) made a case for progressive taxation.[4] For another example, MacLean (p. 43) thought it ironic that "Buchanan found a way of thinking about fairness in Wicksell's work [on voting] that matched his own inclination as a man of the midcentury right (because Wicksell was a man of the left …)." Apparently, it never occurred to MacLean that Buchanan was less bound by ideological bias than she, or that he gave the concept of fairness and justice far more careful thought than she has, or ever will. Maybe she didn't read, or forgot about having read, Buchanan's (1999 [1976], pp. 301–308) favorable comments about Rawls's *Theory of Justice*, or the other writings in which he agreed with the approach of Rawls, clearly a man of the left, in his consideration of justice. Would MacLean's narrative have changed if she knew that, at least partly based on Rawls's work, Buchanan (footnote 32, p. 307) supported confiscatory taxation of inheritances? Would she still have argued that Charles Koch wanted to bankroll Buchanan's work for the "diabolic" purpose of putting political shackles in place that would be "so binding and permanent … that the will of the majority could no longer influence representative government on core matters of political economy?"[5] The safe answer is yes, given her obvious willingness to ignore everything Buchanan ever said (effectively all of it) that is inconsistent with her story of him as an evil man.

MacLean clearly chose to ignore, or misinterpreted, even the most obvious and well known insights in works by Buchanan when

---

[4]It should be acknowledged that MacLean would not have approved of Brennan's and Buchanan's motivation since they showed that under certain conditions progressive taxation would restrain a government's ability to raise more tax revenue.

[5]See MacLean (2017, pp. xxv–xxvi).

convenient for her to do so. For example, she refers to Buchanan and Tullock (1999 [1962], Chaps. 6 and 7) on page 79 of her book when misrepresenting Buchanan's and Tullock's discussion of an unanimity voting rule. That insight, one of those discussed in *The Calculus of Consent*, concerns the tradeoff between the expected external cost and the expected decision cost when determining the "'optimal' or most 'efficient'" [voting] rule. MacLean (p. 79) interprets this as Buchanan and Tullock claiming that "[t]he only truly fair decision-making model to 'confine the [political] exploitation of man by man within acceptable limits' was unanimity … Only if a measure gained unanimous consent, they argued, could it honestly be depicted as 'in the public interest.'" To justify her remarks, MacLean refers the reader to pages 96 and 284 of *Calculus of Consent* in her endnote 14. What one finds on those two pages are comments to the effect that as a practical matter, variations from a unanimity rule will be rationally chosen because of the costs of reaching unanimity.

MacLean consistently expresses her outrage at anything that interferes with majority voting and representative government. For example, she sees the "power of the most propertied to restrain representative government through the courts … [as having] allowed states to legislate racial segregation …" (p. 80). On the next page, she once more tries to connect Buchanan to John C. Calhoun and racism by asserting that the *Calculus* was not, as Buchanan argued "an implicit defense of the Madisonian structure embodied in the United States Constitution," but more in keeping with John C. Calhoun's "case for minority veto power."[6] One might wonder if MacLean is aware that racial segregation was supported by a majority of American voters for about 100 years after the end of the Civil War and required a ruling by the courts (in keeping with the type of constitutional restrictions on majority voting which Buchanan favors) to increase the freedom and opportunities of African Americans.

[6]MacLean implies a number of times in her book that Calhoun had a significant influence on Buchanan and his scholarship despite the complete lack of evidence that Calhoun had any influence on Buchanan or any of his writings.

Enough has been said about how "The Nobel Lie," and many other papers by Buchanan solely, or with coauthors, serve to undermine MacLean's claims about Buchanan. But there is another reason we appreciate the "The Nobel Lie." It motivates us to give some thought to the morality of the public choice analysis of the political process. But first we consider the importance of Plato's noble lie to the public support for the ideals of both the democratic political process and constitutionally limited government.

The Importance of Noble Lies

Early in *The Calculus* (p. 20) Buchanan and Tullock ask: "Why has the conception of man been so different in the two closely related disciplines of economics and political theory?" More specifically, why have modern students of political science been resistant to economic analysis as a means of understanding the political process? Their answer begins with the reasonable observation that eighteenth-century philosophers considered economic interests to be the paramount motivation in both the political and economic orders. And "[i]n the context of a limited government devoted to the passage of general legislation applying, by and large, to all groups, the development of an individualistic and economic theory of collective choice is perhaps not of major import" (p. 21). But in the context of a government that directly controls a large percent of the national product, in which "special interest groups clearly recognize the 'profits' to be made through political action, and when a substantial portion of all legislation exerts measurably differential effects on the separate groups of the population, an economic theory can be of great help in pointing toward some means through which these conflicting interests may be ultimately reconciled" (pp. 21–22). With this changing role of government, "there should be little reason to expect constitution rules developed in application to the passage of general legislation would provide an appropriate framework for the enactment of legislation that has differential or discriminatory impact on separate groups of citizens" (p. 22). Buchanan and Tullock continue:

> Perhaps largely because they have not adopted this conceptual [economic] approach to collective choice, many modern students have found it necessary to rely on moral principle as perhaps the most important means of preventing the undue exploitation of one group by another through the political process. (p. 22)

We find this explanation surprising coming from Buchanan, and even slightly surprising from Tullock. We don't believe the resistance of so many modern students of the political process to the public choice approach is because they "found it necessary to rely on moral principle" to prevent the "exploitation of one group by another." They already had well-articulated moral arguments, not so much to prevent what Buchanan and Tullock saw as "exploitation of one group by another through the political process," but to justify much of it not as exploitation, but rather as public-spirited citizens sharing with one another out of the compassion and concern encouraged by "a heroic vision of the 'stateman' or 'public servant …'".[7] This justification can be thought of as an example of the noble lie Brennan and Buchanan defend in "The Nobel Lie." Growth in government no doubt has encouraged such noble lies, but those lies have also encouraged growth in government. Ironically, and obviously, it was the growth in government, partly encouraged by such noble lies, that was important to the development of public choice as an opposing way to understand the political process.

Of course, it is not just the ideal of an expansive and activist government that depends on noble lies for public support. Noble lies are also important in creating and maintaining public support for constitutionally limited government. No economist in the twentieth century had a better understanding of the importance of constitutions to the ideal of a limited government responding to the general interests of its citizens than Buchanan. He knew that no matter how appropriately suited the constitutional rules are for maintaining such a government, or how clearly stated, they cannot be effective unless backed up with

---

[7] See Brennan and Buchanan (2000 [1988], p. 84). Recalling our previous quote of this statement by Brennan and Buchanan, it continues "because only by holding such a vision can the possibility of public-interested behavior on the part of political agents be increased."

widely accepted moral norms. Such political norms have been important factors in maintaining the ideal of limited government providing general benefits for much of U.S. history. And those understandings have been reflected in and strengthened by stories we tell of, for example, the Boston Tea Party; the Revolutionary War and the colonies' fight for liberty; all men are created equal; government deriving its just powers from the consent of the governed; the U.S. Constitution and the Liberty Bell; the founders' dedication to representative government; Manifest Destiny and western expansion; free markets and equal opportunity for all; and America as the shining city on a hill.

These stories contain elements of truth, despite being embellished with Plato's noble lies. And those embellishments surely increased the stories' effectiveness at supporting political norms favoring the perceived morality of limited government throughout the nineteenth century and into the twentieth, during which the United States went from an economic backwater to the wealthiest nation in the world. The nineteenth century was unmistakably a century of federal fiscal responsibility. The peace-time federal budget rarely exceeded 3% of GDP, and budget surpluses were more common than budget deficits during peace. Peace-time deficits occurred during economic downturns, but because of declines in federal revenues, not because of spending increases. Spending increases did cause budget deficits during war time, but those deficits were followed by budget surpluses that reduced the government debt, sometimes almost entirely, that increased during wars. For example, after the end of the Civil War the federal budget was in surplus, or balanced, in every year from 1866 until 1893 (Fig. 19.1).

Grover Cleveland best exemplified the prevailing attitude about federal spending during his 8 years as president by vetoing hundreds of spending bills, such as one in 1887 to spend $10,000 to distribute seed grain to Texas farmers suffering from a serious drought. Cleveland vetoed this bill, like other bills he vetoed, because he thought it called for spending that wasn't permitted by the Constitution.[8] It is difficult to imagine a president vetoing such a bill today and being reelected,

[8]See Higgs (1987, pp. 83–84).

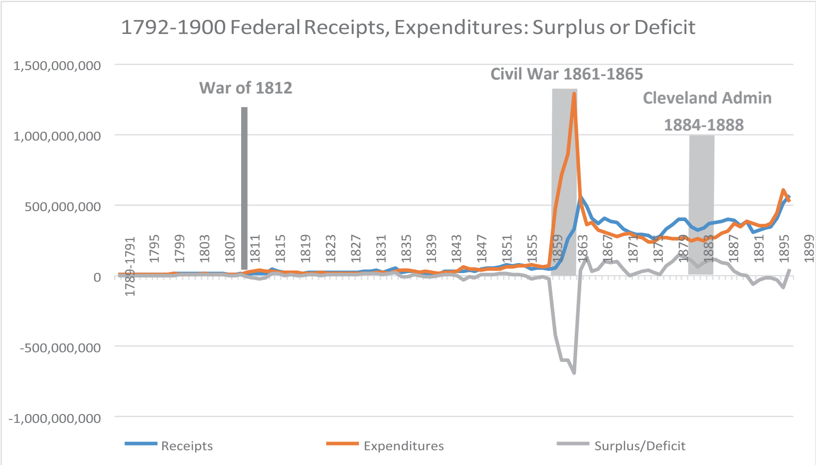


Fig. 19.1 Federal budget surplus and deficit, 1792–1900 (*Source* Historical Statistics of the United States, Colonial Times to 1970. https://www.census.gov/library/publications/1975/compendia/hist_stats_colonial-1970.html)

as Cleveland was.[9] Interestingly, Cleveland comes in second behind Franklin Roosevelt in the number of bills vetoed by an American president (635–584), reflecting the continued, though fading, effect of the political norms that buttressed limited government into the 1930s. The difference in vetoes obviously reflects that Roosevelt served slightly over 12 years as president as opposed to 8 years for Cleveland. Also, Cleveland's vetoes were more heavily concentrated on limiting government spending than were Roosevelt's.[10] Even though Franklin Roosevelt has the understandable reputation for expanding government, it should be noted that within one month of his first inauguration he got what is known as the Economy Act of 1933 through Congress and signed. This resulting government spending cut is described by Cogan (2017, p. 71)

[9]Cleveland failed to be reelected in1888 as the end of his first term approached because he lost in the electoral college despite receiving more popular votes than his opponent, Benjamin Harrison. He served 8 years by being reelected in 1892, and he continued vetoing spending bills.

[10]See https://en.wikipedia.org/wiki/List_of_United_States_presidential_vetoes and https://www.britannica.com/list/9-us-presidents-with-the-most-vetoes.

as “the most consequential in pension history.” Unfortunately, it was also the last cut in pension spending of any consequence in U.S. history, and later in his first term Roosevelt was responsible for creating the largest U.S. government retirement program in history, which is still growing despite looming bankruptcy.

By the time Roosevelt died in office in April 1945, the political norms favoring the morality of limited government were rapidly losing influence relative to political norms favoring the morality of government assuming responsibility for problems traditionally seen as solved best by individual initiative and voluntary cooperation facilitated by private-sector arrangements. Political solutions were increasingly seen as not only instrumentally superior to private solutions, but morally superior as well because they were motivated by compassion and good intentions instead of self-interest. And as this shift in political norms and moral understanding occurred, support for the constitutional restrictions on government growth weakened. Henry Simons (1951, p. 20) was prescient when warning:

> Constitutional provisions are no stronger than the consensus that they articulate. At best, they can only check abuses of power until moral pressure is mobilized, and their check must become ineffective if often overtly used.

But this raises the question: What is the moral environment that provides support for constitutional restrictions that limit government primarily to the provision of general benefits to all its citizens? And how do those moral environments compare with those that favor a negative-sum expansion of government expansion to the point of devoting most of its expenditures to benefiting particular groups at the expense of the general public?[11]

[11]Higgs (1987) argues, as do most historians, that the shift in the political norms or ideology began changing with the progressive advent of the progressive movement in the 1890s. See Higgs (1987, pp. 106–122) who also points out that the effects of this movement did have a major impact on government growth until the 1930s.

Does Buchanan Really Want Heroic Presidents?

Buchanan (2001 [1981]) suggests a plausible dynamic by which the political order moves from a constitutionally limited government to one in which the constitution becomes ineffective. This dynamic is interesting, and especially so for our paper, because it points to the danger of protecting the "Nobel Lie" as Brennan and Buchanan suggest we do. Buchanan begins the paper he wrote in 1981 by considering "the 'ties that bind persons with each other in society'" (p. 187), making use of three idealized communities, while recognizing that all societies are some mixture of the three. The communities are labeled moral community, moral order, and moral anarchy. Buchanan notes that there is no moral content in his discussion in a normative sense, but different moral norms (or lack of such norms) are dominant features in each.

A moral community consists of members who identify with the community, and in varied degrees with other members in that community, rather than conceiving "of themselves to be independent, isolated individuals" (p. 188). Such moral communities vary from nuclear families to the nation state, with many intermediate-sized and dispersed groups in between. A moral order exists when members, not necessarily sharing membership in any moral community, interact with each other with "moral indifference" while respecting the freedom of others as equal to their own, and abiding by social norms required for "reciprocal trust and confidence" (p. 189). A market economy is an obvious example of a moral order. Finally, moral anarchy "exists in a society (if it can remain a society) when individuals do not consider other persons to be within their moral communities and when they do not accept the minimum requirements for behavior in a moral order" (p. 190).

Buchanan employs these descriptions of interaction to consider "problems of social viability and, indirectly, problems of government in a society" (p. 190). He considers first a setting which is dominated by the behavior of moral anarchists. Thomas Hobbes famously described the lives of those in such a setting as "poor, nasty, brutish, and short." This is a setting in which people are, given no other alternative, willing to sacrifice their freedom to an authoritarian government in return for personal protection. As Buchanan states, "Men who neither feel a sense of community with others, nor respect others as individuals in their own right, must be ruled" (p. 191). One is reminded of Edmund Burke's observation:

> Men are qualified for civil liberty in exact proportion to their disposition to put moral chains upon their own appetites …. Society cannot exist unless a controlling power upon will and appetite be placed somewhere, and the less of it there is within, the more there must be without. It is ordained in the eternal constitution of things, that men of intemperate minds cannot be free. Their passions forge their fetters.[12]

While Buchanan recognizes the possibility of a collapse into moral anarchy leading to repressive government, we consider how his model suggests more gradual ways for government to increase toward repressive levels, something that could eventually lead to collapse into moral anarchy. His discussion begins in what seems an optimistic way. He observes that the necessary role of government is smaller when "most but not necessarily all persons are expected to follow the precepts of moral order, [which means] government as such may be restricted to a minimal, night watchman, or protective state. The government need only protect person and property rights and enforces contracts among persons …. In one sense there is no need for governing as such" (pp. 191–192). Yet, Buchanan sees a danger in this social togetherness by recognizing that the most effective force for bringing us together—a crisis such as that created by a threat from an external enemy—also creates strong demands for government to increase and centralize its power to confront the crisis (p. 192). Such an increase in centralized power can be reversed once the crisis is over, as we shall see. Over time, however, recurring crises can begin weakening the political norms and constitutional restrictions of even a limited government with modest powers. And when those limits erode and government expands, opportunities are invariably created for

[12]Quoted in Muller (1995, p. 99).

organized groups (which can have characteristics of moral communities) to benefit from government action at the expense of others; and each starts seeing that action as more compelling than government action limited to providing general benefits to the inclusive moral order. The result can, not surprisingly, be more hostility between moral communities, more social divisiveness and the emergence of identity politics supposedly dedicated to increasing social justice with policies that expand government and increase the number of groups that feel they are suffering from social injustice. This can easily increase public demand for heroic presidents whose outlandish promises (many expressive voters will benefit from believing) and increase the supply of ambitious politicians unburdened by modesty anxious to campaign for the job.[13]

Healy (2009, pp. 142–145) quotes several prominent opinion leaders from across the ideological spectrum "welcoming the togetherness terrorism brought." For example, Healy considers Robert Putnam, who wrote in his 2000 book *Bowling Alone* that restoring America's sense of common purpose "would be eased by a palpable national crisis, like war or depression or natural disaster, but for better and for worse, America at the dawn of the new century faces no such galvanizing crisis." In what Healy (p. 143) described as "welcoming the togetherness that terrorism brought," he quotes Putnam, writing a little over a year later, that "as 2001 ended Americans were more united, readier for collective sacrifice, and more attuned to public purpose than we have been for several decades" (p. 143). Without knowing it, Putnam was describing Buchanan's inclusive "moral community" as being brought about by 9/11, something Buchanan surely recognized, but with less enthusiasm than Putnam because he would have seen it as an irresistible opportunity of government to take advantage of the readiness "for collective sacrifice" to ride to the rescue.[14]

[13]Buchanan doesn't use the term *hero* or *heroic* in this discussion, but he describes a process of government expansion that has both resulted from and led to what Healy (2009, Chap. 3) refers to as "the age of the heroic presidency" and which has resulted in the erosion of the U.S. Constitution in the twentieth century. Healy is primarily concerned with the crises created by external enemies but considers other types of crises as well.

[14]Although both of us would bet that Buchanan, like most Americans, shared in that readiness.

Healy (pp. 144–145) also points to David Brooks, the conservative New York *Times* columnist, as someone who was unable to be too upset by 9/11. In 1997 Brooks criticized limited-government conservatives who "have become besotted with localism, local communities, and the devolution of power to the localities …. [replacing] high public aspiration with the narrower concerns of private life." About a month after 9/11, Brooks, remaining shockingly consistent with his 1997 view, asked, "Does anyone but me feel upbeat and guilty about it [9/11]?" He continues, "I feel upbeat because the country seems to be a better place than it was a month ago …. I feel guilty about it because I should be feeling pain and horror and anger about the recent events. But there is so much to cheer one up." In other words, Brooks apparently felt cheered up because an expanded and more heroic government was going to become even more expanded and heroic to not just rescue us from terrorists, but also by expanding our aspirations and visions with more noble concerns than our local communities and private lives. And he was right. Fortunately, our aspirations and visions soon returned to normal. Unfortunately, the expansion of a more heroic and intrusive government has been more permanent, as Healy's book discusses in detail.

Of course, crises such as the War of 1812, the Civil War, and numerous other military conflicts and crises occurred in the eighteenth century and motivated increased federal spending and higher federal debt. But there was no noticeable ratchet effect on the increased spending and higher debt after the crises were over. Federal expenditures as a percentage of GDP effectively returned to pre-crisis levels, and the federal debt was steadily and significantly reduced with subsequent federal budget surpluses. As argued in the section entitled "The Importance of Noble Lies," the norms of acceptable government action limited government growth through the nineteenth century and continued to largely do so until well into the twentieth century.[15] It is useful to consider one

[15]In his study of the effect of crises on the growth of American government, Higgs (1987, p. 18) states "one must explain why crises led to upward-ratcheting government powers in the twentieth century but not in the nineteenth, which had its own emergencies." He acknowledges that differences in the growth of government between the nineteenth and twentieth centuries is not completely explained by upward ratcheting. It should also be noted that the seeds to subsequent growth in government were planted in the late nineteenth century and early twentieth.

political norm that both reflected and supported this limited role of government for so long. It is a norm that didn't noticeably change until the early twentieth century, but as it changed it reflected and facilitated the growth in the heroic government that soon became evident. Interestingly, it is a change that Brennan and Buchanan (2000 [1988]) worry might be reversed by the influence of public choice because that influence might erode the standards of public life. Recall once more their statement that preventing that erosion "may require a heroic vision of the 'stateman' or 'public servant,' because only by holding such a vision can the possibility of public-interested behavior on the part of political agents be increased."

The norm we have in mind concerns prevailing expectations regarding appropriate campaigning for the presidency. That norm changed as the presidency shifted from being a modest political position to one of a heroic figure prepared to vanquish wide-ranging problems, such as consoling us in our grief, healing our planet, slowing the rise of our oceans, spreading democracy around the world, lifting the unfortunate, and reflecting our highest ideals. Through the nineteenth century, and well into the twentieth, the norm was that, compared to presidential candidates after the 1930s, presidential candidates barely campaigned for the job. They gave few, if any, speeches; and when they did, they were commonly delivered from their door steps and contained few promises sober persons could believe. Granted, the relaxed campaigning was explained in large part by the high cost of travel in the nineteenth century and the lack of the communication technology that became widely available in the twentieth century. But it is also true that throughout the nineteenth century the federal government had a far smaller effect on our daily lives than it does today. The state governments also had less influence over our lives than they do today, but they had more influence than did the federal government. As Madison pointed out in paper No. 45 of *The Federalist*, "[t]he powers delegated by the proposed Constitution to the federal government are few and defined. Those which are to remain in the State governments are numerous and indefinite." Also, not only was the federal government relatively weak, but the executive branch of the federal government (and therefore the president) had much less power than the legislative branch. Madison wrote in No. 51 of *The Federalist* that "in a republican government, the legislative authority necessarily predominates." As president, George Washington didn't believe he had the constitutional authority to command the military to engage in a preemptive strike against hostile Indians without Congress having "deliberated on the subject, and authorizing such a measure." President Monroe observed in a message to Congress in 1822 that of the three branches of government "the legislature … is by far the most important."[16] With rare exceptions, nineteenth-century presidents were not thought of as heroic, if they were thought of at all. That view pretty much continued until the 1930s except for Theodore Roosevelt and possibly Woodrow Wilson, the first considered a war hero before becoming president and the latter being a war-time president, and with both being advocates of activist government.

Buchanan's discussion of "Moral Community, Moral Order, or Moral Anarchy" is consistent with the shift from the norm of presidential campaigning as it was in the nineteenth century to the current norm of long and arduous campaigning for a position with enormous power and heroic expectations associated with that power being increasingly centralized in the federal government and increasingly exercised by the president and the executive branch of the federal government. Of course, the move from moderately powerful presidents in the past to heroic presidents we expect today is only one change that both reflects, and at least partially explains, the increased control government exerts over us. But it is interesting for our purpose because it is consistent with what we see as a clear conflict between Brennan's and Buchanan's recommendations in "The Nobel Lie" and the implications regarding the concentration of government power that flow from Buchanan's article, "Moral Community, Moral Order, or Moral Anarchy." But there are other writings of Buchanan that show unexpected consistency and apparent inconsistency with "The Nobel Lie" that deserve comment, not to mention the apparent inconsistency of the "The Nobel Lie" with Buchanan's well-known desire for public choice to increase public awareness of government failure to bring it in line with that of market failure.

[16]The Washington and Monroe statements are quoted in Healy (2009, pp. 33 and 37).

Did Buchanan Change His Mind?

Nine years before "The Nobel Lie" was published, Buchanan (1999 [1979]) published an article titled "Politics without Romance." He describes public choice theory as:

> the avenue through which a romantic and illusionary set of notions about the working of governments and the behavior of persons who govern has been replaced by a set of notions that embody more skepticism about what governments can do and what governors will do, notions that are surely more consistent with the political reality that we may all observe about us.[17] (p. 46)

But this article, originally published in 1979, hardly seems consistent with Brennan's and Buchanan's (2000 [1988]) concern about the damaging influence of public choice on "political morality."

It is not that we disagree with their concern about political morality as expressed by their observation in "The Nobel Lie" (p. 84) that "because there is no invisible hand operative in majoritarian political institutions analogous to that operative in the market setting, any lapse in political morality is of normative significance." Of course, but the lack of strong incentives for moral behavior in the political arena does not seem like a compelling reason for downplaying public choice insights that are "surely more consistent with the political reality that we may all observe about us." We may all observe that political reality, but many have little reason to do so, and even less reason to take it seriously if they do. This seems to us to make the moral case for public choice even stronger.

So, the morality of the political process is a concern, but not because that morality is being threatened by public choice. The threat comes from the tendency for large numbers to see political morality as accomplishing noble goals motivated by good intentions with the coercive

[17]Here we consider myths and romance about the political process as closely related if not synonymous. Myths are easy to believe when under the influence of romance, and the myths about the political process we have been discussing can be reasonably described as romantic myths.

arms and agencies of government programs. This view of political morality is a tremendous asset for politicians, members of government bureaucracies, and their special-interest supplicants, not necessarily because of the good it allows them to do, but quite often because of the self-serving harm it allows them to get away with. Both of us wonder: what exactly is the social advantage of the intellectual horsepower of Buchanan and Brennan being used to protect the already inflated perception of government morality by questioning the morality of public choice analysis, no matter how mildly?

But while we were wondering, we discovered something that redirected our wondering when we had effectively finished this paper. Maybe some of our criticisms of "The Nobel Lie" are not quite as convincing as we had thought. Possibly we had missed something in Brennan's and Buchanan's argument that weakens our criticism. Or, maybe it was something we missed, primarily, in Buchanan's 1979 article "Politics without Romance" that caused us to conclude mistakenly that it contradicted the arguments in the 1988 article "The Nobel Lie" with Brennan. Part of our confidence (though not all) in our criticism of "The Nobel Lie" was based on a suspicion that Buchanan had changed his mind between 1979 and 1988 by more than we considered reasonable. We even considered the possibility that "The Nobel Lie" reflected Brennan's views far more than Buchanan's. We were wrong on both accounts. What we discovered was a letter Buchanan wrote to Richard McKenzie on 4 June, 1979, regarding the draft of an article McKenzie was writing that considered the implications of Beard's criticism of the process leading to the U.S. Constitution.[18] Buchanan pulls no punches in his response to McKenzie. He writes:

> There are limits beyond which it is inappropriate to go, for to do so will undermine myths, sacrosanct objects, concepts, ideas that have intrinsic value in their own rights. If you should be able to

[18]We thank Pete Boettke for calling our attention to the letter in a session of the 2018 meeting of the Association of Private Enterprise Education®, and Richard McKenzie for making the letter available to us. It is available, with permission, under the heading "James M. Buchanan papers, C0247, Special Collections Research Center, George Mason University Libraries."

> convince me, empirically, that the Founders really were like Beard (and you) say they were, I still would think that the mythology that they were somehow gods and hence disinterested has served us very well for two centuries, and, quite literally, I think it is a sin to destroy this mythology. (emphasis in original)

This statement could have been inserted into the "The Nobel Lie" nine years later and been right at home. Apparently, Buchanan had not changed his mind between 1979 and 1988. But that is only true if he had changed his mind between 1979 and 1979. So, the discovery of Buchanan's letter to McKenzie forces us to face the fact that there are ambiguities between the inconsistencies in some of Buchanan's writings we have considered and the arguments in "The Nobel Lie." Yet, we still believe our fundamental criticism of the Brennan and Buchanan article is correct; i.e., it overstates the threat of positive public choice analysis to the perceived morality of the political process. But the ambiguities and inconsistencies the letter to McKenzie reveals also connect with some comments by Wagner (2017) that we believe provide a genuine insight into Buchanan's genius. We conclude with our attempt to convey that insight.

Conclusion

Wagner (2017, p. 188) points out that "any theorist of social interaction will operate with some form of sociological theory, even if that theory might be implicit rather than explicit." He then points out that there are two major perspectives in such theory which can be labeled concordant (or exchange) and discordant (or conflict). As Wagner sees it, Buchanan's "implicit sociology fits the exchange tradition" (p. 188) as opposed to the conflict tradition, which is the better fit for Tullock's implicit sociology. This obviously doesn't imply that Buchanan is unaware of the conflict in society that is always in evidence. But for Buchanan the relevant question is "[i]s there some central point on which everyone can potentially agree, or does society operate without such a point?" (p. 188). Much of Buchanan's work is based on his belief, and attempt to establish, that there is such a point. Buchanan's belief is based on his "presumption that people want to live together in harmony, and need only to find the rules that will allow them to do so" (p. 190). Buchanan's search for such rules was motivated by his fundamental insight on constitutions that Wagner describes as the "distinction between choice of rules and choice of strategies within the rules" (p. 188). Agreement on the general rules to be followed when individuals make decisions can potentially be agreed upon (and provide the basis upon which social life can proceed harmoniously), even though reaching agreement on the decisions people choose within the rules is an impossible task.

We add to this by pointing out that Buchanan had little interest in using his public choice insights to give advice to politicians because he was convinced that it was the general rules, and the political incentives they create, that would determine their behavior for good or bad. Buchanan believed the only way to improve the rules in the form of effective constitutional limits on government was by restoring political norms consistent with those limits. His comparative advantage in this effort, as he knew, was expanding the intellectual influence of public choice with his scholarly contributions. He also believed he could increase the effectiveness of his scholarly insights by communicating them beyond the public choice choir. This belief was evident in a point Wagner remembers Buchanan making to him when the two disagreed on a theoretical issue in public choice. As Wagner recalled, Buchanan's response (p. 191) was to

> acknowledge my points and concerns …. [and then] remind me that the creation of scholarship is a social activity, and that it is necessary to speak the common language if you are to participate in that activity. The creative scholarly life entails working with a *dialectical tension* where you must use the language your colleagues use to change the language they use. (emphasis added)

We find this an interesting statement because it helps explain why almost all who were lucky enough to know Buchanan well, and considered themselves informed on his work, were often surprised (at least initially) by statements he made and, somewhat less often, by positions he took in his writing. Based on Wagner's statement above, it is reasonable to conclude that Buchanan was creatively playing with ideas despite, or often because of, their dialectic tensions with other ideas and positions of his. It is also why so many of Buchanan's former students, colleagues and collaborators are aggravated with MacLean and her book for being, at best, completely misinformed by depicting Buchanan as a rigid ideologue. So, as this paper evolves as we write it—a necessary but not sufficient condition for a good paper—we conclude by acknowledging that we now see the inconsistencies we discussed in the sections entitled "Does Buchanan Really Want Heroic Presidents?" and "Did Buchanan Change His Mind?" in a less critical light. But we remain unwilling to withdraw our criticism of "The Nobel Lie" since we hope it may create some useful dialectic tensions of its own.

References

Anderson, M. *Encyclopedia Britannica*, s.v. U.S. Presidents with the Most Vetoes. Encyclopedia Britannica Inc. https://www.britannica.com/list/9-us-presidents-with-the-most-vetoes. Accessed April 23, 2018.

Brennan, G., & Buchanan, J. M. (2000 [1980]). The Power to Tax: Analytical Foundations of a Fiscal Constitution. In G. Brennan, H. Kliemt, & R. D. Tollison (Eds.), *The Collected Works of James M. Buchanan* (Vol. 9, pp. 48–55). Indianapolis: Liberty Fund.

Brennan, G., & Buchanan, J. M. (2000 [1988]). Is Public Choice Immoral? The Case for the "Nobel" Lie. In G. Brennan, H. Kliemt, & R. D. Tollison (Eds.), *The Collected Works of James M. Buchanan: Politics as Public Choice* (Vol. 13, pp. 79–89). Indianapolis: Liberty Fund.

Brennan, G., & Lomasky, L. (1993). *Democracy and Decision: The Pure Theory of Electoral Preference*. Cambridge: Cambridge University Press.

Buchanan, J. M. (1954). Individual Choice in Voting and the Market. *Journal of Political Economy, 62*(4), 334–343.

Buchanan, J. M. (1999 [1976]). The Justice of Natural Liberty. In G. Brennan, H. Kliemt, & R. D. Tollison (Eds.), *The Collected Works of James*

M. Buchanan: The Logical Foundations of Constitutional Liberty (Vol. 1, pp. 292–310). Indianapolis: Liberty Fund.

Buchanan, J. M. (1999 [1979]). Politics Without Romance. In G. Brennan, H. Kliemt, & R. D. Tollison (Eds.), *The Collected Works of James M. Buchanan: The Logical Foundations of Constitutional Liberty* (Vol. 1, pp. 45–59). Indianapolis: Liberty Fund.

Buchanan, J. M. (2001 [1981]). Moral Community, Moral Order, or Moral Anarchy. In G. Brennan, H. Kliemt, & R. D. Tollison (Eds.), *The Collected Works of James M. Buchanan* (Vol. 17, p. 187). Indianapolis: Liberty Fund.

Buchanan, J. M., & Tullock, G. (1999 [1962]). The Calculus of Consent: The Logical Foundations of Constitutional Democracy. In G. Brennan, H. Kliemt, & R. D. Tollison (Eds.), *The Collected Works of James M. Buchanan* (Vol. 3, pp. 63–96). Indianapolis: Liberty Fund.

Carden, A., & Magness, P. (2017). Buchanan the Evil Genius. *Regulation, 40*(3, Fall), 60–64.

Cogan, J. F. (2017). *The High Cost of Good Intentions: A History of U.S. Federal Entitlement Programs.* Stanford: Stanford University Press.

Healy, G. (2009). *The Cult of the Presidency: America's Dangerous Devotion to Executive Power*. Washington, DC: Cato Institute.

Higgs, R. (1987). *Crisis and Leviathan: Critical Episodes in the Growth of American Government*. Oxford: Oxford University Press.

Historical Statistics of the United States, Colonial Times to 1970. https://www.census.gov/library/publications/1975/compendia/hist_stats_colonial-1970.html. Accessed April 23, 2018.

Horwitz, S. (2017). Review of the book *Democracy in Chains: The Deep History of the Radical Right's Stealth Plan for America*, by Nancy MacLean. *Cato Journal, 37*(3), 593–608.

MacLean, N. (2017). *Democracy in Chains: The Deep History of the Radical Right's Stealth Plan for America*. New York: Viking.

Muller, J. Z. (1995). *Adam Smith in His Time and Ours*. Princeton: Princeton University Press.

Munger, M. C. (2018). On the Origins and Goals of Public Choice: Constitutional Conspiracy? *The Independent Review, 22*(3, Winter), 359–382.

Simons, H. C. (1951). *Economic Policy for a Free Society*. Chicago: University of Chicago Press.

Tullock, G. (1971). The Charity of the Uncharitable. *Western Economic Journal, 9*(4), 379–392.

Wagner, R. E. (2017). *James Buchanan and Liberal Political Economy: A Rational Reconstruction*. Lexington: Lexington Books.

Wikipedia Contributors, List of United States Presidential Vetoes, *Wikipedia, The Free Encyclopedia*. https://en.wikipedia.org/w/index.php?title=List_of_United_States_presidential_vetoes&oldid=839291217. Accessed April 23, 2018.

20

Beneficent Bullshit

Peter T. Leeson

Whereas the lie in words is in certain cases useful and not hateful.
—Plato, *The Republic* (Jowett trans. 1991, p. 80)

Introduction

The world is a wondrous place, full of natural splendor, manmade marvels—and bullshit: the technical term for false, often nonsensical, beliefs. I'm a dragon; you're the Queen of Sheba; Russian election hacking is responsible for the Democrats' electoral failure. As the latter example suggests, a belief being false, even absurd, does not preclude it from being popular. On the contrary, a great deal of bullshit is widely held. Astrology has countless devotees, many of whom are intelligent and well-educated; so does acupuncture, gluten-free dieting, "8-Minute abs." On and on it goes.

P. T. Leeson (✉)
Department of Economics, George Mason University, Fairfax, VA, USA
e-mail: pleeson@gmu.edu

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_20

For the most part, these beliefs are harmless. Other popular false beliefs, however, are not so innocuous. In the political-economic realm in particular, bullshit can be incredibly destructive. False belief in socialism—that economies could flourish without private property—brought Eastern Europe to its knees. False belief that punitive taxes on the rich could save a foundering economy prolonged America's Great Depression. And continuing false belief that wage floors can help all working-class men and women hinders young minorities from getting a foot in the workplace door.

It would therefore be easy to conclude that false beliefs in the political-economic arena are universally harmful. But it would also be wrong. James M. Buchanan identifies popular false beliefs in the constitutional realm as foundational supports of political-economic order. I argue that popular false beliefs in the judicial realm support criminal law and order. The beneficence of bullshit in such arenas may help explain the prevalence of bullshit in political-economic life.

Buchanan on Bullshit

The idea that false beliefs can be socially productive is at least as old as Plato, whose *Republic* infamously endorses a "noble lie" of citizen/city origin. According to that lie, citizens of the city are born from the earth, making them one another's siblings and the city's land their mother. Each citizen is born with a soul containing a metal that reflects his divinely-willed role as a city ruler, protector, or producer. Should a divinely-willed protector, for example, rule instead of protect, an oracle foretells the city will be destroyed.

Socrates encourages rulers to peddle this falsehood to citizens. The logic is simple: if citizens believe they're kin and that the city's land is their mother, they're more likely to cooperate for the city's protection and collective good. If citizens believe that their social station is divinely willed—departure from it liable to provoke divine punishment—they're more likely to accept their station, however unappealing, and to support their "kin" in more appealing stations, in particular, rulers. In short, Plato sees bullshit as a mechanism for aligning citizens' private incentives with desired political-economic outcomes.

James Buchanan famously rejects Plato's conception of rulers as philosopher-kings. But he's quite close to Plato in viewing bullshit as foundational to political-economic order. For Buchanan that order is liberal, and its proximate underpinning is constitutional, residing in a "social contract" concerned with prescribing "*rules that constrain governments*" (Brennan and Buchanan 2000, p. 166). The trouble lies in enforcement of those rules, without which they cease to bind and liberal political-economic order crumbles.

Ultimately, constitutional rules must be self-enforcing (Tullock 1987; Wagner 1987). Rulers must find it in their interest to limit their activities to those constitutionally enabled, which means citizens must be willing to hold transgressive rulers accountable—to protect constitutional protections. Their willingness to do that depends on their belief about the origin and nature of their constitution, hence their government. Where popular belief sees the constitution as wise and righteous, sacred even, citizens are more likely to act for its protection, preserving constitutional government, and vice versa. In this way, Buchanan informs, popular belief is "essential to maintenance of an underlying popular consent of the citizenry to be governed, in the absence of which no tolerable stable political order is possible" (Brennan and Buchanan 1988, p. 186). Or as he puts it elsewhere, "I think a social order's stability-viability depends critically on the existence of some civic religion" (Buchanan to Richard McKenzie June 4, 1979).

A telling choice of words to describe such belief, for "Buchanan was a resolute atheist" and presumably regarded religious beliefs of all kinds as false, absurd even (Brennan and Munger 2014, p. 331). Yet he also regarded at least some of them as socially productive. According to Buchanan, "The fear of hellfire," for example, is "instrumental in guaranteeing tolerable behavioral standards among ordinary men" in America (Buchanan 1970, p. 655).[1] There is no hell, of course; it's bullshit. But the fact that many Americans falsely believe in hell incentivizes good conduct all the same.

[1]Or at least it has been historically—up through the mid-twentieth century, after which Buchanan (1970) sees such beliefs as deteriorating.

Buchanan takes a similar view of American's civic-religious beliefs: critical for constitutional political-economic order—and quite possibly bullshit. At the core of those beliefs is, pace Plato, an origin story. The US Constitution was born of near-deities, the Founding Fathers, whose enlightened benevolence gave us governmental rules to which all would in principle consent, devised to promote the public good. As Buchanan puts it, "James Madison, Benjamin Franklin, Thomas Jefferson, and their peers are distinguished by their essential understanding of the reason of rules in political order, an understanding they implanted in the constitutional documents," America's "'sacred' texts," which reflect "The wisdom and understanding of the Founders" (Brennan and Buchanan 2000, p. xv). In other words, your government is just as your sixth-grade civics teacher described it: a preternatural product of sage and selfless statesmen.[2]

Several scholars have expressed doubts about this origin story, and empirical work corroborates their skepticism. It finds that less noble, private interests played an important role in shaping the United States Constitution (see, for instance, Beard 1913; McGuire 2003). It turns out the Founding Fathers weren't deities; they were men.

It's possible that Buchanan himself believed in the civic religion, and his public commentaries generally seem to affirm the religion's veracity. At the same time, the fact that Buchanan—a "resolute atheist"—calls it a "religion" points rather in the other direction. Moreover, in private correspondence quoted below, Buchanan seems to refer to America's constitutional origin story as a "myth," its civic-religious beliefs as popular "illusions."

Whatever he really believed, Buchanan insists that scholars refrain from publicly acknowledging the civic religion's falsity—even if it is decidedly false:

[2]And the logical structure of American government is that described in *The Calculus of Consent* (1962). As Buchanan puts it, that book simply "provide[s] a tight logical structure to what must have been the essential vision of James Madison and the Founding Fathers in their conceptualization of the workings of a political order" (Buchanan 1988, p. 16).

> There are limits beyond which it is inappropriate [for scholars] to go, for to do so will undermine myths…If you should be able to convince me, empirically, that the Founders really were like [Charles] Beard (and you) say they were, I still would think that the mythology that they were somehow gods and hence disinterested has served us very well for two centuries, and, quite literally, I think it is a sin to destroy this mythology. (Buchanan to Richard McKenzie June 4, 1979)

The reason: "Cynicism about the behavior of" the Founders, "however empirically justified it may be, may wreak damage to the 'civic religion'" (Brennan and Buchanan 1988, p. 185).

Buchanan continues:

> America in a sense is built out of its own illusions about its social order. It has been a part of our "civic religion" and one undermines this only if one recognizes the costs that are involved. It is surely deserving of more consideration than the mere working out of interesting ideas by a scholar. Ideas do have consequences. (Buchanan to Richard McKenzie June 25, 1979)

Consider "the boy who called attention to the emperor's nakedness":

> the familiar story might be given a quite different twist if it went on to relate that the emperor fell into disgrace, that the nobles fought among themselves, that the previously stable political order fell into chaos, and that the kingdom was destroyed. The moral might then have been not that one should call a spade a spade, whatever the possible consequences, but rather that a sensitive to consequences may require one to be judicious in exposing functionally useful myths. (Brennan and Buchanan 1988, p. 185)

To ask whether "the idealization" of constitutional origin claimed by America's civic religion was ever "real in the first place" therefore misses the point. "Perhaps it was not," Buchanan confesses, "but the idea has useful social consequences" (Buchanan to Richard McKenzie June 25, 1979). Namely, "the veneration Americans accord their Founding Fathers," which facilitates constitutional enforcement (Brennan and Buchanan 2000, p. xv).

According to Buchanan, “Our normative role, as social philosophers is to shape this civic religion” (Brennan and Buchanan 2000, p. 166). And “If cynicism destroys politically useful illusions, then equally romanticism within limits fosters those illusions” (Brennan and Buchanan 1988, pp. 181–182). Far from exposing order-supporting falsehoods as superstitions, then, we should actively propagate them—falsely profess to believe in false beliefs:

> my view is that social order, and the behavior in it, is extremely fragile, and that investment in constructive stability is worthwhile. In this sense, this makes me support the hypocrite. And I do think hypocrisy has genuine social value. Men and women are better because they profess religious precepts, even if, in practice they disregard them. (Buchanan to Richard McKenzie June 25, 1979)

In other words, when it comes to supporting social order, a little bullshit goes a long way, but a lot of bullshit goes even longer. An important insight, to which I return below.

Criminal Justice and Bullshit in Medieval Europe

Social order requires social rules, which regulate interpersonal conduct (Buchanan 1975). Constitutional rules regulate the processes by which “ordinary” social rules are created, for example criminal laws proscribing theft, violence, and so on (Buchanan and Tullock 1962). Buchanan highlights the role of popular false beliefs in enforcing the former, enabling constitutional political-economic order. Here, I consider the role of popular false beliefs in enforcing the latter, enabling criminal law and order.

In Buchanan’s (1975) framework, criminal law enforcement is government’s job. But in much of the world, government is unable or unwilling to reliably perform this task (Leeson 2014). Moreover, even where government functions well, criminal law enforcement is not “automatic”; difficulties inevitably arise. To take but one example: it’s not always obvious whether an individual has committed a crime, hence, whether he should be punished. A chief function of judicial institutions is to answer this question—to find facts. Facts, however, are skilled at hiding; they require evidence, which is often in short supply.

This was especially true historically, before the advent of fingerprint technology, the discovery of DNA, or even the invention of streetlamps. In medieval Europe, for example, there was often little evidence to go on in criminal cases besides the equally plausible, contradictory claims of accuser and accused. Courts could've indiscriminately exonerated defendants when clear evidence of their guilt was lacking, but short of eyewitnesses or spontaneous confessions, such evidence would usually be lacking, so that would've meant letting many guilty people go free. Alternatively, courts could've indiscriminately condemned defendants simply because they had been accused, but since a non-trivial proportion of accused defendants were probably innocent, that would've meant punishing many innocent people. It turns out there was a better way of deciding difficult criminal cases in medieval Europe—one grounded in bullshit. Perhaps paradoxically, medieval European courts used popular falsehoods to ferret out the truth.

For 400 years, between the ninth and thirteenth centuries, medieval criminal justice systems throughout Christendom decided the guilt or innocence of defendants by asking the accused to plunge his arm into a cauldron of boiling water and pluck out a ring. Afterward, the defendant's arm was wrapped in a bandage; three days after that, the bandage was removed and his arm examined. If it showed signs of having been burned, the defendant was found guilty; if not, he was found innocent.

This trial by boiling water is called the hot water ordeal. A variety of other judicial ordeals were also used in medieval Europe. In the hot iron ordeal, for instance, the defendant was asked to carry a piece of burning iron a certain number of paces. And in the cold water ordeal, he was bound and cast into a pool of holy water to see whether he would sink (innocent) or float (guilty). Below I explore the workings of the hot water ordeal in particular, but the logic I describe applies also to other judicial ordeals of the day.

Those ordeals were grounded in a popular medieval superstition according to which their outcomes reflected *iudicia Dei*—judgments of God. If priests performed the appropriate rituals, it was believed, they could call on God to reveal defendants' guilt or innocence through clergy-conducted physical tests. Man might not know the truth, but God surely does, so just ask Him. In the hot water ordeal, for example, if the defendant is guilty, God will let the water burn him. If he's innocent, God will perform a miracle that prevents the water from burning him. The belief that God would participate in judicial affairs this way was propagated by the Church and reiterated by priests, who conducted ordeals as part of special masses, complete with ordeal prayers and rituals that reminded citizens of ordeals' divine foundation—and the defendant of his possible fates: a pleasant, holy-water wash-up, followed by exoneration if he was innocent; horrendous pain, followed by the legally prescribed punishment upon conviction if he was not.

Iudicium Dei is a false belief. God doesn't actually intervene in judicial affairs to find fact when courts aren't up to the task. Yet because medieval citizens falsely believed that He did, courts could use ordeals to accurately discern defendants' guilt or innocence.

Consider a medieval farmer who's been accused of stealing his neighbor's cow. The court thinks he might have committed the theft but isn't sure, so it orders him to undergo the hot water ordeal. Like other medieval Europeans, the farmer believes in *iudicium Dei*—that a priest, through the appropriate rituals, can get God to reveal the truth, performing a miracle that prevents the water from burning him if he's innocent, letting him burn if he's not. If the farmer undergoes the ordeal and God says he's guilty, he has to pay a large fine—the legal punishment for stealing cows. If God says the farmer is innocent, he's cleared of the charge and pays nothing. Alternatively, the farmer can avoid undergoing the ordeal by confessing to having stolen the cow. If he confesses, he must pay a fine, but a smaller one since he came clean. What will the farmer do?

First, suppose the farmer is guilty: he knows he stole his neighbor's cow, and so does God. In this case, the farmer expects that if he undergoes the ordeal, God will let the boiling water burn him, evidencing his guilt. Thus, the farmer will have to pay the large fine, and he'll have his hand boiled to rags to boot. In contrast, if the farmer confesses, he'll save a bit of money, not to mention his hand. So, if the farmer is guilty, he'll confess.

Now suppose the farmer is innocent: he knows he didn't steal his neighbor's cow and, again, so does God. In this case, the farmer expects that if he undergoes the ordeal, God will perform a miracle that prevents the boiling water from burning him, evidencing his innocence. Thus, the farmer won't have to pay any fine, and he'll keep his hand intact. In contrast, if the farmer confesses, he'll have to pay a fine for a theft he didn't commit. So, if the farmer is innocent, he'll undergo the ordeal.

Because of his false belief in *iudicium Dei*, the specter of the ordeal leads the farmer to choose one way if he's guilty—confess—and another way if he's innocent—undergo the ordeal—revealing the truth about his criminal status though the choice he makes. The result is a separating equilibrium. By asking God to "out" defendants through the ordeal, the court incentivizes defendants to "out" themselves.

It's brilliant bit of bullshit. But of course, it works only if the ordeal water doesn't burn the farmer when he sticks his hand in it. Priests, then, needed make sure the boiling water wasn't really boiling. And it seems they did.

The "instruction manuals" that priests followed when administering ordeals directed them to prepare the fire used to heat the ordeal water in private, permitting priests to cool the fire. They directed priests to "sprinkle" holy water over the ordeal water, permitting priests to cool the water. They directed the cauldron to be removed from the fire during the ordeal mass and that the defendant shouldn't be tested until the priest was done saying his prayers, allowing the priests to cool the water some more by the drawing out their prayers. And, as a failsafe, ordeal instructions directed priests to adjudge the ordeal's outcome—to inspect the defendant's unwrapped hand after the three-day waiting period to decide whether it was burned.

A "miraculous" ordeal result was thus practically assured. For example, in the early thirteenth century, 208 defendants in Várad, Hungary underwent hot iron ordeals. Nearly two-thirds of them were unscathed by the "red hot" irons they carried and exonerated.

Why not all? One possibility is that medieval European belief in *iudium Dei* wasn't perfect. If criminal defendants see that everyone who undergoes the ordeal is exonerated, they might begin to wonder whether priests rather than God are really behind it. In that case, even the guilty may decide they want to take a chance undergoing the ordeal. And if that happens, the ordeal ceases to separate defendants by their guilt or innocence. To avoid this situation, priests condemn some defendants who choose to undergo the ordeal.

As long citizens repose even a bit of belief in the possibility that ordeals are genuine *iudicia Dei*, the guilty person's expected cost of undergoing the ordeal is higher than the innocent person's. Thus, there exists some proportion of ordeal takers that priests can condemn that will make the guilty prefer to confess and the innocent prefer to undergo the ordeal, preserving separation. Unavoidably, however, these defendants are innocent—the only defendants who want to take the ordeal when it's separating the properly. And the weaker is citizens' faith that ordeals are genuine *iudicia Dei*, the more defendants priests must condemn to preserve separation, which means the worse ordeals perform in terms of securing criminal justice. Much as stronger belief in America's civic religion offers better support for constitutional political-economic order, stronger belief in *iudicum Dei* offered better support for medieval criminal law and order. When it comes to criminal justice, too, a little bit of bullshit goes a long way, but a lot of bullshit goes even longer.

Criminal Justice and Bullshit in Contemporary Liberia

To see this in the contemporary world, consider, for example, criminal justice in Liberia. Liberia is a least-developed country (LDC) in Sub-Saharan Africa and characteristic of LDCs in general in at least two important ways: its government is highly dysfunctional, and its citizens believe in a great deal of bullshit. These features are related, though not in the way you might think.

Between 1989 and 2003, Liberia was embroiled in civil war, which decimated much of the country and left its formal legal institutions in shambles. I don't mean to suggest that before 1989 Liberia's public judicial institutions were well functioning. They were not, but civil war has made things even worse.

Formal courts that handle criminal matters are inaccessible to many Liberians, in particular those who live in the rural parts of the country, where such courts don't exist. Traveling to find a formal court is possible in principle but often expensive and time consuming, precluding it in practice. Not that most Liberians would want to rely on a formal court if they could anyway, for judicial corruption in Liberia is rampant: public officials routinely use their positions for private gain rather than to administer justice.

Even for a Liberian judicial official interested in administering justice, there's a problem: his tools for finding fact are few. The legal system lacks resources to preserve crime scenes, track down, obtain, and record relevant information from potential witnesses or other useful parties, let alone to produce, say, DNA evidence through the assistance of scientific lab technicians. A judicial official may not even have a pen and paper to write things down—and that's assuming that he is able to write things down, which, much of the time, he is not, for a large share of Liberian judicial officials are illiterate.

In light of these factors, for rural Liberians at least, if criminal justice is to be found, it must usually be found outside of formal judicial institutions. And it is—in community based judicial ordeals called "sassywood."

Occasionally these ordeals take the same form as hot ordeals in medieval Europe: trial by boiling water or burning iron. More often, however, sassywood is a trial by poison ingestion. Indeed, the Liberian ordeal takes its name from an ingredient in the poisonous concoction administered to the accused, which comes from the bark of a sasswood tree.

The sassywood trial procedure is straightforward. A criminal defendant, for example someone of accused of theft, is ordered to imbibe a poisonous potion that has been prepared by a "sassywood specialist." The specialist is a spiritual leader in the community, who alone is believed capable of mixing the potion properly and whose role in administering sassywood is analogous to that of the priest in medieval judicial ordeals.

Upon imbibing the liquid, the defendant is watched closely to determine his reaction. If he vomits the liquid, he's exonerated. If he not does not and shows signs of the mixture acting upon him negatively, such as convulsing in pain, he's convicted. In that case, the defendant is punished for the crime of which he was found guilty, assuming the poison didn't kill him. Alternatively, the defendant may confess to the crime, in which case he avoids the specter of imbibing poison that seems certain to kill him or at least cause him serious pain. However, by confessing, the defendant subjects himself with certainty to the punishment for the crime to which he confesses.

As discussed above, what seems to be a startlingly stupid procedure for securing criminal justice is in fact capable of correctly finding fact if citizens popularly believe in certain falsehoods. *Iudicium Dei* will not do the trick in contemporary Liberia, since contemporary Liberians are not medieval Christians. There is no scope for this exact superstition in their particular context. There is, however, scope for a popular false belief that reflects the essence of *iudicium Dei*, namely, belief in an infallible supernatural force that can be called up on to reveal the truth. This superstition is pervasive in Liberia.

According to widespread belief, the sassywood elixir is inhabited by a lie-detecting spirit. When a defendant drinks the potion, the spirit enters him and inspects the state of his soul. If the defendant's soul is guilty, the spirit makes him convulse and/or kills him—its way of reporting his guilt. In contrast, if the defendant's soul is innocent, the spirit expels itself along with the potion, leaving the defendant unharmed—its way of reporting his innocence.

The logic behind sassywood's capacity to accurately find defendants' guilt or innocence is the same as the logic behind the medieval hot water ordeal. Popular false belief—here, in a spirit that inhabits the draft—incentivizes the guilty to confess and the innocent to drink up, revealing through their choice the fact of their criminal status. The sassywood specialist need only make sure that the concoction will induce vomiting, an effect reliably producible by mixing the appropriate natural ingredients into the potion.

Like its medieval European counterparts, Liberian sassywood is obviously an imperfect institution of criminal justice. There is ample opportunity for things to "go wrong," and I think most people would prefer a well-functioning governmental system that relies on "hard evidence" rather than hocus pocus to find fact. But that is hardly reason to look with askance on sassywood since, as discussed above, a well-functioning governmental system of fact finding is not currently available in Liberia. Given the general absence and dysfunction of formal Liberian courts, the alternative to sassywood in Liberia is either no criminal fact finding at all or corrupt fact finding, if one could call it that. Compared to what is actually possible, Liberian law and order as facilitated by sassywood looks quite good. And, limited though it may be, that law and order is supported by—indeed, possible only because of—firm belief in bullshit.

With this in mind, return to the observation that LDCs tend to exhibit both dysfunctional governments and superstitious populations. It's tempting to see this connection as reflecting a nefarious influence of popular false beliefs on governmental operation, and in some cases, perhaps that is so. The more likely connection, however, goes in the other direction: dysfunctional government gives rise to false beliefs, or at least encourages their persistence, since such beliefs offer a workaround to absent or dysfunctional government. Liberian sassywood, for example, suggests that superstition is a substitute for formal institutions of social order, making bullshit especially valuable where government comes up short.

Final Thoughts: Criminal Justice and Bullshit in Contemporary America

The particularly high value of popular false beliefs in supporting social order historically and in the contemporary least-developed world does not mean that such beliefs have zero value in the contemporary developed world. Buchanan's identification of popular false beliefs as a critical support of constitutional political-economic order in the modern United States furnishes one counterexample. But popular false beliefs also support criminal law and order in the modern United States in much the same way as they did in medieval Europe and continue to do in LDCs.

All criminal justice systems face the same basic problem: information relevant for correctly finding fact is often private. The defendant knows whether he murdered the victim but the court does not; the witness knows whether she's telling the truth about what she saw but, again, the court does not. There may be physical evidence that points in one direction or the other. In a developed country with well-functioning public institutions of law enforcement, the defendant's DNA, for instance, may be found at the crime scene, or better yet, the defendant may have been recorded in the act on videotape. But even when such evidence is available and definitive, work must be done before it can be discovered. Long before the police can obtain the search warrant that allows them to turn up the videotape in Greg's home, they must identify Greg as a suspect, and rule out Dan, and David, and Derek. That requires accessing the private information of these fellows. And as we saw with medieval ordeals and Liberian sassywood, in accessing such information, bullshit can be very helpful.

Consider polygraph tests—so-called "lie detectors." By all scientific accounts, these tests are bullshit; there's no way to physiologically measure if a person is telling the truth. Precisely for this reason, most courts in the United States ban polygraph results as evidence in criminal trials. Yet contemporary America's criminal justice system more broadly relies extensively on lie detector tests to aid in securing criminal law and order. The police use polygraphs, the FBI uses them, and so does the CIA. The ability of these law enforcement officials to use lie detectors to promote criminal law and order is grounded in popular false belief.

Many Americans believe that lie detector tests "work." The same logic underlying medieval judicial ordeals and Liberian sassywood thus permits American law enforcement officials to access relevant parties' private information through the administration of polygraphs, even though that information cannot be directly used by courts to find fact. Given citizens' false belief, taking a lie detector test has different expected costs for liars and truth-tellers. Anticipating that the polygraph will "out" them, the former are more likely to decline the polygraph than the latter. The choices people make when confronted with the specter of taking a lie detector test therefore reveal something—if only a vague something—about their private information to the polygraph administrators, who may interpret the results to comport with what they learned, much as the medieval priest interpreted whether the ordeal-taker's arm had burned. In this sense, you might say ordeals were like medieval lie detector tests, or rather, lie detector tests are like modern-day ordeals.

What I've called "bullshit" throughout my discussion might be more generously characterized as something like an "institutional placebo effect." The effectiveness of political-economic institutions—constitutional, judicial, or otherwise—depends not necessarily, or at least not exclusively, on their realities but rather on people's beliefs about them. False beliefs can be tremendously productive in this regard, and while there is also potential danger inherent in such beliefs, I doubt social order can do without them. Besides, "In a world where political institutions were 'optimal' in some sense"—and in a world of rational maximizers, surely they are—"what useful purpose would it serve to destroy popular illusions about those institutions?" (Brennan and Buchanan 1988, p. 186).

Acknowledgements I thank Solomon Stein for sharing the letters from Buchanan's archives that motivate this chapter. My discussion draws on previous work in Leeson (2012a, 2012b, 2017), Leeson and Coyne (2012), and Leeson and Suarez (2015).

References

Beard, C. A. (1913). *An Economic Interpretation of the Constitution of the United States*. New York: Macmillan.

Brennan, G., & Buchanan, J. M. (1988). Is Public Choice Immoral? The Case for the 'Nobel' Lie. *Virginia Law Review, 74,* 179–189.

Brennan, G., & Buchanan, J. M. (2000). *The Reason of Rules: Constitutional Political Economy*. Indianapolis: Liberty Fund.

Brennan, G., & Munger, M. (2014). The Soul of James Buchanan? *Independent Review, 18,* 331–342.

Buchanan, J. M. (1970). The 'Social' Efficiency of Education. *Il Politico, 35,* 653–662.

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

Buchanan, J. M. (1988). This Week's Citation Classic. *Current Contents, 2,* 16.

Buchanan, J. M., & Tullock, G. (1962). *The Calculus of Consent: Logical Foundations of Constitutional Democracy*. Ann Arbor: University of Michigan Press.

Leeson, P. T. (2012a). Ordeals. *Journal of Law and Economics, 55*, 691–714.
Leeson, P. T. (2012b). An Austrian Approach to Law and Economics, with Special Reference to Superstition. *Review of Austrian Economics, 25*, 185–198.
Leeson, P. T. (2014). *Anarchy Unbound: Why Self-Governance Works Better Than You Think*. Cambridge: Cambridge University Press.
Leeson, P. T. (2017). *WTF?! An Economic Tour of the Weird*. Stanford: Stanford University Press.
Leeson, P. T., & Coyne, C. J. (2012). Sassywood. *Journal of Comparative Economics, 40,* 608–620.
Leeson, P. T., & Suarez, P. A. (2015). Superstition and Self-Governance. *Advances in Austrian Economics, 19,* 57–66.
McGuire, R. A. (2003). *To Form a More Perfect Union: A New Economic Interpretation of the United States Constitution*. New York: Oxford University Press.
Plato. (1991). *The Republic: The Complete and Unabridged Jowett Translation* (B. Jowett, trans.). New York: Vintage Books.
Tullock, G. (1987). The *Calculus*: Postscript After 25 Years. *Cato Journal, 7,* 313–321.
Wagner, R. E. (1987). Courts, Legislatures, and Constitutional Maintenance. *Cato Journal, 7,* 323–329.

21

Groups, Sorting, and Inequality in Constitutional Political Economy

Jayme S. Lemke

Introduction

This essay is about groups. The study of collective action is in many ways about *choosing within* groups, and how complicated that can be, and figuring out the circumstances under which this choosing can be productive rather than perverse. When choosing within groups goes well, those groups are able to effectively resolve problems for themselves that might otherwise be considered insoluble without the use of force or external intervention (Buchanan and Tullock 1999 [1962]; Ostrom 1990). When choosing within groups goes poorly, the groups become plagued with free-riding, rent-seeking, and oppressive power relationships. This much is fairly straightforward, standard fare for public choice theorists and constitutional political economists.

J. S. Lemke (✉)
Mercatus Center, George Mason University, Fairfax, VA, USA
e-mail: jlemke@mercatus.gmu.edu

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_21

Conversations about groups are more controversial when instead of focusing on *choosing within*, the discussion turns to the matter of how a group's actions affect the welfare and opportunities of outsiders. Many theorists of constitutional politics consider the efficacy, legitimacy, and welfare implications of a system of rules to be a function of the process by which the rules were created. Generally, constitutional processes involving high degrees of participation and consent are expected to generate rules that will be socially beneficial for the group. However, the expected impact of voluntary constitutional processes on those living outside the constitutional group is significantly less settled. Even the most enlightened, democratic, internally well-functioning group could potentially make decisions that generate negative externalities for those whose well-being is not incorporated into their internal decision-making calculus. Of course, they may generate positive externalities as well, and this should be kept in mind when engaging in comparative analysis about different types of groups and the rules governing group formation.

Concerns about the way that the collective activities of one group might affect the well-being of others are often expressed as concerns about inequality. These concerns about inequalities between heterogeneous groups are considered to be particularly serious in the presence of one or both of the following aggravating circumstances. First, externalities among groups are considered a more serious matter of concern when those groups are formed in ways that make it difficult for individuals to join or exit, such as when groups are formed using criteria such as race, nationality, gender, religion, or social caste. Depending on the context, entering or exiting such groups can potentially be quite high cost. At higher costs of entry and exit, the individual group member's ability to use the threat of exit as a negotiation tactic within the group will be lessened, and there is a greater possibility of both oppression and enduring segregation. Second, externalities among groups are considered to be more potentially harmful when groups are competing amongst each other for resources from a common pool. To the extent that the system in question is indeed a zero sum game, in which one groups' access to resources for public education, infrastructure spending, or policing diminishes others' ability to access the same, then in a world of differential political power, it's not hard to imagine one group suffering at the hands of another.

The constitutional political economy framework as developed by James Buchanan, Gordon Tullock, Elinor Ostrom, Vincent Ostrom, Richard Wagner, and others is critically important for understanding the debates over the desirability of systems within which individuals are free to sort themselves into groups. The constitutional political economy approach emphasizes the importance of understanding the rules of the game that individuals and groups face when attempting to resolve problems of intergroup externalities. Since the rules of the political game shape both the process and the outcomes expected from intergroup negotiation, understanding those rules is critical to being able to identify the conditions under which heterogeneous groups will be able to effectively resolve problems of intergroup externalities. The area in which this subject has been most thoroughly explored is through analysis of the functioning and efficiency of political systems that have heterogeneous decision-making subunits as well as open mobility into and out of those subunits, such as the American federal system (Buchanan 1950, 1952; Buchanan and Tullock 1999 [1962]; Ostrom 1991; Wagner 1976).

Government in the United States is a complex network of overlapping jurisdictions that includes federal, state, and local governments as well as a wide variety of other special jurisdictions, large and small (Ostrom et al. 1961). As such, all questions related to public endeavors within the United States are at some level a matter of many heterogenous groups bumping up against each other, sometimes competing over resources, and facing the difficulty of having to negotiate with other groups in situations where the choices of one jurisdiction impact the welfare of citizens in another. One example of a public endeavor where the complexity of the political arrangements involved is particularly apparent, and where contests between groups over resources can be particularly contentious, is the matter of public education.

An important constitutional question within the arena of public education is that of the extent to which voucher systems, privatization of education, and other proposals designed to introduce entry, exit, and voluntary group formation should be admitted into publicly supported education systems. Both sides of the debate recognize that the actions of groups impact outsiders. Those in favor of introducing choice into local public economies generally argue from the perspective of the efficiency-enhancing properties of market competition (Friedman 1997; Friedman and Friedman 1990; Hoxby 2003; Sandstrom and Bergstrom 2005). Those against are more concerned with the possibility that allowing choice may contribute to segregation and the impoverishment of already underperforming education systems (Bifulco and Ladd 2007; Ladd 2002; Saporito 2003; Valenzuela et al. 2014). Similar dynamics are relevant for other, broader versions of this argument, such as those that propose the redesign of political systems in ways that incorporate significantly greater choice over membership and exit (Kukathas 2003; Leeson 2014; Powell and Stringham 2009). In all cases, the approach of James Buchanan and other constitutional political economists has a great deal to contribute.

In this essay, I explore insights from constitutional political economy for the concern that the voluntary group formation and processes of sorting into groups could generate or exacerbate inequality in harmful ways. The essay proceeds as follows. In section two, I present the argument for why choice in group membership is welfare-enhancing in political contexts. In section three, I present some criticisms that have been levied against the way that groups and group formation are treated in public choice and constitutional political economy. Both the 'pro' and 'con' side of the voluntary group membership debate are illustrated through reference to the literature on choice within the K-12 educational system, an example chosen because it highlights the contentious nature of the theoretical concept of voluntary group membership. In section four, I discuss Jim Buchanan's treatment of mobility and intergroup externalities, exploring how insights from constitutional political economy can help us better understand this set of questions. Section five concludes.

Arguments for Mobility and Voluntary Selection of Groups

The fact that sorting by preference will occur in a political system that permits choice among jurisdictions is not disputed by those who argue either for or against such systems. The point of disagreement is about whether such sorting is a beneficial feature of the system or a dangerous flaw. The argument in favor of sorting goes something like this:

Coming to political agreement is hard, and political negotiation is rife with opportunities for one set of interests to come to dominate in a way that causes serious harm for those with other interests. This was the concern that the author of Federalist 51 had in mind when he wrote, “It is of great importance in a republic not only to guard the society against the oppression of its rulers, but to guard one part of the society against the injustice of the other part” (“Federalist Papers” 1788). This injustice could take the form of either a tyrannical majority, imposing its will on the underrepresented minority, or an effective special interest group successfully marshalling political power for its particular ends. One way to safeguard against either of these possibilities is to create a system of constitutional rules that impose limits on political authority and balance the power of different groups within those limits. Such was the nature of the inquiry posed by Jim Buchanan and Gordon Tullock in *The Calculus of Consent: Logical Foundations of Constitutional Democracy* (1999 [1962]).

One way to mitigate the problem of negotiation across diverse populations is to engage in collective action within a group that is (1) smaller and (2) shares a more uniform set of interests. All else constant, reducing the size of a group can simplify negotiation. Compare deciding where to go for dinner in a group of four versus a group of twenty-five. Even with a group of only twenty-five, the options available for resolving the problem without incurring an excessively high cost become limited. However, even in the group of four, the greater the divergence in preferences, the more difficult it will be to find a restaurant that will satisfy the preferences of all or even most of the members of the group. If one of your dinner companions is on the Atkins diet, and the other objects to even being in a restaurant that serves meat on ethical grounds, you’re not likely to come to an acceptable solution in even the smallest group.

One solution to this problem is to abandon the original group entirely, and instead operate on the principle that if there is a collective goal to be accomplished, everybody is going to have to find their own subset of people who both share the same collective goal and find a similar set of solutions to be acceptable. This is one way of describing Buchanan's (1965) theory of clubs. Clubs are an alternative means of organizing a group of people for the accomplishment of a collective goal when both comprehensive, society-wide collective action and atomistic individual action are either infeasible or too costly. Within a club, membership is voluntary, so those in charge of making and enforcing group decisions can't get away with taking an action that would be repugnant to too many of the members. If the club consistently acts in a way that is against an individual's interests, that individual can simply leave. In this way, collective action problems are resolved in a way that can be confirmed to have generated effects that the members of the group consider to be positive on net. This is a meaningful market test, and the jurisdictional competition that takes place within such systems can generate something of a market-like tendency towards the efficient provision of public services.

Perhaps *the* canonical treatment of this issue within economics is Charles Tiebout's 1956 article, "A Pure Theory of Public Expenditures." Tiebout (1956) offers a theory of competition between local governments within which individual political units operate much like individual firms in a perfectly competitive market. Under conditions of perfect knowledge and costless mobility, with large numbers of generally homogenous communities to choose between, local governments are expected to adjust their taxation and public goods bundles to attract or repel residents according to whether an increase in population will increase or decrease the average cost of public goods provision. In this model, market equilibration occurs as residents seamlessly arrange themselves into jurisdictions of optimal size, resulting in the efficient production of local public goods. Even in this highly stylized model, the impetus that generates the beneficial properties expected from Tiebout sorting are the individuals who "vote with their feet," choosing their communities for themselves (to the extent that the jurisdictions described by Tiebout can be considered to be things resembling actual communities).

Although Tiebout (1956) has been criticized for being inadequately realistic, the general idea that choice in politics can be an effective disciplining force has been widely accepted within economics.

This is particularly true when one adds the caveat that jurisdictional competition is best conceived as an imperfect analog of market competition rather than an example of a perfectly competitive market at work (Easterbrook 1983; Epple and Zelenitz 1981). Wagner (2011) contrasts the Tiebout framework with a Wagnerian framework that approaches interactions between political units as institutionally complex matters. These alternative frameworks have different epistemic properties and therefore different implications for understanding the interactions between individuals and groups in settings of political competition. Competition in the public sector does not always and cannot be expected to benefit the citizen in the same way that competition in the marketplace will benefit the consumer (Boettke et al. 2011). How political competition plays out depends on whether the game being played will reward the decisions makers of a political group for their efficiency and justness, or if the better path to reward is less wholesome (Lemke 2018).

An important feature that differentiates Buchanan's (1965) theory of clubs from Tiebout's (1956) theory of sorting across competitive municipalities sorting is the significance of residual claimancy. Although the theory of clubs derives its efficiency properties from a different set of conditions, particularly through placing emphasis on the residual claimancy of those in positions of decision making authority, it shares the characteristic of depending upon individuals being able to choose their own group memberships (Leeson 2011). Similarly, there is a related contemporary literature that places a high priority on individual self-selection into groups as the way—sometimes the only way—that collective action can generate results that can be known to benefit the entirety of the group and explores how systems founded entirely upon this principle might operate (Kukathas 2003; Leeson 2014; Powell and Stringham 2009).

In these analyses, the voluntary nature of participation in a group or community is the critical feature that disciplines political decision makers and ensures that they provide public services in a manner which in any way satisfies the needs of the members of the community. The fact that individuals voluntarily chose to join the community is how the observer knows that the actions of the group are valued by the community, or at least considered preferable to no group action at all. This is the heart of why mobility and self-sorting into community is appealing to so many economists, particularly those who understand how severe of a challenge political decision makers face when they try to act without getting this kind of feedback from the members of their community.

From this perspective, public education is an example of a system wherein the participants would benefit from increased competition and voluntary group membership. Economists have argued that the introduction of competitive forces into K-12 education through either privatization or public support of something like a school voucher system would improve the quality or lower the cost of education, or both (Friedman 1955, 1997; Friedman and Friedman 1990; Hoxby 2003). The basic logic of the proposal is that although education has the potential to generate important public benefits, school administrators and public school teachers receive little market feedback on whether or not the education they provide is actually. Instead, education is evaluated primarily on a set of bureaucratic criteria—such as standardized test performance—that may or may not align with a student's educational goals. This is particularly problematic when students are assigned to school based on geography rather than on their own unique goals and educational needs. If students were instead allowed to choose between a range of educational options, not only would the innovation of new educational options be likely to emerge, but the competitive dynamics introduced would also hold school administrators to a higher degree of accountability regarding their school's performance than is currently common. So, by introducing choice into the system, we introduce the possibility of beneficial adaptations as teachers and administrators respond to the choices made by students and parents.

As we will see in the next section, there is no guarantee that a particular school choice system will generate these positive effects. Instead, the rules governing group membership—including when new groups can be created, who is allowed to join, and the types of political restrictions their activities will be subject to—all matter for the extent to which choice and voluntary group membership can generate beneficial, market-like outcomes.

Critics of Mobility and Voluntary Selection of Groups

The picture of mobility and group sorting painted in the section above is not universally appealing. For many, the competitive systems described above open the door to segregation, inequality, and differential political privilege. Their argument goes something like this:

In practice, in the 'real world,' voluntary can mean a range of things. What is and is not coercive is not always a matter of universal agreement, and sometimes society considers a person to be a member of a group regardless of that individual's preferences or perspective. Could a person of color have forfeited that particular group membership in Alabama in 1950? Not likely. Further, even if all would agree that membership in a particular group is genuinely voluntary, just because something is optional does not mean it is not extraordinarily costly. For example, a recent scandal within the Church of Jesus Christ of Latter Day Saints has brought to light an apparent pattern of Mormon bishops counseling abused women to stay with their abusive husbands lest they risk destroying their lives and the lives of their children.[1] These women voluntarily entered marriages, and voluntarily embraced religious tenets, but now exiting either comes only at extraordinary cost.

This issue of non-voluntary group memberships and prohibitive exit costs becomes most problematic from an efficiency or well-being perspective when (1) groups have the means to impose meaningful externalities upon each other, which is particularly prevalent when groups have conflict over resources in a zero sum context, such as a common fiscal pool and (2) the overarching system of rules within which groups negotiate with each over those shared resources either obfuscates peaceful agreement or permits some groups to enjoy differential political power over others. When these two factors are both present—i.e.,

[1]See, for example, Jana Reiss, "Commentary: Mormon church needs to train bishops better — and teach them that most domestic violence reports turn out to be true." *Salt Lake Tribune,* February 13, 2018. Online at https://www.sltrib.com/religion/local/2018/02/12/commentary-rob-porter-case-shows-mormon-church-needs-to-train-bishops-better-and-teach-them-that-most-domestic-violence-reports-turn-out-to-be-true/.

groups with unequal political power are in competition over common resource pools—the concern emerges that self-selection into groups, clubs, or communities could potentially exacerbate inequality.

The inequality of concern here is that some groups will have greater access to public resources than others, and that this public support will translate into greater options and opportunities in life. Further, so long as political power continues to be shared across groups unequally, the fact that some groups will have greater access to opportunities than others can potentially have a self-reinforcing effect, in which political power secures personal advantage which is then used to secure further political power. One way this concern has shown up in the existing literature on political competition is in the debate on whether competition between political jurisdictions will lead to legal changes that particularly favor those who are relatively wealthy and mobile, including through the efforts of state legislatures to attract business by maintaining the lowest regulatory burden (Baysinger and Butler 1985; Cary 1974; McGuire 1997).[2] To the extent that concerns about this "race to the bottom" rely on the presumption that stronger regulation of business will benefit members of the community who are relatively less wealthy and mobile, they make an empirical claim which requires further validation in order to prove in this specific case. However, the general concern that there may be political rules in place that allow groups to impose externalities on each other, and that there are circumstances in which those externalities may systematically advantage some groups of people at the expense of others, cannot be so easily dismissed.

Public education is another context within which questions have been raised over the potential for problematic inequality in the distributions of public resources. Of particular relevance here is the concern that allowing parents and children to voluntarily choose among a variety of schools, or even school districts, might either lead to or reinforce patterns of segregation. The literature on the extent to which permitting

[2]Oates and Schwab (1988) counter this line of argumentation by contending that a focus on attracting capital will raise wages for all residents of the jurisdiction, so even if incentives are focused on the wealthy the consequence will not be an allocation of public goods distorted in favor of the wealthy.

choice within K-12 education systems will increase segregation along racial lines has been motivated in part by Thomas Schelling's model of dynamic segregation, in which even minor discriminatory preferences, meaning any "awareness, conscious or unconscious, or sex or age or religion or color or whatever the basis of segregation is… that influences decisions on where to live, whom to sit by, what occupation to join or to avoid, whom to play with or whom to talk to" can result in patterns of widespread segregation (Schelling 1971, p. 144). For example, Schelling gives the example of the seemingly innocuous matter of whether one attends Methodist or Baptist religious services as a discriminatory preference that can contribute to voluntary but systemic patterns of racial segregation.

Saporito (2003) finds support for the Schelling hypothesis in his study of a magnet school program introduced by the city of Philadelphia in 1990. The city of Philadelphia designed the magnet school program in an attempt to create an educational environment that was less segregated than the pattern that which had emerged from assigning students to schools based on the geographic location of their residence. Saporito finds that the higher the percentage of nonwhites in a particular pre-existing school, the more likely the white students attending that school are to apply to transfer to a magnet program. This pattern does not hold for the nonwhite students, whose decision as to whether or not to apply for the magnet program do not seem to vary based on the racial composition of their current school (Saporito 2003, p. 192). Consequently, although the magnet schools themselves are less racially segregated than Philadelphia's pre-existing neighborhood schools, exit from the neighborhood schools occurred in such a way that they became significantly more racially homogenous, undercutting the intended objective of a more racially heterogenous educational environment (Saporito 2003, pp. 194–197).

A more recent study that looks at the entirety of Pennsylvania's charter school system from 2008 to 2012 finds that African American and Hispanic students who opted into charter schools tended to choose more racially homogeneous environments, as did white students living in urban areas (Kotok et al. 2017). Similarly, Bifulco and Ladd (2007) find that when charter schools are introduced in North Carolina, students who enroll are most likely to wind up in a school that is more racially homogeneous than the one they left. A study that looks at areas with high concentrations of charter schools across the country finds that charter schools tend to be more racially isolated (Frankenberg et al. 2011). Outside the US, Chile has introduced a relatively strong degree of choice into their primary and secondary school systems. Valenzuela et al. (2014) find that over time, individuals have made choices that have led to greater degrees of socio-economic segregation across schools in Chile.

This is a particularly complicated issue in the American context because of the extent to which public schools have been superimposed on communities where there are pre-existing patterns of geographic segregation. Up through the 1960s, segregated housing was both common and supported by a variety of policies and practices, including the construction of segregated public housing, the enforcement of zoning laws that incorporated racial requirements in both de jure and de facto ways, and federal loan programs that encouraged settlement into racially homogenous communities (Rothstein 2017). Although these policies have been considered unconstitutional for 50 years, it is unlikely that the patterns they have generated could possibly unravel in so short a period of time, and even less likely to expect the preferences that such policies not only enabled but encouraged to have disappeared.

How it is that particular combinations of laws and preferences could generate patterns of segregation is a question that students of constitutional political economy have good reason to address for at least two reasons. First, constitutional political economy is a very useful mode of theorizing for determining how particular sets of rules are likely to shape behavior. To the extent that a primary goal of public education is to ensure that all children have equal educational opportunities, often with the added corollary that there is some correlation between educational opportunity and other forms of opportunity, constitutional political economy can help to identify the extent to which the rules that govern the use of public educational resources are consistent with that goal. Second, an important and difficult question within political economy is that of identifying the conditions under which people will be most likely to negotiate the peaceful resolution of common problems without need for recourse to imposition and violence. Although more homogeneous groups likely have an easier time making decisions amongst themselves, might there be long run consequences to individuals living for too long in circumstances where there is no need to come to peaceful agreement with anybody who holds substantially different opinions? If this is a possibility, then the extent to which a school system contains diversity and diversity of opinion may be an important determinant of how well the students it educates will be able to go on to successfully participate in democratic processes and the resolution of other common local problems.

Buchanan on Self-Sorting

Both the example of choice within public educational systems and the larger issue it is intended to illuminate—specifically, the question of when the consequences of group choice within political systems can be expected to have positive outcomes, and when choice might instead have problematic secondary consequences—is a significant unresolved tension in the economic approach to the study of political processes. In order to begin to identify ways in which this tension can be productively explored, this section will highlight some potentially relevant ideas from Jim Buchanan and other collaborators from within the field of constitutional political economy.

Constitutional political economists have never ignored the group choice problem. The reality that political problems will be more difficult to resolve the greater the diversity of interests within the negotiating population has been acknowledged since the creation of the research program. Most if not all political problems will be easier to resolve within a group that can easily agree on what the most desirable outcome will be, how it can be achieved, and whether or not the solution is worth the cost. Buchanan and Tullock emphasize that the logic of their system holds only when individuals approach the constitutional process as equals, which means that it can be difficult to even get to the starting place:

> Therefore, our analysis of the constitution-making process has little relevance for a society that is characterized by a *sharp cleavage* of the population into distinguishable social classes or separate racial, religious, or ethnic groupings sufficient to encourage the formation of predictable political coalitions and in which one of these coalitions has a clearly advantageous position at the constitutional stage. (1999 [1962], p. 81, emphasis added)

Exactly how little relevance do they have in mind, and how sharp must the cleavage be before the constitutional logic outlined in Buchanan and Tullock (1999 [1962]) fails to hold? If their constitutional logic depends on any sort of Harrison Bergeron-like degree of extreme conformity, then it would be nothing more than an exercise in science fiction. However, the insights generated by constitutional political economy do seem to offer reasonable explanations of why people engage in particular types of collective action. For example, the idea that individuals will scale collective action according to the net costs of alternative possible governing arrangements seems to offer good justification for why most communities make decisions about how to fund local schools at the township or city level, and decisions about the size of the standing military at the national level. One of the questions that can hopefully be resolved by more careful inquiry into the matter of self-sorting within political systems is exactly how far this applicability extends, and how different degrees or types of social cleavage might necessitate adjustments in the analysis.

Fortunately from an analytical perspective, Buchanan and other constitutional political economists have developed a variety of useful tools for the purpose of better understanding situations in which individual actions impose externalities on others, and for the way in which individuals can negotiate to resolve those externalities. The point of exploring these analytical tools is not to work around or to find a theoretically ideal solution to the difficulties that have been raised with respect to voluntary group membership within democratic political systems. Rather, the purpose is to take those concerns seriously, and to develop a better understanding of the conditions under which voluntary sorting will be productive and efficiency-enhancing, and conversely, the conditions under which voluntary sorting will exacerbate the destructive or pathological features of a political system.

To begin, it's worth acknowledging some concerns about the logic of competitive local government that have been expressed by Buchanan and others. Despite the perceived similarity to his own theory of clubs (1965), Buchanan had some serious concerns about the way the efficiency properties of Tiebout's neoclassical model of competitive local jurisdictions were being interpreted (Boettke and Marciano 2017). An important condition of Tiebout's model is that "The public services supplied exhibit no external economies or diseconomies between communities" (Tiebout 1956, p. 419). Tiebout does address the possibility of externalities by citing violence and contagious disease as having obvious spillover potential, but the solution proffered is to either centralize—simply abandon local organization in order to eliminate the externality—or for local groups to arrange themselves such that they are adjacent to the communities that are most similar to their own in order to minimize spillovers (Tiebout 1956, p. 423). These solutions extrapolate away from the problem of groups making decisions that damage their neighbors rather than pursue meaningful solutions.[3]

Buchanan and Goetz (1972, p. 25) argue that "there remain inherent inefficiencies in the Tiebout adjustment process, even when this is interpreted in a conceptually idealized form. Specifically, we neglect (1) the problems of fiscal spillovers among local communities and (2) all problems of discreteness that locational groupings almost necessarily introduce." Specifically, they are concerned with the fact that it is possible even in the most idealized form of the Tiebout model to generate scenarios in which those who are wealthier will cluster together, or for individuals to cluster together in areas with higher private returns or larger public benefits. Either way, the outcome is an equilibrium in which some communities will have access to either greater private or public benefits (or both), and an incentive to discourage individuals from less wealthy areas from sharing in those gains.

[3]However, Wagner (1976) suggests that solutions such as that proposed in Buchanan (1965) are primarily exercises in adjusting the boundaries within which collective action takes place to an appropriate scale. In this sense, Buchanan does not do much better in terms of solving rather than avoiding the problem, at least not in this initial treatment.

Buchanan's concern that divisions within a larger fiscal unit admit the opportunity for inequality and expropriation goes all the way back to his discussion of "fiscal equity," a topic he began writing on as a graduate student in the 1940s (Boettke and Marciano 2017, p. 212). Buchanan (1950) takes an institutional approach to understanding the relationship between different associations operating within the same system, using state governments within the United States as an example. As the productivity of American industry began to increase over the nineteenth century, greater inequalities in wealth emerged, both between individuals and between different states. He suggests that two factors contributed to this inequality becoming a source of political discord: (1) the Federal government's demand for revenue increased along with the scale of its operation, opening the question of where that revenue would come from given the unequal distribution of wealth across the states, and (2) the direction of federal funding towards social services that were designed to benefit all equally highlighted the fact that this would be easier for some states to afford than others (Buchanan 1950, pp. 584–585). In short, inequality becomes politically contentious when groups—in this case, states—endeavor to make economic decisions jointly rather than separately.

Another important insight that emerges from Buchanan (1950, p. 588) is the idea that "equal fiscal treatment" is a matter of not just taxation, but of the public services provided in return, and that these factors will influence geographic sorting. Equal taxation is not equal treatment if one area enjoys a greater level of services than another. If the residents of a community are being taxed at a level that exceeds the benefits of public services, then their relationship with the "fisc" will be negative and they will have an incentive to move to an area that receives better fiscal treatment. Significantly, in the treatment in Buchanan (1950), a lower income area will always have worse fiscal treatment than a higher income area, because all else held constant, the lower income jurisdiction only has two choices: (1) provide the same level of public services as their neighbors by taxing more, or (2) tax the same but provide a lower level of public services. Consequently, in an institutional structure within which subgroups such as states make economic decisions jointly, the provision of public services itself creates an incentive for individuals to move from low income to high income areas. This is in addition to other incentives that might attract individuals to high income areas, such as greater job potential, safer communities, or whatever other factors might have caused or been created by that community's wealth. Using this logic, the "policy objective for intergovernmental transfers then becomes one, reduced to individual terms, of providing or ensuring "equal fiscal treatment for equals." If this objective is attained, the individual's place of residence will no longer have a significant effect upon his fiscal position" (Buchanan 1950, p. 591). This policy solution ameliorates the incentive for individuals to flee from low income to high income areas because of their fiscal treatment, thus slowing down one of the forces driving inequality across groups.

The extent to which Buchanan wrote about the potential efficiency benefits of intragovernmental transfers might surprise some who are most familiar with those aspects of his work that emphasize the difficulty and importance of constraining the state. (Although, even in these works, he rarely gets too specific about declaring particular policies out of bounds, so long as a group of free individuals can agree on their benefits.) In a later article on the use of federal powers to transfer resources between states in order to prevent patterns of mobility that might further impoverish areas that are already less well off, he writes:

> No one has come forward with a proposal to tax the low-income agricultural laborers of the cotton-growing South at a much heavier rate than their "equals" elsewhere in order to provide them with an added incentive to move off farms into industry. Nor has anyone suggested that the proper solution to the whole problem of distressed and blighted areas is the severe and discriminatory taxation of residents to force desired out-migration. Yet the support of such seemingly harsh and oppressive measures is similar to objecting to interarea income transfers solely on "allocative" grounds. (Buchanan 1952, p. 217)

This early treatment is effectively an example of making an adjustment to the constitutional rules within which externality-generating fiscal decisions are made. By adjusting the constitutional rules in a way that reduces the generation of externalities, Buchanan proposes a way to think about addressing any social conflicts arising from mobility and voluntary sorting by a means other than centralization through the dissolution of local units. This particular solution, however, does require a centralized apparatus capable of designing and implementing the sequence of corrective intergovernmental transfers. The major unresolved difficulty in this proposal is whether the centralized apparatus could be designed in such a way that would insulate it from rent-seeking on the behalf of the individual subgroups, or from becoming dominated by monopolistic rather than competitive patterns of behavior (Wagner and Weber 1975).

This perspective seems to be in the same spirit as Wagner (1976, p. 110), which posits that "the economic analysis of urban government should become less "neo-classical" and more "institutionalist" because optimality models can never be related to social *reality independently of the institutional framework within which collective choices emerge*." From this institutional perspective, *of course* we don't see the kind of efficiency that the Tiebout model or even the theory of clubs predicts when we turn to examining issues of mobility and social sorting in the real world. These are models that describe one extremely specific and rarely observed institutional configuration. When applied to behavior in the real world, voluntary sorting through mobility and then taking political action in the groups formed by that process is going to take place in a wide array of different institutional contexts. Identifying the predicted effects of sorting through geographic mobility, and whether they will be welfare-enhancing or contribute to the pathologies of the existing institutional system, is a question that requires a unique answer according to the circumstances of the case in question.

Buchanan and Nutter (1959) directly addresses the topic of introducing choice into public education. They argue that "The case for universal education is self-evident: a democracy cannot function without an informed and educated citizenry," and further, "It is equally clear that there must be collective financing of universal education, for some parents will not be able to afford the minimum quality of education prescribed by government for their children" (1959, pp. 2–3). However, consistent with the approach later outlined in Buchanan and Tullock (1962), the most important question is not whether there would be some benefit to solving a public problem, but rather, whether or not there is a solution to the problem that will secure sufficient benefits to justify its cost. Further, if there are multiple types of public education that would generate net social benefits, the task of a democracy is to deliberate over which of these is likely to secure the greatest net benefit to society. In this spirit, Buchanan and Nutter argue that the question of how the public is to provide the necessary support for education is a question of comparative institutional analysis:

> There is no single set of institutions uniquely required to fulfill the objectives of universal education. For example, our present system of what are called "public schools" is but one method of organizing universal schooling. There are a number of alternative systems, each as good as the other in certain basic respects, but all differing from each other in other respects. The problem is to find the system with the largest number of desirable characteristics and the smallest number of undesirable ones. (Buchanan and Nutter 1959, p. 4).

Buchanan and Nutter (1959, p. 5) observe that even if education is to be financed by the state, it need not be provided by the state. Instead, a system within which funding is provided by the state but schools operated on a private basis, with parents and children free to choose among a range of diverse offerings, is an alternative arrangement for accomplishing roughly the same objectives. The primary advantage to this institutional alternative is that if a greater diversity of educational forms are attempted, then not only will students have more options from which to choose, but the process of experimentation can potentially reveal better ways forward. Further, "Competition, wherever it can and does operate, is the machine of efficiency… And just as the producer of the outmoded mousetrap is forced to make the better one or go out of business, so the proprietors of inefficient schools will be forced to imitate the better ones, unless they have a monopolistic position in a community" (Buchanan and Nutter 1959, pp. 8–9). In short, the arguments offered in this piece are standard economic arguments offered in favor of competition over the provision of local public goods. Under an institutional system in which educators are rewarded for better educating students, as observed through voluntary continued attendance rather than mandatory enrollment, higher quality and lower cost education are the expected result.

The more controversial element of the argument is its relationship to the social tension in the 1950s over the Supreme Court's decision in *Brown v. Board of Education of Topeka,* which declared segregation of public schools to be unconstitutional, and the various methods proposed for undoing the existing system (Fleur and Marciano, unpublished). Although most of the treatment remains at the level of pointing out alternative institutional arrangements and explaining how competition would function if there were choice in education, Buchanan and Nutter (1959, p. 1) do state up front that "We believe every individual should be free to associate with persons of his own choosing. We therefore disapprove of both involuntary (or coercive) segregation and involuntary integration."[4] The complexity of the particular policies being discussed is such that I will not attempt to offer a comprehensive statement of them here, other than to note that the rejection of all instances of coercion is consistent with Buchanan's general commitment to preferring democratic consensus to the use of force and to considering the evaluation of an individual's objectives as being either good or bad as being outside the domain of social science, regardless of ones' personal views on a subject.

The two discussions of intergroup conflict discussed above have in common the fact that it is the system of rules within which the groups interact that determine the likely effects of those interactions. In the case of interactions between richer and poorer states (Buchanan 1950, Buchanan 1952), it is the fact that states with unequal political power are competing over a common pool of resources that leads to the

[4]To the extent that forced integration is objectionable on the grounds that it interferes with free association, then the history of forced segregation is at least as objectionable on ethical grounds, and arguably more so on Buchanan's logic because of the extent to which it exacerbates the kinds of enduring political inequality that Buchanan found so objectionable, e.g. in his argument for the desirability of intergovernmental transfers in contexts of political inequality as discussed above.

potential for poor states to become systematically disadvantaged in the absence of some means of recompense. In the case of tension between different schools and communities over public resources for education, it is the rules governing the direction of educational resources, including the incentive structure faced by the providers of education, that determine whether an educational system will generate outcomes considered to be beneficial by its participants. Buchanan and Nutter (1959) here suggest a way to *get out* of a constitutional commons situation by shifting decision making to local groups and equalizing access to educational resources from the start.

In connecting their discussion about alternative institutional systems for the provision of education to the question of integration, Buchanan and Nutter's treatment suggests that they were not unaware that the institutional arrangement within which education was provided could impact the composition of communities. The implication for the primary question posed in this essay—under what circumstances will the voluntary formation, entry, and exit of political groups be likely to exacerbate harmful forms of inequality—is that whatever answer is provided must by institutional in nature. Although this essay unfortunately offers no opportunity to draw any more specific conclusions, I sincerely hope to draw attention to the importance of the inquiry, and to encourage future research in constitutional political economy on this important question.

Conclusion

The extent to which mobility within federal and other polycentric political systems is and has been a source of tension within constitutional political economy is underappreciated. Economists find it easy to become enamored of anything that resembles a market, forgetting that not all institutions that incorporate elements of competition will also have incentives and constraints that are systemically welfare-enhancing. Jim Buchanan, Richard Wagner, and others working in the constitutional political economy tradition have called attention to this institutional variation, both implicitly and explicitly.

This institutional point has yet to be fully embraced in the conversation about individuals sorting themselves into groups, particularly when that sorting takes place through physically moving from one place to the next. When individuals sort geographically within a political context where taxes, public services, and other important features of political and social life, then public goods and access to political power can become concentrated within the hands of particular groups of people. This type of political inequality is important to recognize for two reasons. First, because of the way it creates the opportunity for oppression of the marginalized group. Second, because history sticks around, and past and current policies that led to patterns of systemic segregation tend to be forgotten as important explanatory variables in the explanation of a variety of forms of inequality in the modern world.

Some may consider James Buchanan and constitutional political economy to be strange guests in the conversation about contemporary problems of segregation and inequality, but their work takes these problems seriously. Their insights are necessary to bridge the gap between idealized normative forms of political economy, and positive forms of analysis capable of explaining the patterns of racial and socioeconomic segregation that are apparent in many parts of the world.

References

Baysinger, B. D., & Butler, H. N. (1985). The Role of Corporate Law in the Theory of the Firm. *The Journal of Law and Economics, 28*(1), 179–191.

Bifulco, R., & Ladd, H. F. (2007). School Choice, Racial Segregation, and Test-Score Gaps: Evidence from North Carolina's Charter School Program. *Journal of Policy Analysis and Management, 26*(1), 31–56.

Boettke, P. J., & Marciano, A. (2017). The Distance Between Buchanan's 'An Economic Theory of Clubs' and Tiebout's 'A Pure Theory of Local Public Expenditures'. New Insights Based on an Unpublished Manuscript. *The European Journal of the History of Economic Thought, 24*(2), 205–237.

Boettke, P. J., Coyne, C. J., & Leeson, P. T. (2011). Quasimarket Failure. *Public Choice, 149*(1–2), 209.

Buchanan, J. M. (1950). Federalism and Fiscal Equity. *The American Economic Review, 40*(4), 583–599.

Buchanan, J. M. (1952). Federal Grants and Resource Allocation. *Journal of Political Economy, 60*(3), 208–217.

Buchanan, J. M. (1965). An Economic Theory of Clubs. *Economica, 32*(125), 1–14.

Buchanan, J. M., & Goetz, C. J. (1972). Efficiency Limits of Fiscal Mobility: An Assessment of the Tiebout Model. *Journal of Public Economics, 1*(1), 25–43.

Buchanan, J. M., & Nutter, G. W. (1959). The Economics of Universal Education. *The Movement in the Archive*. http://civilrights.woodson.virginia.edu/items/show/1225.

Buchanan, J. M., & Tullock, G. ([1962] 1999). *The Collected Works of James M. Buchanan*. Vol. 3 of *The Calculus of Consent, Logical Foundations of Constitutional Democracy.* Indianapolis, IN: Liberty Fund.

Cary, W. L. (1974). Federalism and Corporate Law: Reflections upon Delaware. *The Yale Law Journal, 83*(4), 663–705.

Easterbrook, Frank H. (1983). Antitrust and the Economics of Federalism. *The Journal of Law and Economics, 26*(1), 23–50.

Epple, D., & Zelenitz, A. (1981). The Implications of Competition Among Jurisdictions: Does Tiebout Need Politics? *Journal of Political Economy, 89*(6), 1197–1217.

Fleury, J.-B., & Marciano, A. (Unpublished). *The Making of a Constitutionalist: James Buchanan on Education*. Last Revised, January 29, 2018. Available at SSRN https://ssrn.com/abstract=2994683.

Frankenberg, E., Siegel-Hawley, G., & Wang, J. (2011). Choice Without Equity: Charter School Segregation. *Education Policy Analysis Archives/Archivos Analíticos de Políticas Educativas, 19*, 1–92.

Friedman, M. (1955). The Role of Government in Education. In R. A. Solo (Ed.), *Economics and the Public Interest* (pp. 123–144). New Brunswick, New Jersey: Rutgers University Press.

Friedman, M. (1997). Public Schools: Make Them Private. *Education Economics, 5*(3), 341–344.

Friedman, M., & Friedman, R. (1990). *Free to Choose: A Personal Statement*. Houghton: Mifflin Harcourt.

Hoxby, C. M. (2003). School Choice and School Productivity: Could School Choice Be a Tide That Lifts All Boats?" In C. M. Hoxby (Ed.), *The Economics of School Choice.* Chicago, IL: University of Chicago Press.

Kotok, S., Frankenberg, E., Schafft, K. A., Mann, B. A., & Fuller, E. J. (2017). School Choice, Racial Segregation, and Poverty Concentration: Evidence from Pennsylvania Charter School Transfers. *Educational Policy, 31*(4), 415–447.

Kukathas, C. (2003). *The Liberal Archipelago: A Theory of Diversity and Freedom*. Oxford: Oxford University Press.

Ladd, H. F. (2002). School Vouchers: A Critical View. *Journal of Economic Perspectives, 16*(4), 3–24.

Leeson, P. T. (2011). Government, Clubs, and Constitutions. *Journal of Economic Behavior & Organization, Special Issue on the Work of James Buchanan, 80*(2), 301–308.

Leeson, P. T. (2014). *Anarchy Unbound: Why Self-Governance Works Better Than You Think*. Cambridge: Cambridge University Press.

Lemke, J. S. (2018). A Note on Interpreting Jurisdictional Competition in U.S. History. *Journal of Prices & Markets, 6*(1), 16–22.

McGuire, T. J. (1997). Intergovernmental Fiscal Relations and Social Welfare Policy. *Intergovernmental Fiscal Relations* (pp. 173–198). Recent Economic Thought Series. Dordrecht: Springer.

Oates, W. E., & Schwab, R. M. (1988). Economic Competition among Jurisdictions: Efficiency Enhancing or Distortion Inducing? *Journal of Public Economics, 35*(3), 333–354.

Ostrom, E. (1990). *Governing the Commons*. Cambridge: Cambridge University Press.

Ostrom, V. (1991). *The Meaning of American Federalism: Constituting a Self-Governing Society*. San Francisco: ICS Press.

Ostrom, V., Tiebout, C. M., & Warren, R. (1961). The Organization of Government in Metropolitan Areas: A Theoretical Inquiry. *The American Political Science Review, 55*(4), 831–842.

Powell, B., & Stringham, E. P. (2009). Public Choice and the Economic Analysis of Anarchy: A Survey. *Public Choice, 140*(3–4), 503–538.

Rothstein, R. (2017). *The Color of Law: A Forgotten History of How Our Government Segregated America*. New York, NY: Liveright Publishing Corporation.

Sandström, F. M., & Bergström, F. (2005). School Vouchers in Practice: Competition Will Not Hurt You. *Journal of Public Economics, 89*(2), 351–380.

Saporito, S. (2003). Private Choices, Public Consequences: Magnet School Choice and Segregation by Race and Poverty. *Social Problems, 50*(2), 181–203.

Schelling, T. C. (1971). Dynamic Models of Segregation. *Journal of Mathematical Sociology, 1*(2), 143–186.

The Avalon Project. Federalist Papers No. 51: The Structure of the Government Must Furnish the Proper Checks and Balances Between the Different Departments. Published Friday, February 8, 1788. Available from Yale Law School at http://avalon.law.yale.edu/18th_century/fed51.asp.

Tiebout, C. M. (1956). A Pure Theory of Local Expenditures. *Journal of Political Economy, 64*(5), 416–424.

Valenzuela, J. P., Bellei, C., & de los Ríos, D. (2014). Socioeconomic School Segregation in a Market-Oriented Educational System: The Case of Chile. *Journal of Education Policy, 29*(2), 217–241.

Wagner, R. E. (1976). Institutional Constraints and Local Community Formation. *The American Economic Review, 66*(2), 110–115.

Wagner, R. E. (2011). Municipal Corporations, Economic Calculation, and Political Pricing: Exploring a Theoretical Antinomy. *Public Choice, 149*(1–2), 151.

Wagner, R. E., & Weber, W. E. (1975). Competition, Monopoly, and the Organization of Government in Metropolitan Areas. *The Journal of Law & Economics, 18*(3), 661–684.

Zimmer, R., Gill, B., Booker, K., Lavertu, S., Witte, J. F. (2008). *Do Charter Schools 'Cream Skim' Students and Increase Racial-Ethnic Segregation?* Prepared for School Choice and School Improvement: Research in State, District and Community Contexts, Vanderbilt University. Available at https://www.researchgate.net/publication/266333088_DO_CHARTER_SCHOOLS_CREAM_SKIM_STUDENTS_AND_INCREASE_RACIAL-ETHNIC_SEGREGATION.

22

Votes, Vetoes, Voice, and Exit: Constitutional Protections in the Work of James M. Buchanan and Vincent Ostrom

Roberta Q. Herzberg

The challenge of how democratic societies can reach social decisions, while maintaining as much individual liberty and democratic responsiveness as possible, continues to puzzle constitutional choice scholars and policymakers alike. Over the past 60 years, public choice theory has extended this quest by introducing the logic of economic theory to the exploration of democratic constitutions and rule systems beyond simple majority rule. Two luminaries in the field, James M. Buchanan and Vincent Ostrom, significantly moved understanding of constitutional choice forward. Each recognized the potential advantages associated with collective activity in the political arena. But, they also understood that such processes pose potential risk for individuals. Those charged with governing often serve their own interests at the expense of the broader public. Buchanan and Ostrom sought to answer how democratic societies might design constitutional rules and, further, how those rules would be implemented in the post constitutional period, so as to minimize the

R. Q. Herzberg (✉)
Mercatus Center, George Mason University, Fairfax, VA, USA
e-mail: bherzberg@mercatus.gmu.edu

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_22

risks to individual liberty. They argued that the right mix of constitutional constraints could limit the power of governing officials, while still permitting action for those activities generally approved by the community.

Democratic processes require rules that protect individual's self-governing capacity in the face of many counter pressures such as rent-seeking and free riding that threaten its continued viability (Wagner 2016; Mueller 2003). As a result, Buchanan and Ostrom spent their careers discovering those constitutional arrangements most resilient to the pressures identified by public choice scholarship. In this chapter, I consider how each of these scholars address key protective decision powers within a constitutional setting–voting: the margin needed to select constitutional or social outcomes and who participates; vetoes: the power to protect existing interests against social action; voice: the ability to express one's preferences and engage with others; and exit: the power to leave the choice process—to suggest some of the core similarities and differences in their constitutional theories. It is impossible in this short piece to do justice to the broad scope of work of either Buchanan or Ostrom given the hundreds of papers and books they produced over their long, distinguished careers.[1] Instead, I focus on intersecting arguments that emerged from their work to identify key contributions and tease out the few differences in their approaches to constitutional theory. I conclude by suggesting how their theories clarify what has happened in US Federalism.

Core Assumptions in the Constitutional Theory of Buchanan and Ostrom

As an economist, James M. Buchanan approached the problem of constitutional choice with an assumption of methodological individualism similar to the logic he brought to his economic reasoning. At the heart

[1]For an excellent survey of James Buchanan's political economy, see Richard Wagner (2017), *James M. Buchanan and Liberal Political Economy: A Rational Reconstruction*. Likewise, Aligica and Boettke (2009), *Challenging Institutional Analysis and Development: The Bloomington School* and Aligica (2013), *Institutional Diversity and Political Economy: The Ostroms and Beyond* for important reviews of Vincent Ostrom's scholarship.

of public choice is the recognition that the same humans who operated with self-interest in economic exchange also populated the social choice processes of the political arena; what Buchanan referred to as 'politics without romance'.

> Self-interest, broadly conceived, is recognized to be *a strong motivating force in all human activity*; and human action, if not bounded by ethical or moral restraints, is assumed more naturally to be directed toward the furtherance of individual or private interest. (Buchanan and Tullock 1999, p. 31)

So, when examining the effects of the rules, an assumption of self-interest, with a focus on the individual, seemed his logical starting point. Unlike decisions in the voluntary economic exchange settings, however, when self-interested individuals act within social decisions, they face potential costs from the self-interested actions of others. The proper constitutional design process becomes a way of limiting these costs. As Buchanan notes:

> When persons are modeled as self-interested in politics, as in other aspects of their behavior, the constitutional challenge becomes one of constructing and designing framework institutions or rules that will, to the maximum extent possible, limit the exercise of such interest in exploitative ways and direct such interest to furtherance of the general interest. (Buchanan 2000, p. 23)

He suggested a way of generating constitutional rules that could tame the negative aspects, while still allowing the social energy associated with self-interest. Of course, self-interest did not simply pose a problem at the policy decision stage, it also raised a serious concern for how rules would be formed during the constitutional stage that would create those constraints. What would prevent the self-interest that challenged democratic processes from undermining the constitutional choice process as well? To prevent an endless regress, Buchanan assumes a somewhat different notion of self-interest is possible at the constitutional choice level, an interest with a longer time horizon or greater uncertainty regarding the specific outcomes that would emerge from any single constitution. As Buchanan and Tullock note in Calculus of Consent:

> At the constitutional level, *identifiable* self-interest is not present in terms of external characteristics. The self-interest of the individual participant at this level leads him to take a position as a "representative" or "randomly distributed" participant in the succession of collective choices anticipated. Therefore, he may tend to act, from self-interest, *as if* he were choosing the best set of rules for the social group. Here the purely selfish individual and the purely altruistic individual may be indistinguishable in their behavior. (Buchanan and Tullock 1999, p. 78)

Uncertainty about the particular choices that would present in the future lead self-interested individuals to select decision rules that are similar to general interest. Geoffrey Brennan and Buchanan liken this assumption to John Rawls' use of a veil of ignorance behind which constitutional choice takes place (Brennan and Buchanan 2000, p. 155). In this way, Buchanan's self-interested individuals are capable of choosing binding constitutional rules, despite diverse interest over the outcomes of future social processes.

Ostrom begins with many of these same assumptions regarding individual incentives and institutional links, but he has a distinctly more socially interactive component to his assumed individual interests even beyond the constitutional process. As he argues: "*The use of extreme rationality assumptions runs the risk of stripping away and ignoring essential epistemic features that are constitutive of human affairs*" (Ostrom 1993, p. 167). Ostrom suggests that Buchanan's approach, while an important step in understanding, is too narrow to be fully adequate to capture interests in social choice:

> Homo economicus is an essential variant for understanding human realities, but exclusive reliance on such a conception of man would forego opportunities for trustworthy relationships. There may be institutional arrangements that reinforce patterns of relationships characteristic of sympathy and trust. … I agree with Buchanan that homo economicus

> narrowly construed needs to be understood, but homo economicus narrowly conceptualized is not a sufficient basis for the viability of constitutional democracies into the indefinite future. (Ostrom 2012, p. 429)

Instead of *homo economicus*, Ostrom assumes a notion of self-interest, rightly understood, that is reminiscent of Alexis de Tocqueville's treatment of individuals engaged in self-governing (de Tocqueville 2012 [1840]). Discovering the process by which that Tocquevillian self-interest can be facilitated becomes one of the objectives of Ostrom's constitutional choice design.

Ostrom's focus on how citizens, by working together, can pursue their individual interests through social processes led to a theory of how rules either encouraged or dampened deliberation, discussion, and language within communities. Voice became a critical ingredient in successful democratic decision processes. Individual interests were understood and shaped by the social setting. As he suggests, "the individual level of being not only serves as a 'lens through which we see all others,' but provides the essential ingredient of artisanship from which all cultural forms of being are derived" (Ostrom 1980c).

Understanding came from a notion comparable to Adam Smith's use of sympathy where others interests and preferences become comprehensible only by placing yourself in the other's position (Smith 1985). As Ostrom suggests:

> This method of normative inquiry is a way of making interpersonal comparisons and arriving at rules of reason. Hobbes viewed these rules of reason as accessible to anyone who draws on his or her fundamental resources as a human being, mediated through the use of language, to build shared communities of understanding. Mutual trust is established by performing covenants made. (Ostrom 1997, p. 94)

Ostrom's was not an isolated model of the individual. Instead, an individual uses her knowledge of others to help her understand her own interests and the space available for achieving social agreement with other like individuals.

Other Mechanisms of Democratic Control

Language and culture were critical features for Ostrom as they allowed individuals to discover common interests that would build consensus to get beyond formal, protective decision powers. Potential common interest, however, did not eliminate the continuing temptations faced by individuals in social settings. Preventing individual violations required empowering government with the power to enforce the social agreement. Of course, once that power exists, it raises the issue of how to restrain the governors so that they do not exceed their authority—the true dilemma of constitutional choice. Ostrom described this tension as a Faustian bargain that would require force to produce the desired social results:

> The relationship of individual choice to collective choice and to collective action reveals a Faustian bargain in which it is necessary to have recourse to instruments of evil to achieve the common good in human societies. To make rules binding, criteria grounded in moral distinctions must be enforceable and enforcement may depend upon imposing deprivations [punishment] for failure to conform to rules. (Ostrom 1997, p. 173)

Force is a potential power of any constituted government and when individuals enter into a social arrangement, they recognize they have moved beyond a situation of individual liberty to, at best, a constrained liberty, defined by the constitutional rules. Buchanan recognized this explicitly in his postscript to 'Federalism and Individual Sovereignty' where he explains that social choice implies that individual sovereignty substitutes for individual liberty within the state (Buchanan 2001, vol. 18). With the potential for coercion, the task for Constitutional Choice Theory is to find the set of rules that strengthens government to a point that it can facilitate collective choice (the productive state) and protect individuals (the protective state), while at the same time, avoiding possible abuses such as the imposition of collective choices without support.

A further challenge of overstep through collective punishment is possible whenever individuals lose their own control over decisions to the state apparatus. Even innocents could be caught up by the state, as Ostrom worries:

> Reliance upon collective sanctions implies that sanctions are being exercised against innocent bystanders as well as those who are culpable of wrongdoing. Reliance upon sanctions against collectivities is, thus, contrary to the requirements of justice. Justice can only be done if the prerogatives of government are exercised with reference to individuals; law properly conceived can apply only to individuals. (Ostrom 1997, p. 39)

This is one of the reasons Ostrom argued for the necessity of continually returning to citizens to self-govern. Citizen's individual interests could only be protected, especially as circumstances change, if they retained their individual role as a check on government. As Ostrom notes,

> Constitutional choice is not limited to an act of formulating an original constitution. Rather, constitutional choice is a continuing process through which structures of government can be revised and altered through time. A theory of constitutional choice includes that body of knowledge which enables communities of people to identify problems of institutional weakness and institutional failure and to formulate alternative arrangements that would continue to advance human welfare. (Ostrom 1976, p. 70)

This continuing constitutional process could keep the rules applicable to new social challenges communities may face through learning and adaptation. The key to success for Ostrom was the extent to which the rule system maintained the link to self-governing communities.

Despite Ostrom's insistence on continued self-governing, he defined constitutional choice as a distinct stage of the social choice process, separate from the collective choice process of legislating and the implementation decisions of the operational stage. Each stage could operate under different decision rules, with the constitutional stage often requiring greater consensus. But, constitution making was always a possibility with citizens able to rethink the viability of existing rules in order to provide sufficient ongoing protection. This is somewhat different from Buchanan's sense of constitutional rule making under uncertainty (or behind the veil). Movement back and forth into the constitutional choice stage, as Ostrom conveys, increases the likelihood that citizens would evaluate the rules relative to existing interests. Thus, it could introduce greater potential for the instability that social choice theorists identified. Ostrom argued that the more onerous process required at the constitutional stage would be sufficient to prevent overuse of constitutional change as a policy strategy.

Buchanan's constitutional decision process was assumed to be separate from the narrower day to day democratic interests of citizens. He recognized, however, that leaving the protective role of the state outside the check of politics and democratic input could be problematic, particularly if those charged with exercising those powers acted in their own self-interest as public choice would predict. As he states:

> …persons may feel themselves being forced to abide by terms of a "social contract" never made and subjected to potential punishment by an enforcing agent over whom they exert no control, either directly or indirectly. This alienation of modern man from the protective state is exacerbated when he observes those persons who hold assigned roles in the functioning of this agency themselves to be departing from the rules defined in the status quo, either to aggrandize personal power or to promote subjectively chosen moral and ethical objectives. (Buchanan 2000, p. 123)

Individuals choosing together must weigh where the balance might best be struck. For Ostrom this problem was constant and was made more difficult as decisions rose to larger and larger collectivities. For Buchanan, it remained a continuing tension as he recognized that democratic checks may be the best of the inadequate checks individuals have on a system of self-interested policymakers.

> If they cannot voluntarily withdraw from the game, players on all sides may insist on retaining some power of removing the referee, even when they recognize that this intrusion of player control will, ceteris paribus, introduce inefficiencies. (Buchanan and Tullock 1999, pp. 127–128)

It was critical to find a constitutional structure that would provide adequate protection against the worst abuses, but still permit the voice of individuals to influence the social choices reached. This is the fundamental challenge Buchanan and Ostrom took up in their quest to find a constitutional choice procedure.

Constituting a Protective Democratic System

For Ostrom, Buchanan and Tullock's approach in the Calculus of Consent went a great distance to identify a logic appropriate for exploring different constitutional choice voting rules which could preserve individuals' interests (Ostrom 2012). Theirs is a logic based in the costs imposed by the acts of others. As the decision margin needed to pass social action increases, the risk of being made worse off declines, but the costs associated with building a winning coalition to pass that social choice increases. It is the interaction of the individual interests with others interests, as evaluated by each group member, that permits a calculation of the optimal decision rule for the group as a whole. If imposed costs to individuals are perceived to be very high, rules requiring near unanimity will be justified. In other areas where there are socially preferred alternatives, but the individual costs of losing are relatively small, citizens will accept lower majority margins to avoid expending decision making costs (Buchanan and Tullock 1999).

Such tradeoffs centered on finding the appropriate aggregation rule sufficient to persuade those empowered in the decision setting. Unanimity held a special place, as it provided absolute protection for each participant, but only at a cost. As Buchanan notes:

> A rule of unanimity provides each and every participant with a veto over final outcomes; it places each person in a position where he can bargain bilaterally with all others, treated as a unit. Because of this feature, the costs of agreement under an unanimity rule may be extremely high or even prohibitive. (Buchanan 2000, p. 55)

Such protections were costly, but they prevented the very worst outcomes from an individual's perspective. Such restrictive rules most likely operate in the constitutional setting, as the design of rules that could shape all future decisions pose the greatest future threat. As the margin needed for social choice moved away from individual veto (unanimity), those larger majority margins could still provide protection for minorities and slow the decision process to ensure greater input from diverse interests.

For both Buchanan and Ostrom, it would seem that the best potential protection from the abuses possible in social choice came in a design of voting systems which allowed both vetoes and voice, exercised through formal and informal rules. Votes permitted citizen preferences to be registered formally in periodic elections and decision processes, aggregated under a variety of electoral rules. As the margin required for success increased from simple majority rule to a maximum of unanimity, change required greater consensus providing more protection for existing positions and individual rights. Any constitutional choice process had to weigh the tradeoffs associated with action and inaction in the social arena.

In slowing the process, veto, or even the threat of veto, can provide space for greater deliberation and voice from citizens to build consensus. As Herzberg and Ostrom note:

> Both votes and vetoes are necessary complements to one another as establishing appropriate boundaries to the exercise of human discretion and to create a structure of incentives to search out mutually productive resolutions to joint problems. The way structures become linked together through mechanisms like elections has an important effect upon the rule-ruler-ruled relationship. (Herzberg and Ostrom 2000, p. 169)

Vetoes, in relation to voting mechanisms, become an important constraint to governing overreach by majorities. In an effort to find an acceptable change for any individual or group possessing a veto, members of the majority coalition will have to move the decision outcomes closer to the general interest of individual liberty.

Whenever restrictive decision powers make it difficult to reach collective decisions, the scope and size of the relevant social choice arena comes under consideration. Who forms together in that social setting, and the interests they hold, become critical factors in the likelihood of reaching collective agreement. The larger or more diverse the decision setting, the more difficult it will be to reach collective decisions as costs of finding consensus increase. Buchanan and Ostrom each recognized the relationship between the size (and diversity) of the collective choice setting and, as a result, each argued in favor of federalism as an alternative to large unified collective choice arrangements.

Federalism

Federalism offers three distinct advantages as a constitutional arrangement. First, it permits individual choice as individuals sort themselves across distinct geographic areas. As a result, the challenges posed by the different preferences of others can be minimized with least conflict as people voluntarily choose the others with whom they wish to socially engage. This opens up the logic of exit as a supplementary check on the potential problems associated with governmental authority. Second, federalism permits smaller decision units with greater likelihood of consensus and homogeneity of preferences, but also more likelihood that those preferences can be known by public officials. Finally, federalism permits different levels of government to act as a check on the decisions or acts of the other levels with respect to individual interests.

Exit and Choice: Federalism as Consumer Choice

Buchanan and Ostrom each produced models linked to the competitive fiscal federalism models of Tiebout (1956). So, it is not surprising that we see similarities in the way in which they highlight the consumer choice model of federalism as a low conflict method of resolving individual interest in the collective choice process. Ostrom et al. (1961) examine the relationship between local governance finance and mobility to suggest that citizens vote with their feet to find collective choices consistent with their individual desires for the best tax and service delivery mix. Such analyses reflect the recognition of diverse preferences and the possibility for citizens (by voting with their feet) to accept or reject different social solutions within a single federalist constitutional system. Similarly, Buchanan sees the exit option associated with free movement within a federal system as a critical mechanism for exercising control over the decisions of local policymakers setting tax levels. Of course, to have meaningful choices requires that there be variation in the options made available to citizens across different localities. As Buchanan suggests, this approach can address both external costs and decision-making costs when compared with a more centralized approach:

> If the individual can have available to him several political units organizing the same collective activity, he can take this into account in his locational decisions. This possibility of individual choice among alternative collective units limits both the external costs imposed by collective action and the expected costs of decision-making. (Buchanan 2000, p. 97)

Because it is voluntary, it is consistent with individual liberty. The costs of searching for a location and making a move can be significant, and government regulations often constrained options in ways that could limit certain individuals from making the full-range of choices.[2] Still, when compared with the challenge of external and decision-making costs associated with making a policy change at the national level, federalism provides an important partial solution.

Ostrom's work on polycentricity suggests an even richer model of how multiple centers for policy within a federalist system can best deliver a wide range of public goods in response to varied citizen demands (Ostrom and Ostrom 2014). Decades of careful empirical work suggest that not all decisions/goods require large scale (national) resolution, but, equally true, is the fact that the local level may be inadequate for certain issues. Protection of rights, highly specialized services, and general conflict resolution between levels of government might best be addressed by the largest level in a polycentric order. Centralize those decisions that reflect general consensus, but leave other choices that were characterized by many competing legitimate options to be resolved

[2]For example, segregation in housing and other decisions regarding property rights limited options to minorities during large periods in U.S. history. Such rules can limit the ability of this model to reflect societal preferences based on locational decisions alone.

through appropriate citizen sorting as Buchanan and Ostrom suggest. By permitting governance at the appropriate level for that good, much conflict could be avoided through instruments of choice.

Federalism: Information and Greater Consensus of Preferences

A second aspect of federalism that suggests it over more unified choice processes is its greater potential to address the knowledge problem. Ostrom argues that those closest to the individual are most likely to exercise collective decision power from a position of knowledge, as they understand the context that those individuals face and have more potential opportunities for low cost interaction with them. By keeping as much decision authority close to the people, variation across constituencies are likely. Competing solutions to the social choice mix can emerge through individual choices among jurisdictions, rather than being forced on minorities within larger jurisdictions that are trying to find a common solution. Ostrom suggested that localized politics would raise accountability through the personal interactions individuals engaged in as they governed within a community. Political decision making at a greater distance was more likely to fail both because of the challenge of finding agreement among a larger and more diverse group, but also, because policymakers at the national level had less knowledge of constituent interests. As Ostrom argues:

> Legislators, having no acquaintance with interest in or responsibility to the people of a locality affected, were free to exploit the opportunities available with no limitations on the rights so far as the local corporations were concerned. (Ostrom 1971, p. 186)

However, those who had to live with members of the community gained understanding of their circumstances, their interests, *and* they had accountability if subsequent decisions violated those interests.

Buchanan makes a similar argument as he raises the informational and power issues posed by moving decision making from the central to the local government level:

> It has long been recognized that the individual's sense of participation in collective choice is relatively greater in localized jurisdictions, rationally so because the influence of a single person on group outcomes is inversely related to group size. (Buchanan 2000, p. 131)

Local communities are advantaged not only in terms of the coalition size that must be put together in order for individuals to act, but, when coupled with the voluntary nature of those communities, externalities are minimized as well. Every decision process requires knowledge of possible joint interests that could be agreed to. When communities are small, the information is more readily available and social interactions individuals engage in can facilitate decisions (Buchanan 2000, p. 98). Individuals, thus, may trust and know more about those charged with acting for them.

Federalism as Check on Consolidation

> Centralized government power is in itself, a power that can be and almost always has been abused. (Buchanan 2002, p. 132)

As Buchanan states, the risk associated with governments consolidating power is one of the key concerns at the center of constitutional theory. As Ostrom and Buchanan considered how to protect individuals in the face of governmental threat, American federalism became a focal point for their analyses. As designed, government overstep in the federalism of the American Founders was constrained by an extensive structure of checks and balances at and between each level of government. In the US, divided executive, legislative, and judicial authority at any given level, and, a further separation between national and state authority, provide important counterweights where states checked national overreach and the national level checked possible state abuses through a veto one over the other. As Ostrom argues:

> A federal system of government is characterized by equilibrating structures that enable people to search out resolutions in commonly defined realms of choice bounded by the limits of multiple veto points. (Ostrom 1971 [1987], p. 23)

Since individual citizens had simultaneous access to each level of government, they could call on one government to press their positions against any overstep of the other and, thus, maximize protection and/or find access to positive action. This protective equilibrium was maintained only if the different levels of government retained their distinct authority and continued to exercise an effective check, one upon the other.

Federalism, structured with a relatively small national component and a thriving and diverse local governing system, as the American founders had conceived, could satisfy both concerns as it contained elements of both centralization and decentralization as needed, based on the nature of the good:

> In responding to problems of diverse economies of scale, elements of centralization and decentralization must exist simultaneously among several jurisdictions with concurrent authority…A federal system of administration would necessarily have recourse to overlapping jurisdictions where coordination would not be confined to command and control in a megabureaucracy but could be achieved by processes of cooperation, competition, conflict and conflict resolution. (Ostrom 1971, pp. 67–68)

This design of contending coercive powers, that could check one another, offered up the possibility of protection that no individual citizen alone could. But, of course this depended on each of the levels of government being recognized and operating under rule of law. Only then, would this structure serve to hold others in check. So, individuals would be protected by contending mechanisms or levels of government each reflecting the individual interests through specified constitutional powers. Each level of governing authority answered to the individual, but also would be interested in protecting its own constitutional powers (Ostrom 1985). As a result, each government would act to check other government(s) from extending too far beyond its constitutionally defined authority (Ostrom 1973).

With time, the tendency to concentrate power has made it increasingly difficult for states to continue to check the federal authority. Buchanan explains this shift as the loss of the ability by the States to exit or secede, as resolved with the Civil War. Without that power of exit, he suggested that the dynamic would drive to greater and greater centralization. As he notes:

> The separate states, individually or in groups must be constitutionally empowered to secede from the federalized political structure, that is to form new units of political authority outside of and beyond the reach of the existing federal government. Secession, or the threat thereof, represents the only means through which the ultimate powers of the central government might be held in check. (Buchanan 2002, pp. 70–71)
>
> In the absence of the threat of the exit option, there then existed no effective limit to the expansion of the powers of the central government beyond those embodied in the formalized structure of constitutional rules. (Buchanan 2002, p. 104)

Thus, Buchanan argued that only the exit option would provide an enforceable check on this natural tendency to concentrate power. By contrast, Ostrom argued that the other constitutional limits in the Founders form could provide protection as long as they remained effectively available to citizens. In fact, he argued that the Compound Republic of the Founders federalism was different than the confederational form most consistent with Buchanan's argument regarding secession or exit (Ostrom 1991). States did not have the authority to secede without citizen approval because individuals had citizenship in the state, but also in the federal government, in their role as individuals. Neither level of government had the right to sever the individual's tie to another governing level without the individual's agreement or due process. Access to each level provided additional protection as the individual could call on the state to challenge the federal government or the federal government to challenge the state, if either is deemed to be threatening his or her basic constitutional protections.

Of course, with time, many of the checks in the Founders design have eroded and once eroded, it may be impossible for the positive protections of federalism to serve their original protective purpose. Ostrom worried that the balance of the US federal system was breaking down in the modern era with the expansion of national power (Ostrom 1973). He suggested that this change was due, in part, to changes in the constitutional structure which permitted greater authority of the national government over the states. Formal constitutional changes like the 17th Amendment, and informal changes like the rise of nationalized political parties contributed to this erosion (Ostrom 1991). Expressing similar concerns, Buchanan argues that the erosion of the American form of federalism can serve as a lesson for the EU member states as they form their own federal structure (Buchanan 2002). Change is an expected feature of democratic constitutional processes, but not all changes improve the institutions from the perspective of the citizens.

Concluding Thoughts

Constitutional choice is ongoing and subject to continuing consideration by communities of individuals. This could keep constitutional rules relevant to the social challenges communities face as it allows for learning and adaptation to changing circumstances in society. The key to success was the extent to which the rule system maintained its link to self-governing communities. But, if constitutional change results in consolidating powers, as both Ostrom and Buchanan suggest has happened in US federalism, then that change is not liberty preserving. It could actually undermine the general approach, as it concentrates power too distant and 'entangled' for democratic checks by the citizenry (Wagner 2016). Federalism is weakened whenever the balance between federal and state authority shifts dramatically in favor of one level or the other. After all, the Founders design was intended to rebalance state and national power relative to excessive state power at the time.

No matter how potentially effective any given constitutional form is at addressing the concerns outlined here, each is vulnerable to the changes that consolidate power over time. Today, the growth of the national level of government and the many financial and regulatory linkages between state governments and national policymakers serve to weaken the effectiveness of each governing level to independently check the actions of the other and remind us of the relevance of both Buchanan's and Ostrom's warnings. As federal policy increasingly guides local/state options, the degree of diversity and choice, once core features of the US federal form, decline. Without this wider range of choice, the costs to citizens of expressing their diverse preferences and, of finding a mix of policy options that works for them through exit, increase as well. Virtually every critical protective power Buchanan and Ostrom identified has weakened with such changes. These giants of public choice identified the threats and suggested the constitutional solutions that could reduce such risks into the future. Taking heed of these lessons would be a good first step towards better constitutional design.

References

Aligica, P. D. (2013). *Institutional Diversity and Political Economy: The Ostroms and Beyond*. Oxford: Oxford University Press.

Aligica, P., & Boettke, P. (2009). *Challenging Institutional Analysis and Development: The Bloomington School*. London: Routledge.

Brennan, G., & Buchanan, J. M. (2000). *The Reason of Rules: Constitutional Political Economy.* Vol. 10 of *The Collected Works of James M. Buchanan*. Indianapolis: Liberty Fund.

Buchanan, J. M. (2000). *The Limits of Liberty: Between Anarchy and Leviathan.* Vol. 7 of *The Collected Works of James M. Buchanan*. Indianapolis: Liberty Fund, 1999–2002.

Buchanan, J. M. (2001). *Politics as Public Choice*. Vol. 13 of *The Collected Works of James M. Buchanan*. Indianapolis: Liberty Fund.

Buchanan, J. M. (2002). *Federalism, Liberty, and the Law*. Vol. 18 of *The Collected Works of James M. Buchanan*. Indianapolis: Liberty Fund.

Buchanan, J., & Tullock, G. (1999). *The Calculus of Consent*. Vol. 3 of *The Collected Works of James M. Buchanan*. Indianapolis: Liberty Fund.

de Tocqueville, A. (2012). *Democracy in America* (E. Novella, Ed. & J. T. Schleifer, Trans.). Indianapolis: Liberty Fund.
Herzberg, R., & Ostrom, V. (2000). Votes and Vetoes. In M. McGinnis (Ed.), *Polycentric Games and Institutions: Readings from the Workshop in Political Theory and Policy Analysis* (pp. 168–183). Ann Arbor: University of Michigan Press.
Mueller, D. (2003). *Public Choice III*. Cambridge: Cambridge University Press.
Ostrom, V. (1971 [1987]). *The Political Theory of a Compound Republic: Designing the American Experiment*. Linckoln: University of Nebraska Press.
Ostrom, V. (1973). Can Federalism Make a Difference? *Publius, 3,* 197–237.
Ostrom, V. (1976). The American Contribution to a Theory of Constitutional Choice. *The Journal of Politics, 38,* 56–78.
Ostrom, V. (1980a). Hobbes, Covenant, and Constitution. *Publius, 10,* 83–100.
Ostrom, V. (1980b). Artisanship and Artifact. *Public Administration Review, 40,* 309–317.
Ostrom, V. (1980c). Some Reflections on Methodological Individualism in Light of Comments by Vickers, Catron and Harmon, and Thayer. *Dialogue, 2,* 14–19.
Ostrom, V. (1985). The Meaning of Federalism in "The Federalist": A Critical Examination of the Diamond Theses. *Publius, 15,* 1–21.
Ostrom, V. (1991). *The Meaning of American Federalism: Constituting A Self-Governing Society*. San Francisco: ICS Press.
Ostrom, V. (1993). Epistemic Choice and Public Choice. *Public Choice, 77,* 163–176.
Ostrom, V. (1997). *The Meaning of Democracy and the Vulnerability of Democracies: A Response to Tocqueville's Challenge*. Ann Arbor: University of Michigan Press.
Ostrom, V. (2012). Buchanan's Opening to Constitutional Choice and Meta-levels of Analysis. *Public Choice, 152*(3/4), 427–431.
Ostrom, E., & Ostrom, V. (2014). *Choice, Rules and Collective Action: The Ostroms on the Study of Institutions and Governance* (P. Aligica, Ed.). Colchester: ECPR Press.
Ostrom, V., Tiebout, C., & Warren, R. (1961). The Organization of Government in Metropolitan Areas: A Theoretical Inquiry. *American Political Science Review, 55*(4), 831–842.
Smith, A. (1985). *The Theory of Moral Sentiments*. Indianapolis: Liberty Fund.
Tiebout, C. (1956). A Pure Theory of Local Expenditures. *Journal of Political Economy, 64,* 416–424.

Wagner, R. (2016). *Politics as a Peculiar Business: Insights from a Theory of Entangled Political Economy*. Cheltenham: Edward Elgar.
Wagner, R. (2017). *James M. Buchanan and Liberal Political Economy: A Rational Reconstruction*. Lanham, MD: Lexington Books.

23

On the Definition and Nature of Fiscal Coercion

George Tridimas and Stanley L. Winer

Introduction

In this chapter we introduce some ideas about coercion in public finance using recent work in the literature as a foundation, while briefly illustrating the connection between selected aspects of this research and earlier seminal work on coercion by Wicksell, Lindahl, and Buchanan and Tullock. We also attempt to contribute modestly towards a fuller understanding of the nature of coercion in a public finance setting.

Coercion in public finance arises from two essential sources: (i) external control of individuals and that of the country exercised through threats of violence and sanctions; and (ii) as a by-product of the compromises that citizens must agree to in a democratic society. In this

G. Tridimas
Ulster University, Belfast, UK
e-mail: G.Tridimas@ulster.ac.uk

S. L. Winer (✉)
Carleton University, Ottawa, ON, Canada
e-mail: stanley.winer@carleton.ca

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_23

chapter we focus on the second source or type of coercion, assuming that the fiscal systems we consider are compatible with a stable democratic society in which the state has a legitimate and constitutionally circumscribed monopoly on violence.[1] This assumption is of course a big one. Nonetheless, as we hope will become clear in what follows, important issues of definition and analysis still remain before a full understanding of the nature of coercion in modern fiscal systems can be achieved.

To fix ideas, it is useful to begin with an example that we have used in earlier work (Winer, Tridimas, and Hettich [hereafter WTH] 2014). Consider a sizeable group of citizens who have come together in a room for a common purpose and who must collectively set the temperature on a thermostat and pay for the resulting use of energy. Inevitably in such a group, some people will be too hot and some too cold, and even those for whom the temperature is just right may be unhappy with the balance they face between what they pay and what they get. Individuals can escape this situation if they move rooms or leave the building that represents the collectivity in the example. But if they stay, they must cope with the coercion implied by their assent to the collectively made decision. Coercion for any individual in this example—roughly speaking, the difference between what they get and what he or she *thinks they deserve* at the tax-price that they have to pay cannot be avoided whatever practical collective choice process is used.

Fiscal coercion of this kind, which arises naturally in all liberal democratic societies, is one of the foundations of what is perhaps the most famous diagram in Buchanan and Tullock's *Calculus of Consent* (1962, Fig. 3, p. 71). This diagram endogenizes the constitutional choice of a decision rule for the making of fiscal and other decisions as the outcome of minimization of the sum of two types of costs: expected external

[1] This and the next section make use of some ideas from Martinez-Vazquez and Winer, eds. (2014) and WTH (2014). For exploration of the connections between the two fundamental sources of coercion and the implications of this relationship for public finance from differing points of view, see Skaperdas (2014) and Wallis (2014).

costs that fall with the proportion of citizens required for a decision to be taken; and expected decision-making costs that rise with this proportion. As they also argue, there is no obvious reason why the optimal, cost-minimizing solution should require a simple majority.

'External costs' in the *Calculus of Consent* are the equivalent of coercion in our stylized example, though they are not referred to as such in the book. Despite the centrality of coercion to the *Calculus*, an exact definition of coercion is not provided nor has it been in their subsequent work. More generally, while philosophers and legal experts have explored its nature at length, work on coercion in economics has lagged behind that in other disciplines even though a concern with it often lies beneath the surface, especially when taxation is involved.

The exception in economics is the literature on mechanism design, recently reviewed by Ledyard (2014), which is built on the early work of Wicksell (1896) and his student Lindahl (1919). The early work was aimed at establishing a fiscal system with public goods that is economically efficient while at the same time minimizing (Wicksell), or even eliminating (Lindahl) fiscal coercion. In the mechanism design literature, the objective is similar to that of Lindahl's, with participation constraints formally requiring that all equilibria or solutions involve the absence of coercion. Whether such a solution with public goods is possible, and how one may be achieved under alternative assumptions about what citizens know about each other's 'type' remains an active area of research.

In the next section we briefly summarize our understanding of how fiscal coercion may be formally defined and used in fiscal analysis when citizens are constrained to remain in the room, so to speak, based on our earlier work. That exit from the community is prevented (or prohibitively costly) is a second important underlying assumption of the present analysis. We then develop an alternative definition of coercion in section three that aims at insuring the aggregate compatibility of individual views about coercion when individual tastes for public goods and individual incomes are both heterogeneous as well as correlated, and we explore some of its implications for fiscal analysis.

The Individual-in-Society, the Individual-as-Dictator and Imposition of Coercion Constraints in a Social Planning Problem

A formal definition of fiscal coercion for an individual requires that a counterfactual be defined, so that an actual situation in which a taxpayer finds himself can be compared to one that the individual regards as non-coercive.[2] This counterfactual may be one in which the individual receives in public services what he or she thinks they deserve at the tax-price that must be paid, a formulation of the counterfactual implicitly used in the example stated earlier, or, analogously, one in which he or she pays what they think is appropriate for the public services actually provided. The former approach is the one used by Breton (1996) and is implicit, we think, in work by Buchanan, for example in his *Demand and Supply of Public Goods* (1968, pp. 145–146) in which he stresses the importance of the individual's recognition that he or she is part of a social situation. It is the approach used in WTH (2014). Adoption of a counterfactual in which the individual pays what he thinks is appropriate for the services actually received is suggested by the work of Lindahl, and is the counterfactual experiment embodied in the computable equilibrium study of fiscal coercion in the U.S. state of Georgia by Sehili and Martinez-Vazquez (2014).

Both of these approaches are part of what we have referred to as individual-in-society definitions. To formalize the approach in which the individual takes as given the socially determined tax rate t_i, let V_i^* be the maximized utility that a citizen enjoys under specified counterfactual conditions, and V_i be the utility he or she actually enjoys from the operation of the public sector. In this individual-in-society approach to defining coercion, the individual determines the level of public good G^*

[2] 'Non-coercive' does not necessarily mean that same thing as 'voluntary'. For a discussion of related issues in the definition of coercion, see Congleton (2014).

that maximizes their utility subject to income Y_i that may be a function of the tax rate. Coercion is then defined as the difference between the resulting counterfactual utility and the utility conferred by the actual fiscal system:

$$\left[V_i^*\left(G_i^*, Y_i, t_i\right) - V_i\right], \text{ where } G_i^* = \underset{\{G\}}{\operatorname{argmax}}\ V_i(G, Y_i, t_i) \tag{23.1}$$

A second approach begins with the assumption that appropriate treatment of an individual by the fiscal system is what that person would want if he or she was a dictator. This is the individual-as-dictator approach, first suggested by Usher.[3] Coercion is then calculated as the difference between utility with the 'dictator's' preferred outcome and the actual utility experienced in the world as it is. In a simple version of this approach, the individual-as-dictator with income Y_i determines a proportional tax rate t and the level of the public good G by maximizing utility subject to the government budget constraint $\sum_i^N tY_i = G$, where N denotes the number of taxpayers. Coercion is calculated as:

$$\left[V_i^*\left(G^*, Y_i, t^*\right) - V_i\right], \text{ where } G^* = \underset{\{G\}}{\operatorname{argmax}}\ V_j\left(G, Y_i, \frac{\sum_i^N Y_i}{N}\right) \tag{23.2}$$

Hintermann and Rutherford (2017) use this individual-as-dictator definition in a computable general equilibrium model to analyse coercion in their study of environmental policy.[4]

An additional issue to be decided using either of the two approaches outlined is whether only citizens who lose relative to the counterfactual are to be considered coerced, or whether, as in WTH (2014), all citizens for whom the differentials above are non-zero are to be included in the measure of coercion.

[3]Personal communication from Dan Usher.

[4]It may be noted that a median voter is essentially a dictator imposing coercion on everyone else.

Coercion Constrained Optimal Policy

A society interested in liberty will set limits on the coercion that can be imposed on its individual members by the state. Studying the implication of such limits is therefore of interest and doing so is easier if there are analytically tractable definitions of coercion like those illustrated above. This brings us to the question of whether to apply coercion constraints at the level of the individual, or at some aggregate level.

In accordance with Wicksell, who advocated approximate unanimity among groups as a way of minimizing coercion, a constraint involving individuals or groups may be specified as

$$V_i^* - V_i \leq K_i, \tag{23.3}$$

where the subscript refers to individuals or to specific social groups.

A more relaxed approach that allows for stronger policy judgments, and a greater degree of coercion in whatever allocation emerges, bears some similarity to the Kaldor–Hicks criterion for potential compensation (in contrast to the strict Pareto criterion). This involves the use of a constraint on the *sum* of individual utility differences, such as

$$\sum_i \left(V_i^* - V_i\right) \leq K. \tag{23.4}$$

A social planning problem with a simple fiscal system and coercion constraints can be written as follows, where F is the social objective:

$$\text{Max}\, F(V_1(Y_1, t, G), \ldots, V_n(Y_n, t, G)) \tag{23.5}$$

such that $\sum_i^N tY_i = G$ and $\left\{V_i^* - V_i \leq K_i, \forall i\right\}$ or $\left\{\sum_i \left(V_i^* - V_i\right) \leq K\right\}$.

It may be noted that when an individual-in-society definition of the coercion is used to define the counterfactual, the degree of coercion is endogenous in this problem since the planner must observe coercion constraints, which affects the choice of fiscal instruments and so the nature of coercion in the solution. On the other hand, if an individual-as-dictator approach is used, the counterfactual depends only on preferences, technology and endowments, and is therefore independent of the planner's objective.

It is also interesting to note, as Munger (2014) points out, that Coase (1960) bargaining solves the problem with individual constraints, while economizing on the government's or the planner's need to know anything about individual preferences or about what levels of coercion are acceptable to the parties involved.[5]

Imposing coercion constraints on a social planning problem is one way of investigating the implications of limitations on coercion for the nature of optimal fiscal systems. This procedure is similar to imposing equity constraints in an inquiry about the kind of tax system that is best suited to achieving an equitable tax burden. Indeed, investigations of these kinds may be regarded as complements in the present context. For Wicksell knowingly avoided the equity problem in his seminal pursuit of a fiscal system that is simultaneously efficient and coercion-minimizing, by assuming at the outset that the problem of distribution had somehow been solved before the legislature acted. Whether the related problems of coercion and of equity in tax design should be tackled simultaneously or in some specific sequence is an open and long-standing question.

Any sort of constraint, whether directed at equity or coercion that is imposed on an optimizing planner will reduce social welfare (Kaplow 2001). From a social planning point of view, this issue could be dealt with by folding coercion constraints and equity constraints into a social welfare function, leading then to an efficient or socially optimal degree of coercion and to an efficient degree of inequity. However, doing so may not be the best way to proceed if the concerns behind these constraints serve broad social objectives that are not clearly subsumed by the usual utilitarian approach to public finance.

[5]The issues involved in determining the practicality of Coasian bargaining are well known and will not be enumerated here.

An Individual-as-Planner Definition of Coercion and Some of Its Implications

A potential problem with both the individual-in-society and individual-as-dictator definitions is that in the counterfactual, each individual desires a different fiscal mix. With individuals having different incomes and tastes for the public good, the desired levels of the fiscal instruments are almost surely inconsistent with each other in the aggregate. This inconsistency suggests that an analysis based on such definitions of coercion contain within them an element of social instability.

For this reason, we introduce a third definition of coercion, the difference between individual utility in a Lindahl equilibrium and the actual utility conferred by the prevailing fiscal mix. This is an example of an individual-as-planner approach to the definition of coercion suggested by Boadway (2014). In a Lindahl solution, there is no coercion and all decisions are mutually consistent. In this section we specify a simple Lindahl-like equilibrium in which all citizens must contribute, and then use this as basis for defining coercion and comparing its nature in an optimal tax system and in an electoral equilibrium. In this investigation, individuals are heterogeneous; they differ in their (exogenously defined) incomes, tastes for a single pure public good, and in their degree of political influence.

We begin this comparative analysis with the specification of a simple fiscal system. Assume there is a society of N citizen–taxpayers indexed by i. Each individual maximizes a Cobb–Douglas utility function defined over private consumption C_i and a public good G, has an (exogenous) income Y_i and pays a proportional income tax at rate t. Thus,

$$U_i = (1 - \alpha_i)lnC_i + \alpha_i lnG, \text{ where } C_i = (1 - t)Y_i \tag{23.6}$$

Here the parameter $0 < \alpha_i < 1, \alpha_i \in [\alpha_m, \alpha_M]$, with $0 < \alpha_m, \alpha_M < 1$, denotes the intensity of taste for the public good of each citizen-taxpayer, and has mean $\bar{\alpha} = \frac{\sum_i^N \alpha_i}{N}$.

Normalizing the unit price of the public good to unity, the budget constraint of the government is

$$\sum_{i}^{N} tY_i = G. \tag{23.7}$$

We note that along with the stability of fiscal institutions and the costliness of exit from the community, the exogeneity of incomes is a third major assumption of our analysis.

A Lindahl-Like Solution

If coercion is to be eliminated in the Lindahl solution, each person must face a personalized price for the public good, τ_i, such that $\sum_i^N \tau_i = 1$ and such that each person optimizes their own welfare at that tax-price with exactly the same level of the public good provided to everyone.

Each individual maximizes their utility (23.6) subject to their Lindahl budget constraint $C_i + \tau_i G = Y_i$, leading to the reduced form utility function

$$U_i = (1 - \alpha_i)ln(Y_i - \tau_i G) + \alpha_i lnG. \tag{23.8}$$

Maximization of (23.7) with respect to G gives $G = \frac{\alpha_i Y_i}{\tau_i}$, the size of the public good that i prefers at the tax-price τ_i. Inverting the latter yields the condition that defines the maximum non-coercive tax-price (the demand price) at which every citizen is content with the same, utility maximizing level of the public good, that is, $\tau_i = \frac{\alpha_i Y_i}{G}$.

Now let the covariance between citizen income Y_i and taste for the public good α_i be written as

$$\sigma^2_{Y\alpha} = \frac{\sum_i^N \alpha_i Y_i}{N} - \frac{\sum_i^N \alpha_i}{N}\frac{\sum_i^N Y_i}{N},$$

where if the rich have less (more) intense tastes for the public good than the poor, $\sigma^2_{Y\alpha} < (>)\ 0$. Then using the condition $\sum_i^N \tau_i = 1$ (tax-prices sum to 1) and the covariance formula, it can be seen that size of the public good in the Lindahl solution G^L has the general form

$$G^L = N\left(\bar{\alpha}\bar{Y} + \sigma^2_{Y\alpha}\right). \tag{23.9}$$

In view of (23.9), each individual pays a Lindahl tax of $\tau_i G^L = \alpha_i Y_i$.[6]

Substitution of (23.9) into (23.6) gives the indirect utility of individual i in the Lindahl solution that we shall use in our comparison of coercion in the optimal tax and electoral equilibrium situations described below:

$$V_i^L = (1-\alpha_i)ln(1-\alpha_i)Y_i + \alpha_i lnN\left(\bar{\alpha}\bar{Y} + \sigma^2_{Y\alpha}\right). \tag{23.10}$$

Before proceeding, it is of interest to derive the analogue to the formula in Buchanan (1964) that shows when the Lindahl tax price will rise, remain constant, or fall with income—that is, be progressive, proportional or regressive with respect to income.[7] Given $G^L = \frac{\alpha_i Y_i}{\tau_i}$, it can be seen that $\frac{dlnG^L}{dY_i} = \frac{d\alpha_i}{dY_i}\frac{1}{\alpha_i} + \frac{dY_i}{dY_i}\frac{1}{Y_i} - \frac{d\tau_i}{dY_i}\frac{1}{\tau_i}$. Since in a Lindahl equilibrium $\frac{dG^L}{dY_i} = 0$, because everyone demands the same level of G, we can multiply through by Y_i to put this in elasticity form. Thus we can write: $\frac{d\tau_i}{dY_i}\frac{Y_i}{\tau_i} = 1 + \frac{d\alpha_i}{dY_i}\frac{Y_i}{\alpha_i}$. In words, in the Lindahl solution, we have that the elasticity of the tax price with respect to income = 1 + the elasticity of α_i with respect to income. Thus if the latter elasticity is greater than 0, the Lindahl tax price schedule (if we can think of it as such) will be progressive in our model economy.

[6]We may use the latter to calculate an economy-wide average income tax rate as follows. Funding G^L requires a tax revenue of $t\sum_i^N Y_i = G^L$ which implies that the notional tax rate is $t = \bar{\alpha} + \frac{\sigma^2_{Y\alpha}}{\bar{Y}}$. However, this is not the actual rate levied on taxpayers in a Lindahl solution. Each individual pays a personalized tax tailored to their preferences.

[7]Buchanan (1964, pp. 229–230): "A more general statement of the necessary condition (for a Lindahl solution—our addition) is as follows: The income elasticity of demand for the public good divided by the price elasticity of demand must be equal to, and opposed in sign to, the income elasticity of the tax-price schedule. Full neutrality is present when this condition is met throughout the range of possible incomes."

The Optimal Tax Solution

In the traditional social planner or optimal tax approach (OT), the government sets the proportional tax rate in (23.7) at a level that is completely unconstrained by the coercive character of its actions, maximizing a social welfare function that we assume is the unweighted sum of individual utilities:

$$S = \sum_{i}^{N} U_i \tag{23.11}$$

Maximizing S with respect to G and using (23.7), we obtain the social welfare maximizing size of the public good, and the corresponding proportional tax rate:

$$G^{OT} = N\bar{Y}\bar{\alpha} \quad \text{and} \quad t^{OT} = \bar{\alpha}. \tag{23.12}$$

The indirect utility of citizen-voter i in this optimal tax scheme then can be stated as

$$V_i^O = (1 - \alpha_i) ln(1 - \bar{\alpha}) Y_i + \alpha_i ln N\bar{Y}\bar{\alpha}. \tag{23.13}$$

An Electoral Equilibrium

Before calculating and comparing coercion levels under social planning and in a political equilibrium, we must also solve for indirect utility in the electoral equilibrium. When the fiscal mix is decided by the outcome of competitive elections, policy outcomes reflect a balancing of the heterogeneous economic interests of citizens. This sort of balance can be modeled using a probabilistic spatial voting model (see Coughlin 1992, or Mueller 2003). In such a setting, electoral equilibrium can be replicated using a Representation Theorem of the sort described by Coughlin (1992), by Hettich and Winer (1999) and by others. This involves maximization of a synthetic political support function defined over individual indirect utilities, where the weights on each citizen's utility reflect their relative political influence in the electoral equilibrium.

We proceed assuming that such a representation theorem applies. Let w_i denote the normalized relative political influence of citizen i in the electoral equilibrium, so that $\sum_i^N w_i = 1$. Equilibrium values of G and t maximize the support function

$$S = \sum_i^N w_i U_i. \tag{23.14}$$

This support function looks like a social welfare function, but it is not. The weights do not reflect a normative view about the distribution of welfare, but rather are determined in the Nash electoral equilibrium. In this case, in the version of the theorem used here, the outcome also lies on the Pareto frontier, though not the one consistent with the OT solution in which each individual's welfare is weighted equally.

Let $\sigma_{w\alpha}^2$ denote the covariance between citizen influence w_i, and taste for the public good α_i,

$$\sigma_{w\alpha}^2 = \frac{\sum_i^N w_i \alpha_i}{N} - \frac{\sum_i^N w_i}{N} \frac{\sum_i^N \alpha_i}{N},$$

where if those with low (high) α_i have more political influence, then $\sigma_{w\alpha}^2 < (>)\, 0$. Maximizing (23.14) and using $\sigma_{w\alpha}^2$ we obtain the equilibrium fiscal system with one pure public good and a proportional tax on income:

$$G^P = N\bar{Y}\left(\bar{\alpha} + N\sigma_{w\alpha}^2\right) \quad \text{and} \quad t^P = \bar{\alpha} + N\sigma_{w\alpha}^2. \tag{23.15}$$

Substituting into the utility function (23.6) leads to the indirect utility of voter-taxpayer i in this electoral equilibrium,

$$V_i^P = (1 - \alpha_i) ln\left(1 - \bar{\alpha} - N\sigma_{w\alpha}^2\right) Y_i + \alpha_i ln N\bar{Y}\left(\bar{\alpha} + N\sigma_{w\alpha}^2\right). \tag{23.16}$$

Who Is Coerced, and When?

We now proceed with an analysis of coercion in OT and in the electoral equilibrium using the Lindahl solution as the standard of reference to define coercion in each case. We begin with the optimal tax solution.

Coercion Under the OT Social Planner

Comparing (23.10) and (23.13), we have

$$V_i^L - V_i^O = (1-\alpha_i)ln(1-\alpha_i) - (1-\alpha_i)ln(1-\bar{\alpha}) + \alpha_i ln\left(1 + \frac{\sigma_{Y\alpha}^2}{\bar{\alpha}\bar{Y}}\right) \tag{23.17}$$

We may say that when $V_i^L > V_i^O$, citizen i is coerced by the social planner. On the other hand, when $V_i^L < V_i^O$, citizen i benefits from the coercion forced on the rest of the polity.

From (23.17) we see that the sign of the utility differential $V_i^L - V_i^O$ depends crucially on $\bar{\alpha}$ relative to α_i, and the sign of $\sigma_{Y\alpha}^2$, the correlation between individual incomes and tastes for the public good. There are three cases to consider, namely, (i) richer citizens have a relatively lower taste for the public good; (ii) the opposite case, where richer citizens have a relatively higher taste for the public good; and (iii) the case in which income and preferences for the public good are independent.

i. When richer citizens have a relatively lower taste for the public good, $\sigma_{Y\alpha}^2 < 0$, in which case $ln\left(1 + \frac{\sigma_{Y\alpha}^2}{\bar{\alpha}\bar{Y}}\right) < 0$. Since for small values of α_i we may use the approximation $ln(1-\alpha_i) \approx -\alpha_i$, the difference in (23.18) yields the following quadratic equation

$$V_i^L - V_i^O = \alpha_i^2 - \left(1 - ln\left(1 + \frac{\sigma_{Y\alpha}^2}{\bar{\alpha}\bar{Y}}\right) - ln(1-\bar{\alpha})\right)\alpha_i$$
$$- ln(1-\bar{\alpha}). \tag{23.18}$$

Denoting $ln(1-\bar{\alpha}) \equiv -k;\ k > 0$ and $ln\left(1 + \frac{\sigma_{Y\alpha}^2}{\bar{\alpha}\bar{Y}}\right) \equiv -\theta;\ \theta > 0$, (23.18) can be rewritten as

$$V_i^L - V_i^O = \alpha_i^2 - (1 + \theta + k)\alpha_i + k. \tag{23.18$'$}$$

Solving the latter yields $\alpha_i = \frac{1}{2}\left[1 + \theta + k \pm \theta\sqrt{1 + \frac{2(1+k)}{\theta} + \frac{(1-k)^2}{\theta^2}}\right]$. Using the approximation $\sqrt{1 + px + qx^2} \approx 1 + \frac{p}{2}x + \frac{1}{2}\left(q - \frac{p^2}{4}\right)x^2$ we obtain the roots

$$\alpha_1 = \frac{ln(1-\bar{\alpha})}{ln\left(1 + \frac{\sigma_{Y\alpha}^2}{\bar{\alpha}\bar{Y}}\right)} > 0 \quad \text{and}$$
$$\alpha_2 = 1 - ln\left(1 + \frac{\sigma_{Y\alpha}^2}{\bar{\alpha}\bar{Y}}\right) - ln(1-\bar{\alpha}) - \frac{ln(1-\bar{\alpha})}{ln\left(1 + \frac{\sigma_{Y\alpha}^2}{\bar{\alpha}\bar{Y}}\right)}$$

Of the above, only the sign of α_1 is unambiguously positive, but at this level of generality we cannot tell whether it is larger or smaller than one. As for α_2, we note that neither its sign nor its size is unambiguous. We therefore list all possible combinations and the corresponding signs of $V_i^L - V_i^O$. Figure 23.1 illustrates graphically what is involved in each case:

(a) $\alpha_1 < 1$ and $\alpha_1 < \alpha_2 < 1$. Then
For $0 < \alpha_i < \alpha_1 \Rightarrow V_i^L > V_i^O$
For $\alpha_1 < \alpha_i < \alpha_2 \Rightarrow V_i^L < V_i^O$
For $\alpha_2 < \alpha_i < 1 \Rightarrow V_i^L > V_i^O$

(b) $\alpha_1 < 1$ and $\alpha_1 < 1 < \alpha_2$. Then
For $0 < \alpha_i < \alpha_1 \Rightarrow V_i^L > V_i^O$
For $\alpha_1 < \alpha_i < 1 \Rightarrow V_i^L < V_i^O$

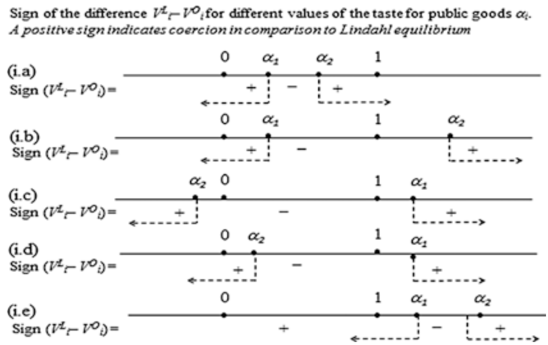


Fig. 23.1 Coercion when rich people have a lower taste for the public good, $\sigma^2_{\alpha Y} < 0$

(c) $\alpha_1 > 1$ and $\alpha_2 < 0$. Then
For $0 < \alpha_i < 1 \Rightarrow V_i^L < V_i^O$

(d) $\alpha_1 > 1$ and $0 < \alpha_2 < 1$. Then
For $0 < \alpha_i < \alpha_2 \Rightarrow V_i^L > V_i^O$
For $\alpha_2 < \alpha_i < 1 \Rightarrow V_i^L < V_i^O$

(e) $\alpha_1 > 1$ and $\alpha_2 > 1$. Then
For $0 < \alpha_i < 1 \Rightarrow V_i^L > V_i^O$.

(ii) When rich people have a higher taste for the public good, we have $\sigma^2_{Y\alpha} > 0$. In this case $ln\left(1 + \frac{\sigma^2_{Y\alpha}}{\bar{\alpha}\bar{Y}}\right) > 0$. Since for small values of α_i we may use the approximation $ln(1 - \alpha_i) \approx -\alpha_i$, the difference in (23.18) yields the following second order polynomial

$$V_i^L - V_i^O = \alpha_i^2 - \left(1 - ln\left(1 + \frac{\sigma^2_{Y\alpha}}{\bar{\alpha}\bar{Y}}\right) - ln(1 - \bar{\alpha})\right)\alpha_i - ln(1 - \bar{\alpha}). \tag{23.19}$$

Working as above, the roots of the quadratic equation are

$$\alpha_1 = \frac{ln(1-\bar{\alpha})}{ln\left(1+\frac{\sigma^2_{Y\alpha}}{\bar{\alpha}\bar{Y}}\right)} < 0 \quad \text{and}$$

$$\alpha_2 = 1 - ln\left(1+\frac{\sigma^2_{Y\alpha}}{\bar{\alpha}\bar{Y}}\right) - ln(1-\bar{\alpha}) - \frac{ln(1-\bar{\alpha})}{ln\left(1+\frac{\sigma^2_{Y\alpha}}{\bar{\alpha}\bar{Y}}\right)}.$$

The negative root α_1 does not make economic sense. We then have

(a) $\alpha_1 < 0$ and $\alpha_2 < 0$. Then
For $0 < \alpha_i < 1 \Rightarrow V_i^L > V_i^O$
(b) $\alpha_1 < 0$ and $0 < \alpha_2 < 1$. Then
For $0 < \alpha_i < \alpha_2 \Rightarrow V_i^L < V_i^O$
For $\alpha_2 < \alpha_i < 1 \Rightarrow V_i^L > V_i^O$
(c) $\alpha_1 < 0$ and $0 < 1 < \alpha_2$. Then
For $0 < \alpha_i < 1 \Rightarrow V_i^L < V_i^O$.

Figure 23.2 illustrates these cases.

(iii) In the case where income and preferences for the public good are independent of each other, $\sigma^2_{Y\alpha} = 0$, so that (23.17) yields

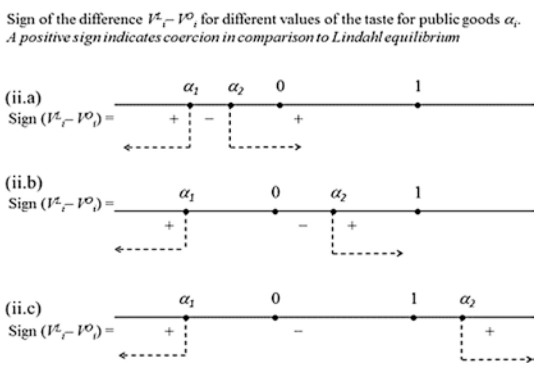


Fig. 23.2 Coercion when rich people have a higher taste for the public good, $\sigma^2_{\alpha Y} > 0$

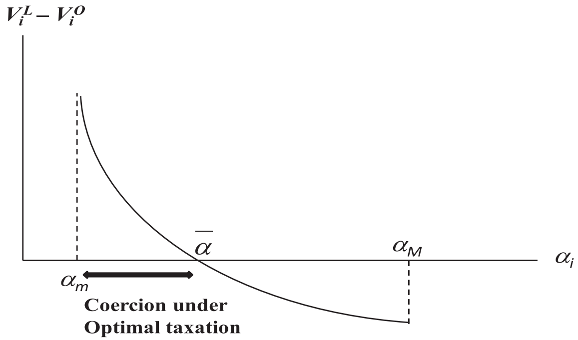


Fig. 23.3 Coercion in OT when income and taste for the public good are independent of each other $(\sigma^2_{\alpha Y} = 0)$. Coercion $= V_i^L - V_i^O > 0$

$$V_i^L - V_i^O = (1 - \alpha_i)(ln(1 - \alpha_i) - ln(1 - \bar{\alpha})) \\ > (<)0 \text{ for } \alpha_i < (>)\bar{\alpha}. \tag{23.20}$$

That is, taxpayers with a public good taste smaller than the mean $\bar{\alpha}$ lose in the counterfactual relative to OT.

Figure 23.3 shows graphically what is involved when $\sigma^2_{Y\alpha} = 0$ and we count as coerced only those who lose relative to the Lindahl counterfactual. The difference between utility under the counterfactual, Lindahl-like solution and the optimal tax one is drawn against the intensity of taste for the public good from lower to higher. Coercion is highest when the taste for G takes its lowest value α_m, and declines thereafter up to a threshold value $\bar{\alpha}$. For individuals with $\alpha_i > \bar{\alpha}$, utility under the OT planner rises as their taste for the public good increases.

Coercion in an Electoral Equilibrium

Working as before, we obtain

$$V_i^L - V_i^P = (1 - \alpha_i)ln(1 - \alpha_i) - (1 - \alpha_i)ln\left(1 - \bar{\alpha} - N\sigma^2_{w\alpha}\right) \\ + \alpha_i ln\left(\frac{\bar{\alpha}\bar{Y} + \sigma^2_{Y\alpha}}{\bar{\alpha}\bar{Y} + N\bar{Y}\sigma^2_{w\alpha}}\right). \tag{23.21}$$

As with Eq. (23.17), the sign of (23.21) is ambiguous and depends on $\bar{\alpha}$ relative to α_i, the sign of $\sigma^2_{Y\alpha}$, the correlation between individual incomes and tastes for the public good, as well as the correlation between political influence and taste for the public good, $\sigma^2_{w\alpha}$. With each one of $\sigma^2_{Y\alpha}$ and $\sigma^2_{w\alpha}$ taking positive, zero and negative values, we have a total combination of nine possible constellations, each one leading to a number of sub-cases. So to go forward, we simplify further.

If it is plausible that the rich have lower intensity of preferences for the public good, we have $\sigma^2_{Y\alpha} < 0$. If it is further assumed that those with a high taste for G are also politically more influential—that is, that the poor have greater influence than the rich, then $\sigma^2_{w\alpha} > 0$. We then have $ln\left(1 - \bar{\alpha} - N\sigma^2_{w\alpha}\right) < 0$ and $ln\left(\frac{\bar{\alpha}\bar{Y}+\sigma^2_{Y\alpha}}{\bar{\alpha}\bar{Y}+N\bar{Y}\sigma^2_{w\alpha}}\right) < 0$. Using the latter, the expression in (23.21) yields a quadratic equation similar to (23.18′) and a similar range of solutions.

On the other hand, if the rich have lower intensity of preferences for the public good and they are also politically more influential or, equivalently, those with low taste for the public good are more influential, so that $\sigma^2_{w\alpha} < 0$, expression (23.21) yields the quadratic equation

$$V_i^L - V_i^P = \alpha_i^2 - \left(1 - ln\left(1 - \bar{\alpha} - N\sigma^2_{w\alpha}\right) - ln\left(\frac{\bar{\alpha}\bar{Y} + \sigma^2_{Y\alpha}}{\bar{\alpha}\bar{Y} + N\bar{Y}\sigma^2_{w\alpha}}\right)\right)\alpha_i - ln\left(1 - \bar{\alpha} - N\sigma^2_{w\alpha}\right) \tag{23.22}$$

The roots of (23.22) are

$$\alpha_1 = \frac{ln\left(\frac{\bar{\alpha}\bar{Y}+\sigma^2_{Y\alpha}}{\bar{\alpha}\bar{Y}+N\bar{Y}\sigma^2_{w\alpha}}\right)}{ln\left(1 - \bar{\alpha} - N\sigma^2_{w\alpha}\right)} - ln\left(1 - \bar{\alpha} - N\sigma^2_{w\alpha}\right) - ln\left(\frac{\bar{\alpha}\bar{Y} + \sigma^2_{Y\alpha}}{\bar{\alpha}\bar{Y} + N\bar{Y}\sigma^2_{w\alpha}}\right) \quad \text{and}$$

$$\alpha_2 = 1 - \frac{ln\left(\frac{\bar{\alpha}\bar{Y}+\sigma^2_{Y\alpha}}{\bar{\alpha}\bar{Y}+N\bar{Y}\sigma^2_{w\alpha}}\right)}{ln\left(1 - \bar{\alpha} - N\sigma^2_{w\alpha}\right)}.$$

For concreteness we assume $\frac{ln\left(\frac{\bar{\alpha}\bar{Y}+\sigma^2_{Y\alpha}}{\bar{\alpha}\bar{Y}+N\bar{Y}\sigma^2_{w\alpha}}\right)}{ln(1-\bar{\alpha}-N\sigma^2_{w\alpha})} > 0$ and $\left(1-\bar{\alpha}-N\sigma^2_{w\alpha}\right) > 0$. A total of six cases are then possible as described below:

(i.a) $0 < \alpha_2 < 1$ and $\alpha_1 < 0$. Then
For $0 < \alpha_i < \alpha_2 \Rightarrow V_i^L - V_i^P < 0$
For $\alpha_2 < \alpha_i < 1 \Rightarrow V_i^L - V_i^P > 0$

(i.b) $0 < \alpha_2 < 1$ and $0 < \alpha_1 < 1$. Then
For $\alpha_i < \min[\alpha_1, \alpha_2] \Rightarrow V_i^L - V_i^P > 0$
For $\alpha_i \in [\alpha_1, \alpha_2] \Rightarrow V_i^L - V_i^P < 0$
For $\alpha_i > \max[\alpha_1, \alpha_2] \Rightarrow V_i^L - V_i^P > 0$

(i.c) $0 < \alpha_2 < 1$ and $\alpha_1 > 1$. Then
For $\alpha_i < \alpha_2 \Rightarrow V_i^L - V_i^P > 0$
For $\alpha_2 < \alpha_i < 1 \Rightarrow V_i^L - V_i^P < 0$

(ii.a) $\alpha_2 < 0$ and $\alpha_1 < 0$. Then
For $0 < \alpha_i < 1 \Rightarrow V_i^L - V_i^P > 0$

(ii.b) $\alpha_2 < 0$ and $0 < \alpha_1 < 1$. Then
For $0 < \alpha_i < \alpha_1 \Rightarrow V_i^L - V_i^P < 0$
For $\alpha_1 < \alpha_i < 1 \Rightarrow V_i^L - V_i^P > 0$

(ii.c) $\alpha_2 < 0$ and $\alpha_1 > 1$. Then
For $0 < \alpha_i < 1 \Rightarrow V_i^L - V_i^P < 0$.

A Comparison of OT and Electoral Equilibrium

Finally we compare coercion with the OT solution and in an electoral equilibrium by considering the welfare differentials (23.17) and (23.21). We might expect coercion under a social planner to always exceed that in the electoral equilibrium, because the social planner is allowed to coerce anyone to any extent, as a matter of social solidarity, as long as social welfare increases.

However, this generalization does not hold in our simple model. After substituting from (23.17) and (23.21) and manipulating, we see that if $\sigma^2_{w\alpha} < (>)\, 0$, when

$$\alpha_i > \frac{ln(1-\bar{\alpha}) - ln\left(1-\bar{\alpha}-N\sigma^2_{w\alpha}\right)}{ln(1-\bar{\alpha}) - ln\left(1-\bar{\alpha}-N\sigma^2_{w\alpha}\right) + ln\left(\bar{\alpha}+N\sigma^2_{w\alpha}\right) - ln\bar{\alpha}}$$

it is the case that $V_i^L - V_i^O < (>) V_i^L - V_i^P$. So coercion for an individual under the social planner may be lower or higher than in our democracy. Of course $V_i^L - V_i^O = V_i^L - V_i^P$ when $\sigma^2_{w\alpha} = \sigma^2_{Y\alpha} = 0$.

Concluding Remarks

Social interaction necessarily requires limits on individual choices. As soon as we are part of a group, various opinions must be heard and compromises must be made. Difficult questions will inevitably arise about how limits to individual actions are to be determined, how such limits or rights are to be defined, and how they will be enforced once agreement on their nature is achieved. Coercion of the individual by the group is an inevitable outcome of our struggle to deal with these issues.

Although coercion is therefore essential to, and plays a key role in the *Calculus of Consent*, it has not been well-defined or studied extensively in economics. A careful definition requires the use of a counterfactual, non-coercive social state against which the coercion inherent in any particular situation is to be judged. We have outlined three different approaches to the choice of a counterfactual in the fiscal context: the individual-as-dictator, in which the counterfactual is what the individual would want if they alone decided everything; the individual-in-society, in which the counterfactual is what the individual would like to pay (or, to have in public services) taking as given the socially determined level of public goods (the socially determined tax rate they must pay); and the individual-as-planner counterfactual, which we have tentatively explored in this chapter. In the individual-as-planner approach, in contrast to the other approaches, all counterfactual positions are explicitly required to be mutually consistent. The Lindahl solution serves as one obvious choice for such a counterfactual, and it is the one that we have employed in our preliminary investigation.

Our analysis of the individual-as-planner approach to coercion has led to somewhat complex results about the nature of fiscal coercion. In the OT solution, if we treat only those who lose relative to the counterfactual as being coerced, the extent of coercion depends entirely on the nature of an individual's taste for the public good relative to a critical threshold that depends on average tastes, average income and the correlation of tastes and income. The sign of the correlation of income and tastes determines how low or high taste citizens fare relative to the counterfactual. In the electoral equilibrium, there is also a critical level that can be compared to an individual's taste for public goods to determine the nature of coercion, but now (and not surprisingly) the threshold taste level depends on the correlation of income and political influence as well as the correlation of income and tastes.

Some statements can be made about the comparative nature of coercion in OT and in the electoral equilibrium; in particular, it is not the case that the (coercion-unconstrained) social planner will always impose more coercion than occurs in the electoral equilibrium. But simple general rules about what does happen do not seem possible even in the stripped down model we have explored. Perhaps others can find sensible assumptions that lead to more definite results.

The analysis we have conducted is subject to two fundamental assumptions: that the power of the state is suitably restrained; and that exit from the community is prohibitively expensive. In addition, we have assumed that income is determined independently of the fiscal system. A full analysis of coercion in public finance and, in this respect, of the calculus of consent, awaits a more complete analysis that relaxes these assumptions while deriving general propositions about coercion that are relevant to modern fiscal systems.

References

Boadway, R. (2014). The Role of Coercion in Public Economic Theory. In Martinez-Vazquez and Winer, eds., pp. 195–200.

Breton, A. (1996). *Competitive Governments: An Economic Theory of Politics and Public Finance*. New York: Cambridge University Press.

Buchanan, J. M. (1964). Fiscal Institutions and Efficiency in Collective Outlay. *American Economic Review, 54*(3), 227–235.

Buchanan, J. M. (1968). *The Demand and Supply of Public Goods*. Chicago: Rand McNally.

Buchanan, J. M., & Tullock, G. (1962). *The Calculus of Consent: Logical Foundations of Constitutional Democracy.* Ann Arbor: University of Michigan Press. (Page reference in text is to the Ann Arbor paperback edition of 1967).

Coase, R. (1960). The Problem of Social Cost. *Journal of Law and Economics, 3,* 1–44.

Congleton, R. (2014). Coercion, Taxation, and Voluntary Association. In Martinez-Vazquez and Winer, eds., pp. 91–116.

Coughlin, P. (1992). *Probabilistic Voting Theory*. New York: Cambridge University Press.

Hettich, W., & Winer, S. L. (1999). *Democratic Choice and Taxation: A Theoretical and Empirical Investigation*. Cambridge: Cambridge University Press.

Hintermann, B., & Rutherford, T. (2017). Social Planning and Coercion Under Bounded Rationality with an Application to Environmental Policy. *International Tax and Public Finance, 24,* 854–878.

Kaplow, L. (2001). Horizontal Equity: New Measures, Unclear Principles. In K. Hassett & G. Hubbard (Eds.), *Inequality and Tax Policy* (pp. 75–97). Washington: American Enterprise Institute.

Ledyard, J. O. (2014). Non-Coercion, Efficiency and Incentive Compatibility in Public Goods. In Marinez-Vazquez and Winer, eds., pp. 143–159.

Lindahl, E. (1919). Just Taxation: A Positive Solution. In R. A. Musgrave & A. T. Peacock. *Classics in the Theory of Public Finance* (pp. 168–176) London: Macmillan, 1958. An excerpt from Erik Lindahl, *Die Gerechtigkeit der Besteuerung* (Lund: Gleerupska Universitets-Bokhandeln 1919).

Martinez-Vazquez, J., & Winer, S. L. (Eds.). (2014). *Coercion and Social Welfare in Public Finance: Economic and Political Perspectives*. New York: Cambridge University Press.

Martinez-Vazquez, J., & Winer, S. L. (2014). Coercion, Welfare, and the Study of Public Finance. In Martinez-Vazquez and Winer, eds., pp. 1–26.
Mueller, D. C. (2003). *Public Choice III*. Cambridge: Cambridge University Press.
Munger, M. C. (2014). Kaldor-Hicks-Scitovsky Coercion, Coasian Bargaining, and the State. In Martinez-Vazquez and Winer, eds., pp. 117–135.
Sehili, S., & Martinez-Vazquez, J. (2014). Lindahl Fiscal Incidence and the Measurement of Coercion. In Martinez-Vazquez and Winer, eds., pp. 201–240.
Skaperdas, S. (2014). Proprietary Public Finance: On Its Emergence and Evolution Out of Anarchy. In Martinez-Vazquez and Winer, eds., pp. 60–81.
Wallis, J. J. (2014). The Constitution of Coercion: Wicksell, Violence, and the Ordering of Society. In Martinez-Vazquez and Winer, eds., pp. 29–59.
Wicksell, K. (1896). A New Principle of Just Taxation. In R. A. Musgrave & A. T. Peacock (Eds.), *Classics in the Theory of Public Finance* (pp. 73–118). London: Macmillan. An excerpt from KnutWicksell, *Finanztheoretische Untersuchungen* (Jena: Fischer).
Winer, S. L., Tridimas, G., & Hettich, W. (2014). Social Welfare and Coercion in Public Finance. In Martinez-Vazquez and Winer, eds., pp. 160–194.

24

Politics as Exchange in the Byzantine Empire

Adam G. Martin and James H. Ruhland

Politics as Exchange is a cornerstone of James Buchanan's political economy (Buchanan 1987). This potentially enigmatic phrase offers a summary of how Buchanan interprets political behavior. Individuals enter politics with their own beliefs and values, looking to make bargains that advance their own goals just as they do in markets. Political activity differs from market activity not in motivations but in that the rules of the game are up for grabs (1975). In its normative meaning, Politics as Exchange differs from alternative approaches to evaluating political behavior (Brennan 2012). Politics is not a truth discovery procedure or a maximization problem. Because individuals and not groups have values, there is no truth about the "will of the people" for political processes to discover, much less to implement. And because costs and benefits are radically subjective, they cannot be meaningfully aggregated or maximized. But politics is also not purely distributive. There are real and important mutually beneficial political bargains that can

A. G. Martin (✉) · J. H. Ruhland
Texas Tech University, Lubbock, TX, USA
e-mail: Adam.martin@ttu.edu

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_24

benefit each individual member of society. The conditions for reaching such bargains may be rare, but they serve as an important evaluative benchmark.

However, viewing politics through an exchange lens also has descriptive value. In the same work that touts the normative benefits of hypothetical unanimity, Buchanan and Tullock (1962) analyze the very real practice of logrolling. Congleton (2010) interprets the British constitution as arising from a series of exchanges between Parliament and the King. Salter (2015) builds on this framework to develop a positive theory of sovereignty as a set of self-enforcing political exchanges. And Young (2018) examines the historical evolution of political bargains between barbarians and Romans that generated medieval political institutions. But these more recent positive and empirical analyses of political exchange are, on the surface, quite different from the constitutional bargains imagined by Buchanan. In particular, these exchanges often occur between fairly narrow groups of elites rather than in the context of mass democracy.

Unanimity is the key difference between the normative and positive senses of Politics as Exchange. Political exchange exists, like many Buchananite concepts, "between predictive science and moral philosophy" (Buchanan 1982). Buchanan argues that key economic ideas serve as components of an individualist and contractarian moral philosophy. Economics can supply valuable insights to such a philosophy even though, in their strict usage, concepts such as cost and choice are radically subjective. But in order to apply these concepts to the world—in order to provide explanations or make predictions—the economist must assume that individuals have certain stable, well-defined, and reasonably common preferences. These assumptions are rarely strictly true, but if they approximate what most individuals value then they can explain observed aggregate patterns of behavior. The public role of the political economist is to bridge these two worlds, utilizing necessarily imprecise mental models of individuals in order to identify potential political bargains that individuals might consent to (Buchanan 1959). Proposals based on better mental models are more likely to approximate unanimous agreement.

This essay exists squarely in that space "between" individualist moral philosophy and aggregative predictive science. We inquire whether

Politics as Exchange can help explain historical episodes of social and political development. Few if any real-world political bargains benefit all the members of society. But some political bargains represent fairly broad-based interests, while others serve only the ends of those who are directly party to the deal. We bring Buchanan's Politics as Exchange paradigm into conversation with more recent work on state capacity. We then apply the insights gleaned from that comparison to understand the case of Middle Byzantium.

Politics as Administration vs. Politics as Exchange

Political exchanges frequently ignore the interests of third parties. Bargains between legislators and special interests, for example, enrich the parties to the exchange while making consumers worse off. Such deals would plausibly be vetoed if decision rules required unanimity. But even in non-democratic systems, political institutions exhibit varying degrees of *generality*. Rules and policies are general insofar as they do not confer special benefits or impose special costs on particular groups. To the extent that generality obtains, whether or not individuals have a say, their likely interests are taken into account. Like Buchanan and Congleton (1998), we understand generality as an effective substitute for unanimity. While this idea is rarely discussed under the heading of Politics as Exchange, it pervades much of the contemporary and classic literature on political economy. Olson (1982) discusses how political configurations that represent encompassing interests lead to periods of economic development. Acemoglu and Robinson (2012) instead use the language of inclusive institutions. But all of these authors associate generality with economic development: prospering societies are those in which individuals engage in largely positive-sum relationships that implicitly or explicitly take into account the interests of others.

Conversely, societies whose institutions do not embody generality are likely to experience stagnation. Again, economists have used different language to convey this point. Buchanan and Congleton (1998, p. 15) contrast generality with *discriminatory politics*. Olson distinguishes between special and encompassing interests. And Acemoglu and Robinson argue that extractive institutions are the fundamental reason "*Why Nations Fail*." Logically, societies in which the primary mode of individual advancement is at others' expense are unlikely to generate large amounts of wealth (Buchanan 1980; Tullock 1967; Murphy et al. 1991). How can societies avoid this trap? The traditional Politics as Exchange answer, put forward by James Buchanan and other public choice scholars, is to *constrain the state* (Brennan and Buchanan 1985). By taking certain political bargains off the table, political institutions can facilitate positive sum interactions (Boettke 2018). These constraints can take the form of either formal or informal rules.

But constraining the state is only a formal, not a substantive, solution to the problem of discriminatory politics. In market exchange, the legal system operates as a backstop to enforce contractual agreements. But in politics, there is no ultimate third-party enforcer to ensure that political bargains conform to either implicit or explicit restraints on state power. Effective constitutions must therefore *align incentives* so that the rules constraining discriminatory politics are self-enforcing. Since no one individual or small group has an incentive to check its own power (Acemoglu 2003), the standard solution to this conundrum is to *divide authority*. This solution can take many forms: federalism, an independent judiciary, the division of powers, the popular vote, a bicameral legislature, supermajority requirements, and a host of other proposals (Gordon 1999). All of these institutional configurations multiply the number of veto players in politics, making it less likely that discriminatory rules or policies can be put into place.

While not always linked to Politics as Exchange, this basic framework for understanding the role of state in economic development characterizes the bulk of work in political economy over many decades. Ostrom (1973) contrasts this public choice approach with a more technocratic approach, which we dub *Politics as Administration*. This approach to understanding politics can be traced back to Progressive Era thinkers such as Woodrow Wilson (1887), and it construes the central problem of politics as one of competent management rather than of constraining discriminatory uses of power. Buchanan may have deemed this approach politics as truth-seeking: experts seek to identify and realize some vision of a social good (Brennan 2012, pp. 351–352). But, in light of its recent revival by economists—and not wanting to read too much into the philosophical foundations of what is mostly applied work—we adopt the more neutral term "administration."

Politics as Administration has regained prominence over the last decade in the literature on *state capacity*. This literature begins from a straightforward empirical observation: in countries with high per capita income, government spending is a large share of GDP. Wealthy societies have powerful states. Besley and Persson (2009) argue that the power to tax is strongly correlated with the power to create market-supporting institutions such as property rights and contract enforcement, as well as with the ability to provide public goods that contribute to economic development. Johnson and Koyama (2017) survey a number of recent contributions that have expanded on this argument, developing the following key points.

The flip side of the literature on state capacity is the literature on "weak and failed states" (Eizenstat et al. 2005; Coyne 2006,) which identifies the absence of effective state authority as a source of social problems. Poor countries characteristically *lack the public goods* characteristic of prosperous societies. These public goods include infrastructure, law and order, public sanitation, etc. Without the background conditions these goods provide, markets cannot deliver growth or equity. A *powerful state*, by contrast, can overcome the resistance of other politically powerful groups and thus can effectively levy taxes in order to finance public goods.

Economists often take the ability of states to collect taxes and enforce laws for granted. In truth, these activities require *investing* in capacity and expertise. The power to levy broad-based, less distortionary taxes requires a relatively professional bureaucracy and the ability to monitor tax collectors. Enforcing property rights and contracts requires a system of courts. All of these processes are aided by having access to professionally trained public servants who can remember and enforce rules and regulations promulgated by rulers. And all of this is aided by the ability to generate and maintain extensive records. Governments do not always have an incentive to engage in these investments, especially since they often spill over at the local level (Acemoglu et al. 2015). Besley

Table 24.1 Politics as Administration vs. Politics as Exchange

Politics as Administration	Politics as Exchange
Propositions	Propositions
A1. Variations in economic development are associated with variation in *state capacity*	E1. Variations in economic development are associated with variation in the *generality* of political institutions
A2. A *lack of public goods* can constrain economic development	E2. *Discriminatory politics* can constrain economic development
A3. A *powerful state* can finance and provide public goods	E3. *Constraining the state* may limit the scope for discriminatory politics
A4. Effective governance requires *investing* in capacity and expertise	E4. Effective governance requires *aligning political incentives*
A5. *Unified control* can create incentives for investments in capacity	E5. *Dividing authority* can align political incentives in a self-enforcing way

and Persson (2009, pp. 1232–1233) argue that *unified control* of the government through time by one political coalition creates the incentive to develop such capacity, since it will only pay off over time. Besley and Reynal-Querol (2017) extend this argument to its logical conclusion: for states with powerful executives, countries with hereditary rule perform better since rulers can pass on investments in state capacity to their heirs.

Politics as Administration and Politics as Exchange paint very different pictures of the relationship between states and economic development. Table 24.1 summarizes these differences. Following Ostrom (1972), it breaks down each tradition into a set of propositions capturing the central argument. It is not meant to be an exhaustive picture of each tradition, and it intentionally excludes what they have in common. For instance, it does not directly address the problem of private predation—protecting individual rights, including property rights—because both traditions argue that this is a critical precondition for economic development. In Politics as Exchange, the solution to private predation is exchange: reciprocal recognition of rights secured through the institution of a protective state (Buchanan 1975). In Politics as Administration, the protection of rights is a public good that requires legal capacity such as paid police and lawyers, courts of law, etc. Instead of highlighting such subtle differences, we focus on more stark contrasts.

By focusing on the differences between these two points of view, we also do not wish to imply that they are mutually exclusive. The state capacity literature has revived the idea of Politics as Administration but has also—sometimes implicitly, sometimes explicitly—addressed the considerations of Politics as Exchange. Besley and Persson (2009, p. 1222), for instance, rule out the possibility of public predation. Some of the main contributors to the state capacity literature, such as Acemoglu, have also written in the Politics as Exchange tradition. Johnson and Koyama (2017), while broadly sympathetic to the state capacity approach, argue that the importance of *limitations* on state power is often underemphasized in the recent literature. Arguably the central thread connecting Politics as Exchange and Politics as Administration is Olson's (1993) stationary bandit model. A stationary bandit may act as if under a generality constraint *because* he can levy taxes. While the conditions for this may not always obtain, Olson's work provides an important bridge between these two traditions.

Nonetheless, treating Politics as Administration and Politics as Exchange as distinct approaches allows us to ask an understudied and important question: what happens when a polity has either high state capacity or political institutions that incentivize generality, but not both? Table 24.2 offers an initial set of hypotheses about this question. If a polity has both generality and state capacity, it fits with Besley and Persson's (2009, p. 1220) observation that wealthy societies tend to have large states. Capacity enables the state to deliver public goods, while generality keeps discriminatory politics in check. Similarly, in the bottom right corner, polities that lack both generality and state capacity fit the mold of weak and failed states: while the government is weak, corruption, violence, and other forms of predation are rampant, retarding economic development. Given the broad patterns identified in the economic development literature, these two outcomes are at least potentially stable.

Table 24.2 Capacity and/or generality

	High generality institutions	Low generality institutions
High state capacity	Wealthy societies with large states	Stationary bandit imposes generality ← or Fiscal and legal commons overgrazed ↓
Low state capacity	Prosperity begets capacity ↑ or Prosperity attracts predators	Weak and failed states

But when we consider the off-diagonals—low capacity and high generality, high capacity and low generality—what should we expect to find? We hypothesize that these two outcomes are *relatively* unstable. In the bottom left quadrant, a society would have the rules in place to generate widespread prosperity, but a state without high capacity. This outcome is probably unstable, for several reasons. First, institutions that generate prosperity will, *ceteris paribus*, tend to increase tax revenue. This gives the state resources with which to invest in capacity. Second, to the extent that capacity is a binding constraint on development owing to a lack of public goods, high generality institutions will facilitate the political bargains necessary to create those goods. In Buchanan's (1975) terms, the same institutions that enable the Protective State are likely to enable the Productive State, because both represent widespread gains from exchange. Finally, because the population largely benefits from political bargains, there is less resistance to tax collection and to state authority more generally, creating a great deal of de facto capacity. Alternatively, given the strong historical connection between state capacity and warfare, the wealth produced by high generality institutions may attract external predators (Johnson and Koyama 2017, pp. 8–9). Such external predators can act as a governance shock that could potentially create any combination of capacity and generality depending on whether the invading forces remain and what sorts of rules they impose.

In this chapter, we are most concerned with the upper right quadrant. Here the state can enforce the outcomes of political bargains through a well-developed apparatus of control, but these bargains are not constrained to satisfy a generality criterion. One possibility is that, following the stationary bandit model, such a state imposes general political institutions. If they do not, capacity is likely to erode. These states can be predatory in the traditional sense, or simply committed to advancing particular agendas at the expense of conflicting visions of the good. This outcome is probably unstable as well. Because the state is not constrained to serving general interests, it can easily undermine its own tax base in order to shower benefits on favored groups. This may involve over-grazing the "fiscal commons" (Wagner 2012). Worse, it may rewrite the rules of the market game to benefit special interests, undermining a key pillar of prosperity. This is essentially the process that Olson describes as the "*Decline of Nations*," which assumes that the state does have the power to concentrate benefits and disperse costs. As the state taxes poorer and poorer citizens, it can enter a downward spiral, eroding its own capacity until it becomes a weak and failed state.

Recognizing that generality and capacity may diverge serves several purposes. First, it informs the selection of interesting case studies. Since so many countries fall within the top left and bottom right quadrants, there may be more to learn by studying countries in the off-diagonals. Second, if our hypotheses about the off-diagonals are plausible, considering generality and capacity as independent variables may help explain periods of economic and political transition. Finally, our approach may help illuminate the relative importance of generality and capacity. Are they equally important, or is one doing the heavy lifting in generating divergent patterns of prosperity?

The Case of Middle Byzantium, 976–1180

A shift in the governance of the Byzantine Empire in the eleventh to twelfth centuries illustrates the relationship between generality and capacity. By the tenth century Byzantium had both relatively high administrative capacity and relatively high generality. However, the latter rested on uncertain foundations as Byzantium adapted to the challenges that came with success. Basil II (976–1025) dealt with political conflicts during his reign in ways that centralized power and sidelined other centers of political authority rather than accommodating them with bargains, much as Louis XIV would later do in France. Basil II reigned long enough to institutionalize his innovations in a way that altered the rules of the game for subsequent political actors. These new rules created incentives that affected the bargains between Byzantium's political elites, moving the state firmly into the upper right quadrant of Table 24.2. Despite continued state capacity and increased unity of control, the politics of Byzantium after Basil II led by stages to cronyism

(1025–1081) followed by nepotism (1081–1180), further undermining generality.[1] These changes left many important segments of society without a stake in remaining loyal to the Byzantine political establishment in Constantinople. This process ultimately led to fragmentation and decline of Byzantium (1180–1204). In this section we examine this history, linking it to the key propositions (A1–A5, E1–E5) detailed above.

Basil II inherited a thriving empire. Over the preceding two centuries Byzantium had undergone a steady revival (Treadgold 1988). Monetary taxation was the norm along with the provision of public goods: law, administration, military defense, commerce including lending at interest, and relatively strong property rights (Laiou 2002, p. 710). Law was continuously developed, and general (Levine 1998, p. 602; Levine et al. 2000, p. 42). The Rhodian Sea Law, one of the precursors to the Law Merchant, was developed in Byzantium (Trakman 1980, 1983). Property was individual or familial fixed lots rather than commons or communally held (Kazhdan 1993, p. 86). This was partly the result of previous political exchanges in which soldiers of the late-Roman regiments were given land (from military estates and lands left fallow by plague and raid) in exchange for service (Treadgold 1998) on a relatively generalized basis. In the aftermath of the plague that wracked Byzantium from 542 with outbreaks continuing until the mid-eighth century (Rosen 2007; Treadgold 1988) and invasions by Avars, Persians, Bulgars, Arabs and others (Shepherd 2008; Treadgold 1997), the relatively decentralized political institutions gave all the important players a stake in Byzantium's continuation (E4, E5), generating a revival of its fortunes: "renewed growth of wealth, power, and knowledge, and of the benefits that follow from them" through "increases in population, general prosperity, trade, urbanization, and the level of education and culture" (Treadgold 1988, p. 331; E1). Byzantium was thus able to undergo a revival in population and prosperity to once again become the pre-eminent polity of the Mediterranean world by the end of the tenth century. As Treadgold (2001, p. 239) observes, Byzantium

[1] See Greif (2006) for a similar pattern in other contexts.

was "comparable in its level of government organization to several of the states of early modern Western Europe, after political centralization, modernization, and standing armies" were developed. During this period, the Byzantine administration remained highly educated and technically capable, with university-level education (A4; Browning 1962; Wilson 1983; Magdalino 1993, pp. 228–412; Markopoulos 2008), as both demonstrated by and chronicled by the Imperial official Michael Psellus.

The pre-Basil II Byzantine Empire was characterized by political bargains that distributed authority widely and constrained the authority of the emperor. The ladders into the circles of military and political elites were also relatively open in the period between the rise of Justinian's uncle, Justin I, to the throne, and the rise of the equally humble (in origins) Basil I, the founder of the dynasty of which Basil II was a member, and at all levels in between (Treadgold 1988, 1997; Shepherd 2008). Despite the appearance that the Emperor was an autocrat, authority was relatively decentralized, without generating fragmentation as emerged, for example, in the Frankish Successor Kingdoms after Charlemagne. Localities exercised initiative in responding to changing conditions (E3, E5). Bargains between the ruling house, aristocratic generals, and civil administrators were reflected in the regency councils and co-Emperorships of the late ninth through tenth centuries and the rising influence of dynastic (*dynatoi*) houses outside of the Imperial House and administrative center, reflecting the growth of rival centers of political power (Toynbee 1973). *Dynatoi* was a legal term in Byzantium referring to the senior civil, military, and ecclesiastic officials (Cappel 1991, pp. 667–668). This reflected the status of the *dynatoi* as not merely wealthy, but by definition politically influential. The political settlement of this period reflected incorporation of these interests, along with small landholders and regional metropoles to a varying degree, and at times uneasily (E4, E5). As Magdalino (1993, p. 151) points out, during the period when the central government in Constantinople was relatively diminished, Byzantine cities such as Monemvasia and Thessaloniki developed "a legacy of self-help [that] undoubtedly provided…a sense of civic spirit and a conviction that their subjection to Constantinople was not, or ought not to be, totally unconditional." There was an "adaptability and willingness to devolve administration to local elites and [administrative] apparatuses" and "[t]he interests of these provincial groupings were not directly opposed to those of central government; in fact their leading members looked keenly to Constantinople for status and some sort of office" (Shepherd 2008, pp. 533–534). On the individual level, as Treadgold (1988, p. 330) writes regarding the ninth century, "Byzantines did usually have most of the kinds of freedom they wanted, including the freedom to circulate criticisms of official doctrine, though they often lacked the particularly cherished freedom to impose their views on others; this situation never got much worse or better."

Basil II expanded the state capacity of the Empire. John I Tzimiskes, who represented the military aristocracy and had reigned as regent and co-Emperor of the young Basil II and the latter's brother, Michael III, died in 976. Acting in the name of the young Basil II the Chamberlain, Basil Lecampenos, declined to name a co-emperor from the military aristocracy, as had been becoming a sort of tradition (Treadgold 1997, p. 513). This break with the established division of authority precipitated a series of revolts by ambitious leaders of the military aristocracy who sought that role (Treadgold 1997, pp. 513–520). Ultimately Basil II determined to assert his own rule and sideline the Chamberlain, who represented the civil administration. Basil II was able to put down these uprisings, but much of Bulgaria, which had been absorbed into the Empire after John I expelled a brutal conquest of it by the Rus, again asserted itself and challenged Byzantium for control of the Balkans. Thus protracted military campaigns dominated much of Basil II's reign, ending in the re-absorption of Bulgaria by 1018 (Treadgold 1997, pp. 520–534). By the end of his long rule (976–1025), Basil II had succeeded in making Byzantium the pre-eminent realm in the Mediterranean world, expanding it territorially, enlarging its military and expanding its tax base (Treadgold 1998, pp. 162, 195), and securing it such that in its core prosperity and trade were increasing, as demonstrated by population growth, urban expansion, increased monetization, and records of trade (Hendy 1985; Harvey 2002; Morrisson 2007, 2010, p. 43; Treadgold 1997, pp. 534–582; Shepherd 2008, p. 533).

Basil II was responding to a very real situation, but in so doing undermined the generality of Byzantine political institutions and increased the power of the central state. From the point of view of politics as administration, Basil II did many things correctly (cf. Treadgold 1997, pp. 532, 550). He "presented the provision of justice and security of property for the lowliest of his subjects as an essential duty of the ruler" (Shepherd 2008, p. 531). Despite expensive military campaigns, he was a frugal and careful administrator who left the currency sound and the treasury full (Psellus 1953, pp. 45–46). He brought the military aristocracy to heel (Shepherd 2008, p. 526) and fought corruption within the civil administration (Treadgold 1997, pp. 513–525; Vasiliev 1958, p. 303), dismissing figures as prominent as the Imperial Chamberlain (Basil, the *Parakoimomenos*, who was the son of a prior co-Emperor). The *parakoimomenos* had used his political position to enrich his relatives and supporters at the expense of the less influential and the Imperial treasury. When Basil II uncovered this corruption, he removed the *parakoimomenos* and returned the embezzled funds (Treadgold 1997, pp. 521, 550). Basil II made an example of "those who had used their senior positions in the establishment to amass properties and who through their wealth and influence put undue pressure on those small proprietors not yet swallowed up by their estates" by divesting them of such gains (Shepherd 2008, p. 531) (A3). His policy helped the Empire maintain its bargain with the relatively small-holder landed soldiery that had been the backbone of Byzantium's survival and revival. Laws against politically influential aristocrats, either of the civil or military aristocracy, were strictly enforced (Lemerle 1979, pp. 103–105, 112–114). In this way he cut down challenges to the government's authority (A5). Indeed, if one of the Byzantine historians of the era is to be believed, Basil II seems to have taken to heart the advice one of the rebellious generals is reported to have given the young Emperor upon Bardas' capture:

> Cut down the governors who become over-proud. Let no generals on campaign have too many resources. Exhaust them with unjust exactions, to keep them busied with their own affairs. Admit no woman to the

imperial councils. Be accessible to no one. Share with few your most intimate plans. (Psellus 1953, p. 43)

A stern ruler, yet magnanimous when successful (Shepherd 2008, p. 530), Basil II also fulfilled most closely the image of the Byzantine Emperor, and one that was personally dedicated to unitary control and generality of law, administration, and policy, warry of the existence of any other center of power outside the throne (Treadgold 1997, p. 519; Psellus 1953). The independent political influence of the military aristocracy, based in the provinces, was considerably reduced as a result of his deliberate policy to cement unified control (A5). War had made the Byzantine state just as it would later make other European states (Tilly 1992). Yet while all this tends to support the politics as administration approach, underlying it all were "burgeoning conflicts of jurisdiction and fiscal rights between the military's needs and the civilian administrative apparatus; as the eleventh century progressed, labyrinthine nexuses of tax-collectors and imposers of charges and services to the state sprawled across the empire" (Shepherd 2008, p. 535) (E3, E4). This opened up the opportunity and incentive for rent-seeking (E2). For all his stern and tight oversight of government, Basil II failed to undertake the "administrative reform needed to cope with success" (Shepherd 2008, p. 536). As Angold (2008, p. 583) points out "[f]ifty years later Byzantium was struggling for its existence."

Basil II enlarged the standing military (*Tagmata*, or imperial regiments) to such a size that his immediate successors were less dependent upon the landholding soldiery of the provinces (Treadgold 1998; Angold 2008, p. 587).

As a result, these successors were less devoted to upholding the political bargain that maintained that "stake in the system" that provincial inhabitants in Byzantium had, which kept the realm unified even during lengthy periods with weaker central government (E1, E4). A foremost illustration of the shift was the formation of the famous *Varangian Guard* during the reign of Basil II (Shepherd 2008, p. 526). This formidable force, however, was comprised of foreign troops who took an oath of personal loyalty to the Emperor (D'Amato 2011), rather than having general loyalty to Byzantium as a whole. The provincial soldiery had repeatedly demonstrated adherence to Byzantine political institutions even if at times this came at the expense of the reigning Emperor. Consisting in the main of small-holding agriculturalists, it was both an arm of the state and a constraint on the arbitrary exercise of authority by the central government (E3, E5), a voice of not just the landed aristocracy but the agriculturalists that formed the basis of the Byzantine economy. Employing more standing forces in the center, as well as foreign guards, marked a transition to a form of *mamelukism* (Blaydes and Chaney 2013; Angold 2008, p. 587) and a departure from generality in the public-goods provision of defense. Future rulers would be less reliant upon provincial soldiery from the *Themes* (Byzantine military provinces). Basil II had cut important elements out of the political bargain and introduced incentives to sideline the *dynatoi*, agriculture-based soldiery, and the rising merchant class.

The generality of political bargains continued to decline throughout the eleventh and twelfth centuries. Basil II's death "was followed by a spate of conspiracies" (Angold 2008, p. 588). Basil II had succeeded in centralizing authority in the Empire to such a degree that capture of the center was more valuable than ever (E3). Basil II's "iron rule represents an aberration in the exercise of imperial authority at Byzantium. His complete ascendancy was without precedent" in Byzantine history (Angold 2008, p. 585). Basil II and Michael III's successors attached themselves to the dynastic succession through marriage and gained and maintained power through a narrowing of generality by granting favorites properties and tax exemptions (Angold 2008, pp. 591–592; Treadgold 1997, pp. 583–584). Thus the fiscal burden fell increasingly on those without the influence to escape it, further spurring an alienation of the properties that formed the bulk of the pay for provincial soldiery (Ostrogorsky 1966, pp. 215–216) and leading to tax revolts (Angold 2008, p. 590; Treadgold 1997, p. 588; E2). Constantine IX (1042–1055) particularly favored the Skleroi family, relatives of his mistress, and granted tax immunities to *dynatoi* in exchange for support (Kazhdan et al. 1985, p. 504; Gregory 2010, p. 248). Angold (2008, p. 597) notes that "the civil list was increasing dramatically as more and more honours were granted out," increasing the fiscal burden (see also Treadgold 1997, p. 591).

Emperors of the mid-eleventh century lavished funds on narrow coalitions of supporters. After the treasury ran dry, they resorted to the rapid debasement of the currency (Angold 2008, pp. 590–591). This, along with the "other items of unnecessary expenditure" is what "bankrupted the state" (Angold 2008, p. 598). This was "the first important debasement since the third century" (Treadgold 1997, p. 595) eight centuries before. "There were many interests to be satisfied. Conspiracy and revolt might become necessary to satisfy supporters and clients or might simply be a gesture of political credibility. Thus instability came to be built into the political structure" (Angold 2008, p. 589).

To reduce the fiscal burden, Constantine IX Monomachus also reduced the size of the military by disbanding entire provincial regiments and armies, eliminating up to 50,000 soldiers from the rolls (Treadgold 1997, p. 595; 1998). Arguably the reduction in military size was not only a necessary cost savings given the declining state of Imperial finances (despite no loss of territory, yet, or population) and given the growth of the total military after previous expansion. However, it was carried out with a disregard for both generality and public goods (defense) provision. Instead of trimming the rolls of soldiers in safe provinces close to the capital and away from the frontier, forces that now rarely were called to service but might be more likely to stage a successful coup, Constantine IX disbanded an entire frontier force, that of the Armenian provinces (Angold 2008, p. 598; Treadgold 1998). This would prove fateful as it created the gap through which the Seljuk Turks were able to pour into Anatolia and conquer it following 1071 (Treadgold 1998). In the interim, prior to the fateful conquests, it opened up previously safe lands to increasingly endemic and bold raiding from 1054–1071. As a result, "territorial contraction thus accentuated the already marked tendency of the Byzantine aristocracy to think fiscally rather than territorially, to invest in office-holding rather than land-holding" (Magdalino 2008, p. 653). This is a classic case of a downward spiral into a rent-seeking society (E2; Coyne et al. 2010).

However, state capacity did not collapse for some time. Administrative capacity was still strong enough in the late twelfth century that Manuel I's break with Venice in March of 1171 was imposed in one day across the Empire, evidently without the Venetians being alerted to the impending policy shift beforehand (Magdalino 1993, p. 93; Treadgold 1997, p. 648). This was an impressive feat for any bureaucracy, but particularly one in the era before modern communications. Alexios I had re-asserted Imperial authority over important areas of law making (Angold 2008, p. 617) and reformed the currency and taxation and "ended the lax fiscal regime of the eleventh century" (Angold 2008, pp. 619–620) and succeeded in navigating the logistical and diplomatic task of transitioning the First Crusade through and out of the Empire (Angold 2008, pp. 621–623), demonstrating continued administrative capacity. The "Komnenian emperors did not in themselves decentralise, weaken or impoverish the machinery of government and warfare. The Komnenian empire had all the apparati of a fully developed pre-industrial state: a standing army and navy, regular monetary taxation and an elaborate bureaucracy," according to Magdalino (2008, p. 647), who goes on to say that "all the indications from written and material evidence are that agricultural production and trade intensified throughout the twelfth century, and that the government was reaping the benefits as well as the aristocracy, the monasteries and the Italian merchants." What had changed was not the administrative capacity of Byzantium, but rather "the deep involvement of the empire with the Latin west, the centralisation of power and resources in Constantinople and the emphasis on family, lineage and kinship as the defining elements in the Byzantine political system" (Magdalino 2008, p. 648).

But despite its high level of capacity, the lack of generality in Byzantine institutions eventually led to the empire's decline. The administrative officials were only too willing to participate in the unfolding tragedy of the fiscal commons (Wagner 2012). Officials of the civil administration and military aristocracy undertook a struggle for who would sit on the throne as the proxy of each faction. Michael VI (1056–1057) for example was "was old and was intended as a figurehead for a faction among the bureaucracy" (Angold 2008, p. 602). Constantine X (1059–1067) made "overgenerous distribution of honours and pensions to the people of Constantinople" and to pay for that "allowed the military establishment to run down" (Angold 2008, p. 607). The relative generality of political exchange under the earlier

Byzantine political settlement (from eighth to ninth centuries) gave way to discriminatory cronyism.

The disbanding of provincial frontier forces led to the alienation of Armenians from the empire, leading to the secession of what became "*Little Armenia*" (in the region that was not conquered by Turkish invasion, as its forces had not been disbanded according to Treadgold 1998). The exposure of Armenia to conquest generated a hostility towards the empire by a previously affiliated people, as expressed in the history written by Armenian historian Matthew of Edessa.[2] Factional infighting can explain the defeat at Manzikert (1071): the Byzantines "had the better of the battle until towards evening on the second day, when a rumour started to spread that Romanos had fallen. This was the work of Andronikos Doukas, a son of the caesar John Doukas. His motives were political. If Romanos emerged from the battle with credit, the Doukas cause was doomed. Andronikos Doukas was in command of the rearguard and in a position to do maximum damage. He abandoned the field leaving Romanos and his elite troops unprotected" (Angold 2008, p. 609). However, "[i]n military terms Manzikert was not a disaster;" (Angold 2008, p. 610)—it was the infighting for control of the throne for the decade afterwards that was ruinous (Treadgold 1997, pp. 604–611). Doukas' faction took control in Constantinople and fought against Romanos. In the factional infighting that took place, each side employed Seljuk invaders against the other, even while losing territory (Angold 2008, pp. 610–611).

This internal strife, having left the Empire in shambles and ruins, beset both east and west, with the rise of Alexios I Komnenos, a military leader and founder of the Komnenan dynasty. Alexios I based his rule on appointing relatives to the key positions of prominence throughout the Empire and succeeded in stabilizing Byzantium and even regaining

[2]Armenians had long had a complicated relationship with the Empire. On the one hand, independent Armenia held heresies and rivals to Imperial authority. On the other hand, however, Armenians had been prominent in the Empire's military and officialdom, with many obtaining the Imperial office prior to the eleventh century. Basil, the *Parakoimomenos*, mentioned above, was the son of Romanus I Lecampenus, an Armenian who had risen from humble origins to high rank, and ultimately regent and Co-Emperor alongside the young Constantine VII Porphyrogenitus, father of Basil II and Michael III.

some lost ground. Alexios I decided to rely upon kin (Angold 2008, p. 612). Indeed, "for almost the first time in the empire's history the threat to the ruling dynasty from a rival faction was entirely eliminated" (Magdalino 2008, p. 629). If the period between the death of Basil II and the rise of Alexios I was dominated by cronyistic political exchanges, the Komnenan system was built on the basis of nepotistic political exchange (cf. Lemerle 1977, pp. 249–312) involving "parceling out out the empire among his family and creating a series of appanages" (Angold 2008, p. 613). This "gave the whole imperial family a share and a stake in the imperial inheritance" (Magdalino 2008, p. 629) but did not eliminate rivalrous competition. Thus John I, Alexios' son, had to create a faction to gain and retain power in the face of rival relatives for the throne (Magdalino 2008, p. 629). The Komnenan restoration, based on the relatively narrow base of kinship-exchange, relied upon one family producing a series of brilliant, or at least able and conscientious rulers. However, "the minority of Manuel's son Alexios II Komnenos (1180–1183) exposed the fragility of the regime inaugurated by Alexios I" (Magdalino 2008, p. 627). Manuel I (1143–1180) continued to show favoritism to kinsmen, a fact that was noted by Byzantine chroniclers of the time such as Choniates as contributing to the Empire's subsequent problems (Magdalino 2008, p. 646; Choniates 1984).

Andronikos I (1083–1085), who overthrew Manuel I's minor son, sought to root out corruption, reign in officials' excesses, and restore even application of law (Magdalino 1993, p. 194; Ostrogorsky 1969; A5). However, rather than cement his shaky reign by making political bargains with the Byzantine aristocracy, Andronkios I Komnenos attempted to purge it of rivals, ruling through fear and notorious cruelty (Ostrogorsky 1969, p. 396; Harris 2014, p. 118). His rule lead to invasion by the Norman King of Sicily, Andronikos I's own overthrow and a period of weak rulers; the breaking away of Serbia and Bulgaria, the loss of Cyprus and Croatia. Alexios I restructured the military into one more personally loyal but financially expensive relative to its size and less general in its geographic and organizational structure (Treadgold 1998). Many of the regions of the Empire no longer had the stake in remaining loyal to the center over time, which they had when its defenses were primarily based on land in exchange for service. Indeed "as Constantinople became more and more self-important, self-centred and exclusive of the 'outer territories', it became increasingly noticeable that Constantinople needed the 'outer territories' more than the latter needed Constantinople" (Magdalino 2008, p. 655).

> Under Manuel I Komnenos' successors, the empire's provinces were lost to imperial control or became centres of opposition to the government in Constantinople.

The revolt that lead to the re-creation of an independent Bulgaria in the core of twelfth century Byzantium is instructive. It originated in "Isaac II Angelos' failure to prevent, punish or recompense the rapacity of his officials who seized Vlach livestock for his marriage feast; secondly, in his rude rejection of Peter and Asen when they requested a modest benefice" they became "local chieftains politicised by the carelessness of central government" (Magdalino 2008, p. 656). This separation was illustrative of a period when "several 'dynasts' who took advantage of the changes of regime in Constantinople to seize power in their localities… they all shared the conviction that more was to be gained from opposition to central government than from service, and that they could count on provincial support" (Magdalino 2008, pp. 656–657). This intention of separation had not happened in past crises. Byzantium was falling apart even before the Venetian diversion of the Fourth Crusade to Constantinople (Echebarria 2013).

One counterargument to this account, more favorable to Politics as Administration, relies on the fact that Basil II had no heir. However, as Angold (2008, p. 588) points out, "[t]here is no prima facie reason for supposing that a troubled succession would necessarily weaken the fabric of the Byzantine state. After all, the succession was in doubt on many occasions in the tenth century, but this did not prevent Byzantium from going from strength to strength. It might be argued that frequent change of the imperial regime was a positive benefit because it made for a greater flexibility and ability to meet critical situations." In the earlier period (eighth and ninth centuries), when the ruling house faltered and was replaced by another dynasty, as happened from 695–717, 802–820, and 867, Byzantium itself was able to carry on relatively unscathed. However in the late eleventh and again in the late twelfth century, the result was disaster for Byzantine civilization (fragmentation, conquests, and ultimately dissolution). Legal education was invested in through this period (A4), with Constantine XI founding a law school (2008, pp. 535, 599), and legal expertise was widely available through the twelfth century (Magdalino 1993, p. 359). However, the Komnenoi "significantly diminished the status of general laws (*leges generalies*) in relation to particular laws (*leges speciales*)" (Magdalino 1993, p. 265; E2). Economically, Byzantine society did grow in prosperity throughout the eleventh and twelfth centuries. However, that had started in the ninth and tenth, prior to the ascension of Basil II, and it is an open question whether it would have prospered more under alternative institutions that were more general and open to internal commercial, merchant groups (Whittlow 2008; Treadgold 1988; Magdalino 1993; Echebarria 2013). Magdalino (1993, p. 147) writes that in the middle twelfth century a chance was missed "to have given the Byzantine economy a last chance to achieve the breakthrough for which it had long been heading." Byzantium's failure was not economic, it was primarily political: low generality institutions led to an over-grazing of the fiscal and legal commons, fragmentation, which left it open to predation by outsiders (Crusaders, Turks, Bulgarians, Serbs, and others); the ruinous plunder, massacre, and subjugation of the *Rhômaîoi* (as the Byzantines called themselves) and their elimination as a distinct people with a distinct civilization.

Conclusion

We have examined two competing paradigms in political economy. Politics as Exchange locates the root of social success in political bargains that appeal to widely dispersed and representative interests, constraining the power of the state to limit the extent to which individuals can benefit through rent-seeking. Politics as Administration emphasizes the importance of public goods provision, fiscal capacity, and a professional civil service, all of which are served by a powerful state. While these two paradigms are not mutually exclusive, they emphasize different causes of the rise and decline of nations: Politics as Exchange focuses on generality, while Politics as Administration focuses on capacity.

Our analysis of Middle Byzantium is not dispositive of the relative importance of capacity vs. generality. However, it provides an important case in which the generality of political institutions seems to explain an important political transition far better than capacity. Plausibly, the *long run* capacity of a state depends on maintaining political institutions that serve general interests. Unconstrained states do not maintain high capacity for long because they undermine the constraints that make state activity either positive sum or relatively benign. Other cases of societies in transition could help create a fuller picture of the relationship between capacity and generality. But we would venture one conclusion: while state capacity is the state of the art, Politics as Exchange is still an invaluable framework for serious students of political economy.

References

Acemoglu, D. (2003). Why Not a Political Coase Theorem? Social Conflict, Commitments, and Policies. *Journal of Comparative Economics, 31,* 620–652.

Acemoglu, D., & Robinson, J. (2012). *Why Nations Fail: The Origins of Power, Prosperity, and Poverty*. New York: Crown Publishing Group.

Acemoglu, D., Garcia-Jimeno, C., & Robinson, J. (2015). State Capacity and Economic Development: A Network Approach. *American Economic Review, 105,* 2364–2409.

Angold, M. (2008). Belle Epoque or Crisis? (1025–1118). In J. Shepard (Ed.), *The Cambridge History of 1121 the Byzantine Empire c. 500–1492* (pp. 583–626). Cambridge: Cambridge University Press.

Besley, T., & Persson, T. (2009). The Origins of State Capacity: Property Rights, Taxation, and Politics. *American Economic Review, 99,* 1218–1244.

Besley, T., & Reynal-Querol, M. (2017). The Logic of Hereditary Rule: Theory and Evidence. *Journal of Economic Growth, 22,* 123–144.

Blaydes, L., & Chaney, E. (2013). The Feudal Revolution and Europe's Rise: Political Divergence of the Christian West and the Muslim World Before 1500 CE. *American Political Science Review, 107,* 16–34.
Boettke, P. (2018). Economics and Public Administration. *Southern Economic Journal, 84,* 938–959.
Brennan, G. (2012). Politics-as-Exchange and the Calculus of Consent. *Public Choice, 152,* 351–358.
Brennan, G., & Buchanan, J. (1985). *The Reason of Rules: Constitutional Political Economy*. Cambridge: Cambridge University Press.
Browning, R. (1962). The Patriarchal School at Constantinople in the Twelfth Century. *Byzantion, 32,* 167–202.
Buchanan, J. (1959). Positive Economics, Welfare Economics, and Political Economy. *Journal of Law and Economics, 2,* 124–138.
Buchanan, J. (1975). *The Limits of Liberty: Between Anarchy and Leviathan*. Chicago: University of Chicago Press.
Buchanan, J. (1980). Rent Seeking and Profit Seeking. In J. Buchanan, R. Tollison, & G. Tullock (Eds.), *Toward a Theory of the Rent-Seeking Society*. College Station: Texas A&M University Press.
Buchanan, J. (1982). The Domain of Subjective Economics: Between Predictive Science and Moral Philosophy. In I. Kirzner (Ed.), *Method, Process, and Austrian Economics*. Lexington: Lexington Books.
Buchanan, J. (1987). The Constitution of Economic Policy. *American Economic Review, 77,* 243–250.
Buchanan, J., & Congleton, R. (1998). *Politics by Principle, Not Interest: Towards Nondiscriminatory Democracy*. Cambridge: Cambridge University Press.
Buchanan, J., & Tullock, G. (1962). *The Calculus of Consent*. Ann Arbor: University of Michigan Press.
Cappel, A. J. (1991). Dynatoi. In A. Kazhdan (Ed.), *The Oxford Dictionary of Byzantium* (pp. 667–668). Oxford and New York: Oxford University Press.
Choniates, N., & Choniate, N. (1984). *O City of Byzantium: Annals of Niketas Choniatēs*. Magoulias, Harry J. (Trans.), Detroit: Wayne State University Press.
Congleton, R. (2010). *Perfecting Parliament*. Cambridge: Cambridge University Press.
Coyne, C. (2006). Reconstructing Weak and Failed States: Foreign Intervention and the Nirvana Fallacy. *Foreign Policy Analysis, 2,* 343–360.

Coyne, C., Sobel, R., & Dove, J. (2010). The Non-Productive Entrepreneurial Process. *Review of Austrian Economics, 23,* 333–346.

D'Amato, R. (2011). *The Varangian Guard 988-453* (Vol. 459). Oxford: Osprey Publishing.

Echebarria, D. (2013). *Byzantine Sorrow and Venetian Joy: The Failure of Byzantine Diplomacy and the Expansion of Trade in the Mediterranean, 700–1200* (Doctoral dissertation). University of Nevada, Reno.

Eizenstat, S., Porter, J., & Weinstein, J. (2005). Rebuilding Weak States. *Foreign Affairs, 84,* 134–146.

Gordon, S. (1999). *Controlling the State: Constitutionalism from Ancient Athens to Today*. Cambridge, MA: Harvard University Press.

Gregory, T. (2010). *A History of Byzantium*. Oxford: Wiley-Blackwell.

Greif, A. (2006). *Institutions and the Path to the Modern Economy: Lessons from Medieval Trade*. Cambridge: Cambridge University Press.

Harris, J. (2014). *Byzantium and the Crusades*. London and New York: Bloomsbury Publishing.

Harvey, A. (2002). *Economic Expansion in the Byzantine Empire, 900–1200*. Cambridge: Cambridge University Press.

Hendy, M. F. (1985). *Studies in the Byzantine Monetary Economy c. 300–1450*. Cambridge: Cambridge University Press.

Johnson, N., & Koyama, M. (2017). States and Economic Growth: Capacity and Constraints. *Explorations in Economic History, 64,* 1–20.

Kazhdan, A. P. (1993). State, Feudal, and Private Economy in Byzantium. *Dumbarton Oaks Papers, 47,* 83–100.

Kazhdan, A. P., Epstein, A. W., & Wharton, A. J. (1985). *Change in Byzantine Culture in the Eleventh and Twelfth Centuries* (Vol. 7). Berkeley: University of California Press.

Laiou, A. (2002). Exchange and Trade, Seventh-Twelfth Centuries. *The Economic History of Byzantium, 2,* 697–770.

Lemerle, P. (1977). *Cinq études sur le XIe siècle byzantin*. Paris: Centre national de la recherche scientifique.

Lemerle, P. (1979). *The Agrarian History of Byzantium from the Origins to the Twelfth Century: The Sources and the Problems*. Galway: Galway University Press.

Levine, R. (1998). The Legal Environment, Banks, and Long-Run Economic Growth. *Journal of Money, Credit and Banking, 29,* 596–613.

Levine, R., Loayza, N., & Beck, T. (2000). Financial Intermediation and Growth: Causality and Causes. *Journal of monetary Economics, 46,* 31–77.

Magdalino, P. (1993). *The Empire of Manuel I Komnenos, 1143–1180*. Cambridge: Cambridge University Press.
Magdalino, P. (2008). The Empire of the Komnenoi (1118–1204). In J. Shepard (Ed.), *The Cambridge History of the Byzantine Empire c. 500–1492* (pp. 627–1380). Cambridge: Cambridge University Press.
Markopoulos, A. (2008). Education. In E. Jeffreys, J. F. Haldon, & R. Cormack (Eds.), *Oxford Handbooks in Classics and Ancient History* (pp. 785–795). The Oxford Handbook of Byzantine Studies. Oxford: Oxford University Press.
Morrisson, C. (2007). Byzantine Money, Its Production and Circulation. In A. Laiou (Ed.), *The Economic History of Byzantium*. Washington, DC: Dumbarton Oaks Museum.
Morrisson, C. (2010). Money, Coins, and the Economy. In P. Stephenson (Ed.), *The Byzantine World* (pp. 34–46). London: Routledge.
Murphy, K., Shleifer, A., & Vishny, R. (1991). Why is Rent-Seeking So Costly to Growth? *AEA Papers and Proceedings, 83,* 409–414.
Olson, M. (1982). *The Rise and Decline of Nations*. New Haven: Yale University Press.
Olson, M. (1993). Dictatorship, Development, and Democracy. *The American Political Science Review, 87,* 567–576.
Ostrogorsky, G. (1966). Agrarian Conditions in the Byzantine Empire in the Middle Ages. In J. H. Clapham & E. Power (Eds.), *The Cambridge Economic History of Europe from the Decline of the Roman Empire* (Vol. I, 2nd ed., pp. 205–234). Cambridge: Cambridge University Press.
Ostrogorsky, G. (1969). *History of the Byzantine State*. New Brunswick: Rutgers University Press.
Ostrom, E. (1972). Metropolitan Reform: Propositions Derived from Two Traditions. *Social Science Quarterly, 53,* 474–493.
Ostrom, V. (1973). *The Intellectual Crisis in American Public Administration*. Tuscaloosa: University of Alabama Press.
Psellus, M. (1953). *Fourteen Byzantine Rulers. The Chronographia of Michael Psellus* (E. R. A. Sewter, Trans.). London: Penguin Classics.
Rosen, W. (2007). *Justinian's Flea: The First Great Plague and the End of the Roman Empire*. London: Penguin.
Salter, A. (2015). Sovereignty as Exchange of Political Property Rights. *Public Choice, 165,* 79–96.
Shepard, J. (Ed.). (2008). *The Cambridge History of the Byzantine Empire c. 500–1492* (Vol. 1207). Cambridge: Cambridge University Press.

Tilly, C. (1992). *Coercion, Capital, and European States, AD 990–1992*. New York: Wiley-Blackwell.

Toynbee, A. (1973). *Constantine Porphyrogenitus and His World*. Oxford, NY: Oxford University Press.

Trakman, L. (1980). The Evolution of the Law Merchant: Our Commercial Heritage. *Journal of Maritime Law and Commerce, 12*, 1–24.

Trakman, L. (1983). *The Law Merchant: The Evolution of Commercial Law*. Littleton, CO: Fred B. Rothman.

Treadgold, W. (1988). *The Byzantine Revival, 780–842*. Stanford, CA: Stanford University Press.

Treadgold, W. (1997). *A History of the Byzantine State and Society*. Stanford, CA: Stanford University Press.

Treadgold, W. (1998). *Byzantium and Its Army, 284–1081*. Stanford, CA: Stanford University Press.

Treadgold, W. (2001). *A Concise History of Byzantium*. Stanford, CA: Stanford University Press.

Tullock, G. (1967). The Welfare Costs of Tariffs, Monopolies, and Theft. *Western Economic Journal, 5,* 224–232.

Vasiliev, A. (1958). *History of the Byzantine Empire* (Vol. 2). Madison, WI: University of Wisconsin Press.

Wagner, R. (2012). *Deficits, Debt, and Democracy: Wrestling with Tragedy on the Fiscal Commons*. Cheltenham, UK: Edward Elgar.

Whittow, M. (2008). The Middle Byzantine Economy (600–1204). In J. Shepard (Ed.), *The Cambridge History of Byzantium* (pp. 465–492). Cambridge: Cambridge University Press.

Wilson, W. (1887). The Study of Administration. *Political Science Quarterly, 2,* 197–222.

Wilson, N. (1983). *Scholars of Byzantium Duckworth Classical, Medieval and Renaissance Editions*. London: Duckworth.

Young, A. (2018). Hospitalitas: Barbarian Settlements and Constitutional Foundations of Medieval Europe. *Journal of Institutional Economics, 14*(4), 715–737.

Part IV

Ethics, Social Philosophy, and Liberal Political Economy

25

James M. Buchanan: Political Economist, Consistent Individualist

Viktor J. Vanberg

Economics and Individualism

Economists' strictly individualistic outlook in explanatory and policy matters is generally regarded as their distinguishing trademark among the social sciences. A common perception is that as theoretical enterprise economics is based on a *methodological individualism*, and as political economy, i.e. in its application to policy issues, it adopts a *normative individualism* as the standard of judgment. Kenneth Arrow voices this perception when he notes on the field's methodological foundations:

> It is a touchstone of accepted economics that all explanations must run in terms of the actions and reactions of individuals. Our behavior in judging economic research, in peer review of papers and research, and in promotions, includes the criterion that in principle the behavior we explain and

V. J. Vanberg (✉)
Walter Eucken Institut, Freiburg im Breisgau, Germany
e-mail: vanberg@eucken.de

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_25

> policies we propose are explicable in terms of individuals, not of other social categories. (Arrow 1994, p. 1)

And when he comments on economists' normative presuppositions:

> Economic or any other social policy has consequences for the many diverse individuals who make up the society or economy. It has been taken for granted in virtually all economic policy discussion, since the time of Adam Smith, if not before, that alternative policies should be judged on the basis of consequences for individuals. (Arrow 1987, p. 124)

Of particular interest for the purpose of the present paper is the fact that, while Arrow stresses the role the individualist perspective plays in economics, the thrust of the article from which the first quotation is taken, "Methodological Individualism and Social Knowledge" (1994), is to argue that methodological individualism[1] does not, and cannot play the role it is claimed to play in economics. As he puts it:

> It is usually thought that mainstream economics is the purest exemplar of methodological individualism, so I will then examine some standard economic models to see if in fact they do conform to its requirements. As we will see, they do not. In fact, every economic model one can think of includes irreducibly social principles and concepts. (ibid., p. 2)[2]

Arrow's view on economists' limited methodological individualism contrasts explicitly with James Buchanan's stance on this matter. Buchanan, so Arrow notes with obvious disapproval, not only "has identified himself with typical vigor as a methodological individualist" (ibid., p. 2), but also "does see a link between methodological and

[1]Arrow (1994, p. 1) defines methodological individualism as the claim "that it is necessary to base all accounts of economic interaction on individual behavior."

[2]Summarizing the message of his paper Arrow (ibid., p. 8) notes: "I do conclude that social variables, not attached to particular individuals, are essential in studying the economy or any other social system."

normative individualism" (ibid.), thereby rejecting "Hume's dichotomy between 'is' and 'ought'" (ibid., p. 3).[3]

The present paper may, in some sense, be read as a response to Arrow's above cited claims. While agreeing with Arrow's diagnosis that in their actual practice economists do not generally adhere faithfully to the principle of methodological individualism, I shall argue that this is not due, as Arrow claims, to inherent limitations of this principle but to economists' failure to consistently apply it. And, while Arrow quite obviously considers Buchanan's methodological and normative individualism ill-founded, I shall argue that the latter's contractarian-constitutionalist approach is solidly based on a consistent methodological individualism and that the way it links methodological and normative individualism is not in conflict with the Humean caveat.

Alleged Limitations of Methodological Individualism

Both, the methodological and the normative version of individualism are meta-principles, they are claims about what counts as an adequate explanation and what counts as an adequate value-judgement in social matters. The first requires that social facts be explained in terms of assumptions about the behavior of the individuals involved, the second that value judgments on social matters, e.g. on policy issues, should be derived from individuals' judgments. Neither of the two principles can be shown to be true or false, they can only be judged in terms of how successful or useful they turn out to be in guiding explanatory efforts and policy judgments.

[3]Arrow (1994, p. 1): "I am old-fashioned enough to retain David Hume's view that one can never derive 'ought' propositions from 'is' propositions."—Contrast this with Arrow's (2010, p. 25) more recent comment on Hume's view: "Obviously, in some sense, this must be right, but the examination of social choice theory suggests that the dichotomy is more blurred than it seems."

The principle of methodological individualism has been the subject of extended and continuing debates in the social sciences.[4] To do justice to the variety of interpretations (and misinterpretations) the principle has found in these debates, and of the arguments exchanged on its prospects and limitations, would require a discussion that is beyond the scope and the purpose of this paper. I shall confine my comments here on the arguments Arrow advances, arguments that, in one form or another, are quite common among critics of methodological individualism.

According to Arrow, economists do not and cannot consistently adhere to a methodological individualism because, as he posits,

> a close examination or even the most standard economic analysis shows that social categories are in fact used in economic analysis all the time and that they appear to be absolute necessities of the analysis, not just figures of speech that can be eliminated if need be. (Arrow 1994, p. 1)[5]

That, in describing the social facts that they seek to explain, economists use "social categories … all the time" is surely right. After all, in describing the very social facts that they seek to explain, economists use "social categories." Always to restate the information social categories confer in individualistic terms would be equally impracticable as unnecessary. The statement, for instance, "the US Congress reduced the corporate tax rate," is indeed not only a "figure of speech" but describes an important social fact. This fact is derived, though, from nothing other than information on how the individual members of the House and the Senate voted, in conjunction with information on the rules according to which in these chambers bills are passed. Yet, it would surely make

[4]The earlier debates I have covered in Vanberg (1975). On the more recent debates, see, e.g., Basu (1996), Udehn (2002), and List and Spiekermann (2013).

[5]The argument that "social-scientific explanations must employ non-individualistic terms" (List and Spiekermann 2013, p. 629) is, as indicated above, a standard objection raised against methodological individualism.

little sense, and the research of students of American politics would come to a stand-still, would one always require statements like the one quoted to be restated in individualistic terms. In any case, the relevant issue is not whether social categories are "absolute necessities of the analysis" but whether the facts they refer to can be explained in terms of assumptions about individual behavior or whether they require to employ what Arrow refers to as "irreducibly social principles and concepts" (ibid., p. 1).

All explanations of whatever phenomena must, in addition to the general conjectures they employ, include assumptions about initial and boundary conditions within which the postulated conjectures are supposed to work. For the purposes of the explanation at stake such conditions are treated as "given facts" that are themselves left unexplained. This does not mean, however, that they in turn cannot be made the subject of an explanation, based on the same conjectures employed in the original explanation. That in economics, as in the social sciences generally, the most important initial and boundary conditions are *social facts*—i.e. facts typically defined in "social categories"—does, accordingly, not imply at all that these social facts are any less explainable in terms of individual behavior than the social facts that are the subject of explanatory efforts in the first place. Nor does the fact, that explanations of the previously unexplained social facts will in turn refer to initial and boundary condition that they leave unexplained, imply that these conditions cannot be made the subject of an individualist explanation, and so forth. Whether or not social facts can be explained in terms of conjectures about the behavior of the individuals involved or require taking recourse to "irreducibly social principles" is, again, a question that cannot be answered a priori but only by looking at specific cases and comparing the explanations offered in either terms.

What are the examples that Arrow refers to in order to substantiate his claims about the need of economists to employ "irreducibly social principles and concepts"? As his first illustration of the fact "that economic theories require social elements" Arrow (1994, p. 4) mentions the "prototypical economic model … (of) general competitive equilibrium" (ibid.). Having briefly sketched basic assumptions of this model he notes:

> Even if we accept this entire story, there is still one element not individual: namely, the prices faced by the firms and individuals. What individual has chosen prices? In the formal theory, at least, no one. They are determined on (not by) social institutions known as markets, which equate supply and demand. (ibid.)

That Arrow means to challenge methodological individualism by posing the question "What individual has chosen prices?" is rather surprising, considering that the theory of how market prices result as an *unintended outcome* of the interactions of market participants is the prime example of the invisible-hand paradigm that has always been viewed as the hallmark of economists' individualistic outlook at social reality. "The failure to give an individualistic explanation of price formation" (ibid., p. 4) of which Arrow speaks, may well be a shortcoming of the "formal theory" to which he subscribes. The Austrian School of Economics, for instance, can hardly be blamed for it. In any case, the "Walrasian auctioneer" may represent an "irreducibly social principle," but does scarcely provide and explanation superior to the Austrian individualistic account.

Arrow is surely right when he stresses the role of "institutions" in price formation, and also when he notes that "tastes may be socially caused," the "expectations are influence by others," and that firms are "not individuals" (ibid.). Yet, merely pointing these matters out does not mean to demonstrate the limits of methodological individualism.[6] Individualistic theories of the origins and the effects of institutions, of the operation of firms, of the social influence on the formation of tastes and expectations can surely be offered, and they can only be challenged

[6]This is equally true for Arrow's (1994, p. 5) remark: "More generally, individual behavior is always mediated by social relations. These are as much a part of the description of reality as is individual behavior."

by showing that on the basis of "irreducibly social principles" superior explanations can be provided.

As "an especially significant case of an irreducibly social category in the explanatory apparatus of economics" (ibid., p. 1) Arrow cites the importance of information or "social knowledge,"[7] by which he means "technical and other knowledge (that) exists in social forms: books or universities" (ibid., p. 7). Such knowledge, he claims, cannot be captured by "the individualist viewpoint about knowledge, that knowledge is held by individuals" (ibid., p. 6). As he puts it:

> There are clear empirical problems with maintaining the individualist orientation. Technical and other knowledge exists in social forms: books or universities … . These are examples of *intended* communication, though not purely individualistic as to recipients. Inference from the behavior of others is even less individualistic. (ibid., p. 7)

Again, merely pointing out that "knowledge exists in social forms" and that knowledge is inferred "from the behavior of others" is not equivalent to demonstrating any inherent limitations of "an individualist viewpoint about knowledge" (ibid., p. 6), nor can one prove anything by posing the question: "Where does … new knowledge come from?" (ibid., p. 7).[8]

Probably no one has paid more attention to the "knowledge problem" than F. A. Hayek (Vanberg 2017), whose "The Use of Knowledge in Society" (Hayek 2014 [1945]) Arrow acknowledges, only to comment that with his arguments on "the dispersed and tacit nature of knowledge" Hayek "has put obstacles in the way of a better understanding of the generation of knowledge" (Arrow 1994, p. 6). When Arrow,

[7]Arrow (1994, p. 2): "Limitations on individualistic methodology appear very strongly when considering the role of information."

[8]Arrow (ibid., p. 7) posits that "it may be easier to think of information breeding information and to suppress the role of individuals."

in order to illustrate the significance of “social knowledge,” quotes Veblen’s phrase of “the accumulated experience of mankind” (ibid., p. 6), readers familiar with Hayek’s work are reminded, of course, of the latter’s theory of cultural evolution the very point of which is to offer an individualistic account of the “accumulated experience embodied in traditions, tools and cultural artifacts of all kinds” (Vanberg 1994).

Finally, and particularly noteworthy in the present context, by pointing out “that the rules of the game are social” and by posing the question “Who sets the rules of real-life games?” Arrow (ibid., p. 5) apparently means to offer further proof of what he alleges to be inherent limitations of methodological individualism. In light of the fact that an individualist account of social rules is at the very heart of James Buchanan’s research program of constitutional economics, and considering the above-mentioned case of Hayek’s theory of cultural evolution, one can only conclude that Arrow bases his verdict on the limits and scope of methodological individualism on a smaller sample of the literature than passing a strong judgment as he does would seem to require.

To sum up, the arguments Arrow provides in support of his claim that economists cannot be consistent methodological individualists but are required to employ “irreducibly social principles and concepts” can, on closer inspection, be shown not to provide any conclusive reason for abandoning the, in his own words, “touchstone of accepted economics that all explanations must run in terms of the actions and reactions of individuals” (ibid., p. 1). To reject Arrow’s claim that there are principal reasons preventing economists from being consistent methodological individualists does not mean, of course, that in their actual practice economists have always lived up to what their “touchstone” requires. In fact, that they have been “bogged down in methodological confusion” is a charge that Buchanan (2000 [1968], p. 4) has levelled against his professional peers, targeting in particular those areas of economic inquiry that deal with organized collective action, specifically with government action. To advance a consistent individualist outlook at collective action, and government action in particular, is the important contribution James Buchanan has made to the discipline.

Buchanan's Political Economy: The Link Between Methodological and Normative Individualism

Political economy is about the application of economic theory to politics. Since economic theory is concerned with answering "what is"-questions while politics deals with "what should be" issues political economy faces the challenge of how to approach its subject, accepting Hume's dichotomy. A political economy that confines itself to studying the factual nature of observed politics can obviously evade this challenge. A political economy that seeks to employ the insights of economic theory to provide advice on policy matters must face the challenge of how to stay within its role as positive science while passing judgments on policy issues. Buchanan makes clear that he considers his approach to political economy as belonging to the latter when he states:

> Indeed the only purpose of science is its ultimate assistance in the development of normative propositions. We seek to learn how the social world works in order to make it work 'better,' to 'improve' things; this is as true for physical science as it is for social science. (Buchanan 1962, p. 308)[9]

Buchanan views his research program of constitutional political economy as one that involves "both positive and normative elements" (Buchanan 1989, p. 93) and he describes himself as "a methodological and normative individualist" (ibid., p. 80). That he clearly sees what Arrow describes as "a link between methodological and normative individualism" does not mean, however, that he rejects, as Arrow charges, "Hume's dichotomy." Even if his statements on this issue may not always be entirely unambiguous,[10] Buchanan explicitly emphasizes the

---

[9]See also Buchanan (1999a [1959], p. 196): "Propositions advanced by political economists must always be considered as tentative hypotheses offered as solutions to social problems."

[10]See, e.g., Buchanan (1989, p. 93): "Some critics have often accused me of skirting dangerously close to, if not actually committing, the naturalistic fallacy, that of deriving the 'ought' from the 'is.' I have never been concerned with such criticism directly because … in a certain sense we do derive 'oughts' from our conceptions of what 'is'."

need to distinguish between "individualism *as a method of analysis* and individualism *as a norm for organizing society*" (1962, p. 315), between a "methodological individualism that builds on individual choice as the basic unit of analysis" and a normative individualism "that locates the ultimate source of value exclusively in individuals" (2001a [1987], p. 9).

Buchanan makes clear that he considers both, methodological and normative individualism as *meta*-theoretical and *meta*-normative principles, principles that define requirements social scientists must meet when they make positive claims or pass normative judgments. He speaks, in this sense, of methodological individualism as a "framework for conducting social science" (2001b [1989], p. 56) or "as a presupposition of inquiry" (1999a [1990], p. 391), defining "the constraints (the constitution) within which the scientific discussion is conducted" (ibid., p. 390). It requires that an

> understanding of any social interaction process must be based on an analysis of the choice behavior of persons who participate in that process. Results that are predicted or that may be observed in social interaction must be factored down into the separate choices made by individuals. (2001b [1989], p. 56)

In an analogous sense Buchanan wants his normative individualism to be understood as "a self-imposed constraint" (2001d [1992], p. 23), as a requirement for how judgments on policy issues are to be justified. A political economy that seeks to provide advice on policy issues cannot do so without presupposing some normative criterion against which to judge potential alternative policy measures. To adopt a particular criterion means to choose a specific focus for one's inquiry into policy issues. It determines what one regards as problems that politics should or can address and which policy measures may count as suitable problem-solutions. Such choice is unavoidably based on a *value judgment*, a judgment about what one considers of interest, of relevance, etc. In this sense Buchanan comments on his "self-imposed constraint" of normative individualism: "I have no interest in structures of social interaction that are non-individualist" (2001d [1992], p. 23). His interest is in exploring what can be said about policy issues *if* one starts from the premise that the valuations of the individuals composing a polity should be taken as the source from which policy judgements are to be derived. As he puts it, his interest is in a theory of politics that starts from the premise that

> (i)mprovement in the working of politics is measured in terms of the satisfaction of that which is desired by individuals, whatever this may be, rather than in terms of moving closer to some externally defined, supra-individualistic ideal. (1999a [1986], p. 461f.)[11]

Stated differently, Buchanan's inquiry into politics starts from the premise that the individuals involved are to be respected as "the ultimate decision-making authority" (Buchanan and Tullock 1962, p. 6), as "the ultimate sovereigns in matters of social organization" (Buchanan 1999a [1991], p. 288), a premise he considers the defining attribute of a democratic society. Normative individualism, he posits, "implies democracy in governance" (2001a [1987], p. 9).[12]

Adopting the premise of normative individualism is, as noted, necessarily based on a value judgment. Judgments on policy issues that are made on the basis of this premise can, however, be kept entirely value-free. They are *conditional* value judgments or, in philosopher's terms, *hypothetical* imperatives, judgements that are claimed to be true only if the presupposed normative standard is adopted. Such conditional value judgments can themselves be stated as purely positive claims that are subject to empirical and theoretical scrutiny like any other positive statement. They are proven false if a policy can be shown not to serve, as they claim, the self-declared interests of the individuals concerned. And they will, obviously, be of no interest to those who do not consider the chosen normative premise as a worthwhile starting point of inquiry.

---

[11]Buchanan (1999a [1990], p. 391) contrasts the premise of normative individualism with premises "implicitly or explicitly asserting the existence of some supra-individualistic source of evaluation … God, natural reason, or the state."

[12]Buchanan (1960, p. 4): "I consider the 'individualistic' assumptions to be the only appropriate ones for democratically organized societies."—Buchanan (1999a [1990], p. 392): "(T)he whole of the constitutional economics research program rests squarely on a *democratic* foundation."

The "Maximization Paradigm" as "Fatal Methodological Flaw"

In a very early—in fact his second—publication Buchanan (1999a [1949]) criticized, as he described it in retrospect, the "still-dominant orthodoxy in public finance and welfare economics" (1999a [1986], p. 456) for adopting an "organismic framework" (1999a [1949], p. 132) in its outlook at politics. As he charged, to view the state "as a single organic entity" (ibid.), "a single decision-making unit acting for society as a whole" (ibid., p. 120) means to abandon in effect the individualistic approach economists traditionally apply in their study of market phenomena. Whereas the individualistic approach would require one to look at the state "as the sum of its individual members acting in a collective capacity" (ibid., p. 119), in the "organismic theory" the state is ascribed a value scale of its own and is presumed to pursue collective ends "called 'general welfare' or 'social utility'" (ibid.).[13]

In later publications, especially in his 1963 presidential address to the Southern Economic Association, Buchanan (1999a [1964]) discussed in more detail the question why economists came to apply simultaneously two categorically different methodological outlooks in their study of social phenomena, an individualist approach when analyzing individuals' interactions in markets, and a collectivist perspective when looking at individuals acting collectively in politics. As he posits, part of the blame for such "methodological confusion" falls on Lionel Robbins' influential definition of economics as "a science which studies human behavior as a relationship between ends and scarce means which have alternative uses" (Robbins 1932, p. 16).[14] Because this definition

[13]As Buchanan notes, in accusing the "orthodoxy" of adopting an "organismic framework" he does not mean to imply that this is by explicit choice but that "scholars working in fiscal analysis have developed constructions which become meaningful only upon some acceptance of an organic conception of the social group" (1999b [1958], p. 29).

[14]Buchanan (2001a [1975], p. 79): "Where did economics, as a discipline, take the wrong turn? My own suggestion is that Lionel Robbins marks the turning point. His book defined 'the economic problem' as the location of maxima and minima."—On the influence of Robbins' definition in the profession, see, e.g., Backhouse and Medema (2009, p. 227ff).

remains silent about "the identity of the choosing agent … for whom the defined economic problem exists," Buchanan (1999a [1949], p. 30f.) argues, it is

> by quite natural or normal extension that the economic problem moves from that one which is confronted by the individual person to that facing the larger family group, the business firm, the trade union, the trade association, the church, the local community, the regional or state government, the national government, and finally, the world. (ibid., p. 31)

By so extending the notion of choice among alternative uses for scarce means from individual human beings to collectivities one implicitly presumes, Buchanan charges, "that collectivities choose analogously to individuals" (1999a [1990], p. 382), a presumption which, in turn, leads one to apply the standard ingredient of the economic model of man, the notion of *rational, maximizing choice*, to collective units, treating them as maximizers "of some appropriately selected objective function" (2001d [1976], p. 125).

The shift of the notion of *rational choice* from the individual to the collective level that Buchanan criticizes is exemplified in paradigmatic fashion by Kenneth Arrow who, in his seminal *Social Choice and Individual Values* (1963 [1951]) expressly draws an analogy between "the usual utility analysis of the individual consumer … (and) rational behavior on part of the community" (ibid., p. 2). Keeping with "the traditional identification of rationality with maximization" (ibid., p. 3) this means, Arrow posits, that a community chooses from among available alternatives the one that, "according to its collective preferences … stands highest" (ibid., p. 2) in its preference ordering, just as individuals choose their most preferred option.

Taking up the theme of his 1949 publication Buchanan criticizes Arrow in his 1954 article "Social Choice, Democracy and Free Markets" (1999a [1954]) for his use of "the concept of social rationality" (ibid., p. 89), charging that attributing rationality to "the social group implies the imputation to that group of an organic existence apart from that of its individual components" (ibid., p. 92). It means, as he later put it, inappropriately to extend "the teleological model of the individual maximizer to that for the community or collectivity as a unit" (1999a [1978], p. 256), an extension that "(c)areful attention to the basic individualistic presupposition would prevent" (2001b [1989], p. 57).[15]

Buchanan targets in particular the fact that Arrow applies the measuring rod of "social rationality" to markets as well as to politics, treating "the market mechanism" and "voting" equally as "methods by which social choices can be made" (Arrow 1963 [1951], p. 1).[16] By viewing voting and the market mechanism as "special cases of collective social choice" (ibid., p. 3) Arrow misclassifies, so Buchanan charges, markets as if they were about choices to which the twin concepts of "rationality" and "maximization" could be meaningfully applied. The market, he argues, "does not belong in the category of collective choice" (Buchanan 1999a [1954], p. 90), it "does not call upon individuals to make a decision collectively at all" (ibid., p. 102). Accordingly, there is no reason in the first place to interpret outcomes that result from market processes in categories of "rational choice" on part of the community.[17] As Buchanan puts it:

> The market or market organization is … the institutional embodiment of the voluntary exchange processes that are entered into by individuals in their several capacities. (1999a [1964], p. 38)

In the dominance of the "allocational or maximizing perspective" Buchanan locates the root cause of economists' failure to recognize the illegitimacy of transferring the rationality concept from the level of

[15]On the so-called "impossibility theorem" for which Arrow's *Social Choice and Individual Values* became famous Buchanan (2001b [1989], p. 58) has commented: "Kenneth Arrow's impossibility theorem appeared surprising only to those who failed to understand the restrictive limits imposed by the individualistic presupposition."

[16]Arrow (1963 [1951], p. 1): "In a capitalist democracy there are essentially two methods by which social choices can be made, voting typically used to make 'political' decisions, and the market mechanism, typically used to make economic decisions."

[17]Buchanan (1999a [1954], p. 101): "The market does not establish the optimum social state in the sense that individuals, if called upon to vote politically (act collectively) for or against the market-determined state in opposition to a series of alternatives would consistently choose it."

individual choice to the outcomes of market processes.[18] As he charges, economists tacitly abandon their inherited methodological and normative individualism when they adopt the concept of "social rationality" or "collective rationality" and ascribe to collectivities "collective preferences" or values scales of their own. Even if those who construct collective value scales or measures of collective welfare claim that they are "respecting individuals' tastes" (Samuelson 1977, p. 83) or that their measure "depends on individual welfares" (Arrow 2010, p. 26), their constructs are, Buchanan submits, only seemingly individualistic. They treat "individual values as the units of account to be used in deriving social welfare functions" (1999a [1954], p. 119) instead of respecting individuals' *choices* as "the ultimate source of evaluation" (2001b [1985], p. 245). Or, as Arrow (1963, p. 104) himself puts it, "individual values are the raw material out of which the welfare judgment is manufactured."[19]

The project of aggregating "the multiplicity of individual preference scales" (Arrow 1969, p. 223) into a measure of social preference rests, Buchanan charges, on the unfounded claim that the "observing economist is … able to 'read' individual preference functions" (1999a [1959], p. 126).[20] Against such claim he insists:

[18]Buchanan (1989, p. 82): "Given the dominance of the Robbins formulation in the economic theory of mid-century, it is not surprising that market solutions were often modeled as analogues to planning solutions to the resource allocation problem. Economists proceeded as if 'the market' embodied 'social choices' among alternative allocations of resources, choices that may be compared with those that might emerge from the monolithic decisions of a single planner."—Buchanan (1999a [1964], p. 37): "If … the economist will look on the market order as a *means* of accomplishing the basic economic functions … (t)he 'market' becomes an engineered construction, a 'mechanism,' an 'analogue calculating machine,' a 'computational device' … In this conception, the 'market,' as a mechanism, is appropriately compared with 'government,' as an alternative mechanism for accomplishing similar tasks."

[19]Arrow (2010, p. 26): "Social choice theory strips down the properties of the members to their preference scales."

[20]Buchanan (1999a [1959], p. 133): "Individual preferences, in so far as they enter the construction must be those which *appear to the observer* rather than those revealed by the behavior of the individuals themselves. In other words, even if the value judgments expressed in the function say that individual preferences are to count, these preferences must be those presumed by the observer rather than those revealed in behavior."—Buchanan (1999a [1954]): "A necessary condition for deriving a social welfare function is that all possible social states be ordered *outside or external* to the decision-making process itself. What is necessary, in effect, is that the one erecting the function be able to translate the individual values (which are presumably revealed to him) into social building blocks."

> Utility is measurable, ordinally or cardinally, only to the individual decision-maker. It is a *subjectively* quantifiable magnitude. While the economist may be able to make certain presumptions about 'utility' on the basis of observed facts about behavior, he must remain fundamentally ignorant concerning the actual ranking of alternatives until and unless that ranking is revealed by the overt action of the individual in question. (1999a [1959], p. 126)[21]

Accordingly, respecting individuals' values can for Buchanan mean nothing other than to respect individuals as "the ultimate decision-making authority" (Buchanan and Tullock 1962, p. 6) in social matters from whose choices any legitimacy to decide or act on behalf of collective units must be derived.[22]

The reasons for economists' failure to consistently adhere to their inherited methodological and normative individualism can in Buchanan's view be clearly identified. According to his verdict, "the maximization paradigm … is the fatal methodological flaw in modern economics" (1979, p. 281). With his 1949 article in which he argued for replacing the "organismic" approach to fiscal theory with an individualistic outlook Buchanan embarked on the project of expounding a consistently individualistic economic theory, in particular an *Individualistic Theory of Politics*,[23] a project that would remain a core

[21]Buchanan (2001a [1988], p. 62): "(T)he values or interests of individuals are the only values that matter for the quite simple reason that these are the only values that exist. Such terms as 'national goals,' 'national interest,' and 'social preference' are confusing at best."

[22]The difference between respecting individuals' choices and respecting individuals' preferences, emphasized by Buchanan, is implied when A. Sen (1986, p. 217f.) comments: "We can also distinguish between the problem of aggregating individual *interests* … and that of aggregating individual judgments on some social matter. … Similarly, the individual preference might be expressed by the persons themselves (e.g. by voting), or guessed by someone doing the aggregation exercise (e.g. by a Planning Commission arriving at a plan for the country by taking note of the interests of each group, or a person making a social welfare judgment by assessing what he sees to be the interests of different people)."

[23]Buchanan (1999a [1979], p. 48): "The basic units are choosing, acting, behaving persons rather than organic units such as parties, provinces, or nations. Indeed, yet another label for the subject matter here is 'An Individualistic Theory of Politics'."—Buchanan (2000 [1968], p. 6): "We

concern of his research efforts throughout his career. Significant fruits of these efforts were his co-founding of *public choice theory* and his founding contribution to *constitutional economics*, the first as a purely *positive* political economy applicable to political systems of any kind, whether democratic, autocratic, or totalitarian, the latter as an *applied* political economy that explores what can be said about politics if one starts from the premise of a normative individualism, understood as the premise of "individuals as ultimate sovereigns."

Individual Choices and Emergent Social Outcomes

The "organismic and the individualistic approaches to fiscal theory" (1999a [1949], p. 132) that he contrasted in his 1949 article Buchanan characterizes in the following terms:

> The organismic framework gives a much more complete normative behavior pattern for the fiscal authority. Since the government is the basic entity, the fiscal theory reduces to a statement of an applied maximization problem. (ibid.)
>
> The focus is completely shifted in the individualistic theory. The individual replaces the state as the basic structural unit. The state has its origin in, and depends for its continuance upon, the desires of individuals to fulfill a certain portion of their wants collectively. The state has no ends other than those of its individual members and is not a separate decision-making unit. State decisions are, in the final analysis, the collective decisions of individuals. (ibid., p. 122f.)

---

should try to derive a theory of individual behavior in the political process … When I looked around at all this, some dozen years ago, I was surprised to find that a theory of individual behavior in political process did not exist, and that only a few scattered attempts had been made to create one. … Since that time, since 1954 roughly speaking, I have been, in the on-and-off manner of academic custom, working within this broadly defined area of research. That is to say, I have been exploring, along with various colleagues and co-workers, some of the aspects of a theory of individual behavior in political choice."

The difference between the two outlooks at government has significant implications for the direction into which research efforts are guided. Approaches that apply the notions of rationality and maximization to collectivities focus attention on how alternative social outcomes among which the community or collectivity is presumed to be able to choose may be compared in terms of "social preferences" or measures of "social welfare," with the aim of identifying the one that ranks highest on the social preference scale. By contrast, an individualistic approach that requires to explain social phenomena in terms of individuals' choices focuses attention on the *process* through which social outcomes are brought about by individuals' choices and their combined effects.

There is, obviously, a categorical difference between processes in which individuals participate as independently choosing actors, constrained only by general rules of conduct that apply equally to all, and processes in which individuals participate as members of on organized collectivity, subject to the rules according to which the organization operates, rules that define, among other things, how individual choices translate into decisions counting as decisions of the collectivity as a whole.[24] Yet, notwithstanding the differences between the two processes, paradigmatically represented by market processes and political decision-making, Buchanan's research agenda requires that both be analyzed within the same individualistic methodological framework. In both processes, he posits, social outcomes as such are not, and cannot be, chosen, they *emerge* from the multiplicity of choices made by the individuals involved.[25] There exists in neither of the two a choosing agent to whose rational-maximizing choice the resulting social outcome could be attributed.

[24]The contrast between the two processes corresponds to F. A. Hayek's (1973, p. 35ff.) distinction between "two kinds of order," spontaneous order and organization.

[25]Buchanan (2000 [1968], p. 4): "I define the economy precisely in the same way that I defined government. It is the complex of institutions that emerges as a result of the behavior of individual persons who organize themselves to satisfy their various objectives, privately as opposed to collectively. Thus, the economy and the government are parallel sets of institutions, similar in many respects, and, of course, intersecting at many separate points."—Buchanan (1989, p. 92): "There is no categorical distinction between the economic and the political process; inquiry in each case centers on the choice behavior of individuals who act, one with another."

That outcomes are not chosen is obvious for market processes or, more generally, for processes of spontaneous social coordination which have been the principal subject of economics since its classical origins. As an offspring of the Scottish moral philosophy, classical economics drew attention to the un-intended social consequences of individual action, to social phenomena that are, in Adam Ferguson's word, "the results of human actions, but not of human design" (Hayek 2014 [1967]).[26] The explanatory logic of the "invisible-hand paradigm" is the characteristic feature of the analytical outlook with which economists approach their subject. From such perspective, so Buchanan argues, the market is viewed as

> the institutional embodiment of the voluntary exchange processes that are entered into by individuals in their several capacities. … It is a setting, an arena in which we, as economists, as theorists (as 'onlookers'), observe men attempting to accomplish their own purposes, whatever they may be. (1999a [1964], p. 38)

The social outcomes that result in this arena

> are 'chosen' by no one …; the aggregative results do not lend themselves to evaluation in terms of … rational choice models … applicable only to the individual's selection among options. (2001b [1989], p. 57)

That, as Buchanan claims, social outcomes are not, and cannot be chosen, is surely less obvious when we move from the realm of market-type processes of spontaneous coordination into the realm of deliberately coordinated action where the "visible hand" of collective choice replaces Adam Smith's "invisible hand." The notion of collective choice or action implies the presence of a collectivity that counts as a decision-making and acting unit, as testified by the fact that as legal entities they can be held liable for damages caused by actions or decisions attributed to

[26]Buchanan (2001b [1989], p. 57): "The discovery and elaboration of this principle were the crowning achievement of the eighteenth-century moral philosophers, from whose work economics, as a discipline, emerged."

them. To be sure, the point of Buchanan's claim is not to deny that it is meaningful to speak of organized collectivities such as polities, corporations, associations, unions, clubs, etc. as acting and decision-making units. His point rather is that in both realms, markets and politics or, more generally, spontaneous order and organization, "individual persons are the basic component units (2000 [1968], p. 4) and the ultimate choice makers,"[27] and that collective action—no less than market processes—must be "factored down into the participatory behavior of individual members" (1999a [1990], p. 383). As he puts it:

> In my vision of social order … individual persons are the ultimate decision-makers, and if we want to discuss governmental decision processes we must analyze the behavior of individuals as they participate in these processes. (2000 [1968], p. 4)

Buchanan does not object to recognizing organized collectivities as decision-making and acting units. He only criticizes the "extension of the choice calculus from the individual to collectivities" (1999a [1990], p. 383) that is implied when collective action is analyzed in categories of rationality and maximization.[28] Against such extension he argues:

> An economic theory that remains essentially individualistic need not have become trapped in such methodological straight jacket. If the maximization exercise is restricted to explanation-understanding of the individual who makes choices, … there is no difficulty at all in analyzing individual choice behavior under differing institutional settings and in predicting how these various settings will influence the outcomes of the interaction

[27]Buchanan and Tullock (1962, p. vi): "Human beings are conceived as the only ultimate choice makers in determining group as well as private action. Economists have explored in considerable detail the process of individual decision-making in what is somewhat erroneously called the 'market sector.' Modern social scientists have, by contrast, tended to neglect the individual decision-making that must be present in the formation of group action in the 'public sector'."

[28]Koppl (1992, p. 294): "(T)here is partial equilibrium modeling wherein 'firms' are given mathematical or graphical representations as profit maximizers and 'households' are similarly treated as utility maximizers. This strand of Post-Marginalist analysis is, of course, widely practiced. It is the meat and potatoes of the practicing economist."

> process. … Comparative analysis should allow for predictions of possible differences in the characteristics of the results that emerge from market and political structures of interaction. (1999a [1986], p. 458)

For instance, when Buchanan notes that "a corporation does not 'choose' alternatives" (2001b [1989], p. 56) this is not meant to say that corporations cannot be regarded as decision-making units, it is simply meant to emphasize that "the choices of individuals, acting as agents for the corporation, are the relevant subjects of meaningful inquiry" (ibid.).[29] One must carefully distinguish between the claim that organized collectivities exist as units of action in the social world, a claim perfectly compatible with a methodological individualism, and the explicitly or implicitly drawn inference that they can be viewed as 'rational actors,'[30] an inference that amounts to shifting from an individualist to an organicist methodological framework.[31] "Careful attention to the basic individualistic presuppositions," Buchanan (2001b [1989], p. 57) argues, would prevent such illegitimate inference. Even if the collectivity is the unit on behalf of which choices are made,

> the only genuine choices made are those of the individuals who participate in the decision process. … From this participation by separate persons, the decision rule or institution generates an outcome … No one 'chooses' this outcome, however, and it is an error of major proportion

---

[29]In this sense one must also interpret statements such as this one: "Only individuals choose and act. Collectivities, as such, neither choose nor act, and analysis that proceeds as if they do is not within the accepted scientific canon. Social aggregates are considered only as the results of choices made and actions taken by individuals" (Buchanan 2001a [1987], p. 8).

[30]Rubin's (1997) discussion of the contrast between economists' declared methodological individualism and their practice of treating firms and other collectivities as rational actors is in parts ambiguous because of the failure carefully to distinguish between speaking of "collective entities as making decisions, adopting strategies" (ibid., p. 1437) and "ascribing rational behavior to the firm" (ibid.).

[31]Buchanan (2001b [1989], p. 57): "There may exist settings in which the collective seems to confront a selection among alternatives. The decision process must generate a single result from among several options available. The political unit, the state, must (1) go to war, or (2) maintain peace. It is natural linguistic usage to refer to the state as 'choosing' among the options, and from this to infer directly that the decision process of the state should exhibit the rationality properties of the individual."

> to attribute to the choosing process, as such any rationality precepts. (ibid., p. 58)[32]

Organized collectivities are units of decision-making and action in the sense that decisions made or actions taken by individual members are counted as decisions or actions of the collectivity, as testified by the fact that, as legal entities, collectivities can be held liable for damages caused by such decisions or actions. Every organized collectivity operates de facto under a formal or informal constitution, i.e. a set of rules that determine who among its individual members is authorized to participate in decisions counting as decisions of the collectivity, and which actions of its members are taken on behalf of the collectivity. As Buchanan notes:

> Clubs, trade unions, corporations, parties, universities, associations – these and many more, exist, and operate under constitutions that are amenable to scientific inquiry. (1999a [1990], p. 384)[33]

Individualistic accounts of the operation of organized collective entities must focus on their formal or informal constitution that define the rules of the processes through which individual members' choices and actions translate into collective decisions and actions. Approaches that treat collectivities as "organic entities" Buchanan charges with neglecting

> the most important problem of all, that is, the manner in which collective decisions actually are made. In a society governed by some authoritarian and benevolent ruler, the organic approach might prove helpful. But societies of the Western world are not constructed in that way. Collective decisions are made through a complex and involved process of discussion,

[32]Buchanan and Tullock (1962, p. 32): "Under the individualistic postulates, group decisions represent the outcome of certain agreed-on rules for choice after the separate individual choices are fed into the process. There seems to be no reason why we should expect these final outcomes to exhibit any sense of order which might … be said to reflect rational social action."

[33]On the notion of organizations as "constitutional systems", see Vanberg (1994 [1992]) and Vanberg and Buchanan (2000 [1986]).

> individual voting, representation in legislative assemblies, and, finally, some administrative discretion on the part of officials periodically elected or appointed. No individual anywhere in the decision-making chain can place himself in the role of the despot, and each will necessarily be limited in his information. (1999b [1958], p. 117)

Looking back, decades later, at his 1954 critique of Kenneth Arrow's *Social Choice and Individual Values* Buchanan blames himself for having given too much away by charging Arrow only for applying the notion of social choice to the outcomes of market processes, instead he "should have recognized that the very notion of social choice is an analytical mirage" (1995, p. 142), that is inapplicable to the outcomes of collective, political decision-making processes as well. Buchanan identifies two reasons why the notion, central to social choice theory, of a choice among "social states" is inapplicable to political outcomes no less than to market outcomes.[34] Firstly, wherever political decisions are not dictated by a single autocrat but are co-determined by a group of individuals, it is the decision-rule in place that determines how a collective decision is to be derived from the separate individual votes. The second reason why political outcomes *emerge* rather than being *chosen* applies to the limiting case of a single autocratic ruler no less than to committee-decisions, namely that what is, and can only be, directly chosen are specific policy *measures*, measures that may or may not produce the outcome the autocratic ruler or the committee intends to achieve. In order to be practically implemented such measures require the active involvement of agents whose behavioral discretion can impossibly be limited to zero and, furthermore, the results they produce will depend on the behavioral responses of individuals who are affected by them. If only

[34]According to Arrow (1963 [1951], p. 67), the "most precise definition of a social state would be a complete description of the amount of each type of commodity in the hands of each individual, the amount of labor to be supplied by each individual, the amount of each productive resource invested in each type of productive activity, and the amounts of various types of collective activity, such as municipal services, diplomacy and its continuation by other means, and the erection of statues of famous men."—Sen (1970, p. 152) defines a social state as "a complete description of society including every individual's position in it."

for this reason, because of the inescapable behavioral discretion on part of the individuals involved, "a social state cannot be chosen, whether by a single person with authority or by a group of persons who might try to make collective decisions through some rule" (1995, p. 144). As Buchanan concludes:

> A central proposition is that spheres of behavioral adjustment exist that are beyond control. … Acceptance of this starting point implies that the observed outcomes of all social interaction processes, that is, all social states, must always be understood to be emergent from the separate choices made by behaving units, each one of which chooses the most preferred option available from alternatives along the dimension of adjustment assigned. (ibid., p. 148f.)[35]

The only feasible objects of social choice are, Buchanan emphasizes, specific policy measures and the rules to which individuals are subject, be it in their private capacity as market participants or in their public capacity as participants in the political process, the latter choice being the principal means by which as members-citizens of political bodies they may hope to systematically shape the *patterns* of outcomes resulting from the multiplicity of their choices in markets and in politics. Again, in Buchanan's words:

> That which may be chosen or selected in some social choice process is an assignment of rights, separately, to participants in interaction, or, in alternative terminology, a set of rules that specify the separate domains for the exercise of choice, and action, by the participants. Given any assignment, the simultaneous exercise of choice by the participants will generate an emergent social state or, more generally, a predicted pattern of possible states. (ibid., p. 144)

[35]Buchanan (1995, p. 142): "My basic proposition is that, in any social setting, individuals … retain personal control over actions along at least some minimal set of dimensions of behavioral adjustment. Once this elementary fact is accepted as a positive description of social reality, the logical fallacy involved in any analysis of choices among social states stands clearly exposed. Social choice, in any meaningful sense, must be behaviorally multidimensional."

Individual Sovereignty, Democracy and the Common Good

If economists, as Arrow (1987, p. 124) notes, have taken for granted "that alternative policies should be judged on the basis of consequences for individuals," they have mostly specified this presupposition as requiring them to "respect" individuals' values or preferences as "units of account" in their calculation of *social* or *collective* preferences. As indicated above, in Buchanan's assessment, this practice amounts to bringing an "organicist conception in by the back door" (Buchanan and Tullock 1962, p. 13), because, even if it is derived from individual values, the collective measure so constructed is treated as a normative standard in its own right, separable from individuals' preferences.[36] A consistent normative individualism, Buchanan insists, requires economists to respect individuals as "ultimate decision-makers" (2000 [1968], p. 4) and not as mere metering stations from which they "read" the utility-data they need for their calculations. It is this normative presupposition on which Buchanan's approach to constitutional political economy is based.

The normative premise that individuals are to be respected as the ultimate decision-makers is, so Buchanan emphasizes, nothing other than the normative foundation of the *democratic* ideal, the ideal of a political order in which the "ultimate decision-making authority" (Buchanan and Tullock 1962, p. 6) rests with the individual members of the constituency.[37] In this sense, the research program of constitutional political economy explores the normative requirements and the factual working principles of "an individualistic society which governs itself

[36]In fact, Buchanan objects to the very notion of "utility functions" that can be identified separately from actual choices and be used as the basis on which "social preferences" may be calculated. He posits "that not even individuals have well-defined and well-articulated objectives that exist independently of choices themselves. Introspectively, we must realize that we do not" (1999a [1979], p. 258).

[37]In characterizing his theoretical outlook Buchanan (1975, p. 2) notes: "The approach must be democratic, which … is merely a variant of the definitional norm of individualism."

through the use of democratic political forms" (1999b [1958], p. 29).[38] In studying such a society it is entirely misplaced to judge alternative policy measures by invoking "the idea of the 'group' or the 'whole' as a sentient being" (ibid.) with its own value scale, be it called social welfare, social utility or public interest. Buchanan takes care, though, to point out that in rejecting the notion of "'the public interest' as something that exists independently of the separate personal or private interests of the individual members of the community" (1999c [1967], p. 221) he does not mean to say that the notion of a 'public interest' can have no meaning in an individualistic-democratic society. What he insists on is that such concepts must be defined in ways compatible with the normative presupposition of individuals as the ultimate decision-making authorities.

Among individuals who as free and equal persons engage in social transactions or cooperative arrangements with each other the concept of "public interest" can have meaning only if it refers to interests that all participants have in common. And the only conclusive test of such commonality of interest is the voluntary agreement of all parties to the transaction or arrangement in question. In their study of markets economists have always, implicitly if not explicitly, taken the participants' voluntary agreement as criterion of "efficiency" in market transactions or, in other words, as indicator of the fact that these transactions are mutually beneficial to the parties involved. It is, Buchanan argues, nothing less than a requirement of consistency that economists must apply the agreement criterion equally to arrangements of *organized collective action* in markets as well as in politics.[39] On the definition of "efficiency" as "that which tends to emerge from the voluntary agreement among persons in the relevant group" Buchanan notes:

---

[38]Buchanan (1999c [1967], p. 174f.): "If the analyst chooses to work within the confines of the democratic model, he must commence at the level of the individual citizen-voter, and he is obliged to explain how the choices of the citizen-voter are translated into collective decisions."

[39]Buchanan (1999a [1986], p. 463): "The political analogue to decentralized trading among individuals must be that feature common over all exchanges, which is *agreement* among the individuals who participate. The unanimity rule for collective choice is the political analogue to freedom of exchange of particular goods in markets."

> This definition becomes the only one possible unless it is presumed that the subjective evaluation of individuals is objectively known to external observers or that the evaluations relevant to efficiency are to be divorced from individual evaluations altogether. (2001c [1986], p. 322)

As far as organized collectivities are concerned that are formed *within* the market arena, such as, for instance, business firms or private associations, economists will surely agree that what qualifies as "common good" must serve the *common interests* of all participants, and that the relevant test of such commonality of interest is observed agreement. According to Buchanan, the same holds true for the public arena, for organized political action. The claim that a policy measure serves the public or general interest can in a democratic polity only mean that it serves the *common interests* of all citizens, and the only conclusive test of such claim is observed agreement. As he puts it:

> If we reject the notion that there must exist a public or general interest apart from that of the participants, we are necessarily led to the conclusion that only upon unanimous consent of all parties can we be absolutely assured that the total welfare of the group is increased. (2000 [1968], p. 10)[40]

Even if consistent adherence to a normative individualism requires one to apply the agreement criterion to organized collective action, private and public, as well as to market exchange, at least in the case of large-size collectivities its practical relevance in guiding collective action seems to be rather limited. It is obvious that with increasing group-size conflicting interests will make reaching agreement on the various particular issues a collectivity may have to deal with increasingly unlikely, such that, if practiced as decision rule, the unanimity requirement would extremely limit the collectivity's ability to act. Addressing this issue Buchanan argues:

---

[40]Buchanan has on many occasions emphasized that in developing his views on the significance of the agreement criterion in fiscal theory he was "influenced strongly by the thinking of Knut Wicksell" (2000 [1968], p. 10).—For more detailed references, see Vanberg (2018).

> It is precisely at this stage that the individualistic model can rescue the 'public interest,' indirectly, through the essential separation between the constitutional and the operational stages of political decision. (2001b [1966], p. 255)

To separate the constitutional and the operational stages or levels of political—and, more generally, collective—decision-making means to draw attention to the fact that, while the individual members of polities or collectivities are likely to disagree on how particular cases should be decided, they may well have a common interest in—and be, therefore, able to agree on—general rules for how to deal with certain types of recurrent issues. A case in point is the prominent place the majority rule occupies in virtually all member-governed organizations and, in particular, in democratic polities. The difficulties to work out, and even more so the inability to reach agreement in instances in which a collective decision is called for may well provide a rational reason for all members of a polity or collectivity to agree on adopting a decision-rule requiring less than unanimity, such as simple majority rule, recognizing that thereby they must accept the risk of decisions being made that go against their interests.[41] In this sense and contrary to wide-spread perception, majority decisions should not be counted as a definitional or generic attribute of democracy but, as Buchanan puts it, "must be viewed primarily as a device for breaking a stalemate and for allowing some collective action to be taken" (1999a [1954], p. 95).

Shifting the focus from the operational level of choice to the choice of rules allows, as Buchanan points out,

> some reconciliation of the purely individualistic and the public interest conception of political order. If the choosing individual is placed in the position of selecting among institutions, among alternative rules of the

[41]Buchanan (2001b [1966], p. 255): "The center of attention becomes the mental calculus of the individual as he is confronted with a choice among alternative rules for the reaching of subsequent political decisions – that is to say, as he is confronted with a genuinely constitutional issue. The individual does not know, nor is he able to predict, what particular issues will be presented subsequent to the adoption of the rule."

> game, and if he cannot predict with any degree of accuracy his own particular position on subsequent rounds of play, his own private interest will … lead him to choose rules that will be efficient for the group, taken as a whole. And consensus among all members on a common set of rules becomes conceptually or potentially possible. The analysis suggests, therefore, that if individuals are appropriately placed in positions where they are required to choose 'constitutionally,' they can be led, by their own self-interest, to act as if they are furthering the general or public interest in some properly meaningful sense. (1999c [1967], p. 221f.)[42]

As indicated, Buchanan likes to illustrate the motivational difference between choosing among alternative options in particular instances and choosing among alternative rules for dealing with issues of a certain kind by drawing an analogy to ordinary games in which

> the player does not know, at the time when he must agree with fellow players on the rules under which the game shall be played, what particular set of rules will be privately most beneficial to him in subsequent rounds of play. … The inherent uncertainty in choice among rules makes consensus among separate players much more likely to be attained than might otherwise be expected. … (I)f no prospective player can predict his own position in the various rounds of play anticipated, consensus on rules moves within the realm of possibility. (1999c [1967], p. 220f.)

The important implication of adopting a constitutional approach to the issue of what may count as public or common interest in politics and in collective action generally is that it draws attention to the nature of the process through which social outcomes are brought[43] about instead

[42]Buchanan (2001b [1966], p. 255): "It is necessary to distinguish sharply between day-to-day political decision-making, where the struggle often does reduce simply to that among conflicting individual-group interests, and 'constitutional' decision-making, where individuals may be thought of as participants in choices of rules under which subsequent day-to-day decisions are to be made. … (A)t this stage, it becomes possible to reconcile separate individual interests with something that could, with some legitimacy, be called the 'public interest' were it not for the confusion that this particular usage might generate."

[43]Buchanan and Tullock (1962, p. 285): "(T)he 'public interest' becomes meaningful only in terms of the operation of the rules for decision-making."

of attempts to judge such outcomes directly in terms of constructs like "social welfare" or "collective preferences."

That a consistent normative individualism necessarily leads one, for the reasons discussed above, to adopt a constitutional perspective has also important implications for the role the political economist can play as advisor in democratic polities. While welfare economists may claim authority to advise on particular policy measures on account of their predicted effects on aggregate social welfare, their "self-imposed constraint" prohibits constitutional political economists from providing any such advice. They may, like their fellow economists, inform citizens and policy-makers on the predictable factual consequences of alternative policy measures, but the normative presupposition of individuals as ultimate decision-making authority does not allow them to pass any judgment on the "social desirability" of these consequences separate from, and independent of the evaluations the individual members of the respective collectivities express themselves in their actual choices. Rather than advising citizens or their political representatives on what policies to adopt in particular instances, the constitutional political economist's advice focuses instead on proposals for how the rules by which political decisions are made and executed may be *improved* in terms of how suitable they are in enabling citizens to realize their common interests. In Buchanan's words:

> (T)he task for the constitutional political economist is to assist individuals, as citizens who ultimately control their own social order, in their continuing search for those rules of the political game that will best serve their purposes, whatever they might be. (1999a [1986], p. 467)[44]

[44]Buchanan (1999a [1986], p. 461f.): "Improvement in the working of politics is measured in terms of the satisfaction of that which is desired by individuals, whatever this may be … There is no criterion through which policy may be directly evaluated. … The focus of evaluative attention becomes the process itself, as contrasted with end-states or outcome patterns. 'Improvement' must, therefore, be sought in reforms in process, in institutional change that will allow the operation of politics to mirror more acutely that set of results that are preferred by those who participate."

Consistent Individualism and Consistent Liberalism

In lieu of a summary I want to conclude by drawing attention to the implications that Buchanan derives from the normative presupposition of "individuals as sovereigns" for an adequate understanding of the political ideal of classical liberalism. In its standard interpretation this ideal accords primacy to the political ideal of *individual liberty*, understood as "freedom under the law" (Hayek 1960, p. 153). Individual liberty, so understood, is tantamount to *private autonomy*, it means "that what we may do … is limited only by the same abstract rules that apply equally to all" (ibid., p. 155). Such characterization of individual liberty raises, of course, the question of where the rules or laws that define what individual liberty entails derive their authority or legitimacy from. Or, in other words, since these rules or laws may define the scope and limits of individual liberty differently, the question arises as to how the merits of potential alternative legal-institutional frameworks might be assessed. It is this question, the question of "the ultimate justification for regimes of social interaction" that, Buchanan charges, "advocates of a free society embodying the maximal exercise of individual liberties have often neglected" (1999a [1991], p. 281).

As far as transactions or collective arrangements are concerned that individuals conclude as private-law subjects within a given legal-institutional framework, the question of justification or legitimacy finds a straightforward answer from a classical liberal perspective. Legitimacy derives from the voluntary agreement of the parties to the respective transactions or collective arrangements. Yet, the contracts voluntarily concluded within a given framework of rules and laws can surely not confer legitimacy on the framework itself.[45] In other words, the value

[45]The contrary claim is implied when Rothbard (1956, p. 250) argues: "The free market is the name for the array of all the voluntary exchanges that take place in the world. Since every exchange demonstrates a unanimity of benefit for both parties concerned, we must conclude that *the free market benefits all its participants*."

of individual liberty as private autonomy cannot provide the normative source from which the framework that defines its scope and limits could derive its legitimacy. Accordingly, a liberalism that focuses on the value of individual liberty as private autonomy faces the challenge of needing a normative criterion for judging alternative legal-institutional frameworks, frameworks that may specify the scope and limits of private autonomy quite differently.

A consistent liberalism, so Buchanan posits, must answer this challenge extending the very criterion it applies in judging the legitimacy of transactions and collective arrangements individuals conclude in their capacity as private law subject, namely voluntary agreement, to the level at which the "rules of the game" are either explicitly chosen or inherited as part of a socio-cultural tradition. This means that a consistent liberalism must, as Buchanan argues, supplement its emphasis on *individual liberty* by recognizing the principle of *individual sovereignty* as a fundamental normative premise, i.e. the premise that individuals are to be respected not only in exercising their private autonomy but also as "the ultimate sovereigns in matters of social organization". It means that the *ultimate* source from which the rules and institutions *within* which individuals deal with each other as private law subjects derive their legitimacy can only be the voluntary acceptance of these rules and institutions by those who are subject to them. As Buchanan explains:

> The justificatory foundation for a liberal social order lies, in my understanding, in the normative premise that individuals are the ultimate sovereigns in matters of social organization, that individuals are the beings who are entitled to choose the organizational-institutional structure under which they will live. In accordance with this premise, the legitimacy of social-organizational structures is to be judged against the voluntary agreement of those who are to live or are living under the arrangements that are judged. The central premise of *individuals as sovereigns* does allow for delegation of decision-making authority to agents, so long as it remains understood that individuals remain as *principals*. The premise denies legitimacy to all social-organizational arrangements that negate the role of individuals as either sovereigns or principals. On the other hand, the normative premise of individuals as sovereigns does not provide exclusive normative legitimacy to organizational structures

> that – as, in particular, market institution – allow internally for the most extensive range of separate individual choice. Legitimacy must also be extended to 'choice-restricting' institutions so long as the participating individuals voluntarily choose to live under such regimes. (1999a [1991], p. 288)[46]

There exists an obvious tension between the two normative premises, individual liberty and individual sovereignty, that, as Buchanan posits, a consistent liberalism must simultaneously honor, at least as we move from ideal cases in which rule-regimes and their reforms are voluntarily agreed upon by virtually all members of the respective collectivity to the common reality of democratic polities in which the "rules of the game" are chosen non-unanimously, by simple or qualified majority rule. If the practiced decision-rules enjoy the voluntary agreement of a polity's citizens-members respecting individuals' sovereignty requires liberals to accept the outcomes they produce even if they curtail individual liberty. Peacock and Rowley (1972) point to this tension when they note that, on the one hand, the "liberal values individual freedom above all other social objectives and will not easily consent to the restriction of such freedom" (ibid., p. 480) and observe, on the other hand, that it "is essential to liberalism … that all men should have the same share in making the law even when such a system of government results in illiberal policy action" (ibid., p. 481).

Peacock and Rowley in effect implicitly argue, as Buchanan does more explicitly, that liberals are required to assign the premise of individual sovereignty priority over the premise of individual liberty in the sense that the former is a *matter of principle* while the latter is a *matter of prudence*. The premise of individual sovereignty is a constitutive, indispensable attribute of an association among individuals who respect each

[46]Buchanan (1996 [1995], p. 267f.): "What is the ultimate maximand when the individual considers the organization of the political structure? … (T)his maximand cannot be summarized as the maximization of (equal) individual liberty from political-collective action. … A more meaningful maximand is summarized as the maximization of (equal) individual sovereignty. This objective allows for the establishment of political-collective institutions … So long as one's agreement to such political action is voluntary, the individual's sovereignty is protected even though liberty is restricted."

other as equals. Its recognition by all can be demanded on account of the principles that define the terms of membership in such association. By contrast, recognition of the premise of individual liberty liberals cannot simply demand from their fellow citizens as a matter of principle, but only on prudential grounds, by seeking pointing out the advantages they can expect from a "constitution of liberty." This is, in essence, the conclusion Peacock and Rowley draw when they state:

> The liberal, therefore, will abide by the decisions arrived at by majority rule while exercising all reasonable means of persuasion available to him … to alter the preferences of those who would encourage illiberal policies, and, in particular, those who are concerned with extending further the scope and power of the state. (ibid.)

References

Arrow, K. J. (1963 [1951]). *Social Choice and Individual Values* (2nd ed.). New Haven and London: Yale University Press.

Arrow, K. J. (1963). Notes on the Theory of Social Choice, 1963. In *Social Choice and Individual Values* (2nd ed., pp. 92–120). New Haven and London: Yale University Press.

Arrow, K. J. (1969). Values and Collective Decision-Making. In P. Laslett & W. G. Runciman (Eds.), *Philosophy, Politics and Society* (pp. 215–232). Oxford: Basil Blackwell.

Arrow, K. J. (1987). Arrow's Theorem. *The New Palgrave Dictionary of Economics* (Vol. I, pp. 124–126). London: Palgrave Macmillan.

Arrow, K. J. (1994). Methodological Individualism and Social Knowledge. *The American Economic Review, 84,* 1–9.

Arrow, K. J. (2010). The Classification of Social Choice Propositions. In K. J. Arrow, A. Sen, & K. Suzumura (Eds.), *Handbook of Social Choice and Welfare* (Vol. 2, pp. 24–28). Amsterdam: Elsevier.

Backhouse, R. E., & Medema, S. G. (2009). On the Definition of Economics. *Journal of Economic Perspectives, 23,* 221–233.

Basu, K. (1996). Methodological Individualism: Resurrecting a Controversy. *Economic and Political Weekly, 31,* 269–270.

Buchanan, J. M. (1960). *Fiscal Theory and Political Economy—Selected Essays*. Chapel Hill: The University of North Carolina Press.
Buchanan, J. M. (1962). Marginal Notes on Reading Political Philosophy. In J. M. Buchanan & G. Tullock (Eds.), *The Calculus of Consent: Logical Foundations of Constitutional Democracy* (pp. 307–322). Ann Arbor: The University of Michigan Press.
Buchanan, J. M. (1975). *The Limits of Liberty—Between Anarchy and Leviathan*. Chicago: The University of Chicago Press.
Buchanan, J. M. (1979). Retrospect and Prospect. In J. M. Buchanan, *What Should Economists Do?* (pp. 279–283). Indianapolis: Liberty Press.
Buchanan, J. M. (1989). The State of Economic Science. In W. Sichel (Ed.), *The State of Economic Science* (pp. 79–95). Kalamazoo, MI: W. E. Upjohn Institute for Employment Research.
Buchanan, J. M. (1995). Individual Rights, Emergent Social States, and Behavioral Feasibility. *Rationality and Society, 7*, 141–150.
Buchanan, J. M. (1996 [1995]). Federalism and Individual Sovereignty. *Cato Journal, 15*(2–3), 259–268.
Buchanan, J. M. (1999a). *The Logical Foundations of Constitutional Liberty*. Vol. 1 of *The Collected Works of James M. Buchanan.* Indianapolis: Liberty Fund.
Buchanan, J. M. (1999a [1949]). The Pure Theory of Government Finance. In Buchanan 1999a (pp. 119–132).
Buchanan, J. M. (1999a [1954]). Social Choice, Democracy, and Free Markets. In Buchanan 1999a (pp. 89–102).
Buchanan, J. M. (1999a [1959]). Positive Economics, Welfare Economics, and Political Economy. In Buchanan 1999a (pp. 191–209).
Buchanan, J. M. (1999a [1964]). What Should Economists Do? In Buchanan 1999a (pp. 28–42).
Buchanan, J. M. (1999a [1978]). Natural and Artifactual Man. In Buchanan 1999a (pp. 247–259).
Buchanan, J. M. (1999a [1979]). Politics Without Romance—A Sketch of Positive Public Choice Theory and Its Normative Implications. In Buchanan 1999a (pp. 45–59).
Buchanan, J. M. (1999a [1986]). The Constitution of Economic Policy. In Buchanan 1999a (pp. 455–468).
Buchanan, J. M. (1999a [1990]). The Domain of Constitutional Economics. In Buchanan 1999a (pp. 377–395).

Buchanan, J. M. (1999a [1991]). The Foundations of Normative Individualism. In Buchanan 1999a (pp. 281–291).
Buchanan, J. M. (1999b [1958]). *Public Principles of Public Debt: A Defense and Restatement*. Vol. 2 of *The Collected Works of James M. Buchanan.* Indianapolis: Liberty Fund.
Buchanan, J. M. (1999c [1967]). *Public Finance in Democratic Process*. Vol. 4 of *The Collected Works of James M. Buchanan.* Indianapolis: Liberty Fund.
Buchanan, J. M. (2000 [1968]). An Economist's Approach to 'Scientific Politics'. In *Politics as Public Choice*. Vol. 13 of *The Collected Works of James M. Buchanan* (pp. 3–14). Indianapolis: Liberty Fund.
Buchanan, J. M. (2001a). *Choice, Contract, and Constitutions*. Vol 16 of *The Collected Works of James M. Buchanan.* Indianapolis: Liberty Fund.
Buchanan, J. M. (2001a [1975]). A Contractarian Paradigm for Applying Economic Theory. In Buchanan 2001a (pp. 79–86).
Buchanan, J. M. (2001a [1987]). Constitutional Economics. In Buchanan 2001a (pp. 3–14).
Buchanan, J. M. (2001a [1988]). Contractarian Political Economy and Constitutional Interpretation. In Buchanan 2001a (pp. 60–67).
Buchanan, J. M. (2001b). *Moral Science and Moral Order*. Vol. 17 of *The Collected Works of James M. Buchanan.* Indianapolis: Liberty Fund.
Buchanan, J. M. (2001b [1966]). An Individualistic Theory of Political Process. In Buchanan 2001b (pp. 251–265).
Buchanan, J. M. (2001b [1985]). Political Economy and Social Philosophy. In Buchanan 2001b (pp. 235–250).
Buchanan, J. M. (2001b [1989]). Rational Choice Models in the Social Sciences. In Buchanan 2001b (pp. 55–70).
Buchanan, J. M. (2001c [1986]). Cultural Evolution and Institutional Reform. In *Federalism, Liberty, and the Law*. Vol. 18 of *The Collected Works of James M. Buchanan* (pp. 311–323). Indianapolis: Liberty Fund.
Buchanan, J. M. (2001d [1976]). Methods and Morals in Economics—The Ayres-Knight Discussion. In *Ideas, Persons, and Events*. Vol. 19 of *The Collected Works of James M. Buchanan* (pp. 123–134). Indianapolis: Liberty Fund.
Buchanan, J. M. (2001d [1992]). From the Inside Looking Out. In *Ideas, Persons, and Events*. Vol. 19 of *The Collected Works of James M. Buchanan* (pp. 18–27). Indianapolis: Liberty Fund.
Buchanan, J. M., & Tullock, G. (1962). *The Calculus of Consent: Logical Foundations of Constitutional Democracy*. Ann Arbor: The University of

Michigan Press (Reprinted as Vol. 3 of *The Collected Works of James M. Buchanan.* Indianapolis: Liberty Fund [1999]).
Hayek, F. A. (1960). *The Constitution of Liberty*. Chicago: The University of Chicago Press.
Hayek, F. A. (1973). *Rules and Order*. Vol. 1 of *Law, Legislation and Liberty*. London and Henley: Routledge and Kegan Paul.
Hayek, F. A. (2014 [1945]). The Use of Knowledge in Society. In B. Caldwell (Ed.), *The Market and Other Orders*. Vol. XV of *The Collected Works of F. A. Hayek* (pp. 93–104). Chicago: University of Chicago Press; London: Routledge.
Hayek, F. A. (2014 [1967]). The Results of Human Action but Not of Human Design. In B. Caldwell (Ed.), *The Market and Other Orders*. Vol. XV of *The Collected Works of F. A. Hayek* (pp. 293–303). Chicago: University of Chicago Press; London: Routledge.
Koppl, R. (1992). Invisible-Hand Explanations and Neoclassical Economics: Toward a Post Marginalist Economics. *Journal of Institutional and Theoretical Economics (JITE), 148,* 291–313.
List, C., & Spiekermann, K. (2013). Methodological Individualism and Holism in Political Science: A Reconciliation. *American Political Science Review, 107,* 629–643.
Peacock, A. T., & Rowley, C. K. (1972). Pareto Optimality and the Political Economy of Liberalism. *Journal of Political Economy, 80,* 476–490.
Robbins, L. (1932). *An Essay on the Nature and Significance of Economic Science*. London: Macmillan.
Rothbard, M. N. (1956). Towards a Reconstruction of Utility and Welfare Economics. In M. Sennholz (Ed.), *On Freedom and Free Enterprise—Essays in Honor of Ludwig von Mises* (pp. 224–262). Princeton, NJ: D. Van Nostrand.
Rubin, E. (1997). Rational States? *Virginia Law Review, 83,* 1433–1451.
Samuelson, P. A. (1977). Reaffirming the Existence of 'Reasonable' Bergson-Samuelson Social Welfare Functions. *Economica, 44,* 81–88.
Sen, A. (1970). The Impossibility of a Paretian Liberal. *Journal of Political Economy, 78,* 152–157.
Sen, A. (1986). Foundations of Social Choice Theory: An Epilogue. In J. Elster & A. Hylland (Eds.), *Foundations of Social Choice Theory* (pp. 213–248). Cambridge: Cambridge University Press.
Udehn, L. (2002). The Changing Face of Methodological Individualism. *Annual Review of Sociology, 28*, 479–507.

Vanberg, V. J. (1975). *Die zwei Soziologien—Individualismus und Kollektivismus in der Sozialtheorie*. Tübingen: J.C.B. Mohr (Paul Siebeck).

Vanberg, V. J. (1994). Cultural Evolution, Collective Learning and Constitutional Design. In D. Reisman (Ed.), *Economic Thought and Political Theory* (pp. 171–204). Boston: Springer.

Vanberg, V. J. (1994 [1992]). Organizations as Constitutional Systems. In V. Vanberg (Ed.), *Rules and Choice in Economics* (pp. 125–143, 272–276). London: Routlege.

Vanberg, V. J. (2017). The 'Knowledge Problem' as the Integrating Theme of F.A. Hayek's Oeuvre: An Introduction to *The Sensory Order*. In V. J. Vanberg (Ed.), *The Sensory Order and Other Writings on the Foundations of Theoretical Psychology*. Vol. 14 of *The Collected Works of F. A. Hayek* (pp. 1–111). Chicago: The University of Chicago Press.

Vanberg, V. J. (2018). Constitutional Political Economy. In R. Scazzieri & I. Cardinale (Eds.), *The Palgrave Handbook of Political Economy*. London: Palgrave Macmillan.

Vanberg, V. J., & Buchanan, J. M. (2000 [1986]). Organization Theory and Fiscal Economics—Society, State, and Public Debt. In *Taxation, Politics, and Public Choice*. Vol. 14 of *The Collected Works of James M. Buchanan* (pp. 429–444). Indianapolis: Liberty Fund.

26

A Public Choice Analysis of James M. Buchanan's Constitutional Project

Randall G. Holcombe

Introduction

James Buchanan (1979, p. 184) says, "In a summary definition, public choice is the analysis of political decision-making with the tools and methods of economics." When Buchanan won the Nobel Prize in economics in 1986, the Nobel committee cited "his development of the contractual and constitutional bases for the theory of economic and political decision-making."[1] The Nobel committee's citation emphasized his constitutional project more than the public choice framework that uses economic methods to analyze political decision-making. Buchanan's constitutional project is perhaps best summarized in the title of his 1975 book, *The Limits of Liberty: Between Anarchy and Leviathan*.

[1] This statement is taken from www.nobelprize.org/nobel_prizes/economics/laureates/1986, "The Official Web Site of the Nobel Prize."

R. G. Holcombe (✉)
Department of Economics, Florida State University, Tallahassee, FL, USA
e-mail: holcombe@fsu.edu

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_26

Buchanan, a self-described classical liberal, saw value in freedom for its own sake in addition to its value underlying institutions that lead to economic prosperity. He viewed government as necessary for the preservation of liberty but at the same time recognized that a government with enough power to protect people's rights must be constrained from using that power to violate people's rights. Thus, the limits of liberty lie between anarchy and Leviathan, and Buchanan's constitutional project was to identify the constitutional rules and institutions that would preserve liberty. This chapter applies Buchanan's summary definition of public choice to analyze his constitutional project.

Much of Buchanan's constitutional analysis rests on a framework of hypothetical consent to evaluate constitutional rules. This framework offers insight into the welfare characteristics of those rules, but often does not take the next step to apply a public choice analysis to see how real-world political decision-making processes could produce welfare-enhancing rules. Buchanan and Tullock (1962, Chap. 6) present a generalized economic theory of constitutions based on the idea that citizens weigh a trade-off between external costs and decision-making costs and could unanimously agree to a less-than-unanimous collective decision-making rule. Buchanan (1975a) establishes hypothetical unanimous agreement in a renegotiation from anarchy as a benchmark for evaluating constitutional rules. These frameworks establish the possibility of agreement under hypothetical circumstances, but do not take the next step of investigating potential real-world political institutions in which these agreements could take place. Doing so applies the ideas of public choice to Buchanan's constitutional project.

Buchanan, who attributes his general framework of analysis to Wicksell (1967), says (1975b, p. 385) "Wicksell admonished economists for their failure to recognize the elementary fact that collective or public-sector decisions emerge from a political process rather than from the mind of some benevolent despot." Yet Buchanan's constitutional project rarely extends to the real-world political process. Emphasizing that idea, Buchanan (1975b, p. 391) says "The economist must recognize that collective outcomes emerge from a complex political process in which there are many participants." Buchanan's constitutional project often relies on hypothetical participants in hypothetical situations rather than framing his analysis within real-world political institutions. Buchanan's constitutional project is both ambitious and worthwhile. A promising avenue for advancing Buchanan's constitutional project is to more explicitly apply public choice analysis to it—that is, to apply economic analysis to the actual political processes that produce constitutional rules.

Politics as Exchange

Buchanan's constitutional project is based heavily on depicting politics as exchange. Taking a public choice approach and applying the methods of economics to analyze political decision-making, Buchanan (1979, p. 26, emphasis in original) says that economics should "… concentrate on *exchange* rather than *choice*." Comparing an analysis of an individual choosing among alternatives to a group of individuals engaging in collective economic activity, Buchanan (1979, p. 28) says, "The fact of association requires that a wholly different, and wholly new, sort of behavior take place, that of exchange, trade, or agreement."

Again taking a public choice approach, Buchanan observes that sometimes individuals will be better able to accomplish their ends through collective action. Buchanan (1979, p. 34) says, "Economics is the study of the whole system of exchange relationships." That would include collective action taken by government. "What I should stress is the potentiality of exchange in those sociopolitical institutions that we normally regard as embodying primarily coercive or quasi-coercive elements."[2]

It is worth emphasizing that Buchanan explicitly applies this "politics as exchange" framework to government institutions that are normally regarded as coercive. Everyone can be better off if they agree to rules that sometimes impose costs on themselves, because they benefit from

[2]Buchanan (1965) illustrates the benefits of collective action in his exposition of a theory of clubs. While the paper refers to clubs, its framework easily extends to governments and provides one rationale for a federal system of government, because the optimal "club" size for different collectively provided goods will be different.

those rules that also constrain the actions of others. Buchanan (1962b) observes that little insight is gained by applying the Pareto principles to demonstrate the advantage of market exchanges of goods and services. Because individuals have an incentive to engage in mutually advantageous exchange, within a given institutional framework, a Pareto optimum is produced almost tautologically. Buchanan (1962b, p. 341) says "… the Pareto criterion is of little value when employed solely to classify 'results' defined with respect to the orthodox economic variables… the criterion must be extended to classify social rules which constrain the private individual behavior that produces such results." Political exchange takes place when people collectively agree to a welfare-enhancing set of rules.

Buchanan (1962b, p. 353) goes on to say that "… the operation of alternative rules can only be evaluated in terms of predicted results, and the Pareto construction can be helpful in this process. At the level of application to the social constitution, to the evaluation of the 'rules of the game,' the Pareto criterion serves, however, a function that it cannot possibly serve in the more standard usage. Unless the observing economist is assumed to be omniscient, his classification of a final position as nonoptimal can never be more than a conjectural hypothesis that is impossible to test." Agreement among the individuals involved, whether in a market setting or in collective decision making, provides the evidence that agreed-upon outcomes are welfare enhancing.

Buchanan (1962b, p. 348) notes that optimal institutions may at times produce specific results that appear nonoptimal when removed from the context of the institution, using the example of traffic signals. If a driver comes upon a red light and no other traffic is approaching the intersection, it appears suboptimal for the driver to have to stop. Yet in the larger context, where traffic signals provide order for potentially conflicting traffic, the institution provides results that enhance welfare. Thus, analyzing an individual outcome, such as the driver stopped at the light with no conflicting traffic, misrepresents the value of the institution that caused the driver to stop.

Buchanan applies the methods of economics to depict the development of constitutional rules within an exchange process. The exchange takes place as people bargain to design the rules of social interaction that bind them all. While those rules may impose costs on people in specific post-constitutional settings, such as when they must stop at traffic lights when no other traffic is approaching an intersection, they agree to the rules because they are better off in a situation in which people follow the rules than in a situation in which there are no rules at all.[3]

Buchanan (1949) says that government should not be viewed as a mechanism for maximizing some measure of social welfare—taking Samuelson (1947) as an example of the approach he recommends against—but should be viewed as an organization that allows individuals to accomplish ends collectively that could not be undertaken individually. Buchanan (1949, p. 496) objects to analysis that views the state "… as a single organic entity…" and says "… the state is represented as the sum of its individual members acting in a collective capacity. … These two approaches have not been clearly separated or distinguished in the literature of government finance." Buchanan (1949, p. 498) says "The state has no ends other than those of its individual members and is not a separate decision-making unit. State decisions are, in the final analysis, the collective decisions of individuals."[4]

Two Challenges Facing Buchanan's Constitutional Project

Buchanan's constitutional project is built on this idea of politics as exchange. People can agree on constitutional rules that make them all better off. Some sets of rules are Pareto-superior to others, and Buchanan's project is to look for those rules that can make everybody better off, the evidence being that those who are bound by the rules agree with them. Note that constitutional rules, as Buchanan sees them and as they are being analyzed in this chapter, are the formal rules that

[3]Individuals might agree to be coerced, following Hochman and Rodgers (1969). Their argument is that everyone might be better off if everyone is forced to abide by the same rules.

[4]Note, however, that despite Buchanan's depiction of politics as exchange and the parallels he notes between political exchange and market exchange, Buchanan (1954) also notes significant differences between resource allocation in markets versus government.

govern people's interactions with each other and enable them to undertake collective action. They may or may not be codified in a written constitution, but are formal constraints on people's behavior.[5] While Buchanan's constitutional project works within the framework of politics as exchange, the fact is that not only did most people not agree to the constitutional rules that bind them, they did not even have the opportunity to agree. One challenge facing Buchanan's constitutional project is reconciling the coercive nature of government with his politics as agreement framework. A second challenge is reconciling his normative constitutional leanings with his self-described classical liberal political values.

Defining constitutional economics, Buchanan (1990, p. 1) says, "The emphasis on the choice of constraints distinguishes this research program from conventional economics, while the emphasis on cooperative rather than conflictual interaction distinguishes the program from much of conventional political science." This frames the first challenge Buchanan faces in his constitutional project. He is attempting to develop a framework within which people cooperate to agree on the constitutional rules that constrain them. Buchanan's project takes on a clearly normative orientation because he depicts desirable constitutional rules as those to which people would agree, not those to which they actually have agreed, and does not claim that the actual constitutional constraints people face would meet his criterion of agreement.[6]

Buchanan goes on to state (1990, pp. 2–3, emphasis in original), "In ordinary or orthodox economics, no matter how simple or how complex, analysis is concentrated on choices made *within* constraints that are, themselves, imposed exogenously to the person or persons charged with making the choice. … Constitutional economics directs analytical attention to the *choice among constraints*." Buchanan evaluates

[5]Formal rules are those that apply third-party sanctions when they are violated, as for example when government fines or jails rule violators. Informal rules govern interpersonal interactions through customs, habits, or agreements without third-party sanctions. See Williamson (2000) for a good discussion of formal and informal institutions.

[6]Yeager (1985, 2001) offers insightful criticisms of this aspect of Buchanan's constitutional project.

constraints based on whether they would command agreement among those on whom they are imposed.

The second challenge Buchanan faces is reconciling his norm of agreement with his classical liberal political views. Buchanan uses the benchmark of consent or agreement to evaluate constitutional rules, and the challenge is that people might agree to illiberal rules. Buchanan (2000, 2005a, b) explicitly identifies himself as a classical liberal. He says (2005a, p. 98) "classical liberalism sketches out a world as I should like to bring into being were I granted omnipotence." He further remarks (2000, p. 117), "A motivating element [underlying classical liberalism] is, of course, the individual's desire for liberty from the coercive power of others—an element that may be almost universally shared." This is consistent with his (1975a) title that places liberty between anarchy and Leviathan. His constitutional project, which rests on the norm of agreement, could conflict with his classical liberal views that rest on the norm of freeing individuals from the coercive power of others.

These two challenges—applying the norm of agreement to groups that did not actually agree, and reconciling Buchanan's two norms of liberty and agreement—are significant, but will be set aside here to consider the actual process by which constitutional rules are created, interpreted, and enforced. This chapter analyzes the degree to which actual political processes that produce constitutional rules satisfy Buchanan's norms of agreement and liberty.

Buchanan's Constitutional Project

Chapter 6 of Buchanan and Tullock's *The Calculus of Consent*, titled "A Generalized Economic Theory of Constitutions," lays the intellectual foundation for Buchanan's constitutional project. They emphasize the unanimity criterion's importance for identifying desirable constitutional rules, noting that (1962, p. 72) "The only means whereby the individual can insure that the actions of others will never impose costs on him is through the strict application of the rule of unanimity for all decisions, public and private." They go on to say (1962, p. 81) "that the rule of unanimity does possess certain special attributes, since it is only though the adoption of this rule that the individual can insure himself against the external damage that may be caused by the actions of other individuals, privately or collectively."

Buchanan and Tullock (1962, p. 88) emphasize the importance of unanimous agreement, saying. "This single decision-making rule acquires a unique position in the whole analysis which suggests that if costs of decision-making could be reduced to negligible proportions, the rational individual should always support the requirement of unanimous consent before political decisions are finally made." They go on to say (1962, p. 89), "Only the unanimity rule will insure that all external effects will be eliminated by collectivization."[7] They reemphasize this point (1962, p. 96), saying "The individualistic theory of the constitution that we have been able to develop assigns a central role to a single decision-making rule—that of general consensus or unanimity." Again they say (1962, p. 72), "The only means whereby the individual can insure that the actions of others will never impose costs on him is through the strict application of the rule of unanimity for all decisions, public and private."

Buchanan and Tullock introduce decision-making costs that are involved in collective decisions and say (1962, p. 75) that an individual will "try to choose a decision-making rule that will minimize the total expected costs that he must incur, both the costs imposed on him by the collective decisions taken adversely to his own interests and those which he will incur as a decision-maker." Recognizing both of these costs, Buchanan and Tullock (1962, p. 75) say, "represents the 'gains from trade' that the individual expects to result from his entering into a 'political exchange' with his fellows for this category of decisions." They conclude that individuals could unanimously choose to adopt a less-than-unanimous decision rule for certain decisions.

A significant point to recognize is that after Buchanan and Tullock emphasize the importance of unanimous agreement in both public and private decisions, they argue that in theory people could agree

[7]Buchanan (1962a) also discusses external political costs as the costs that majority rule decision-making imposes on the minority.

to less-than-unanimous decision rules for certain decisions to offset collective decision-making costs. However, the unanimous agreement is purely hypothetical. They do not argue that people actually have agreed to the less-than-unanimous decision rules, and they do not argue that there are collective decision-making institutions that could facilitate such an agreement. In their generalized economic theory of constitutions, unanimous agreement, while important, is hypothetical. Meanwhile, less-than unanimous decision rules are a feature of real-world political institutions.

Buchanan (1975a) deals further with the issue of hypothetical unanimous agreement, but still leaves agreement within a hypothetical framework and does not examine political institutions that would facilitate consensus on constitutional rules. Buchanan (1975a) develops a contractarian framework based on Hobbes (1651) within which individuals explicitly escape from a Hobbesian anarchy in which life is a war of all against all by agreeing to a social contract consisting of rules that all would agree to if the existing constitutional rules were renegotiated. The conceptual experiment is that individuals imagine themselves returning to a state of Hobbesian anarchy where there are no rules and from there renegotiating a social contract. The social contract then consists of those provisions which would command unanimous agreement.

This conceptual experiment offers a criterion for evaluating actual constitutional rules: would people agree to them if the existing set of rules were wiped away and a new set renegotiated from Hobbesian anarchy? Buchanan (1975a, pp. 6–7) says of *The Calculus of Consent*, "The framework for analysis was necessarily contractarian, in that we tried to explain the emergence of observed institutions and to provide norms for changes in existing rules by conceptually placing persons in idealized positions from which mutual agreement might be expected. … I have come to be increasingly disturbed by this basically optimistic ontology. … Zero-sum and negative-sum analogues yield better explanatory results in many areas of modern politics…"

Buchanan (1975a, p. 8) then raises a question about the applicability of the politics as exchange analogy, saying, "So long as collective action is interpreted largely as the embodiment of individual behavior aimed at securing the efficiency attainable from cooperative effort, there was a natural tendency to neglect the problems that arise in controlling the self-perpetuating and self-enhancing arms of the collectivity itself. The control of government scarcely emerges as an issue when we treat collective action in strictly contractarian terms. Such control becomes a central problem when political power over and beyond plausible contractarian limits is acknowledged to exist." After laying out his social contractarian model, Buchanan (1975a, p. 161) notes that even under democratic institutions, Leviathan government can escape constitutional constraints. "Democracy may become its own Leviathan unless constitutional limits are imposed and enforced."

Buchanan himself expresses some doubt about whether his conceptual experiment is consistent with the real-world political process, but nonetheless bases his constitutional framework on it. Within Buchanan's conception of unanimity, negative-sum outcomes can only arise in the absence of unanimity—in the absence of consensus.[8] This suggests a reason to evaluate Buchanan's constitutional framework against real-world political institutions. In political decision-making, some people agree to them, but most people do not. Are there political mechanisms that can create outcomes that would resemble those that would be generated with actual unanimous agreement?

Buchanan's Emphasis on Constitutional Rules

Buchanan's constitutional project focuses on optimal rules for constraining Leviathan government. The criterion for deciding whether rules are optimal is whether they would command unanimous agreement. Brennan and Buchanan (1980) use this constitutional framework to develop rules that have the potential to constrain government from using its power to tax to exploit the citizens it taxes, depicting government as a revenue-maximizing monopoly. Brennan and

[8]People might agree to policies that make them worse off if they inaccurately forecast the results of those policies. It is easy to imagine situations in which after the fact, people would say "If I knew that this would be the result, I never would have agreed." Buchanan's hypothetical unanimous agreement rules this out by assuming people know their own interests.

Buchanan (1980, p. 20) justify this, saying "The monopoly-state model of government may be acknowledged to be useful, not necessarily because it predicts how governments always, or even frequently, work, but because there are inherent tendencies in the structure of government to push it toward that sort of behavior implied in the monopolistic model, tendencies that may emerge in settings where constraints are wholly absent." Their focus is on deriving rules that can constrain a Leviathan government, not the institutional processes that could produce these rules.

In a follow-up volume sub-titled "constitutional political economy," Brennan and Buchanan (1985) further develop the idea that a framework of agreed-upon constitutional rules provides a foundation for individual interaction that can avoid zero-sum and negative sum outcomes. Brennan and Buchanan (1985, p. 5) reference Hobbes to say that we benefit from a set of rules that govern people's interactions with each other because "…without them we would surely fight. We would fight because the object of desire for one individual would be claimed by another. Rules define the private spaces within which each of us can carry out our own activities." Brennan and Buchanan (1985, p. 2) note, "If rules influence outcomes and if some outcomes are 'better' than others, it follows that to the extent that rules can be chosen, the study and analysis of comparative rules and institutions become proper objects of our attention."

That last sentence is a good statement of Buchanan's constitutional project. It is an analysis of comparative rules and institutions to constrain government and protect people's rights, with the decisive normative factor being whether the rules and institutions would command general agreement. The institutions Buchanan refers to are the rules and enforcement mechanisms, not the collective decision-making processes that produce them. Buchanan's constitutional project can be developed and extended by applying his public choice approach to those decision-making processes that produce the rules.

Buchanan and Congleton (1998) look further into the design of constitutional rules that would meet with a consensus of approval by citizens. They extend Hayek's (1960) generality principle to apply to political decisions, arguing that rules that apply generally rather than discriminatorily will be more likely to meet Buchanan's unanimity criterion, and that durable constitutional rules that will apply to specific situations in the future, when an individual's specific situation is less certain, will also be more likely to gain widespread approval. Think again about the traffic light example. People will approve of this method of regulating traffic because on average they expect to benefit, even though in some specific future situations they may find themselves waiting at a red light when there is no conflicting traffic. Certain types of rules are more likely to receive consensus approval than others.

Buchanan's constitutional project has been heavily oriented toward identifying constitutional rules that protect individual rights, that facilitate productive collective action among individuals, and that constrain Leviathan government from abusing its power. Buchanan's criterion for identifying rules that satisfy those goals has consistently been consensus—unanimous agreement—among those who are governed by the rules. The use of agreement as the criterion marks an important advance over the neoclassical welfare economics criterion of Pareto optimality in that it directly links individual choice to the selection of constitutional rules. Optimal rules are not those chosen by an omniscient benevolent despot implementing the welfare-maximizing policy indicated by an economic model, but are those chosen by consensus among the people who will be governed by them.

Some Issues with Buchanan's Contractarian Framework

Recognizing the impracticality of actually getting everyone to agree, Buchanan's agreement criterion was a hypothetical one. In principle, people would agree under certain hypothetical circumstances. Buchanan (1975a) imagines a return to a Hobbesian anarchy where there are no rules, and rules pass his hypothetical unanimity test if people would agree to those rules in a renegotiation from anarchy. If rules pass this test of hypothetical agreement, Buchanan views them as meeting his requirement of unanimity.

A number of issues could be raised regarding this framework. One is that because one set of rules applies to everybody, nobody will get the complete set of rules he or she prefers. People will have to accept some rules they might not like in order to get other rules they do. Holcombe (2014) notes that if one compares the status quo in almost every place in the world today with Hobbesian anarchy, the status quo clearly dominates, so in that sense, Buchanan's criterion says everyone agrees with the rules of the status quo, because they would choose it over Hobbesian anarchy. Another issue, Holcombe (2011) discusses, is that because Buchanan's agreement is hypothetical, his argument can always be used to justify the status quo. People who say they do not agree might just be trying to be free riders, in the sense of Hochman and Rodgers (1969). Even if they say they are not in agreement, the Buchanan argument that they would agree in a renegotiation from anarchy could be used to say that conceptually they are in agreement even if they say they disagree.

Consider the Buchanan and Wagner (1977) argument that people would agree to a balanced budget amendment. According to Buchanan (1975a), people agree to the social contract if they would agree in a renegotiation from Hobbesian anarchy. Now consider whether people would rather live in today's society, with massive budget deficits, or return to Hobbesian anarchy. If people would prefer the status quo to Hobbesian anarchy, then deficit finance is a part of the social contract, using Buchanan's criterion.

These issues arise because of the hypothetical nature of Buchanan's criterion for agreement. Because of the hypothetical nature of agreement, Buchanan's constitutional project discards to a substantial degree the public choice approach to analyzing political decision-making. While his approach does connect (hypothetical) individual preferences to constitutional rules, it does not analyze the actual political process by which constitutional rules are developed. The remainder of this chapter sets aside problems that arise from the hypothetical nature of agreement in Buchanan's constitutional project to look at the actual political processes that produce constitutional rules.

The Choice of Rules

Buchanan's framework stops short of fully applying the tools of public choice to the selection of constitutional rules, because it relies on a hypothetical model of agreement. While Buchanan's framework does not imply that optimal rules are those that would be chosen by an omniscient benevolent despot, he relies on an equally hypothetical criterion in which everybody agrees to the rules. As a matter of fact, not only are constitutional rules determined through a process in which most people are not given the option of approving them, the process for selecting constitutional rules could never be designed so that everybody would have the option of agreeing. All but the smallest groups have too many members to make agreement among all of them feasible. Buchanan and Tullock (1962) emphasize the decision-making costs that make unanimous agreement excessively costly in post-constitutional decision-making, and that same argument applies to constitutional decision-making. It would not be possible for everyone to participate, because decision-making costs would be too high.

Buchanan's constitutional project points toward a destination regarding a set of constitutional rules. That destination is a constitution that is unanimously supported by those who live under its rules. One dimension in which this constitutional project can be advanced is to apply public choice analysis to seek institutional mechanisms that can move toward that destination of unanimously agreed-upon rules. Because it is not feasible to implement a process by which everyone agrees, that benchmark of unanimous agreement is as far removed from reality as the benchmark of Pareto optimality. Public choice uses the methods of economics to analyze the way the political process actually works, not how one would hope it works. Buchanan's constitutional project can be advanced by applying public choice analysis to the institutional mechanisms that design constitutional rules. A public choice approach must set aside hypothetical benchmarks to analyze the actual process by which constitutional rules are created. How can political institutions be designed so that they produce rules that would be approved by everybody?

A Public Choice Approach to Constitutional Decision-Making

Buchanan and Tullock (1962, pp. 132–145) discuss the potential efficiency gains from logrolling, which is an important institutional feature that determines both post-constitutional collective decisions and the determination of constitutional rules. Logrolling is political exchange, and political exchange can produce value, just as with market exchange, because parties to an exchange participate only because they perceive that they benefit. Buchanan's unanimity criterion for evaluating constitutional rules builds on this idea, because unanimous agreement with the rules means that everyone benefits from their collective adoption. An issue is that while one could imagine rules to which everyone would agree, in practice unanimous agreement could never occur because of what Buchanan and Tullock (1962) label decision-making costs.

Buchanan's constitutional project can be fruitfully developed by taking a public choice approach to evaluating institutions that create constitutional rules, which means applying economic methods to analyze the actual process by which constitutional rules are designed, rather than using hypothetical criteria like Pareto optimality or renegotiation from Hobbesian anarchy to evaluate those rules. Buchanan's benchmark of hypothetical agreement is at odds with the public choice methodology. Public choice analyzes actual collective decision-making processes rather than hypothetical ideal processes that have no real-world parallel. Buchanan objects to the neoclassical welfare economics approach that (often implicitly)[9] assumes that policy decisions will be made by an omniscient benevolent despot, but the same objection could be raised toward constitutional rules that might be approved in a hypothetical unanimous agreement. A productive way to advance Buchanan's constitutional project would be to apply public choice analysis to the process by which constitutional rules are actually developed in the real world.

[9]The assumption of an omniscient benevolent despot often is made explicitly, however, in the form of "the planner's problem." The planner is assumed to have all the information in the model, and is assumed to be willing and able to implement an optimal solution.

A public choice approach begins with the observation that not everybody participates in the design of constitutional rules. There are an elite few who design constitutional rules, and the masses are largely left out of the process. There are solid economic reasons for this. Following Buchanan and Tullock (1962), decision-making costs would be excessively high if everyone participated. The Coase (1960) theorem lends insight into the process by which constitutional rules are designed. One way to state the Coase theorem is that in the absence of transaction costs, resources are allocated to their highest-valued uses. This will be the case because if there are no transaction costs standing in the way of mutually advantageous exchange, the people who value resources the most will buy them. Applied to political decision-making, this means that when transaction costs are low enough to facilitate political exchange, resources will be allocated to maximize their value to those who participate in the exchanges.

Now consider Buchanan and Tullock's (1962) discussion of the potential efficiency gains of logrolling in the context of the Coase theorem. Those who are able to engage in political bargaining because transaction costs are low can bargain to maximize the value of those political exchanges to those in the bargaining group. If everybody was able to participate in the bargaining process, Buchanan's unanimity criterion would be satisfied and the result would be optimal constitutional rules. However, high decision-making costs, to use Buchanan and Tullock's (1962) terminology, are transaction costs that prevent everyone from participating in political exchange. A few people face low transaction costs and are able to bargain, while most people face high transaction costs and are prevented from engaging in political bargaining.

Legislators are able to bargain with each other because they face low transaction costs, and lobbyists buy their way into the low-transaction cost group and are also able to bargain so their interests are represented in the design of public policy. Most people face high transaction costs and cannot participate in the political bargaining process. Applying the Coase theorem, people can be divided into two groups: a low-transaction cost group whose members can bargain with each other to produce public policy, and a high-transaction cost group whose members are unable to enter the bargaining process. This idea has been well-recognized for more than a century. Marx and Engels (1948) called those groups the bourgeoisie and the proletariat, political scientists and sociologists have referred to them as elites and masses (Bentley 1908; Mills 1956), and more recently those groups have been referred to as the 1% and the 99%. In economic terms, the bourgeoisie, the elite, the 1% are the members of the low-transaction cost group, and the proletariat, the masses, the 99% are members of the high-transaction cost group.

Who Makes Constitutional Rules?

A public choice approach to constitutional decision-making must recognize that an elite few are in the position of actually designing constitutional rules. Even the design of the Constitution of the United States, that provided the inspiration for Buchanan and Tullock (1962), was designed by an elite few who were selected to attend the Constitutional Convention, and perhaps equally significantly, were able to attend. The Constitutional Convention extended from May through September of 1787, an entire growing season, which made it impossible for most people in an agrarian economy to participate, even if they wanted to. The Convention was shrouded in secrecy, as Holcombe (2002) explains, preventing anyone but a few delegates from participating in its design. Beard (1913) concludes that the Constitution was designed by elites to further their own interests.

Congleton (2011) draws similar conclusions about the development of the constitutions of European governments. He describes a process whereby different elites negotiated based on their interests, which resulted in an evolving constitutional framework based on the relative powers of each group. Members of the masses have some voice because they can participate in interest group politics, and they do get to vote, as Wittman (1989, 1995) notes. And, Becker (1983) concludes, the legislature can act as a political marketplace in which competing interests are weighed against each other. However, individuals have an incentive to free ride off the efforts of others, Olsen (1965) notes, and Downs

(1957) argues that individuals tend to be rationally ignorant regarding politics, because they realize that their actions will have no influence on political outcomes. The masses have no influence because they are in the high-transaction cost group.

A public choice approach to constitutional decision-making recognizes that actual constitutional rules are not unanimously approved; they are designed by an elite few who bargain with each other to design the rules for their benefit. Sometimes the rules that benefit the elite also benefit the masses. Other times, rules that benefit the elite impose costs on the masses.

Public choice clearly recognizes that public policy often benefits some at the expense of others. The rent-seeking literature (Tullock 1967; Krueger 1974) depicts some people as receiving rents by imposing costs on others. The literature on regulatory capture (Stigler 1971) depicts some people as capturing the regulatory process for their benefit, at the expense of others, and interest group theory (Olson 1965) explains how concentrated interests are able to generate benefits for themselves by imposing costs on the masses. The elite—the members of the low-transaction cost group—are the people who receive the rents, who capture regulatory agencies, and who are the concentrated interests who benefit at the expense of others. These same insights that public choice has developed and applied to post-constitutional decision-making also apply to the development constitutional rules. The elite few design them, but they apply to everyone.

The first step in a public choice analysis of constitutional decision-making is to recognize that constitutional rules can never be agreed to by everyone who is subject to them, except when the size of the group is very small. High transaction costs prevent everyone in a large group from participating. Even if everybody votes to accept them, this falls short of actual agreement because, first, the masses are only able to vote on the alternatives offered them by the elite, so they are left out of the bargaining process, and second, as Wicksell (1967) and Buchanan and Tullock (1962) explicitly recognize, actual unanimous agreement is infeasible in all but the smallest groups anyway. Constitutional rules are designed by the elite and imposed on the masses.

Constraining Government

Buchanan's constitutional project is heavily oriented toward designing rules to constrain government—to prevent it from becoming a Leviathan that violates individual rights, and that uses excessive power to reduce the welfare of individuals subject to its authority in other ways. The project points toward a set of rules that can constrain government effectively, so that acts in the best interest of those it governs. The project is worthwhile, but to ultimately succeed, it must go beyond just enumerating a set of rules to consider how they will be (1) interpreted and (2) enforced.

In the real world, rules are always subject to interpretation. Consider the First Amendment to the Constitution of the United States, which states, "Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof; or abridging the freedom of speech, or of the press, or the right of the people peaceably to assemble, and to petition the government for a redress of grievances." More than two centuries after that constitutional rule was written, every part of it remains subject to continual reinterpretation. The role of government's interactions with religious organizations, what speech people are allowed to engage in, what the press may publish, conditions under which people are permitted to assemble, and ways in which they may petition for a redress of grievances all remain controversial and subject to interpretation. Every other aspect of the Constitution of the United States could be subject to similar questions, and unwritten constitutional rules that constitute the social contract are vaguer still.[10] Formal models give unambiguous answers. In the real world, rules are subject to interpretation.

[10]Buchanan and Devletoglou (1970) object to student protests of the 1960s that opposed the Vietnam war and the military draft, and that opposed racial segregation. One might argue that they were assembling to petition their government to redress their grievances, or in Buchanan's (1975a) terms, arguing that those things they were protesting were injustices that would not be a part of a social contract renegotiated from anarchy. Similarly, Buchanan and Wagner (1977) argue that a balanced budget rule has been a part of the implied social contract that, now that it is routinely violated, should be added to the written Constitution; yet the actual political process routinely agrees to deficit finance.

A public choice approach to constitutional rules must recognize that those who interpret and apply them are members of the elite. Thus, constitutional political economy must go beyond simply finding a set of rules to which everyone would hypothetically agree. It must also address the issue that those who interpret and apply the rules are in a position to do so in ways that favor themselves. When Brennan and Buchanan (1980, p. 20) say "The monopoly-state model of government may be acknowledged to be useful, not necessarily because it predicts how governments always, or even frequently, work, but because there are inherent tendencies in the structure of government to push it toward that sort of behavior implied in the monopolistic model, tendencies that may emerge in settings where constraints are wholly absent," they must recognize that simply making rules is insufficient constraint on government. To meet Buchanan's criterion of hypothetical unanimous agreement, they must also be objectively interpreted and enforced.

Enforcement is at least as big a challenge as designing the rules in the first place. Given the rules, two options suggest themselves: democratic accountability, and checks and balances within the government. Holcombe (2018) concludes that democratic accountability is an inadequate method of enforcement, pointing toward checks and balances. Regarding democratic accountability, Downs (1957) notes that citizens tend to be rationally ignorant of the activities of their governments, and Olson (1965) explains why concentrated interests often are able to use the political process to their advantage, at the expense of the masses. Democracy has symbolic value to the elite because it offers the masses the illusion that they have ultimate oversight over their government, Edelman (1967) argues. Transaction costs prevent the masses from negotiating the design of constitutional rules or public policy more generally. Voters can only choose among the options offered them by the elite, and in representative democracy, those options are not even rules or policies, but only which individuals will have the power to design and interpret rules and make public policy.

This leaves checks and balances, an area that has been neglected in constitutional economics. Buchanan and Tullock (1962, Chap. 16) discuss the role of a bicameral legislature, but the role of checks and balances has taken a back seat to the design of constitutional rules within constitutional political economy.

A major part of the genius of the Constitution of the United States is its use of checks and balances. If the elite ultimately design, interpret, and enforce constitutional rules, democratic oversight by the masses is likely to have little effect, and the idea behind checks and balances is that political power is divided among different elites so that the elite do not act in concert, but rather check and balance each other to guard their own domains of power. The idea of three branches of government checking and balancing each other is well-enough known that it need only be mentioned. The Founders also designed a major role for state governments to check the power of the federal government.

Buchanan and Tullock (1962) emphasize that a bicameral legislature creates a higher bar for the passage of legislation. As originally designed, members of the House of Representatives were (and still are) elected directly by citizen voters, but Senators were chosen by their state legislators.[11] Thus, legislation had to meet with the approval of the representatives of the people, in the House of Representatives, and the approval of the representatives of the state governments, in the Senate. More than that, the Constitution specified that the federal government had limited and enumerated powers, and reserved those powers not explicitly given to the federal government in the Constitution to the states or to the people. The idea was that the three branches of government would check and balance each other, and that the state governments also had a role in checking the power of the federal government.

Buchanan's constitutional project has focused heavily on identifying constitutional rules that further the collective interests of the citizens who are governed by them, using the criterion that those rules are rules with which citizens would, under hypothetical conditions, agree with them. The rules are important, Brennan and Buchanan (1985) emphasize, but Buchanan's constitutional project can be further advanced by examining the actual processes by which the rules are determined,

[11]This was changed by the 17th Amendment, ratified in 1913, which mandated direct citizen voting for Senators.

interpreted, and enforced. Real-world constitutional frameworks evolve as a result of struggles among various groups of elites to alter the rules for their benefit. When elites are divided in their interests, they can check and balance each other, and it is worthwhile to further explore the degree to which checks and balances can lead constitutional rules toward those that might command a consensus of agreement among those who are governed by them.

Holcombe (2002) looks at the evolution of rules and political power in the United States, an Congleton (2011) describes the evolution of the constitutional framework in Europe as an ongoing negotiation among elites for a share of political power. These are examples of works by public choice economists in constitutional political economy who look at the actual evolution of constitutional rules. Holcombe (1994) suggests that with a certain balance of power, the rules designed by the elite will also be those that would be agreed to by the masses. Buchanan's focus on rules lays a foundation for constitutional economics, but there is room to go beyond this by looking at the process by which they are created, interpreted and enforced.

Conclusion

James Buchanan's constitutional project has significantly advanced the way that economists and social scientists more generally think about the institutional constraints that individuals face. Buchanan emphasized the need for rules to enable individuals to interact productively, and to undertake activities collectively that they could not undertake as individuals. He also recognized that governments capable of designing and enforcing such rules might also be capable of using that power to the advantage of those who hold it, at the expense of most who are subject to the rules. He depicted desirable rules as rules that would be agreed to by those who were subject to them.

Buchanan's criterion of agreement takes constitutional political economy a long way in terms of identifying rules that benefit everyone. One problem is that in any but the smallest groups, obtaining actual agreement from group members is infeasible. Transaction costs—or in Buchanan and Tullock's (1962) terminology, decision-making costs—are too high. Retaining the criterion of unanimous agreement, Buchanan resorts to hypothetical or conceptual agreement as a benchmark for evaluating constitutional rules. While this works as a method of theoretically identifying desirable constitutional rules, using the values of those who are governed by them as the arbiter of desirability, it falls short of identifying a mechanism for designing constitutional structures that are able to create, implement, and enforce those rules. It falls short because it does not take into account the actual process by which rules are created, implemented and enforced.

Buchanan's constitutional project can be advanced by applying the methodology of public choice to the analysis of constitutional rules. Public choice uses the methods of economics to analyze the process of political decision-making. Buchanan's benchmark of hypothetical agreement is subject to the same criticism as the criterion of Pareto optimality in neoclassical welfare economics. Just as there is no omniscient benevolent despot who is able to implement Pareto optimal policies, there also is no omniscient benevolent despot who is able to identify and implement policies to which everyone would agree under hypothetical circumstances. A public choice approach to constitutional political economy would look at actual decision-making processes that produce constitutional rules to see the degree to which those decision-making processes can be designed to conform with Buchanan's criterion of conceptual agreement.

The preceding sections have suggested some fruitful avenues for exploration. A public choice approach to Buchanan's constitutional project would recognize that in fact, constitutional rules are designed by an elite few, that democratic oversight is likely to be a weak enforcement mechanism, and that checks and balances within government have been underappreciated in the constitutional political economy literature. Ultimately, this chapter is a commentary on Buchanan's constitutional project, only suggesting ways in which it might be advanced. Buchanan has left us with a set of principles for understanding and evaluating constitutional rules and constitutional decision-making, but this is an unfinished research program. One way Buchanan's constitutional project can be advanced is by explicitly taking a public choice approach to constitutional decision-making; that is, looking at the actual process by which constitutional rules are designed, implemented, interpreted, and enforced.

References

Beard, C. A. (1913). *An Economic Interpretation of the Constitution of the United States*. New York: Macmillan.

Becker, G. S. (1983). A Theory of Competition Among Pressure Groups for Political Influence. *Quarterly Journal of Economics, 98,* 371–400.

Bentley, A. F. (1908). *The Process of Government: A Study of Social Pressures*. Chicago: University of Chicago Press.

Brennan, G., & Buchanan, J. M. (1980). *The Power to Tax: Analytical Foundations of a Fiscal Constitution*. Cambridge: Cambridge University Press.

Brennan, G., & Buchanan, J. M. (1985). *The Reason of Rules: Constitutional Political Economy*. Cambridge: Cambridge University Press.

Buchanan, J. M. (1949). The Pure Theory of Government Finance: A Suggested Approach. *Journal of Political Economy, 57,* 496–505.

Buchanan, J. M. (1954). Individual Choice in Voting and the Market. *Journal of Political Economy, 62*, 334–343.

Buchanan, J. M. (1962a). Politics, Policy, and the Pigouvian Margins. *Economica,* n.s., 29, 17–28.

Buchanan, J. M. (1962b). The Relevance of Pareto Optimality. *Journal of Conflict Resolution, 6*, 341–354.

Buchanan, J. M. (1965). An Economic Theory of Clubs. *Economica, 32*, 1–14.

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

Buchanan, J. M. (1975b). Public Finance and Public Choice. *National Tax Journal, 28*, 383–394.

Buchanan, J. M. (1979). *What Should Economists Do?* Indianapolis: Liberty Press.

Buchanan, J. M. (1990). The Doman of Constitutional Economics. *Constitutional Political Economy, 1*, 1–18. The Soul of Classical Liberalism.

Buchanan, J. M. (2000). The Soul of Classical Liberalism. *The Independent Review, 5*, 111–119.

Buchanan, J. M. (2005a). *Why I, Too, Am Not a Conservative: The Normative Vision of Classical Liberalism*. Cheltenham, UK: Edward Elgar.
Buchanan, J. M. (2005b). Afraid to Be Free: Dependency as Desideratum. *Public Choice, 124*, 19–31.
Buchanan, J. M., & Congleton, R. D. (1998). *Politics by Principle, Not Interest: Towards Nondiscriminatory Democracy*. Cambridge: Cambridge University Press.
Buchanan, J. M., & Devletoglou, N. E. (1970). *Academia in Anarchy: An Economic Diagnosis*. New York: Basic Books.
Buchanan, J. M., & Tullock, G. (1962). *The Calculus of Consent: Logical Foundations of Constitutional Democracy*. Ann Arbor: University of Michigan Press.
Buchanan, J. M., & Wagner, R. E. (1977). *Democracy in Deficit: The Political Legacy of Lord Keynes*. New York: Academic Press.
Coase, R. H. (1960). The Problem of Social Cost. *Journal of Law and Economics, 3,* 1–44.
Congleton, R. D. (2011). *Perfecting Parliament: Constitutional Reform, Liberalism, and the Rise of Western Democracy*. Cambridge: Cambridge University Press.
Downs, A. (1957). *An Economic Theory of Democracy*. New York: Harper & Row.
Edelman, M. (1967). *The Symbolic Uses of Politics*. Urbana: University of Illinois Press.
Hayek, F. A. (1960). *The Constitution of Liberty*. Chicago: University of Chicago Press.
Hobbes, T. (2012 [1651]). *Leviathan*. Oxford: Oxford University Press.
Hochman, H. M., & Rodgers, J. D. (1969). Pareto Optimal Redistribution. *American Economic Review, 59,* 542–557.
Holcombe, R. G. (1994). *The Economic Foundations of Government*. New York: New York University Press.
Holcombe, R. G. (2002). *From Liberty to Democracy: The Transformation of American Government*. Ann Arbor: University of Michigan Press.
Holcombe, R. G. (2011). Consent or Coercion? A Critical Analysis of the Constitutional Contract. In A. Marciano (Ed.), *Constitutional Mythologies: New Perspectives on Controlling the State* (pp. 9–23). New York: Springer.
Holcombe, R. G. (2014). Consenting to Collective Action: The Classical Liberal Constitutional Calculus of James M. Buchanan. *The Independent Review, 18,* 359–372.

Holcombe, R. G. (2018). *Political Capitalism: How Economic and Political Power is Made and Maintained*. Cambridge: Cambridge University Press.

Krueger, A. O. (1974). The Political Economy of the Rent-Seeking Society. *American Economic Review, 64,* 291–303.

Marx, K., & Engels, F. (1948). *The Communist Manifesto*. New York: International Publishers.

Mills, C. W. (1956). *The Power Elite*. New York: Oxford University Press.

Olson, M., Jr. (1965). *The Logic of Collective Action: Public Goods and the Theory of Groups*. Cambridge, MA: Harvard University Press.

Samuelson, P. A. (1947). *Foundations of Economic Analysis*. Cambridge: Harvard University Press.

Stigler, G. J. (1971). The Theory of Economic Regulation. *Bell Journal of Economics and Management Science, 2,* 3–21.

Tullock, G. (1967). The Welfare Costs of Tariffs, Monopolies, and Theft. *Western Economic Journal, 5,* 224–232.

Wicksell, K. (1967). A New Principle of Just Taxation. In R. A. Musgrave & A. T. Peacock (Eds.), *Classics in the Theory of Public Finance* (pp. 92–118). New York: St. Martin's Press.

Williamson, O. E. (2000). The New Institutional Economics: Taking Stock, Looking Ahead. *Journal of Economic Literature, 38,* 595–613.

Wittman, D. A. (1989). Why Democracies Produce Efficient Results. *Journal of Political Economy, 97,* 1395–1424.

Wittman, D. A. (1995). *The Myth of Democratic Failure*. Chicago: University of Chicago Press.

Yeager, L. B. (1985). Rights, Contract, and Utility in Policy Espousal. *Cato Journal, 5,* 259–294.

Yeager, L. B. (2001). *Ethics as a Social Science*. Cheltenham, UK: Edward Elgar.

27

Buchanan's Social Contract Unveiled

Enrico Colombatto

On the Legitimacy of Governments and Clubs

Most people accept that the presence of an authority endowed with coercive powers—let us call it a government or a ruler—is a desirable feature of a community. Although one may object to the identity of the ruler (who could be accused of usurping power) and/or disapprove of what he does (abuse of power), some issues garner broad consensus. For example, hardly anybody believes that God designates the ruler, possibly through an earthly intermediary; and even fewer people maintain that this divine appointment includes ownership of a region and the right to consider the creatures living in such region as his own chattel. Likewise, theorising about the social nature of man is also regarded as a rather doubtful way of justifying government. The very fact that people interact because this is their instinct (as argued by Lord Shaftesbury in the

E. Colombatto (✉)
Università di Torino, Turin, Italy

E. Colombatto
Institut de Recherches Économiques et Fiscales, Paris, France

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_27

early eighteenth century) and/or because sociability enhances individual and collective wealth (Bernard Mandeville, also in the early eighteenth century) ensures that individuals usually welcome those who strive to make cooperation possible and easier. However, even if laudable, the efforts of self-appointed and possibly altruistic coordinators do not give them legitimacy to rule, to impose their views about cooperation, let alone to resort to direct or indirect coercion.[1]

In spite of the agreement about what does not justify the presence of government, acknowledging the problem of legitimacy and establishing what gives the ruler authority remains troublesome. This is understandable. By questioning the legitimacy of governments, one necessarily accepts the possibility of libertarian anarchy, an option that horrifies a very large portion of the population and that most authors consider unfeasible.[2] In fact, public opinion tends to regard the presence of governments inevitable, and considers their ubiquitous presence as some sort of proof of legitimacy. Dissatisfaction with their activities leads to disputes about what justifies the rulers' actions, and where one should draw the line between abuse and compliance with their supposed mission. However, most people do not question the role of governments because they are illegitimate, but because they fail to meet expectations (Rothstein 2009). Put differently, today's debate about the legitimacy of government continues to aim at establishing what governments can do and to whom they are accountable, and neglects to analyse their very existence and nature.

As mentioned above, in the Western world the term "government" identifies an actor who rules a community and features two elements:

[1]The expression "indirect coercion" describes a situation in which the ruler wants to influence B's choice. In order to do so, the ruler forces agent A, who interacts with B, to modify his (A's) behaviour and thus affect the alternatives and costs that B is facing. Nudging, compulsory persuasion (or libertarian paternalism) are forms of indirect coercion and are thus in contrast with a free-market vision (Beraldo 2018). This is the case, for example, when the government requires that the seller position his goods on a shelf in a given order to encourage the consumer to buy one item rather than the other.

[2]Of course, the fact that libertarian anarchy is unfeasible does not justify the presence of a ruler. Yet, it strengthens the case for government as a lesser evil. This is the basis for a pragmatic view of the social contract. See Spooner (1867–1870), for an early and forceful argument against the legitimacy of all governments and the irrelevance of constitutions; and Huemer (2013) for a more recent contribution on the feasibility of the anarchic option.

He has the authority to apply coercion (violence is legal), and the exclusive power to do so (the monopoly of violence). By contrast, a ruler without legitimacy is a predator, since coercion would be equivalent to aggression, and his request to enjoy the monopoly of violence unacceptable. To illustrate this point, let us imagine that people living in a given region trade and interact on a voluntary basis. Of course, living and interacting give none of these individuals (or somebody coming from outside the region) the right to impose his/her will on any of the residents. A group of residents could decide to create a club,[3] agree on a statute, and call such club a political community. Moreover, this group could appoint/elect a board of directors responsible for ensuring that the club members comply with the statutory rules, and perhaps issuing new rules. The board can take any name, including "government". Yet, neither the club members nor the directors have the authority to force all those who reside in a given area to join the club or follow the rules of the club. Put differently, the government appointed or elected by the members of the political community (the club) has no authority over those who never applied to join the political community, chose to remain outside and possibly trade with the club and with other clubs on a voluntary, case-by-case basis. The same applies to those who have left the club. Likewise, the non-members have no obligation towards those who acknowledge the authority of the government (the members of the political community).

Certainly, in today's real world there is a crucial difference between a club or a cooperative agreement on the one hand, and a political community on the other. A club provides for freedom of exit by dissatisfied members, and its board of directors has the right to exclude unruly

[3]It is also important to underscore the difference between a club and a (social) community. A club is an association among individuals with a view to producing excludable and non-rival goods (within limits). A social community is a group of people who share a set of conventions. Thus, although a political community is frequently composed by the members of a social community, being part of a social community does not imply the existence of a political community. See also Hume (2001 [1752]), according to whom the agreement that justifies a political community is a set of conventions. In this light, a political community is legitimate only if its members are part of a social community. Of course, this condition would be necessary, but not sufficient.

members and undesirable candidates. In this context, therefore, the use of violence is limited to preventing entry or forcing exit. By contrast, when a group of residents in a given region creates a political community and its government claims authority over all those residing in that region, the outcome consists in the use or threat of violence against potential dissenters. Not surprisingly, the political community or the government that claims to act on its behalf would argue that its use of violence against the reluctant residents is legitimate. Yet, over three centuries of pondering have not produced very strong arguments supporting such claim (see Cordes and Schubert 2007). The use of violence is associated with the power to rule; otherwise, it would be a matter of cooperation. However, where does such power come from? Few would accept that a ruler has an innate natural right to govern.[4] Hence, legitimacy without agreement must necessarily come from outside—from above (God) or from below (the people).

The social contract is how the literature defines the latter option, which theorises how a political community can force outsiders within a given region to join and recognise the incumbent governing body as their own ruler. This is the focus of the first part of this paper, which considers some aspects of social-contract theorising with emphasis on the Hobbesian approach (sections "An Introduction to Social Contract Theorising" and "Rationality and the Hobbesian Ruler"). The following parts analyse the constitutional alternative and Buchanan's view (sections "The Constitutional Alternative" and "Buchanan's Position"), discuss the implications for natural liberty (section "What About Natural Liberty?") and offer some conclusions (section "Concluding Remarks").

[4]The word "innate" is important. In this context, it means that given individuals have a natural right to rule, a notion in contrast with the principle of men's moral equality (birth does not justify rent-seeking). The medieval belief in the existence of an innate right to rule differs from the modern notion of an acquired right to rule. The modern notion mentions one's social upbringing, as argued by Edmund Burke; or historical accident, as argued by a tradition that started at least three centuries ago (Thomas Hobbes) and is now presented in term of procedural compliance.

An Introduction to Social Contract Theorising

This and the next sections draw attention to two different ways of framing the social contract. One assumes that the social contract materialises before government comes to life: The residents do not accept a self-appointed ruler, but recognize a government as long as it is born out of the social contract they have created, and complies with the terms defined by the agreement. With regard to violence, this makes the difference between aggression and legitimate coercion. In particular, the social contract is an agreement subscribed by all the residents, who form a political community in order to reduce their transaction costs, enhance the division of labour, and take advantage of the opportunities for exchange. In order to reach unanimity, therefore, the social contract is necessarily limited to cooperation and enforcement, and the ruler is the actor to whom the contractors give the authority to make the agreement operational for a given time period, and the instruments necessary to function.[5] Clearly, the social contract should be renewed relatively frequently, since each draft weakens as time goes by, as the number of the original subscribers necessarily drops, and new residents who never agreed to the current contract are born. In this paper, we put the question of obsolescence aside, and draw the reader's attention to the tensions that emerge when the ruler tries to expand his role and expects to enjoy—say—monopoly power in promoting cooperation, interpreting the very meaning of cooperation, attaining efficiency, enforcing contracts and preventing/sanctioning crimes. When this happens, most residents often agree with the essence of the ruler's requests—see the expansion of the welfare state in modern democracies during the

[5] The same would be true when a very large majority suffices to give birth to a social contract. Those who do not want to subscribe to an agency enhancing cooperation can stay out of the political community or form their own political community, with their own agency. Dissenters might well enjoy a free ride. Yet, if their number is relatively small, the other residents can still create and finance an agency that enhances cooperation, ensures contract enforcement and possibly provides security (police and defence). Some people could find the presence of free riding annoying. However, free riding is not an act of aggression and causes no victims.

twentieth century—and stay in the political community. In fact, this apparent acquiescence results from a compromise between two parties. One party includes the members of the political community who tend to collude with the ruler in order to share the prospective privileges that the ruler promises to create and distribute. The other party includes those who feel inclined to oppose the ruler's requests and resist the institutional change, but are also unwilling to abandon the cooperative contract and lose the benefits it entails. Typically, the two parties meet halfway. The dissidents fear retaliation by the other group, and hope to fine tune or redefine the limits of government from within the political community. At the same time, the ruler's supporters yield ground in order to avoid turmoil and enhance the ruler's role and legitimacy by keeping the size of the political community intact.

By contrast, according to the second approach, the residents consider the incumbent ruler inevitable, and the social contract is a device that the residents use in order to restrain oppression. According to this view, therefore, legitimacy plays a minor role, and an agreement is signed between the residents (or some of them) and the ruler/predator. In particular, the population offers a veil of legitimacy to the incumbent government. By declaring loyalty and support to the incumbent predator, the residents make it more difficult for the newcomers to grab power. In return, the residents obtain that the ruler restrains abuse, and possibly extends his time horizon and becomes a long-term exploiter, rather than a roving bandit. Of course, most of the time this is a dream, since the incumbent predator knows that loyalty is fragile. In fact, long-term exploitation takes place only when—a necessary but not sufficient condition—the ruler is in absolute control, and does not fear that his authority can be challenged from outside (an invasion) or from within (a palace coup). When this is the case, however, the existence of a social contract is an illusion; and much of the literature devoted to finding ways of showing the legitimacy of government is an exercise aimed at pleasing the ruler. A strong ruler would feel reassured, while a weak ruler would know where to find loyal supporters.

In fact, today the real world devotes little attention to the first view (the social contract as a cooperation agreement). Rather, it focuses on the second perspective (the social contract as a deal between an unavoidable predator and its victims): People resign themselves to the fact that a group of predators inevitably takes control of a given region and imposes its will on the residents, possibly colluding with rulers in other regions (Sugden 1993; Holcombe 2004). Getting rid of one predator merely opens the way to other predators, and it is by no means obvious that the latter are better than their predecessors. Thus, rather than engaging in useless debate (let alone fighting), most of the time the residents strive to avoid the worst and converge on an institutional deal that fills the gap between their own interests and the ruler's.

Rationality and the Hobbesian Ruler

The Hobbesian perspective is different, and despite intense criticism, it still offers some elements that help understand how people regard institutions. Absent explicit unanimous agreement among the residents in a given area, Hobbes gives a compelling argument that justifies the presence of a ruler based on natural principles. Hence, it does not require a contract between the ruler and his counterpart. As a matter of fact, although Thomas Hobbes is often regarded as the founding father of modern social-contract theory, the core of his argument is not a real contract.

The essence of the Hobbesian view consists in claiming that the social contract materialises when an individual—or a group of individuals—forces other individuals to buy security, possibly from the same and unique provider. The legitimacy of this forced transaction rests on two key assumptions. Survival is the priority of all human beings, and in order to meet this goal, each individual needs and welcomes protection against aggression. In particular, the Hobbesian approach postulates that no one prefers to rely on his own resources to repel an attack, nor does he choose to organise collective defence. Moreover, all individuals are characterised by aggressive instincts, which urge them to attack and rob to enhance their wellbeing and guarantee their own survival. Two consequences follow. Nobody endowed with a human nature would decline an offer by a supplier of security services (the Hobbesian ruler), unless one is himself an aggressor. In this light, the presence of aggressors from within the community (criminals) and from outside (enemies) legitimizes the Hobbesian ruler to engage in suitable action—including taxing a community to finance the required security services—as long his action aims at protecting the potential victims.

Three points deserve attention within this context. First, the identity of the supplier of protection services plays a minor role. This explains why the procedure through which a community selects the supplier is all but irrelevant from a Hobbesian standpoint. Second, since one cannot rule out that more suppliers intend to offer their services, either the potential suppliers resort to violence in order to obtain a monopolistic position; or they compete for clients by adding to the effectiveness of the protection they supply and lowering the price they charge. In the latter case, one can imagine that various groups of residents choose different suppliers. This process would create different political communities within the same geographic area (political fragmentation), each community characterised by a different ruler (i.e., several Hobbesian security suppliers).[6] Third, as mentioned above, the Hobbesian perspective not only takes it for granted that the primary natural goal of man consists in the struggle to survive, but also postulates that human nature includes the instinct to attack and rob/kill other human beings. A Hobbesian supporter would argue that one individual can attain his primary goal (survival) only if the others' violent instinct is checked by a third party acting as a watchman (the ruler), lest he be robbed or killed. Hence, each man is necessarily born with a built-in desire to ensure that the others obey the ruler and, moreover, that each man is legitimised in requiring that all other men do so.

All the points mentioned above have been subject to critiques (see, for instance, Goldman 1988; Baier 1994), the evaluation of which lies

[6]This situation would correspond to libertarian anarchy (see, for example, Rothbard 1982). In contrast with what suggested in Buchanan (2000 [1975], Chap. 1), anarchy does not necessarily imply Hobbesian warfare and chaos. In fact, anarchy corresponds to an institutional context in which no agency has the monopoly of violence or the authority to prevent people from pursuing their preferences and choosing accordingly.

beyond the scope of this paper. However, we believe that this line of reasoning also raises two broader questions, which pertain to the very nature of the Hobbesian contract, and have been somewhat neglected. One regards the fact that the ruler's source of legitimacy is actually his alleged superior ability to make an appropriate use of coercive power. We have already observed that the presence of the Hobbesian ruler is not the only solution generated by the Hobbesian view of human nature. An individual who believes that aggressing another individual is the right thing to do to survive might also choose to look for aggressive allies, rather than for neutral watchmen. Actually, since the purpose of the watchman consists in the preservation of the community (or of humankind) despite the individuals' bellicose instincts, one suspects that his presence is the result of long-term rational reasoning, rather than of a natural disposition of all human beings. Put differently, the Hobbesian ruler is not justified by man's natural instinct to survive. Rather, he justifies himself by appealing to an ideal of knowledge and foresight, which gives him the authority to force the residents in a given area to set aside their aggressive instincts and submit to the provider of security.

Furthermore, one wonders whether one can call a contract an arrangement with no contracting parties. If one accepts the Hobbesian postulate following which instinct leads individuals to believe that the best way to survive and augment their wellbeing consists in aggressing other individuals, they will hardly cooperate by agreeing to hire a protecting agency. Indeed, the Hobbesian agency does not need a contract. Rather, it draws its legitimacy to exist and operate from a combination of an a priori assumption regarding human nature and rationalistic paternalism, regardless of the individual's actual preferences about how to survive.[7]

[7]The Rousseauvian and the Rawlsian social contracts reproduce the same pattern: the elites are not legitimised to rule because their policies reflect people's preferences. Rather, in the Rousseauvian context they govern because they enforce a general will, the meaning of which is defined by the elites themselves. Instead, in the Rawlsian context the elites enforce some form of equalitarianism. The difference between the two approaches is in the principles advanced by the elites: consequentialism in the Rousseauvian case, (social) justice in the Rawlsian framework.

The Constitutional Alternative

Today's alternative to the Hobbesian paradigm is the constitutional social contract, which excludes references to human nature and moral principles, and draws its legitimacy from an agreement on procedures (Hayek 1960, 1976). In particular, procedures determine how and to whom the members of a community delegate decision-making power, and the areas to which such power applies. In theory, procedures are established at times called constitutional moments and are approved unanimously. Of course, constitutional moments also serve purposes other than institutional design. For example, in the real world constitutions often include a list of desirable goals (e.g., health and education for the largest possible number of individuals) and/or of fundamental principles, possibly with qualifications (e.g., the inviolability of private property, unless it runs against the interest of the community). Yet, shared ambitions and vague promises are subject to interpretation. As a matter of fact, ranking priorities and choosing among sets of possibilities becomes the very task of the legislator, the legitimacy of which is measured with reference to procedural compliance. This explains why procedures frequently end up transferring considerable discretionary power to the selected rulers.

Not surprisingly, the constitutional alternative presents a number of elusive issues, especially in regard to the position of those individuals who reject the constitutional contract and opt to remain in the Lockean state of nature. Similar comments apply to those born in a region where the constitution is enforced but are never asked to manifest their opinion about it, let alone join it or opt out of it (Huemer 2013). In theory, constitutional authors acknowledge that the jurisdiction of a political authority legitimized by a procedural agreement does not apply to dissenters. In practice, however, those who subscribed to a constitutional contract and/or their representatives do not hesitate to attack the nonconformists. This is unjustified violence. The fact that dissenters can profit from the positive externalities created by the members of a political unit—those who joined the constitutional contract—makes no difference. Free riding is not a violation of property rights or a breach of contract.

Another question regards the width and composition of the political community identified by the constitutional contract. As mentioned earlier, in the real world a political community is defined by the area over which a political body exercises its power, an area that results from an agreement among different political bodies (governments), none of them overly concerned about their own legitimacy, especially after the decline of absolute monarchies. This standpoint is consistent with the view of the public, which usually accepts the state as inevitable, and its jurisdiction as a historical accident. Two consequences follow. Within this context, the issue of legitimacy over a territory replaces the problem of justifying government vis-à-vis the individual. Individuals are no longer considered as persons, but as creatures (chattel?) identified by the territory in which they live or in which they are born. Likewise, the legitimacy of the current context is taken for granted (it is inherited from the past), and opposition to governmental action is reduced to disagreement with ordinary law making, rather than with the inherited constitutional corset.

Of course, if one ignores the issues related to the legitimacy of the status quo, the constitutional social contract becomes a fiction, since it does not originate from a constitutional moment, but from historical accidents that created and empowered a political agency and its territorial jurisdiction. In the same vein, the frailty of a contract that comes to life when a historical accident occurs becomes apparent when one considers what it takes to change the features of the contract (the procedures). Arguing that the constitution can change only by unanimous decision is equivalent to saying that all procedural changes are actually defined by the procedures established at the latest constitutional moment—the moment of the accident. In other words, the constitutional contract is drafted by the elites that happen to be in power when a significant historical accident occurs, and the current procedural context follows from the rules set at the point in time. For example, at the historical moment the ruling elite may establish that no changes are possible, or that all changes must be agreed by all members of the community, or that changes must be approved by qualified majorities. In brief, change can take place when a new historical accident materialises (a coup?), or is in the hands of those in charge of interpreting the alleged social contract (e.g., a constitutional court).

Buchanan's Position

James Buchanan (2000 [1975], pp. 9, 12–13) takes for granted that the state is inevitable. In his view, people need and accept a ruler in order to recognise property rights, enforce spontaneous cooperative agreements, and produce a set of merit goods, including security. Certainly, justifying the existence of government because it is necessary or at least desirable draws heavily on the Hobbesian tradition. However, and consistent with what we observed in the Hobbesian context, this argument does not rely on a social contract. Although Buchanan does not develop his case in these exact terms, he assumes that a ruling agency that enforces private contracts and guarantees security brings about a Pareto improvement for the community.[8] Thus, as long as it does not engage in improper behaviour, government is legitimate or—better—not illegitimate. This description corresponds to what Buchanan calls "the protective state".

Yet, Buchanan goes beyond the Hobbesian approach, and in his (2000 [1975]) book develops a theory about what we call the pragmatic (social) contract,[9] a theory designed to justify the so-called "productive

---

[8]Legitimising an institutional arrangement by claiming that its presence involves a Pareto improvement is not unique to Buchanan. For example, De Jasay (1991, 2005) bases his presumption of liberty on a Paretian criterion. However, in De Jasay, the criterion is met when you guarantee freedom to choose, the ownership of one's own self and private property. By contrast, according to Buchanan the very fact that government is preferable to anarchy seems enough to qualify government as legitimate. This seems to apply even when the government operates in a condition of "constitutional anarchy", i.e. when it violates the contract it should have enforced.

[9]Buchanan's notion of "constitutional" differs from that used by Hayek and E. Ostrom. According to Buchanan, constitutions define both the rules of the game and what governments are allowed and possibly encouraged to produce. By contrast, Hayek emphasises constitutional design with a view to preserving the rule of law, while E. Ostrom uses this term to separate the substance of ordinary law making from the rules of the game within which ordinary law making takes place. This explains why we prefer to use the term "pragmatic" when we refer to Buchanan, and the term "constitutional" when we refer to the Hayekian tradition.

state", in which the government produces merit goods and, more generally, takes an active role in defining property rights. Surprisingly enough for a free-market supporter, Buchanan does not follow the classical liberal view on property rights. In particular, he ignores the Lockean and libertarian views on the origins of private property,[10] and argues that the assignment of property rights and the definition of the limits to private property are in fact the substance of the constitutional moment, and imply deviations from the status quo.[11] These deviations and later amendments must be approved unanimously, but it does not matter how unanimity is obtained—whether it emerges spontaneously or as a response to threats.[12] In other words, Buchanan believes that the legitimacy of the pragmatic contract originates from the fact that the contract makes each member of the community better off, compared with a situation in which property rights are up for grabs. It makes no difference whether resources are up for grabs because property rights are undefined, or because they are indeed defined, but poorly enforced by the government. In particular, this agreement includes two parts. One specifies the deviations from the property-right arrangement characterising the status quo, including the perimeter within which the ruler can exercise discretion or—better—the social goals that justify encroachment. A second part defines procedures, by means of which the social contract is amended, the ruler is selected, and ordinary law making unfolds.

Thus, and consistent with what we already pointed out earlier, Buchanan tacitly tries to circumvent the requirement of unanimity by resorting to multilateral bargaining, which is expected to lead to a Pareto improvement. This process takes off when a significant portion of the community is dissatisfied with the status quo and threatens to attack the rest of society. When turmoil is realistic, the potential victims

---

[10]See Colombatto and Tavormina (forthcoming).

[11]Interestingly enough, Buchanan does not seem to attach much importance to the legitimacy of the status quo. Yet, it is a crucial point, as emphasised in Vanberg (2004) and Meadowcroft (2014), especially since the status quo is the point of departure for developing a social contract based on unanimous consensus.

[12]See, for example, Buchanan (2000 [1975], pp. 224–225).

give in, and amend the contract by compromising with the aggressor and stop wasting resources in fighting. The aggressors are pleased because they improve their condition by extracting resources from the prospective victims. Of course, it is apparent that in this context the notions of spontaneity and individual sovereignty take an unusual turn.

Eminent authors have argued that the social contract exists because it is inevitable, and it is inevitable because the members of a community cannot avoid agreeing on a set of reasonable procedural rules emerging from below through utilitarian conjectures (e.g., Hayek 1945); or because it follows from an evolutionary process driven by "immanent criticism" (e.g., Hayek 1960, Chap. 1; 1976); or because it is imposed from the top by enlightened lawmakers (e.g., Sen 2009). Yet, this view is not free from ambiguities. First, the very fact that some people could consider opting out of the social/constitutional contract shows that the initial assumption is flawed. The possibility that a constitutional contract makes everybody better off because it avoids conflict (Buchanan), and/or allows institutional efficiency (Hayek),[13] and/or is the result of shared wisdom and articulated debate by the elites (Sen) could make the contract attractive. However, it is only a possibility, and is not enough to make it compulsory.

Moreover, if one accepts Buchanan's line of reasoning, according to which the social contract is driven by the need to avoid tensions (this justifies the ceaseless redefinition of property rights), the protective nature of government is inevitably weakened. In brief, in Buchanan's world the government enforces property rights only up to a point. If opposition turns out to be unbearable, the terms of the social contract would be revised, allegedly obsolete rights would no longer be protected, and new rights would be enforced. However, who decides about the new terms of the social contract or, more precisely, who is in charge of reinterpreting the set of norms and principles listed in the constitution, to match the new balance of powers within the community? And what about the credibility of a protective state whose range of activities is ultimately a question of discretion by the elite, which has a choice

[13] See Sugden (1993) and Servant (2017) for a detailed analysis of "Hayek as a contractarian".

between negotiating a compromise to avert tensions and resorting to violence to enforce the existing rules? Third, it seems that Buchanan's emphasis on qualified protection and ongoing change driven by the power, noise and threats of different interest groups supports the redistributive and regulatory state, rather than the productive state. Once again, the fact that an elite (possibly backed by a majority) believes that a good is desirable because it defuses social tensions legitimises neither taxation, nor state production of goods and services. In other words, we suspect that the argument in favour of the productive/redistributive state actually undermines the working of the protective state. If this were true, Buchanan's pragmatic contract would replace the rule of law with the rule of compromise (or expedience), and definitely take a community far away from the classical liberal perspective.

To summarise, we submit that Buchanan's view on the constitutional contract is in fact an ex-post utilitarian rationalisation of why political communities do not break up in spite of weak legitimacy for the ruler. In particular, Buchanan's contract does not define the composition of the community; and it does not explain how a community gives birth to a collective agreement and, if such agreement does exist, from where it draws the authority that legitimises the use of violence against dissenters. Certainly, Buchanan's constitutional (social) contract describes the operational features of a system of rules inherited from the past, how these rules should evolve and how they should relate to ordinary law making. Yet, if this imaginary institutional context is deprived of normative content, then it remains all but a tautology, since the expression "social contract" actually represents a situation characterised by the lack of tensions within the community, and considers that the presence of tensions characterises a situation in which the social contract is about to be redefined.

That said, it is conceded that the vision put forward by Buchanan is a fitting description of the institutional context prevailing in today's Western democracies, a context in which a rather awkward notion of social contract applies. Most people accept that, regardless of its history, the status quo "must be evaluated as if it were legitimate contractually" (Buchanan 2000 [1975], p. 109), and that from the status quo rent-seeking activities and political manoeuvring unfold. In particular, the origin and legitimacy of the existing property rights are hardly disputed,[14] and the nature of the alleged social contract that defines a community is de facto ignored. Past historical events define the extent to which a government has authority, while a set of procedures characterised by different majoritarian mechanisms (procedural legitimacy) specifies the law-making process. Moreover, and in accord with the Hobbesian perspective, very few individuals doubt the desirability of some form of central government enjoying monopolistic privileges, fearing that otherwise a community would end up in chaos and self-destruction. In contrast with Hobbes and in at least partial accord with Buchanan, however, in today's democratic practice government is not an agency that enforces the terms of an agreement, but an actor who is born out of the agreement and who contributes to defining its terms by making proposals with a view to defusing tensions. Of course, governments frequently fail to meet people consensus and allow violations of the current agreement (if it exists), thus leading to "constitutional anarchy" (Buchanan 2000 [1975], p. 19). Oddly enough, however, this very context does not open the way to investigating the nature of libertarian anarchy, but becomes a new (legitimate) status quo, from which a new agreement would be negotiated.

What About Natural Liberty?

Interestingly enough, Buchanan's approach to the social contract changed over time, from a normative vision based on an ideal contract that applies to a hypothetical community behind the veil of uncertainty (Buchanan and Tullock 1962),[15] to a more pragmatic concept designed

[14]An important exception is the legitimacy of the past structure of property rights when a change in regime occurs—see, for example, the transition from communist dictatorship to democracy in Eastern Europe after the fall of the Berlin wall. Of course, it is not clear why expropriation by a democratic ruler is legitimate, while it is not acceptable under a dictatorial regime.

[15]The veil of uncertainty is still present in later years, although in a different form. See, for example, Brennan and Buchanan (1985) and the critique levied by Müller (1998).

to describe how the real world operates, how changes are brought about, rationalised and justified (Buchanan 2000 [1975]).

The libertarian critique of the ideal contract behind the veil of uncertainty is well known. Critics point out that although some could prefer a world free from rent-seeking, this possibility does not exclude that other individuals might actually like the presence of privileges. For example, most people believe that patents are fair, and that a minimum income level should be guaranteed to all residents. Put differently, and in contrast with the view presented by Buchanan and Tullock, freedom from rent-seeking is not necessarily a goal that would garner unanimous or even majoritarian agreement. More generally, libertarians would insist that a community does not have a goal. Individuals do. Thus, men and women may agree on common rules because such rules allow them to pursue their own individual objectives. Absent a general will or a general goal, rules are necessarily based on fundamental principles (primarily private property and freedom to choose and exchange). These are in fact the bedrock of a system of natural liberty. In other words, the difference between cooperation within a community and collusion by a set of cronies is that the former rests on voluntary actions, while the latter is based on the violation of somebody else's natural liberty, which necessarily requires the use or the threat of force against dissenters. In this light, rent-seeking is unacceptable not because individuals agree to ban it, nor because the community as a whole would be better off without it. Rather, it is intolerable because it violates a fundamental right peculiar to all human beings, and remains intolerable until all the members of the community agree to give it away. Ironically, one can thus conclude that a social contract cannot rest upon an agreement to ban rent-seeking (you do not need an agreement to recognise and authorise the natural order), but rather upon an agreement to accept it.

As mentioned earlier, Buchanan discarded the libertarian anarchic alternative as impractical, and neglected to consider its epistemological value. At the same time, he was hesitant about the Hayekian view, a view following which the evolutionary quest for the rule of law is the core explanation of the existence of a political community. On the one hand, despite his scepticism towards the evolutionary standpoint, one may suppose that Buchanan appreciated the fact that the Hayekian approach does not require that a community explicitly agrees on a social contract, and regards the outcome of an evolutionary process as satisfactory proof of the rightfulness or at least acceptability of the existing rules. Of course, this implies that history rather than principles is the basis for legitimacy, and that the lack of conflict testifies to the presence of a collective agreement, which can be assimilated to a contract. If so, this would justify Buchanan's emphasis on how the contract operates, rather than on its founding principles.

On the other hand, the pragmatic strategy undertaken by Buchanan is also useful in appreciating his notion of liberty, shared by many classical-liberal scholars. As observed earlier, Buchanan rejects the libertarian view according to which liberty is an end in itself; and follows the classical-liberal tradition, according to which liberty is an instrument. For example, Smith (2018 [1776]) argued that natural liberty promotes the common good (the wealth of the community), but neglected to mention the principle of equal dignity (i.e., nobody has a right to impose his own preferences upon somebody else).[16] Put differently, the classical-liberal tradition argues that natural liberty means freedom to choose within an existing set of institutional arrangements, and that constraints apply even before the constitutional moment.[17] Hence, the case for liberty within the classical-liberal context reflects the fear that government may abuse its powers, engage in discretionary policymaking, and eventually make the community worse off. From this viewpoint, the fight for freedom is actually the fight against whatever threatens the wellbeing of a society. Big government is clearly the prime suspect, but merely a suspect.

[16]Some two centuries later, Hayek (1960) suggested a similar line of thinking, by claiming that in a world of uncertainty in which institutions follow a virtuous evolutionary path, a system of (natural) liberty is the best way of redressing and possibly avoiding mistakes. As Rees (1963) promptly pointed out, however, Hayek's notion of liberty is not equivalent to the absence of coercion, but to freedom of action within norms consistent with the rule of law. In turn, Hayek's notion of the rule of law corresponds to the absence of privileges.

[17]Individuals enter the constitutional moment with the rights and constraints defined by the "natural distribution" (which differs from the natural order), a distribution inherited from a past necessarily characterized by an (almost) undisputed ruler.

The intuition that makes it possible to bridge the gap between social wellbeing (a concept normally meaningful only in a Benthamite perspective) and individual wellbeing without being constrained by unanimity consists in conceiving of a notion of welfare based on opportunity costs in a Hobbesian context. In brief, it is assumed that an individual considers the appeal of an institutional change by examining the benefits and costs he/she would enjoy as a result of the proposed change. However, the costs also include the likely reaction of the rest of the community or of its representatives, should the individual decide to oppose the change. This is the Hobbesian touch. For example, suppose that according to the constitutional context inherited from the past, state revenues are initially generated by a proportional tax on net wealth. Suppose now that some political groups aim at replacing the current system with a progressive tax on income. If the potential opponents to the proposed change fear that their refusal to comply ends up in expropriation or in migration (which involves costs), they might rationally accept the new tax regime, possibly negotiating some minor amendments in exchange for their support.

Certainly, Buchanan does not believe in the Hayekian evolutionary process and emphasises the importance of "philosophical precepts" (2000 [1975], pp. 210–211; 2001 [1978]). However, and similarly to Hayek, he believes that liberty cannot be unbounded (Buchanan 2000 [1975], p. xv), and suggests that individuals voluntarily and rationally accept to limit their liberty, lest undesirable scenarios come true.

Investigating the potential tensions between the idea of bounded freedom and the philosophical concept of unbounded liberty under threat is beyond the purpose of this paper. Nonetheless, one must recognise that nowadays the notion of natural liberty is far less important than the quest for political freedom within a political community. The emphasis is on freedom of expression (which includes no censorship and democratic elections) and of association, while economic freedom plays a secondary role (Wagner and Gwartney 1988). At the same time the cost of not being part of one—and especially of quitting one—has become high. The individual is vulnerable to attack by the government that claims sovereignty over a given region, and faces discrimination if he/she succeeds in leaving the political community. How can he/she travel if no authority issues a passport? How would an employer subject to a government treat a potential employee who has no nationality and objects to social security or withholding taxation?

Two phenomena may help understand why economic liberty is no longer a critical issue in public debate. First, the cost of qualified quitting (migrating to another community) is regarded as fair, since public opinion holds that one must always belong to a political community, even if it is not particularly attractive. Put differently, and consistent with Buchanan's approach, natural liberty is not a natural right characterising each individual, but an ideal that one could strive to approach through peaceful compromise with the rest of the community. Second, it is undeniable that the ruling elites do their best to stay in power and possibly create additional rent-seeking opportunities. Within this framework, sustainable success is guaranteed by their ability to ensure that the cost of leaving the political community is prohibitively high, by garnering consensus towards the regime (if it is a democracy) or by eliminating potential competitors (if it is a dictatorship). Certainly, manipulating the rent-seeking process is a key ingredient under all circumstances, and weakening the sense of individual responsibility is essential. It is thus clear that the roles of ideology and education can hardly be overestimated. Buchanan would have disliked resorting to ideology and education to manipulate a community, but his view with regard to the outcome would have been benign, and he would have probably considered the loss of natural liberty a tolerable price to pay to reduce transaction costs and guarantee social tranquillity.

Concluding Remarks

As mentioned in the early sections of this article, unless one accepts the Hobbesian standpoint and turns a blind eye on its ambiguities, social contract theories find it impossible to circumvent the need for unanimous, explicit agreement among the potential members of a political community.[18] Compromise prevails, both when the ruler asserts his/her legitimacy and when he/she expands its powers. In this light, the approach proposed by Buchanan (and partially derived from Hayek) is not very persuasive. Yet, it is realistic. Although it fails to offer a satisfactory justification of government, it offers a good description of where the real world stands: constitutional anarchy punctuated by pragmatic contracts.

Hayek and Buchanan assign a minor role to principles and natural rights, and introduce the idea of an agreement about the rules of the game. The agreement is generated by evolution (Hayek) and bargaining (Buchanan), and the parties involved may modify it when they wish to do so. This is the essence of today's constitutional arrangement. Thus, these authors aim at describing the ideal working of a democratic system aiming at creating chances for the member of a political community. The downside is that they neglect to discuss the intrinsic legitimacy of a monopolistic government. They content themselves with arguing that the presence of government is the outcome of a historical process; and that its legitimacy originates from its compliance with the rule of law (Hayek) or with its ability to guarantee social tranquillity (Buchanan).

The views put forward by Hayek and Buchanan complement each other. Since a political community seldom corresponds to the ideal of the rule of law imagined by Hayek, Hayek's evolutionary vision calls for a theory about dealing with disagreement. Such theory is the cost-benefit analysis suggested by Buchanan. Buchanan's constitutional moment and contract are in fact a synonym for compromise, in which the weaker gets the short end of the stick. Of course, there is hardly any room for a contract free from ominous pressures.

[18]The Hobbesian hypothetical contract rests on the principle of survival, which is a natural trait of all human creatures. Buchanan's and Rawls' veils rest on the assumptions that people are necessarily against privileges and on the notion that inequality is bad, respectively. Yet, none of these veils is based on natural principles and, therefore, none of them justifies a hypothetical implicit contract.

Moreover, it is true that the classical-liberal view of the social contract presented by Hayek and Buchanan admits that an individual reject a constitutional contract and leave the political community in which he/she is born. However, since all political communities claim unconditional sovereignty on the land they control, the act of leaving necessarily implies physical dislocation; and since political communities have occupied all the land on the planet, dislocation necessarily means migration from one political community to another. The upshot is that in order to preserve natural liberties, the classical-liberal view should recognise that territorial control and political legitimacy are two distinct notions, and that individuals—not political communities—have property rights on the land. In other words, the classical-liberal theory of property rights should reproduce the libertarian view on the matter (see, for example, Rothbard 1974). Of course, this is not the case.

In the end, Hume's approach based on conventions is much more persuasive. Yet, conventions relate to a social community within which the members are happy to interact and exchange on a voluntary basis. Certainly, conventions are not compulsory rules. Rather, they are default rules that have developed to reduce transaction costs and from which the trading partners may deviate if they agree to do so. This makes the difference between Hume on the one side, and Hayek and Buchanan on the other; and explains why the former rightly rejects the notion of social contract, while the latter are indeed contractarian. Although Hume's scepticism has won the war of ideas, however, it is apparent that Hayek's and Buchanan's views prevail in today's real world.

Acknowledgements I am grateful to Leonardo Baggiani, Paul Lewis, Alain Marciano and John Meadowcroft for their comments on a previous draft.

References

Baier, A. (1994). *Moral Prejudices*. Cambridge: Harvard University Press.

Beraldo, S. (2018, January). *An Impossibility Result on Nudging Grounded in the Theory of Intentional Action* (IREF Working Paper Series). IREF, Paris.

Brennan, G., & Buchanan, J. (1985). *The Reason of Rules*. Cambridge: Cambridge University Press.
Buchanan, J. (2000 [1975]). *The Limits of Liberty.* Chicago: University of Chicago Press (Reprinted by Liberty Fund, Indianapolis).
Buchanan, J. (2001 [1978]). Law and the Invisible Hand. In B. H. Siegan (Ed.), *The Interaction of Economics and the Law* (pp. 127–138). Lexington: D.C. Heath (Reprinted in *Moral Science and Moral Order*, by Liberty Fund, Indianapolis).
Buchanan, J., & Tullock, G. (1962). *The Calculus of Consent*. Ann Arbor: University of Michigan Press.
Colombatto, E., & Tavormina, V. (forthcoming). Private Property: Origins. In A. Marciano & G. B. Ramello (Eds.), *Encyclopedia of Law and Economics.* New York: Springer.
Cordes, C., & Schubert, C. (2007). Toward a Naturalistic Foundation of the Social Contract. *Constitutional Political Economy, 18,* 35–62.
De Jasay, A. (1991). *Choice, Contract, Consent: A Restatement of Liberalism*. London: Institute of Economic Affairs.
De Jasay, A. (2005). Freedom from a Mainly Logical Perspective. *Philosophy, 80,* 565–584.
Goldman, A. (1988). *Moral Knowledge*. London: Routledge.
Hayek, F. (1945). The Use of Knowledge in Society. *American Economic Review, 35,* 519–530.
Hayek, F. (1960). *The Constitution of Liberty*. Chicago: University of Chicago Press.
Hayek, F. (1976). *The Mirage of Social Justice*, vol 2 of *Law, Legislation and Liberty.* Chicago: University of Chicago Press.
Holcombe, R. G. (2004). Government: Unnecessary but Inevitable. *The Independent Review, 8,* 325–342.
Huemer, M. (2013). *The Problem of Political Authority*. Basingstoke: Palgrave Macmillan.
Hume, D. (2001 [1752]). Of the Original Contract. In P. B. Kurland & R. Lerner (Eds.), *The Founders' Constitution* (Vol. 1, Chapter 2, pp. 49–52). Indianapolis: Liberty Fund.
Meadowcroft, J. (2014). Exchange, Unanimity and Consent: A Defence of the Public Choice Account of Power. *Public Choice, 158,* 85–100.
Müller, C. (1998). The Veil of Uncertainty Unveiled. *Constitutional Political Economy, 9,* 5–17.
Rees, J. C. (1963). Hayek on Liberty. *Philosophy, 38,* 346–360.

Rothbard, M. N. (1974). Justice and Property Rights. In S. Blumenfeld (Ed.), *Property in a Humane Economy* (pp. 101–122). La Salle: Open Court.

Rothbard, M. N. (1982). *The Ethics of Liberty*. New York: New York University Press.

Rothstein, B. (2009). Creating Political Legitimacy. *American Behavioral Scientist, 53,* 311–330.

Sen, A. (2009). *The Idea of Justice*. London: Allen Lane.

Servant, R. (2017). Let's Agree Not to Agree: F. A. Hayek's 'Calculus of Consent. *Cambridge Journal of Economics, 41,* 259–281.

Smith, A. (2018 [1776]). *An Inquiry into the Nature and Causes of the Wealth of Nations*. Vol. I and II of the *Glasgow Edition of the Works and Correspondence of Adam Smith.* Indianapolis: Liberty Fund.

Spooner, L. (1867–1870). *No Treason*. Boston: Published by the Author.

Sugden, R. (1993). Normative Judgments and Spontaneous Order: The Contractarian Element in Hayek's Thought. *Constitutional Political Economy, 4,* 393–424.

Vanberg, V. J. (2004). The *Status Quo* in Contractarian-Constitutionalist Perspective. *Constitutional Political Economy, 15,* 153–170.

Wagner, R. E., & Gwartney, J. D. (1988). Public Choice and Constitutional Order. In J. D. Gwartney & R. E. Wagner (Eds.), *Public Choice and Constitutional Economics* (pp. 29–56). Greenwich, CT: JAI Press.

28

Constitutional Design and Politics-as-Exchange: The Optimism of Public Choice

Georg Vanberg

Introduction

Public choice theory consists of the application of the economic approach to the analysis of collective decision-making ("politics"). Although often associated with the school of Virginia political economy that derives from the foundational work of James Buchanan and Gordon Tullock, it is a broad, interdisciplinary intellectual tradition whose founding figures include Duncan Black, Anthony Downs, Mancur Olson, and William Riker, among others. Beyond the Virginia school, it is represented most prominently by the Rochester school in political science, as well as by some work in the Chicago school of economics.

Over the past fifty years, this research tradition has had a transformative effect on academic understandings of the political process, and the "growth of public choice theory" has been "one of the most

G. Vanberg (✉)
Department of Political Science, Duke University, Durham, NC, USA
e-mail: georg.vanberg@duke.edu

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_28

impressive trends in the study of politics" (Scaff and Ingram 1987, p. 613). Central features of the public choice approach have spread well beyond the domain of public choice and have become received wisdom among scholars who would not self-identify as "public choice scholars." (Perhaps the best example is the assumption—by now central to most work in political science—that politicians are fundamentally driven by the desire for reelection.) One of the most important consequences of this transformation has been to challenge overly idealized conceptions of the political process. As James Buchanan has observed, public choice is "politics without romance," providing a "'theory of government failure' that is fully comparable to the 'theory of market failure'" (1999 [1979], pp. 45–46).

Ironically, it is in large part precisely because it often suggests a sober assessment of political processes that public choice remains deeply controversial, and continues to attract vociferous criticism. These critiques—which often view public choice as an example of a pernicious economic imperialism in the social sciences—typically direct their fire at the central behavioral assumption undergirding public choice analysis: The claim that individuals, whether as politicians, voters, or in other capacities, act in a goal-directed ("rational"), self-interested manner in the political process. This *homo economicus* assumption, critics contend, is not only cynical, but empirically inaccurate in characterizing behavior. According to the critics, this fact accounts for an alleged lack of empirical support for central implications of public choice arguments and paints an overly pessimistic picture of democratic politics. The use of the *homo economicus* model in the analysis of the political process is also attacked as immoral: Academic analyses built on the premise of self-serving politicians, bureaucrats, and voters, it is claimed, serve to undermine norms of public spiritedness that sustain democratic governance.

In this brief contribution, I offer a defense of the public choice approach, rooted in a particular subfield of public choice: constitutional political economy. I first provide a methodological justification for the assumption that as individuals participate in the political process, they pursue their interests rather than some well-defined "common good." The central argument I advance is that the *homo economicus* assumption is best understood as a methodological tool in the context of comparative institutional analysis, rather than as a descriptive (or explanatory) claim about human behavior. Seen in this light, this motivational assumption is consistent with a long and well-established tradition in Western constitutional theory, going back to the work of David Hume and the *Federalist*. I then argue that understanding the self-interest assumption as a methodological commitment that facilitates comparative institutional analysis focuses attention on a central thrust of the public choice enterprise that is often ignored: The potential for institutional reforms that can serve to improve the "political game" from the perspective of all citizens. This emphasis on potential institutional reforms reveals, in turn, that despite its seemingly cynical foundations, the public choice paradigm is—particularly within the sub-discipline of constitutional political economy—a fundamentally optimistic enterprise.

It is important to stress at the outset that I claim no originality for the argument I present, which expands upon the logic articulated by Brennan and Buchanan (1981, 1988) and Vanberg and Vanberg (2012). Rather, my purpose is to build on this foundation, and to draw out the importance of comparative institutional analysis more clearly. The remainder of the chapter is organized as follows. In section "Public Choice—A Short Introduction", I provide a brief overview of public choice theory, and the critiques offered of the approach. In sections "Public Choice and Its Critics" and "Politics-as-Exchange", I defend the self-interest assumption as a methodological commitment in the context of comparative institutional analysis. Section "Comparative Institutional Analysis and Homo Economicus" concludes by sketching the optimism implied by a focus on comparative institutional analysis.

Public Choice—A Short Introduction

As with any successful research tradition, public choice scholars are diverse in their views, and important differences exist among approaches. What ties scholars within this paradigm together is a (loose) commitment to *methodological individualism* and *rational choice*.

Methodological individualism is the principle that social phenomena must be explained with reference to the actions of individuals.[1] The rational choice, or *homo economicus*, postulate asserts that such explanations should proceed by assuming that individuals have well-defined goals and desires, and that they act in pursuit of these, responding to the incentives and constraints presented by the physical environment, social institutions, and the presence of other individuals.

The *homo economicus* model is often summarized by public choice scholars and critics as the claim that individuals pursue their "self-interest." Typically, the preferences of individuals are assumed to include material or economic interests (such as re-election for politicians or career advancement for bureaucrats). But it is important to stress that the critical element for the public choice paradigm is not the *substantive content* of preferences. Rather, the key issue is that individuals *differ* with respect to their preferences. Such differences become critical in the context of collective ("political") action because they imply potential disagreement. As Buchanan and Tullock stress in the opening of their seminal *The Calculus of Consent* (1962, pp. 3–4):

> The analysis does not depend…upon any narrowly hedonistic or self-interest motivation of individuals in their behavior in social-choice processes. The representative individual in our models may be egoist or altruist or any combination thereof. Our theory is "economic" only in that it assumes that separate individuals are separate individuals and, as such, are likely to have different aims and purposes for the results of collective action.

Put differently, what is central is that the public choice approach assumes that when individuals engage in collective decision-making ("politics"), they do not pursue some agreed-upon "common good"

[1]Contrary to common misconceptions, this does not imply a view of "atomistic" individuals, or that "groups" can play no role in social processes. It merely implies that groups must ultimately be reducible to their individual members, and "group action" must be explained in terms of the behavior of individual group members. This was, of course, the fundamental insight of Olson's critique of interest group pluralism offered in *The Logic of Collective Action* (1965).

that is distinct from their preferences. Rather, individuals have separate goals—which may include material self-interest, but can also extend to different views over what might constitute the "public interest." When individuals act in the political process, they do not set these aside, but act in pursuit of them.[2]

Public Choice and Its Critics

When public choice is described as the application of the economic approach to the study of politics, what is typically meant is it extends the analytical method defined by methodological individualism and *homo economicus* from the realm of economic activity within markets to the analysis of collective decision-making. (I argue below that there is a second sense in which public choice extends the economic approach to politics that is typically ignored.) Perhaps the most well-known implication of the public choice perspective—with its insistence that individuals should be assumed to pursue their self-interest in the political process, just as they are assumed to do in market interactions—is that it typically leads to sobering assessments of collective decision processes. For example, public choice scholarship points to the prevalence of voter ignorance, the influence exercised by special interests, and to the costs of rent-seeking. As Saul Levmore (2002, p. 375) concludes, "it is easy to dip into the public choice literature and emerge only with distressing normative conclusions about that which emanates from legislatures, large electorates, bureaucracies, and even judiciaries."

These pessimistic conclusions of public choice approaches are driven by the assumption that individuals (be they voters, politicians, or bureaucrats) pursue their distinct goals in the political process, and are

[2]One important consequence of this position—and a key contribution of public choice—is that it implies that is inappropriate to impose on the political process a unitary actor assumption that policy is chosen by a "benevolent dictator" who maximizes social welfare. Instead, political decisions must be explained as "the results of individual decisions when the latter are combined through a specific rule for decision-making" (Buchanan and Tullock 1962, p. 35), which may place significant limitations on what is feasible in the political process. See Vanberg and Vanberg (2012, pp. 247–248) for an elaboration.

not committed to some agreed-upon, overarching common good that can lead them to set aside their self-interest. For example, voters remain ignorant of critical issues because the opportunity costs of becoming informed are too high, given the low probability that a citizen's vote will be pivotal. Voter ignorance, in turn, allows policymakers to cater to narrow special interests without fear of being held accountable by citizens at large. Or legislative majorities shift burdens onto minorities in order to benefit their particular constituencies, or cater to special interests at the expense of citizens who bear widely dispersed costs (e.g., Tullock 2005 [1967], 2005 [1970], 2005 [1994]). Critics of the public choice paradigm typically focus on this "self-interest" assumption and raise two distinct concerns.

The first is that the *homo economicus* model is empirically inaccurate or inapplicable when considering how individuals behave in the political process. As Quiggin (1987, p. 11) asserts, "the egoistic rationality assumption is radically at variance with the available empirical evidence." In particular, with respect to policymakers, critics claim that the particular types of goals that often dominate public choice analyses—such as reelection or career concerns, or a desire for maximizing power or budgets—are poor descriptions of the motivations of real-world political actors, who may in fact seek to serve because they "desire to participate in the formulation of good public policy" (Kelman 1987, p. 81). Similarly, with respect to voters, critics contend that public choice overestimates the extent to which citizens are motivated by their particular narrow interests, and underestimates voters' commitment to broad values.[3] As Steven Kelman puts it, the public choice "account of the operation of the political process is a terrible caricature of reality" (1987, p. 81). And because the *homo economicus* model is descriptively inadequate, these critics contend, the empirical success of public choice

[3]It is worth noting in this context that there are some disagreements even within the public choice tradition on the importance of material self-interest as a motivation for voters. Most prominently, the theory of "expressive voting" argues that voting behavior is not primarily driven by material self-interest (precisely because voters recognize that they are highly unlikely to be pivotal), but instead motivated by desires to express support for particular values (see Brennan and Lomasky 1993).

accounts has been rather modest. Public choice theory is—at least in the view of these critics—not particularly useful as a tool for explaining or predicting real-world political behavior (Quiggin 1987; Kelman 1987; Green and Shapiro 1994).

A second line of criticism is explicitly normative. Just as scholars have argued that studying economics may make students less likely to act in cooperative ways, and more likely to pursue their narrow self-interest (see, e.g., Frank et al. 1993), so critics assert that public choice's focus on the pursuit of self-interest is potentially damaging to the health of the political system. According to this view, by focusing on the operation of self-interest, and presenting a cynical view of the political process, public choice analysis threatens democractic governance by destroying norms of public morality that are required in a well-functioning political system. Thus, Kelman (1987, p. 94) concludes that, "the cynicism of journalists – and even the writings of professors – can decrease public spirit simply by describing what they claim to be its absence. Cynics are therefore in the business of making prophecies that threaten to become self-fulfilling. If the norm of public spirit dies, our society would look bleaker and our lives as individuals would be more impoverished. That is the tragedy of 'public choice'." In short, according to its critics, the public choice paradigm offers a cynical, pessimistic view of the political process that is not only empirically inaccurate, but potentially harmful. What can public choice offer in its defense?

Politics-as-Exchange

A full assessment of the status and contributions of rational choice/public choice, including the self-interest assumption, is a vast topic and beyond the scope of this chapter. There are various avenues of responding to the critiques outlined above. For example, Brennan and Buchanan (1988) take on Kelman's argument that it is normatively undesirable or inappropriate to approach the analysis of politics through the lens of self-interest. There is also significant scholarly debate about the proper standards for evaluating the empirical content of the rational choice framework, with a number of scholars reaching the conclusion that the empirical success of rational choice approaches is impressive (see, e.g., Cox 1999; Fiorina 1995). Here, I focus on a separate issue: A methodological argument in favor of the *homo economicus* assumption.

Developing this argument demands a somewhat circuitous route. This route begins with a third element beyond methodological individualism and *homo economicus* that is identified by James Buchanan in his Nobel Prize acceptance speech (1999 [1986], p. 460) as central to the public choice paradigm: "Politics as exchange." As Buchanan noted (2003, p. 1), this "third element…is less familiar," and has caused some confusion. For example, the prominent political theorist Philip Pettit (2008, p. 50)—perhaps misled by the description that public choice extends the economic approach from market exchange to the political process—claims that "the public choice school of political economy, led by James Buchanan and Gordon Tullock," presents a "market model" of the political process that holds that

> …(p)articipants in the market divide into consumers and producers, and interact in the determination of prices; they do this in the way in which bargain-hunters and shop-keepers combine to determine the prices in a mall, or town, or region. Likewise, so the market model suggests, participants in the electoral polity divide into consumers and producers, and interact in the determination of policies. The producers stand for office in groupings of parties, advertising certain policies and policy-programs, and the consumers go to the polls to register their preferences – presumptively, their consumerist, self-oriented preferences – among the parties and programs on offer. Thus, with nothing more than the collaboration required for parties to form, members of an electorate act in concert to shape the policies that prevail in government. And they allegedly do so, as the model of the competitive market suggests, in such a way that the policies ought to track the trend in preferences expressed by voters. Under suitable methods of aggregating votes the policies should be shaped so that they conform to the majoritarian preferences of voters.

That is, in Pettit's reading, Buchanan's notion of "politics as exchange" refers to exchanges between voters (as consumers) and politicians/parties (as producers). On this account, public choice (labeled "the market model" by Pettit) holds that—analogous to Adam Smith's famous "invisible hand" in market settings—such political exchanges in the ordinary political process generate socially desirable outcomes.

Ironically, Pettit's interpretation not only misconstrues the meaning of "politics as exchange"—it misses the fundamental logic of the Buchanan approach.[4] To see where Pettit takes a wrong turn, it is useful to begin by considering voluntary market exchanges. A critical characteristic of a voluntary exchange between two parties in a market setting is that the voluntary nature of the exchange ensures that both parties are better off—that is, the voluntary nature of the exchange serves as an indicator that the transaction has resulted in *mutual gain*.[5]

As we have already seen, the first dimension of public choice's extension of the economic approach consists of the application of the explanatory framework provided by methodological individualism and rational choice to the political process. But there is a second, crucial—and distinct—element of public choice's "economic imperialism" that is not explanatory, but normative: Namely, to approach collective decision-making—politics—through the lens of the potential for mutual gains. That is, public choice—in the particular version offered by Buchanan and Tullock—rests on a *normative ideal* of approaching the political process with the aim of securing (analogous to voluntary market exchanges) mutual gains for all participants in the process of collective decision-making. As Buchanan and Tullock (1962, p. 250) put it,

> …(o)ne of the great advantages of an essentially economic approach to collective action lies in the implicit recognition that "political exchange," at all levels, is basically equivalent to economic exchange. By this we

---

[4]As Brennan and Buchanan (1988, p. 184) note explicitly, "…there is no invisible hand operative in majoritarian political institutions analogous to that operative in the market setting…" In a bizarre twist, Pettit (2008, pp. 50–51) proceeds to criticize what he has described as the "market model" on the basis of arguments that identify precisely the kinds of issues raised by public choice analysis of majoritarian politics, including the fact that voters are rarely pivotal and must confront bundles of choices, and cannot choose "at the margin."

[5]Note that in the idealized market setting, this conclusion can be reached on purely procedural grounds, without any detailed information about the parties' preferences, etc. Of course, there are potential complications here, e.g., the question of what makes exchange voluntary (see Munger 2011).

> mean simply that *mutually* advantageous results can be expected from individual participation in community effort.

Note that the reference to the "economic approach" in this passage is radically distinct from an *explanatory* model (captured by methodological individualism and rational choice), and instead refers to an orientation towards mutual gain as a *normative* criterion by which social interactions can be judged.

Any attempt to extend the economic focus on mutual gain to the political realm must confront two challenges. The first concerns the analogue to voluntary exchange between two parties in a market setting. What is the procedural equivalent that guarantees mutual advantage when we shift from two-person exchange in a market to the realm of collective decision-making involving many individuals? The key feature that ensures mutual gains in market exchange is that *all* participants to the exchange must agree. This suggests that in the realm of multi-person exchanges (such as are required for collective decision-making), the *unanimity* rule is the appropriate procedural standard that ensures mutual gain. As Buchanan (1999 [1986], p. 463) argues,

> The political analogue to decentralized trading among individuals must be that feature common to all exchanges, which is *agreement* among the individuals who participate. The unanimity rule for collective choice is the political analogue to freedom of exchange of partitionable goods in markets.

It is this insistence on unanimity that marks public choice—and in particular, the subdiscipline of constitutional political economy—as a modern version of contractarianism (see Vanberg and Vanberg 2017).

The second challenge flows from the application of the unanimity principle. Can unanimity serve as a relevant criterion for collective decision-making? Put differently, is it possible to expect mutual gains for all participants in the political realm? It is in this context that a fundamental distinction in the constitutional political economy paradigm becomes relevant. This distinction concerns two separate levels of choice confronting individuals as they participate in collective decision-making: Choices at the "constitutional level," and choices at the "sub-constitutional level."

Consider an ordinary game, defined by a set of rules that outline the permissible strategies of the players, and the outcomes that flow from the various combinations of actions players can take. In playing the game, the objective of the players is to win, and to do so, they choose actions *within the rules*. Such choices are choices at the "sub-constitutional level"—they are choices within a framework of rules. However, there is also a higher level of choice: the choice of *the rules of the game*. Individuals interested in playing a game might come together to decide on the rules by which they would like to play, or players in an existing game might come together to decide on potential revisions of the rules of the game they are playing. Such choices of the rule-framework itself are choices at the "constitutional level."

A key thrust of the constitutional political economy paradigm is to argue that the distinction between these levels of choice also applies to collective decision-making. The political process is defined by a set of rules that outline the scope for collective decision-making, and the procedures and institutions by which collective decisions are taken. Within these rules, individuals make "sub-constitutional choices" as they pursue their ends in the ordinary political process. At the same time, at the constitutional level, individuals can make choices about the set of rules and institutions that define the political process. The criterion of unanimity (or mutual gain) is difficult to conceptualize in the context of *particular* decisions taken within a specific framework that defines the ordinary political process. Unanimity is unworkable as a collective decision-rule for day-to-day politics. And under decision procedures that require less than unanimity (such as majoritarian procedures), there will, in most cases, exist "losers" on whom a collective decision is imposed by the superior numbers of the other side.

The crucial insight of Buchanan and Tullock's approach in *The Calculus of Consent*, which laid the foundation for the research tradition of constitutional political economy, is that the same is *not* true if one shifts the perspective from sub-constitutional choices to the constitutional level. At the level of rule choice, there is—Buchanan argues—considerably greater scope for the operation of the unanimity principle.[6] This is the case because some games ("rules") or change in rules are advantageous from the perspective of all players in the sense that they create a better game. This is especially likely if rules are expected to be stable over time, thus introducing some uncertainty for individuals about the precise situations in which they will be applied, and therefore, about the distributional consequences of particular rule choices:

> To the extent that the individual reckons that a constitutional rule will remain applicable over a long sequence of periods, with many in-period choices to be made, he is necessarily placed behind a partial "veil of uncertainty" concerning the effects of any rule on his own predicted interests. Choice among rules will, therefore, tend to be based on generalizable criteria of fairness, making agreement more likely to occur than when separable interests are more easily identifiable. (Buchanan 1999 [1986], p. 464)

Thus, at the level of constitutional choice, there may be considerable scope for mutual gains to be secured as individuals jointly commit to a set of constitutional rules for collective decision-making. Critically, this does not imply that individuals will, or expect, to benefit from any individual decision to be taken within this framework of rules. Rather, it is the anticipated sequence of decisions over time under a set of rules that is preferable to the alternative.

The key take-away from this argument is that in the constitutional political economy paradigm, "politics as exchange" does *not* refer to the on-going interactions in the ordinary political process (as implied by Pettit). It refers to decisions at the constitutional level as individuals "exchange" commitments to a set of rules—and do so because each individual expects to be better off under the set of constitutional rules agreed to. As Buchanan (2001 [1988], p. 150) concludes, "(b)y shifting

[6]As Buchanan puts it (1999 [1990], p. 386): "As it operates and as we observe it to operate, ordinary politics may remain conflictual…while participation in the inclusive political game that defines the rules for ordinary politics may embody positively valued prospects for all members of the polity."

"voluntary exchange" upward to the constitutional level of choices among rules, the consensual or general agreement test may be applied."[7]

Comparative Institutional Analysis and Homo Economicus

"Politics-as-exchange" refers to the potential for individuals to secure mutual gains by "contracting" for a constitution, i.e., to commit jointly to a set of rules for collective decision-making. Of course, this implies that individuals must consider (and perhaps debate) alternative rules (or revisions in existing rules) in order to identify those that promise mutual gains, and these are thus candidates for joint agreement. Are there sets of rules, or changes in existing rules, such that it would be in the interest of all individuals to consent?

Such comparisons can only be made if individuals have some expectations about the working properties of alternative rule frameworks. In other words, constitutional choices must be based on *comparative institutional analysis*, i.e., systematic evaluation of the ways in which particular institutional arrangements will shape individual behavior and, thereby, outcomes of collective decision-making. From the perspective of constitutional political economy, the central purpose of public choice is to provide such analyses in order to inform public debates about the desirability of particular institutional choices, or institutional reforms (Brennan and Buchanan 1981, p. 159).[8] Buchanan and Tullock's seminal

[7]One of the key analytic points made by Buchanan and Tullock is that this "calculus of consent" regarding the constitutional rules that an individual would want to consent to will typically imply that individuals prefer constitutional rules that *do not* require unanimous consent for day-to-day decisions. See Vanberg (2018) for a detailed discussion.

[8]Critically, for Buchanan, this is a humble role. Expert judgments cannot be substituted for the judgements of citizens as sovereigns as expressed in their decisions to consent to a particular institutional arrangement. Expert judgments can only be offered as advice. See Buchanan (1999 [1991], p. 288): "If individuals are considered the ultimate sovereigns, it follows directly that they are the *addresses* of all proposals and arguments concerning constitutional-institutional issues. Arguments that involve reliance on experts in certain areas of choice must be addressed to individuals, as sovereigns, and it is individuals' choice in deferring to expert-agents that legitimizes the potential role of the latter, not some external assessment of epistemic competence as such."

The Calculus of Consent (1962), perhaps *the* central contribution in launching the public choice/constitutional political economy paradigm, is a primary example of this kind of analysis offering detailed analysis of the workings of ordinary majority rule and bicameralism, among others.

Against this background, we are finally in a position to appreciate the *methodological* argument for the *homo economicus* assumption. Systematic comparison of the working properties of alternative rules—comparative institutional analysis—requires an assumption that specifies how individuals will act within the incentives and constraints presented by alternative rules. In other words, it requires a model of human action. Because comparative institutional analysis is designed to assess the working properties of alternative rule frameworks, the model of human action that is employed must be constant across the analysis. By holding constant the behavioral assumptions under which alternative rules are evaluated, we force any differences in the anticipated working properties of different rules to emerge from the *institutional* differences between the rules.[9]

Of course, the need to employ uniform behavioral assumptions leaves open the question of which particular behavioral model to employ. Imposing the assumption that behavior confirms to the rational choice model of *homo economicus* requires additional justification. I focus here on a methodological point: The key argument in favor of this particular model is that the behavioral assumptions of *homo economicus* are best suited to achieving the underlying purpose of comparative institutional analysis. Importantly, this purpose is *not* to provide an accurate explanatory or predictive model of individual action under a set of institutional rules. Rather, the purpose is to provide an analytical perspective that can usefully inform *constitutional choices* among alternative rules.[10]

[9]Brennan and Buchanan (1981, p. 159): "…whatever model of man is to be used in evaluating alternative social orders – alternative rules of the economic/political/social game – it must be applied *uniformly* over all the possibilities to be compared…If we are to employ one set of behavioral postulates for one institution, and another set for another institution, no legitimate comparison of the two institutions can be made."

[10]As Brennan and Buchanan put the point, the "claim is that *homo economicus* rightly belongs in the analytical derivation of normative propositions about appropriate institutional design" (1981, p. 159).

To clarify this argument, I present it from three different (though closely related) vantage points.

Frame 1: A foundational assumption of the rational choice approach is that individuals—whatever the substantive content of their preferences—*differ* with respect to their goals and desires (including their visions of what is desirable in collective action). In other words, there is no common, agreed upon version of the public good which would serve to eliminate conflict among individuals over the direction of collective decision-making. Starting from this assumption, consider the position of an individual contemplating the working properties of different institutional rules. Her understandings of these properties inform her decision about which rules would (conditional on the commitment of all others to the same rule) provide a net benefit.

In conducting this analysis, the key consideration for the individual is the extent to which a particular institutional framework is conducive to her ability to realize her goals, and to what extent such a pursuit might be frustrated by the divergent preferences of other individuals. Because the purpose of the analysis is to determine to what extent divergence of preference poses a potential threat under a particular institutional framework, it is useful for the individual to assume that—to the extent that the institutional framework makes this possible—other individuals will attempt to realize their preferences. In other words, given the purpose of attempting to understand the working properties of alternative institutional arrangements, the behavioral assumption that serves the individual's analytic purpose best is to suppose that all individuals act in a self-interested manner (where self-interest is understood as the pursuit of their particular preferences without regard to their substantive content)[11]. The self-interest assumption is appropriate because it allows the individual to forecast to what extent the divergence of interests among

[11]This is, of course, exactly the kind of "calculus of consent" that the representative individual conducts when considering the trade-off between "external costs" (the costs imposed by collective decision the individual opposes) and "decision-making costs" (the costs of reaching a decision in light of divergent preferences, as well as the costs of decisions the individual favors that are blocked by others) in the model presented by Buchanan and Tullock in Chapter 6 of *The Calculus of Consent*.

individuals will threaten to frustrate her own preferences under alternative institutional rules.

Frame 2: Brennan and Buchanan (1981) provide an alternative frame for the same underlying logic. The great intellectual achievement of Adam Smith's *Wealth of Nations* (and the tradition of classical political economy more generally) was to demonstrate that within an appropriate institutional structure, markets can reconcile the pursuit of individuals' self-interest with common interests by ensuring that what individuals are led to do in order to achieve their private purposes (e.g., the pursuit of wealth) is in the interests of the community—understood as the interests of other individuals—as a whole. Put differently, the potentially beneficial effect of market institutions lies in their ability—if properly designed—to make private interests compatible with public interests.

As we move from the economic to the political realm, for Brennan and Buchanan, the central problem confronting individuals is precisely the same: It is to consider (through comparative institutional analysis) whether there are political institutions that can ensure that the pursuit of private interest by individuals is compatible with public interest.[12] Therefore, comparative institutional analysis employs "the *homo economicus* assumption, not because it is necessarily the most accurate model of human behavior, but because it is the appropriate model for testing whether institutions serve to transform private interest into public. It is as simple as that" (Brennan and Buchanan 1981, p. 161).

Frame 3: Yet a third framing of the same point is provided by considering the link between constitutional political economy's insistence

[12]Brennan and Buchanan (1981, p. 160): "The question we are interested in posing about any particular social order is whether the rules by which individual actions are coordinated are such as to transform actions undertaken by participants in their own *private* interests into outcomes that are in the interests of others. We know that this curious alchemy is in fact worked by the *market* – that the invisible hand operates, under certain more or less well-defined conditions, to convert private interest into public interest. The prime task of comparative institutional analysis is to enquire whether other institutions do the same…"

on comparative institutional analysis and the tradition of classical political economy as it derives from David Hume and *The Federalist*. This frame presents the *homo economicus* model as a *prudential* assumption that is appropriate in evaluating alternative institutional frameworks because it focuses attention on a central purpose of constitutional designs, namely to offer protection against policymakers or other political actors, including organized interests, who pose a potential threat to the political order precisely because they are motivated by narrow self-interest. In this context, the critical question to ask of a particular institutional framework is to what extent it can serve this purpose, i.e., offer such protection.

Consider James Madison's argument in *Federalist 10*. In this paper, Madison confronts a concern over the potentially detrimental impact of "factions" who might attempt to use the political process to advance their (typically economic) interests at the expense of other citizens. As Madison (1961 [1787], p. 48) argues, "it is in vain to say that enlightened statesmen will be able to adjust these clashing interests and render them subservient to the public good. Enlighted statemen will not always be at the helm." Instead, Madison contends, the answer must be found in institutional designs that prevent self-interested factions (or statesmen) from being in a position to harm the legitimate interests of other citizens. This theme is the explicit focus of *Federalist 51*, in which Madison argues that the proposed US Constitution will—through separating powers horizontally and vertically—contain the threat posed by self-interest. Harkening back to Adam Smith, Madison contends that proper constitutional designs can serve the purpose of "supplying, by opposite and rival interests, the defect of better motives," thus ensuring that "the private interest of every individual may be a sentinel over the public rights" (1961 [1787], p. 322).

David Hume offered precisely the same prudential argument in his essay on "The Independency of Parliament," in which he observes that "in contriving any system of government, and fixing the several checks and controls of the constitution, every man ought to be supposed a *knave*, and to have no other end, in all his actions, than private interest…It is therefore, a just *political* maxim, *that every man must be supposed a knave*: Though at the same time, it appears somewhat strange, that a maxim should be true in *politics*, which is false in *fact*…" (1985, pp. 45–46).[13]

Note the critical last part of Hume's statement—the explicit acknowledgment that the supposition that "every man is a knave" is descriptively wrong, a point also acknowledged by Brennan and Buchanan, and in Madison's observation that enlightened statesmen will not *always* be in charge (thus suggesting that they will be in charge at least some of the time). Put differently, from the vantage point of the methodological argument for the *homo economicus* assumption, the question is not whether *homo economicus* represents a realistic model of human motivations. It is also not whether it is a model that is suitable for explanatory or predictive analysis. Rather, the key point is that the *homo economicus* model—though perhaps descriptively inaccurate—is appropriate to the task of comparative institutional analysis because it forces attention on the degree to which alternative institutional designs can confront and mitigate the potential challenges posed by the individual pursuit of self-interest in the political process.[14] (Of course, this methodological argument does not imply that one could not also defend the *homo economicus* model as a useful explanatory model.)

---

[13]See also John Stuart Mill in his *Considerations on Representative Government* (1991, p. 374): "…since the very principle of constitutional government requires it to be assumed, that political power will be abused to promote the particular purposes of the holder; not because it always is so, but because such is the natural tendency of things, to guard against which is the especial use of free institutions."

[14]Note the close affinity between this methodological point, and Karl Popper's defense of the "rationality principle" as part of what he calls "situational logic." For Popper, the rationality principle serves as the animating force for models in the social sciences by ensuring that we assume that individuals act "appropriately" within the context of a model. As he put it (1985 [1967], p. 359): "If you look upon the rationality principle from the point of view which I have here adopted, then you will find that it has little or nothing to do with the empirical or psychological assertion that man always, or in the main, or in most cases, acts rationally. Rather, it turns out to be an aspect of, or a consequence of, the methodological postulate that we should pack or cram our whole theoretical effort, our whole explanatory theory, into an analysis of the situation: into the model."

The Promise of Institutional Reform and the Optimism of Public Choice

In defending the *homo economicus* assumption, Brennan and Buchanan (1988, p. 184) concede the apparently cynical perspective of public choice, and appear almost embarrassed by some of the central conclusions of their research tradition. Invoking the thought experiment of a "public choice economist or political scientist [who] is asked to talk to a group of young persons training for employment in the bureaucracy," they ask sheepishly on "what aspects of public choice would he or she focus? On explaining how to manipulate agendas? On showing how to maximize the size of an agency's budget?"

The answer lies in understanding that the analytical focus of public choice—and the conclusions reached—are not an end in themselves. They are tools in the process of comparative institutional analysis. And comparative institutional analysis, in turn, holds out the potential for institutional reforms of the political process that may improve the "political game" from the perspective of citizens. Thus, Brennan and Buchanan (1988, p. 184), returning to their thought experiment, conclude that "(t)he public choice analyst would probably soft-pedal the cynical edges, and focus more on the prospects for institutional reform than on the maximization of career prospects."

In other words, the central aim of the public choice research tradition is not simply to offer a "theory of government failure." It is to offer positive analyses that can point the way to potential institutional changes that alter the incentives and constraints confronting policymakers and citizens in ways that improve expected political outcomes. Examples include potential changes to the rules governing fiscal governance (Feld and Burret 2018; Martin and Vanberg 2013), alternative federal structures (Vanberg and Kerber 1994), or proposals for introducing "generality constraints" in the political process (Buchanan and Congleton 1998).

In closing his Nobel Prize acceptance speech, James Buchanan explicitly sketched this vision for the role of the political economist:

> Normatively, the task for the political economist is to assist individuals, as citizens who ultimately control their own social order, in their continuing search for those rules of the political game that will best serve their purposes, whatever these might be…helping to resolve the continuing question of social order: How can we live together in peace, prosperity, and harmony, while retaining our liberties as autonomous individuals who can, and must, create our own values?

This vision—built on the foundation of *homo economicus* as a methodological tool, not as a descriptive model of human motivations—is (or, more accurately, should be) at the core of the public choice tradition. Viewed in this light, public choice is not a dismal enterprise, but an expression of an optimistic faith in the potential for improvements in the human condition through careful design of political institutions.

References

Brennan, G., & Buchanan, J. M. (1981). The Normative Purpose of Economic 'Science:' Rediscovery of an Eighteenth Century Method. *International Review of Law and Economics, 1,* 155–166.

Brennan, G., & Buchanan, J. M. (1988). Is Public Choice Immoral? The Case for the 'Nobel' Lie. *Virginia Law Review, 74,* 179–189.

Brennan, G., & Lomasky, L. (1993). *Democracy and Decision: The Pure Theory of Electoral Preference*. Cambridge: Cambridge University Press.

Buchanan, J. M. (1999 [1979]). Politics Without Romance: A Sketch of Positive Public Choice Theory and Its Normative Implications. In *The Logical Foundations of Constitutional Liberty. The Collected Works of James Buchanan* (Vol. 1, pp. 45–59). Indianapolis: Liberty Fund.

Buchanan, J. M. (1999 [1986]). The Constitution of Economic Policy. In *The Logical Foundations of Constitutional Liberty. The Collected Works of James Buchanan* (Vol. 1, pp. 455–470). Indianapolis: Liberty Fund.

Buchanan, J. M. (1999 [1990]). The Domain of Constitutional Economics. In *The Logical Foundations of Constitutional Liberty. The Collected Works of James Buchanan* (Vol. 1, pp. 377–395). Indianapolis: Liberty Fund.

Buchanan, J. M. (1999 [1991]). The Foundations of Normative Individualism. In *The Logical Foundations of Constitutional Liberty. The Collected Works of James Buchanan* (Vol. 1, pp. 281–291). Indianapolis: Liberty Fund.

Buchanan, J. M. (2001 [1988]). Economists and Gains from Trade. In *Ideas, Persons, and Events. The Collected Works of James Buchanan* (Vol. 19, pp. 135–152). Indianapolis: Liberty Fund.

Buchanan, J. M. (2003). *Public Choice: The Origins and Development of a Research Program*. Typescript. Fairfax: Center for Public Choice, George Mason University.

Buchanan, J. M., & Congleton, R. (1998). *Politics by Principle, Not Interest: Towards Nondiscriminatory Democracy*. Cambridge: Cambridge University Press.

Buchanan, J. M., & Tullock, G. (1962). *The Calculus of Consent*. Ann Arbor: University of Michigan Press.

Cox, G. (1999). The Empirical Content of Rational Choice Theory: A Reply to Green and Shapiro. *Journal of Theoretical Politics, 11,* 147–169.

Feld, L., & Burret, H. (2018). (Un)intended Effects of Fiscal Rules. *European Journal of Political Economy, 52,* 166–191.

Fiorina, M. (1995). Empirical Contributions of Rational Choice. *Critical Review, 9,* 85–94.

Frank, R., Gilovich, T., & Regan, D. (1993). Does Studying Economics Inhibit Cooperation? *Journal of Economic Perspectives, 7,* 159–171.

Green, D., & Shapiro, I. (1994). *Pathologies of Rational Choice*. New Haven: Yale University Press.

Hume, D. (1985). Of the Independency of Parliament. In D. Hume (Ed.), *Essays Moral, Political, and Literary*. Indianapolis: Liberty Fund.

Kelman, S. (1987). 'Public Choice' and Public Spirit. *Public Interest, 87,* 80–94.

Levmore, S. (2002). From Cynicism to Positive Theory in Public Choice. *Cornell Law Review, 87,* 375–383.

Madison, J. (1961 [1787]). Federalist 51. In C. Rossiter (Ed.), *The Federalist Papers* (pp. 320–325). New York: Mentor.

Martin, L., & Vanberg, G. (2013). Multiparty Government, Fiscal Institutions, and Public Spending. *Journal of Politics, 75,* 953–967.

Mill, J. S. (1991). Considerations on Representative Government. In J. S. Mill (Ed.), *On Liberty and Other Essays*. Oxford: Oxford University Press.

Munger, M. (2011). Euvoluntary or Not, Exchange Is Just. *Social Philosophy and Policy, 28,* 192–211.

Olson, M. (1965). *The Logic of Collective Action*. Cambridge, MA: Harvard University Press.

Pettit, P. (2008). Three Conceptions of Democratic Control. *Constellations, 15*, 46–55.

Popper, K. (1985 [1967]). The Rationality Principle. In D. Miller (Ed.), *Popper Selections*. Princeton: Princeton University Press.

Quiggin, J. (1987). Egoistic Rationality and Public Choice: A Critical Review of Theory and Evidence. *Economic Record, 63,* 10–21.

Scaff, I., & Ingram, H. (1987). Politics, Policy, and Public Choice: A Critique and a Proposal. *Polity, 19,* 613–636.

Tullock. G. (2005 [1967]). Political Ignorance. In *The Economics of Politics*. Vol. 4 of *The Selected Works of Gordon Tullock* (pp. 225–240). Indianapolis: Liberty Fund.

Tullock, G. (2005 [1970]). A Simple Algebraic Log-Rolling Model. In *The Economics of Politics*. Vol. 4 of *The Selected Works of Gordon Tullock* (pp. 319–330). Indianapolis: Liberty Fund.

Tullock, G. (2005 [1994]). Democracy as It Really Is. In *The Economics of Politics.* Vol. 4 of *The Selected Works of Gordon Tullock* (pp. 395–400). Indianapolis: Liberty Fund.

Vanberg, G. (2018). Constitutional Political Economy, Democratic Theory, and Institutional Design. *Public Choice, 177*(3–4), 199–216.

Vanberg, V., & Kerber, W. (1994). Institutional Competition Among Jurisdictions: An Evolutionary Approach. *Constitutional Political Economy, 5,* 193–219.

Vanberg, G., & Vanberg, V. (2012). Towards a (Re-)integration of the Social Sciences: *The Calculus of Consent* at 50. *Public Choice, 152,* 245–252.

Vanberg, G., & Vanberg, V. (2017). Contractarian Perspectives in Law and Economics. In F. Parisi (Ed.), *The Oxford Handbook of Law and Economics*. Oxford: Oxford University Press.

29

Doing Liberal Political Economy: James M. Buchanan as Exemplar

Glenn L. Furton and Alexander W. Salter

Introduction

How does one go about "doing" classically liberal political economy (Boettke 2014)? The social sciences provide us with the means of acquiring a heightened understanding of how societies operate. They do not, however, specify *which* way of doing social science is more apt to provide us with a liberal science, of the sort in which the Enlightenment was steeped. Such a science is concerned, first and foremost, in understanding to what extent social order is possible without centralized control. 'Coordination without command' is the ultimate focus of liberal social science. But this positive science is often coupled with normative ends. In particular, liberal social science is concerned with the empowerment and sovereignty of the individual: with maximizing freedom and minimizing coercion (e.g., Hayek 2011). Though temporarily lost in the early twentieth century, the latter half of this century saw a rebirth

G. L. Furton (✉) · A. W. Salter
Free Market Institute, Texas Tech University, Lubbock, TX, USA
e-mail: glenn.furton@ttu.edu

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_29

of the 'art of political economy' (Boettke 1998), the *sine qua non* of liberal science. We argue that the reemergence of classically liberal political economy, and its re-integration into contemporary scholarship, is best exemplified by the work of Nobel laureate James M. Buchanan and his distinct approach to economics: constitutional political economy.

What is it that we mean when we refer to "liberal" scholarship in political economy? We mean that method of analysis which applies the tools of economics to matters of public importance. This method of analysis concerns itself, in what is often called analytical egalitarianism, with the well-being of all individuals (von Mises 2010). The conception of liberalism espoused herein is merely an extension of the science of human action to social affairs. It recognizes that individuals—via their capacity for genuine choice—are the exclusive source of value in an explanatory social science. Buchanan's political economy is remarkable because it extends the standard assumptions in economics of methodological individualism and subjective valuation (Hayek 1948; von Mises 1949) to the realm of political and constitutional choice (e.g., Buchanan 1975a; Buchanan and Tullock 1962).

It has been recognized, however, that there exists some tendencies within liberalism that are difficult to reconcile, and pose a challenge to even the most careful social scientist. Levy (2014) argues that a deep tension exists between what he describes as liberal *pluralism* and liberal *rationalism*. On the one hand, liberalism has traditionally held a fear of centralized authority. Normatively, discovering political arrangements that protect individuals from arbitrary exercises of power has always been a chief concern within the liberal tradition. Positively, figuring out what these arrangements are and how they operate has been liberal political economy's central concern. The pluralist conception within liberal thought argues for greater individual autonomy and freedom of association. This idea is cogently expressed by Robert Nozick in his discourse on Utopia (2013, pp. 297–334), wherein he theorizes how individuals might sort themselves into groups by choice, and provide public goods without reliance on a coercive central authority such as the state.

On the other hand, liberals have recognized that local sources of power and authority can equally burden individuals and diminish human dignity. The rationalist conception of liberalism seeks to prevent such tyranny by deriving all-encompassing rules that to which liberal society must conform. This implies individuals would be nontrivially limited to the extent to which they would be free to associate themselves with more local groups (e.g., churches and civic organizations) in a manner free from outside interference. History shows that individuals often desire to subject themselves to coercive authorities other than the state, in order to live the kind of lives, or become the type of individuals that they aspire to be. The rationalist strain of liberalism seeks to prevent abuses of power by local authorities by using centralized power as a check on these authorities.

Levy sees these two conceptions of liberalism as irreconcilable: liberalism is besought with a tension that must be wrestled with but can never pacified An attempt to develop a pluralist defense of liberalism leaves individuals open to local oppression, while the rationalist defense exposes us to tyranny from Leviathan. While this may be the case, it ought to be recognized that there exists some spectrum of liberal social science that deals with the problem of irreconcilability better than others. We argue that the research program of James Buchanan represents an effective way to embrace this tension to fruitful ends. Throughout his career Buchanan has made significant contributions, positive and normative, to political economy that encompasses both pluralist and rationalist liberal insights. He manages to take and apply the best of both conceptions of liberalism, thereby increasing our understanding of the potentials and perils of the human condition. It is because of this that he has remained a relevant thinker throughout in the social sciences, and why he will assuredly continue to do so. Buchanan's scholarship ought to be, and indeed is, a model for contemporary liberals that shows them how to do liberal political economy.

The remainder of this essay will outline Buchanan's political economy as exemplary liberal scholarship. Section 'Buchanan the Rationalist Liberal: Constitutions by "Reflection and Choice"' will describe the rationalist current of Buchanan's liberal thought. This largely follows from his commitment to social contractarianism. Section "Buchanan the Pluralist Liberal: Taking the Status Quo Seriously" will address the pluralist side of his research program. This work is best understood by his deep commitment, arguably as strong as his contractarianism, to the *here-and-now* as a starting point of political change. Section "Buchanan: The Liberal *Par Excellence*" concludes by emphasizing Buchanan's continued relevance as a liberal social scientist, as well as referencing contemporary scholarship that makes direct use of his insights.

Buchanan the Rationalist Liberal: Constitutions by "Reflection and Choice"

Alexander Hamilton, in the opening paragraph of Federalist 1, poses the following question:

> It has been frequently remarked that it seems to have been reserved to the people of this country, by their conduct and example, to decide the important question, *whether societies of men are really capable or not of establishing good government from reflection and choice, or whether they are forever destined to depend for their political constitutions on accident and force*. (Hamilton 2001, para. 1, emphasis added)

Buchanan answers this question by strongly affirming the role of "reflection and choice" in "establish[ing] good government". In doing so he makes recourse to social contract theory— informed and extended by price theory—demonstrating his affinity for rationalist liberalism. In order to make state action legitimate, it must be consented to by those who will be subjected to its coercive authority. This is a familiar pillar of classically liberal political thought. Thinkers such as Hobbes, Locke, Montesquieu, and Kant have bequeathed to posterity the building blocks of liberal thought rooted in some form of contractarianism. As a result, contractarianism and liberalism have become so entwined to become, in some circles, near synonyms. This connection appears, once again, strongly in the rebirth of political economy and philosophy throughout the latter part of the twentieth century (e.g., Buchanan and Tullock 1962; Hayek 2011; Rawls 1971), due in no small part to Buchanan.

But there are other strains of constitutionalism than contractarianism (Brennan and Buchanan 1985, p. 24). One might conceive of a constitution as being the overall body of generally adhered to rules, subject to evolutionary change over time (see Hayek 1973, 2011, Chap. 10). The animating principle is a sort of group fitness or consensus, rather than that of explicit individual choice. In this alternative perspective, rules are outside of the realm of choice and therefore cannot be fully comprehended by any one individual or group of individuals. This obviously places limits on the degree to which individuals can reform the rules that govern their interactions. Individuals are subject to the existing body of rules, and changes are made only through a gradual process (e.g., Leoni 1961) that itself can seldom be predicted, let alone controlled. Normative value can be placed on the existing body of rules precisely because of their existence and temporal durability. To thinkers such as Burke, the durability of rules for coordinating behavior that are not themselves the product of reflection and choice demonstrate the inapplicability of human reason to questions of governance at the deepest level.

But this is not how Buchanan thought about constitutions. An endorsement of the broadly conservative-Burkean view of constitutions would render the individuals subject to existing rules helpless to alter them. Individuals would be, as noted by Hamilton, "destined to depend for their political constitutions on accident and force" (2001), accident being the evolutionary process, and force being the recourse of the reactionary Throne and Altar state. Instead, Buchanan developed a contractarian constitutionalism which follows from his advocacy of moral equivalence among individuals and their capacity for reasoned choice over governance institutions. Extending insights from economics regarding methodological individualism and subjective value (e.g., Buchanan 1999a), Buchanan argues that individuals are the sole source of value. To Buchanan, statecraft is not soulcraft. Politics is not a means to uncover and institutionalize Truth, but instead an exchange process among rational and free individuals to advance collectively their separately held ends. By denying a source of value outside the beliefs and choices of individuals party to the social contract, Buchanan goes beyond the standard, positive assumptions in economics and public choice theory, giving normative status to individual autonomy. Value is expressed through individual consciousness and choice.

He does not rule out, of course, the potential for individuals to form groups on the basis of shared values, and the recognition of the efficacy of group action for advancing those values. Buchanan instead argues that all expressions resulting from such influences are originally housed and cannot be separated from the acting individual. In this sense, Buchanan's contractarianism owes as much to the Kantian tradition as to the Hobbesian tradition, within which his thought his typically placed (Kliemt 2005, 2011).

Buchanan was one of the spearheads of the public choice revolution, which extended economic theories of choice to non-market decision making. But more specifically, Buchanan is best remembered as the father of the field of constitutional political economy (Brennan and Buchanan 1985; Buchanan and Congleton 2003; Buchanan and Tullock 1962) "Constitutional political economy is a research program that directs inquiry to the working properties of rules, and institutions within which individuals interact, and the processes through which these rules and institutions are chosen or come into being" (Buchanan 1990, p. 1) Whereas constitutional *politics* deals with conflicts over what the polity, in essence, should be, constitutional *economics* focuses on how the polity can be viewed as a vehicle for mutually beneficial collective action. Constitutional politics is about conflict; constitutional economics, cooperation. Buchanan conforms to the ideal of a rationalist liberal in developing this project, to better understand the conditions that enable individuals to realize their vision of the 'good society' through collaborative non-market exchange. The 'rules of the social game' can be chosen by individuals; those rules can be generally beneficial, rather than beneficial to some subset of individuals at the expense of others; and individuals can amend those rules, choosing alternative institutional arrangements as changes in underlying conditions make such choices in the interests of those individuals.

Thus, Buchanan's constitutionalism does not seek to explain the existence of a state on the basis of the protection of a pre-existing set of individual rights. Instead, the state, as specified in the constitution, is a reflection of individuals who act to advance their own ends: "…there is no resort to any source of value external to the expressed preferences of individuals who join together in political community" (Brennan and Buchanan 2000 [1985], p. 27). In addition to putting Buchanan at odds with views of politics as the pursuit of truth, goodness, or beauty, it also put him out of step with orthodox welfare economists of the time. Buchanan's constitutionalism, too, rules out the possibility of a "social utility function," as no such thing could possibly exist independent of individual preferences as expressed by their actions and choices (Buchanan 1954; Buchanan and Tullock 1962).

Both Buchanan and Rawls participated in the rebirth of social contract theory in the 1960's and 1970's with the publications of *The Calculus of Consent* (coauthored with Gordon Tullock 1962) and *A Theory of Justice* (1971), respectively. And while there is clearly a great deal of overlap between these projects, they diverge in their ultimate purposes. Buchanan describes his contractarian project as explanatory, rather than hortatory (Buchanan 1972). We can rationalize the existing order of institutions *as if* they had emerged from a process of genuine consent, deliberation, and agreement among hypothetical rational beings, knowing full well that this conceptual explanation is—except in perhaps rare cases—an historical fiction. This is altogether different from asserting that actual humans, in the here-and-now, ought to place themselves behind the *veil of ignorance* in an attempt to see one-another as moral equals and derive some ideal rules of justice. Thus, Buchanan's use of the social contract, both in an explanatory and justificatory sense, is not without nuance and restraint. Furthermore, when combined with an appreciation for Buchanan's thoughts on real-world political reform, we discover that Buchanan is no Voltairean liberal. "If you want good laws, burn those you have and make new laws" would *certainly not* be a position embraced by Buchanan. It is at the nexus of constitutional choice and *status quo* reform that Buchanan's rationalism becomes tempered by a sophisticated pluralism. The following section will feature the latter elements of Buchanan's research project.

Buchanan the Pluralist Liberal: Taking the Status Quo Seriously

Buchanan is not a run-of-the-mill social contractarian. While he remains committed to contractarianism throughout his life, he does so in a way that allows for and often times embraces liberal pluralism.

Buchanan often describes himself as a "philosophical anarchist" (see, e.g., 1977a, p. 11; 2000 [1975], p. 5). His "ideal" world is "necessarily anarchistic":

> This world is peopled exclusively by persons who respect the minimal set of behavioral norms dictated by mutual tolerance and respect. Individuals remain free to "do their own things" within such limits, and cooperative ventures are exclusively voluntary. Persons retain the freedom to opt out of any sharing arrangements which they might join. No man holds coercive power over any other man, and there is no impersonal bureaucracy, military or civil, that imposes external constraint. (Buchanan 2000 [1975], p. 5)

That anarchism occupies the place of the ideal in Buchanan's thought, even if that ideal is ultimately unobtainable (Buchanan 1977a, p. 11), is significant. It demonstrates that Buchanan is comfortable with the idea of a society populated with numerous 'little platoons' that are the ultimate source of moral authority (in the eyes of those who comprise these intermediate spheres themselves) and social order. This is already a break with the Rousseau-Mill-Rawls line of contractarianism, which is in varying degrees less comfortable with intermediate bodies as social constituents.

Liberal pluralist tendencies can also be seen in Buchanan's view of the political *status quo*. Unlike highly rationalist liberals, Buchanan does assign such starting situations some normative weight (Kliemt 2004). Unsurprisingly, this commitment is viewed through the lens of contractarianism, as opposed to more conservative positions (Brennan 2015). This can be seen in Buchanan's views on agreement and change. Agreement, meaning consent among sovereign individuals, is required to move from one set of rules to another. Furthermore, as specified in the previous sections, the ultimate evaluation of whether the rules should be changed must be made with recourse to the valuations of the individuals who are subject to these rules. But this is precisely why the political *status quo* is so analytically important in Buchanan's thought. Beginning in the here and now allows us to move forward "as if" the existing rules had been reached by consent (Brennan and Buchanan 1985, p. 26), which forestalls the Rousseauvian-Voltairean need to hit some sort of 'social reset button' to achieve meaningful reform. This allows for a more practical political economy, where agreement over changes in the existing rules might be reached in some feasible sense.

This leads us directly into the heart of Buchanan's liberal pluralism. Buchanan is not an adherent of any school of thought that is interested in social engineering. In fact, Buchanan is at his most pluralist—perhaps also the most Hayekian—in insisting on a firm distinction between complex social outcomes, and the rules that give rise to those outcomes. The latter can be a product of reflection and choice, but the former are not amenable to tinkering in the manner popular amongst Sameulsonian policy economists. Buchanan is particularly eloquent when discussing how important it is for social scientists to appreciate, and at a deep level understand, the concept of spontaneous order (Buchanan 1964, 1982 [1999], 1986a; Buchanan and Vanberg 1991). Buchanan is opposed to the 'economics of control' as a means of managerial governance for normative and positive reasons. Normatively, his contractarianism leads him to oppose social engineering on the basis of its violation of legitimate coercion. Positively, his understanding of the market as a spontaneous order or "creative process" (Buchanan and Vanberg 1991) leads him to oppose it on the basis of its means-ends incompatibility. Buchanan's criticism of constructivism lies in the constructivist's "urge to assume a role as social engineer, to suggest policy reforms that 'should' or 'should not' be made, independently of any revelation of individuals' preferences through the political process, has simply proved too strong for many to resist. The scientific integrity dictated by consistent reliance on individualistic values has not been a mark of modern political economy" (1986b, p. 249).

Here the reader may think we are exaggerating Buchanan's pluralist sympathies. Buchanan obvious does not endorse the spontaneous order principle when applied to politics (Buchanan 1977b) at the constitutional level, as is well known. Critics of rationalist liberalism may find this sufficient to indict Buchanan as a pure rationalist. Buchanan worries that leaving everything to spontaneous order does not leave any room for the political economist to prescribe changes to existing rules. If existing institutions lack any external means of measuring their efficiency then one cannot recommend, as a constructivist might, any changes to the rules (Buchanan 1977b, 1986a). Critics of rationalist liberalism could plausible accuse Buchanan of constitutional engineering which is different in degree but not in kind from social engineering.

But such an indictment from Buchanan's critics would be mistaken. It is here that Buchanan reconciles his appreciation of spontaneous order—referred to by him as "the major intellectual discovery in the whole history of economics" (Buchanan 1986a, p. 75)—with the zealous desire of the social scientist to nurture positive institutional change. In this regard, he is a "positive political economist" (Buchanan 1959). Rather than appealing to a "benevolent despot," Buchanan sees the role of the political economist as prescribing changes in the existing rules. Political change—the kind which necessarily involves coercion of the individual—can only be justified on the basis of agreement. And while agreement is difficult, if not impossible to secure, it is the standard that must be embraced nonetheless. Agreement is the only 'test' that the social scientist, whether in his role of positive scholar or normative change agent, can accept to ascertain whether proposed social arrangements are welfare improving in the eyes of those whose agreement is required to give legitimacy to rules changes. Even if social scientists come up with a seemingly perfect scheme for social reform that, on the blackboard, meet all the requirements of Pareto improvement, if the agreement of individuals cannot be secured, Buchanan concludes it is the theorist who is in error. This is a marked difference between the more rationalist social contract theorists, because it shows Buchanan places definite limits on both the positive and normative value of 'hypothetical consent' and 'quasi-unanimity'. As a contractarian, Buchanan obviously makes heavy use of these concepts in developing his social philosophy. But they are not an excuse for the theorist to run roughshod over reality. In fact, the role they serve is more nearly the opposite: they constrain the scholar as student of society by forcing him to find the rationality in seemingly irrational rules, and they constrain the scholar as activist by refusing him the temptation of using his expertise as an excuse to disregard the plans and expectations of the individuals subject to his proposed schemes.

Thus, it is difficult to paint Buchanan as a pure rationalist liberal, with all its attendant vices. Buchanan was often fond of invoking "Relatively Absolute Absolutes" in various contexts (Buchanan 1999b), allowing him to assume the middle ground on many of these seemingly irreconcilable issues. This is what gives normative weight to the rules, norms, and traditions that place us in the here-and-now from which change must begin. But these rules don't by themselves legitimize coercion from the state. Something else is required. Munger (2018) argues that Buchanan's contractarianism is depends upon individuals maintaining an *exit* option. Buchanan's later work on federalism and secession (Buchanan 1950, 1995a, b, 2001; Buchanan and Faith 1987; Buchanan and Goetz 1972) show he was deeply concerned with social mechanisms other than voice. To Buchanan, exit and voice are complementary goods. They are tools that individuals make use of as needed to ensure coercive institutions remain within their acceptable bounds. Students of political economy who only pay attention to Buchanan's occupation with consent overlook significant nuances in his thought. These nuances suggest Buchanan's contractarianism is best classified as a "contingent contractarianism" (Munger 2018, p. 29). The contingencies are precisely where the concerns for liberal pluralism can be found.

Buchanan's work on federalism and secession are distinctly pluralist. In rationalist liberal camps, these mechanisms are at best viewed with suspicion, and at worst must be actively combated. While the rationalist elements in Buchanan's thought may confront the all-too familiar problems associated with states being monopolies, his pluralist tendencies offer away around these problems. Take, for example, his views on the role of federalism in constitutional systems. To Buchanan, the central authority is an entity that sets the rules for further competition among smaller sub-units (Buchanan 1995b). When movement among these sub-units is not prohibitive, individuals can sort themselves, by choice, into those sets of rules that best fit their preferences. Furthermore, competition among the groups will tend to produce rules that increasingly fit those preferences (Tiebout 1956). Once one recognizes that a diversity of institutional possibilities exist for the supply of governance goods (e.g., Buchanan 1965; Coase 1974), it becomes a quasi-market situation in ascertaining which institutional arrangements serve as the most efficacious means of supplying those goods. The extent to which national sovereignty—in the sense of a central authority over sub-units—and competition of sub-units within that monopoly are desirable becomes a comparative institutional question for Buchanan. Competition among sub-units within a federated system becomes the pluralist solution to the both the epistemic and incentive problems that must be confronted pure rationalist liberal schemes for good governance.

Buchanan: The Liberal *Par Excellence*

Kenneth Boulding (1971) argued that the classic works of the past remain relevant in the present and the future to the extent that the questions they asked and dilemmas they proffered remain unresolved. In economics, Adam Smith occupies our "extended present." The questions raided by he and other classical economists remain unanswered, and their framework remains useful in furthering our understanding of a wide array of social phenomena. Buchanan is foremost among the scholars who have carried forward the Smithian project. His work has sparked a several complementary, yet wide-ranging, lines of research.

Buchanan takes the best out of both liberal sub-traditions and put those insights in the service of a project that constitutes a powerful engine of analysis for understanding both market and non-market institutions. Rather modestly, Buchanan insisted that his entire research program was an extension of the Madisonian project of American constitutionalism, driven by an extension of the Smithian project of classical liberalism. Still, the methods he developed undoubtedly changed the way that economists approached their study. Buchanan not only reinvigorated political economy in an age of institutional sterilization, he forever changed the way that economists would approach the field.

We have argued that Buchanan's liberal political economist has both rationalist and pluralist elements. Our argument is not that he was a rationalist with pluralist sympathies, nor a pluralist with rationalist sympathies. Instead we contend that Buchanan managed to navigate the fundamental tension in liberalism, as pointed out by Levy (2014), in a manner that enabled him to make significant advances on the problems that liberal social scientists confront anew in every generation. Buchanan understood the need for a coherent body of rules to facilitate effective collective action and defend the sovereignty of individuals. Yet, he also understands the value of the *status quo*, even when it fell short of rational justification. He appreciates the nature of spontaneous order and cultural evolution. Finally, he understands that democracy, conceived as 'democracy by discussion,' necessarily comes with a series of normative attachments that prevents the theorist from placing himself in a privileged position in the reform process. From this the rules already in place derive normative weight not simply because they exist, but because changing them requires a consensual, persuasive process if the ultimate norms of democratic self-governing society are to be preserved. Beginning from where we are, the here-and-now, individuals come to the table as equals and reform their institutions to best advance their several ends. Buchanan is committed to the idea of reason, reflection, and choice, providing a resounding affirmation to Hamilton's opening question in *The Federalist*. This is where his rationalist liberalism is most apparent. But he simultaneously cautions us to recognize the complexity of the world and provides us with a framework for understanding social change given this complexity. He frequently involves social norms and other cultural practices in his discussions of the political economy of change, according to these intermediate sources of social order a degree of authority that more rationalist contractarians do not share (see Buchanan 1975b, 1978, 1999c). We now describe the lasting innovations Buchanan, due to his deft navigation of the tensions between rationalist and pluralist liberalism, made in economics.

We have emphasized Buchanan's thought in the context of liberal political economy. In this sense, liberal political economy is not ideological economics. Instead, it is a specific tradition in the history of economic thought: the chain of insights held by the men who carry forward Adam Smith's legacy. Liberal political economy is, first and foremost, a project devoted to understanding the sources of social order when there is no centralized coordination or command. Buchanan is such an important *liberal* political economist because he is, first and foremost, a liberal *political economist*. Entire research projects in post-War political economy, many of which are still active today, owe their existence to Buchanan and the approach he adopted.

Consider Buchanan's views on rationality in economics. Buchanan was devoted to the rationality postulate, properly understood: not an insistence on omniscience and robotic maximization, but instead human purposiveness and choice under conditions of genuine uncertainty. He recognizes not only that individuals acknowledge and exploit gains from trade, but that private property, prices, and profit and loss are necessary preconditions that guide individuals towards potential gains. To Buchanan, these insights represented a similar thread that ran through the Sottish Enlightenment Philosophers (Hume and Smith), the Classical Economists (Ricardo and Mill), the Austrian School (Mises, Hayek, Kirzner), and the Chicago school in which he himself was educated (Knight and Simons) (Boettke 2014). With such traditions in mind, Buchanan became increasingly worried about the lack of institutional analysis in neo-classical economics. He urged economists to focus on the process by which allocations resulted, rather than mere allocative efficiency itself. He contrasted the allocative approach that is necessary for understanding the economizing behavior of individuals, with the exchange paradigm which must focus on the institutions within which rational individuals engage in exchange behavior. Much of the 'institutional turn' in economics looks the way it does because of Buchanan's influence, reflecting both rationalist and pluralist concerns.

Buchanan also deserves credit for extending the rationality postulate to the realm of politics, but this radically understates his contribution (Buchanan 1979). Buchanan's insistence on *behavioral symmetry* and the distinction between *choice over rules* vs. *choice within rules* are the twin pillars on which rest the most significant alternative paradigms to orthodox welfare and public economics. He pointed out serious conceptual flaws and limitations in emerging theories of "market failure" (see Bator 1958; Pigou 1920; Samuelson 1954), and questioned their suitability for making relevant institutional comparisons. Absent the process by which individuals expressed their actual preferences, Buchanan saw no means of prescribing solutions to the supposed failures (Buchanan 1954). Thus orthodox theories of market failure, and the attendant corrections, assumed away what ultimately ought to have received the bulk of economists' attention. Buchanan's alternative was to conceive of politics as an exchange process, a means by which individuals could achieve their own individual ends (Buchanan and Tullock 1962). Individuals would enter into political arrangements voluntarily, and as equals, to achieve would could not be achieved by private exchange alone. Thus, politics became a realm of exchange, and constitutional politics a *primary* realm for exchange, because it analytically preceded private exchange by assigning constituting all posterior exchange processes (Buchanan 2000).

The literature on constitution—an rule-making 'from the ground up,' most prominently exemplified in the work of Nobel Laureate Elinor Ostrom (2010), also owes much to Buchanan. The literature on endogenous solutions to problems of collective goods provision represents a practical application of Buchanan's insights. Recognizing the inherent diversity of potential institutional arrangements, Ostrom explored how different cultures and groups of individuals went about solving various collective action problems as they pertained to the management of common pool resources (Ostrom 1990). She documented several enduring practices across cultures that were successful in overcoming the predicted outcomes of the standard (institutionally antiseptic) economic models. Rather than leaving it up to the state to assign property rights in an effort to internalize the externalities produced when faced with commons problems, Ostrom recognized that communities could design and agree upon rules without recourse to an external enforcer. These rules were made against a diverse institutional background and, functionally, took the place of conventional, black-box, 'either markets or states' solutions promulgated by her contemporaries.

Ostrom's work and the literature derived from it contains many themes originally developed by Buchanan. From Buchanan, this literature made use of the analytical toolkit to understand how rules influence behavior, as well as an empirical bent for uncovering how these rules grow and adapt. This demonstrates both rationalist and pluralist *bona fides* from Buchanan's *oeuvre*. For example, Ostrom was not satisfied with analyzing social phenomenon strictly within the accepted models of the economist. Maintaining the rationality postulate, she engaged the complex institutional background within which exchanges and improvements in the existing rules were taking place in the real world. She exemplified the advice given to Buchanan in "What Should Economists Do?" (1964). Institutional problems, such as market failure, government failure, commons, etc…, demand institutional solutions (Boettke 2014, p. 120). Ostrom saw, first hand, how individuals—through a combination of choice and reflection, as well as accident and spontaneous order—went about solving such problems.

More recent work has studied how individuals outside of the traditional legal/political institutions go about constituting their own rules so as to provide public goods that were traditionally thought to be provided solely by states. This is perhaps best represented by the research of Leeson (2014), Skarbek (2014), and Stringham (2015). Themes from Buchanan themes are replete in each of these works. Each of these authors provides an analysis of how individuals come together to form groups and constitute their own rules in an effort to solve familiar economics problems or develop entirely new and creative institutional mechanisms for their own use. Leeson (2007, 2014), studies how individuals can, even under highly unfavorable conditions, can create viable social orders. This is true even when the individuals in question would be expected to behave particularly knavishly, as in the case of criminal enterprises. "Criminal constitutions" (Leeson and Skarbek 2010) can help even selfish and short-sighted individuals overcome collective action problems. Likewise, Skarbek (2014) shows how the failure of formal governance in large prisons in the United States led to the formation of gangs, which supplied collective goods such as protection and contract enforcement, and worked well even in an environment characterized by high risk and violence.

Stringham (2015), in a similar vein, documents how the emergence of the world's first stock market took place not only without, but despite government's refusal to enforce the relevant financial contracts. The complex trading institutions survived with the formation of clubs which were able to exclude those who failed to live up to their contractual agreements. Large benefits could be had by keeping promises, and the clubs were successful due to the "discipline of continued dealings" as described by Adam Smith in his *Lectures on Jurisprudence* (1978).

Other club-like institutions were equally successful at providing governance without state-enforcement in the London and New York Stock Exchanges, and continue to be utilized on Wall Street in the wake of the 2008 recession (Stringham 2015, Chaps. 4–6 and 11).

Other scholars have taken Buchanan's framework and show how it can be used to understand how even informal constitutions developed and sustained. Salter and Young (2016, 2017), firmly within Buchanan's constitutional political economy perspective, conduct a comparative analysis of the governance institutions in medieval Western Europe. They explain why the balance of power between the estates of the realm resulted in the rise of the rule of law. They also explain why representative institutions differ across polities, such as England and France. Those that tended towards less authoritative representative assemblies (e.g., England) did so due to the high costs associated with organizing special interests following the reform. These assemblies had mixed representation and were parliamentary. Those with estate based representation were able to concentrate benefits on special interests at a relatively lower cost, leading to more estate-based assembly (e.g., France). Importantly, the tools used to describe these results all originate in Buchanan.

Finally, prominent place must be given to Richard Wagner, arguably Buchanan's greatest student and the one most responsible for carrying forward his insights on the institutional contingencies of spontaneous order. Wagner (2017) argues Buchanan's project, beginning with classic works on public finance and culminating in broad social philosophy, is best understood as an attempt to understand the background conditions for a successful and renewable liberalism. This is also a useful way of understanding Wagner's recent work (2009, 2013, 2016) on the institutional underpinnings of market vs. non-market, and especially political, orders. Wagner is adamant that public-sector outcomes in democracies, such as budgeting and taxation, cannot be reduced to choice. Rational choosers are an essential part of the process, but not the only part. Instead, such outcomes are interaction-dependent. Interaction between choosers always takes on an added layer of complexity depending on the rules governing that interaction. Wagner, extending the insights of early marginalist economists on complexity, develops a framework for understanding these kinds of situations, and uses that framework to uncover essential differences—as well as overlooked similarities—between commercial and coercive social spheres. In this project, rationalist insistence on the universality of purposive human action and the primacy of rules is wedded to pluralist analysis of intermediate institutions from which rules can derive. Wagner puts these rationalist and pluralist themes from Buchanan to work and arrives at novel contributions to economics and politics.

Given this broad spectrum of work that continues to draw upon Buchanan, we can be confident that Buchanan's framework for social analysis will continue to be relevant long into the future. His contributions will occupy the "extended present" of political economy in a similar way that the classic thinkers going back to Adam Smith continue to do so. He shows us how to do classically liberal political economy without the vices associated with unchecked rationalism on the one hand, and unchecked pluralism on the other. Buchanan demonstrates to us how these two reservoirs of social thought can be simultaneously drawn upon to advance humanity's knowledge of social order. In brief, Buchanan is the "once and future liberal," and subsequent generations of political economists will necessarily continue down the trails he blazed.

References

Bator, F. M. (1958). The Anatomy of Market Failure. *The Quarterly Journal of Economics, 72,* 351–379.

Boettke, P. J. (1998). James M. Buchanan and the Rebirth of Political Economy. In R. Holt & S. Pressman (Eds.), *Economics and Its Discontent: Dissent in 20th Century Economics* (pp. 21–39). Northampton: Edward Elgar.

Boettke, P. J. (2014). What Should Classical Liberal Political Economists Do? *Constitutional Political Economy, 25*(1), 110–124.

Boulding, K. E. (1971). After Samuelson, Who Needs Adam Smith? *History of Political Economy, 3*(2), 225–237.

Brennan, G. (2015). Buchanan's Anti-conservatism. *Public Choice, 163*(1–2), 7–13.

Brennan, G., & Buchanan, J. M. (1985). *The Reason of Rules: Constitutional Political Economy*. *The Collected Works of James M. Buchanan* (Vol. 10). Indianapolis: Liberty Fund.
Buchanan, J. M. (1950). Federalism and Fiscal Equity. *The American Economic Review, 40*(4), 583–599.
Buchanan, J. M. (1954). Social Choice, Democracy, and Free Markets. *Journal of Political Economy, 62*(2), 114–123.
Buchanan, J. M. (1959). Positive Economics, Welfare Economics, and Political Economy. *The Journal of Law and Economics, 2,* 124–138.
Buchanan, J. M. (1964). What Should Economists Do? *Southern Economic Journal, 30*(3), 213.
Buchanan, J. M. (1965). *An Economic Theory of Clubs. Economica, 32*(125), 1–14.
Buchanan, J. M. (1972). Before Public Choice. In G. Tullock (Ed.), *Explorations in the Theory of Anarchy* (pp. 27–37). Blacksburg, VA: Center for Study of Public Choice.
Buchanan, J. M. (1975a). *The Limits of Liberty: Between Anarchy and Leviathan*. Chicago: University of Chicago Press.
Buchanan, J. M. (1975b). The Samaritan's Dilemma. In E. S. Phelps (Ed.), *Altruism, Morality, and Economic Theory* (pp. 71–85). New York: Russell Sage Foundation.
Buchanan, J. M. (1977a). A Contractarian Perspective on Anarchy. In *Freedom in Constitutional Contract: Perspectives of a Political Economist* (pp. 11–24). College Station: Texas A&M University Press.
Buchanan, J. M. (1977b). Law and the Invisible Hand. In B. H. Siegan (Ed.), *The Interaction of Economics and the Law* (pp. 127–138). Lexington, MA: D.C. Health.
Buchanan, J. M. (1978). Markets, States, and the Extent of Morals. *American Economic Review, 68*(2), 364–368.
Buchanan, J. M. (1979). Politics Without Romance: A Sketch of Positive Public Choice Theory and Its Normative Implications. *IHS Journal, Zeitschrift Des Instituts Für Höhere Studien*. Vienna, Austria: Institute for Advanced Studies.
Buchanan, J. M. (1982 [1999]). Order Definied in the Process of Its Emergence. In The Collected Works of James M. Buchanan, *The Logical Foundations of Constitutional Liberty* (Vol. 1, pp. 244–245). Indianapolis: Liberty Fund.

Buchanan, J. M. (1986a). Cultural Evolution and Institutional Reform. *Liberty, Market and State: Political Economy in the 1980's* (pp. 75–86). Brighton, UK: Wheatshelf Books.

Buchanan, J. M. (1986b). The Constitution of Economic Policy. *Les Prix Nobel*, 334–343.

Buchanan, J. M. (1990). The Domain of Constitutional Economics. *Constitutional Political Economy, 1*(1), 1–18.

Buchanan, J. M. (1995a). Federalism and Individual Sovereignty. *Cato Journal, 15,* 259–268.

Buchanan, J. M. (1995b). Federalism as an Ideal Political Order and an Objective for Constitutional Reform. *Publius: The Journal of Federalism, 25*(2), 19–28.

Buchanan, J. M. (1999a). *Cost and Choice: An Inquiry in Economic Theory*. Indianapolis: Liberty Fund.

Buchanan, J. M. (1999b). The Ethics of Constitutional Order. In *The Collected Works of James M. Buchanan. Volume 1: The Logical Foundations of Constitutional Liberty* (p. 368). Indianapolis, IN: Liberty Fund.

Buchanan, J. M. (1999c). The Relatively Absolute Absolutes. In *The Collected Works of James M. Buchanan. Volume 1: The Logical Foundations of Constitutional Liberty* (pp. 442–454). Indianapolis, IN: Liberty Fund.

Buchanan, J. M. (2000). *The Limits of Liberty: Between Anarchy and Leviathan*. Indianapolis: Liberty Fund.

Buchanan, J. M. (2001). *Federalism, Liberty, and the Law*. Indianapolis: Liberty Fund.

Buchanan, J. M., & Congleton, R. D. (2003). *Politics by Principle, Not Interest: Toward Nondiscriminatory Democracy*. *The Collected Works of James M. Buchanan* (Vol. 11). Indianapolis: Liberty Fund.

Buchanan, J. M., & Faith, R. L. (1987). Secession and the Limits of Taxation: Toward a Theory of Internal Exit. *American Economic Review, 77*(5), 1023–1031.

Buchanan, J. M., & Goetz, C. J. (1972). Efficiency Limits of Fiscal Mobility: An Assessment of the Tiebout Model. *Journal of Public Economics, 1*(1), 25–43.

Buchanan, J. M., & Tullock, G. (1962). *The Calculus of Consent: Logical Foundations of Constitutional Democracy*. Ann Arbor: University of Michigan Press.

Buchanan, J. M., & Vanberg, V. J. (1991). The Market as a Creative Process. *Economics and Philosophy, 7*(2), 167.

Coase, R. H. (1974). The Lighthouse in Economics. *The Journal of Law and Economics, 17*(2), 357–376.
Hamilton, A. (2001). No. 1. In G. W. Carey & J. McClellan (Eds.), *The Federalist* (Gideon, pp. 1–4). Indianapolis, IN: Liberty Fund.
Hayek, F. A. (1948). *Individualism and Economic Order*. Chicago and London: University of Chicago Press.
Hayek, F. A. (1973). *Law, Legislation and Liberty*. *Rules and Order* (Vol. 1). Chicago: University of Chicago Press.
Hayek, F. A. (2011). *The Constitution of Liberty: The Definitive Edition*. In R. Hamowy (Ed.), *The Collected Works of F.A. Hayek: 17*. Chicago: University of Chicago Press.
Kliemt, H. (2004). Contractarianism as Liberal Conservatism: Buchanan's Unfinished Philosophical Agenda. *Constitutional Political Economy, 15*(2), 171–185.
Kliemt, H. (2005). Public Choice and Political Philosophy: Reflections on the Works of Gordon Spinoza and David Immanuel Buchanan. *Public Choice, 125*(1–2), 203–213.
Kliemt, H. (2011). Bukantianism—Buchanan's Philosophical Economics. *Journal of Economic Behavior & Organization, 80*(2), 275–279.
Leeson, P. T. (2007). An-*arrgh*-chy: The Law and Economics of Pirate Organization. *Journal of Political Economy, 115*(6), 1049–1094.
Leeson, P. T. (2014). *Anarchy Unbound: Why Self-Governance Works Better Than You Think*. New York: Cambridge University Press.
Leeson, P. T., & Skarbek, D. B. (2010). Criminal Constitutions. *Global Crime, 11*(3), 279–297.
Leoni, B. (1961). *Freedom and the Law* (Expanded 3rd ed.). Indianapolis: Liberty Fund.
Levy, J. T. (2014). *Rationalism, Pluralism, and Freedom*. Oxford: Oxford University Press.
Munger, M. C. (2018). 30 Years After the Nobel: James Buchanan's Political Philosophy. *The Review of Austrian Economics, 31*(2), 151–167.
Nozick, R. (2013). *Anarchy, State, and Utopia*. New York: Basic Books.
Ostrom, E. (1990). *Governing the Commons: The Evolution of Institutional Forms of Collective Action*. Cambridge, MA: Cambridge University Press.
Ostrom, E. (2010). Beyond Markets and States: Polycentric Governance of Complex Economic Systems. *American Economic Review, 100*(3), 641–672.
Pigou, A. C. (1920). *The Economics of Welfare* (4th ed.). London: Macmillan.

Rawls, J. (1971). *A Theory of Justice*. Cambridge, MA: Harvard University Press.
Salter, A. W., & Young, A. T. (2016). Market-Preserving Federalism as Polycentric Sovereignty. *SSRN Electronic Journal, Working Paper*.
Salter, A. W., and Young, A. T. (2017). Medieval Representative Assemblies: Collective Action and Antecedents of Limited Government. *Constitutional Political Economy*, Forthcoming.
Samuelson, P. A. (1954). The Pure Theory of Public Expenditure. *The Review of Economics and Statistics, 36*(4), 387.
Skarbek, D. (2014). *The Social Order of the Underworld: How Prison Gangs Govern the American Political System*. Oxford: Oxford University Press.
Smith, A. (1978). *Lectures on Jurisprudence*. Oxford: Oxford University Press.
Stringham, E. P. (2015). *Private Governance: Creating Order in Economic and Social Life*. Oxford and New York: Oxford University Press.
Tiebout, C. M. (1956). A Pure Theory of Local Expenditures. *The Journal of Political Economy, 64*(5), 416–424.
von Mises, L. (1949). *Human Action: A Treatise on Economics*. New Haven: Yale University Press.
von Mises, L. (2010). *Liberalism*. Auburn, AL: Mises Institute.
Wagner, R. E. (2009). *Fiscal Sociology and the Theory of Public Finance: An Exploratory Essay*. Cheltenham: Edward Elgar.
Wagner, R. E. (2013). *Mind, Society, and Human Action: Time and Knowledge in a Theory of Social Economy*. London: Routledge.
Wagner, R. E. (2016). *Politics as a Peculiar Business: Insights from a Theory of Entangled Political Economy*. Cheltenham: Edward Elgar.
Wagner, R. E. (2017). *James M. Buchanan and Liberal Political Economy: A Rational Reconstruction*. Lanham: Lexington Books.

30

Buchanan, Hayek, and the Limits of Constitutional Ambitions

Donald J. Boudreaux

Over the past 100 years, no scholar has done more to fashion and to strengthen the intellectual foundations of classical liberalism than has F. A. Hayek. Fundamental to Hayek's enterprise was his insistence on the dispersion of knowledge and the need for each individual to use his or her unique bits of knowledge constrained only by abstract rules. If these rules are 'good' ones, they will generally lead each person, in pursuing his or her own goals, to act in ways that give rise to a larger, unplanned order that furthers the ability of individuals to achieve their ends. For Hayek, the foundational rules for any social order of large numbers of people are necessarily the product of unplanned evolution. These rules might be 'good' or 'bad' when judged by whatever criterion you choose. But because these rules—and the expectations both to which they give rise and that give rise to them—are part of a vast and complex web, human consciousness can never realistically hope at any one time to

D. J. Boudreaux (✉)
George Mason University, Fairfax, VA, USA
e-mail: dboudrea@gmu.edu

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_30

consciously change any more than a tiny sliver of these rules for the better.

James Buchanan, while in strong agreement with Hayek on most other questions in economics and political economy, dissented—also strongly—from Hayek's rejection of the possibility of consciously engineering, in one fell swoop, the foundational rules of society. Stated less starkly, Buchanan was far more optimistic than was Hayek of the ability of human beings to consciously devise, agree upon, and implement workable constitutional rules for society.

Careful scholars will correctly note that Hayek, contrary to how he is often portrayed, was not rigidly opposed to consciously designed rules. Hayek explicitly identified what he regarded to be a proper role for legislation. That role was not only to complement evolved law, but sometimes consciously to override such law. In addition, Hayek wrote an entire book describing his ideal constitution (Hayek 1979). As for Buchanan, he did not deny that particular laws often evolve into existence. It is not my purpose in this paper, however, to do a full exegesis of each man's work on the nature and sources of law. I will here accept as valid, as well as take as my starting point, Buchanan's own statement of his differences with Hayek on the nature of constitutional rules and the limits of legal evolution. On the basis of Buchanan's own understanding of his differences with Hayek on this score, I will then argue that Buchanan's case for the superiority of conscious social-contracting over Hayekian legal evolution fails.

Buchanan Rejected Hayekian Constitutional Modesty

Buchanan spelled out his social-contract theory of society most fully in his book *The Limits of Liberty* (1975). In summary, Buchanan argued that the specific features of the foundational rules on which every functioning social order rests will be best if they are consciously crafted and agreed to unanimously by members of the society to which the rules apply. Buchanan recognized that in the absence of such a social contract, social rules—including property rights—will indeed emerge through a process of social evolution, but he insisted that these purely evolved rules and rights will be less desirable than will any set of rules that are consciously chosen and implemented by a social contract. Throughout his vast work on constitutional economics, Buchanan frequently argued that, precisely because evolved rules will achieve local optima, they will not 'evolve away' from these local optima toward a global optimum. Movement of rules away from local optima toward a global optimum must, therefore, be done by conscious design and effort. The role of a social-contracting process is, for Buchanan, precisely to supply this conscious design and effort.

Buchanan explicitly contrasted his vision of constitutional change with that of Hayek, who was highly critical of what he (Hayek) called "constructivist rationalism." While Buchanan joined Hayek in rejecting as unrealistic any of the many social-reconstruction schemes the success of which depend upon changes in human nature, he parted ways with Hayek in the latter's refusal to condone ambitious, wholesale social change even when achieved through a social contract that enjoys unanimous consent. After proclaiming the American constitutional structure to be in "disarray," Buchanan (1975, p. 166) said about the social scientist that "[h]e must ask the question: What sort of social order can man create for himself at this stage in his history?" Buchanan's use of "create" was careful: to *create* a better social order is not to wait and hope for such an order to emerge unplanned.

To make clear that his call for social change is both radical and to be carried out by conscious design, Buchanan added that his

> analysis suggests that there are structural flaws in the sociopolitical system which can scarcely be remedied by superficial tampering. Acceptance of this, as diagnosis, becomes a necessary starting point in the search for alternatives. I am convinced that the social interrelationships that emerge from continued pragmatic and incremental situational response, informed by no philosophical precepts, is neither sustainable nor worthy of man's best efforts. History need not be a random walk in sociopolitical space, and I have no faith in the efficacy of social evolutionary processes. The institutions that survive and prosper need not be those that maximize

> man's potential. Evolution may produce social dilemma as readily as social paradise. (1975, p. 167)

In a footnote to this passage, Buchanan wrote:

> My basic criticism of F.A. Hayek's profound interpretation of modern history and his diagnoses for improvement is directed at his apparent belief or faith that social evolution will, in fact, insure the survival of efficient institutional forms. Hayek is so distrustful of man's explicit attempts at reforming institutions that he accepts uncritically the evolutionary alternative. We may share much of Hayek's skepticism about social and institutional reform, however, without elevating the evolutionary process to an ideal role. Reform may, indeed, be difficult, but this is no argument that its alternative is ideal. (1975, p. 194)

Again, my interest here is not to criticize or otherwise to parse Buchanan's interpretation of Hayek. In broad outline at least, Buchanan's interpretation of Hayek is accurate. Hayek was in fact far more skeptical than was Buchanan of attempts to consciously create society's foundational rules. This Hayekian skepticism—what we might call his 'constitutional modesty'—remained even if it is proposed that such reconstruction be carried out by an inclusive social-contracting process in which each individual enjoys veto power.

Buchanan's Social-Contracting Process

A summary of Buchanan's social-contract theory is useful. Normatively, Buchanan's theory is rooted in the presumption that every individual should have a say, equal to that of each of the other individuals in the social group, in choosing the rules by which he or she is governed. If members of the subset 'A' of individuals are forced to do the bidding of members of the subset 'B' of individuals, or to otherwise live according to rules to which the 'A's did not agree, the 'A's are treated as if they are inferior to other individuals. For the dyed-in-the-wool egalitarian and small 'd' democrat Buchanan, any such arrangement is profoundly inequitable and undemocratic and, hence, normatively unacceptable.

According to Buchanan's egalitarian and democratic principles, therefore, each individual should have veto power over the set of rules proposed to govern that individual's society. With each individual in possession of such veto power, any set of rules that is eventually chosen for that society will be a set of rules to which each person agrees. This unanimous consent ensures that no one is forced to act against his will.

Of course, as Buchanan often observed, rules that receive unanimous agreement likely include provisions to 'force' individuals acting within the rules to take certain actions and to refrain from taking other actions. For example, each individual might agree to a rule that allows a simple majority of his fellow citizens to raise his taxes and to imprison anyone who is found guilty of evading such taxes.[1] Each individual who agrees to this rule is, in one sense, "forced" to pay taxes if the majority so declares. But in a fuller, "constitutional" sense, the apparent force is not the sort that raises ethical issues: because the individual agreed to the rule, the individual volunteered to be 'forced' to abide by the majority's decision to tax him. And if one volunteers to be so forced, one is not really forced.

An analogy with a simple contract is helpful. By agreeing to borrow money to purchase a home, a mortgagee agrees to abide by a host of contractual provisions regarding repayment as well as to suffer certain consequences if he defaults on the contract. A mortgagee who is thus 'forced' out of his home because of his failure to make the timely mortgage payments that he agreed to make is not thought of as a victim of force. No other person is unilaterally imposing her will on the mortgagee.

Central to the above example is a distinction that appears throughout Buchanan's writings—namely, the distinction between choices *within* constraints and choices *of* constraints. Put differently, the distinction is between "constitutional choices" (which are choices *of* the rules) and "post-constitutional choices" (which are choices made *within* the rules).

---

[1]For an analytical demonstration of why individuals, when choosing the specific rules of how governments will routinely operate, are likely to agree to rules that require less than unanimous consent for government to enact legislation, see Buchanan and Tullock (1962), especially Chapter 6.

Buchanan rightly and repeatedly scolded those who overlook this distinction. Ultimately, we are governed by rules, even if among the rules is one that gives vast discretionary power to a monarch or a democratic assembly. And because each set of rules determines a particular array of incentives and constraints for those who operate within the rules, any systemic improvement in society can be brought about only by changing the rules rather than by pleading with individuals to respond differently to the incentives and constraints that are implicit within the existing set of rules.

Buchanan was careful never to say very much about the particular set of rules that he personally expected, or hoped, would emerge from an actual social-contracting process in which each individual has equal say and veto power at the rule-setting stage. The reason for Buchanan's reticence here was his refusal to "play God." Buchanan, self-consciously, was just one individual among millions. His opinion about what the details of the social contract 'should' be are just that: *his* opinion, which is no more or less worthy than is the opinion of any other individual. Thus, for Buchanan the social-contracting process is a discovery procedure. No one knows, or can possibly know, beforehand what will be the particular array of rules that wins unanimous consent. The 'correct' social contract will be simply that which emerges through inclusive constitutional discussion and compromise. When finally a set of rules wins unanimous consent, it will be with the input—or, at least, with the equal opportunity of offering input—of all who will be governed by that set of rules. This constitution will reflect both the subjective preferences of those who are party to it, as well as their 'scientific' judgments of the likely workings of different rules. This constitution will be neither 'right' nor 'wrong' if judged according to some external code of morality. But it *will* be right if judged by Buchanan's own liberal individualist norms because it will be *chosen* through a process in which each person who is to be governed by the set of rules has input and—importantly—veto power. This constitution ensures that no one's will is overridden or ignored by another.

One normatively attractive feature of Buchanan's social-contract theory is that it puts the individual front and center. Each individual, possessing veto power, has a meaningful role to play in crafting the rules by which he will be governed. And because no one is forced to follow rules that he did not agree to follow, Buchanan's social contract satisfies the normative Pareto criterion. Given that literally everyone agreed to it, the social contract makes no one worse off and at least one person better off. Once in place and in operation, then, no injustices or even Pareto-inefficient moves occur.[2] Everything is optimal, efficient, and ethical.

That's Buchanan's theory. This theory is useful for demonstrating the flaws inherent in those many political and economic philosophies that, explicitly or implicitly, posit as relevant benchmarks for the performance of a society objective criteria which are external to the preferences and judgments of the individuals who are members of that society. Buchanan's theory also keeps the focus on the importance of rules—a focus that allows us to avoid the conceptual confusions that arise when the analysis is of *outcomes* rather than of the rules that generate outcomes.

Despite this usefulness, however, Buchanan's social-contract theory is not without problems of its own. Ultimately, as I argue below, Buchanan's case for rejecting Hayek's constitutional modesty fails. Sometimes Buchanan wrote as if the social contract is simply an analytical tool that gives us a benchmark against which to *evaluate* either the set of rules currently in play in reality or proposed changes to these rules.[3] At other times, however, Buchanan wrote as if he believed that society can and should actually be reconstructed—actually re*constituted*—through a real-world social-contracting process. Apart from Buchanan's own ambiguity on the role of the social contract, there are problems with each of these proposed uses of the social-contract device.

[2]Buchanan (1962) demonstrated that the appropriate level for applying the Pareto criterion is at the level of rules.

[3]For example:

> [T]he contractual models are not designed to be historically descriptive. They are, instead, designed to assist in the development of criteria with which existing political-legal systems may be evaluated. (Buchanan 1975, p. 50)

Evaluating Existing and Proposed Rules

The chief problem with using social-contract theory to derive a benchmark against which to evaluate real-world rules is that, ultimately, it doesn't allow the Buchananite social-contract theorist to escape playing the role of God. Buchanan is correct that the rules that would be chosen through an inclusive real-world social-contracting process of the sort that is his ideal cannot be divined beforehand. The actual process of inclusive, unanimous-consent social contracting is necessary to discover what an 'optimal' set of rules are for the group in question.

But if there is no such actual social-contracting process then there is no actual social contract. How, then, can Buchanan or anyone else evaluate the rules actually in play in society against those of the hypothetical social contract? Any such attempted evaluation necessarily involves the analyst making his own assumptions about what rules an actual social-contracting process *would* generate if such a contracting process were to occur. Once the contents of an *actual* unanimous-consent social contract are replaced in the analyst's mind with what that analyst *imagines* would be the contents of an actual unanimous-consent social contract, one of Buchanan's core justifications for social-contracting disappears—namely, the need to discover through an *actual* unanimous-consent social-contracting process the details of the rules that would be chosen. In short, such an analyst would, by Buchanan's own lights, "play God."

The above is perhaps too harsh. An objective analyst might be unable to know in detail what rules an actual social-contracting process would generate, but he *is* able to rule out large swathes of rules as ones that no rational human being would agree to. He can perform this 'ruling-out' function by putting himself behind a veil of ignorance while he assesses all of society's actual rules-in-play as he understands them. Any number of actual rules are likely to be revealed by this exercise to be ones that no rational person in an actual social-contracting process would agree to.

All true. Yet how does such use of social-contract theorizing differ from that which is done regularly by any analyst who takes seriously the need to judge the 'goodness' or 'badness' of society by the pattern of consequences that are (believed to be) generated by society's rules? Whether the analyst is a social contractarian in the mold of Buchanan, a Hayekian emergent-law theorist, a Rawlsian, or whatever, each such person uses his personal judgment—hopefully one that is informed—to declare which sort of rules reasonable people in society would agree to and which they would reject.

Indeed, the Hayekian emergent-law theorist is arguably more true to Buchanan's process criteria for judging rules than was Buchanan himself. The Hayekian attaches great normative significance to the evolved rules as these exist. The Hayekian accords these evolved rules a strong presumption of legitimacy. He does so because he is aware of his own inability to fully understand their purpose. And he is inclined to hold to this position even if he perceives in many of these rules only irrationality or even apparent cruelty.

The Hayekian's stance is that even the wisest, most-astute, and long-standing member of a society cannot know all of the detailed and nuanced facts that give rise any particular set of rules. And much less can this person, or anyone, know the details of how all of the many rules interact with each other, and interact with the physical environment, to incite and to constrain human action. The Hayekian, not wishing to play God, presumes that the rules as they exist at any moment are likely the best such rules as are possible.

This Hayekian presumption is rebuttable. As Hayek made clear (1973, pp. 124–144), he did not oppose all legislation—that is, he did not oppose all conscious efforts to change some evolved laws. Hayek recognized that evolved law can and sometime does assume forms that are inconsistent with society's norms. Because it is not the proper role of judges to change this law, the agency to whom this responsibility falls is the legislature. Hayek, therefore, agreed with Buchanan that evolved law can get 'trapped' in 'suboptimal equilibria.' Hayek agreed also that rescuing society from such undesirable law requires the conscious effort of people acting in a legislative capacity.

But a critical difference separates Hayek's support for legislation from Buchanan's social-contract proposal. For Hayek, legislation is properly used only at the margins—only to change some laws and never to change the entire corpus of laws, at least not all at the same time.

In contrast, as discussed below, Buchanan often endorsed a social-contracting process as an actual means of changing society's entire constitution. For the Hayekian, any attempt to reconstruct wholesale all of society's rules—to try to alter all at once the entire set constitutional rules *for society*—would be hubristic folly of the most dangerous sort. The human mind simply cannot know enough to reconstruct society's rules in the manner endorsed by Buchanan. Indeed, the possibility of using legislation to successfully change individual laws depends upon the stability of expectations made possible by keeping most of the vast matrix of laws untouched.

Actually Crafting a Social Contract

Buchanan explicitly rejected Hayek's constitutional modesty. On several occasions Buchanan went beyond using the social-contract construct as merely a means against which to evaluate existing rules: he advocated actually using the social contract to *reconstruct* society.[4] For Buchanan, a

[4]For example:

> The prescription that follows from my diagnosis is straightforward. Genuine constitutional revolution should be possible. All, or substantially all, persons or groups in the United States of 1978 should be able to reach agreement on a carefully designed and properly orchestrated set of legal-institutional arrangements which could then replace those that are in existence or in disarray.

Buchanan then proceeds to mention some practical problems that might obstruct such a real-world social-contracting convention—practical problems such as that the public-goods nature of a sound constitution will perhaps prompt each person at the contracting stage to free-ride on the contracting efforts of others. But not to worry, concludes Buchanan:

> It is easy to become extremely pessimistic about prospects for effective constitutional revolution when such questions are raised. But economists tend to overlook the interests of men that extend beyond the narrow confines of *homo economicus*. Men who are excited by the grand design of the new constitutional order that is possible may, in fact, be willing to overcome the public-goods threshold noted above.

This curiously romantic assessment of the possibility of a real-world social-contracting process taking place appears in Buchanan (1977, pp. 183–184).

social-contracting process that is sufficiently inclusive and that operates according to a rule of unanimity (or something very close) will succeed because everyone has a say and no one is obliged to agree to rules that he judges will be intolerable.

Buchanan's embrace of what Hayek derisively called "constructivist rationalism" is difficult to understand, especially given Buchanan's profound recognition—when he wasn't doing constitutional political economy—of the enormous complexity of reality, of the great dispersion of knowledge, and of the benefits of decentralized, competitive, on-going, and open-ended *processes* of political and economic interaction.[5]

Buchanan points to his being an American, rather than a European, as an explanation for his rejection of Hayekian modesty when it comes to reconstructing society through a social contract. According to Buchanan, America's unique history gives to us Americans both an unwillingness to remain passive before the forces of history and an optimism that our active wrestling with these forces can be successful. And for evidence Buchanan points to the creation in Philadelphia during the summer of 1787 of the U.S. Constitution.

In addition to Buchanan's own explanation for his rejection of Hayekian modesty, there is, I believe, an additional reason why Buchanan was optimistic that a social-contracting process can work in reality. This additional reason is Buchanan's frequently used example of a poker game as an analogy for the social contract.[6] While much can be learned both from American history and from the poker-game analogy, neither, in fact, supports Buchanan's case for a social contract.

[5]See, for example, Buchanan (1982).

[6]For example, see Buchanan (1981, p. 44):

> On many occasions and in several places in print, I have used the analogy with games since I think this allows us to present the basic distinction most clearly. Consider a poker game. Participants must initially agree on the set of rules that will define the game to be played. This agreed-on set of rules becomes the constitution of the game. Play takes place within these rules, and this play may be termed *post-constitutional*.

The United States Constitution Is Not a Social Contract

Consider first the U.S. Constitution. As admirable as that document is—and as wise as were the men who wrote it and pleaded for its ratification—the U.S. Constitution is not remotely close to being a social contract. Contrary to much careless commentary and many unjustified allusions, the U.S. Constitution did not remake American society. Instead, it remade only America's national government. It reconstituted a single organization, nothing more.

Of course, because of government's distinctive powers to coerce all who are within its jurisdiction, the men who in 1787–1789 reconstituted the U.S. national government did so with an eye to ensuring that its coercive powers were kept in check. And while the then-agreed-upon understanding by the framers of what are and what are not acceptable functions of government was a product of then-prevailing cultural norms and ideology—and while this understanding heavily influenced the substance and spirit of the written Constitution—that document was not a social contract of the sort that Buchanan seems to have had in mind when he expressed his inability to go along with Hayek's refusal to remake the basic rules of society.

Indirect yet strong evidence that Buchanan envisioned a social-contracting process as a realistic means of reconstituting society at large (rather than merely reconstituting a central government) is the fact that Hayek himself famously admired the U.S. Constitution.[7] Buchanan obviously knew of Hayek's high regard for the Constitution. If, therefore, Hayek admired the U.S. Constitution, Hayek's objection to reconstituting the rules of society was almost certainly an objection to some effort more encompassing and grand than reconstituting a national government.

[7]Hayek (1960, p. 182): "And the Constitution which the new American nation was to give itself [in 1787] was definitely meant not merely as a regulation of the derivation of power but as a constitution of liberty, a constitution that would protect the individual against all arbitrary coercion." In the chapter from which this quotation is drawn Hayek explains, admiringly, that the U.S. Constitution was not intended to effect a wholesale restructuring of American society.

There is here an admitted contradiction—or at least an ambiguity—in my interpretation of Buchanan's position. On one hand, Buchanan presented the U.S. Constitution as evidence in support of his belief in the efficacy of his particular conception of social contracting. On the other hand, because Buchanan knew of Hayek's admiration for the Constitution—yet also because Buchanan insisted that Hayek was too modest in his willingness to remake society's rules—it appears that Buchanan had in mind a process of social contracting more encompassing and grand than that which resulted in the ratification of the U.S. Constitution.

This ambiguity in Buchanan's writings on social contracting testifies, I believe, to Buchanan's failure to fully escape the snares of legal positivism. Unlike Hayek, for whom law *always* precedes the state and is never a product of the state, Buchanan often wrote as if the state necessarily precedes law and is law's indispensable foundation. If legal positivism is correct, then law in the United States must come ultimately from the state. It follows that the successful reconstituting of the central U.S. state—such as was done with the drafting and ratification of the U.S. Constitution—meant the successful reconstituting not just of the U.S. government but also of America's legal foundations.

Again, though, any interpretation of the U.S. Constitution as a social contract is mistaken. On its face, that document defines only the organizational structure, some operational details, and the range of powers of the U.S. national government. Even granting that the U.S. national government is an especially important organization, and that specification of the boundaries of its powers is an especially important set of rules, the vast bulk of the rules—including the formal laws—by which Americans lived in 1787–1789, and by which Americans have lived ever since, are the results neither of the U.S. Constitution nor of any other social-contracting process. Instead, the great majority of the rules and laws in place in the late eighteenth century and in place today are overwhelmingly the evolved results of a spontaneous-order process. These rules and laws were designed by no one and get their authority from no consciously made collective decision. They are, in short, laws of the sort that Hayek insisted no successful society can do without and that cannot possibly be consciously designed and implemented. Because, therefore, the inspiration for the U.S. Constitution sprang from—and because the document's legitimacy and workability rests upon—a vast body of evolved law, it is not an example of real-world social contracting of the sort that Buchanan advocates when he calls for consciously chosen social change that is more fundamental than that which was tolerated by Hayek.

Choosing Rules for a Poker Game Is Not Akin to Social Contracting

The second likely source of Buchanan's overly optimistic belief that social contracting can successfully be used in reality to change society's fundamental rules is his frequent reliance on a poker-game analogy. Buchanan imagines people sitting around a poker table having agreed to play poker together. But the particular rules have yet to be chosen. Will the players stick to only one kind of poker game throughout the evening? If so, which game? Or will they vary the kind of poker game played throughout the evening? If so, how? What's the ante? Will or will not wild cards be used? Will new players be admitted after the evening's play commences?

These and several other rules must be chosen. They can be chosen explicitly or by implicit consent. But all such rules, by the time the playing commences, will have been chosen and agreed to unanimously. Having chosen the rules of the game (the "constitution"), each player will then make his or her in-game ("post-constitutional") choices according to these rules. Further, each player's in-game choices will inevitably be influenced by the incentives and constraints created by these rules.

Among the attractive features of unanimity of agreement is that no poker player has any ethical claim to complain about, or to demand a change in, the *outcomes* of the games.[8] Because a player who, say, loses

[8] I assume throughout that the rules, once chosen, are obeyed.

an unusually large amount of money during the evening agreed to the rules under which his and his compatriots' poker-playing led to his losses, that player's loses reflect no injustice or other wrongdoing. That player lost nothing that calls for compensation under the Pareto criterion or under any other commonly accepted efficiency or ethical standard. The player must be presumed to have known of the possibility of losing a large sum of money while playing poker. Thus, because this player nevertheless chose to play poker under the agreed-upon rules, the gains from playing that he expected *ex ante*—whether these gains be exclusively pecuniary or include some amount of subjective enjoyment of the camaraderie of his poker-playing mates—obviously outweighed his expected losses. That his losses exceed his gains *ex post* is ethically (and economically) irrelevant given that this player must be presumed to have figured in beforehand, at the start of the evening's playing, the possibility of his losing a substantial sum of money.

Put differently, despite this player losing money during the course of play, this player suffered no ethical, legal, or economically relevant *damages*.[9] The *ex ante* prospect—with a probability less than 100% but higher than zero percent—of losing a large amount of money was, for each player in the game, a *cost* that he willingly bore when he agreed to join in the game according to the chosen rules. When this prospect becomes reality for a particular player, that 'losing' player merely must make good on paying a cost that he earlier agreed to pay. No property or contract interest of this "losing" player is violated. He loses nothing that he did not agree to put himself in the position of losing. And the fact that this player "played by the rules" emphatically does *not* justify relieving him from bearing the loss that he earlier agreed to bear. Indeed, to relieve this player *ex post* from bearing this loss would itself be a *violation* of the rules.

Insights, such as this one, drawn from the poker-game analogy are valuable. Yet as valuable as is the poker-playing analogy for getting a

[9]Put yet another way, we may say that the possibility of this loss was *internalized* on the player by his agreement to join in the play.

firmer grip on the centrality of rules for many aspects of economics and politics, it is misleading as a model for social contracting. Most obviously, in a real-world poker game agreement truly is unanimous. Any individual who doesn't agree to the rules simply choses not to play. And because the cost of not playing is very small, no player can legitimately be thought to be obliged by his situation to play.

This poker-game unanimity differs fundamentally from any attempt at unanimous-agreement social contracting in reality. In a society of millions of people—indeed, even in a society of only dozens of people—securing unanimous agreement on rules is practically impossible. Any social contract chosen by such a society will necessarily, in practice, not have the approval of everyone to be governed by it. Not only is it practically impossible for multitudes of people to converse and bargain with each other as can the small handful of people who play poker, the ability of an individual to opt out of participating in the 'game' of society or 'nation' is far more difficult than is the ability of an individual to opt out of a poker game. Therefore, unlike in a poker game, the continuing participation of an individual in the 'game' of society or 'nation' cannot be interpreted as implicit consent of the sort that a person gives to the full set of rules of a poker game by his choosing to join and remain in that game.

Also, when debating on and choosing the rules of a poker game, each person can, without any superhuman effort, put himself behind veils of both ignorance and uncertainty. The fall of the cards as they will be dealt is genuinely unpredictable. No player at the start of any game can possibly know if his will be a favorable hand or an unfavorable one. Indeed, over the course of an evening of play each player expects to sometimes be dealt favorable hands and at other times to be dealt unfavorable hands. In contrast, asking flesh-and-blood individuals to put themselves behind a veil of ignorance—or even behind the less-demanding veil of uncertainty—when evaluating alternative social rules is to ask too much of them. Each person knows who he or she is, and knows more or less how he or she 'fits' into society. The amount of uncertainty that any individual can possibly have about changes in his or her position in society, and hence about how he or she will be affected by whatever rules are in place, simply cannot be as great as is the uncertainty that each individual player has at the start of an evening of poker-playing.

Yet another shortcoming of the poker-game analogy is this: unlike rules for society, the set of different possible poker rules is relatively small. There are only so many alternative poker rules that are up for consideration among the players. Also, each player can be expected to know the full array of possible rules from which the choices of specific rules will be made. And crucially, each player likely has a good sense of just how these rules differ from each other in the effects that each rule has on how players respond to different in-game circumstances. The situation is very different with all of the possible social rules potentially under consideration at the social-contracting stage. The number of such rules is huge, and the effects that each rule is likely to exert on post-constitutional choices are unknown to most choosers at the constitutional stage.

Furthermore, because whichever set of rules is chosen for a poker game applies only to one tiny sliver of human activity (namely, playing poker for an evening), the manner in which each of these rules affects other, non-poker aspects of life is largely irrelevant and, thus, can be ignored by the poker players. In stark contrast, choosing foundational rules for society affects nearly every aspect of life. Not only, therefore, is the number of rules up for consideration while social contracting extremely large—and not only does a 'sensible' assessment of alternative rules require a good understanding of how each rule, standing alone, affects post-constitutional choices—but also such a sensible assessment requires that the rule-choosers know how different rules will interact with each other. An analogy with economic theory is helpful: choosing rules for a poker game is a straightforward partial-equilibrium exercise, while choosing rules for society is a far more complicated general-equilibrium problem.

Given the uncountably large number of possible social rules, and the exponentially larger number of different combinations of these rules, it is simply too much to expect that any group of persons can know enough to choose wisely the set of rules that is best for them.[10] Any attempt to actually do social contracting will either take as background a large set of rules the existence of which is regarded as given, or that attempt will destroy the society that the social-contractors are seeking to improve.[11]

Rational Ignorance and Irrationality Even with Unanimous Consent

There's one final weakness worth flagging in Buchanan's social-contracting proposal—namely, even the requirement of actual unanimous consent does not, as a practical matter, guarantee that individuals 'rationally' consent to the contract. One of the beneficial consequences of a requirement of unanimous consent is said to be that each person has strong incentives to become adequately informed about the issues at stake and to make prudent decisions. Because each person knows that his vetoing a proposed rule means that that rule will not become part of the social contract, each person will consider with appropriate care whether or not he should vote for the rule.

[10]Buchanan might here defend his use of social-contracting processes by insisting that the number of rules up for consideration at the constitutional stage would be sufficiently small and general for ordinary people to sensibly assess. Rules at the constitutional stage would, perhaps, be limited to those that constitute the government, describe its manner of operation, and—with a handful of general rules—define, or confine, the scope of government's powers. Any additional and more-detailed rules would then, in some cases, be chosen consciously by the government and, in other cases, emerge spontaneously within the confines of the general constitutional rules chosen by the social contractors. But if this rather limited social contract is what Buchanan had in mind, it is, again, difficult to see how it differs from Hayek's position—a position that Buchanan expressly rejected as too modest.

[11]Rogopalan and Wagner (2013) offer similar criticisms of Buchanan's use poker-game analogies for making laws in the real world. They summarize: "But this small-number setting [of a poker game] may not be scalable to large societies. The presumptions of full knowledge and unanimity break down because there is no way that millions or hundreds of millions of people can participate in making or amending rules with a framework of universal agreement" (301).

This carefulness on the part of each decision-maker under a rule of unanimous consent is contrasted with the carelessness of decision-makers under rules of less-than-unanimity, including simple majority rule. Under, say, simply majority rule, because each voter has no reason to believe that his vote will decide the outcome of the election, each voter can free ride on the knowledge and rationality of other voters. The voter under simple majority rule who does not invest the time and resources necessary to improve his knowledge and understanding of the issues pays no price for his ignorance because his vote will not decide the outcome of the election. Likewise, and for the same reason, the voter under simple majority rule has no incentive to vote dispassionately rather than emotionally.[12] With all voters facing the same poor incentives in a majority-rule election, there is no reason to believe that the results of that election reflect the 'true' preferences of even the winning majority of voters.

Surprisingly, the same is true under a rule of unanimity, for there is a little-noted parallel between a rule of simple majority and a rule of unanimity. For a voter to believe that his vote will determine the outcome of a simple majority-rule election featuring X number of voters he must believe that, without his vote, an option under consideration will receive exactly $X/2$ votes.[13] For a voter to believe that his vote will determine the outcome of an election involving X number of voters under a rule of unanimity, he must believe that, without his vote, an option under consideration will receive exactly $X-1$ votes. In any election with more than a handful of voters, the latter belief is just as implausible as is the former belief. Therefore, even under a rule of unanimity, no rational voter will ever reckon that his vote is likely to be decisive.

The fact that Buchanan seems to have overlooked the perceived indecisiveness of each voter under a rule of unanimity likely is due to Buchanan's reliance either upon the American Constitutional convention in 1787 or his poker analogy. In both settings, all voters are

[12] See, e.g., Brennan and Lomasky (1993) and Caplan (2007).

[13] A similar calculus—with only the denominator changed—applies to any other voting rule.

relatively few in number and are face-to-face with each other. In contrast, in any real-world inclusive social-contracting process options would, as practical matter, have to be presented to voters in settings in which none of them has contact with any but a tiny fraction of other voters. Whether each clause of the social contract is presented for an up-or-down vote, or whether the social contract itself is presented in its entirety for an up-or-down vote, no voter will have any reason to know if, or even to suspect that, the vote count on the clause or contract under consideration is $X-1$. Having no good reason to believe that literally all other voters will vote for whatever proposal is under consideration, no voter will perceive his vote to be decisive. Each voter, therefore, is likely to be both rationally ignorant and rationally irrational.

Conclusion

James Buchanan is justly famous among social scientists for insisting that social processes, including politics, be analyzed realistically rather than romantically. Yet when any realistic assessment is made of Buchanan's proposed uses of social contracting, many of those proposed uses are found to be either not uniquely grounded in social-contract theory or ones that are wildly unrealistic. In particular, social-contract theory when used as a means of judging the merits of actual or proposed rules offers nothing that any of a large number of non-contractarian approaches do not offer. Absent an actual social contract, to say that a rule, a law, or a constitution would be agreed upon or not agreed upon by hypothetical social contractors is simply to guess what such hypothetical contractors would do. These guesses would unavoidably reflect the normative values of those making the assessment, as well as the 'positive,' scientific judgments that the assessors have of the likely workings of different rules.

Alternatively, when proposed as an actual method for achieving fundamental constitutional change—a change not just of the institution called "government," but of the foundational rules governing society itself—Buchanan offers no sufficiently detailed description of how such an inclusive social-contracting convention would operate in reality. While his admiration for both the effort and the result of the American framers in 1787 is justified, that admiration does not translate into any practical program of social contracting of the sort that he sometimes called for. And although Buchanan's poker-game analogy has many good uses, the differences that separate, on one hand, a few people choosing rules for a card game, and, on the other hand, millions of people choosing rules for society, are so large and fundamental that the former supplies no reason to believe that the latter is even remotely feasible. Society is not a poker tournament merely scaled up to a huge size. Society is fundamentally different. And among the most significant differences is that in any passably workable society there is no escaping the need to rely largely on rules that, to use one of Hayek's favorite phrases, "are the results of human action but not of human design."

References

Brennan, H. G., & Lomasky, L. (1993). *Democracy and Decision*. Cambridge: Cambridge University Press.

Buchanan, J. M. (1962). The Relevance of Pareto Optimality. *Journal of Conflict Resolution, 6,* 341–354.

Buchanan, J. M. (1975). *The Limits of Liberty*. Chicago: University of Chicago Press.

Buchanan, J. M. (1977). Criteria for a Free Society: Definition, Diagnosis, and Prescription. Reprinted in Buchanan (2001, pp. 173–184).

Buchanan, J. M. (1981). Constitutional Restrictions on the Power of Government. Reprinted in Buchanan (2001a, pp. 44–59).

Buchanan, J. M. (1982). Order Defined in the Process of Its Emergence. *Literature of Liberty, 5,* 5.

Buchanan, J. M. (2001a). *Choice, Contract, and Constitutions*. Indianapolis: Liberty Fund.

Buchanan, J. M. (2001b). *Federalism, Liberty and the Law*. Indianapolis: Liberty Fund.

Buchanan, J. M., & Tullock, G. (1962). *The Calculus of Consent*. Ann Arbor: University of Michigan Press.

Caplan, B. (2007). *The Myth of the Rational Voter*. Princeton: Princeton University Press.

Hayek, F. A. (1960). *The Constitution of Liberty*. Chicago: University of Chicago Press.
Hayek, F. A. (1973). *Law, Legislation, and Liberty: Rules and Order*. Chicago: University of Chicago Press.
Hayek, F. A. (1979). *Law, Legislation, and Liberty: The Political Order of a Free People*. Chicago: University of Chicago Press.
Rajagopalan, S., & Wagner, R. E. (2013). Constitutional Craftsmanship and the Rule of Law. *Constitutional Political Economy, 24,* 295–309.

31

James Buchanan and the Return to an Economics of Natural Equals

David M. Levy and Sandra J. Peart

> Adam Smith still has much to teach us,
> but can we, will we, attend his lectures?
> James Buchanan (1979, p. 133)

Introduction

It is critical to understand Buchanan's seriousness in his discussions of Adam Smith. Buchanan was no specialist, as he readily acknowledged in his review of the Glasgow edition of Smith's *Lectures on Jurisprudence* (Buchanan 1979), but he never lost sight of the big picture. A central question for Buchanan was whether the social world is characterized by natural differences, as Plato argued, or natural equals, as Smith (and

D. M. Levy
George Mason University, Fairfax, VA, USA

S. J. Peart (✉)
University of Richmond, Richmond, VA, USA
e-mail: speart@richmond.edu

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_31

Buchanan) posited. Smith's characterization of the fundamental equality of people in terms of the street porter and the philosopher is a commonplace in Buchanan's writings. Thus, the first issue in what follows is whether economic theory can deal with natural equals. Here Buchanan functioned as an intellectual entrepreneur, calling attention to the Smithian roots of theories of increasing returns developed in the 1970s and 1980s in which people are identical.

Buchanan always emphasized that fairness, not benevolence, is the norm for dealing with equals. One of the most subtle points of Buchanan's work is his insistence on being fair to scholars of the past. This posture is evident in both little and big things. One little gesture is Buchanan's note to George Stigler, later published in *Public Choice* (Buchanan 1976a), calling attention to a counterexample to Stigler's reading of Smith's incoherence on private and public action. More substantially, Buchanan insisted on this fairness when he compared John Rawls's *Theory of Justice* with Smith's work. He did so in two essays separated by nearly thirty years. In the first (in 1975), Buchanan dealt with the stereotyped reading of Smith; he argued that Smith and Rawls are closer than one might think. In the second (in 2004), the progress of Smith scholarship allowed him to point to the fundamental equivalence of the theories of Smith and Rawls.

The centrality of the history of ideas for Buchanan and the Thomas Jefferson Center was evident in the motto proposed by its co-founder, G. Warren Nutter—to save the books. Buchanan modified the motto—to save the ideas—perhaps to emphasize the importance of their permanence. Yet two of the authorities whom Buchanan cited as most influential (Buchanan 2004), Frank H. Knight and Rutledge Vining, had radically different conceptions of the history of economics. For Knight, the history of economics was useful only as the means to learn about mistakes made by unreflecting people (Knight 1935). For Vining, on the contrary, the past was a source of ideas in his advocacy for the methods of classical economists, rather than those of the new optimizing foundations provided by T. C. Koopmans and others (Vining 1956).

Learning from Adam Smith

Buchanan used the occasion of his Presidential address to the Southern Economic Association to appeal for his fellow economists to return to Smithian roots:

> Let me call your attention to a much-neglected principle enunciated by Adam Smith. In Chapter II of The Wealth of Nations he states that the principle which gives rise to the division of labor, from which so many advantages are derived,
>
> is not originally the effects of any human wisdom, which foresees and intends that general opulence to which it gives occasion. It is the necessary, though very slow and gradual, consequence of a certain propensity in human nature which has in view no such extensive utility; the propensity to truck, barter, and exchange one thing for another. (1964, p. 213)

Buchanan noted that a political economy based on two people trading had been developed by Richard Whately in 1831 when he proposed to rename the discipline "catallactics," his coinage for the science of exchange. Buchanan worked with the first edition of Whately's lectures so he was surprised and delighted to learn from us that Whately added a footnote to the second edition of 1832 in which he explicitly allowed for the involuntary trades associated with government activity.[1]

> I had not thought it necessary to observe that, in speaking of exchanges, I did not mean to limit myself to voluntary exchanges;—those in which the whole transaction takes place with the full consent of both parties to all the terms of it. Most exchanges, indeed, are of this character; but the case of taxation,—the revenue levied from the subject in return for the protection afforded by the sovereign, constitutes a remarkable exception; the payment being compulsory, and not adjusted by agreement with the payer. Still, whether in any case it be fairly and reasonably adjusted, or

[1]The following year, Whately published *Money Matters* in which the details for trading taxes for protection is worked out in considerable detail (Whately 1833). Not surprisingly, Whately's argument is one from specialization.

> the contrary, it is not the less an exchange. And it is worth remarking, that it is just so far forth as it is an exchange,—so far forth as protection, whether adequate or not, is afforded in exchange for this payment,—that the payment itself comes under the cognizance of this science. There is nothing else that distinguishes taxation from avowed robbery.

Once sympathetic agency and democratic politics are added to the mix, an array of political exchanges become understandable. Smith himself thought the abolition of slavery and the coming of free inland trade were impossibilities but his followers, inspired by his teachings, carried these changes out once the democratic era had begun (Levy and Peart 2005). This would not surprise Buchanan since he pointed out that with sympathetic agents, the range for real compensation in a democracy widens. It is important to notice that Buchanan's compensation principle pertains to collective action where reciprocity is enforceable, something unlikely with voluntary action.[2] Reciprocity is of course central to all of Smith's work.

One of the consequences of this line of thinking, in which the isolated couple is the catallactic atom (Edgeworth 1881), is that the theorist needs to specify the relationship between the two. If one starts with Robinson Crusoe, at least before Friday shows up, there is no

[2]Buchanan (1959, pp. 129–130): "An additional simple, but often overlooked, point on compensation needs to be made. The requirement of full compensation as here interpreted need not imply that the measured incomes of individuals or groups may not be reduced by acceptable social policy changes. 'Welfare' is defined as that which is expressed by individual preference as revealed in behavior. And individual behavior may be fully consistent with a reduction in measured personal income or wealth. For example, a policy which combines progressive income taxation and public expenditure on the social services may command unanimous support even though the process involves a reduction in the measured real incomes of the rich. The existence of voluntary charity indicates that individuals are, in fact, willing to reduce their own incomes in order to increase those of others. And the peculiar nature of collective choice makes support for collective or governmental action perhaps even more likely. Many individuals may find themselves saying: 'I should be willing to support this proposal provided that other equally situated individuals do likewise.' Thus collective action may command relatively widespread support, whereas no purely voluntary action might be taken in its absent." In *Calculus of Consent* the compensation is by log rolling which seemed to dispense with the need for sympathetic agency. K. J. Arrow (1963) pointed out the link between log rolling and compensation but he did not think it escaped the reversals that plagued Kaldor-Hick possible compensation. This is an odd argument since the Buchanan-Tullock log rolling is an actual trade not simply a possible one, whatever possible is taken to mean (Levy and Peart 2017).

such requirement. What is the relation between the two traders? In his 1971 "Equality as fact and norm," Buchanan formulates the argument as between the followers of Adam Smith or Plato over human capacity. Buchanan argues that the collectivist might well agree with Plato:

> He agrees with Plato and disagrees with Adam Smith about the differences between the common street porter and the philosopher (1971, p. 238) … Empirically, Plato's hypothesis of inequality may not be refuted, no matter how much we might prefer Adam Smith's. The inequalities that we see may stem from both attributes, and satisfactorily corrective measures may be beyond the scope of social policy. (1971, p. 239)

Importantly, concern for the relative capacity of individuals is connected with Buchanan's economics. Indeed, since he began with the idea of two traders, relative capacity was fundamental. Thus, it is entirely common in Buchanan's work to find appeal to "natural equals."[3]

The Economics of Natural Differences

When Buchanan entered the profession, it was settled doctrine that exchange was based on the principle of difference. David Ricardo's account of international trade, offered only as a special case when goods are mobile but factors of production are not (Ricardo 1821, Chap. 7), had been generalized to account for all trade. Ludwig von Mises summarized the argument that difference in ability sufficed to explain trade:

> Ricardo expounded the law of association in order to demonstrate what the consequences of the division of labor are when an individual or a group, more efficient in every regard, cooperates with an individual or a group less efficient in every regard. He investigated the effects of trade

[3]Buchanan (1978, p. 40): "Individuals need not be 'natural equals' in this Hobbesian equilibrium, but they would still find it mutually advantageous to enter into contractual agreements which impose limits on their own activities, which set up ideally neutral govern mental units to enforce these limits."

> between two areas, unequally endowed by nature, under the assumption that the products, but not the workers and the accumulated factors of future production (capita1 goods), can freely move from each area into the other. The division of labor between two such areas will, as Ricardo's law shows, increase the productivity of labor and is therefore advantageous to all concerned, even if the physical conditions of production for any commodity are more favorable in one of these two areas than in the other. It is advantageous for the better endowed area to concentrate its efforts upon the production of those commodities for which its superiority is greater, and to leave to the less endowed area the production of other goods in which its own superiority is less. The paradox that it is more advantageous to leave more favorable domestic conditions of production unused and to procure the commodities they could produce from areas in which conditions for their production are less favorable, is the outcome of the immobility of labor and capital, to which the more favorable places of production are inaccessible.
>
> Ricardo was fully aware of the fact that his law of comparative cost, which he expounded mainly in order to deal with a special problem of international trade, is a particular instance of the more universal law of association. (Von Mises 1949, pp. 158–159)

Von Mises' industrious disciple Murray Rothbard claimed that these differences were necessary.[4]

If trade depends upon differences, what might those be? Ricardo himself appealed only to differences is land and climate.[5] But the doctrine of variations in national characters was revived in the

[4]Rothbard (2009, p. 97): "It is clear that conditions for exchange, and therefore increased productivity for the participants, will occur where each party has a superiority in productivity in regard to one of the goods exchanged—a superiority that may be due either to better nature-given factors or to the ability of the producer." It is thus no accident that in Rothbard's eyes, egalitarianism is a "revolt against nature" to quote the title of one of his books (Rothbard 2000).

[5]Ricardo's acceptance of Smith's proposition of the equalization of the net advantages of employment in competitive equilibrium demonstrates that, like Smith, he believed people were fundamentally the same. If people were fundamentally different we would not expect equal wages in competitive equilibrium. Thus, "In speaking, however, of labour, as being the foundation of all value, and the relative quantity of labour as almost exclusively determining the relative value of commodities, I must not be supposed to be inattentive to the different qualities of labour, and the difficulty of comparing an hour's or a day's labour, in one employment, with the same duration of labour in another. The estimation in which different qualities of labour are held, comes soon to be adjusted in the market with sufficient precision

context of twentieth century international trade theory, abandoning one of Adam Smith's most important principles (Levy and Peart 2016). Frank Taussig's *Some Aspects of the Tariff Question* went so far as to identify national character with comparative advantage.[6] Avoiding the "crypto-explanations" of such natural character as "Yankee-ingenuity" was on the benefits that Paul Samuelson claimed for the Heckscher-Ohlin approach to trade (Samuelson 1948, pp. 164–165).

Given his well-known antipathy toward models of government policy with unitary actors, Buchanan might seem to be last person imaginable to be interested in standard international trade theory. Nonetheless, as he was working out the details of his explanation for the positive effects of a work ethic, he came to realize that the apparently "harmless" assumption of constant returns to scale was anything but. From there, he turned his attention to new developments in trade theory in which the assumption of constant returns to scale was dropped. Buchanan's 1994 volume, *The Return to Increasing Returns*, co-edited with Yong Yoon, was a step forward in this thinking because they appreciated that the new work on increasing returns allowed economists to work with the Smithian assumption of natural equals. We quote the critical passage[7]:

for all practical purposes, and depends much on the comparative skill of the labourer, and intensity of the labour performed. The scale, when once formed, is liable to little variation. If a day's labour of a working jeweller be more valuable than a day's labour of a common labourer, it has long ago been adjusted, and placed in its proper position in the scale of value" Ricardo (1821, 1.24). Ricardo appeals to Book 1 Chapter 10 of the *Wealth of Nations* in which Smith's makes the argument. Buchanan once asked us if Ricardo was a racist. No, but you can see this in the later Ricardians.

[6]Taussig (1915, III.21): "Again, implements themselves, big and little, are likely to be well made in a country where people are constantly turning to machinery; from kitchen utensils and household hardware to machine tools, electric apparatus, and huge printing presses. These are things in which the success of American industry is familiar; which are exported, not imported; in which it is proverbial that the Yankee has a peculiar knack,—another way of saying that he has a comparative advantage."

[7]An earlier version with a good deal less detail is found in Buchanan (1994).

> The economists whose papers represent applications to these areas of inquiry were motivated by the search for explanatory argument for observed or intuited phenomena. They were not driven by some desire to find illustrative applications in order to criticize the orthodoxy effectively. This point is illustrated by the international trade papers by Ethier and Krugman, included in this volume. Why should two economic units (whether persons, firms or nations) that are identical in preferences and endowments find it mutually advantageous to engage in trade? The conventional wisdom offers no ready response, although we know that the response of Adam Smith would have been simple and straightforward. Advantageous trade is explained in the conditions postulated by the presence of increasing returns to the scale of the economic nexus, the size of the market, increasing returns that allow for the exploitation of extended specialization. (Buchanan 1994, p. 9)

Buchanan's History of Economics Society keynote address returned to this ground and pushed forward to examine Smith's distinction between productive and unproductive labor, that embodied in goods versus that in services. Buchanan made the intriguing point that that physical goods, such as chairs, have a publicness of the Samuelsonian sort whereas services are purely private (Buchanan 2008, pp. 26–27).[8]

Challenging George Stigler

When Buchanan was a graduate student, it was common for authorities to assert that the greatest economists wrote books that were inconsistent with each other. Jacob Viner's celebrated article argued that Smith's *Wealth of Nations* was incompatible with *Theory of Moral Sentiments* (Viner 1928). As noted above, Buchanan's teacher, Knight, held that the classics were useful only to learn how to avoid mistakes.

[8]The choice of a physical good such as a chair instead of a stream of labor services might be formulated as akin to the utility-enhancing constraints to address the dynamic inconsistencies that Robert Strotz pointed out (1955–1956). The cover image for the journal Buchanan inspired, *Constitutional Political Economy,* is Odysseus, bound to the mast and thus unable to act on the temptation of the sirens.

Buchanan renounced that view in his lecture on Smith's teaching about increasing returns (Buchanan 2008).[9] With the growth of rational choice theorizing the supposition of mistaken choice became tenuous. Thus, when George Stigler collected his papers on economic regulation he offered his considered view on the problem of policy mistakes—"To say that such policies are mistaken is to say that one cannot explain them" (Stigler 1975, p. x).

Stigler worried about whether a "mistake" in the classical authors was their fault or ours. Allowing that the fault might be ours helps explain Stigler's concern about reticence in standard editions to assign blame for a "mistake" and the importance of reading how authors responded to their contemporaries (Levy and Peart 2019). But Stigler never renounced the possibility of finding errors in the classics as emphatically as he did in policy.

Stigler's eventual paper for the 1976 Glasgow celebration of the bicentennial of the *Wealth of Nations*—"Adam Smith's Travels on the Ship of State" (Stigler 1971)—considered many instances in which Smith's explanations did not fit neatly within a paradigm of self-interest.[10] Most dramatically, he considered how the actor failed to understand the consequences of a choice, when the selected means did not yield the desired ends. It seems unproblematic to describe this action as a "mistake." Essentially, Stigler read Smith as offering a paternalistic view of economic policy.[11]

The importance of correspondence comes into play when Buchanan writes to Stigler about the inconsistency between Smith's view of private and public activity (August 8, 1975). Buchanan accepted Stigler's view of the published work, but he pointed out that John Rae had offered an interpretation about incentives and public policy that is anything but naïve:

---

[9]With evident amusement, he found himself in agreement with George Stigler's dictum "it was always best to proceed on the presumption that it was Smith, rather than we, who had things right."

[10]His first proposed paper was "Adam Smith's use of empirical evidence to support theoretical positions."

[11]Stigler (1971, p. 272): "In general, however, Smith's attitude toward political behavior was not dissimilar to that of a parent toward a child: the child was often mistaken and sometimes perverse, but normally it would improve in conduct if properly instructed."

In a letter to Henry Dundas, Smith supports free trade for the Irish, but follows this up with the statement below:

Whatever they (the Irish) may demand, our manufacturers, unless the leading and principal man among them are properly dealt with beforehand, will probably oppose it. That they may be so dealt with I know from experience, and that it may be done at little expense and no great trouble. I could even point to some persons who, I think, are fit and likely to deal with them successfully for this purpose.

The letter is cited in full in John Rae's *Life*, and Rae seems clear as to his own interpretation. With reference to the statement above, Rae says: "I cannot explain the allusion in the closing parts of the letter to the writer's personal experience of the ease with which the opposition of manufacturers to proposed measures of public policy could be averted by sagacious management and a little expenditure of money. Nor can I say what persons he had in view to recommend as likely to do this work successfully; but his advice seems to imply that he agreed with the political maxim that the opposition of the pocket is best met through the pocket." The passages occur on p. 355 of the Augustus Kelley Reprint.

Thus, years before he turned to increasing returns, Buchanan was trying to understand Smith. As far as we can determine, Stigler never responded to Buchanan's point but he did keep the letter.

John Rawls and Adam Smith

In a paper of 1976, the bicentennial of the *Wealth of Nations*, Buchanan explored the relationship between Smith's system of natural liberty and Rawls's construction in *Theory of Justice*. He prefaced the argument by noting the importance of reading the texts and shying away from stereotyped readings:

In what may be surprising, and especially to those who are only casually familiar with the works of each man, I shall demonstrate that the similarities outweigh the differences. A returned Adam Smith would be a long distance from the modern libertarian anarchists, and even from

> the espousal of the minimal state described by Robert Nozick. But John Rawls is also a long distance from the position which has attributed to him, that of being a "defender of the liberal welfare state, somewhat modified in the direction of greater egalitarianism." These philosophers would surely be closer to each other than either would be to the image that intellectual fashion has imposed. (Buchanan 1976b, pp. 1–2)

Buchanan distinguished Smith from modern economists by appeal to *Theory of Moral Sentiments*[12]:

> Smith did not use this terminology and he was not intellectually hidebound by the now-dominant orthodoxy which largely neglects basic questions about the meaning of utility itself and then proceeds to impose a particular form on the utility function. Instead, Smith carefully distinguished between that which drives men to action promised or anticipated utility from an increasing stream of real goods and services or from a growing stock of assets-and that which measures the actual satisfactions secured subsequent to the receipt of such incremental flows and stocks. Beyond a certain level of real income (a level which was, nonetheless, presumably out of reach for the average or representative member of the working class), the anticipated marginal utility of income to an individual exceeds the realized marginal utility. This divergence constituted, for Smith, the great deception that was essential in driving the whole system, which acted to insure that self-interest would, in fact, generate increasing prosperity and economic growth. (1976b, pp. 2–3)

In expanding upon Smith's conception of justice, Buchanan called attention the street porter and the philosopher:

> There is a second element of Adam Smith's model of social interaction that is helpful in evaluating his conceptions of justice. Smith did not assume or postulate significant differentials in capacities among human

---

[12]Buchanan benefited from A. L. Macfie's work which appeared too late for Rawls to benefit from it. Buchanan also relied upon Jacob Viner's edition of John Rae's *Life of Adam Smith* from which he found the material to question Stigler's reading of a fundamental difference between public and private activity. Nate Rosenberg's work was early enough for Rawls but only Buchanan saw its importance.

beings. The differences between the "philosopher and the street porter" were explained largely in terms of upbringing, training, and education. In the current debates, Smith would find himself arrayed squarely on the side of those who stress environmental factors and who play down the relevance of genetic endowment. (1976b, p. 3)

Buchanan struggled with Rawls's interpretation of "natural liberty." In Buchanan's view, Rawls's interpretation was not Smithian but rather consistent with a neoclassical supposition of efficiency as the goal (Buchanan 1976b, p. 13).

Buchanan laid out his own approach in Smithian terms:

Finally I should note a possible difference in the implications of a commonly shared philosophical rather than empirical presupposition for normative discourse. Even if he should have recognized, empirically, that persons differ, and substantially so, in basic capacities, Adam Smith might well have argued that such inequalities have no place in, and in fact must be presumed away, in the process of designing a just and viable social order. The basic institutions of society must be based on the presumption that men are "equals" in some fundamental genetic sense.[35]

Footnote 35 reads:

For a discussion of this presumption of fundamental equality, even in the context of empirical inequalities, see James M. Buchanan, The Limits of Liberty: Between Anarchy and Leviathan (1975), esp. at 11-12

Between 1976 and 2003, Buchanan sharpened the argument. No longer were Smith and Rawls closer than they appear, but they are fundamentally the same. The critical paragraph in Buchanan's obituary notice reformulated Rawls's principle as Smith's:

I have always considered the utilitarian arguments to the effect that Rawls presumed generalized risk averseness to be trifling and contrary to the spirit of his whole construction. His elevation of the difference principle to a central role in his definition, properly interpreted, is roughly

> comparable to Adam Smith's criterion that measures be adjudged in accordance with the promised benefits to the "labouring classes." And, interestingly in this respect, why have the utilitarian critics concentrated their fire almost exclusively on the difference principle? The criticism could be equally applied to the first principle, that of equal liberty. Slavery may indeed, in some forms, maximize expected utility, as perceived from behind the veil John Rawls remained consistent in his focus on justice, not utility.

The closing lines of the obituary are entirely Smithian, aimed directly at the vanity of the philosopher who does not recognize the street porter as an equal:

> He was not a "do gooder" in the surface sense of that word; he did not think himself to be a member of a natural elite, looking down from Harvard on the peons below. He was a genuine seeker after justice for a society of natural equals, each of whom can imagine better worlds.

These are, in our opinion, helpful reformulations, yet they go beyond Rawls's own words.

Buchanan was able to go beyond Rawls for at least two reasons. He had access to texts that were unavailable to Rawls and he had access to better scholarship since *Justice* was published at approximately when Smith scholarship was rising from its nadir. In 1971, the standard edition of the *Wealth of Nations* was a great one, carefully edited by Edwin Cannan. However, the inexpensive Modern Library version of the edition caricatured Smith in an introduction that claimed he spoke only for merchants (Lerner 1937). At the time, *Theory of Moral Sentiments* was so obscure that even a scholar of Rawls's carefulness worked with extracts provide in the *British Moralists* compendium (Levy and Peart 2013).

Between *Justice* and 2003, Smith became the center of intense study and not just by economists. Liberty Fund published the Glasgow edition of Smith's entire corpus in easy-to-afford paperback printings. The Soviet Union collapsed, and scholars turned their attention to the economist who had been characterized as an apologist for capitalism. Scholars were surprised by the difference between what they expected and what they found, and they reconsidered Smith's work, something that continues to this day.

Two not independent re-readings resulted from this reconsideration. First, scholars revisited Smith's relationship with the work of Robert Malthus, who wrote in 1798:

> The professed object of Dr. Adam Smith's inquiry, is, the nature and causes of the wealth of nations. There is another inquiry, however, perhaps still more interesting, which he occasionally mixes with it; I mean an inquiry into the causes which affect the happiness of nations, or the happiness and comfort of the lower orders of society, which is the most numerous class in every nation. I am sufficiency aware of the near connection of these two subjects, and that the causes which tend to increase the wealth of a State, tend also, generally speaking, to increase the happiness of the lower classes of the people. But perhaps Dr. Adam Smith has considered these two inquiries as still more nearly connected than they really are; at least, he has not stopped to take notice of those instances, where the wealth of a society may increase (according to his definition of wealth) without having any tendency to increase the comforts of the labouring part of it. I do not mean to enter into a philosophical discussion of what constitutes the proper happiness of man; but shall merely consider two universally acknowledged ingredients, health, and the command of the necessaries and conveniences of life. (1798, XVI.1)

There is now much agreement that Smith's major concern, as Malthus and Buchanan wrote, was for the well-being of the working class, the "lower order of society, which is the most numerous class" (Levy 1995; Peart and Levy 2005; Hollander 2015; Schleisser 2017). This would not have surprised Buchanan.[13]

Smith's words were in fact interestingly different from what Malthus remembered:

---

[13]Buchanan (1976b, p. 6): "Smith's great work, *The Wealth of Nations*, has been widely interpreted as being informed normatively by efficiency criteria. This emphasis is broadly correct, provided that the efficiency norm is not given exclusive place. Smith's purpose was that of demonstrating how the removal of restrictions on free market forces, how the operation of his 'system of natural liberty,' would greatly increase the total product of the economy and, more importantly, how this

> Is this improvement in the circumstances of the lower ranks of the people to be regarded as an advantage or as an inconveniency to the society? The answer seems at first sight abundantly plain. Servants, labourers and workmen of different kinds, make up the far greater part of every great political society. But what improves the circumstances of the greater part can never be regarded as an inconveniency to the whole. No society can surely be flourishing and happy, of which the far greater part of the members are poor and miserable. It is but equity, besides, that they who feed, cloath and lodge the whole body of the people, should have such a share of the produce of their own labour as to be themselves tolerably well fed, cloathed and lodged. (1904, I.8.35)

The difference between "the greater part" and "the far greater part" prefigures the difference in *Calculus of Consent* (Buchanan and Tullock 1962) between a majority rule and one of many super majority rules. What is important, is that in all cases decision can be made by a simple show of hands, a count. The counting rule is, of course, up for discussion. Rawls struggled with F. Y. Edgeworth's version of utilitarianism (Edgeworth 1881), which replaced the counting of classical political economy with the expert's hedonometer, a calculus of overall benefit.

Careful readers of the *Wealth of Nations* notice what we have described as analytical egalitarianism. Smith coined a phrase which captured his point wonderfully. His careful reader, Lionel Robbins in his famous "Representative firm" referred to "Adam Smith, that discredited *laissez- faire* economist, with his insistence on the original similarity of porters and philosopher" (Robbins 1928, p. 401). What Buchanan saw in Rawls was an answer to the question of how to make Smith's "natural equals" operational:

> His analytical enterprise was not driven by fellow feeling, at least directly. He sought to find principles that embody justice in a society of natural

would generate rapid economic growth, thereby improving the lot of the laboring classes." The exceptions Smith makes when natural liberty is rightly violated occur when the well-being of the majority is harmed by the actions of a few (Levy and Peart 2013).

> equals, in the same sense of equality defined by Thomas Jefferson in the Declaration of Independence and referenced by Adam Smith in his comparison between the street porter and the philosopher. (2003, iv)

In his discussion with Warren Samuels, Buchanan summed up the interrelation between fairness and natural equality:

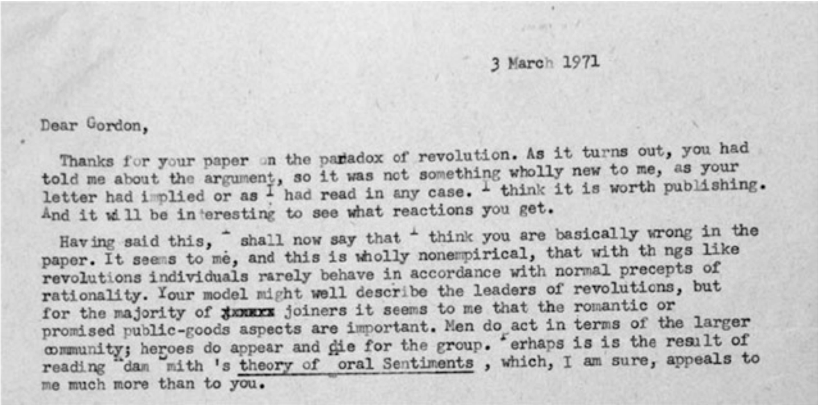
> There you define justice in terms of a kind of a compassion, an altruism, benevolence … you can talk about [how] you are just to the man who is poor, but if you classify him totally differently from yourself … you can't apply fairness criteria. Fairness criteria, and the fact that you say everybody honors this, mean that you're accepting this idea that basically we're natural equals out there to be considered as equals. And so I think that's an important distinction to make, and it does separate these two conceptually. (2008, pp. 37–38)

Conclusion

What are our obligations toward writers of the past? Here the distinction Buchanan makes between the fairness we owe our equals and the benevolence we owe our inferiors comes into its own. It makes no sense to think of being benevolent toward Adam Smith. But we can be fair to his writings because, as Buchanan pointed out, he still has a good deal to teach us if only we will pay close attention. As noted above, when Buchanan was a graduate student Jacob Viner held that *Theory of Moral Sentiments* and *Wealth of Nations* were inconsistent. If Smith were our equal and we try to be consistent, we would expect the same to be true for him. Thus in 1976 Buchanan relies on *Moral Sentiments* when he argued that there is more similarity between Smith and Rawls than their stereotypes would suggest.[14]

[14]We have heard that Buchanan never cited *Moral Sentiments*. If one only uses the JSTOR search engine, one will not find *Theory of Moral Sentiments* because *Sentiments* occurs at a line break in Buchanan (1976b) and the search engine fails to recognize Senti-ments as Sentiments.

We can date Buchanan's acquaintance with *Theory of Moral Sentiments* with some precision since he mentioned it in a letter to Gordon Tullock of 3 March 1971.[15]



3 March 1971

Dear Gordon,

Thanks for your paper on the paradox of revolution. As it turns out, you had told me about the argument, so it was not something wholly new to me, as your letter had implied or as I had read in any case. I think it is worth publishing. And it will be interesting to see what reactions you get.

Having said this, I shall now say that I think you are basically wrong in the paper. It seems to me, and this is wholly nonempirical, that with things like revolutions individuals rarely behave in accordance with normal precepts of rationality. Your model might well describe the leaders of revolutions, but for the majority of ~~xxxxx~~ joiners it seems to me that the romantic or promised public-goods aspects are important. Men do act in terms of the larger community; heroes do appear and die for the group. Perhaps is is the result of reading Adam Smith's theory of Moral Sentiments, which, I am sure, appeals to me much more than to you.

References

Unpublished Work

Hoover Institute Special Collections, Gordon Tullock Papers.

Published Work

Arrow, K. J. (1963). *Social Choice and Individual Values*. New York: Wiley.
Buchanan, J. M. (1959). Positive Economics, Welfare Economics, and Political Economy. *Journal of Law and Economics, 2,* 124–138.
Buchanan, J. M. (1964). What Should Economists Do? *Southern Economic Journal, 30,* 213–222.
Buchanan, J. M. (1971). Equality as Fact and Norm. *Ethics, 81,* 228–240.
Buchanan, J. M. (1976a). Adam Smith on Public Choice. *Public Choice, 25,* 81–82.

[15]Gordon Tullock Papers, Box 11, Buchanan 1 of 2 Folders.

Buchanan, J. M. (1976b). The Justice of Natural Liberty. *Journal of Legal Studies, 5,* 1–16.
Buchanan, J. M. (1978). A Contractarian Perspective on Anarchy. *Nomos, 19,* 29–42.
Buchanan, J. M. (1979). Review of *Lectures on Jurisprudence* by Adam Smith, R. L. Meek, D. D. Raphael and P. G. Stein. *British Journal of Law and Society, 6*, 130–133.
Buchanan, J. M. (1992). Economic Science in the Future. *Eastern Economic Journal, 18,* 401–403.
Buchanan, J. (1994). The Return of Increasing Returns: An Introductory Summary. In J. M. Buchanan & Y. Yoon (Eds.), *The Return to Increasing Returns* (pp. 3–13). Ann Arbor: University of Michigan Press.
Buchanan, J. M. (2003). Obituary: Justice Among Natural Equals: Memorial Marker for John Rawls. *Public Choice, 114*, iii–v.
Buchanan, J. M. (2004). 10x10: James M. Buchanan. *Politik, 7,* 50–52.
Buchanan, J. M. (2008). Let Us Understand Adam Smith. *Journal of the History of Economic Thought, 30,* 21–28.
Buchanan, J. M., & Rawls, J. (2008). The Buchanan-Rawls Correspondence. In S. J. Peart & D. M. Levy (Eds.), *The Street Porter and the Philosopher: Conservations in Analytical Egalitarianism*. Ann Arbor: University of Michigan Press.
Buchanan, J. M., & Samuels, W. J. (2008). Politics as Exchange or Politics as Power: Two Views of Government. In S. J. Peart & D. M. Levy (Eds.), *The Street Porter and the Philosopher: Conversations on Analytical Egalitarianism* (pp. 15–40). Ann Arbor: University of Michigan Press.
Buchanan, J. M., & Tullock, G. (1962). *The Calculus of Consent: The Logical Foundations*. Ann Arbor: University of Michigan Press.
Edgeworth, F. Y. (1881). *Mathematical Psychics*. London: C. Kegan Paul & Co.
Hollander, S. (2015). *John Stuart Mill: Political Economist*. Singapore: World Scientific.
Knight, F. H. (1935). The Ricardian Theory of Production and Distribution. *The Canadian Journal of Economics and Political Science/Revue canadienne d'Economique et de Science politique, 1*(3–25), 171–196.
Lerner, M. (1937). Introduction. *Inquiry into the Nature and Cause of the Wealth of Nations* by Adam Smith. New York: Modern Library.
Levy, D. M. (1995). The Partial Spectator in the *Wealth of Nations*: A Robust Utilitarianism. *European Journal of the History of Economic Thought, 2,* 299–326.

Levy, D. M., & Peart, S. J. (2005). The Theory of Economic Policy in British Classical Political Economy: A Sympathetic Reading. *History of Political Economy, 37,* 120–142.
Levy, D. M., & Peart, S. J. (2013). Adam Smith and the State: Language and Reform. In C. Berry, C. Smith, & M. Paganelli (Eds.), *Oxford Handbook on Adam Smith*. Oxford: Oxford University Press.
Levy, D. M., & Peart, S. J. (2019). George Stigler as a Reader of Adam Smith. In C. Freedman (Ed.), *Understanding the Enigmatic George Stigler: Extending Price Theory in Economics and Beyond*. Springer.
Levy, D. M., & Peart, S. J. (2016). Group Analytics in Adam Smith's Work. *Eastern Economic Journal, 42,* 514–527. https://doi.org/10.1057/s41302-016-0004-y.
Levy, D. M., & Peart, S. J. (2017). *Escape from Democracy: The Role of Experts and the Public in Economic Policy*. New York: Cambridge University Press.
Malthus, T. R. (1798). *An Essay on the Principle of Population*. London: J. Johnson, in St. Paul's Church-yard. Library of Economics and Liberty [Online]. Available at http://www.econlib.org/library/Malthus/malPop6.html. Accessed May 18, 2018 (Internet).
Peart, S. J., & Levy, D. M. (2005). *The "Vanity of the Philosopher": From Equality to Hierarchy in Post-Classical Economics*. Ann Arbor: University of Michigan Press.
Ricardo, D. (1821). *On the Principles of Political Economy and Taxation*. London: John Murray. Library of Economics and Liberty [Online]. Available at http://www.econlib.org/library/Ricardo/ricP.html. Accessed May 19, 2018 (Internet).
Robbins, L. C. (1928). The Representative Firm. *Economic Journal, 38,* 387–404.
Rothbard, M. (2000). *Egalitarianism as a Revolt Against Nature and Other Essays*. Auburn: Von Mises Institute. Available at https://mises-media.s3.amazonaws.com/Egalitarianism%20as%20a%20Revolt%20Against%20Nature%2C%20and%20Other%20Essays_2.pdf?file=1&type=document.
Rothbard, M. (2009). *Man, Economic and State: A Treatise on Economic Principles.* Auburn: Von Mises' Institute. Available at https://mises.org/sites/default/files/Man,%20Economy,%20and%20State,%20with%20Power%20and%20Market_2.pdf.
Samuelson, P. A. (1948). International Trade and the Equalisation of Factor Prices. *Economic Journal, 58,* 163–184.
Schleisser, E. (2017). *Adam Smith: Systematic Philosopher and Public Thinker*. Oxford: Oxford University Press.

Selby-Bigge, L. A. (1897). *The British Moralists, Being Selections from Writers Principally of the Eighteenth Century*. Oxford: At the Clarendon Press.

Smith, A. (1904). *An Inquiry into the Nature and Causes of the Wealth of Nations*. E. Cannan (Ed.). London: Methuen & Co., Ltd. Library of Economics and Liberty [Online]. Available at http://www.econlib.org/library/Smith/smWN3.html. Accessed May 18, 2018 (Internet).

Stigler, G. J. (1971). Smith's Travels on the Ship of State. *History of Political Economy, 3*, 265–277.

Stigler, G. J. (1975). *The Citizen and the State*. Chicago: University of Chicago Press.

Strotz, R. H. (1955–1956). Myopia and Inconsistency in Dynamic Utility Maximization. *Review of Economic Studies, 23*, 165–180.

Taussig, F. W. (1915). *Some Aspects of the Tariff Question*. Cambridge, MA: Harvard University Press. Library of Economics and Liberty [Online]. Available at http://www.econlib.org/library/Taussig/tsgSTQ7.html. Accessed May 19, 2018 (Internet).

Viner, J. (1928). Adam Smith and Laissez-Faire. In J. M. Clark, P. H. Douglas, J. H. Hollander, G. R. Morrow, M. Palyi, & J. Viner (Eds.), *Adam Smith, 1776–1926* (pp. 156–179). Chicago: University of Chicago Press.

Vining, R. (1956). *Economics in the United States of America A Review and Interpretation of Research*. Paris: UNESCO.

Von Mises, L. (1949). *Human Action.* New Haven: Yale University Press.

Whately, R. (1832). *Introductory Lectures on Political Economy*. London: B. Fellowes. Library of Economics and Liberty [Online]. Available at http://www.econlib.org/library/Whately/whtPE.html. Accessed May 20, 2018 (Internet).

Whately, R. (1833). *Easy Lessons on Money Matters; For the Use of Young People*. London: J. W. Parker.

32

From Highway to Clubs: Buchanan and the Pricing of Public Goods

Alain Marciano

Introduction

Not much has been written about the history of James Buchanan's "An Economic Theory of Clubs" (1965a), which is one of the most important of his articles. In another work (Boettke and Marciano 2017), we have shown why Buchanan's article should not be read as an answer or a complement of Charles Tiebout's "A Pure Theory of Local Public Expenditures" (1956). Our objective is now to shed as much light as possible on why Buchanan came to write about clubs. From this perspective, a point of reference is given by Richard Wagner: Buchanan started to discuss the provision and financing a local public good—more precisely, a swimming pool—with students in the fall of 1963 (2017, pp. 181–182). Another date is important: August 8, 1964. It is not possible to know if Buchanan had already written his article on

A. Marciano (✉)
Faculté d'Économie, MRE and Université de Montpellier,
Montpellier, France
e-mail: alain.marciano@umontpellier.fr

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_32

clubs by that date but August 8, 1964 was when he started to write an article entitled “The Highway Network Considered as a Club”.

The manuscript is made of different parts that may have been written later. Yet, it is certain that the pricing of highway services was the first area to which Buchanan tried to apply his work on clubs. We thus claim that the idea individuals could form clubs to finance public goods can be traced back to his first works on public finance, at the end of the 1940s, and relates to a very important question for Buchanan: the financing of highways and the pricing of their construction and of their use. Convinced very early in his career that users should pay (see Marciano 2018), Buchanan adopted first Knut Wicksell’s proposal to use a marginal cost pricing rule. But, the many criticisms raised against this rule led him to abandon it and replace—or at least supplement—it with clubs. The object of this paper is to retrace the steps that led Buchanan from marginal cost pricing to clubs.

Voluntary Exchange Theory, Benham and Clubs

To understand Buchanan’s theory of clubs, one must go back to his dissertation—“Fiscal Equity in a Federal State” (1948)—or to the preliminary version of “The Pure Theory of Government Finance” (1949a). In these works, Buchanan presented and defended the voluntary exchange theory of public finance that had been put forward by, among others, Luidi Einaudi, Maffeo Pantaleoni, Antonio de Viti de Marco, Erik Lindahl of Knut Wicksell. Buchanan’s arguments were close to those he made in the published version of the article—“The Pure Theory of Government Finance: A Suggested Approach” (1949b). However, for both obvious—a dissertation is longer than an article—and less obvious—one of the reviewers suggested to shorten a paper that he found too long—reasons, Buchanan removed certain references when he revised his article. One of these references is not without interest for the purpose of this chapter.

Buchanan might have had difficulties to find references written by English speaking economists about voluntary exchange theory. The theory had not attracted much positive comments in England or in the USA

(Johnson 2015). Henry Simons was one of those who had criticized it. Buchanan could not have ignored his criticisms of de Viti de Marco (Simons 1937) but, for some reason, did not cite him. He cited only Richard A. Musgrave and Frederic Benham, for having provided "a summary of the basic postulates of this theory" (1948, p. 50). The former had also criticized that theory (in particular, Musgrave 1939) while the latter had praised it. An Australian economist who taught at the London School of Economics and who later became a member of the Mont Pelerin Society, Benham had indeed found that Viti de Marco's *Principii di Economia Finanziaria* was "probably the best treatise on the theory of public finance ever written." (1934a, p. 364)[1]. He had also been the first to link de Viti de Marco and Wicksell—"the second part of Wicksell's *Finanztlheoretische Untersuchurngen* forms a good supplement to the present volume" (1934a, p. 366; see Johnson 2015). In an interview, Buchanan later declared that he had then been convinced that "Benham was right and Simons was totally wrong" and that "he understood the impact of [de Viti de Marco's] book" (in Mosca 2016, p. 124).

Buchanan did not refer to this review in his dissertation, but to another of Benham's article, also published in 1934, and tellingly entitled "Notes on the Pure Theory of Public Finance" (1934b). In that article, Benham was more specifically interested in reviewing Einaudi's *Contributo all ricerca della 'ottima imposta'* (1929), but in the course of his discussion, he also made a connection with the work of de Viti de Marco, Pantaleoni and Wicksell. Also, and of particular importance for our purpose, Benham proposed his interpretation of Einaudi's theory of "neutrality" of taxation that he linked to the a theory of the state.[2]

Thus, Benham started by noting that, according to him, Einaudi had only one "end … in mind" (1934b, p. 449) when he wrote about "optimal" taxation and it is "of having no ends" (1934b, p. 450). In other

[1]Simons had written that "[i]f his book is "the best treatise on the theory of public finance ever written," one hopes that it may be the last" (1937, p. 716)

[2]He wrote: "[t]he sketch has been given to illustrate and explain this concept [neutrality]. And it is this concept which, in my view, Einaudi has in mind" (1934b, p. 455; emphasis added).

words, he wants a "neutral" system of taxation and public expenditures, that is a system designed in order not interfere with taxpayers's preferences and choices, or that "translates into effect the voluntary judgments and preferences of the citizens, whatever they may be" (1934b, p. 450).

That said, Benham was left with a question about the institutions that could implement such a system. His answer was not empirical or historical. He proposed what he called "a logical explanation, from the economic angle, of why States continue to exist" (1934b, p. 451). He thus distinguished between two situations.

The first case is that of "a fairly small number of men in a certain area, without a State [who …] have equal incomes and tastes" (1934b, p. 451). These individuals may want goods and services that must be provided collectively. That happens for two reasons. First, these services would not be produced privately at all—"a private entrepreneur would not provide them at all" (1934b, p. 451)—because the benefits they generate are "indivisible" (1934b, p. 452) and individuals cannot be excluded from their consumption or, when benefits are divisible, entrepreneurs are reluctant to provide these services because they "would have to depend on voluntary subscriptions, and some would give little or nothing in the hope that others would give more" (1934b, p. 452). Then, second reason, the collective provision of these services is more efficient than private provision. Hence, to benefit from these services, individuals have to form a state. Benham equated this process with the one that consists to "form *clubs* and similar associations" (1934b, p. 451; italics added). He thus viewed clubs as groups of individuals who decide "to spend part of their incomes upon the collective provision of certain services" (1934b, p. 451). In a club, no voting rules is necessary to determine how much would be produced and how much individuals would pay. Having identical tastes and incomes, individuals—the members—would receive the same benefits from the use of the good and then would pay the same tax—"all would contribute equally, for incomes and tastes would be equal" (1934b, p. 452). All would also contribute "voluntarily" (1934b, p. 452) under a crucial condition: "provided the others also agreed" (1934b, p. 452).

The second situation Benham envisaged was that of a group of individuals which is no longer homogenous, which does not imply that it is larger in size. He then abandoned the analogy with clubs to characterize these heterogenous groups made of individuals with different incomes and tastes, "including those arising from their different locations or occupations" (1934b, p. 453). These individuals also want goods and services that must be provided collectively because the benefits they generate are indivisible. Now, because of the differences between individuals, they will not desire the same amount of goods and services or pay the same price to use them. Their benefits are necessarily different. Then, decisions on "expenditures and contributions" (1934b, p. 453) must be made by voting. To guarantee neutral taxation, the only satisfactory solution was to choose the program that "would meet with unanimous agreement" (1934b, p. 453). To him, "[t]he postulate of unanimous agreement [was] implied in the concept of neutrality" (1934b, p. 453). Of course, some groups of individuals will want goods that others will not desire. They might nonetheless unanimously agree to produce the good, provided that some compensation be paid to those who did not desire it. The one case in which unanimous agreement would not work was "if some persons declare themselves unwilling to contribute anything towards collective services" (1934b, p. 453). Because of the indivisibility of the benefits, they could not be prevented to consume these services. However, de Viti de Marco, that Benham quoted, was convinced this type of behavior was "negligible in number or as … pathological" (de Viti de Marco 1923, p. 114).

Thus, in both cases, individuals could be expected to voluntarily contribute to the provision of collective services—pay taxes—as long as they anticipate that others will also cooperate. The sum individuals willingly share with others determine the amount of collective goods or services that is going to be produced. And the role of the state is to collect taxes and provide the goods. Thus, this is a clearly individualist theory of the state—the latter implements what individuals want.

How much—if—Buchanan was influenced by Benham is hard to tell precisely. It nonetheless remains that his explanation of the existence of states was close to Buchanan's individualist theory of government (1948, 1949a, 1949b). It would thus not be surprising that Buchanan had been attracted by Benham's reading of Einaudi. In particular, Buchanan could have been interested by the example Benham chose to illustrate his analysis.

Roads: Benham, Wicksell and Buchanan

Benham thus compared the provision of roads in either of the two environments he envisaged. In small groups, roads could well ben provided by private entrepreneurs—"charging tolls" to users (1934b, p. 532)—but it would be more efficient if these goods were provided by the state: "the inconvenience of frequent stoppages to pay tolls could be overcome if the State provided "free" roads out of taxation" (1934b, p. 452). It is one of the case, in which "the State can provide [services which could be sold by entrepreneurs] to greater advantage" (1934b, p. 532). Similarly, the state should also provide roads in heterogenous groups, but the reason put forward was slightly different. Following what Wicksell had written in his *Finanztheoretische Untersuchungen*—the book that was so important for Buchanan and that had not be translated in English yet—Benham included roads in the category of goods that generate indivisible benefits "which would not have paid a private entrepreneur" (1934b, p. 454). The only means to finance them is by charging taxes and delegate the task to provide them to the State. The reason was "the State can charge different prices to different people while the entrepreneur cannot discriminate so completely, if indeed he can discriminate at all" (1934b, p. 454). Benham distinguished between the prices charged by private firms—that are identical for all consumers—from taxes—that can vary from one taxpayer to the other.

Roads, in Benham's analysis, may have reminded Buchanan that, in the early 1930s, he went to college in Murfreesboro—at the Middle Tennessee State Teachers College—"on a day-student basis" (2007, p. 35). Murfreesboro was only a few miles away from the village where Buchanan lived, but, in those years, even traveling only a short distance could have been quite difficult. The state of roads, that was bad in the South in general, was worse in Tennessee. The improvements that had taken place in the second half of the 1920s and in the 1930s remained insufficient. Farmers were particularly affected. They needed better roads to improve the delivery of their products to markets, to "break the railroad's monopoly on the shipment of farm products" (Pierce 2010) and also "end [their] social isolation" (Weingroff 2017, p. 7).

Yet, farmers had not seemed ready to finance roads. More precisely, until the beginning of the twentieth century, roads and highways were financed and maintained locally under the form of a "labor tax", that consisted in paying "their local taxes by spending a day or so each year actually working … on the improvement of their communities' public roads" (Preston 1991, p. 20). The system did not work very well: "[m]ost citizens never spent a day doing road work, preferring either to pay the small annual fine or to enlist the assistance of a local politician who had the power to grant a permanent exemption from the requirement" (Preston 1991, p. 22). To solve the problem, the state overtook the provision of roads and raised taxes to finance them. A property tax was then introduced but that was insufficient too because the there were more and more roads to be built and maintained. To solve the problem and raise enough money to finance and maintain roads and highways, states issued bonds—that counties were obliged to buy. The justification was indeed that "roads had come to be regarded as a general benefit, for which the general public should pay the larger part, if not all, of the cost" (Martin 1923, p. 73). In other words, that was the situation that Benham (and Wicksell) had described.

No difference was made however, in public policies, between state and local roads; all roads were treated as if they were the same type of public good, consumed by the same public. That had not appeared in Benham's typology either. But, also, no difference was made between users and non users. The first aspect was apparently not perceived but the second was. The increase in the size of the road network and in expenditures, and the insufficient amount of money generated by bonds, gave birth to the idea that motorists should pay for the surfaced or paved roads they were almost the only ones to use—"the building and maintenance of roads is in very large part a special service to the users of motor cars, and that, therefore, the motorists should be called on to pay most of the cost" (Martin 1923, p. 73). License fees were added to complement the resources provided by bonds, but they had two flaws: they were costly to implement and did not provide enough resources either. That was why was eventually introduced an earmarked tax for highways, the gasoline tax, first in Oregon in 1919 and in 1923 in Tennessee. Then, the road system really started to improve. That is, roads started to improve when a specific, earmarked, tax was adopted to finance them.

The centralized collection of the gasoline tax raised a specific problem: how to share the taxes collected by the state with the counties that needed them to built and maintain roads and highways? Answering the question was precisely the purpose of the master essay Buchanan wrote in 1941, when he was at the University of Tennessee, Knoxville. In his essay, Buchanan made a few points that deserve to be noted. First, Buchanan claimed that roads should be managed by the “state”. At least, he acknowledged that the cooperative solution—based on a “labor tax”, in which individuals were supposed to work “a few days per year spent in clearing of rights-of-way, grading, etc.” (1941, p. 13)—had not worked well—the system “was very inefficient and unsatisfactory” (1941, p. 13). And he noted that it had also been the case it had been private companies had taken over the provision of roads. This implied the need for a certain centralization in the collection of resources. Second, he accepted that roads should be financed via a gasoline tax—rather than by another of the other mechanisms that had previously been used, property tax or “labor tax”. The reason was that roads should be financed by those who use them. Indeed, and this is a third point, users receive benefits from using roads or, more globally, for consuming collective services.

In other words, Buchanan had found in the works of published economists answers to the some of the questions had discussed in 1941. These economists suggested that farmers may not have “paid” labor taxes because they had observed that others were not paying—the necessary condition for having a club was not satisfied. Also, it legitimized one of the intuitions he had had in his master essay—users should pay for roads but also that the state should collect taxes and built and maintain roads. It also allowed him to answer the question of how much should users pay. Benham had linked the tax to the individual benefits. Was it possible to be more precise and go further than Benham? Yes.

The Pricing of Highway Services

Indeed, reading Wicksell and using his insights, Buchanan could set up the basis that would allow him to explain how to price highway services. This is what he did in his first article specifically devoted to Wicksell (1951). He explained that public enterprises should “charg[e] fees equal to the marginal costs of providing the service and making up the deficit by tax revenues" (1951, p. 174). In the specific case of public enterprises that are already in operation, taxation would be used to cover fixed costs (1951, p. 176). However, these taxes should not be levied on *all* the taxpayers—including non users—way as said Harold Hotelling (1938) or Abba Lerner (1944). The type of pricing Buchanan envisaged was grounded in a benefit theory of taxation: taxes should be paid by "the individuals who benefit from the proposed enterprise" (1951, p. 176); "[t]he losses must be made up from "contributions" paid by those benefited" (1951, p. 178) or Wicksell's solution "does not require collection of taxes from any one other than the specific beneficiaries" (1951, p. 178). Actually, as he himself stressed it, his approach was "similar to the multi-part pricing systems proposed by Coase and others" (1951, p. 178; see Coase 1946). With a difference: "voluntarism" (Buchanan 1951, p. 178). He did not doubt that individuals, who receive benefits from using certain gods, would pay the taxes they were asked to pay. And, another difference that Buchanan did not mention yet, discrimination among taxpayers.

That Buchanan had a theoretical frame about the pricing of road or highway services in the early 1950s was particularly timely. Indeed, in the immediate post-WWII U.S.A., roads still represented "major social problem" (Buchanan 1952, p. 97). A problem that was nonetheless slightly different than in Tennessee in the 1930s. It was no longer a matter of how to share a sum between different levels of government but rather how to find these funds. And, another difference, one was talking of state or national roads only and no longer of local roads. As Buchanan noted, it was now "an area of emerging national importance" (1958, p. xvii). The problem had two dimensions: on the one hand, the size of the network was insufficient to face, on the other hand, the increasing traffic flow. To deal with this twofold problem, the government was trying to build more infrastructures and expand the size of the network—without realizing that there was an optimal traffic flow for each given network. Buchanan then suggested to rather focus on the regulation of the traffic flow, that is on the use—or consumption or demand—of the network. And economists knew how to do that: by using of a price mechanism. They also knew how to determine the price that would lead to an optimal traffic flow, namely by setting the price at the level of the marginal cost. This is precisely what he explained in the first article in which he applied Wicksell's theory, "The Pricing of Highway Services" (1952).

But, and Buchanan certainly did not ignore this aspect, roads are what would later be known as impure public goods; the quality of the services they provide depends on the number of users; congestion reduces this quality and creates a "'spillover' cost represented in poorer service provided all users" (Buchanan 1952, p. 100). This did not represent an obstacle to the use of a price mechanism but was rather a condition that could not be neglected. The price to charge still had to be set at the level of the marginal cost but spillover costs had to be included in the calculus. Thus, the "correct price" for highway services correspond "to the marginal social cost incurred in providing a unit of that type of service" (1952, p. 100). And, of course, as said in the 1951 article, this was a realistic solution since individuals were be ready to pay a price even if it included the external costs imposed on others because of the benefits they receive from using roads and highways.

Buchanan repeated the same claim in different notes he wrote around the mid-1950s in preparation for his article on "The Road Case Re-Examined" (1956). In a first note—"Resource Allocation and the Highway System"—Buchanan explained his purpose: to determine "the proper amount of the nation's economic resources which should be devoted both to the utilization and the construction of the highway system" (1954a, p. 1). But he was perfectly aware of the "external diseconomies in the consumption or utilization of highway services" (1954a, p. 2). In another note, written during the fall of 1954 and entitled "Consumption Interdependence and the Interpretation of Social Cost", Buchanan insisted again that "[i]n the presence of either external economies or diseconomies of consumption, the competitive economy should not appear to allocate resources properly." (1954b, p. 2).

Yet, he still believed that one should use prices. He insisted that "it is necessary that the prices of highway services be set equal to the marginal *social* costs of providing such services" (1954a, p. 6; emphasis added); or that the price "includes the incremental costs (or reduced enjoyments) imposed upon other road users!" (1954a, p. 6). Or, in 1955, "[t]he answer to the whole highway problem lies in "pricing" the highway correctly. The existence of congestion on our streets and highways is solely due to the fact that we do not charge high enough "prices" for their use. This is one of the main functions of price in our free enterprise economy" (1955b, pp. 14–15).

Eventually, in "The Road Case Re-examined", he wrote that he only "meaningful criterion for operational efficiency" (Buchanan, 1956, p. 315) was such that "the government… own the roads and price the road services at the level of marginal social cost" (1956, p. 315). That result indeed combined what Benham had written about Wicksell—roads should be built and maintained by the state, even if a club of users existed—and what he had put forward about the pricing of road services in terms of marginal social cost.

Some Criticisms of Benefits and Marginal Cost Pricing

Pricing public goods as it could be done with private goods was not easily admitted. One of the strongest criticisms was Paul Samuelson's. In his famous "A Pure Theory of Public Expenditure" (1954), he reached definitive negative conclusions about the possibility to use a decentralized mechanism—including voting—to lead individuals to pay a price corresponding to their marginal rate of substitution between a private and a public good. The only condition that one could impose to reach an optimal allocation of resources bore, as it is well known, on the sum of the individual marginal rates of substitutions. Prices, or taxes, could not be individualized—at least not according to individual benefits. Pricing public goods by using a benefit theory of taxation as it was done with private goods was impossible (Samuelson 1954, p. 389).[3] This implied,

[3]Samuelson "emphasize[d] this: taxing according to a benefit theory of taxation can not at all solve the computational problem in the decentralized manner possible for the first category of "private" goods to which the ordinary market pricing applies and which do not have the "external effects" basic to the very notion of collective consumption goods" (1954, p. 389). As noted by Maxime Desmarrais-Tremblay, another argument was that marginal cost pricing could not be used for public goods or in the case of decreasing costs because it would to set zero prices (2016, p. 133).

by extension, that marginal social cost pricing could not be used for pure public goods.

Buchanan almost immediately wrote a comment that he first sent to Julius Margolis in January 1955 and then to Samuelson in February. He defended the idea that a benefit theory of taxation could not be abandoned. The reason lied precisely in the fact that the prices for public goods may differ from one individual to the other—they "depend upon the manner in which the real costs of the collective goods are allocated among individuals, that is, on the structure of the tax system" (1955a, p. 3). This means that any change in the quantity of supplied public good will be borne differently by all the individuals; some will pay more than others. Hence, to guarantee the Pareto optimality of the change in the supply of a public good, one had to be sure that the gains of the winners will not be made at the expense of the other individuals. Hence, one had to add a condition to guarantee how the marginal costs would be distributed among individuals. He then suggested that the "tax bill" or the "tax burden" should be allocated according to a benefit principle, that is by guaranteeing that "each individual must equate the marginal rate of substitution in consumption between any one collective and private good with the marginal rate of substitution between these two goods for him" (Buchanan 1955a, p. 3; emphasis in original). Hence, to push Buchanan's analysis one small step further, this condition about the sharing of the marginal costs of the provision of an additional unit of public good could restore the marginal social cost pricing rule.

Samuelson was not, however, the only one who criticized the pricing of public goods. For instance, Oscar Brownlee and Walter Heller agreed that "highway services should be priced in much the same manner as other services would be priced in a competitive market" (1956, p. 237), citing Buchanan as one reference on that. They nonetheless insisted on the practical difficulty to collect information about how motorists use highways and which prices they should pay. Hence, to them, "deciding precisely what prices should be charged for each of the various kinds of services would prove to be a difficult [problem] to solve" (1956, p. 237).

Shortly after—his paper was published in August 1957—Margolis also reached a pessimistic conclusion about the possibility to price a public service. He studied the case of an irrigation project, noting a decision about building a dam and distributing water had two dimensions. First, one had to determine the optimal size of the dam and the network. Margolis demonstrated why this optimal size should be such that "the value of the marginal product of water is equal to the marginal cost of providing the water" (1957, p. 451). Second, one had to price the use of the system. Among the different possible systems that could be used, Margolis concluded that "[a] two-part, or a discriminatory, pricing system, or a combination of both, is necessary to allocate water efficiently" (1957, p. 462). Indeed, "it achieves the optimal output, since the price of the marginal unit purchased by each consumer equals its marginal cost" (1957, p. 452)—in other words, he agreed with Buchanan. In addition, did he add, this method "permit[s] projects to be financially independent and thereby autonomous" (1957, p. 462). Then, he nonetheless also stressed "that efficient pricing practices are unlikely" (1957, p. 462). Inefficiencies in government production should be accepted. That was unavoidable. He thus also agreed with Samuelson.

Also in 1957, was published "The Theory of Public Utility Price-An Empty Box", written by Jack Wiseman who concluded that "no general pricing rule or rules can be held unambiguously to bring about an 'optimum' use of resources by public utilities, even in theory" (1957, p. 56). Wiseman criticized Hotelling's marginal cost pricing and multi-part pricing "both in its simple form and as modified by a 'club' principle" (1957, p. 57). According to this principle, rather than paying "a price per unit equal to marginal cost" (1957, p. 64), each consumer pays "a fixed charge … that part of the common cost that he has stated his willingness to bear" (1957, p. 64). But, to Wiseman, clubs do not really involve voluntarism—individuals' "agreement [is] 'voluntary' … in the special sense that a malefactor voluntarily goes away to prison after a judge has sentenced him; he chooses the best alternative still available" (1957, p. 66). The only type of clubs that Wiseman viewed acceptable in terms of voluntarism was "the *direct production club* … created and administered by the consumers themselves" (1957, p. 66; emphasis in original). But it "seem[ed] unlikely to be of widespread importance" (Wiseman 1957, p. 67). Thus, the club version was no more satisfactory than the simple version of multi-part pricing.

Buchanan did not immediately react to Margolis's or Wiseman's articles. There is no direct evidence that he read them, but one may assume that he did. At least, he was sufficiently interested in the question to invite Brownlee to present a paper at the conference on "Public Finances: Needs, Sources, and Utilization" he organized in 1959—Tiebout and Musgrave and also Margolis attended the conference. In his paper, "User Prices vs Taxes" (1961), Brownlee developed the same kind of reasoning as in his 1956 article on highways. He explained that he "favor[ed] using price as a rationing device wherever a reasonable opportunity exists" (421), and compared the pricing of highway services to the pricing of education and being more favorable to pricing of education services than highways'. But, he also concluded that "[a]llocating government services by pricing them has limited applicability" (432). A skepticism that Buchanan eventually shared, since he accepted the view that marginal cost pricing or multi-part pricing should be abandoned. And then chose club financing instead. Before he came to that, however, he made other steps that also contribute to his analysis of clubs.

Problems with Majority Voting

As said above, part the criticisms against pricing public goods bore on the difficulty to determine prices. "The solution "exists"", had written Samuelson, "the problem is how to "find" it" (1954, p. 389). Buchanan could not ignore it. Meeting Gordon Tullock—in 1958—led him to study and write about that problem. From this perspective, *The Calculus of Consent* (Buchanan and Tullock 1962) provides an answer to Samuelson in that it shows that majority voting rules are imperfect but also decisions about the provision and pricing public goods and the internalization of externalities could efficiently be made via *voluntary* private arrangements, rather than through government intervention: if property rights are correctly defined, "voluntary cooperative arrangements among individuals emerge to insure the elimination of all relevant external effects" (Buchanan and Tullock 1962, p. 44). To them, there was no doubt that individuals were willing to organize—spontaneously and voluntarily—collective actions between them to deal with externalities. However, they departed from the position that consists in claiming that individuals would always voluntarily cooperate with others to which Buchanan had stuck since the 1940s. From this perspective, two chapters—ten and eleven—based on articles respectively written by Tullock and Buchanan deserve particular attention.

Chapter 10 of *The Calculus of Consent* was based on Tullock's "Problems of Majority Voting" (1959) and bore on a question that could not but interest Buchanan: the repair and maintenance of roads in a community of farmers. The issue was political in that the decisions about which roads would be repaired and how much each farmer would pay were made by voting—using a majority rule. Farmers were asked to vote for proposals of repair and maintenance of their own and also of others' roads. Tullock took as a democratic benchmark—the Kantian solution—the situation in which individuals "vote to repair a given road in the same way as he would vote for repairs his own road" (Tullock 1959, p. 573). Kantian farmers were thus those who follow a sort of Kantian ethical rule. Would individuals behave as Kantians?

No, explained Tullock: "any individual farmer" has interest in behaving as a maximizer, if he expects others to behave as Kantians. That is, he has an interest in voting only in favor of proposals to repair their road and against the proposals aimed at repairing the roads used by other famers. Indeed, "his taxes would be reduced, or his road kept in better-than-average repair" (1959, p. 574). If other farmers imitate him, this would increase the standard of repair on their roads, decrease the standard of repair on others' roads while reducing their share of the costs and increasing the costs incurred by other taxpayers (1959, p. 574).

On the whole, the general level of repair of the roads would be lower in a community in which individuals behave as maximizers rather than as Kantians. And that would be at the advantage of maximizers and at the disadvantage of Kantians since the latter support the cost of repair of the roads of the maximizers who, by contrast, only pay for the repair of their own roads or those of the members of their coalition. Kantians are "exploited by the maximizers" (1959, p. 574). Then, since "virtue

… conspicuously is not paying" (1959, p. 575), they become "tired" (1959, p. 574) of "never hav[ing] his own road repaired [while] pay[ing] heavy taxes for the support of repair jobs on other roads" (1959, p. 576) and eventually "switch to a maximizing pattern of behavior" (1959, p. 574). To be more precise, there exists a threshold in the number of maximizers within the group of farmers under which Kantians accept to be exploited. Kantians tolerate a certain number of maximizers in the community before departing from the moral rule. When the proportion of maximizers becomes too important, Kantians too change their behavior and become maximizers.

Thus, Tullock provided another explanation to the failure of the labor tax Buchanan had heard about when he was young, and mentioned in his master essay: some of the farmers were maximizers and refused to cooperate, even if other were ready to cooperate. That implied, as a corollary, that individuals could free ride, even in small groups or, in other words, that homogeneity in tastes and incomes did not guarantee that individuals would cooperate. Benham's clubs seem to lose consistency. In addition, Tullock also demonstrated that "the system of majority voting is not by any means an optimal method of allocating resource" (1959, p. 579). Under majority voting, some individuals could impose taxes that would exceed the benefits they receive from consuming collective goods.

Buchanan developed the same ideas in a few papers that he wrote at the same time. Thus, in "Simple Majority Voting, Game Theory and Resource Use" (1961)—the paper was submitted for the first time in August 1960—Buchanan extended and deepened Tullock's analysis.[4] Starting with the same problem—farmers and road repair—he discussed how collective decisions could be made in a simple majority voting process. Then, like Tullock and even though he did not refer to Kant, Buchanan distinguished behaving ethically or morally—that is being "interest[ed] in the welfare of his fellow citizen" (1961, p. 340)—from utility maximization. And his conclusion was similar to Tullock's:

[4]The paper appears under the title "Simple Majority Voting and The Theory of Games" in *The Calculus of Consent* (1962, Chapter 11, pp. 143–164).

> as the size of the group increases, any tacit adherence to moral or ethical principles that might inhibit individual utility-maximizing behaviour becomes more difficult to secure. … the individual's interest in the welfare of his fellow citizen falls off sharply as the group is enlarged. (1961, p. 340)[5]

Hence, one should distinguish small groups—in which individuals cooperate—from large ones—individuals no longer cooperate because the ethical rule of behavior loses strength. This was the first occurrence of that idea about "numbers" that Buchanan will insist on over the next few years (see Marciano 2016). It started with "Ethical Rules, Expected Values, and Large Numbers" (1965b), an article that Buchanan wrote as an extension of his papers on clubs. On March 15, 1965, he wrote Roland McKean about "a piece that I plan to send off to an ethics journal… it spells out the importance of small numbers."[6]

But in the early 1960s, Buchanan rather insisted on another problem: coalitions that could impose costs on minorities. He made that point in a discussion of the case of the provision of purely collective goods that "provide equal benefits to all members of the group" but "are financed by taxes that may be levied in a discriminatory fashion among the separate individuals and groups in the population" (1961, p. 344). He then demonstrated that "[*a*]*ny* project yielding general benefits … will tend to be approved by the dominating majority *if* they are successful in imposing the full tax cost onto the shoulders of the minority" (1961, p. 344; emphasis added). Which not only meant that there was not limit to social wastage but also that these wasteful public projects benefit to the members of the majority while being paid by the members of the minority—they pay "differentially higher taxes" (1961, p. 345). It was a situation that Buchanan had identified as preventing

[5]That was also a point one also finds in "A Note on Public Goods Supply" co-authored with Milton Kafoglis: even if private arrangements could be said to be efficient, there were circumstances in which they would be too costly to organize, in particular, did they write, "when the interactions extend over a large number of persons" (1963, p. 412).

[6]Buchanan to Roland McKean, March 15, 1965, BP.

the use of the marginal cost principle *à la* Wicksell (1951, p. 176). Indeed, the price paid by the members of the minority does not correspond to their marginal benefit nor to the marginal social cost their activity generates.

The problem might be corrected—and social wastage avoided. First, if the principle of discriminatory taxes to finance collective projects was abandoned (1961, p. 345). In that case, individuals could be expected to vote in comparing or "balanc[ing] off some pro rata share of total marginal benefits against an appropriate pro rata share of total marginal costs" (1961, p. 345). Thus, the benefit principle would be rescued and one could then envisage to use again the marginal cost pricing rule. But, added Buchanan, unless constitutionally forced to do so, no majority would ever propose a project that does not generate "differential benefits, differential taxation, or both" (1961, p. 345).

Another solution was envisaged in a paper that Buchanan also wrote in 1960—but that was published in 1962—"Politics, Policy, and the Pigovian Margins" (1962). He was then trying to understand under which conditions majority voting would remove what he called the "Pigovian divergence", that is the difference between the marginal private and social costs. To him, this was possible only when each individual "is required [to vote] by includ[ing] in his calculus a share of the total marginal cost … that is proportional to his individualised share of the total marginal benefits" (1962, p. 26). Here, taxes could vary from one individual to the other but the result would be the same: "the individual voter must pay for the marginal unit of the collective good or service in proportion to the marginal benefit enjoyed" (1962, p. 26). Yet, such a cost-sharing mechanism was "politically unimaginable" (1962, p. 27) and "conceptually impossible" (ibid.). Hence, it was "of little practical value" (1962, p. 28). No realistic mechanism existed that could prevent the members of the majority to oblige the members of the minority to pay more than their share of the total marginal costs. A conclusion that seemed to imply that the marginal social cost pricing rule to which Buchanan had stuck since 1951 was not going to be used if decisions were made at the majority. Did this mean that he was no longer convinced by the marginal cost pricing rule? And would this not imply that Samuelson was right (and that pricing of public goods should also be abandoned)?

From Marginal Social Cost Pricing to Club Pricing

Buchanan made the step from marginal cost pricing to clubs between 1962 and 1964. As he wrote George S. Tolley, when discussing of the possibility to present papers in February 1965 at North Carolina State—the branch of the University of North Carolina in Raleigh—,

> I could talk on "An Economic Theory of Clubs", which will be published soon in Economica. Or alternatively, I could talk on the topic "Some Fallacies in the Interpretation of Highway Costs", a paper that I have not written, but which I hope to get started on during this term.[7]

A few days later, Buchanan gave additional details about that paper on highway costs. He wrote that he had, "influenced by Davis-Whiston on externalities, now come to the view that all the stuff on trying to 'price' highways by measuring marginal costs of congestion, a position that [he] firmly supported in past, is conceptually wrong because it is impossible."[8]

Buchanan was probably referring to "Externalities, Welfare, and the Theory of Games" (1962), in which Otto Davis and Andrew Whinston had demonstrated that the marginal cost pricing rule could be used only when (technological) externalities are separable (1962, p. 247).[9] Now, the externalities generated by highway users were obviously non-separable since indirect marginal social costs "clearly increase in some direct relation to traffic density" (Buchanan 1952, p. 100). Indeed, he had to abandon his objective to price highway services at their marginal social cost. Did it imply that one should no longer price highway services, as Samuelson and others had suggested? No. Buchanan then noted that "the use of price to restrict usage to some "optimal" level of traffic remains relevant [but], we should, I now think, come at price

---

[7]Buchanan to Tolley, October 7, 1964, BP.

[8]Buchanan to Tolley, October 19, 1964, BP.

[9]An externality is separable if the consumption or output of *i* does not affect the marginal utility or cost of *j*. Otherwise, it is non-separable.

differently, and not via the cost side at all."[10] How should it be done? Precisely by using the ideas he had on clubs, did he write. This is where we must refer to "The Highway Network Considered as a Club".[11]

In this draft, Buchanan first discussed the approach that he had defended for more than a decade, that consists in pricing highway services at the marginal social cost. That rule could not be used in the case of highways as it could—one would note the example chosen—for water-supply facilities. The use of such facilities could be rationed by charging a specific price or tariff. This is what Margolis had demonstrated in 1957, concluding also that this would generate a revenue sufficient to cover also the investment costs. That was not the case with highways that are "fixed facilities with private adjustments" (1964; emphasis in original) and for which "the government provides, or supplies not a final quantity of services, but, instead a fixed quantity, which, depending on how it is utilized may produce varying amounts of final output." Then, a two-part tariff could lead to an optimal use but, even if congestion costs were computed and included in the tariff, would not guarantee that the revenue thus generated would be sufficient to cover the investment in the facility. To deal with the problem, Buchanan used the concept of "club". Put differently, he switched from two-part pricing in its simple form to two-part pricing in its *club* form.

As he would do in his 1965 article, Buchanan defined clubs as cost-sharing arrangements—"a club as an organization of persons designed solely for the objective of utilizing a single communal community. Each "member" contributes to the common cost of maintaining the facility and each member also envisages the benefits of its availability" (1964). Beyond the definition in itself—which is interesting because it establishes a connection with Wiseman and Benham—it is important to note the twofold objective Buchanan assigned to clubs: to "determin[e] the most "efficient" size of the commonly-used facility, along with the

[10]Buchanan to Tolley, October 19, 1964, BP, George Mason University, Library, Special Collections.

[11]We refer to this manuscript as one unique document dated from 1964.

most "efficient" size membership of the club" (1964). Hence, the optimal network was the point for which "the optimal size of facility for a given traffic flow be equal to the facility that generates the same traffic flow as optimal" (1964).

Obviously, in the same community, individuals could not be allowed to use different highway networks. The size of the facility had to be chosen in the first place. Without giving much details, Buchanan wrote that if this collective choice respected individual preferences—he noted that it *should* be the case in a democratic economy—, then the chosen network would be the one "collectively judged to be efficient of optimal" (1964). The optimal size of the facility was reached when "the marginal gains from an increased size just equal the marginal costs" (1964). Then, once this optimal network had been chosen, one could choose the optimal traffic flow, the optimal number of users—that is the optimal size of the club. It would be "attained when the marginal benefits secured from adding another unit of traffic is just equal to the marginal costs" (1964). The goal was thus to charge an individual fee that would allow to reach this point.

But then, there remained the criticism Wiseman had raised against clubs and the impossibility to respect voluntarism and to impute costs to individuals without coercion. It seems that Buchanan had only repeated exactly what Wiseman had already rejected. Yet, Buchanan could not accept a criticism that challenged his Wicksellian approach of the relationships between individuals and the state. This is precisely why, according to us, he explained that, with clubs, there was no need to determine the spillover costs and to impute them to individuals. By contrast with marginal social cost pricing, spillover costs were no longer taken into account in the price charged to users but rather through the decrease in benefits due to the increase in the number of users:

> [t]he club approach, by contrast, involves no attempt to impose a charge on users that reflects spillover congestion costs. Users pay a share in the common costs of providing the facility; costs that are initially borne by the supply providing agency. The costs of congestion enter the analysis through their effects on the estimated benefits to be received by final consumers. (1964)

Thus, to a certain extent, they were no longer included as costs but as foregone benefits. In other words, clubs were pricing mechanisms that could replace two-part pricing. He could safely "abandon" marginal social cost pricing: he had found another way of pricing the use of highways.

Conclusion

Early in his career, Buchanan acquired the conviction that public goods should be priced—like private goods—at their marginal cost. Taxes could complementarily be used to cover losses a public enterprise would incur because of this rule. In addition, those prices should be set at the marginal *social* cost to include the spillover costs that using public goods generate. That method of pricing public goods was known as a form of two-part pricing. In many of his writings about highways and roads, Buchanan repeated that highway services should be priced at their marginal social cost. But, at some point, because of the many criticisms that had been raised against this rule, he switched to "club" pricing. The move seems to have been inspired by Wiseman: the note he wrote about highways as clubs answered the latter's criticism against clubs. Clubs were thus, this is the claim we defend in this chapter, a means to replace marginal social cost pricing—or multi-part tariffs—that had become increasingly difficult to defend without abandoning the objective of pricing public goods and services.

References

BP—Buchanan Papers: James M. Buchanan's Archives, Special Collections Research Center, George Mason University Libraries, George Mason University.

Benham, F. C. (1934a). Review *Principii di Economia Finanziaria* by A. De Viti de Marco; *Grundlehren der Finanzwirtschaft* by A. De Viti de Marco. *Economica, 1*(3), 364–367.

Benham, F. C. (1934b). Notes on the Pure Theory of Public Finance. *Economica, 1*(4), 436–458.

Boettke, P. J., & Marciano, A. (2017). The Distance Between Buchanan's "An Economic Theory of Clubs" and Tiebout's "A Pure Theory of Local Public Expenditures". New Insights Based on an Unpublished Manuscript. *European Journal of the History of Economic Thought, 24*(2), 205–237.

Buchanan, J. M. (1941). *Gasoline Tax Sharing Among Local Units of Government in Tennessee*. Master's Thesis, University of Tennessee. http://trace.tennessee.edu/utk_gradthes/2683.

Buchanan, J. M. (1948). *Fiscal Equity in a Federal State*. University of Chicago, Ph.D.

Buchanan, J. M. (1949a). The Pure Theory of Government Finance: A Suggested Framework. Mimeo, BP.

Buchanan, J. M. (1949b). The Pure Theory of Government Finance: A Suggested Approach. *Journal of Political Economy, 57*(6), 496–505.

Buchanan, J. M. (1951). Knut Wicksell on Marginal Cost Pricing. *Southern Economic Journal, 18*(2), 173–178.

Buchanan, J. M. (1952). The Pricing of Highway Services. *National Tax Journal, 5,* 97–106.

Buchanan, J. M. (1954a). Resource Allocation and the Highway System. Mimeo, BP.

Buchanan, J. M. (1954b). Consumption Interdependence and the Interpretation of Social Cost. Mimeo, BP.

Buchanan, J. M. (1955a). Painless Pavements: Highways by High Finance. Mimeo, BP.

Buchanan, J. M. (1955b). A Note of the Pure Theory of Public Expenditure. Mimeo, BP.

Buchanan, J. M. (1956). Private Ownership and Common Usage: The Road Case Re-examined. *Southern Economic Journal, 22*(3), 305–316.

Buchanan, J. M. (1958). *Public Principles of Public Debt: A Defense and Restatement*. Homewood, Ill.: Irwin.

Buchanan, J. M. (1961). Simple Majority Voting, Game Theory and Resource Use. *Canadian Journal of Economics and Political Science, 27*(3), 337–348.

Buchanan, J. M. (1962). Politics, Policy and the Pigovian Margins. *Economica, 29*(113), 17–28.

Buchanan, J. M. (1964). The Highway Network Considered as a Club. Mimeo, BP.

Buchanan, J. M. (1965a). An Economic Theory of Clubs. *Economica, 32*(125), 1–14.

Buchanan, J. M. (1965b). Ethical Rules, Expected Values, and Large Numbers. *Ethics, 76*(1), 1–13.

Buchanan, J. M. (2007). *Economics from the Outside in: "Better Than Plowing" and Beyond*. College Station, TX: Texas A&M University Press.

Buchanan, J. M., & Kafoglis, M. Z. (1963). A Note on Public Goods Supply. *American Economic Review, 53*(3), 403–414.

Buchanan, J. M., & Tullock, G. (1962). *The Calculus of Consent: Logical Foundations of Constitutional Democracy*. Ann Arbor: University of Michigan Press.

Brownlee, O. H. (1961). User Prices Versus Taxes. In J. M. Buchanan (Ed.), *Public Finances: Needs, Sources, and Utilization* (pp. 421–432). National Bureau of Economic Research. Princeton: Princeton University Press.

Brownlee, O. H., & Heller, W. W. (1956). Highway Development and Financing. *American Economic Review, 46*(2), 232–250.

Coase, R. H. (1946). The Marginal Cost Controversy. *Economica, 13*(51), 169–182.

Davis, O. A., & Whinston, A. (1962). Externalities, Welfare, and the Theory of Games. *Journal of Political Economy, 70*(3), 241–262.

Desmarais-Tremblay, M. (2016). *La théorisation des dépenses publiques de Richard A. Musgrave: essai d'histoire de la pensée et d'épistémologie économiques. Economies et nances*. Université Paris 1 Panthéon-Sorbonne; Université de Lausanne. https://hal.archives-ouvertes.fr/tel-01475790.

De Viti de Marco, A. (1923). *First Principles Of Public Finance*. London: Jonathan Cape.

Einaudi, L. (1929). *Contributo all ricerca della 'ottima imposta'*. Milano: Università Bocconi Editrice.

Hotelling, H. (1938). The General Welfare in Relation to Problems of Taxation and of Railway and Utility Rates. *Econometrica, 6*(3), 242–269.

Johnson, M. (2015). Public Goods, Market Failure, and Voluntary Exchange. *History of Political Economy, 47*(Annual Supplement 1), 174–198.

Lerner, A. P. (1944). *The Economics of Control*. New York: Macmillan.

Marciano, A. (2016). Buchanan's Non-Coercive Economics for Self-Interested Individuals: Ethics, Small Groups and the Social Contract. *Journal of the History of Economic Thought, 38*(1), 1–20.

Marciano, A. (2018). Buchanan and Public Finance: The Tennessee Years. *Review of Austrian Economics*. https://doi.org/10.1007/s11138-018-0419-2.

Margolis, J. (1957). Welfare Criteria, Pricing and Decentralization of a Public Service. *Quarterly Journal of Economics, 71*(3), 448–463.

Martin, J. W. (1923). The Gasoline Tax. *The Bulletin of the National Tax Association, 9*(3), 73–87.

Mosca, M. (2016). *Antonio de Viti de Marco A Story Worth Remembering*. New York: Palgrave Macmillan.
Musgrave, R. A. (1939). The Voluntary Exchange Theory of Public Economy. *Quarterly Journal of Economics, 53*(2), 213–237.
Pierce, D. (2010). *Good Roads Movement, The Tennessee Encyclopedia of History and Culture*. http://tennesseeencyclopedia.net/entry.php?rec=554.
Preston, H. L. (1991). *Dirt Roads to Dixie: Accessibility and Modernization in the South, 1885–1935*. Knoxville: University of Tennessee Press.
Samuelson, P. A. (1954). The Pure Theory of Public Expenditure. *Review of Economics and Statistics, 36*(4), 387–389.
Simons, H. C. (1937, October). Review of the First Principles of Public Finance, by Antonio de Viti de Marco. *American Economic Review, 45*, 712–717.
Tiebout, C. M. (1956). A Pure Theory of Local Expenditures. *Journal of Political Economy, 64*(5), 416–424.
Tullock, G. (1959). Problems of Majority Voting. *Journal of Political Economy, 67*(6), 571–579.
Wagner, R. E. (2017). *James M. Buchanan and Liberal Political Economy*. Lanham and London: Lexington Books.
Weingroff, R. F. (2017). *Creation of a Landmark: The Federal Aid Road Act of 1916*. https://www.fhwa.dot.gov/highwayhistory/landmark.pdf.
Wiseman, J. (1957). The Theory of Public Utility Price-An Empty Box. *Oxford Economic Papers, 9*(1), 56–74.

Part V

Economic Theory as Social Theory

33

In Defense of (Some) Vainglory: The Advantages of Polymorphic Hobbesianism

Gerald Gaus

> So that in the nature of man, we find three principall causes of quarrell. First, Competition; Secondly, Diffidence; Thirdly, Glory.
>
> The first, maketh men invade for Gain; the second, for Safety; and the third, for Reputation. The first use Violence, to make themselves Masters of other mens persons, wives, children, and cattell; the second, to defend them; the third, for trifles, as a word, a smile, a different opinion, and any other signe of undervalue, either direct in their Persons, or by reflexion in their Kindred, their Friends, their Nation, their Profession, or their Name.
>
> —Hobbes, *Leviathan*

A Janus-Faced Feature of Social Cooperation

In the *Limits of Liberty* (1975) James Buchanan develops a Hobbesian-inspired analysis of why and how rational individuals would abandon the state of nature and accept a constitutional order. On Buchanan's

G. Gaus (✉)
University of Arizona, Tucson, AZ, USA

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_33

(1975, p. 26) reading, Hobbes's analysis assumes that all agents act according to "narrowly defined self-interest" (cf. Chung 2016). Although Buchanan (1975, p. 80) insists that his own model does not suppose that each acts only out of self-interest, his guiding aim is to show "how 'law,' 'the rights of property,' 'rules for behavior' might emerge from the nonidealistic self-interested behavior of men" (Buchanan 1975, p. 54). Buchanan's insight is that truly rational, self-interested, agents are apt to learn that mutual invasion for gain is a sucker's game; if one can count on others being as sensible as oneself, it is not hard to model an end to the state of war. Narrowly self-interested agents will come to see the possibility and desirability of a Pareto-superior moves from the state of nature: although each prefers more goods to less and is not concerned with improving the lot of others, each can see that cooperation, not conflict, best promotes one's interests. Sensible, prudent, egoists are the sorts of folks one can do business with and with whom one can reach constitutional terms for ending the state of war. Perhaps they will be tempted to secretly cheat on the rules of peaceful cooperation, but they grasp the critical importance of general compliance with such rules.

Hobbes's state of nature, however, is populated by a second type of agent: glory-seekers who are apt to make war "for trifles, as a word, a smile, a different opinion, and any other signe of undervalue" (Hobbes 1994, p. 76). A recent game theoretic analysis of conflict in Hobbes's state of nature identifies glory-seekers as the real root of instability (Chung 2015). While narrowly self-interested individuals can grasp that conflict leaves them all in a Pareto-inferior position, glory-seekers are willing to turn their backs on mutual benefit, and make everyone worse off, for any "signe of undervalue."

In this essay I argue that vanity is a Janus-faced feature of social cooperation: while, as Hobbes stresses, it certainly can lead to conflict, its very insensitivity to Paretian gains motivates enforcing norms of fairness. A society composed of both egoists and glory-seekers is thus more likely to stabilize fair terms of cooperation than even the most enlightened society of self-interested agents. Rather than, as in many economically-inspired analyses of social order, assuming a society of purely self-interested agents (which, on some views, defines *homo economicus*, see Gaus 2008, pp. 19–27), we would do better to model polymorphic populations, containing multiple agent types.[1]

I first examine what I call the "Paretian exploitation of egoists." Straightforward egoists of the kind celebrated in accounts of mutual benefit such as Buchanan's are often stuck with accepting very small gains—and we will see why many have thought this is a deep feature of their rationality. However, as is well known, Ultimatum Game experiments indicate that in a wide range of contexts people do not submit to Paretian exploitation: they prefer nothing to small gains. I then consider several ways that these results have been explained: I suggest that the most satisfying is an account based on social norms of fairness, which enhance cooperation and help self-interested agents avoid Paretian exploitation. This, however, drives us to a deeper puzzle: why do some individuals refuse miserly offers and so uphold fairness norms? I survey a number of experiments that have identified negative emotions as critical in the decision to refuse small gains, especially when they run counter to fair sharing. I close by returning to the more general idea of pride, arguing that its critical role in upholding fair share norms is supported by these experiments. I thus advance a hypothesis: an aversion to being undervalued by others—a willingness to turn one's back on schemes of mutual benefit when one feels insulted—is an important support for schemes of fair cooperation, independent of both pro-social egalitarian preferences and to a considerable extent even the normative expectations of others.

[1]Buchanan (1975, p. 118) sometimes pursues this possibility.

Paretian Exploitation

Rational Traps

For our purposes, two core commitments of the orthodox conception of rationality are of interest (Gaus 2011, pp. 63–70).

> *More is Better than Less*: In any given choice Alf will always choose a greater over a lesser value.
>
> *Modularity*: At each point in a decision tree, Alf will choose that course of action which, from that point on, leads to the greatest value.

More is better than less seems basic to the very idea of a rational agent. "The simplest definition of rationality…is that one should choose more rather than less value" (Hardin 2003, p. 16). When faced with a choice where the only considerations are between the satisfaction of valued goal *G* to degree *p* and the satisfaction of *G* to level *q*, where *p* is greater than *q*, a rational agent will choose *pG* rather than *qG*. *Modularity* is an interpretation of *More is Better than Less*: it insists that when a person employs *More is Better than Less*, she is only concerned with, as it were value from "here on out." To see *Modularity* at work—in a case where it seems worrisome to many—consider David Gauthier's (1994, p. 692) adaptation of a tale from Hume (1976: Book III, Part II, §5):

> My crops will be ready for harvesting next week, yours a fortnight hence. Each of us will do better if we harvest together than if we harvest alone. You will help me next week if you expect that in return I shall help you in a fortnight. Suppose you do help me. Consider my decision about helping you. I have gained what I wanted – your assistance. Absent other not directly relevant factors, helping you is a pure cost to me. To be sure, if I were to help you I should still be better off than had I harvested alone and not helped you, but I should be better off still if having received your help, I did not return it. This calculation may appear short sighted. What about next year? What about my reputation? If I do not help you, then surely I shall harvest alone in future years, and I shall be shunned by our neighbors. But as it happens I am selling my farm when the harvest is in and retiring to Florida, where I am unlikely to cross paths with anyone from our community.

Being rational persons, we both know this, the scenario I have sketched is one each of us can sketch – and each of us knows it to be true. It would be pointless of me to pretend otherwise. So you know that I would not return your help, and being no sucker, will therefore leave me to harvest my crops alone. Neither of us will assist the other, and so each of us will do worse than need be. We shall fail to gain the potential benefits of cooperation.

The problem can be depicted as in Fig. 33.1.

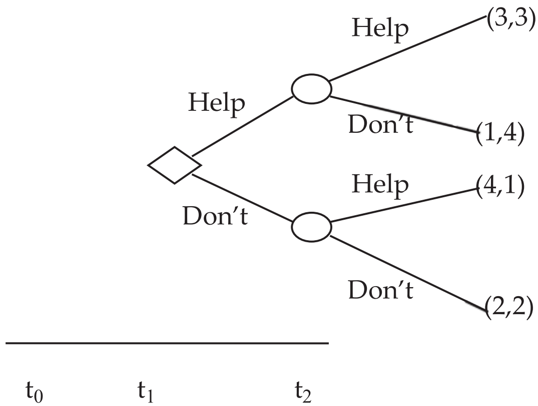


Fig. 33.1 The Hume–Gauthier one-play Harvesting Game

My neighbor chooses at the diamond, I choose at the ovals; payoffs are ordered from 4 (best) to 1 (worst), first my neighbor's, then mine. The problem is that my neighbor knows the decision tree and knows that I am modularly rational; once it is my turn to choose I will look to what decision will be best for me from *there on into the future*. If my neighbor helps, I do best by not helping (getting 4 rather than 3). If my neighbor doesn't help, I do best by not helping (getting 2 rather than 1). As in the Prisoners' Dilemma, my dominant strategy is not to help. My neighbor knows this, and so will not help; we are stuck at a Pareto-inferior outcome where neither helps the other.

Gauthier famously argues that *Modularity* should be rejected in favor of the Commitment View, according to which a person can rationally commit himself to a course of action (at time t_0) that, at some point (here t_2), will pursue less value over more. In this case, Gauthier argues,

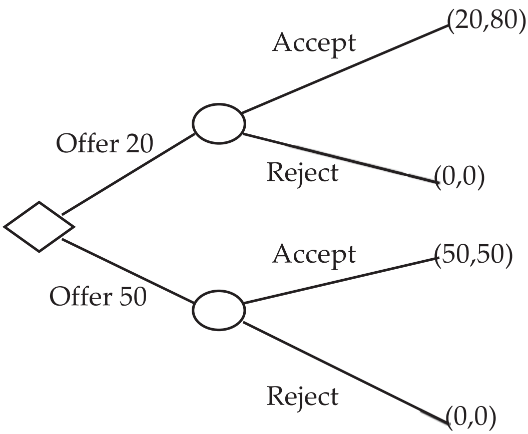


Fig. 33.2 Limited Ultimatum Game

I will get more value by choosing "Help if my neighbor helps." If my neighbor knows at t_0 that I can make such a commitment, she will choose to help, and we will both be better off (3, 3) than if neither helps (2, 2). Unlike in Buchanan's (1975, pp. 136–140) account, the rationality of cooperation does not depend on expected future returns—this is a one-play game with no expectations of future interactions.

Consider now the famous Ultimatum Game, a single-play game between two anonymous subjects, Proposer and Responder, who have X amount of some endowment (say, money) to distribute between them. In a common version Proposer is given an amount of money; he can propose any division he wants. Responder then can either accept or reject. If Responder accepts, both parties get what the Proposer offered; if Responder rejects, no one gets anything. Simplifying, consider (as in Fig. 33.2) an Ultimatum Game in which the Proposer only has two choices about sharing: $100: (i) take 80/offer 20 (ii) split 50/50.

Assuming that the money is the only value under consideration (an assumption that the rest of this paper will interrogate), a modularly rational second player will always choose "accept," since for any offer this is demanded by More is Better than Less; a rational first player will know this, and so she should offer 20, giving her the most ($80 rather than $50).

The Harvesting and the Ultimatum games represent different ways in which rational agents can be trapped into unappealing outcomes. In the Harvesting Game they are trapped into a Pareto-inferior outcome; there is a payoff-dominant outcome they cannot reach. In the Ultimatum Game, however, the a rational, narrowly self-interested, second player is trapped into accepting a minimum offer, and a Paretian outcome *is* achieved. It is this "Paretian Exploitation" with which I largely will be concerned. As in familiar cases of exploitation, a bargain is structured in such a way that one party is forced to settle for whatever she can get, no matter how miserly the offer; it is her own rationality and the structure of the interaction that forces her into accepting the miserly offer.

The Ultimatum Game is not an idiosyncratic case: it sums up a variety of real-world situations in which all can benefit, and share in the fruits of social cooperation, but some are offered take-it-or-leave-it deals by others. Consider, for example, Gauthier's (1986, pp. 190–191) story of the slave society. At one point a member of a slave-owning class, who appreciates the importance of Paretian gains, makes an offer to the slaves: we will stop beating you if you stop trying to escape. The slaves' decision tree would be captured by Fig. 33.2; as modularly rational people they should choose more over less and accept the bargain.[2]

Play in Ultimatum Games

As is well-known, numerous experiments in diverse settings employing the Ultimatum Game show that Responders very seldom take miserly offers.[3] In the United States and many other countries, one-shot Ultimatum Games result in median offers (of Proposers to Responders) of between 50 and 40%, with mean offers being 30–40%. Responders refuse offers of less than 20% about half the time (Bicchieri 2006,

[2]On Buchanan's (1975: Chaps. 2 and 5) account, if the slaves would be enslaved in the state of nature they are rational to accept this offer; if they believe they could successfully rebel and obtain another deal, they have a threat advantage in changing the contract.

[3]Some see this as a major challenge to rational choice theory; see Güth and Tietz (1990). Zamir (2001) objects that investigators rushed to this conclusion, and we have no clear game theoretical prediction as to what fully rational agents would do in ultimatum games.

Table 33.1 Experimental results in Ultimatum Games

	UCLA	Ariz	Pitt	Hebrew	Gadjah	Machiguenga	Mapuche
Mean offer	.48	.44	.45	.36	.44	.26	.34
Modal offer	.50	.50	.50	.50	.40	.15	.50/.33
Reject rate	0	–	.22	.33	.19	.048	.065
Reject offers < 20%	0/0	–	0/1	5/7	9/16	1/10	2/12

p. 105). Play in Ultimatum Games does not significantly differ by gender or age; results are strikingly similar whether the stakes are high or low (more on this anon). While those in market societies throughout the world play Ultimatum Games in roughly similar ways, there is much more variance in small-scale, non-market, societies. Indeed, in some small-scale societies (the Machiguenga of the Peruvian Amazon and the Mapuche of southern Chile) the game is played in more "miserly/exploitative" way, as Table 33.1 indicates.[4]

One response to these findings is to see it as evidence supporting Gauthier's Commitment View. A rational Responder can, on the Commitment View, commit ahead of time to rejecting miserly offers, and can rationally carry through on this commitment. If this is generally known, then Proposers would not make miserly offers, knowing that rational Responders will not be trapped by having to make the modular choice for more rather than less. Thus the Commitment View would explain why rational agents are not easily caught in exploitative offers. There are, however, three good reasons to seek to explain these results within the traditional rational choice framework of modular choosers. (i) As has been widely recognized, there are a number of problems in explicating the Commitment View as a general theory of rationality; it is one thing to say that it is appealing in special cases, another thing to show just what constitutes a rational commitment, how long a commitment should last, what new information should alter commitments, and so on (Gaus 2011, pp. 76–86). (ii) We may be hesitant

[4]Data from Henrich and Smith (2004). The Machiguenga and the Mapuche are small-scale societies; the other results are from urban university students in the United States, Israel, and Indonesia.

about drawing the conclusion that the Machiguenga are less rational than University of Arizona students. They certainly choose differently, but if rationality itself dictates that those who prefer more to less should adopt a Commitment View, then it seems we must attribute some lower level of rationality to the Machiguenga as Responders, or failure to understand the game. Once one builds the solution to these problems into the very concept of rationality, diversity of play becomes, from the point of view of rationality, problematic. (iii) Lastly, in one-play anonymous games, when the Proposer does, as sometimes happens (see, e.g., the Hebrew and Gadjah data) make a lower offer, the Commitment View instructs the Responder to choose less (i.e., 0) than what *Modularity* would yield, even though the promise of the Commitment View was that it would yield more to agents than they would receive by following *Modularity*. If one had made a threat to reject and the threat has failed, should one actually make oneself even worse off by following through on the threat?[5] That would seem utterly pointless behavior. Aiming to get more, one gets nothing. In this case the Commitment View seems especially unfortunate. Let us see if we can better explain rational resistance to Paretian Exploitation.

Explanations for Modular Choosers

The Commitment View grants that Responders characterized by *More is Better than Less* could care *only* about money, and yet reject low offers. As I have said, one possibility is that the players suffer from defects of rationality or failure to understand the rational strategies of other players (Harrison and McCabe 1996).[6] However, if we are not willing to reject *Modularity* and wish to provide an account of how Responders' rejections could be rational, we should question the assumption that the only value at stake in the game is monetary (Bolton 1991; van Damme et al. 2014, p. 294; Zamir 2001). Perhaps players have a more complex

[5]Gauthier (1994) recognizes that threats pose special problems.

[6]For learning in Ultimatum Games, see Eric van Damme et al. (2014, p. 296ff).

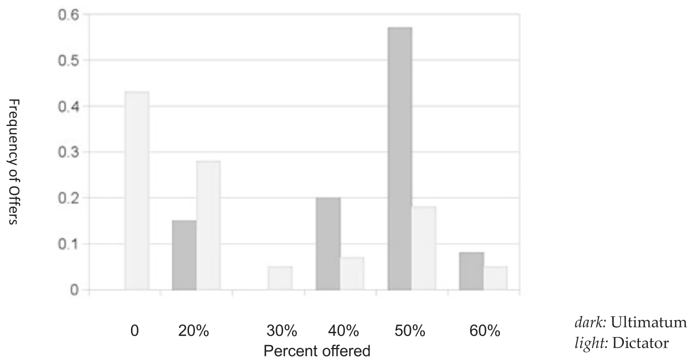


Fig. 33.3 Typical offers in Ultimatum and Dictator games (*Source* Henrich and Henrich [2007, p. 166])

value scheme in which they prefer more money over less *and* also greater over lesser egalitarian splits. In a classic of evolutionary modeling, Brian Skyrms (1996: Chap. 1) showed how a population of players who prefer 50/50 splits could evolve, and how such an evolutionary outcome is more robust than evolutionary paths that lead to populations in which some are greedy and others take what is left. However, a simple preference for egalitarian outcomes is not well supported by the data. Consider the so-called "Dictator Game" in which Proposer decides on the two shares, and that's the end of the game (not much of a game, to tell the truth). Figure 33.3 compares typical results in Dictator Games and Ultimatum Games.

In contrast to Ultimatum Games, play in Dictator Games is significantly affected by age and gender. For our purposes, what is important is that when people are guaranteed that their proposal will "be accepted," the modal offer (over .4 of all offers) looks much more like it is determined by straightforward monetary maximization: one takes everything. Yet sharing often occurs (offering 20% of endowment), and a significant number do split 50/50. However, egalitarian sharing is much rarer than in Ultimatum Games, where Responder's choices have to be anticipated by Proposers. This meta-analysis is supported by individual studies, comparing behavior in the two games (Kirchsteiger 1994). This is not to say that sharing cannot be encouraged in Dictator

Table 33.2 Rejection rates depend on choices made by proposers

	Proposer's options		
	Pair 1	*Pair 2*	*Pair 3*
	80/20	80/20	80/20
	50/50	20/80	0/100
Responder's rejection rate of 80/20 offer	44.4%	27%	9%

Games: group norms—and especially whether others in the group are believed to actually share—increases sharing behavior (Bicchieri and Xiao 2009). Moreover, evidence indicates that if affect is primed, and Dictators have less time to think about the decisions, more generous offers occur (Schulz et al. 2014).

An important line of inquiry holds that Ultimatum Game egalitarianism is explained by a more complicated valuing of egalitarian outcomes (Fehr and Schmidt 1999; Fowler et al. 2004). Perhaps people have a general aversion to inequality, but it is much stronger when one gets the short end of the stick. This is a hypothesis with significant support, yet Bicchieri (2005: Chap. 3; Bicchieri and Chavez 2010) persuasively argues that it fails to explain behavior in restricted choice Ultimatum Games. We might contrast two possible hypotheses about why Responders refuse offers: (1) *Equal Outcomes*, according to which Responders prefer roughly equal outcomes and (2) *Norm Violation*, in which Responders are reacting to perceived violation of a norm of fair splits. Both no doubt tell a part of the story but, I believe, overall the data indicate that *Norm Violation* is the fundamental explanation. Consider a modified ultimatum game conducted by Armin Falk et al. in Table 33.2.[7]

In each version of this game the Proposer has only two possible choices. The first in all treatments is to take 80% and offer 20%; in different versions the paired option is (i) a fifty–fifty split, (ii) take 20% and offer 80%, and (iii) give everything to the Responder. The Responder knows the Proposer's options. Under pair 1, rejection rates of the 20% offer are 44%. Note that rejection rate of 20% offers

[7]Reported by Bicchieri, *The Grammar of Society*, pp. 121–122.

drops dramatically when the only option of the Proposers is either to take 80% and give 20% or take 20% and give 80%. If those are the Proposer's options, it does not seem unfair for the Proposer to take the 80% for himself, though the inequality of the outcome is the same as under pair 2. And Responders are almost always willing to live with 20% given Pair 3, though again the overall outcome is just as inegalitarian as in pair 1. Bicchieri thus concludes that Responders are sensitive to norms: when one gives only 20% when one might have shared equally, one violates a sharing norm, but there is no norm requiring you to sacrifice for the sake of others, in the sense of giving them the lion's share.

It is important that on Bicchieri's account, a social norm is a rule *r* governing some type of behavior in a social network *S*, where most individuals in the social network prefer to conform to *r* on the conditions that (i) most others in *S* conform to *r* (an empirical expectation) and (ii) most people in *S* believe that most others in *S* ought to conform to it (a normative expectation).[8] Condition (ii) does not require that anyone in *S* actually believes that others ought to conform to *r* (the definition of a norm does not require that most people hold first order normative beliefs),[9] but that most share a second-order belief about the first-order normative beliefs of others in *S*. Because of this a norm can be based on "pluralistic ignorance"—most people in *S* could have the second-order belief that others in *S* think one ought to conform to *r*, yet it could be the case that no one actually has this first-order belief. The conditions for *r* being a norm would still be satisfied.

The preference to follow *r* is, of course, contextual; it depends on the circumstance for *r*'s application which, we might say, is implicitly a part of *r* (see Cialdini et al. 1990). The preference to follow *r* is a stable part of a person's value function: it is something a person cares about, and which can lead her (as in Ultimatum Games) to forgo monetary benefits in order to follow *r* (say, by rejecting a low offer as a Responder).

[8] This less formal characterization is employed by Bicchieri (2017: Chap. 1); for a more formal characterization, see Bicchieri (2006, p. 11).

[9] Cf. Brennan et al. (2013, pp. 1–14).

On Bicchieri's analysis, then, Proposers will tend to give fair offers when they believe that the majority of Responders do, as a matter of fact, reject low offers (the empirical condition) *and* they believe that most others believe that most people normatively disapprove of low offers—the normative condition (Bicchieri and Chavez 2010). The preference to follow *r* is thus *conditional* upon these two conditions being met. I shall return presently to the importance of expectations.

Why Say "No!"?

A Sense of Justice?

I am a firm supporter of the thesis that we are sensitive to social norms (or, as I tend to say, social rules), and that we tend to punish those who violate them. But the nature of this enforcement mechanism is not well understood. Why are so many individuals in Ultimatum Games so ready to deprive themselves of significant resources in the face of miserly offers, when there is no possibility of compensating gains through future interactions?

An explanation (with some empirical support) that is deeply rooted in political philosophy is that individuals naturally develop a sense of justice—a disposition to comply with, and uphold, just principles and rules (Rawls 1999: Chap. VIII; for empirical support see Carlsmith and Robinson 2002). We might extend "upholding" to "enforcing"—a person with a sense of justice would go out of her way to approve of action in conformity to norms of fairness and to punish action that violates them. Suppose, then, Responder Betty has a sense of justice: we might expect that if she identifies a certain Proposer, Alf, as one who generally fulfills these social expectations, she will tend to accept Alf's offers, as he is generally a fair-minded person. We can think of her as policing the norm, and so rewarding those who fulfill social expectations. On the other hand, we would expect her, if moved by her sense of justice, to reject the offers a Proposer who has shown himself to disappoint social expectations. If Betty is truly moved by an *impartial* sense of justice, the critical question is not just what offer *she* receives, but what sort of offers Alf generally makes. If he is a generally fair-minded person, she should still tend to accept a low offer from him—after all, her action is not a response only to his actions against her: his status as a friend or foe of justice is crucial. In an interesting experiment Simon Knight (2012) sought to determine whether Responders were upholding such a sense of justice—whether “the concern is with unfair offers in general”—or were responding to what the Proposer has done to *her*—whether the Proposer gave *her* a high or low offer. Knight found that Responders’ behavior supports the latter hypothesis: Responder Betty’s action stems from what has been done to *her*, so she will be apt to accept a high offer from a generally unfair Proposer and reject a low one from a generally fair Proposer.

The Reactive Emotions View

This leads to what we might call the *Reactive Emotions View*: Responders’ rejection of low offers is primarily to be explained in terms of Responders’ emotional reaction to the offers Proposers make to *them*, in particular whether the offer evokes negative emotions such as anger, irritation, or envy (Bosman et al. 2001; Kirchsteiger 1994). General theories of emotion support the anger/irritation/indignation version of this view; as Nico H. Frijda (1986, p. 311) notes, anger and indignation are generally evoked by norm violation. However, we should distinguish anger from indignation/resentment. Indignation and resentment are distinctly moral emotions that are evoked by norm violation: one can only resent an action if it is perceived as a wrong of some sort, and thus it presupposes a moral evaluation (Strawson 1962). Some see this as a moralized form of anger: we might have anger towards a number of frustrations, impediments, insults and so on, but these need not be moralized.[10]

I have analyzed resentment and indignation at some depth elsewhere (Gaus 2011: Chap. IV); here I shall focus on emotions such as

[10]For an experiment focusing on the role of moral anger in trust games, see Thulin and Bicchieri (2016).

anger, irritation and contempt, which are not inherently moralized. The Reactive Emotions View can be modeled in terms of a two-part value function. Let *X–n* be an offer in an Ultimatum Game, where *X* is the total endowment and *n* is the percentage that the Proposer reserves for himself. Then Responder's total value of the *X−n* offer will be $V_{MG}-V_{RE}$, where V_{MG} is the value of the absolute *monetary gain*, and V_{RE} is the value based on the *reactive emotions*, a value arising from the negative emotions, which focus on the relation between *X* and *n*.[11] A Responder will accept if total value is positive, reject if it is negative. This supposes that negative emotions are either themselves directly disvalued, or are concomitants of disvalued states (Gaus 1990: Part I). Thus, for example, an emotional reaction that derives from the Responder's belief that a norm violation has occurred could be the basis of V_{RE}[12]; on the other hand, simply seeing the offer as insulting, or getting angry at someone who violates one's expectations in this way would also come under V_{RE}.

If we suppose that emotions (V_{RE}) are more subject to fluctuation than the value of straightforward monetary resources (V_{MG})—in particular, Responders might "cool down" after a period—then we would expect Responders to accept an offer after a cool down period that they would immediately reject. The results of experiments appear contradictory. In an earlier study a break of an hour had no effect (Bosman et al. 2001) while the more recent study of Veronika Grimm and Friederike Mengel (2011) found a marked decrease in rejection rates after only ten minutes: "While almost no low offers are accepted without delay, a large share (65–75%) of these offers gets accepted after a 10 minutes delay only." Grimm and Mengel also find that low offers of Proposers increase after a break; this is consistent with work on Dictator Games, which indicates that Dictators whose decisions are driven by immediate

[11]We can add positive value that would arise because of pleasure or happiness due to a high offer, treating this as a negative in the second term. As we shall see positive emotions have been measured in Ultimatum-like games, but our real concern is why one would reject an offer where the value of the monetary is above zero, and so what negative (emotional) valuation could drive total value below zero.

[12]The norm regulates the relation between the *X* and *n*.

affect rather than calculation make more generous offers; apparently a cool down period gives each party time to switch into calculation mode, which favors the V_{MG} element (Schulz et al. 2014). In an experiment on the related "Power-to-Take Game" (see next section) a more complicated pattern emerged: here both a "cooling off" and a "getting steamed up" effect seemed present. If the Proposer's actions are not too miserly from the perspective of the Responder, the Responder seems to cool off after a wait time; however as Proposers get greedier, wait time *raises* the Responders' level of punishment (Galeotti 2013). If both cooling off and getting steamed up occur, we would expect ambiguous results from wait time experiments.

According to the Reactive Emotions View, low offers, defined as where $X–n$ is (1) a small amount and (2) n is a large proportion of X, should tend to be rejected: V_{MG} would be low because of (1) and V_{RE} high because of (2). Conversely, high offers, where $X–n$ is (3) a sizable amount and (4) n is a small percentage of X, should be accepted because V_{ME} is high (due to 3) and V_{RE} low (due to 4). This is the generally observed behavior (see, e.g., Knight 2012). But what of offers that are absolutely large, but proportionally low (i.e., in $X–n$, n is a very high percentage of X, but the absolute size of $X–n$ is large)? An important mark against the Reactive Emotions View would seem to be the insensitivity of Responder's behavior in Ultimatum Games to the size of the stakes. One would assume that as V_{MG} increases (measured, it will be recalled, in absolute size), Responders would be more ready to accept offers, even if n is a high proportion of X. Of course it could be that as the stakes in the game go up so do emotional reactions, but a reasonable hypothesis is that V_{RE} would not keep increasing as the stakes become higher and higher: one can only get so insulted or angry, but stakes can go up and up.[13] At some point we would expect that $V_{MG} > V_{RE}$, and so the (proportionally) "low" offer would be accepted. Yet a variety of studies have shown that play in Ultimatum Games is not very sensitive to the absolute size of the endowments being divided (see, e.g.,

[13]For simplicity, I leave aside decreasing marginal utility of money.

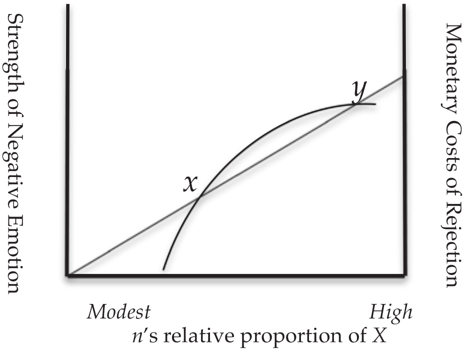


Fig. 33.4 The reactive emotions view

Slonim and Roth 1998).[14] However, as Steffen Andersen et al. (2011) point out, in many of these experiments Proposers advance very few low offers, making it difficult to judge what Responders would do in the face of such offers. In their study, some treatments drastically increased the size of endowments to be divided (equivalent to 1600 hours of work in India, where the experiment took place) and they elicited many low offers by Proposers. In treatments with traditional sized stakes the behavior of Responders was in line with normal play (though there were more low offers to be rejected); in their very high stakes treatments only 1 of 24 Responders rejected low offers. Letting the curved line indicate emotional reaction and the straight line monetary gains, Fig. 33.4 sums up the predictions of the Reactive Emotions View: offers between x and y should be rejected.

Emotions in Power-to-Take Games

A problem with measuring the role of emotions in Ultimatum Games is that Responders only have a take-it-or-leave-it choice and, as we have seen, low offers are typically uncommon. The role of emotions in

[14]This is not to say that stakes have no effect, as stakes rose, "responders (pooled over all rounds) rejected offers less often" (Slonim and Roth 1998, p. 591), thus supporting a prediction of the Reactive Emotions View.

Responders' behavior has been extensively studied in a cousin of the Ultimatum Game, the Power-to-Take Game, which allows more scope for emotional reaction. A Power-to-Take Game involves two players, a Taker and a Responder; their roles are determined at random. To start, each player is given an endowment; in some treatments the players earn their endowment in a pre-game task, in others it is simply distributed by the experimenter. Suppose the endowment for each is Y_{Take} and $Y_{\text{Resp.}}$ The Taker, then determines take rate—the proportion of the Responder's endowment he will take. The Responder then has an option of destroying any amount of her endowment that she wishes, before the Taker's percentage is transferred from her. So if the endowment was $10, and the Taker announced a take rate of 50%, the Taker would get $5 if the Responder destroyed none of her endowment, which would yield total payoffs of $15 for Taker and $5 for Responder. If the Responder decides to destroy half her endowment after the Taker announces his take rate, it would reduce her endowment to $5, of which the Taker would get $2.50. This game is sometimes described as an Ultimatum Game that allows variable punishment, since Responder can decide on the level at which she will deny Taker's resources.[15] But note that in this game the Responder cannot affect the Taker's endowment, but only the amount of her endowment the Taker can transfer (see Reuben and van Winden 2010, p. 908).

In an early pioneering study by Ronald Bosman and Frans van Winden, where players earned their endowments, out of 39 subjects, only three Takers took 0, positive takings ranged from 25 to 100%, with a mean of 58.5%, and median 66.7%; 70% was the mode (Bosman and van Winden 2002).[16] Eight Responders chose to destroy part of their endowment, and of these, seven destroyed the entire endowment. In a later study Bosman, Matthias Sutter and van Winden

[15]The variability of destruction is meant to uncover the relation of degree of emotional response to degree of punishment; I discuss presently a version of Power-to-Take that gives only limited punishment options which, not too surprisingly, considerably blunts the importance of emotions.

[16]This is typical of takings in Power-to-Take Games; see Reuben and van Winden (2010).

Table 33.3 Results in two power-to-take experiments (Reuben and Van Winden 2010)

	Effort	No effort
Destroy everything	7	6
Destroy part	1	9
Destroy nothing	31	25
Total	39	40

compared this play to another experiment in which endowments were simply distributed at the start of play (Bosman and van Winden 2005). Play in the no effort experiment was markedly different; Takers took an average of 32% more, and many more Responders destroyed, and more opted for intermediate destruction rates. Table 33.3 summarizes the differences between the effort and no effort experiments.

Especially interesting is that these experiments sought to determine the extent to which emotional reactions explained behavior. Emotions were measured via self-reporting on a seven-point scale ranging from "no emotion at all" (1) to "high intensity of the emotion" (7). The emotions measured were irritation, anger, contempt, envy, jealousy, sadness, joy, happiness, shame, fear, and surprise (Reuben and van Winden 2010).[17] The following findings are of interest to us:

- Responders who destroyed report more intense emotional reactions than those who do not.
- The most intense emotions of Responders who destroy in the *no effort* condition were (in order) anger, contempt, surprise and irritation.

[17]"In both conditions, the sequence of actions was as follows. Before subjects played the one-shot PTT-game, they were randomly divided into two groups. One group was referred to as participants A (the take authorities) and the other as participants B (the responders). Subsequently, random pairs of a responder and a take authority were formed by letting take authorities draw a coded envelope from a box. The envelope contained a form on which the endowment of both participant A and participant B was stated. The take authorities then had to fill in a take rate and put the form back in the envelope again. After the envelopes were collected, we asked the take authorities to report their emotions as well as their expectation of what the responder would do. The envelopes were brought to the matched responders who filled in the part of their endowments to be destroyed. The envelopes containing the forms were then returned to the take

- The most intense emotions of Responders who destroy in the *effort* condition were (in order) irritation, contempt, surprise and anger; the emotions tended to be more intense in this treatment.
- For both treatments, the intensity of these emotions is correlated with the take rate.
- "With effort, the probability of destruction…depends positively on the intensity of irritation and contempt. Without effort, the probability of destruction depends positively on the intensity of anger and contempt, and negatively on the intensity of happiness and joy" (Reuben and van Winden 2010, p. 420).
- Responders who destroy everything report more irritation than those who destroy only part. Reuben and van Winden (2010, p. 417) indicate that this provides support for what I have called the Reactive Emotions View: this group, they comment, "appear to make a tradeoff between the (emotional) satisfaction of punishment and monetary reward."

In these studies intensity of emotional reactions is a strong predictor of Responder behavior. In a recent study Fabio Galeotti (2015) has shown that the predictive value of emotional reactions can be considerable lessened if the Responders' destroy options are restricted to a fixed rate (2:1) for each unit taken. Rather than Responders deciding how much to destroy in response to a taking, they simply opt to destroy at the fixed rate or not at all. In this treatment negative emotions remain correlated with the take rate, but have less predictive value of punishment. At low levels of punishment (for smaller takings) only contempt was of predictive value; at higher take rates (and so levels of punishment), those with higher levels of anger, irritation and contempt punished more, but this was significantly less predictive than under variable destruction rate treatments. Fixed rate punishment thus appears to blunt the effect of

authorities for their information. Meanwhile, responders were asked to indicate which take rate they had expected and how intensely they had experienced several emotions after having learned about the take rate. After completing the questionnaires and collecting all envelopes, subjects were privately paid outside the laboratory by the cashier who was not present during the experiment. Experimenters were not able to see what decisions subjects made in the game and how much they earned" (Reuben and van Winden 2010, p. 415).

emotions; it especially thwarts Responders' emotionally destroying their entire endowments in response to modest takings.

Expectations and Fairness

I have suggested that emotional reactions may be an important foundation of behavior to uphold norms. The mere fact that in Power-To-Take Games Responders' destructive behavior is significantly, in some cases powerfully, explained by their emotional reactions does not show that emotions are related to norms. However, data does indicate a connection. Recall the importance of expectations in Bicchieri's account of social norms: a rule *r* is a social norm when the majority in a certain group or social network hold the requisite empirical and normative expectations. Experimental evidence involving Dictator Games indicates that when normative and empirical expectations diverge, there is a strong tendency to align behavior with the empirical expectations (Bicchieri and Xiao 2009). An important finding in the Power-to-Take Games is that the Responders who punished very strongly tended to be (and in one study were exclusively) those who expected lower take rates than they experienced—recall the presence of surprise (Bosman and van Winden 2002, p. 156; Bosman et al. 2005, p. 421; Galeotti 2015, p. 12). This suggests that while negative emotions are well correlated with punishing behavior, this is strongly mediated by empirical expectations.

Thus far I have focused on Responders. Reuben and van Winden (2010) studied the effect of Responders' punishment on Takers' take rate in a multi-stage Power-to-Take game. They found that when Responders did not destroy, the Takers who increased their take rate in the second round tended to experience regret after the first round—apparently regretting that they could have taken more and got away with it! Takers who did not experience destruction tended to increase their take rate in the second round. The behavior of Takers who did experience Responder destruction in the first round, however, was complex: some decreased their take rate while others did not. The key appears to be whether the Takers thought their taking was fair or unfair:

those who took what they considered to be an unfair amount, to a significant degree reacted to Responders' punishment (i.e., destruction) by decreasing their takings. It is worth pointing out that in the first round these Takers apparently were willing to incur some guilt (say, level Z) in return for high monetary gain X (as they think the offer was unfair), but proceeded anyway, so it would seem ($\boldsymbol{V}_{\mathrm{MG}}X > \boldsymbol{V}_{\mathrm{RE}}Z$); in the second round they experienced an increased in guilt (Z^{+}), thus it would seem that $\boldsymbol{V}_{\mathrm{RE}}Z^{+} > \mathbf{V}_{\mathrm{MG}}X$, causing them to lower their taking. However, Responder destruction did not have the effect of lowering the take rate of those Takers who thought their takings fair. This is consistent with other studies concluding that, in addition to the anger of punishers, effective punishment requires violators to experience guilt, say in recognition that they have violated their understanding of fairness or a social norm (Hopfensitz and Reuben 2009). Thus again we are led to the interrelation of emotional reaction and social norms.[18]

The Vile and Contemptible

There is, then, considerable evidence that the emotions of irritation, contempt and anger play an important role in some types of punishing behavior, or, more carefully, in grounding choices that lead one to go away with less (often nothing) rather than accept small gains or allow others to take some of what one possesses. Now we might ask, what does this have to do with "vain glory" or, as Rousseau described

[18]Experiments by Thulin and Bicchieri (2016) have shown that "moral outrage"—which is closely related to anger—also seems to underlie third-party *compensation* behavior, when norm violation has occurred. This is important: we should not suppose that negative emotions must be attached to a preference to punish violators, as opposed to compensating victims. It is important, however, that Thulin and Bicchieri's target emotion appear distinctly moral; in one study emotions were measured, for example, on a 7-pount scale from "Strongly Disagree" to "Strongly Agree" with statements such as "I feel angry when I learn about people suffering from unfairness" and "I think it's shameful when injustice is allowed to occur." These emotions are thus clearly moral emotions, presupposing a normative content.

it "*amour-propre*?"[19] Pride and vanity are not, after all, among the specific emotions studied. But we should not see Hobbes's glory-seeking or Rousseau's *amour-propre* as a specific emotion; it is more of an agent type or personality orientation. Very much in the spirit of Rousseau, William McDougall thought that pride was part of the growth of self-consciousness and a manifestation of the "self-regarding sentiment." As Rousseau might well have said, McDougall (1950, p. 155) held that "…the idea of self and the self-regarding sentiment are essentially social products; that their development is effected by constant interplay between personalities, between the self and society; that, for this reason, the complex conception of the self thus attained implies constant reference to others and to society in general, and is, in fact, not merely a conception of self, but always of one's self in relation to other selves". This self-regarding sentiment McDougall (1950, p. 165) maintained, takes two basic forms "which we may distinguish by the names 'pride and 'self-respect'." McDougall associated pride with a "positive self-feeling," what Hobbes might call a valuing of the self, which makes one especially sensitive to signs of undervaluing by others and a tendency to insist on one's own way. Pride so construed is high valuing of the self, which is then associated with a tendency to stress a group of specific emotions. Richard S. Lazarus (1991, p. 229) thus observes that "[a]rrogance and smugness, especially the latter, seem to combine with contempt (hence anger) with pride…." Frijda (1986, p. 89) also notes the association of pride, contempt and scorn. This is not to say that all these emotions are perfectly correlated: in a factor analysis of emotions in Power-to-Takes Games, contempt was the second most unique

[19] *Amour-propre* must not be confused with love of self: for they differ both in themselves and in their effects. Love of self is a natural feeling which leads every animal to look to its own preservation, and which, guided in man by reason and modified by compassion, creates humanity and virtue. *Amour-propre* is a purely relative and factitious feeling, which arises in the state of society, leads each individual to make more of himself than of any other, causes all the mutual damage men inflict one on another, and is the real source of the "sense of honour" (Rousseau 1975, p. 66).

emotion (after fear), though it still has a .48 and .47 Spearman's rank correlation coefficient with, respectively, irritation and anger (the two emotions it was most closely associated with). However, anger and irritation were themselves much more closely associated (.75) (Galeotti 2015, p. 9). Of course, if contempt is more pronounced in low takings, this might be expected.

It is perhaps worth noting the importance of contempt in research on Power-to-Take Games. It is an explanatory value in all the experiments we have considered; even in Galeotti's recent study, which minimizes the effect of emotion, contempt remains the sole emotion significantly affecting reactions to small take rates. Recall Hobbes's (1994, p. 28) claim that contempt sees its object as "vile and inconsiderable" and the honorable person has "contempt of small difficulties, and dangers" (Hobbes 1994, p. 53). To such individuals, gains that indicate an undervaluing are vile and inconsiderable, and are to be rejected. "For every man looketh that his companion should value him, at the same rate he sets upon himself" (Hobbes 1994, pp. 75–76). And when such a person feels undervalued, he is apt to respond destructively, unlike the pure egoist who takes what he can get. "Better nothing than that!" is not a motto of the egoist, and that is why the egoist can get caught in Paretian exploitation and, indeed, submit to takings when he has no choice except submit or engage in self-destructive response.

In the *Limits of Liberty* Buchanan (1975: Chap. 8) proposes a solution to this Paretian trap. If the social contract gives an individual especially meager gains over the state of nature, and if the individual has an effective threat to do better by restarting the state of war, she may be able to renegotiate a better deal. But not only is this claim based on highly uncertain calculations, it can lead to further *diminishing* the meager benefits of the social contract: if she would end up enslaved in the state of nature the renegotiation may lead her to make even greater concessions for peace. However, a prideful agent will have contempt, irritation or anger at such vile offers, and so would prefer to destroy her holdings rather than submit. When the prideful are around, hard bargaining can lead to disaster for all. Thus, the Janus-faced nature of pride: it can undergird, as well as undermine, effective social cooperation.

Acknowledgements My thanks to Chad Van Schoelandt for comments and suggestions; thanks too to fellow participants at the Workshop on Sharing, University of Manchester and the Workshop on Exploitation, University of San Diego. My special thanks to David Wiens for his comments.

References

Andersen, S., Ertaç, S., Gneezy, U., Hoffman, M., & List, J. A. (2011). Stakes Matter in Ultimatum Games. *The American Economic Review, 101,* 3427–3439.

Bicchieri, C. (2006). *The Grammar of Society: The Nature and Dynamics of Norms*. Cambridge: Cambridge University Press.

Bicchieri, C. (2017). *Norms in the Wild: How to Diagnose, Measure, and Change Social Norms*. New York: Oxford University Press.

Bicchieri, C., & Chavez, A. (2010). Behaving as Expected: Public Information and Fairness Norms. *Journal of Behavioral Decision Making, 23,* 161–178.

Bicchieri, C., & Xiao, E. (2009). Do the Right Thing: But Only If Others Do So. *Journal of Behavioral Decision Making, 22,* 191–208.

Bolton, G. E. (1991). A Comparative Model of Bargaining: Theory and Evidence. *American Economic Review, 81,* 109–136.

Bosman, R., & van Winden, F. (2002). Emotional Hazard in a Power-to-Take Experiment. *The Economic Journal, 112,* 147–169.

Bosman, R., Sonnemans, J., & Zeelenberg, M. (2001). *Emotions, Rejections, and Cooling off in the Ultimatum Game*. Available at http://hdl.handle.net/11245/1.418488.

Bosman, R., Sutter, M., & van Winden, F. (2005). The Impact of Real Effort and Emotions in the Power-to-Take Game. *Journal of Economic Psychology, 26,* 407–429.

Brennan, G., Eriksson, L., Goodin, R. E., & Southwood, N. (2013). *Explaining Norms*. Oxford: Oxford University Press.

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

Carlsmith, K. M., Darley, J. M., & Robinson, P. H. (2002). Why Do We Punish? Deterrence and Just Deserts as Motives for Punishment. *Journal of Personality and Social Psychology, 83,* 284–299.

Chung, H. (2015). Hobbes' State of Nature: A Modern Bayesean Game-Theoretic Analysis. *Journal of the American Philosophical Association, 2,* 485–508.

Chung, H. (2016). Psychological Egoism and Hobbes. *Filozofia, 71,* 197–208.
Cialdini, R., Kallgren, C., & Reno, R. (1990). A Focus Theory of Normative Conduct: A Theoretical Refinement and Reevaluation of the Role of Norms in Human Behavior. *Advances in Experimental Social Psychology, 24,* 201–234.
Fehr, E., & Schmidt, K. M. (1999). A Theory of Fairness, Competition, and Cooperation. *Quarterly Journal of Economics, 114,* 817–868.
Fowler, J. H., Johnson, T., & Smirnov, O. (2004, January 6). Egalitarian Motive and Altruistic Punishment. *Nature, 433*, E1.
Frijda, N. H. (1986). *The Emotions*. Cambridge: Cambridge University Press.
Galeotti, F. (2013). An Experiment on Waiting Time and Punishing Behavior. *Economics Bulletin, 33,* 1383–1389.
Galeotti, F. (2015). Do Negative Emotions Explain Punishment in Power-to-Take Game Experiments? *Journal of Economic Psychology, 49,* 1–14.
Gaus, G. (1990). *Value and Justification*. Cambridge: Cambridge University Press.
Gaus, G. (2008). *On Philosophy, Politics and Economics*. Belmont, CA: Wadsworth.
Gaus, G. (2011). *The Order of Public Reason*. Cambridge: Cambridge University Press.
Gauthier, D. (1986). *Morals by Agreement*. Oxford: Clarendon Press.
Gauthier, D. (1994). Assure and Threaten. *Ethics, 104,* 690–721.
Grimm, V., & Mengel, F. (2011). Let Me Sleep on It: Delay Reduces Rejection Rates in Ultimatum Games. *Economics Letters, 111*, 113–115.
Güth, W., & Tietz, R. (1990). Ultimatum Bargaining Behavior: A Survey and Comparison of Experimental Results. *Journal of Economic Psychology, 11,* 417–449.
Hardin, R. (2003). *Indeterminacy and Society*. Princeton: Princeton University Press.
Harrison, G. W., & McCabe, K. A. (1996). Expectations and Fairness in a Simple Bargaining Experiment. *International Journal of Game Theory, 25,* 303–332.
Henrich, J., & Henrich, N. (2007). *Why Humans Cooperate*. Oxford: Oxford University Press.
Henrich, J., & Smith, N. (2004). Comparative Evidence from Machiguenga, Mapuche, and American Populations. In J. Henrich, R. Boyd, S. Bowles, et al. (Eds.), *Foundations of Human Sociality: Economic Experiments and Ethnographic Evidence from Fifteen Small-Scale Societies*. Oxford: Oxford University Press.

Hobbes, T. (1994). *Leviathan* (E. Curley, Ed.). Indianapolis: Hackett.
Hopfensitz, A., & Reuben, E. (2009). The Importance of Emotions for the Effectiveness of Social Punishment. *The Economic Journal, 119,* 1534–1559.
Hume, D. (1976). *Treatise of Human Nature* (2nd ed.) (L. A. Selby-Bigge & L. P. H. Nidditch, Eds.). Oxford: Clarendon Press.
Kirchsteiger, G. (1994). The Role of Envy in Ultimatum Games. *Journal of Economic Behavior and Organization, 25,* 373–389.
Knight, S. (2012). Fairness or Anger in Ultimatum Game Rejections? *Journal of European Psychology Students, 3,* 1–14.
Lazarus, R. S. (1991). *Emotion and Adaptation*. Oxford: Oxford University Press.
McDougall, W. (1950). *Social Psychology* (30th ed.). London: Methuen.
Rawls, J. (1999). *A Theory of Justice* (Rev ed.). Cambridge, MA: Harvard University Press.
Reuben, E., & van Winden, F. (2010). Fairness Perceptions and Prosocial Emotions in the Power to Take. *Journal of Economic Psychology, 31,* 908–922.
Rousseau, J.-J. (1975). Discourse on the Origin of Inequality. In *The Social Contract and Discourses* (G. D. H. Cole, Trans.). London: Dent.
Schulz, J. F., Fischbacher, U., Thön, C., & Utikal, V. (2014). Affect and Fairness: Dictator Games Under Cognitive Load. *Journal of Economic Psychology, 41,* 77–87.
Skyrms, B. (1996). *Evolution of the Social Contract*. Cambridge: Cambridge University Press.
Slonim, R., & Roth, A. E. (1998). Learning in High Stakes Ultimatum Games: An Experiment in the Slovak Republic. *Econometrica, 66,* 569–596.
Strawson, P. F. (1962). Freedom and Resentment. *Proceedings of the British Academy, 48,* 187–211.
Thulin, E. W., & Bicchieri, C. (2016). I'm so Angry I Could Help You: Moral Outrage as a Driver of Victim Compensation. *Social Philosophy & Policy, 22,* 146–160.
van Damme, E., et al. (2014). How Werner Güth's Ultimatum Game Shaped our Understanding of Social Behavior. *Journal of Economic Behavior & Organization, 108,* 292–318.
Zamir, S. (2001). Rationality and Emotions in Ultimatum Bargaining. *Annales d'Économie et de Statistique, 61,* 1–31.

34

Toward a Rule-Based Model of Human Choice: On the Nature of *Homo Constitutionalus*

Roger D. Congleton

Anglo-American jurisprudence emphasizes the rule of reason; it grossly neglects the reason of rules. We play socioeconomic-legal-political games that can be described empirically only by their rules. But most of us play without an understanding or appreciation of the rules, how they came into being, how they are enforced, how they can be changed, and most important, how they can be normatively evaluated. (Brennan and Buchanan 1985, preface)

Introduction: *Homo Constitutionalus*

At several points during his long career, Buchanan wrote on human nature, the process of making choices, and weaknesses in the Neoclassical conceptions of the same. That line of his research stressed the selection and evolution of personal goals and constraints. It was not

R. D. Congleton (✉)
West Virginia University, Morgantown, WV, USA
e-mail: roger.congleton@mail.wvu.edu

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_34

a major focus of his research, and his writing in this area often simply attempted to remind economists that their utility-maximizing model of man was just a "model" and one that has significant limitations. In his economic and constitutional research, he routinely used conventional rational choice models.[1]

Given the latter, it is possible that Buchanan regarded the *homo economicus* model to be adequate for most analytical purposes in spite of its weaknesses. Another possibility is that he was simply too busy on other projects to develop the rule-based, constitutional model of human nature that would bridge the gap between his comments on human nature and his work on political economy. This paper provides that missing model.

The model developed below is grounded loosely on Buchanan's writings, but it is not an attempt to read his mind. Rather, it undertakes the task of creating a more complete model of human thought and action—one that is consistent with Buchanan's remarks on human nature and ethics—and also with other work in psychology, biology, and philosophy. I believe that he would agree with most of what is written below, but that can no longer be put to the test, and it is not the main aim of the essay.

The analysis begins with what Hayek (1952) referred to as the "sensory order," which is to say the idea that our information about the external world is provided by our various senses, none of which are perfect but which nonetheless cannot be too often mistaken or misleading without undermining our species's prospects for survival. Our senses do not provide our "sensory order" but rather provide the data that our minds use to construct one.

This paper suggests that various systems of relatively stable rules ultimately determine our sensory orders—which is to say our perceptions concerning both the real and the possible. Systems of rules determine our understanding of the world, our beliefs about what can be changed, and the meanings of "better" and "best" as applied to choices among

[1]See Kirchgässner (2014) for a longer discussion of this point with respect to Buchanan's work on constitutional political economy.

possible actions that might be undertaken. Our internal systems of rules largely determine how and what we choose to do in both our mental and physical universes.

The rule-based alternative to *homo economicus* sketched out in this essay is termed *homo constitutionalus*. It is a more general model of humankind than the utility-maximizing model used in economics and game theory. It addresses many of the weaknesses of the *homo economicus* model noted by Buchanan. And, although *homo constitutionalus* is not as mathematically tractable as *homo economicus*, special cases of the model can be used to model and predict choices and actions in well-understood circumstances. Indeed, the utility-maximizing model is one such special case. Simple autocorrelation (habitual) models of behavior are another.

A Generalized Conception of Rules: Rules as "If-Then" Relationships

Buchanan often used the term "rules of the game" as a way of illustrating that choices take place within a hierarchy of rule-governed domains. Choices over rules bind choices made in subordinate domains after rules are adopted and implemented. One chooses rules for a game and then plays the game by choosing strategies allowed by those rules. Such rules are taken to be "given" or "binding" for choices made while playing the game of interest. Although Buchanan normally stressed just two-levels of choice, he occasionally mentioned that a hierarchy of rules existed. In *Limits to Liberty* (1975), for example, he develops a three-level hierarchy of laws: (i) civil laws, (ii) constitutional law, and (iii) public policy decisions, which jointly frame a fourth level of choice: day-to-day decision making within a society characterized by the rule of law. His work also includes at least two other categories of rules: rules that provide procedures for making choices (Buchanan 1979, 1998, 2005) and rules that constrain choices to various subsets of the possible (Brennan and Buchanan 1985). Hierarchies, procedures, and constraints all play roles in the framework developed below.

Although Buchanan uses the term “rules” frequently, he never defined what he meant by a “rule.” For the purposes of this essay, rules are “if-then” relationships. Any and all relationships that can be characterized by if-then statements are said to be rules. Interpreted in this way, the term “rule” encompasses a very broad range of human knowledge. If-then relationships include most—if not all—definitions, natural and social causal relationships, ethical propositions, personal routines for adapting to weather, work, and family, and also, rules for parlor games and politics. If-then relationships are by their nature systematic and allow predictions about consequences and conditional plans to be made.

The following examples illustrate if-then relationships that we all use or might use: (i) *If* an object in a grocery store is round, orange colored, and releases orange drinkable juice when squeezed, *then* it is probably an orange. (ii) *If* one simultaneously drops two unequally sized oranges from the top of a tall building, *then* they will hit the ground at the same time. (iii) *If* a frost wipes out half of the Earth’s crop of oranges, *then* the price of orange juice will increase. (iv) *If* one drinks a glass of orange juice in the morning, *then* he or she is likely to be more alert for the next hour than if he or she had not done so and possibly a bit less likely to catch a cold. (v) *If* the light at a crosswalk is red, *then* one should not cross the street—except in an emergency. (vi) *If* one is in normal circumstances (not at war or threatened with death), *then* it is immoral and illegal to kill another person—even if one “sees red” because he or she has been insulted. (vii) *If* one is playing poker, *then* a hand in which every card has a red diamond on it beats a hand with two pairs or three of a kind.

There are so many if-then relationships that it is useful to subdivide them into various categories such as natural law, constitutional law, regulatory law, moral maxims, rules of thumb, rubrics, and so forth. Such classification schemes are normally done with other if-then statements. For example, if a rule describes part of the standing procedures through which public policies are chosen, then it is a constitutional law, whether formally or informally so.

If-then relationships also characterize what we mean by true and false. (viii) The hypothesis “if O, then X” is perfectly true *if* it is always the case that *if* “O,” *then* “X.” (ix) It is stochastically true *if* “O” occurs, *then* probably “X” also occurs. Furthermore, (x) it is demonstratively false *if*

"O" *then* not "X" (e.g., X is never observed when O occurs). Hierarchies among rules can also be expressed using if-then statements. (xi) Rule "b" can be applied, only if it is allowed under rule "a," that is, if rule "a" allows rule "b," then rule "b" can be applied whenever rule "a" is in force.

Note that only a small subset of the rules that we use characterize "rules of a game" or serve as "constraints." The term "rules" has far broader scope than that implied by Buchanan's usage of the term. Moreover, even in cases in which a system of rules is used to characterize a game, such rules normally do not fully characterize how a game is played or how one truly wins the game. Other higher-level "internalized" rules are taken as given by the designers of card and board games, and these have significant effects on the nature of and participation in the games created.

For example, the formal rules of a game of poker characterizes the types of cards one should use, how they are to be distributed to players, the card strategies allowed, and provides a ranking of possible collections of cards (hands) at the end of a round of play. The rules imply that one wins a round (dealing of the deck) if he or she has the "highest" hand. However, the aim of winning in this sense may not be the main goal of individual card players. A variety of other rules in the minds of the players actually determine how they play the game, why they play the game, and who truly wins.

Such rules include internalized rules about various strategies one might use. Will one cheat—mark cards, try to see other player's hands, etcetera—be calm or emotive, threaten other players with violence, file charges for fraud if others cheat, and so on? And will one try to win as many hands as possible or simply play because the conversations and reactions that arise during the course of play tend to be funny, entertaining, or informative. Many, perhaps most, participants in parlor games play the game simply to observe the reactions of fellow players and to be part of the associated conversations—they care little about winning in the manner the rules suggest. The number of hands won is of secondary importance to such players.

If conversation is the aim, then the more interesting the other players are, the greater are the rewards of participating. If winning money from side bets is the aim, then weaker and wealthier players are ideal poker companions. If a challenge to take one's mind off one's day-to-day life is the aim, one might want competent, honest, and humorous opponents, rather than overly chatty or incompetent ones.[2] (Competence in this case, refers to knowledge of the if-then rules of probability as applied to card games, and of psychology as applied to reading faces and body language.) Even in cases in which winning hands is the aim, it is often because winning improves one's reputation for shrewdness or generates status for persons in the greater world beyond the parlor games of interest.[3]

The formal rules of parlor games are only a subset of the rules one uses to determine how one plays "the game." Who one plays with, how one selects strategies, and how one evaluates the merits of spending a night playing such games are largely determined by other rules in the minds of the participants. How one plays a game, how one really wins, and who one plays with are all determined by rules that are entirely separate from the formal rules of poker. Those other internalized rules ultimately determine how the game is played. The same is true of constitutional rules, as acknowledged by the terms written and unwritten constitutional laws. It is these and other internalized rules that are the main focus of this essay.

Homo Constitutionalus: Rule Bound But Not Rule Determined

> Each person is, of course, a product of his own history, the cultural environment, the conventions and traditions that exist and the public literature that explains these, all of which combine to describe the inclusive status quo that cannot be literally superseded.…This statement does not,

[2] The poker games in Blacksburg that Buchanan attended included Robert Tollison and Winston Bush among others.

[3] The various "social" payoffs of parlor games are less obvious for games played on the Internet or against computers. Such games may provide relief from one's everyday toils as well as status within the context of the game through rankings of accumulated scores. The latter may generate self-confidence or self-esteem for the persons participating. Only a few "addicts" and "fanatics" allow the number of games won to be their entire reason for play (or life). Indeed, the derogatory nature of the terms "addicts" and "fanatics" implies that such persons are unusual—exceptions to the rule, exceptions to the less winning oriented theory of game playing sketched out above.

> however, imply…that a person, any person, is locked permanently into a predisposition as determined by personal history, experience and social environment. (Buchanan 2005, p. 102)

> We move through time, constructing ourselves as artifactual persons. We are not, and cannot be, the "same person" in any utility-maximizing sense. (Buchanan 1999 [1979], pp. 250–251)

The *homo constitutionalus* characterization of human nature begins with the observations that adults have many internalized rules, can internalize new rules and overturn previously internalized rules, and that doing so is often a matter of choice. These four observations imply that humans are rule bound but not fully rule determined. One is rule bound insofar as one's internalized rules create dispositions to make particular choices, but one is free to choose insofar as new rules can be internalized and old ones revised or selectively ignored.[4]

Our internalized systems of rules have three sources: genetic, social, and personal. The first accounts for the largest subset of our rules and includes the biological foundations of our human capacities and prerequisites for sustaining a human life. Such rules distinguish humankind from other species. We have 1 mouth, 1 brain, 2 legs, 2 eyes, 2 ears, 10 fingers, etcetera. We cannot fly; can run only at moderate speeds; require water, food, and sleep to survive; can remember the past, can imagine alternative futures; and can communicate in a relatively finely grained manner with others of our species who speak the same language. The other two sources of internalized rules are of greater interest for the purposes of this essay, because they are more variable. They are grounded in the capacities inherent in the human genotype but are not direct products of it. In the language of computer design, genetics provide our hardware and firmware; society and personal invention provide our software. Socially transmitted rules are largely what distinguish modern man from ancient cave dwellers of the same genotype.

[4]For other complementary rule-based models of man see Hayek (1952), Newell and Simon (1972), Nozick (1994), or Seligman et al. (2016). This essay differs from others in its use of more general meaning of the term "rules," by its emphasis on the internalization processes, and by its linkages to economics and Buchanan's work, but there are many overlaps and common themes.

Most of our "software" has been learned from others. It is that which accounts for our longer and more comfortable lives than cave dwellers. Socially transmitted rules initially were simply private or personal rules. They were invented or discovered by individuals at some point in the past, who found them useful for their own purposes. When new or refined rules reduce risks or enhance possibilities, they may be passed on to others in one's family and tribe and subsequently across generations. When they are deemed counterproductive by others, they are less likely to be copied or passed along, except as examples of rules to be avoided. As the collection of useful rules expands through time, their origins tend to be forgotten and only the rules themselves are passed along to others and internalized—often without much thought.

The individual acts of learning that produce human knowledge account for the smallest subset of an individual's own system of rules. They are the rules that were refined, invented, or discovered by that individual—many of which were catalyzed by conversations with others. Many, perhaps most of one's private internalized rules will never go further than one's own mind, but a few may be passed onto others, who find them sufficiently useful to be internalized and passed on to their friends, neighbors, and colleagues. Although this process arguably produces the smallest of our subsets of internalized rules, through time the accumulated individual innovations are the ultimate source of human progress. Without our ability to invent and learn new rules, we would still be cave dwellers (at best).

The remainder of this section provides a more thorough discussion of these three sources of our internalized rules and how they generate dispositions to engage in one or another response to the choice settings confronted.

Genetically Transmitted Rules

It is sometimes said, "we are what we eat," but it would be more precise to say, "we eat to be what we are." Although it is literally the case that most of our cells are composed of the raw materials collected through our mouths, the use that we make of those raw materials is a consequence of our biology, which in turn is a consequence of our genetic code(s). That code provides the rules that determine both what we can eat and how what we eat is used to create our physical persons. It does not, however, determine precisely what we eat, nor precisely who we are. What we eat is largely determined by our knowledge of nature and how it may be used to please our taste buds, while sustaining life. Limoncello, spaghetti, meatballs, and panna cotta were not available to cave dwellers.

How the food is used depends in part on the extent and type of exercise that we undertake as well as our genotype. Our choices thus play a modest role in determining how food is used to produce our physical persons. Our physical persons, in turn, are bound by a huge number of if-then relationships, only a subset of which is understood by ourselves or the scientists who study human physiology and psychology.

We know, for example, that we need some water, some food, and some sleep on a regular basis. We understand why we need food and water but do not really understand why most of us need to spend about a third of our lives sleeping. Nor do we understand what—if anything—our dreams add to our ability to survive and pass our genes to the next generation. Yet, if we sleep well, then we always dream at least part of the time we are asleep.[5]

Genetically transmitted rules include those that produce and maintain the sense organs that provide us with data about the world and the brains that attempt to make sense of that data. We process most of that data more or less automatically and we take for granted our many common conclusions about the nature of the world that we inhabit. The difficulty of making sense from a collection of raw data about the world was not fully appreciated until engineers and computer scientists attempted to devise machines—robots, self-driving cars, and voice-decoding software—to do what humans do automatically "without"

[5]The dream state (REM) is one of the three phases of sleep. There are several theories of the purpose of dreams, most of which involve information processing of various kinds but a few of which simply regard them to be unnecessary correlates with a good sleep. See, for example, Freud (1913), Jung (1938/2005), Revonsuo (2000), or Zhang (2004).

much thought. Our "hardware," "firmware," and "software" have to be extraordinarily sophisticated—indeed marvelous—to do so.

One's visual system allows one to distinguish among objects. One's auditory system allows us to identify the sounds of a familiar voice. With training and practice, one can make sense of the sounds spoken by others and also of the many sounds that tend to be associated with opportunities for food, water, and danger. One's sense of touch allows one to distinguish among all sorts of materials. One's sense of balance allows one to stand on one foot, run, and climb trees. Together with our ability to learn, most of us can assemble an IKEA chair without years spent reprogramming ourselves. No robot can yet do all of these or even a significant subset of these things—even after a half century of hard work by thousands of very talented scientists and engineers.[6]

The basic parameters of our physical capacities to hear, see, lift, manipulate, and run are all biologically set—although with training we can get a bit better at each of these capacities, albeit within limits that are also genetically determined. Training for a marathon can increase one's natural aerobic capacity, strength, and endurance beyond that of an ordinary person who does not train, but our maximal speed and endurance are nonetheless genetically constrained.

What is most relevant for the purposes of this essay are the internal systems of rules that affect how we make choices. A subset of these rules can be said to be "hard wired" or genetically determined, but there are many others that can be modified or overturned. For example, one can "overcome" one's instinctive fear of fire, heights, and death. One can hold onto hot objects to the point where one is burned, parachute from airplanes, charge enemy lines, or commit suicide.

The human ability to override genetically transmitted propensities, evidently improves our chances for survival. Our ability to learn new rules also makes us all more adaptable and malleable than simple

[6]In the spring of 2018, two robots were able to assemble a relatively simple IKEA chair in about 20 minutes. However, the programming was limited to a single type of chair. Numerous videos of the robots are available. See, for example, https://www.zdnet.com/article/robot-builds-an-ikea-chair-everyone-goes-nuts. Needless to say, a cave dweller might well have taken longer but not a modern man or woman who had assembled such chairs before.

models of genetic determinism suggest. These capacities both improve our chances of survival in an ever-changing world and extend the domain of humankind by increasing the number of ecosystems in which we can flourish. Our capacities to communicate and learn new rules are among those that can be enhanced by training and experience.

Socially Transmitted Rules

Most of our socially transmitted rules were learned without giving alternative rules or principles much thought, as parents, friends, and neighbors encouraged us to reach particular conclusions about particular circumstances, evaluate the consequences of our actions in particular ways, and act in certain ways in particular circumstances or when our actions will have particular consequences.

Perhaps the most obvious of our socially transmitted skills is our native tongue, the if-then relationships between sounds, characters, and ideas learned in our households and communities when we were children. Currently, more than 5000 languages exist and the one that most of us know best was learned during our childhood. So varied are these rules, that individuals who know just one of the 5000 languages, are unable to communicate with persons who know only one of the 4999 others. A few simple universal concepts—love, anger, hunger, me, you, etcetera—might be gotten across by pointing, nods, and general sorts of sounds, but not much else. Without a common language, our efforts to communicate resemble those used by dogs and chimpanzees.[7]

Socially transmitted rules differ among communities because the individual insights out of which a community's knowledge base is created tend to be path dependent, idiosyncratic, and context specific. Cave dwellers had greater use for fire and food than linguists and economists—so more effort would go into teaching the rules most relevant

---

[7]Once one knows that languages are possible and exist, one might attempt to learn another. Absent a translator or teacher, the first steps in such a process also uses pointing, nods, and general sounds to establish various if-then relationships between sounds and ideas, as with learning the names for things and actions. In such cases, one hopes to gradually internalize these if-then relationships of the new language so that more subtle forms of communication become possible.

for making fires, undertaking hunting expeditions of various kinds, and preparing meals than in developing theories of language and relative prices. They would also put more effort into creating sounds and symbols for fire, hunting, and cooking than for past participles and equilibrium prices.

The specific circumstances out of which language and other rules emerged were different and so were the results. As a consequence, there are significant differences in languages. Other differences emerged for similar reasons with respect to other rules of life, as is evident in regional differences among foodstuffs, cuisines, languages, architecture, clothing, music, religions, and ethics. Such differences are evident throughout recorded history, and they are still commonplace; there are few Lutherans in Beijing and few Buddhists in Mecca, and there are Chicago and Virginia schools of political economy.

Our measures for physical phenomena such as colors, temperatures, the seasons, lightening, our periods of development, and the point at which one changes to another are also largely products of lessons learned during our early education.[8] Other rules learned as we "grow up" affect our routines for judging what is important or interesting about a given situation and the relative merits of alternatives. A hunter, farmer, geologist, architect, and tourist do not look at the same place in the same way.

Many of our learned rules were internalized at such an early age and have played such an important role in our understanding of our self and the universe that they may be mistakenly regarded as "innate" or "hard wired." although they are socially rather than genetically transmitted.

Socially "transmitted" rules tend to reduce variations within communities and amplify them among communities. Socially transmitted rules form the basis of our civilized conduct and civilizations. It is the gradual improvement in our understanding of the seasons, life cycles, and of the

---

[8]This list reflects differences among cultures in the names for colors, measurement of years, assessment of ages and responsibilities associated with "growing up" (as for example with the youngest age at which one can work for a living, marry, or vote). Many of these have varied through time within a given society. Evidence that perceptions of color vary among individuals includes the phenomenon of "color blindness," and other psychological (Özgen and Davies 2002) and physiological evidence (Siok et al. 2009).

things that can be done with fire, plants, animals, metals, and electrons that account for our ability to dominate other species on the planet and to live relatively long and comfortable lives.

As the stock of knowledge increases and becomes more difficult to learn by watching and listening to others, innovations in education often take place. After grounding ideas are taught by one's family and friends, children may be placed in apprenticeships or under the supervision of rule-teaching specialists such as teachers and priests. As mass education became commonplace, more of our if-then relationships were learned from such educational programs. This tends to increase the uniformity in our ideas about cosmology, chemistry, economics, and ethics insofar as our teachers were trained in similar schools and universities. We may, for example, all agree that the earth is round, rotates, and revolves around the sun rather than the earth being flat and the sun rising in the East and setting in the West. Most of us do so without direct knowledge of more than the latter. Our more sophisticated models of the solar system are "simply" what we were taught.

Of course, not all of the rules passed along are correct or complete, and so both major and minor improvements in socially transmitted rules are always possible. It turned out that neither the earth nor the sun was the center of the universe—although the earth and sun are naturally centers of our attention.

Personally Modifying and Inventing Rules

The third process through which rules are acquired accounts for only a small subset of our internalized rules, but the process through which such rules are developed is of major significance.[9] This process

[9]This claim can be contested. Insofar as our "selves" emerge gradually from our early education and biological development, subsequent learning is always a bit active and allows individuals to develop their own interpretations of the lessons and information to which they were exposed. However, it is clear that relative to our genotypes, this body of self-created knowledge is small. And, insofar as that which is transmitted socially is accumulated knowledge, privately created rules—even when subject to a huge number of idiosyncratic variations—is also small relative to that created and learned by all previous generations.

is the source of the rules that we create for ourselves through insights, accidental discoveries, and trial and error. Such rules include minor revisions of one's genetically and socially transmitted rules as well as major insights about how the world is put together. Minor innovations include how one organizes one's room, unique aspects of one's diet and clothing, and idiosyncratic word usage and inflection. Major innovations include Aristotelian, Newtonian, and Einsteinian physics; Smithian, Marxist, Marshallian, and Schumpeterian economics; and the rules for making wheels, printing presses, and integrated circuits. The ability to create slightly different rule-based systems make each of us a bit different from all others in our communities and all others of our species. Although we have much in common, we are all unique—even twins exhibit many differences.

The set of self-made rules tends to be small relative to the others for many reasons including our limited imagination and the fact that it is costly to revise one's collection of learned and inherited rules. Rules are not all independent of one another; thus, changing one rule often requires significant modifications to others to avoid undermining systems of rules that have worked tolerably well in the past. Moreover, there are emotional costs to changing strongly internalized rules: one may feel intensely guilty or disoriented when one violates an "important" rule learned from one's parents, priests, or teachers.

In addition, being conventional has both survival and social benefits. The rules passed on through informal and formal educational systems reflect the innovations of many generations of persons in the past, whose cumulative knowledge will naturally tend to dwarf that of even the most clever unconventional man or woman. Many innovations—perhaps most—are rejected because they conflict with other already internalized rules that seem to work reasonably well or are valued by one's community. Because this is implicitly recognized, those who violate conventions are often disparaged by other members of their communities.

Nonetheless, without the innovations that do take place, there would be no conventions, no rules to be transmitted socially. It is individual innovations that are ultimately the source of all socially transmitted rules. Without past innovations and the ability to pass them on to others, we would all be entirely dependent on the essentially static systems of rules and very limited ability to learn with which we were born.

Survivorship and the Realism of Rules

All three types of rules are affected by many tests associated with survivorship. Only rules that actually work better than previous ones or at least appear to do so tend to survive in the long run. This is true of biological rules including those that ground our species' ability to recognize, imagine, learn, and communicate new rules. It is also true of socially transmitted rules, including ones regarding diet, work, and play. It is also true of personally revised or invented rules.

Of course, many mistakes are made by both mutation and by innovative individuals, but in the long run, these tend to be weeded out. A mutation may be fatal or simply do less well than more commonplace genes at garnering the calories and mates necessary to be transmitted to the next generation. A family or society may disappear because its rules induce the wrong response to a crisis. A person may mistakenly believe that he or she can succeed by remaining asleep in bed, or that he or she can leap off of a cliff or tall building without harm. The rule systems that produce such beliefs are not likely to be copied by others.

Rules that tend to produce poor results are far less likely to be transmitted to future generations than are rules that produce good results. Thus, the quality of our information-processing rules, natural laws, and routines for making choices tends to gradually improve through time. In this sense, our understandings and expectations tend to become more "realistic" through time—that is, more consistent with their survival and transmission to future generations—although individual rules and rule systems may remain far from perfect.[10] Such gradual progress

[10]Dawkins (1989) originated the term "meme" and argued that ideas (memes) are similar to genes in that they are subject to repeated tests and most pass most of them to survive through time. Thus, only "good" ideas—ideas that can propagate themselves—survive in the long run. This term has been extended to include other aspects of cultures by other scholars in the period that followed. This paper focuses on a subset of potential memes, namely rules, and in particular rules that can be internalized. Although Dawkins coined the term "meme," the idea of cultural evolution preceded Dawkins by at least a century. See Spencer (1851) for the first clear statement of social evolution.

is the basis of Hayek's (1973) and Burke's (1790) defense of cultural conservatism.

Unfortunately, nonconvexities in what may be regarded as the rules-to-survivorship function limit the extent to which small innovations can improve the systems of rules used to understand our true opportunities in the universe as it is. Both individuals and community adjustments tend to reach local maxima, rather than global ones—what Hayek (1973, pp. 99–100) refers to as dead ends. Aristotle's theory of physics was used for centuries before it was replaced with Newtonian physics and molecular chemistry. The medieval system of governance and religion were stable systems of rules that required relatively large innovations—new ideas about both life and governance—to move from the medieval local maximum to the modern one. These great revisions of natural and social rules required both luck and many innovations to achieve (Kuhn 2012; Congleton 2011).

Together survivorship and nonconvexities imply that our internalized rules and the societies built on rule-bound foundations exhibit a good deal of realism and stability, although they are not completely realistic or stable. The stability of our internalized rules implies that we ourselves are stable—that we have stable dispositions—which makes us predictable counterparts in life's many social activities. That changes in one's internalized rules are possible also allows social systems to evolve. In the end, realism constrains our subjectivity and imagination, although it does not fully determine them. Survivorship implies that our internalized rules—even ones that may not appear to be rational—tend to provide useful realistic assessments of the world and its possibilities.[11]

[11]See Frank (1988) for a book length exposition on the underlying rationality of many human passions. With regards to religion, for theists the same evolutionary claims will make sense. Theology improves through time as ideas are generalized and conflicts resolved. Atheists, however, may regard religion as largely delusional. However, atheists should acknowledge that the cosmology of a religion is only a small part of its rule-set. Other aspects of a religion—its causal and ethical theories—evolve during time, becoming both more general and in many cases more realistic and internally consistent. In that sense, at least, atheists should acknowledge that religions also tend to improve through time.

Putting the Pieces Together: A Model of Choice and Experience

Having described where internalized rules come from and why they tend to be realistic and stable but imperfect, the next step is to provide a model of rule-bound choice. Choices determine a nontrivial subset of our physical and mental actions. They include single actions—picking up a penny on the floor—and also long sequences of actions—as in a game of chess, travel from one country to another, career choices, the founding of a new company, or the writing of a book. Decisions to engage in various mental activities include remembering the past, sustained efforts to devise principles to account for past experience or to improve one's future choices, decisions to go to sleep or not, and also such matters as whether to continue thinking about the ideas developed in this essay or not.[12]

As a possible model of ongoing rule-bound choice, consider the following recursive process of winnowing and elimination. In the first phase, sensory data arrive, and internalized rules are used to characterize general features of a choice setting, including both key characteristics and possibilities for change. The "actual" or "status quo" is a subset of the possible. Where specifically am I; and given that, what is possible and what is not? In the second phase other rules are applied to determine the most important or relevant features of the choice setting. It is those features that will be given significant attention. In the third phase, those features which include current conditions, possible choices and consequences—are evaluated by various systems of rules that anticipate and evaluate the consequences associated with physical and mental actions. The third phase ends with the choice of a particular course of action, which may involve sequences of both mental and physical activities.

This winnowing process may yield a choice to engage in physical action (actions in the outer world) or conclude that more data and evaluation are necessary before a choice can be made (actions within one's self). The latter, in effect, restarts the process at step 1 if more external

[12]This is not to say that mental activities involve no physical changes—merely to say that such changes are within ourselves and bodies, rather than in the world outside of ourselves.

data are gathered, or at step 2 if a better understanding of what is important is undertaken, or step 3 if a clearer understanding of consequences and assessment of their relative merits seems worth additional time and attention. If the choice is to engage in additional winnowing and evaluation or to expand the range of possibilities considered, no external actions are necessary. New more refined "data" can be produced within the mind without additional sensory input as old data are further analyzed and processed. When physical actions are undertaken, additional sensory data are generated, which reinitiates the process. The process of choice occupies most of our waking hours. It is not a once in a lifetime event.

Essentially every choice—excepting suicidal ones—is subject to ongoing re-evaluation and revision. We do not close our eyes when walking from point A to point B, even in cases in which we "know" where our feet should be placed on the way from A to B. Instead, we continually update and judge whether we are making progress and adjust the placement of our feet and hands, and so on, until B is reached. Our awareness that we engage in such ongoing data collection, updating, and decision making is what is meant by self-awareness. As Descartes aptly put it, "I think therefore I am" (Cogito, ergo sum).[13]

Figure 34.1 illustrates the case in which this process of winnowing leads to an external action. It is essentially a Venn diagram with an associated feedback loop. Each step in the winnowing process uses systems of if-then relationships to reduce the domain of possibilities focused on in the next step. The process begins with sensory data and rules that discern one's situation (choice setting) from that data. Those rules may be said to determine which part of the universe the choice takes place within. The second step uses rules to identify the most important (salient) features of that setting and the alternatives worthy of more attention. The third step applies more fine-grained rules to more carefully assess the relative merits of the most important and relevant possibilities: What should I actually do? Should I just follow my routines for

[13]That such ongoing decision making is not part of the homo economicus model is a weakness of that model, but also a strength. By treating decisions as once and forever events, the number of factors that need to be modeled (taken into account) is greatly reduced, which facilitates reaching clear conclusions—even if they are only approximately correct.

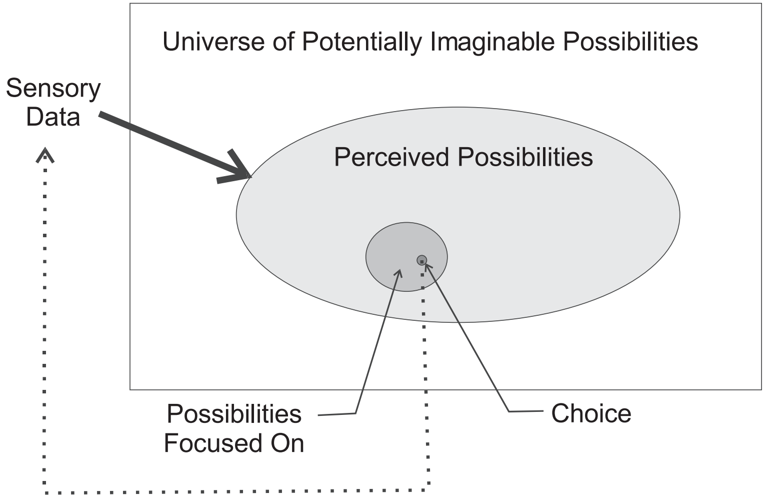


Fig. 34.1 Identifying, screening, evaluating, and choosing among possibilities

this setting? Or, should I try something new? If so, what? All three steps can be regarded as "winnowing," a process of eliminating alternatives from one's attention.

Note that this process is not simply an evaluative process. Steps 2 and 3 require imagining the actions that one can undertake and their likely consequences, both of which require an understanding of natural laws. Deciding which courses of action are worthy of attention also requires evaluation, and this is undertaken with various combinations of practical, aesthetic, and moral rules. The final choice is largely evaluative, but in a social setting normally includes expectations about other people as well as consequences.

The amount of attention devoted to making a decision varies with the apparent importance of the physical or mental actions that may be undertaken and their associated consequences. If speed seems important, the three steps will be done quickly without much analysis. If the choice seems to be a major one and speed is not important, several days—indeed years—may be spent identifying, winnowing down and evaluating alternatives. A decision to pursue a career, change religions, or marry someone will be given more attention than choosing a drink or meal at a restaurant or choosing a salutation when leaving friends at a restaurant.

Fortunately, we do not confront very many major choices. In a stable life, we mostly confront familiar choice settings, settings in which our standing routines work well. In such settings, our routines require only minor fine tuning for the oddities of a given time or place. As Hayek (1973) and Newell and Simon (1972) noted, such routines and rubrics free one's time and attention for other more significant or consequential decisions—or simply for pleasant day-dreaming.

In cases in which the action is physical, new sensory data are generated by the action which provides additional evidence about the consequences of the action(s) chosen, which allows our expectations and plans to be updated. If the results are more or less as anticipated, the plan of action is likely to be continued. If not, some "course corrections" may be undertaken—a pothole may be avoided, a crazy (non-norm-following) pedestrian dodged, the weather adjusted for or not, and so on. In other case, more analysis and reflection is necessary. In extraordinary circumstances, our standing routines work less well and significant adjustments are often necessary, as when one visits a foreign country or hears a new language for the first time or experiences a major surprise at home.

In cases in which the course of action is internal—as with mental actions to "test" the coherence, generality, and consistency of a new theory or idea—new "data" are generated without sensory inputs, but the process of decision making is similar. Relevant details and alternatives are focused on, and winnowing takes place until a plausible rule, principle, or theory is identified or not and adopted or not.

The rules applied in each stage of the process may differ according to the choice setting at hand. For example, choice settings in warfare and romance are often said to differ from those in peace or in meetings among strangers. This is, of course, the implicit meaning of the expression "all is fair and love and war." Context-specific rules apply different criteria to identify possibilities and rank them according to the circumstances at hand.

For the purposes of this essay, the highly simplified model presented above is sufficient. It includes the major features of decision making stressed in Buchanan's work, without becoming nihilistic or solipsistic. It is also largely consistent with evidence from psychology and neural science. A more finely grained analysis would attempt to better understand the rule systems that individuals use at each step in the winnowing process. Such efforts attract a good deal of attention in psychology and neurology and many book-length analyses have been undertaken, but such an analysis is not possible in a short essay nor likely to be of interest to its anticipated readership.[14]

Parallels Between Self and Political Constitutions

This subsection discusses parallels between self-constitutions and political constitutions. Such parallels are hinted at in a few clauses and asides in Buchanan's work but never really developed. A political constitution characterizes an organization with the authority to create and impose rules on persons within a particular territory. As organizations, governments are inherently rule bound, although the rules are not all written down. A written constitution specifies the general process through which a government's leadership is chosen and major policy decisions are to be made. Many of the details, however, are left to be worked out by government officials. For example, both the internal organization of parliament and election laws are often left unspecified by the constitutions of liberal democracies.

[14]Hayek (1952), Pinker (1999), and Seligman et al. (2016), for example, include book-length overviews of research on how the mind operates. Pinker, for example, notes that the human mind is adept at recognizing a wide range of shapes and objects—a very difficult capacity for computer programmer to replicate, but one that is far easier to do than many others that humans routinely undertake. His short discussion of the if-then systems of rules that loosely describe how the mind recognizes faces, places, and shapes of object takes more pages than included in this essay. And, in that book, Pinker deals only with capacities that he believes to be innate rather than learned.

Both self- and political constitutions have hierarchies of rules and standing procedures for decision making; they also continually collect data and update their decisions. New policies are adopted and old ones revised every year. Constitutional rules limit the kinds of processes that can be used to make policy decisions by the persons elected to high office and to a lesser extent by officials holding offices at lower levels of government. A constitution's rules are stable, which is to say they are binding and not subject to rapid change, although they can be revised (amended).

A liberal constitution usually includes formal limits on the kinds of rules that can lawfully be adopted. In the U.S. constitution, the Bill of Rights limits the types of laws that can be produced by national legislatures and regulatory agencies. Its amendment procedures imply that such constraints can be changed, but both popular support for such rights and the formal amendment procedure assures that neither the Bill of Rights nor the organization of governance are likely to be rapidly and repeatedly reformed. They are not chiseled into stone but sufficiently stable to be taken as "relatively absolute absolutes" to use Buchanan's phrase.

Although political scientists and political economists often classify governments into two or three categories such as democracies, autocracies, and totalitarian regimes, a nation's political constitution is more complex than suggested by that coarse categorization. There is a continuum in the extent and division of authority to and among office holders and also among the methods through which office holders may be chosen.

The "rules of the political game" are so complex and nuanced that they are rarely fully understood by those who study or are active participants in politics. For example, authority over policy is often divided up in many ways. Most legislative systems are recursive in the sense that there are many "loops" of review, revision, and selection that take place before an idea becomes law or policy. A proposal may be made by a single person or small group, then it is reviewed, revised, and voted on by another person or committee, then the same sequence occurs again with votes by yet another person or committee, which initiates another cycle of review, revision, and voting, and so on, until a bill becomes law or policy (or not). Veto power exists within subcommittees, committees, the legislature as a whole, and the government's chief executive (king, prime minister, chancellor, or president). Policy-making authority is further distributed among unelected staff within the legislative and executive branch and among bureaus and bureaucrats.

The hierarchical nature of government allows attention to be focused on the "top-level review" which in some cases may be that undertaken by voters (as in referenda and elections for representatives) and in others the decisions of elected officials. The term "democracy" is often used as a summary or approximation for the process of governance whenever the top officials are all directly or indirectly selected by voters in competitive elections. However, this top-down model of policy making is a highly simplified model of the complex decentralized process that actually produces suggestions for reform, evaluates such reforms, and implements any new laws and regulations adopted.

The model of a self-constitution developed above is similar in all respects to that of a political constitution except that only a single person is involved in the decisions reached. One's internal rules are hierarchical and veto power and agenda control often exists at several levels of our internal processes of reflection and winnowing. Several independent systems of rules may veto a course of action. One may reject an action or sequence of actions because it is too dangerous, takes too long, is ugly, or is immoral.

An internalized collection of rules can be revised, but the process is costly and thus relatively few major reforms are undertaken. Many—perhaps most—of our internalized rules are sufficiently stable that a person's "personality" can be said to last a lifetime. Even relatively unimportant mannerisms change slowly in most cases after adulthood is reached. Major revisions are occasionally observed after a personal crisis—as is also true of political constitutions—but both are rare and not always successful.

Theories that include stable rules, hierarchies, recursiveness, and gradual reform are all commonplace in psychological research. For example, Freud regarded the mind as a loose hierarchy of decision-making authority, with the superego, ego and id (Freud 2018 [1923]). Maslow (1943) stressed the hierarchical nature of what he referred to as needs. Seligman et al. (2016) used a hierarchy of virtues and dispositions to identify traits that contribute to a good life. Such hierarchies imply that some aims or aspects of character development are given attention before others.

There are also coarse classifications of personality types undertaken by psychologists that are similar in many ways to those used by political scientists to classify governments. For example, Myers-Briggs (1962) developed a widely used categorization of "personality types" based on Jung's (1923) theory of types. Such types are accounted for in the present theory as differences in the constellations of internalized rules that characterize each person's self-constitution. Another typography (Adorno et al. 1950) regards some persons to be authoritarian, which makes the connection between politics and psychology explicit. Such categories tend to be "rough approximations" because they somewhat divide up what most will acknowledge to be a continuum into discrete subsets. Such coarse classifications are useful for many purposes, as is the case for our equally coarse classifications of colors, heights, weights, and ages.

As true of the processes of government, many of our own standing procedures for making decisions are so complex that neither we, nor psychologists, fully understand them. Pinker (1999), for example, stresses their recursive and evolutionary—but still not fully understood—nature.[15] The still-mysterious parts of the process of self-governance and decision making can be regarded as judgement or intuition for the purposes of this essay, and they play nontrivial roles at every point in the process of identifying alternatives, focusing attention on a subset of the alternatives, and taking whatever course of action is decided upon.

[15]Although the model of self-governance sketched out above is consistent with all of the above psychological theories, the *homo constitutionalus* perspective developed in this paper is most similar to what Pinker refers to as the computational-evolutionary model of the mind, although without committing to a completely deterministic perspective or to particular claims about the rules that govern our thoughts and actions.

Revising and Generalizing Internalized Rules

> Recognition of the temporal dimensionality of choice provides one "reason for rules"—rules that will impose binding constraints on choice options after the rules themselves have been established. That is to say, in either a private-choice or a public-choice role, persons may choose to restrict their own futures, and such behavior may be wholly rational. (Brennan and Buchanan 1985, p. 77)

That a subset of our "soft-wired" rules are products of our unique experiences, assessments of that experience, and epiphanies about alternatives never experienced has several important implications. It implies that a person's self-constitution—one's complex system of internalized rules—is not entirely "given," but evolves through time as one makes choices, observes consequences, and reassesses the relative merits of the rules already in one's mind. This evolution is bounded by one's physical and mental capacities, but the bounds are sufficiently broad to allow for a significant range of variation among individuals and cultures. As positive and normative rules are adjusted or extended to new circumstances, we become somewhat different persons because we understand the world and behave a bit differently than our former selves—a point mentioned several times in Buchanan's writings.

Self-Evolution

How much we change through time depends on experiences, one's grounding norms with respect to tradition and innovations, and on one's ability and will to change oneself—which like other abilities varies somewhat among individuals. It is also limited by the same processes that support the internalization of rules. To unlearn or override if-then relationships can be very difficult. Even simply retraining oneself to drive on the left rather than the right side of the road—which involves revising a relatively small number of if-then relationships and ought-tos—is disorienting and time consuming, although most people can do so.

The more central and important the rules under revision are to one's sense of the universe and self, the more "connections" (e.g., supportive and cross-linking if-then relationships) one must overturn and the greater the emotional costs and time and attention required to undertake a successful revision of one's self-constitution. To withdraw from a comfortable romance, career, religion, or ideology—even when experience implies one should—can be nearly impossible.

As a consequence, our selves exhibit considerable stability, continuity, and path dependence. One's persona in retirement is not so different from that in one's middle-aged period, which is not so different from that in one's twenties. When two old friends meet after not seeing each other for a decade or two, a very common remark is "you haven't change a bit,"—which is to say their personalities, their unique systems of if-then rules, is still fundamentally the same as it was 10 or 20 years before. Of course, there are exceptions, persons who have significantly changed their rules for understanding, screening, evaluating, and acting. Such changes happen to us all as we "grow up" but occur less frequently within adults. For people who substantially revise their internal constitutions, meetings of old friends elicit comments such as "you're so different" or "I liked you better when you were your old self."

Change is always possible, but changes are evidently easier at some stages of life and settings than others, and for some systems of internalized rules than others.

Principles as Generalizations of Context-Specific Rules

The context-specificity of many of our internalized rules implies that some rules work less well when our choice settings change. As rule failures are noticed, "amendments" to our internal constitutions may be considered and adopted—not all of them consciously so. The aim of such reforms is to refine one's existing rule systems so that they work better in the new circumstances, where "betterness" is judged via other internalized rules, including ones that induce one to defer to the opinions of others or tradition.

In the course of such amendments, it is likely to be noticed that some rules are more general than others in the sense that they work well in a greater variety of circumstances. Because it takes time to develop new rules and mistakes are made before new rule systems are fully worked out, general rules have obvious advantages. They allow individuals to more easily and effectively live in new choice settings.

As the value of general rules comes to be recognized, some individuals may devote time and attention to discerning and developing such rules. Such persons may be called wise, thoughtful, or insightful. They attempt to generalize the rules most people appear to use by identifying common if-then relationships among them. By doing so, they may recognize how existing rules can be reinterpreted or revised to broaden their applicability. When one seeks advice from such a person, it is often because one's internalized rules cannot be easily generalized to unfamiliar circumstances. Scientists, philosophers, and theologians all attempt to discern such increasingly general if-then relationships, but everyone does this to some extent.

When more general rules are discovered, efforts may be made to persuade others to adopt the new rules. Persuading others to adopt new rules or general principles is not an easy task, even when the proposed new rule is actually an improvement. Truly general "principles" are always more general than useful at the time they are developed. Their usefulness is evident only after choice settings change. Moreover, many proposed generalizations prove to be false and provide little if any improvement over narrower rules when circumstances actually do change.

As long as new rules yield essentially the same choices in the choice settings most often experienced as the old rules, why invest the time and attention necessary to master new, more general rules? This natural conservatism is one of the reasons that individual dispositions and cultures evolve slowly and incrementally rather than in great leaps. How often does it really matter whether the sun rises in the East or the earth rotates counter-clockwise at a constant speed while the sun remains in place? In spite of the revolution induced by Copernicus five centuries ago, most of us still use the expressions "sunrise" and "sunset" rather than "first and last sun sight" or equivalent phrases describing our rotational journey to a point where the sun can be seen or not.

Nonetheless, many rules are gradually refined and generalized. This is true of natural laws that are developed to characterize relationships in the external world, ethical rules that characterize moral conduct and the good life, and principles for selecting new rules or revising old ones.

Rationality as a Principle for Rules and Decision Making

"Rationality" and "consistency" are two such higher-level principles for evaluating rules. Proponents of rationality insist that one's theories and overall pattern of choice should be as free from contradiction as possible. Freedom from internal contradiction is facilitated through the use of general rules. Freedom from contradiction in one's choices is facilitated by carefully considering the consequences associated with one's actions.

Because one's internalized rules are largely assembled in a haphazard way from family, friends, and others in one's community, they are not necessarily or even usually entirely consistent with one another. Some rules, for example, may encourage "living for today" and others "planning ahead." Rationality is not a consequence of simply being human but of conscious efforts to be so and survivorship insofar as consistent natural laws exist. For example, enlightenment scholars self-consciously used various consistency tests to discard a wide variety of medieval beliefs and conventions that were "overly complicated," "insufficiently general," or "unrealistic." Lightening, for example, became random discharges of electricity rather than evidence of divine displeasure.

All individuals that accept the rationality principle attempt to use rules and reach conclusions that are self-consistent, realistic, and universal. Nonetheless, rationality by itself does not induce complete convergence in the rules used by devotees of rationality. Aristotle and Adam Smith were both scholars who employed rational methodologies, but they wrote at different times, experienced very different lives, and read quite different books and stories. Their lists and theories of virtue are similar, but not identical, as noted by Smith himself. Bentham's and Kant's ethical theories were developed at roughly the same time and were both grounded in the rationality principle. However, they reach different conclusions about the domain of moral choice and one's moral duties within those domains.

In contrast to devotees of the rationality principle, other persons may acknowledge the usefulness of the rationality principle for some purposes but insist that it is not a universal guide for conduct or for selecting rules. Such persons will attempt to be rational only in circumstances in which it appears to be especially useful. As a consequence, they will exhibit rationality (realism, generality, and consistency) in some of their decisions but not others.

They might, for example, rationally undertake the design of a house, their career, and financial planning but make no effort to be consistent when engaging in hobbies, romance, or conversations with friends and family. They might watch a football game on television alone, but still cheer out loud when their favorite team scores or prevents their opponent from scoring. Other screening and evaluative rules would be used in choice settings in which rationality does not appear to be especially useful.

Persons who are "less than rational," may still exhibit a great deal of consistency in their choices, but that consistency emerges from properties of the rules that they have internalized, rather than from self-conscious efforts to "rationalize" their routines and intuitions.[16] Contradictory rules often fail the test of time, because they tend to be mistake and regret prone. Screening and evaluative rules that often contradict one another also tend to consume time and attention as

[16]The "framing effect" identified by Tversky and Kahneman (1981) may be regarded as information that induces an individual to use one set of evaluative principles rather than another. That choices change because of framing implies that the overall collection of evaluative rules is not entirely self-consistent (transitive). Nonetheless, within a particular type of choice setting (frame), choices may still be self-consistent on average—sufficiently so that economic models can shed useful light on behavior.

contradictions are sorted out and regrets accumulate. Inconsistent rules thus tend to be revised or replaced with more general and realistic rules through time because they work better, rather than because they are "rational." This evolutionary aspect of the rules that parents pass on to their children tends to produce more internal consistency than the persons using those rules realize.

Both devotees of rationality and others may recognize that part of their behavior is "irrational" or "nonrational," which is to say inconsistent with forward-looking, realistic, consistent analysis of one's interests and of the means for promoting them. Among rationalists, such irrational choices would be regarded as errors or evidence of weakness of will. Among nonrationalists, such irrational behavior may be celebrated as a type of freedom from their own internalized rules and routines. In either case, the irrational is recognized only because rational choices are known to be possible.

In choice settings in which one's rules are entirely self-consistent the results of behavior can be represented using the utility-maximizing model. Even though no conscious effort to maximize "utility" has been undertaken, the theory of "revealed preference" implies that any pattern of self-consistent behavior can be characterized with a utility function.[17] The utility-maximizing models of economics and game theory are thus perfectly reasonable models of choice in settings in which one's rules are consistent with one another. This could well be the case within grocery stores, production lines, and investment banks.

For devotees of rationality, such domains may be quite large, and they will be embarrassed by cases in which inconsistencies emerge. For others, there will be choice settings in which consistency is evident, but their overall pattern of decisions will exhibit many inconsistencies as, for example, different systems of rules may be applied to make choices in different types of choice settings.

[17]See Samuelson's (1948) and Houthakker's (1950) theories of revealed preference.

Does *Homo Constitutionalus* Solve Problems Associated with Conventional Rational Choice Models?

> The individual is presumed to be facing the following question: What ethical rule shall I adopt as a guide to my behavior in subsequent actions? There are two alternatives before him. He can adopt a rule, which we shall call "the moral law," or he can adopt a rule which, loosely, we shall call "the private maxim." By selecting the first, the individual commits himself to act in subsequent situations on the basis of some-thing like the generalization principle…By selecting the second rule instead, he commits himself in advance to no particular principle of behavior. He retains full freedom to act on the basis of expedient considerations in each particular instance that arises. (Buchanan 1965, p. 2)

The rule-based model of human choice sketched out above can be regarded as a generalization of the utility-maximizing model, one that includes that model as a special case but that can account for inconsistencies and both personal and cultural evolution. Choices remain purposeful but now include choices about which rules to internalize and how to apply the various rules one has internalized. That we are aware that our own systems of rules are imperfect also makes sense of various products and services such as self-help books and psychologists that make no sense in the utility-maximizing model. That we have the ability to learn and internalize rules makes the "self" and "self-interest" partly endogenous.

There are many cases in which people fail to behave as predicted by *homo economicus*, but which are predictable under the *homo constitutionalus* model. For example, experiments on a variety of social dilemmas find far more cooperative and ethical behavior than can be accounted for by narrow self-interest, ignorance, or confusion.[18] Economic experimenters believe that their subjects attempt to maximize monetary rewards, because this is what *homo economicus* would do in their

[18]See, for example, Tversky and Kahneman (1981, 1884), Andreoni (1995), or Pinker (1999).

contrived choice settings. Yet, in many cases, most of the subjects in the experiments behave in other ways—they behave as rule-bound individuals using rules devised for other choice settings and purposes.

Whenever moral rules and similar norms affect behavior, then the manner of play also matters. *Homo constitutionalus* will assess the relative merits of actions with practical and moral interests in mind. The rewards associated with small monetary payments can easily be less than the rewards of playing in accordance with one's internalized norms—or with routines that have been profitably used in other circumstances. The cost of such moral or routine behavior in most experiments is a trivial reduction in one's monetary payoffs. Indeed, if one plays with other moral persons, the payoffs are often increased by such "irrationality." Differences in the behavior among subjects can largely be explained by differences in their internalized rules.[19]

Another puzzle for the *homo-economicus* model is the framing effect(s) identified by Tversky and Kahneman (1981, 1984). Subjects were found to make choices among risky outcomes according to the manner in which the setting and risks were described. *Homo economicus* would be unaffected by such "framing effects" because he, she, or it always maximizes expected income or utility. *Homo constitutionalus*, in contrast, is subject to framing effects whenever the rules used to select among alternatives are context specific. Framing in such cases determines which rules are applied, which affects the choices ultimately made. The existence of framing effects is a predictable consequence of internalized rule systems that are context specific and not entirely self-consistent.

That one's internalized systems of rules imperfectly account for laboratory settings is not surprising, because one's internalized rule systems emerged for other choice environments and are not likely to be perfect for the lab. If laboratory settings became commonplace for individuals, their internalized systems of rules would gradually be revised in the direction that maximizes the rewards of lab performance—which might still include a variety of other considerations than the small monetary rewards on offer.

[19]See, for example, Vanberg and Congleton (1992) or Wilson et al. (2012).

The Rule-Based Sensory Order: A Model of Everything?

There is a sense in which this short essay covers just about everything, and it is meant to do so. By defining rules as "if-then relationships," it clarifies what is meant by the somewhat loose usage of the term "rules" that characterizes most papers about rules. By doing so, it reminds readers of the many types of if-then relationships that we use every day. The laws of natural and social science are rules in this sense. Most laws enforced by government have this character, as do most ethical principles and moral maxims, and most of our rubrics and routines. Our capacities for internalizing and revising rules have generated the rule systems that we each use to understand the world, determine possibilities, and decide what to do.

Choices are influenced by a variety of if-then relationships—not all of which are subject to our control—but many of which are. Without our abilities to gradually learn and improve our understandings of natural laws and our own interests, self-improvement and human progress would be impossible. And, there would be little that an individual could do beyond the mandates of their genetic makeup. We would all be ants or monkeys, rather than humans. It is our ability to use and refine our if-then relationships to change both ourselves and the world we live in that demonstrates that individual choices matter.

With respect to social science, that rules can be learned and revised and are used to guide decisions has a variety of implications. Only if common rules exist are social sciences and psychology possible. Without such rules, human behavior could not be expressed as conditional propensities or natural laws, and only vague statistical predictions would be possible. That differences exist among our internalized rules accounts for the individuality of human experience and differences among cultures. Such differences also account for the limits of social science and the irreducible error terms of both social science and psychology.

With respect to economics and political economy, the internalization of rules has a number of implications. If all the rule-based systems internalized by individuals are internally consistent and aim only for survival, income, and domination, then the widely used *homo economicus* models may be sufficient to explain and predict human behavior. However, when the rules internalized include moral principles, lack consistency, are in some ways unrealistic, and change through time, analysis that assumes narrow and rational self-interest will be limited in its ability to explain human behavior, social outcomes, or human progress.

The model developed in this essay stresses the subjectivity and individuality of experience, but it does not imply that "anything can happen," as some scholars stressing subjectivism tend to. Rather, the biological and social evolutionary foundations of our inherited and learned rules imply that many, perhaps most, of our grounding rules have survival value: they address commonplace problems associated with the emergence of homo sapiens as a species and the subsequent emergence of civil society. Our rules for understanding the world ground our sensory orders, and they cannot be entirely unrealistic without undermining our prospects for survival in the long run.

However, it should be acknowledged that the rules we invent for ourselves in developed societies are less constrained by survivorship pressures. Many less than life-threatening delusions are compatible with survival in societies that live well away from the margins of survival. Self-delusion in such societies is not necessarily fatal. Nonetheless, there are limits on the rules one can apply in everyday life. In prosperous societies, the evolution of rules is propelled by social pressures that help create the conditions for prosperity and also other higher-level principles that can be used to separate "crazy" from "realistic" or "reasonable" rules. Rationality is one such principle, although it is not the only one.[20]

Overall, this essay is one that Buchanan might well have enjoyed and had sympathy with, although that can no longer be known with any certainty. However, its aim is not to obtain his imagined approval but

[20]The rationality principle has been more widely taught and so has become more widely internalized during the past two centuries. This may well account for a significant part of the acceleration of prosperity that took place during the same period. Rules that are realistic allow one to more accurately anticipated the consequences of one's actions, which clearly helps to improve plans of all sorts whenever consequences matter.

to integrate and extend some ideas from his work and connect them with others from philosophy and evolutionary psychology. The result is a coherent model of man, one that accounts for our individual sensory orders, commonalities among them, the importance of culture, human progress, and behavior that cannot easily be brought into the utility-maximizing models of decision making widely used in economics and game theory.

References

Adorno, T. W., Frenkel-Brunswik, E., Levinson, D., & Sanford, N. (1950). *The Authoritarian Personality*. New York: Harper and Brothers.

Andreoni, J. (1995). Cooperation in Public-Goods Experiments: Kindness or Confusion? *American Economic Review, 85,* 891–904.

Brennan, G., & Buchanan, J. M. (1985). *The Reason of Rules.* Cambridge: Cambridge University Press. Reprinted by Liberty Fund, Indianapolis, IN (2000).

Buchanan, J. M. (1965). Ethical Rules, Expected Values, and Large Numbers. *Ethics, 76,* 1–13.

Buchanan, J. M. (1979). *What Should Economists Do?*. Indianapolis, IN: Liberty Fund.

Buchanan, J. M. (2005). *Why I, Too, Am Not a Conservative: The Normative Vision of Classical Liberalism*. Cheltenham, UK: Edward Elgar.

Buchanan, J. M., & Congleton, R. D. (1998). *Politics by Principle, Not Interest: Towards Nondiscriminatory Democracy*. Cambridge University Press.

Burke, E. (1790). *Reflections on the Revolution in France* (4th ed.). London, UK: J. Dodsley.

Congleton, R. D. (2011). *Perfecting Parliament: Liberalism, Constitutional Reform, and the Emergence of Western Democracy*. Cambridge: Cambridge University Press.

Congleton, R. D., & Vanberg, V. (1992). Rationality, Morality, and Exit. *American Political Science Review, 86,* 418–431.

Dawkins, R. (1989). *The Selfish Gene*. Oxford: Oxford University Press.

Frank, R. H. (1988). *Passions Within Reason: The Strategic Role of the Emotions*. New York: W. W. Norton & Co.

Freud, S. (1913). *The Interpretation of Dreams* (A. A. Brill, Trans.). New York: Macmillan.

Freud, S. (1923/2018). *The Ego and the Id*. Mineola, NY: Dover Publications.
Hayek, F. A. (1952). *The Sensory Order: An Inquiry into the Foundations of Theoretical Psychology*. Chicago, IL: University of Chicago Press.
Hayek, F. A. (1973). *Law, Legislation and Liberty Vol. 1: Rules and Order*. Chicago, IL: University of Chicago Press.
Houthakker, H. S. (1950). Revealed Preference and the Utility Function. *Economica, 17*(66), 159–174.
Jung, C. G. (1923). *Psychological Types: Or the Psychology of Individuation*. Oxford, UK: Harcourt, Brace.
Jung, C. G. (1938). *Dream Analysis: Notes of the Seminar Given in 1928–30* (Vol. 1) (W. McGuire, Ed.). East Sussex, UK: Routledge.
Kirchgässner, G. (2014). The Role of Homo Oeconomicus in the Political Economy of James Buchanan. *Constitutional Political Economy, 25,* 2–17.
Kuhn, T. S. (2012). *The Structure of Scientific Revolutions*. Chicago, IL: University of Chicago Press.
Maslow, A. H. (1943). A Theory of Human Motivation. *Psychological Review, 50,* 370.
Myers, I. B. (1962). *The Myers-Briggs Type Indicator: Manual*. Palo Alto, CA: Consulting Psychologists Press.
Newell, A., & Simon, H. A. (1972). *Human Problem Solving*. Englewood Cliffs, NJ: Prentice-Hall.
Nozick, R. (1994). *The Nature of Rationality*. Princeton, NJ: Princeton University Press.
Özgen, E., & Davies, I. R. (2002). Acquisition of Categorical Color Perception: A Perceptual Learning Approach to the Linguistic Relativity Hypothesis. *Journal of Experimental Psychology, 131,* 477.
Pinker, S. (1999). *How the Mind Works*. New York: Penguin Books.
Revonsuo, A. (2000). The Reinterpretation of Dreams: An Evolutionary Hypothesis of the Function of Dreaming. *Behavioral and Brain Sciences, 23*, 793–1121.
Samuelson, P. A. (1948). Consumption Theory in Terms of Revealed Preference. *Economica, 15,* 243–253.
Seligman, M. E. P., Railton, P., Baumeister, R. F., & Sripada, C. (2016). *Homo Prospectus*. Oxford: Oxford University Press.
Siok, W. T., Kay, P., Wang, W. S., Chan, A. H., Chen, L., Luke, K. K., et al. (2009). Language Regions of Brain Are Operative in Color Perception. *Proceedings of the National Academy of Sciences, 106,* 8140–8145.
Spencer, H. (1851). *Social Statics*. London: Routledge.

Tversky, A., & Kahneman, D. (1981). The Framing of Decisions and the Psychology of Choice. *Science, 211,* 453–458.

Tversky, A., & Kahneman, D. (1984). Choices, Values, and Frames. *American Psychologist, 39,* 341–350.

Wilson, B., Jaworski, T., Shurter, K. E., & Smyth, A. (2012). The Ecological and Civil Mainsprings of Property: An Experimental Economic History of Whalers' Rules of Capture. *Journal of Law Economics and Organization, 28,* 617–656.

Zhang, J. (2004). Memory Process and the Function of Sleep. *Journal of Theoretics, 6,* 1–7.

35

The Constitution of Markets

Geoffrey Brennan and Hartmut Kliemt

Sketching the Agenda

The question of the appropriate role of markets in the constitution of a well-ordered society is a long-standing one and boasts an enormous literature. Although we shall say a little about this literature in section

G. Brennan (✉)
Philosophy Department, Australian National University,
Canberra, ACT, Australia
e-mail: geoffrey.brennan@anu.edu.au

G. Brennan
UNC-Chapel Hill and Political Science Department,
Duke University, Chapel Hill, NC, USA

H. Kliemt
Philosophy & Economics, Frankfurt School of Finance & Management,
Frankfurt am Main, Germany

H. Kliemt
Behavioural and Institutional Economics Unit,
Justus Liebig University, Giessen, Germany

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_35

"The Normative Assessment of Markets" below—emphasizing both the range of criteria of 'appropriateness' and the variety of claims that have been made both for and against "the" market—that exercise is not the main focus of this paper. Instead, as the reference in our title to the "constitution" of markets indicates, we focus on Buchanan's view that, as in the case of other legal institutions, the legitimacy of markets is ultimately constituted by the unanimous agreement of those who are to be participants in those markets.

Many (probably most) libertarian and classical liberal[1] defenders of a liberal market order do not assess markets in these constitutional political economy terms. Instead, they see the arguments they present for markets as independently normatively grounded—either in terms of 'natural rights', or in consequentialist terms emphasizing the vast general benefits to which market organization gives rise, or perhaps in terms of the distinctive virtues that markets tend to inculcate. As a self-confessed "classical liberal",[2] Buchanan presumably acknowledges the normative force of at least some of these claims. But, as we shall argue, Buchanan's attitude to considerations of this kind has to be ambivalent (and somewhat equivocal), because that attitude must be interpreted within the wider justificatory scheme to which he is also demonstrably committed. Buchanan's point of departure and his mode of justification is *political* in that it embodies an essentially collective mode of democratic constitutional decision-making. Explicating Buchanan's intellectual scheme in these 'political' terms is the task of section "Buchanan's General Intellectual Scheme".

In section "From Politics to Markets", we shall take a familiar piece of Buchanan analytics from what is widely regarded as his most significant work *The Calculus of Consent* (written jointly with Gordon Tullock)

[1]The precise relation between 'libertarian' and 'classical liberal' positions is an interesting matter. The terms are sometimes used interchangeably, though we are disposed to think that there are significant differences of emphasis that are worth drawing out. That, however, is a task for another occasion. For our purposes it is sufficient to note that "the logical foundations of constitutional democracy" embody neither "natural rights" nor "visions of the good life" but rest *ultimately* on a specific conception of unanimous "collective" agreement.

[2]And interestingly, no less explicitly, *not* a conservative. See Buchanan (2005).

and indicate succinctly how the analytics apply in principle to the case of market arrangements. The piece in question involves the derivation of the optimal decision rule for in-period collective (political) decisions—with 'decision rule' here understood in terms of the proportion of the decision-making body required to bring a proposition into law. Emphasizing the close analogy between the choice of the collective decision rule and the choice of market institutions (as well as the specification of the appropriate domain of market activity), we show that, in Buchanan's justificatory scheme, legitimate market rules rest on the same 'logical foundations of constitutional democracy' that *The Calculus* applies in detail to in-period politics. Section "Buchanan's Classical Liberalism?" raises the question as to whether Buchanan's innovative, but also somewhat idiosyncratic, procedural constitutionalism may legitimately be classified as classical liberalism. Section "Summary Conclusions and Assessments" summarizes and indicates some upshots of Buchanan's line of argument.

The Normative Assessment of Markets

Over the history of Economics as a separate discipline,[3] assessing the pros and cons of market organization has been a core element of the intellectual agenda. Clearly, any such assessment pre-supposes a set of normative criteria, as well as claims about how the market as an institution performs against those criteria. We shall attempt in what follows to lay out a list of the more important normative criteria that have been deployed, as well as the more significant of relevant assessments. This will occupy the second subsection. First, we want to make a more general point about normative assessment—one with which Buchanan and the 'public choice project' has been strongly associated.

[3] And arguably, well before. The ancients had views about the issue—and though they were not as analytically sophisticated as their successors, their conceptions of what aspects of market operation (to the extent they had markets of the modern kind) are normatively relevant has a distinctive and arguably ethically respectable cast.

1. *The comparative mode of assessment.*

Often, normative assessment is conducted as if the object of assessment can properly be treated in isolation. But as Winston Churchill's famous quip about democracy illustrates, that 'isolated' exercise can be extremely misleading. If, as Churchill claimed, "*democracy is the worst system of government – except for all the others*" then democracy, for all its flaws, turns out to be the *best* system of political organization available.

The exercise of specifying the various ways in which a particular arrangement is imperfect involves an (often implicit) comparison between a real-world institution and the best alternative that the assessor can possibly imagine. Assessors' imaginings, however, typically abstract from real-world constraints—constraints that explain why what exists is not better than it is. This is a general point about normative assessment and operates largely independently of what the criteria of assessment are.[4] In the world we inhabit, constraints of various kinds are operative; and simply assuming those constraints away is a recipe for bad choices![5]

In modern times, Buchanan and his followers have been persistent advocates of this *comparative* approach. For them, the question: "*compared to what*?" is properly central in all normative analysis—and not least in the assessment of alternative *institutions*.[6] In the case at hand, the challenge is that market arrangements ought to be assessed vis-a-vis realistic alternatives—whether decision-making via politics (and with plausible renderings of democratic political processes)[7] or via law (with realistic assessments of judicial procedures and the limits of what the law can achieve) or via some yet other mechanism.

---

[4]Which constraints are relevant is likely to depend on the normative criteria.

[5]The challenge at stake is often treated in terms of an insistence on "feasibility" considerations—but it is not entirely clear that that kind of formulation of the problem is unproblematic. See Brennan (2013).

[6]The relevant argument is connected to the "public choice theory" critique of "benevolent despot" conceptions of government. The line gets a more general airing in John Broome's (1999) claim that "goodness is fully reducible to betterness".

[7]This arguably represents the core of the "public choice" project.

Buchanan's advocacy of the 'comparative' approach arose specifically in relation to the analysis of so-called "market failure" in the welfare economics of the 1950's and 1960's and is closely associated with Buchanan's 'public choice' project. The fact that markets in the presence of externalities and generalized public goods could be shown to produce equilibria that are not Pareto optimal had been taken in the welfare economics literature to establish a presumptive case for policy intervention[8]. The public choice critique of this presumption insisted that market performance in such cases has to be analysed by reference to plausible models of (democratic) political processes—rather than by reference to an imaginary, omniscient benevolent despot.[9] The critical normative question—so the argument goes—is not whether there is "market failure" but rather whether the market failures in question are more significant than the failures of alternative institutional arrangements in the relevant case. That is, if the options to be assessed are: an unregulated market on the one hand; and on the other, a regulated one in which the specific regulations are ones that can be expected to emerge from actual political determinations; then the "political failures" to be expected from those real world, working (democratic) systems have to be compared with the expected failures of markets.

We fully accept the insistence on a comparative institutional approach—in particular in the context of Public Choice analyses. Yet, the comparative institutional approach has appeared so late in the scene (and its acceptance in practice is still far from universal) that its influence on the formation of liberal market ideals historically has been rather minor. To put Buchanan's constitutional political economy of markets into historical perspective, we therefore pursue the older tradition in what follows. That is, we shall briefly rehearse the main arguments for and against markets as they have appeared in, and/or

---

[8]Quite explicitly by Samuelson (1955). He makes it clear that the "strong polar case" of public goods is designed so that the "student of public expenditure" can make a case for government action.

[9]The point had earlier been conceded by Samuelson (1954). As he put it, the "optimal solution might exist" but the real problem is to find it! And he explicitly expresses scepticism about various kinds of voting mechanisms as means for doing so.

influenced, liberal thinking. Any alternatives would have to be examined independently under a parallel procedure and comparison undertaken as a separate exercise.

2. *The Evaluation of markets.*
a. *Adam Smith and the Production of Wealth*

It makes sense to begin with Adam Smith's broadly consequentialist defence of market society. Smith famously sees market society as producing "*general opulence which extends itself to the lowest ranks of society*" [WN I.i.10]. According to Smith, there are two related elements in bringing this general opulence about: specialization (the "division of labour"); and market exchange. Although Smith believed that these two elements co-evolved and were mutually reinforcing, it is perhaps worthwhile to emphasize that they are conceptually independent. One could have a market where there is no division of labour; and a division of labour without markets. It also seems clear that, though Smith recognizes that dyadic market exchange delivers benefits to both exchange-partners, it is the division of labour that constitutes the primary source of the "*general opulence*": it is that element that is responsible for increases in labour productivity of 240-fold and perhaps 4800-fold—in his "*trifling example*" of the pin factory (aired in Chapter 1). And such productivity increases are, Smith claims, replicated for countless other products and across the entire range of human market interactions.

Two features of Smith's account are worth noting. One is that it involves generalized increasing returns to scale: increasing the size of the trading nexus more than proportionately increases the total product.[10] The other is that it is an objectivist account: the wealth so created is measurable in ways that render inter-individual disagreements about the meaning of the measured values as pointless as in case of, say, measures of "weight" or "length".

[10]In that sense, Smith's reasoning can explain the experience of the world since 1700—increasing population and increasing per capita output—in a manner that constant returns to scale models (still less diminishing returns models of the Malthusian type) cannot do; a thought that has increasingly occupied Buchanan, see Buchanan and Yoon (1994).

b. *The Mainstream "Welfare Economics" Account*

Interestingly, the general consequentialist case that inhabits the mainstream economics textbooks and appears in the core 'theorems' of welfare economics lacks both of these latter properties. That is, there are no generalized increasing returns—the analysis is lodged firmly in a constant-returns-to-scale model. And the focus of attention is not so much ("objective") wealth as ("subjective") preference-satisfaction.[11] 'Economic efficiency' is understood as Pareto optimality, a notion that is parasitic on agent-relative individual preferences, rather than, say, in terms of vectors of wealth-distributions (ranked in preference independent terms).

c. *The Market as an Instantiation of Freedom*

There is a rather different defence of markets that does not rely on the good things that a market order delivers (whether objectively accessible or not) but rather on the freedom that markets are claimed to instantiate. The thought is that from a base of rights (including both personal and property rights) the right to contract or to "truck and barter" can be derived; and hence the outcomes achieved by the voluntary agreements that are entered into, consistent with such rights, are an expression of respect for individual autonomy in a free society.[12] When Milton Friedman refers, in the title of a well-known book, to people being "free to choose" he makes a gesture in this direction. Likewise, Robert Nozick believes that commercial relations among "consenting adults" are to be respected as instantiations of freedom.

---

[11]Questionnaires that purport to offer evidence of preference satisfaction are widely regarded among economists as unreliable; yet, it is an empirical question whether or not there are, say, corroborated law-like regularities to make reliable predictions based on stated preferences. In any event, the dogmatic but empirically precarious insistence on revealed rather than stated preferences does not alter their "subjectivity".

[12]The German constitutional theorist Franz Böhm (1966) perceptively spoke of the "private law society" in which markets are just one instantiation of free contracting among autonomous persons.

In more than one setting, Buchanan appears sympathetic with the view that what is distinctive about markets is the play they give to individual freedom. As he puts it (in an essay arguing for the primacy of a kind of "exchange gestalt" in economic analysis)

> The market or market organization is not a means towards the accomplishment of anything. It is instead the institutional embodiment of the voluntary exchange processes that are entered into by individuals in their several capacities. That is all there is to it …In this conception there is no explicit meaning of the term 'efficiency' as applied to aggregative or composite results. ("What Should Economists Do?" p. 38)

There is however an important qualification to this line in Buchanan's thinking: it is only if there is ("conceivable") unanimous agreement of all those affected by an exchange that the agreement of those who are themselves party to an economic exchange suffices to normatively ratify that exchange. Only then can the market be seen as an instantiation of a freedom that fully respects the autonomy of each and every separate person involved. Otherwise, the results of in-period exchange are simply imposed on those who are not contracting parties to the exchange. Like political institutions requiring less than unanimity, "economic exchange" that involves less than all members of the relevant community must be authorized via a (higher order) *political exchange* that involves all members of that community.[13]

Two examples of this application of "the logical foundations of constitutional democracy" to "economic exchange" will be useful here. When sellers of a product agree to form a cartel, and coordinate their production and price-setting behavior, they engage in a (dyadically) voluntary contract. The effect of that contract will however be to redistribute away from consumers towards sellers. As is well-known, in such a

[13]With Buchanan's own words "*'political exchange' necessarily involves all members of the relevant community rather than the two trading partners that characterize economic exchange*" (Politics without romance 1999, p. 50). Whether the involvement of all needs to be "prior in time" or some other kind of "priority of higher order" agreement is 'conceptually' sufficient may be left open here.

case the gains to sellers are less than the losses sustained by consumers. However, this 'efficiency' aspect is not relevant to the voluntariness claim: the central point for voluntariness is rather that those consumers sustain their losses *in*voluntarily.

A second case of interest occurs when a new invention reduces the value of the human capital embodied in the old technology. In any such case, workers who had developed the relevant skills suffer a loss. The losses so sustained may be less than the benefits to consumers and owners of the new technology, but again the overall 'efficiency' of the process is not relevant to the 'liberty' issue: all that matters for freedom in such a case is that the losses sustained by displaced workers are sustained *involuntarily*. Moreover, if, as Schumpeter claimed, such 'creative destruction' is a routine aspect of the operation of markets, then the enduring of involuntary losses is just a natural part of in-period or sub-constitutional market process!

To express the relevant point more generally, any 'right' serves not just to protect its owner against certain kinds of impositions: it also provides permission for the right-owner to impose on others the consequences of making use of that right. At the level of constitutional choice, losses so inflicted need not be "harms" since losses may be legitimized by agreeing on a "constitutional" rights structure—but to call such losses irrelevant for the "voluntariness" of market processes seems to define the problem away. Put yet another way, the central observation here is just that there is a distinction between "*mutual* advantage" and "*universal* advantage"—and indeed between mutual and "*general*" advantage. If a process inflicts losses on some persons and those persons do not agree to have such losses imposed, then it is not obvious how the process can be an instantiation of liberty.

d. *Distributional Concerns*

One familiar line of criticism of the free-market order focuses on the distribution of well-being or of "opportunities" (or more narrowly of income or wealth) to which that market order gives rise. Yet, for Adam Smith at least, one of the virtues of market order is that the "*general opulence*" to which it gives rise, "*extends itself to the lowest ranks of* *society*" (Smith *Wealth of Nations*, Chap. 1). In a famous passage in *The Theory of Moral Sentiments,* Smith even goes so far as to suggest that the distribution at least of 'necessaries' (to be distinguished from 'luxuries') that emerges spontaneously in the free market is almost the same as that which would be selected on justice grounds![14]

It is worth noting our earlier general point about comparative analysis here. Comparison of the actual distribution of income (say) that emerges from the market-place with an ideal required by considerations of justice is insufficient to draw conclusions about the desirability of government intervention on 'justice' grounds. Whether government intervention makes for greater equality depends on what kinds of political institutions are in place and how credible constitutional commitments in a society are.[15] There are in fact good reasons to think that electoral competition will give rise to redistribution from the richer to poorer under realistic assumptions about the pre-tax/pre-transfer distribution within markets.[16] In any event, whether the market is a vehicle for positive redistribution or a source of avoidable inequalities, its performance in terms of the distributions to which it gives rise and the considerations that should guide the pursuit of distributive justice are clearly important matters for most commentators.[17]

There is one specific aspect to the 'distributional' issue that plays an important role in the Buchanan scheme—which is whether the institutional arrangements serve to make *everyone* better off in some normatively relevant sense. In other words, do the chosen institutions satisfy the Pareto criterion, broadly construed? To be sure, this requirement reflects more Buchanan's contractarian commitments (whether the arrangements could have been chosen by the participants under

---

[14]Other theorists would deny the empirical validity of the Smithean claim. Like Rawls, and, for that matter also Buchanan they would deem some politico-legal distribution at least at the constitutional stage appropriate to assure that advantage is universal and—in case of Rawlsian justice the least advantaged are benefitting most.

[15]Many putatively "democratic regimes" seem to be consistent with political leaders enriching themselves at the public's expense.

[16]See Buchanan (1999, pp. 13, 129–152) and Meltzer and Richard (1981).

[17]Less so Buchanan than most, interestingly—and this despite the claimed sympathy with the work of John Rawls.

appropriate choice conditions) than any specifically 'distributive justice' concerns. But the requirement that no-one be made worse off is essentially a distributional stipulation—and it serves to underline the distinction between "mutual advantage" as characterizes market exchange (or arguably "general advantage") on the one hand and "universal advantage" as the Pareto criterion requires on the other.

e. *Concerns with Agents' "Virtue"*

The thought that operating in market institutions has effects on the dispositions and modes of calculation and perhaps more broadly on the 'character' of participants is also a familiar one; and also has its origins in remarks (rather undeveloped, to be sure) in Adam Smith (and in a rather different way by Mandeville before him).[18] Many critics of market societies think it obvious that market transactions tend to make people greedy—encouraging a mode of calculation in which the interests of the chooser figure excessively highly and promoting a disposition to ignore the 'public interest' or broader ethical issues.

Smith's anxieties in this area focus less on the consumer aspect of markets and more on the effects of the division of labour in stunting workers' minds. (Smith suggested subsidised education as a possible remedy for this problem.)[19] Quite generally, the effects of markets on "character" are argued to be negative. At the same time, there is much to be said in favour of the "bourgeois virtues" (see McCloskey 2016) and in favour of markets as a source of their cultivation. In particular, the fairly common view that the proper functioning of markets relies on moral capital that is necessarily created in non-market contexts is in no way self-evident. There is rather strong theoretical support for the thesis that markets can endogenously create the virtues on which they rely (see Baurmann 2002).

---

[18]Manderville makes highly salient the possibility (for Manderville it is a fact!) that there may be a conflict between agent virtue and good consequences in terms of general material well-being.

[19]Incidentally, Smith thought that market society encouraged trustworthiness and punctuality. He thought it also discouraged the "martial spirit" (and therefore rendered a population less able to defend itself—or at least to do so without a professional military establishment).

f. *On Balance*

As far as the relationship between advantage and liberty is concerned, over an extensive range, the consequential and 'liberty-grounded' lines of argument in favor of market institutions can operate as complements. To be sure, there may be conflicts at the margin[20]—but even in that case, both kinds of arguments can have weight and "optimal compromises" can be sought. If trade-offs are allowed at all, one doesn't have to declare liberty worthless in order to think that material well-being matters!

We shall not have anything further to say about these various familiar lines in relation to the normative assessments of markets. On the face of things, any observer might consistently hold that all are relevant—and that a satisfactory overall assessment of the market order requires attention to all the foregoing and an appropriate weighing of the various considerations in specific cases. For our subsequent analysis of Buchanan's constitutionalist approach, it is worth underlining the critique of the thesis that economic exchange per se has a claim to voluntariness. Despite a certain flirtation with the "free to choose" or voluntariness line, Buchanan was well aware of the problems with it. He was not only himself a significant participant in the public economics literature on market failure[21] but fully aware of the normative centrality

[20]Amartya Sen (1970, 1982) seems to think that conflicts between "liberty" and "Paretianism" are endemic—and that such conflicts amount to an "impossibility theorem". This claim has initiated an extended discussion. Since Sen also starts from a collectivist conceptualization of rights yet with conclusions orthogonal to Buchanan's, this discussion may seem highly relevant. We think it is not so relevant; but cannot satisfactorily deal with the issues here. In other places, one of us has argued both that the conflict may be overstated and that its resolution need not involve any deep conceptual conflict (see Brennan 2014; while the other see Kliemt 2006), though insisting that Sen mis-specifies the institutional concept of a "right" in his argument concerning the "impossibility of a Paretian Liberal" has a point against a variant of *philosophical* rather than political liberalism to which Buchanan seems sometimes also to subscribe. For further discussions particularly relevant to the relationship between Buchanan's and Sen's approaches, the special volume of *Analyse & Kritik*, 18, (1996), as occasioned by Buchanan (1996 [1975]) may be useful. Several articles by Sugden (e.g. 1985, 1993) express views closely related to Buchanan's in more technical terms, while Pattanaik (2005) offers a balanced overview. See also footnote 33.

[21]See, for example, Buchanan and Stubblebine (1999 [1962], p. 15) on externalities; Buchanan (1999 [1965], p. 15) on club goods; Buchanan (1999 [1968], p. 5) on the demand and supply of public goods; to name some of the more notable contributions.

of the distinction between mutual advantage (focusing on the parties to any simple bilateral exchange) and universal advantage.[22] Indeed, one might reasonably claim that that distinction is critical to the formation of his "general intellectual scheme" as we shall term it.

Buchanan's General Intellectual Scheme

To further "universal advantage"—with "advantage" understood for each individual in the terms in which that individual herself understands it—was the central normative goal in the Buchanan enterprise. In pursuit of this goal, economists can contribute to the full realization of the cooperative potential in human affairs by helping to identify situations that might be changed to the advantage of all.[23] More specifically, on the basis of the diagnosis that A is such a situation, the economist can submit the hypothesis that a so-called Pareto-superior move to a situation B exists. If the addressees of the diagnosis unanimously agree to switch from A to B, they corroborate the economist's hypothesis.[24]

Buchanan's emphasis on unanimous agreement is expressive both of substantive norms of interpersonal respect within a democracy and of broadly epistemic concerns. These two aspects are complementary in the following way: According to "politics as exchange", legitimacy ultimately arises from a unanimous *collective choice*. Independently of the *collective* choices in which the preferences are expressed, it cannot be *known* whether Pareto-superior moves are on offer. Hypotheses concerning Pareto-improvements therefore translate into predictions concerning the emergence of unanimous collective choices that then can also provide the justification for the suggested changes.

---

[22]The challenge for a broadly subjectivist account of individual preference (and perhaps derivatively well-being) was how to formulate the idea of universal advantage in some operational manner.

[23]Cooperative advantage seems more closely related to advantage as assessed subjectively while "symbiotic" relations seem to have stronger objective ring to them.

[24]Sometimes Buchanan seems to allow for normative moral-political assessments that are not restricted to pointing out Pareto improvements. Yet, ultimately politics as exchange requires that unanimous agreement is at least conceivable.

Here, Buchanan borrows directly from Wicksell's habilitation thesis (1896). Wicksell argued that there is a one-to-one relation between the Pareto criterion and unanimous choice. Given only agent rationality, so the thought went, if agents unanimously agree to a collective action, then that action must produce universal net benefits as assessed by the agreeing actors under the unanimity constraint. The unanimity rule becomes thereby the institutional rule of recognition of Pareto improvements in both the epistemic and the justificatory sense.[25] By their unanimous agreement, individuals reveal that they prefer a change (epistemic condition) and they normatively ratify the change by not vetoing it though they could have (justificatory condition).

As Wicksell himself recognized, unanimity might present hold-out problems: individuals might rationally refuse to consent in order to secure a better deal. Accordingly, Wicksell retreated to 'virtual unanimity' as a concession to that difficulty. He did so without actually demonstrating that the problem would be entirely solved even if virtual unanimity would ever be plausible. But is it plausible that virtual unanimity would ever be forthcoming?

Buchanan recognizes that unanimity is simply unworkable as a rule for in-period policy choice. To put the point most starkly, rational citizens in a well-defined polity would unanimously *reject* the unanimity rule for in-period choices: whatever, if anything, would survive the in-period unanimity test would be "too" small a subset of the collective actions that promise positive expected benefits. Individuals would foresee on the constitutional level that in-period hold-out strategies would interfere with realizing their subjective interests. In response, Buchanan insisted, unanimity would be used only at the more abstract level of the determination of the basic institutions of society—the rules of the socio-political game. Along lines first indicated by Vickrey (1945) in his adaption of welfare economic reasoning to the modern preference-representational utility concept [and strongly redolent of Rawls (1971)] and Harsanyi (1953, 1955)], Buchanan added an auxiliary argument

[25]It may be noted in passing that Herbert Hart's (1961) central concept of the rule of recognition is also foundational in an epistiemic and a justificatory sense for identifying what is positive law.

to render the hold-out problem less salient on the foundational constitutional level. Buchanan's thought was that the shift to the level of decision-making on which the choices are constitutional commitments expected to be in place "for good" would make it exceedingly difficult for individuals to foresee how alternative institutional arrangements would differentially affect them personally. This would moderate the role that narrow self-interest plays in bargaining over rules and make securing unanimity at the constitutional level more likely.[26]

Buchanan's imagined point of departure is one in which each member of the relevant polity is to be involved in the selection of the basic constitutional commitments and each can exercise a veto over any particular selection. It is worthy of emphasis that this departure point is *democratically-collectivist* and *constitutionally-individualist*. Ultimately the normative authority to legitimize actions and, more importantly, to create justified rules and norms emerges from a democratic process that is ineluctably collective. But since *every* individual is endowed with a veto and since the veto is assigned to individuals, the scheme is constitutionally-individualist.

Noting that, in politics, sovereignty is traditionally characterized as normative authority that is not subject to any other normative authority, Buchanan's fundamental point of departure can be instructively characterized also in terms of the traditional political sovereignty concept. Since ultimately justification requires a collective decision, individuals cannot be sovereign in their separate capacities; yet, since the democratic body-politic has normative authority only under the unanimity constraint, *it* is not sovereign either. By this construction in a Buchanan type constitutional democracy, there is no traditional sovereign and the claim that, in a constitutional democracy, all constitutional powers are normatively constrained is fulfilled.

Nevertheless, even if there is no sovereign in the traditional sense of that term, there is a single ultimate source of justification in the

[26]It is worth noting that in the Wicksellian version, the normative credentials of unanimity are contingent on a prior "just" distribution. Unanimity is then for Wicksell merely "justice-preserving" rather than justice-*creating* (and he does indeed talk explicitly in terms of justice).

setting Buchanan envisages.[27] Three features of this setting are worth underlining:

a. Whereas in the conventional Hobbesian scheme for normatively sovereign *individuals,* nothing is originally forbidden (the natural right to everything amounting to the absence of the obligation to omit anything in "state of nature"), one might say that, according to Buchanan's "logical foundations of constitutional democracy" "everything is presumptively forbidden" in the sense that each individual has to acquire the permission of all (other) members for any action whatsoever. In that situation, very little (perhaps nothing) can get done. Each can only act if he can secure the consent of his fellows—if he can avoid the veto of any other. Yet, as Buchanan sees it, this is the price for procedurally operationalizing the idea of ("Kantian") respect for the separateness of persons at the ultimate level of democratic constitutional choice.
b. The situation Buchanan envisages is one of radical equality. By endowing each individual with a veto against any action to be taken by anyone, each and every individual is equally and fully respected as a separate person. There is only one currency in the constitutional arena—the possession of the veto. That veto is each individual's sole bargaining chip; and the collective unanimity principle endows everyone with the same chip!
c. There is no scope for comparative advantage in the setting of constitutional opinion formation because everyone is in an identical position (with nothing on the basis of which to develop tastes or specialized skills). There may, to be sure, be differences of opinion about how institutions work or about which of their working properties are significant. But the problem confronting those involved in foundational "politics as exchange" is one of securing agreement, not of managing exchanges as such. Until the institutions are agreed

[27]The hierarchy of norms emerges from a single basic normative source which guarantees the unity of the order so constructed; see for the traditional concern with the unity of the order Kelsen (2000 [1934]).

and up and running, there are no goods to trade, no productive skills to develop. It is worth emphasizing this feature, because Buchanan often talks of "exchange, trade *and agreement*" as if they amount to the same thing. We think that that kind of elision is misleading. Exchange may give rise to an agreement of sorts—concerning the terms on which the exchange is to occur. But agreement can also arise more generally, simply on the basis of common beliefs. In that sense, the terms of the agreement that makes up the "constitutional contract" can be a mix of compromise on the one hand (where I give up insistence on one feature in return for others conceding in relation to other features) with simple 'overlapping consensus' on the other, under which there happens to be universal agreement about the desirability of particular arrangements. The "exchange" of ideas and beliefs and the "exchange of goods" operate by processes that are different in what seem to us to be important respects.

This then is the setting on the basis of which Buchanan derives his normative recommendations, such as they are. Note that it is quintessentially a 'process test'. Whatever emerges from that constitutional agreement carries normative authority—and it does so, not because of its independent properties, but because it is *chosen* by all! This fact explains why Buchanan so often emphasizes that his own (and others') specific recommendations concerning "desirable" institutions are merely conjectures—speculations as to what *would* be so chosen. Perhaps (in some moods) Buchanan might stipulate that they are speculations as to what would be chosen by *rational* choosers—but we are sceptical that Buchanan would want "rationality" to do serious independent normative work. One possible interpretation of Buchanan here is that he is contributing a unifying model to the deliberative process in which members of a *constitutional democracy*, who subscribe to Churchill's comparative institutional endorsement (about democracy being the best of all actual systems), explicate their fundamental justificatory principles.

It is worth noting too that, to the extent that there *is* any constitutional bargaining (any exchanging among individuals of "veto-restraint") then it is necessary to distinguish between 'constitutional design' and 'constitutional reform'. Put another way, there is a distinction between: on the one hand, the use of the Buchanan scheme as a critique of existing institutions on the basis that those institutions could not have emerged from unanimous agreement; and on the other, the use of the Buchanan unanimity rule to evaluate changes in prevailing institutional arrangements. In the former case, the status quo is an imagined state in which there are no institutions in place; in the latter case, there is a regime in place and the issue is whether all will agree to the change under consideration. (There is a general proposition that the outcome of any bargaining game depends on the status quo—and there seems no good reason to doubt that that proposition will not hold good in the constitutional setting.)

A second distinction relevant here is that between the justificatory scheme as a piece of conceptual apparatus on the one hand and as a practical empirical test on the other. In the latter case, it would be the fact that institutional arrangements emerged from a universal-veto setting that constitutes their justification. But since this test is almost never met, there is very little in the way of operative institutions that is truly justified. In the former case, the justificatory scheme operates not so much as a genuine process test and more as a means of framing the approach to justification that the analyst is committed to. The test here operates negatively in the sense that the critical question becomes: "how plausible is it that the constitutional arrangement under consideration could have emerged from unanimous agreement?" If the answer is: "pretty implausible"—then we have reason to search for alternatives that seem ("comparatively") more likely to satisfy this test. This exercise may involve a significant amount of pure speculation, since we have little direct evidence to discipline our speculations. But, as Buchanan might claim, they will at least be speculations anchored in a decision rule that is systematically expressive of both democratic and individualist values and in this sense of the "right kind".[28]

[28]The adherents of what alluding to Buchanan's theory of clubs may be called "club contractarianism" might be inclined to argue here that unanimity concerns merely the exit and entry choices to clubs with alternative constitutions. Yet this kind of argument is foreclosed for those who take both the communitarian nature of constitutional democracy and its inherent conception of mutual respect seriously.

From Politics to Markets

In the most familiar application of the general justificatory scheme in *The Calculus of Consent*, Buchanan and Tullock (1999 [1962]) derive the appropriate decision rule for in-period politics. They illustrate this by means of a diagram, in which the decision variable is the proportion of the relevant vote (assumed to be among representatives in a single-member electoral district system) required for a bill to be passed into law. As will be recalled, as the vote-share rule for in-period political decisions is conjecturally altered across the range from simple majority to unanimity, there is a trade-off between two considerations. On the one hand, there are the expected costs endured when one is not a member of the majority coalition (something is authorized that one does not want to be authorized). These "costs of imposed decisions" are zero at unanimity—because then one can veto any proposal that makes one worse off as compared to the status quo. But they are taken to be positive at anything less than unanimity and increasing when requiring lesser and lesser shares of votes. On the other hand, there are decision-making costs—the costs of securing agreement across a larger and larger proportion of the voting population as the decision-making rule becomes more restrictive. These decision-making costs become prohibitive as unanimity is approached. See Fig. 35.1.

As Buchanan and Tullock indicate, the cost curves are aggregated to form an overall "political cost" function. And where that function has its minimal value determines the optimal decision-rule.[29] It also indicates a level of "political failure", the cost P, below which public policy intervention will not be justified. That is, unless the degree of market

[29]Optimal to the extent that the costs are all that matters.

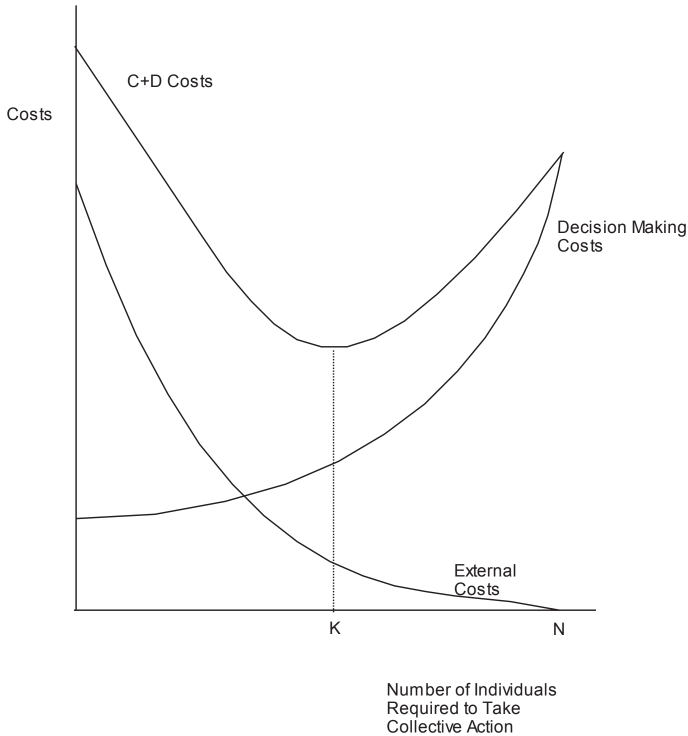


Fig. 35.1 Costs of collective decision making

failure exceeds P, political correctives should not be undertaken: the expected losses from political processes will exceed those from market processes.[30]

[30]The cost curves of Fig. 35.1 are either those of a representative individual or assumed to be representative of a class of cost curves that are inter-individually different but identical in shape. In the latter case, we cannot say that each individual will come to the same conclusion as far as the optimal majority parameter is concerned. However, if the individuals are not optimizers but boundedly rational satisficers there may be a non-empty region in which individual aspirations are satisfied and no veto is provoked, despite the fact that individually *optimal* solutions may not be reached. In particular, if the model of Fig. 35.1 serves—like Rawls' original position—as a device to assist the equilibrium search of individuals who reflect on the society in which they as a matter of fact live and which as a matter of fact has shaped their aspirations, framing-cum-satisficing seems to lead to acquiescence more plausibly (corresponding to non-veto). On bounded rationality, aspiration levels, and satificing see Simon (1957, 1985) and Selten (1990, 1998).

Buchanan and Tullock emphasize in this connection that there is nothing special about simple majority rule. They believe (conjecture) that for many domains (issues) of in-period political decision-making, a more restrictive decision-rule than simple majority will be chosen. Restrictiveness may be increased not only by increasing the majority requirement of the decision-rule itself but also by other kinds of additional stipulations—e.g. bicameralism of an appropriate kind; or via a federal structure. Analogously, restrictiveness may be decreased by reducing the number of votes necessary for ratification or by increasing the realm of issues to be politically decided.

So much can be taken as given here. Our concern is to extrapolate from this reasoning to the case of markets. Extending the familiar argument of the *Calculus,* we might conjecture that unanimous agreement on a division into 'public' and 'private' domains would emerge. Though the precise terms of that divide remain somewhat underspecified, it seems clear that individuals endowed with a veto would not agree to give up their veto unconditionally across domains. For certain domains (issues) of decision-making, they should surely insist on both: (a) being granted the authority to decide on behalf of the collectivity with their single vote; and (b) on retaining the right to veto any in-period political imposition of decisions affecting that domain.

To illustrate, individuals will plausibly demand to be authorized to make the decision whether to sleep on their "belly or back" by their single vote (each potential veto-er effectively guarantees to ratify that decision by giving up her veto concerning such decisions); and to veto any interference with her "sleeping decisions" by collective in-period politics.[31] In view of the costs involved, the interest of making such decisions with a "single own-vote" seems likely to outweigh by far any expected interest in vetoing decisions of others concerning *their* "sleeping decisions". Likewise, the interest of being able to veto decisions of others that interfere with one's own "sleeping decisions" must be expected to be much stronger than the interest in interfering

[31] Sen does not sufficiently distinguish between the stage on which the rights are constituted as parts of the rules of the game, where he may prima facie have a point, and the post-constitutional stage on which the rights are in place as parts of the *move* structure of the game. On the post constitutional stage, there certainly is no paradox even though Sen tries hard to make it appear so.

with the same kind of decisions of others. Weighing costs and benefits of decreasing the number of votes necessary to ratify an individual "sleeping-decision" to one (eliminating the veto power of others) and giving up one's own power to veto the "sleeping-decisions" of others should speak loudly in favour of putting "sleeping-decisions" in the domain that is constitutionally defined and protected as 'private' in the sense that reaching a decision is requiring only a single vote—of the individual whose back (and sleep) it is.

Beyond the somewhat artificial illustrative example of "sleeping decisions", politics as exchange should generally lead to unanimous agreement on political institutions that guarantee in some way or other "*stability of possession, its transference by consent and the execution of promises*" [Humean "natural law", as in Hume (1978 [1739])]. Since for Buchanan, there are no natural rights and no "natural law" antecedent to politics as exchange, there can be no prior specifications of the appropriate terms of private contracts, no notions of desert: all these things are derived, exactly as in the case of collective political decision-making procedures, from the inclusive constitutional choice in which all have the right of veto.

Buchanan might have chosen to settle the question of politics first. He might have treated decisions under the unanimously chosen in-period political rules as the best representation of unanimity, given the realities of transactions costs and individuals' motivational structure. He could then have allowed market arrangements to be derived from that 'best' realization of politics. Yet the logic of the *Calculus* does not suggest that individuals who are endowed with an original veto would unanimously delegate to in-period politics itself, the authority to define what can legitimately be *subject to* in-period politics. Rather, the 'constitution' is taken to include parallel and simultaneous decisions for in-period collective decision rules *and* the rules of private contracting and markets.

It is not entirely clear whether this structural feature is to be seen as a prior aspect of the justificatory procedure or is itself 'predicted' to emerge from the relevant unanimous agreement. However, the procedures for market operation—the specification of personal and property rights; the rules governing their exchange; the laws of contract and so forth—are all a *creation* of the idealized unanimous constitutional compact emerging from politics as exchange.[32]

And here, the same basic considerations weigh in the determination of what those rules and specifications will be with respect to market and collective decision-making. In particular, there will be a compromise between: 'external costs'—the costs that are imposed on one by virtue of the lawful decisions of others, on the one hand; and decision-making costs—the requirement to secure the permission of larger numbers of persons, on the other. For example, one might imagine a property regime in which individuals who suffer significant losses from the market actions of others (whether these 'externalities' be technological or merely pecuniary) could have standing in the courts: they could sue for damages just by virtue of having endured 'significant losses'. So, to make the example more concrete, individuals who lose substantially from the introduction of some new technology (hand spinners in the face of the introduction of automated looms in the spinning case; or leather-workers in the case of shoe-manufacturing machinery) could have some right to be compensated for losses in salary if these can be shown to be "significant". Such a requirement might be predicted to slow the introduction of innovations[33]; and to significantly increase transactions costs (since the predicted costs of attendant litigation would be non-negligible for both claimants and defendants). Just as in the in-period political case, so in the market case, protection against losses increases 'decision-making costs'.

Of course, in making the relevant decisions, constitutional deliberators can be assumed to weigh the working properties of different institutional arrangements: standard market economics and analogous theories of the workings of democratic political processes (including the insights of public choice theory, for example) can hardly be assumed to

[32]"*…the inclusive constitutional contract …defines the whole set of individuals' rights*" [LL: 1999 [1975], p. 55].

[33]It is not entirely obvious that this is the case however. Specialization in markets involves each individual in acquisition of highly risky (because specialized) human capital. Arguably individuals will be more disposed to make such risky investments if there are in place "safety nets" that will limit the downside losses if things go wrong.

be irrelevant in informing the rational choices that constitutional contractors are to make. And arguably, it is precisely the economist's role to provide this kind of analysis. But appeals to substantive normative theories (like natural rights and competing foundationalist schemes) is not, on Buchanan's conception, "what economists should do". Such appeals are ruled out by the Buchanan structure of justification. Ultimate normative authority rests with the collective decision *procedure* under the unanimity constraint and leaves no direct room for substantive normative considerations. As Buchanan has remarked time and again, 'whatever comes out, comes out of the procedure'. It should be noted that this acknowledges that, without substantive normative constraints, there is no iron-clad guarantee that constitutional deliberators and their economic counsellors will be led to substantively liberal institutional conclusions. If unanimous collective choice in the shadow of universal veto power should lead to substantively illiberal conclusions, those conclusions, Buchanan insists, must be seen as *justified*, however much they might be regretted by Buchanan personally.[34]

Buchanan's Classical Liberalism?

Buchanan is a self-proclaimed classical liberal.[35] If what we have laid out in the foregoing accurately reflects his basic justificatory logic, his classical liberalism cannot amount to endorsing substantive classical liberal norms and values. Instead, it must reduce to the quasi-empirical belief that individuals would, under conditions of virtual unanimity, collectively choose arrangements that allow a predominant role for 'free' markets and a rather limited role for government in social affairs. There are two questions that arise here.

[34]Buchanan might add, though, that the model of politics as exchange underlying the *Calculus*, when framing the *deliberations* of individuals who were brought up and are living under the institutions of a Western constitutional democracy, is unlikely to lead them in reflective equilibrium to illiberal conclusions.

[35]See in particular Buchanan (2005), where he attempts to lay out the "normative vision of classical liberalism" (as the sub-title has it) and to distinguish that vision from the 'conservative' one with which it is often confused.

First, what are the grounds for this belief? After all, as we have noted, it is not as if there is a large number of natural experiments in which the basic rules of social order are actually chosen under conditions of universal (or quasi-universal) veto. As Buchanan emphasizes in many places, beliefs about the likely outcome of idealized constitutional contract are ultimately to be recognized as mere speculations. In that sense, for example, the analysis of the 'optimal decision rule' for collective decisions laid out in the *Calculus* ought to be regarded as *illustrative* of the kind of calculus constitutional contractors would rationally undertake, rather than as a definitive determination of what the optimal rule should be.[36] If, however, that analysis is (at best) a speculation as to what is likely to emerge from the constitutional compact, the speculation is one for which the test for validity—and, for that matter, even a plausibility test—appears to be relatively inaccessible. In that sense, the Buchanan scheme seems to licence each of us to retain our pet theories about what rational persons in the original position would choose—with very little by way of a test as to which of us is correct.

Second, is Buchanan's commitment to the authority of constitutional contract as complete as he makes out? Think of the 'calculus of consent' in this way: suppose each of us (including Buchanan) has firm convictions as to what arrangements would be best.[37] Suppose equally that each of us recognizes an overarching obligation of 'equal respect' to fellow-citizens. Then each is possessed of two competing normative impulses: one to secure the best outcome; the other to accord fellow-contractors the respect that he himself considers is their due. Just as any conscientious market participant must recognize that her own preferences do not unilaterally determine the outcome of an exchange—that those of her contracting partner operate as a proper constraint—so in the collective decision about basic institutions, each must treat the

[36]As Buchanan (1999 [1975]: 7, p. 55) emphasizes, in the *Calculus*, he and Tullock '*derived a logical basis for the adoption of less-than-unanimity rules, although we did not present arguments for any specific one among a large set of alternatives.*'

[37]Here "best" may be interpreted "*either in terms of the individual's own interests or in terms of the individual's own version of some general interest*" (Buchanan 1999: 1, p. 372) or indeed, presumably of other ethical precepts which the individual endorses.

beliefs and judgments of others about the relative virtues of different institutional arrangements as having independent normative authority. That is what it means to take *unanimous* consent as authoritative.

Seeing himself as participant in an ongoing "constitutional conversation" Buchanan must hold in tension his own views about what arrangements would be best and his commitment to the normative authority of the corresponding views of fellow-citizens. In that sense, he may simultaneously hold the substantive view that a free-market liberal order is most desirable normatively—and uphold the principle that that view is only one among many and has no a priori authority. He can of course attempt to persuade his fellow constitutional contractors that his classical liberal views are the "right ones" and array his arguments to that effect by an appeal to the substantive normative properties of markets. But he is torn between the intrinsic normative authority of such arguments, as they seem to him, and the normative claims of other no less opinionated fellows. He need not be committed to the view that the latter consideration trumps the former[38]—but to the extent that the claims of his fellows to 'equal respect' play any role at all, the weight appropriately accorded to his own personal classical liberal commitments must be diminished.[39]

There is perhaps an alternative interpretation—which is that constitutional contractarianism just *is* classical liberalism, properly interpreted. Arguably, in certain moods, Buchanan may be sympathetic to that position—but we think that the better interpretation is one that ascribes to him a mixed normative commitment. Buchanan was famously coy about substantive normative commitments: he routinely declared that he didn't want to impose his own moral judgments on the world. However, it is consistent with that reluctance that he would nevertheless *have* moral judgments, and that he be prepared to advance those as a participant in an ongoing 'constitutional conversation' in which he claims nothing more than equal status with all other

[38]Though, wearing his constitutional contractarian hat, Buchanan does often talk as if he *were* so committed.

[39]It is exactly here that the aforementioned problems footnotes 26 and 37 with the paradox of liberalism arise.

participants. This latter position would retain the essentially collectivist point of departure for classical democratic liberalism in that it would retain a view of private rights and other attributes of the market order as politically constituted in collective unanimous agreement. Arguably, Buchanan's own classical liberal commitments and his speculations as to what rational constitutional contractors would choose in terms of market arrangements might come together. But ultimately, that coming together is, in our view, more a matter of hope than of well-grounded empirical and/or logical argument.

Summary Conclusions and Assessments

At the level of abstraction at which Buchanan's ultimate justificatory structure operates, it is unreasonable to expect detailed hypotheses as to the specific institutions to which politics as exchange would give rise. However, bearing in mind that unanimous agreement of all members of the "sovereign" democratic body politic is necessary and sufficient for normative legitimacy of constitutional arrangements there are some general conclusions that we can draw:

1. that in a Buchanan type constitutional democracy, the status of markets and the status of democratic politics (under the emergent collective decision-rules) are identical! There can be no general privileging of markets over democratic politics, (or vice versa) unless the circumstances of constitutional determination fall short of the unanimity requirement. And in the absence of unanimity, there does not seem to be anything in general that can be concluded (beyond the proposition that the emergent institutions are to that extent defective).[40] This point needs special emphasis since government action is not on

[40]We will not engage the discussion concerning whether fictitious agreement is agreement at all, whether a merely virtual unanimous agreement is in some sense less defective than a virtual disagreement etc. As a matter of comparative political philosophy (parallel to comparative institutional theory) the contractarian competitors of Buchanan's approach are no better off in these regards.

this view intrinsically *coercive* while allegedly private contracting is not. The constitutional specification of the sphere and procedures of politics and government action rests on the same foundation as the political definition of the private sphere. There is a determination of the public/private divide and of the rules under which the 'public' operates (namely those consistent with the universal-veto test) under which taxes are no more coercive than the prices people have to pay in market transactions: taxes simply represent the prices that individuals have to pay for public services. Of course, the actual public/private divide and/or the rules for collective decision-making may diverge from the 'ideal' ones. But so too may the prevailing 'constitution of the market';

2. that the operation of in-period politics will predictably be "limited"—not just by electoral processes but also by a prior specification of the proper domain of public as distinct from private activity. This implication has serious bite—in particular, it goes a long way towards legitimizing the principle of judicial review in any constitutional system[41];
3. that unanimous agreement, as a necessary condition for legitimate political action, will certainly specify some constraints on what government can do according to the power-conferring rules of the constitution—and conceivably reasonably restrictive ones. For a rather wide range of personal matters, we might predict that liberally minded individuals who are endowed with a universal veto will not give up their veto unless they receive in exchange quasi dictatorial powers in these personal matters at the sub-constitutional stages. Following the logic of the *Calculus*, just as it is possible for a community to agree unanimously to decide political matters with majorities less than unanimity, so is it possible for that community to authorize individuals to make certain 'private' decisions as if those individuals were "local dictators" acting as agents of the collectivity. Such collective determination is an element of the ultimate constitutional political agreement, in which such decisions are

[41]Whether judicial review is a legitimate piece of a constitutional regime has recently become a contested issue. See, for example, Waldron (1998, 2005).

separated from the sub-constitutional political domain by unanimous (constitutional-political) agreement. Afterwards, there is no way to legitimately interfere with such decisions via in-period politics. The only legitimate moves available to a (justified) political coalition are either: to make in-period offers or bids that leave "rights possessors" better off by their own lights (i.e. via contractual agreement and market exchange) or to pursue a renegotiation of the public/private divide under the constitution (and hence under conditions of effective unanimity);

4. that, nevertheless, the status of substantive normative accounts of the advantages and disadvantages of markets (and no less, of the success and failures of politics) remains somewhat obscure in the Buchanan treatment. Perhaps these accounts play a secondary role in normative justification (as Buchanan's commitments to classical liberal principles might suggest). Perhaps they illustrate the kinds of considerations that might weigh in the constitutional deliberations of ordinary individuals—and in that sense have a kind of explanatory role in speculations about what kinds of constitutions people will ultimately agree to. In either case, there is an equivocation about their status that Buchanan does not convincingly resolve. Either his 'classical liberal' commitments are highly contingent, or he has a view of 'classical liberalism' that is extremely distinctive—not to say, decidedly eccentric;
5. that, as the reference to judicial review suggests, any constitutional system must raise issues about how the terms of the constitution are to be interpreted and enforced. This is a somewhat neglected issue in the Buchanan corpus. Buchanan (1999 [1989], vol. 1, pp. 368–373) appeals to "ethical considerations" to explain why individuals might engage in a constitutional process in which each of them has negligible influence. Perhaps he would likewise appeal to "ethical considerations" to explain why individuals would have some incentive to abide by the provisions of a constitution that they had collectively agreed to. But there is also a significant question—of obvious relevance to any institutional analyst—about the way in which the actual real-world institutions of the law operate (since presumably much of the task of interpretation and enforcement will fall to the

legal system).[42] Alongside "market failure" and "political failure" it seems we need some recognition of the likelihood of "legal failure" and the constitutional restrictions that might minimize failure in that domain;

6. that appeals to intrinsic motives to comply seem to be institutionally "incomplete". To have a rule of law at all, intrinsically motivated individuals need to support institutions that provide extrinsic motives to behave in law abiding ways and need to be supported by such institutions. The constitutional theorist will "predict" that the necessity of institutions providing extrinsic motivation would be foreseen by participants engaging politics as exchange. It is here that the constitutional political economy perspective of the preceding discussion has to be complemented by the perspective of Public Choice (and the theories of institutional operation more generally);
7. that one available possibility is to interpret Buchanan's constitutional advice as addressed only to those who as a matter of fact share the ultimate normative commitment to politics as exchange. If fellow citizens as a matter of fact do not think in terms of "politics as exchange"—if they think in particularistic terms of "I against the rest of us" or "we against them" and simply seek advice of how to get their way with or without the assent of others—Buchanan as self-declared meta-ethical non-cognitivist cannot consistently claim to know that they are ethically wrong. However, addressing the "constituency" of those who share the ideals of constitutional democracy, Buchanan's procedural justificatory model can lend some support to the opinion that substantively liberal institutions would be unanimously accepted. Though this may not seem much of an accomplishment, since "*… the power of the mighty hath no foundation but in the opinion and belief of the people*" (Hobbes (1990 [1682], p. 16) the whole Buchanan construction significantly alters the terms on which institutional arrangements are assessed and opinion may form. That is no small achievement.

[42]Independently of whether or not the motivation to play by the rules of law is "ethical", to have rule of law at all, there certainly must be sufficiently many sufficiently influential individuals who are intrinsically motivated to uphold the legal rules in compliance with a common rule of recognition.

References

Analyse & Kritik. (1996). *Das Paradox des Liberalismus/The Paradox of Liberalism Vol. 18*. Available at http://www.analyse-und-kritik.net/HeftDetails.php?AusgabeID=39.

Baurmann, M. (2002). *The Market of Virtue*. The Hague: Kluwer.

Böhm, F. (1966). Privatrechtsgesellschaft Und Marktwirtschaft. *ORDO, 17,* 75–151.

Brennan, G. (2013). Feasibility in Optimizing Ethics. *Social Philosophy and Policy, 30,* 314–329.

Brennan, G. (2014). Liberty, Preference Satisfaction and the Case Against Categories. In I. Hirose & A. Reisner (Eds.), *Weighing and Reasoning*. Oxford: Oxford University Press.

Broome, J. (1999). *Ethics out of Economics*. Cambridge: Cambridge University Press.

Buchanan, J. M. (1996). An Ambiguity in Sen's Alleged Proof of the Impossibility of a Pareto Libertarian. *Analys und Kritik, 18*.

Buchanan, J. M. (1999). *The Collected Works of James Buchanan*, Vols. 1–20. Indianapolis: Liberty Press.

Buchanan, J. M. (2005). *Why I Too Am Not a Conservative*. Cheltenham: Edward Elgar.

Buchanan, J., & Tullock, G. (1999 [1962]). *The Calculus of Consent*. Michigan University Press: Ann Arbor.

Buchanan, J. M., & Yoon, Y. J. (Eds.). (1994). *The Return to Increasing Returns*. Ann Arbor: University of Michigan Press.

Harsanyi, J. (1953). Cardinal Utility in Welfare Economics. *Journal of Political Economy, 61*, 434–435.

Harsanyi, J. (1955). Cardinal Welfare, Individualistic Ethics and Interpersonal Comparisons of Utility. *Journal of Political Economy, 63*, 309–321.

Hart, H. L. A. (1961). *The Concept of Law*. Oxford: Clarendon Press.

Hobbes, T. (1990 [1682]). *Behemoth or the Long Parliament*. Chicago: University of Chicago Press.

Hume, D. (1978 [1739]). *A Treatise of Human Nature*. Oxford: Clarendon.

Kelsen, H. (2000 [1934]). *Reine Rechtslehre (2.Übrarb.Aufl.)*. Wien: Verlag Österreich.

Kliemt, H. (2006). The World Is a Table. Economic Philosophy Stated Flatly in Terms of Rows, Columns and Cells. In G. Eusepi & A. Hamlin (Eds.), *Beyond Conventional Economics. The Limits of Rational Behaviour in Political*

Decision Making (125–143). Cheltenham, UK and Northampton, MA: Edward Elgar.

McCloskey, D. (2016). *The Bourgeois Virtues*. Chicago: University of Chicago Press.

Meltzer, A., & Richard, S. (1981). A Rational Theory of the Size of Government. *Journal of Political Economy, 89*, 914–927.

Pattanaik, P. K. (2005). *Little and Bergson on Arrow's Concept of Social Welfare, 25*(2/3). https://doi.org/10.1007/s00355-005-0009-7.

Rawls, J. (1971). *A Theory of Justice*. Cambridge, MA: Harvard University Press.

Samuelson, P. (1954). The Pure Theory of Public Expenditure. *Review of Economics & Statistics, 36*, 387–389.

Samuelson, P. (1955). A Diagrammatic Exposition of a Theory of Public Expenditure. *Review of Economics and Statistics, 21*, 350–356.

Selten, R. (1990). *Some Remarks on Bounded Rationality* (Vol. 172) (Discussion Papers Des Sonderforschungsbereichs 303). Bonn: Sonderforschungsbereich 303 "Information und die Koordination wirtschaftlicher Aktivitäten."

Selten, R. (1998). Aspiration Adaptation Theory. *Journal of Mathematical Psychology, 42*(2), 191–214. https://doi.org/10.1006/jmps.1997.1205.

Sen, A. K. (1970). The Impossibility of a Paretian Liberal. *Journal of Political Economy, 78,* 152–157.

Sen, A. K. (1982). *Choice, Welfare and Measurement*. Oxford: Basil Blackwell.

Simon, H. A. (1957). *Models of Man*. New York: Wiley.

Simon, H. A. (1985). *Models of Bounded Rationality (1&2)*. Cambridge, MA: MIT Press.

Sugden, R. (1985). Liberty, Preference, and Choice. *Economics and Philosophy, 1,* 213–229.

Sugden, R. (1993). Rights: Why Do They Matter, and To Whom? *Constitutional Political Economy, 4,* 127–157.

Vickrey, W. (1945). Measuring Marginal Utility by Reactions to Risk. *Econometrica, 13*, 319–333.

Waldron, J. (1998). Judicial Review and the Conditions of Democracy. *Journal of Political Philosophy, 6*, 335–355.

Waldron, J. (2005). The Core of the Case Against Judicial Review. *Yale Law Review, 115*, 1346–1407.

Wicksell, K. (1896). *Finanztheoretische Untersuchungen nebst Darstellung und Kritik des Steuerwesens Schwedens*.

36

The Extent of the Market and Ethics

Yong J. Yoon

Introduction

In this paper, I discuss Buchanan's contributions to generalized increasing returns and ethics. Instead of reviewing and evaluating his work in the two areas, I shall cover only what became familiar to me through the projects on which I participated as a coauthor.

My discussion is based on his ideas expressed in *Ethics and Economic Progress* (1994), *The Economics and the Ethics of Constitutional Order* (1991), and his collected works Vol. 1: *The Logical Foundation of Constitutional Liberty* (1999) and Vol. 17: *Moral Science and Moral Order* (2001). In several articles there, he addresses a basic question in political economy; whether the work ethic has economic content. The mainstream (neoclassical) economists would deny it. Buchanan finds an answer from (generalized) increasing returns, which is an application

Y. J. Yoon (✉)
Department of Economics, George Mason University,
Fairfax, VA, USA
e-mail: yyoon@gmu.edu

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_36

of Adam Smith's theory of industrial organization and economic progress. In this logic of Smith, the work ethic makes sense as the economic exchange nexus extends.

In a competitively organized economy in which individuals work independently, each individual will allocate his resources efficiently between work (production and consumption) and leisure. If there is a team production possibility, an entrepreneur may emerge to exploit the opportunity (Congleton 1991). A Puritan version of work ethic is to work more hours than the individually efficient level. The external effect of a work ethics, however, is not limited to location or people. Individuals do not affect each other directly. Instead, the extra hours worked by someone allow unrealized specializations become viable. The result is enhanced productivity of input factor for the whole economy. This argument of work ethic that relies on large size seems to contract Buchanan's theory of ethical rule in his 1965 paper, "Ethical rules, expected values, and large numbers."

In that paper, Buchanan argues that choice of ethical behavior depends on the size of interacting members. Ethical rule is more likely to emerge in a small number group, and as the group size increases, people will choose to rely on personal expediency. This superficial conflict can be reconciled. The paper proceeds as follows. Section "Work Ethic" discusses Buchanan's analysis of work ethic based on increasing returns. Section "Models for Increasing Returns" develops a formal model for a work ethic. Section "Neoclassical Assumption Versus Generalized Increasing Returns" discusses Buchanan's theory of ethics (Buchanan 1965). The work ethic is analyzed by Buchanan's argument for ethical rules. Section "Generalized Increasing Returns" contains concluding remarks.

Work Ethic

Perhaps the first question to ask is how we recognize the existence of a work ethic. Buchanan relies on a psychological sentiment. You feel moral discomfort when you loaf. Buchanan tells a personal story about watching the Super Bowl in January (Buchanan 1989, 1994). He feels moral discomfort from watching the playoff games for so many (sixteen) hours. His self-diagnosis is that his discomfort reflects the "internalized work ethic." Ordinary people will readily understand such a sentiment. Buchanan realizes that economists might have trouble in reconciling economic theory with the sentiment. If you have chosen a work-leisure allocation based on your (raw) preferences, the allocation should be efficient, and any change in work effort will only reduce your overall welfare. Work ethic may work against self-interest or one's wellbeing.

Buchanan argues that the welfare advantages of a work ethic come from increasing returns. This insight comes from the Smithean theorem. That economic progress was made possible by specializations that enhance economy-wide productivity; and that the division of labor and specialization is limited by the extent of the market. Buchanan calls this generalized increasing returns. In such market settings, if everybody works more, everybody will benefit.

To appreciate the generalized increasing returns, consider a behavioral shift to "work more" (than the raw preference would dictate). If enough people in the production-exchange nexus do likewise (i.e., work more), the production-exchange nexus will be extended. This makes potential specializations become viable and input productivity will be enhanced. The participants will be better off than under the status quo. This remarkable insight, however, did not have much follow ups. In the era of globalization as we are in, work ethic is not that important, as some may argue. The size of the market and the exchange nexus is already big enough.

However, Buchanan's insight into the work ethic has relevance even in the era of globalization. In the United States, imports and exports accounted for 12% of national income in 2005 (Krugman and Obstfeld 2009). Thus, even in the era of global economy, the work ethic still applies to the production-exchange nexus of nontraded goods, which represents 88% of the national income. The insight has implications for rent seeking. Do we have reasonable obligation to restrain from rent seeking? I would say yes, much as we have reasonable obligation to restrain from loafing.

Public choice economists typically argue this way. Bribery is illegal but does not cause any social costs (other than the transfer of wealth from one entity to another); while rent seeking is legal yet causes social costs. The rent seeking activities cause social costs as the monopoly rent is dissipated by rent-seeking activities. Then, rent seeking activities reduce the size of the potential market. Tullock (1988) also argues that rent seeking activities are social costs because the resource could be invested in more productive areas that will enhance productivity. The subtraction of resources from the production-exchange nexus prohibits further division of labor and specializations in the economy. Tullock's argument is consistent with the economics of work ethics. When generalized increasing returns are considered, economy-wide productivity will fall and there are more costs than Tullock's trapezoid in rent seeking.

The growth of literature on rent-seeking reflects the widely observed rent-seeking activities. For instance, the edited volume by Congleton et al. (2008) includes 95 major articles. Buchanan once pointed out that rent-seeking is smaller than our legal system allows. Most people do not think rent-seeking is ethically desirable, especially the rent-seeking activities by other people. Some ethical restraint makes people feel reasonably obligated to refrain from rent-seeking much as they refrain from loafing. Tullock (1988) also notices that most people would regard "rent seeking" as an unadulterated evil.

In the following sections I attempt to formulate Buchanan's ideas on work ethics in his narrative. I will first consider the situation in which work ethic has no economic content. This is the case with the neoclassical production model below.

Models for Increasing Returns

There are formal models for generalized increasing returns. These models have been developed during the 1980s, the heyday of increasing returns when the interest in this topic returned after a long silence after the 1930s (Buchanan and Yoon 1994). Four such models are of interest in providing analytical insights into the workings of increasing returns. They are Krugman's (1979) model for new trade theory, Lucas's (1988) and Romer's (1990) endogenous growth model, Arrow (1962) and Yang's (2000) learning by doing model, and Buchanan and Yoon's (2009) stochastic demand model. I will discuss only briefly the stochastic demand model, which seems to be most relevant to the model developed in this paper.

Yoon (2008, 2009) consider a sea of goods that can be divided into two categories; goods whose demand is routine and good s whose demand is infrequent and probabilistic. The second category is called "stochastic goods." Yoon (2008) model shows that the principle of generalized increasing returns applies to stochastic goods. Unless the size of the exchange nexus becomes large enough, stochastic goods do not appear on the market. An increase in the size of the economic nexus will disproportionately increase the varieties and value of outputs. This framework also offers a model for the gravity theory of trade, which is an empirical model for trade first proposed by Tinbergen (1962). Empirical data suggest that bilateral trade flows are increasing in the size (GDP) of the countries involved and decreasing in the distance between them.

Neoclassical Assumption Versus Generalized Increasing Returns

Consider a neoclassical model that exhibits constant returns to scale production. Multiple persons are connected by the production–exchange nexus. Individual "A" is the person whose behavior we are interested in analyzing, and "B" is a stand-in person for the rest of the persons in the nexus. Individuals are of equal capacity in all relevant dimensions. Each person independently considers the trade-off between work (production and consumption) and leisure. Let a be the optimal level of welfare (e.g., in utils) persons (A or B) enjoy from the efficient allocation of her resources. The notation for the efficient level of work is "Eff." Any extra work effort above the efficient level will reduce her welfare. Let this lower level of welfare be denoted by a^{-}: $a^{-} < a$.

To analyze the choice behavior of the individuals, we consider the payoff matrix in Fig. 36.1. The decision to work at an efficient level is denoted by "Eff", and the decision to work more than the efficient level is denoted by "More." Individuals choose an action between "Eff" and "More".

		B	
		Eff	More
A	Eff	I (a, a)	II (a, a^{-})
	More	III (a^{-}, a)	IV (a^{-}, a^{-})

Fig. 36.1 Supply of effort

Payoff pairs are in the boxes of the matrix; the first element of a payoff pair is Person A's level of welfare, and the second element is Person B's level of welfare. For instance, the payoff pair in cell-I represents the outcome when both persons act to work at their efficient level. The payoff pair in cell II, (a, a^{-}), represents the outcome when Person A works at the efficient level while Person B chooses to work more than the efficient level. Person B's welfare will be reduced while Person A's welfare remains unchanged. By the same reasoning, we obtain the payoff pair (a^{-}, a) for cell III. The payoff pair in cell IV (a^{-}, a^{-}) represents the case when both persons work too much.

The payoff matrix leads to a unique Nash equilibrium, cell I, in which both A and B work at the individually efficient level. As the number of persons involved increases, each individual works at the efficient level in Nash equilibrium, as is expected in a competitive equilibrium. Large numbers make no difference, and there is no way to justify the economic content of the work ethic in this economy. Buchanan overcomes the dilemma by invoking Adam Smith's theory of increasing returns.

Generalized Increasing Returns

Buchanan coined the term to distinguish it from the increasing returns of a production function or a specific production process. The generalized increasing returns emerges as a decentralized order, not a planned order. The Smithian theorem summarizes this; "the division of labor and specialization is limited by the extent of the market." The productivity of an input factor depends on the extent of the market that provides an environment for division of labor and specialization. Smith's increasing returns is generalized or economy-wide.

Under the assumption of generalized increasing returns, the individual choice of action is analyzed. Figure 36.2 summarizes. Again, A is our reference person and B is a stand-in person for the others. In contrast to the neoclassical case examined in Fig. 36.1, individual A's welfare will depend on what others, B, do.

If none are motivated by the opportunity for generalized increasing returns, the result will be cell-I in Fig. 36.2. The payoff pair will be (a, a). If everyone works "more", then the outcome will be (b, b) in cell-IV, where $b > a$. The productivity of the input factor has been enhanced by further specializations in the economic nexus. I assume that the benefits from enhanced productivity will more than compensate for the lost leisure; when everybody works more, each person will be made better off by working more. For clarity, we can use an indifference diagrams as Buchanan (1991) and Levy (1988) did, which I do not attempt here.

The payoff matrix in Fig. 36.2 illustrates other possible payoffs. In cell II, for individual A, b is an attainable state. He can also obtain a higher level of utility, higher than b, by trading off between work and leisure, by working less than More. This optimal level is denoted by a^+: $a^+ > b$. The Nash equilibrium will be cell-II, which emerges as A chooses "Eff" row and all others choose "More" column. However, cell-II is not

		B	
		Eff	More
A	Eff	I (a, a)	II (a^+, b)
	More	III (a^-, a)	IV (b, b)

Fig. 36.2 Ethical rules and supply of effort

a sustainable equilibrium. If individual A's behavior applies to everybody in the community, everyone will end up adopting "Eff".

A problem with the analysis so far is that only two polar cases are examined in Fig. 36.2: None or all person chooses "More." I analyze the in-between cases and resolve the dilemma by invoking Buchanan's (1965) approach to ethical rules. In Buchanan's approach, individuals choose an ethical rule rather than an action.

In Fig. 36.3, we introduce another column for the in-between case. The column "Mixed" means "some follow Moral Law as rule". The column "None" means that "almost none follow Moral Law as a rule", and the column "All" means "almost all follow Moral Law as a rule."

Note that, in cell III of Fig. 36.3, everybody except individual A works at the efficient level "Eff". Since individual A's hard work is negligible to the total economy, there is no economy-wide increasing returns. The extra effort of individual A will only reduce her welfare to a^{-}. Now, consider the outcome in cell-II of the column "Mixed". The payoff to Person B is x, which will depend on the size of persons who follow the moral law of work ethics. (To be more accurate, x depends on individual A's subjective assignment of the probability that she will meet a person who follows a work ethic as a moral law.) The payoff to individual A is denoted by a^{x}. If enough people follow "work ethic", x will be greater than a. Since x is accessible to A, the payoff a^{x} will be greater than x, $x < a^{x}$, by an indifference curve argument.

Others

		None	Mixed	All
A	Expediency	I (a, a)	II (a^{x}, x)	(a^{+}, b)
	Moral law	III (a^{-}, a)	IV (x, x)	(b, b)

Fig. 36.3 Dominance of expedience over morals

Figure 36.3 illustrates that, regardless of the parameter x, individual A's choice behavior is to follow "expediency" because this row dominates the row for "moral law". Again, work ethic will fail to prevail.

Ethical Rules and Work Ethic

In analyzing a moral community, Buchanan (1965) analyzes the choice behavior of individuals among alternative ethical rules, private expediency criterion vs. moral law. Buchanan's central hypothesis is that the size of the interacting group is the major determinant of our moral behavior. This hypothesis is crucial for generating work ethic in my model.

Our reference individual A chooses from two alternative rules, expediency or moral law (of work ethics). Her payoff depends on the ethical rules chosen by other persons, and her choice will depend on the expected values of the alternative ethical rules. Following the suggestion in Buchanan, Fig. 36.4 summarizes the choice matrix using data in Fig. 36.3.

To calculate the expected values for alternative ethical rules, the individual needs an assignment of the probability distribution of the choice patterns of others. Following Buchan's central hypothesis, I assume that the subjective assignment of the probability distribution p for the first row "expediency criterion" is different from q, the assignment of probability distribution for the second row "moral law."

Note that the payoffs a^x and x depend on, and increases, in the number of individuals (N) who follows the moral law of a work ethic. For the purpose of a simple computation, I consider two columns, All and None, with some modification. For the first row of Expedience criterion, let p be the probability assignment for the state All and $(1-p)$ be the probability for the state None. For the second row of Moral Law, let q be the probability assignment for All and $(1-q)$ for None. We expect that q is bigger than p. The justification is this. The social interactions in a small group makes individuals behave by moral law. On the other hand, individuals interacting in a large group perceives others as part of nature. Naturally, expediency criterion becomes her behavioral choice.

	Others		
Individual	None	Mixed	All
Expediency	a	a^x	a^+
Moral Law	a^-	x	b

Fig. 36.4 Effect of group size on moral behavior

As the social interactions become dispersed into the bigger anonymous society, the probability q converges to p.

The payoff matrix in Figs. 36.3 and 36.4 do not have any information about the socially interacting group for individual A. I will have to elaborate on additional information to understand the work ethic as a moral law. The expected value for choosing expediency and moral law are respectively,

$$\text{Exp(expedience)} = a(1-p) + a^+p = a + \left(a^+ - a\right)p$$
$$\text{Exp(moral law)} = a^-(1-q) + bq = a^- + \left(b - a^-\right)q$$

Individual A will choose moral law (work ethic) if the expected value of "moral law" is bigger than that of "expediency". This is the case if

$$q > \left(a - a^-\right)/\left(b - a^-\right) + p\left(a^+ - a\right)/\left(b - a^-\right) \qquad (36.1)$$

It is easy to check algebraically that condition (36.1) indeed implies $q > p$.

If the individual does not believe that his social interactions will influence other's behavior, his assignment of probabilities will be $q = p$. Edward Banfield tells a story of an extreme expediency case in his book *The Moral Basis of a Backward Society* (1958). This could be the case of a moral anarchy. In an "amoral familism" a minimum kind of social interactions would be pursued.

The individual, our reference person A, interacts consciously in a social group of size N. If she interacts in a small social group, she will assign a high value for q on All, the probability that most people follow a moral rule of a work ethic. This will lead to her following moral law. To be more formal, let N^* be the critical number for a groups size, so that if the social group size is below N^*, the individual follows moral law. However, the effect of generalized increasing returns will enhance economy wide productivity only for large enough N. For this analysis, consider the column "Mixed" in Fig. 36.4. Suppose that the payoff x to the individual becomes bigger than a when the size of the group is N^w. If the critical number N^w is less than N^*, then work ethic is a viable ethical rule. For the social group size N between N^w and N^*, $N^w < N < N^*$, the expected value for moral law will be bigger than that of expediency. However, if N^w is bigger than N^*, the payoff matrix in Fig. 36.4 predicts that the individual will follow "expediency".

This dilemma can be resolved if we note that the generalized increasing returns is not confined to places and persons. A numerical illustration can be helpful. There are several social groups, say m of them, in the economic nexus. The size of each group is N_1, N_2, …, N_m, and each group is small enough for moral rule; $N_1 < N^*$, $N_2 < N^*$, …, $N_m < N^*$. And each group is too small for increasing returns; $N_1 < N^w$, $N_2 < N^w$, …, $N_m < N^w$. However, if the sum of the membership is bigger than the critical number N^w; $N_1 + N_2 + \ldots, + N_m > N^w$. The economy-wide productivity is determined by the size of the individuals from these small groups.

There is a justification for this view. Max Weber (1920), in "Protestant Sects and the Spirit of Capitalism", observed that Protestant sects served as groups of social interactions proposed in this paper. The sect membership was voluntary but required a certain standard of behavior.

Concluding Remarks

Buchanan (1994) shows that work ethic increases economic efficiency in Paretian terms. Though he tries to limit himself in identifying the economic basis for an ethic of work, we note his emphasis that we are ethically as well as economically interdependent. In this sense, the growing welfare policies mean eroding moral law.

In particular, Buchanan (1965) emphasizes the effect of group size in the market, politics, and ethics. The most populous countries in the world are; China, India, United States, Indonesia, Brazil, Pakistan, Nigeria, Bangladesh, Russia and Japan. Other than the US and Japan, these countries are not impressive by its political order or economic performance. On the other hand, the countries with highest per capita income are small countries except the US. This suggests that the ethical rules and generalized increasing returns can be useful concepts for studying political economy. Buchanan emphasized the economic basis of a work ethic and emphasized generalized increasing returns. However, as is shown in this paper, we can define the ethical basis of a work ethic. I could fully understand an ethic of work only by considering the ethical rules in social groups. Max Weber's recognition of the protestant sectors in contributing capitalism in America is instructive. It is in the same line of thought expressed in this paper.

As the group size in politics increases beyond that of a moral community, the effectiveness of cooperation decreases. This insight has potential applications in legal and other social institutions, as well as the structure of federalism. Fraud and deceit, the absence of which is an important factor for liberal order as Hayek (1960) emphasized, can be analyzed by Buchanan's theory of ethical rules.

References

Arrow, K. (1962, June). The Economic Implications of Learning by Doing. *The Review of Economic Studies, 29*(3), 155–173.

Buchanan, J. (1965). Ethical Rules, Expected Values, and Large Numbers. *Ethics, 76,* 1–13.

Buchanan, J. (1989). *Essays on Political Economy.* Honolulu: University of Hawaii Press.

Buchanan, J. (Ed.). (1991). Economic Interdependence and the Work Ethic. In *The Economics and the Ethics of Constitutional Order*. University of Michigan Press.

Buchanan, J. (1994). *Ethics and Economic Progress.* Norman: University of Oklahoma Press.

Buchanan, J., & Yoon, Y. (1994). *The Return to Increasing Returns.* Ann Arbor: University of Michigan Press.

Buchanan, J., & Yoon, Y. (2009). Stochastic Demand and the Extent of the Market: Another Smith Puzzle. In J. Young (Ed.), *Elgar Companion to Adam Smith*. Edward Elgar Publisher.

Congleton, R. (1991). The Economic Role of a Work Ethic. *Journal of Economic Behavior and Organization, 15,* 365–385.

Congleton, R., Hillman, A., & Konrad, K. (2008). *40 Years of Research on Rent Seeking*. Springer.

Hayek, F. (1960). *The Constitution of Liberty*. Chicago: University of Chicago Press.

Krugman, P. (1979, November). Increasing Returns, Monopolistic Competition, and International Trade. *Journal of International Economics, 9*(4), 469–479.

Krugman, P., & Obstfeld, M. (2009). *International Economics: Theory & Policy.* Boston, MA: Addison Wesley.

Levy, D. (1988). Utility Enhancing Consumption Constraints. *Economics and Philosophy, 4*, 69–88.

Lucas, Robert. (1988). On the Mechanics of Economic Development. *Journal of Monetary Economics, 22,* 3–42.

Romer, Paul. (1990). Endogenous Technological Change. *Journal of Political Economy, 98,* S71–S102.

Tinbergen, J. (1962). *Shaping the World Economy*. New York: Twentieth Century Fund.

Tullock, G. (1988). Rents and Rent-Seeking. In C. Rowley, R. Tollison, & G. Tullock (Eds.), *The Political Economy of Rent Seeking*.

Weber, M. (1920). *Protestant Ethic and the Spirit of Capitalism*. New York: Norton.

Yang, X. (2000). *Economics: New Classical Versus Neoclassical Framework*. Oxford: Blackwell.

Yoon, Y. (2008). Stochastic Demand, Specialization, and Increasing Returns. *Journal of Division of Labor and Transaction Costs, 3,* 1–5.

37

When Roving Bandits Settle Down: Club Theory and the Emergence of Government

Andrew T. Young

Introduction

How does a government arise from anarchy? In a classic article, Mancur Olson (1993) theorized that it could occur when a roving bandit decides to settle down. In anarchy, roving bandits prey upon whoever possesses wealth. The latter then have little incentive to maintain and/or create more of that wealth. Neither the predators nor prey are particularly well off under these circumstances. However, an enterprising bandit can settle down in a particular territory and establish repeat games with its prey. This stationary bandit comes to recognize an encompassing interest in that territory, improving its lot by providing public goods (e.g., security) and committing to stable rates of theft. It provides its prey with incentives to create wealth and both can be better off with some division of a larger pie.

A. T. Young (✉)
Rawls College of Business and Free Market Institute,
Texas Tech University, Lubbock, TX, USA
e-mail: a.t.young@ttu.edu

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_37

Olson (1993) provides the illustrative the case of the early twentieth century Chinese warlord, Feng Yu-hsiang:

> China was in large part under the control of various warlords. They were men who led some armed band with which they conquered some territory and who then appointed themselves lords of that territory. They taxed the population heavily and pocketed much of the proceeds. The warlord Feng Yu-hsiang was noted for the exceptional extent to which he used his army for suppressing bandits and for his defeat of the relatively substantial army of the *roving bandit*, White Wolf. Apparently most people in Feng's domain found him much preferable to the roving bandits. (p. 568)

Since Olson, researchers have pointed to a number of other empirical examples consistent with his theory. These include early medieval Viking groups (Kurrild-Klitgaard and Svendsen 2003; Baker and Bulte 2010) and the Visigoths in the fourth and fifth centuries (Young 2016). In general, Fukuyama (2011, p. 74) emphasizes that "the most basic and enduring unit of political organization [is] a leader and his band of armed retainers." Whether roving or stationary, armed retinues are "virtually universal in […] human history and continue to exist today in the form of warlords and their followers, militias, drug cartels, and street gangs" (p. 74).

Notably, the bandits highlighted by Olson (1993) are not individuals but rather groups organized to act collectively. When Olson (1993, p. 568) references the stationary Feng Yu-Hsiang defeating the roving White Wolf, these individuals serve as convenient shorthand for the groups they led. In the background are the organizational problems associated with bandits.[1] These problems are fundamental to understanding how an organization that imposes costs (via theft) on a group of individuals begins to *also* benefit them with governance provision.

[1]Theoretical analyses of predatory governments that are motivated by Olson (1993) tend to focus on the decision-making of an individual agent (e.g., Grossman and Noh 1994; McGuire and Olson 1996; Robinson 1999; Moselle and Polak 2001; Konrad and Skaperdas 2012).

In Young (2016), I aim to acknowledge and confront the collective action problems lurking in the background of Olson's (1993) analysis. Monopolizing theft over a substantial territory requires the coordination of a large group of agents. The problems associated with doing so to further a group interest is the focus on Olson's (1971 [1965]) most famous work, *The Logic of Collective Action*. Using Olson's (1971 [1965]) terminology, in Young (2016) I argue that a roving bandit provides exclusive collective goods to its in-group while a stationary bandit also provides inclusive collective goods to the out-group; the transition from roving to stationary will likely involve a redefinition of the in-group and its group interest. Those points are illustrated by a case study of the Visigoths.

Complementing that prior work, here I provide a club-theoretic (Buchanan 1965) analysis of bandits. I characterize the (actual or threats of) violence as a club good, i.e., one that is non-rival, subject to congestion, but from which out-group members can be excluded at low cost. I also characterize the governance provided by a stationary bandit as a club good. The benefits of that governance provision will be excludable within the context of the bandit's in-group, despite the governance representing essentially a public good from the out-group's perspective. This is a melding of constitutional economics and club theory (Leeson 2011) towards understanding the emergence of government.

There is value-added from this complementary analysis. Buchanan and Tullock (1962) and Buchanan (1975) discuss the emergence of government through social contracting, but few would claim that the theory is empirically relevant.[2] Rather, social contract theory provides insights into the sorts of constitutional arrangements that are self-enforcing. However, there are numerous examples of clubs providing governance in the absence or inadequacy of government. For example, Anderson and Hill (1979, 2004) provide case studies of the land, mining, and wagon trail clubs that provided governance in the nineteenth century

[2]An exception is Leeson (2007a, 2010) who documents the unanimously-agreed-to constitutions of eighteenth century pirate groups. However, these are very small groups who never realized an encompassing interest in the broader communities within which they interacted.

American West. Also, Stringham (2002, 2015) discusses the emergence of clubs to provide governance for early modern stock exchanges. Club theory, then, may very well account for the historical emergence of governments out of anarchy.

This chapter is organized as follows. I first provide an overview of Buchanan's (1965) club theory and associated contributions in section "Buchanan's Club Theory". I then provide a club-theoretic analysis of bandits, both roving and stationary, in section "Roving Bandits as Clubs; Stationary Bandits as Governance-Providers". In section "A Historical Illustration: How the Visigothic Bandit Settled Down", I return to the experience of the Visigoths in the fourth and fifth century as an illustrative case. After briefly providing some background on the Gothic peoples at the later imperial era, I describe the emergence of the Visigothic confederacy, its migration and subsequent settlement, and the establishment of the Visigothic Kingdom. Section "Conclusion" contains concluding discussion.

Buchanan's Club Theory

In his seminal 1965 paper, James Buchanan conceives of a *club* as a voluntary organization that provides its membership with nonrival goods, the benefits of which can be excluded from non-members. Buchanan's paper is a critical response to Paul Samuelson's (1954, 1955) development of public goods theory:

> [In that theory] a sharp conceptual distinction is made between those goods and services that are 'purely private' and those that are 'purely public'. No general theory has been developed which covers the whole spectrum of ownership-consumption possibilities[….] One of the missing links here is 'a theory of clubs', a theory of co-operative membership, a theory that will include as a variable to be determined the extension of ownership-consumption rights over differing numbers of person. (Buchanan 1965, p. 1)

Along with the subsequent development of common pool resource theory (Ostrom 1990), Buchanan's theory of clubs contributes to our understanding of the "whole spectrum" of not-purely-private (collective) goods.

Taking his "sharp conceptual distinction" to be empirically relevant, Samuelson draws strong, negative implications regarding the potential for voluntary, cooperative arrangements to provide collective goods. Club and common pool resource theory serve to significantly temper those implications. Those theories emphasize that the separate characteristics of "publicness"—nonrivalry and nonexcludability—are associated with different collective action costs; also, that the costs associated with each characteristic are dependent on the degree of the other. Whether coercive or voluntary arrangements will better provide a collective good will depend upon the relative degrees of nonrivalry and nonexcludability involved. Furthermore, as Ronald Coase (1974) would demonstrate (in another critique of Samuelson), the degrees of those characteristics are always institutionally contingent.

While Buchanan is to be credited with the introduction of club theory, Sandler and Tschirhart (1997, pp. 335–336) correctly point to three contemporaneous papers that enriched the development of that theory. Tiebout's (1956) work on jurisdictional competition emphasizes how individuals when allowed to "vote with their feet" will sort themselves into different competing clubs based on the policy bundles each offers. Wiseman (1957) elaborates on how cost-sharing within a club can exploit economies of scale. Most importantly, in the same year that Buchanan's theory of clubs appeared in print, so did Olson's (1971 [1965]) *Logic of Collective Action*. Olson's analysis detailes how organizations (e.g., clubs) aimed towards achieving the shared interests of its members and faced increasing costs in the number of members involved.

Since Buchanan's work, club theory has been fruitfully applied to a wide variety of empirical and potential contexts. These include airports (Lipsman 1994), highways (Boardman and Lave 1977), international organizations (e.g., Murdoch and Sandler 1982; Khanna and Sandler 1996; Congleton 2004), income security clubs (Congleton 2007), public utility commissions under a regional regulatory body (Jones et al. 1992), wilderness areas (Cicchetti and Smith 1976), faculty governance (Prüfer and Walz 2013), and "climate clubs" (Nordhaus 2015). Also, numerous extensions to the theory have been formally fleshed out (Sandler and Tschirhart 1997).

Roving Bandits as Clubs; Stationary Bandits as Governance-Providers

In this section I discuss the *bandit* as a club-theoretic conceptual template. The template is stylized enough to accommodate a wide array of empirical cases. Furthermore, it allows for a positive analysis of the *roving-to-stationary bandit* account of government formation (Olson 1993; McGuire and Olson 1996). A *roving* bandit is a club where its members produce violence as a means towards plunder that they then enjoy. A *stationary* bandit is a club that also produces violence; however, it also provides governance to a set of non-members.[3]

Roving Bandits

Banditry (theft) can be a profitable endeavor. An individual will engage in banditry when the returns to doing so are greater than those associated with wealth creation. Successful bandits effectively apply and/or threaten violence to steal the property of others and/or intimate them into surrendering it. The application and/or threat of violence often "scales up", leading to opportunities for bandits to exploit economies of scale via collective action.[4] Congleton (2011) employs the term "formeteur" to describe individuals who can identify such opportunities and organize individuals to act upon them.

A roving bandit is a club in the sense of Buchanan (1965). At first blush, a roving bandit may not seem to fit the definition of a club. The fruits of banditry take the form of rivalrous goods (i.e., plunder).

[3]This is to be distinguished from governance of the club's membership, though that is essential to clubs generally and any banditry organization in particular.

[4]Indeed, the term "bandit" often connotes an individual as part of a group of thieves; according to definition 1 of Merriam Webster: "an outlaw who lives by plunder; *especially*: a member of a band of marauders": https://www.merriam-webster.com/dictionary/bandit (accessed May 14, 2018). Wiseman (1957) early on emphasized the cost-sharing role of clubs in achieving economies of scale. Of course, there are almost certainly limits to such economies of scale; Olson (1971 [1965]) provides the classic treatment of the increasing costs to collective action as the size of an organization increases, an effect that will dominate at some point.

However, bandit's members are collectively producing violence as a means towards plunder. Violence produced by one member creates effects that can be non-rivalrously enjoyed by the others. A credible threat of violence changes the behavior of potential prey, making them less likely to fight back and more likely to surrender their property. When one member creates a credible threat, other members can free ride. The incentives of a potential victim are based on his *expectations of* violence. One member of a roving bandit can shape those expectations either through his actions upon the potential victim *or* his reputation based on actions previously taken. In either case, other members can free ride.[5] Alternatively, the violence is excludable. Any non-member cannot benefit from the actions and/or reputations of members.

A roving bandit collectively produces violence, a club good that is aimed towards the acquisition of plunder to be enjoyed by its members (the *in-group*); non-members (the *out-group*) represent potential victims. This characterization of a roving bandit is different but complementary to the one I offer in Young (2016). There I emphasize that a roving bandit is what Olson (1971 [1965], pp. 36–43) refers to as an *exclusive group*: one that provides an *exclusive collective good* to its members.[6] An exclusive collective good is one that is rivalrously enjoyed by the in-group and difficult to exclude members of the in-group from enjoying. Because plunder is rivalrous, a critical problem for a roving bandit is governing its distribution across the in-group. (This is an entrepreneurial challenge for the leadership of a roving bandit.)

In the context of a roving bandit, plunder is an exclusive collective good. However, the violence that it collectively produces is a club good. An organization can be characterized as a "club" to the extent that its members derive mutual benefits from the sharing of (i) production costs, (ii) the characteristics of members, and/or (iii) a good the benefits of which are excludable from non-members (Sandler and Tschirhart 1997, p. 335). When considering (iii), the roving bandit seems to be an exclusive group as described by Olson (1971 [1965]). However, when

[5]Conversely, if one member's threat of violence causes potential victims to curb or conceal production, then this creates negative spillovers for other members.

[6]This is also how Congleton (2015, p. 222) characterizes a roving bandit.

considering the production costs of violence, (i), the roving bandit is better characterized as a club. While these characterizations are not mutually exclusive, I focus on the latter here.[7]

Stationary Bandits

The roving bandit's production of violence is aimed towards the extraction of wealth from out-group members. *Roving* implies continual movement from one out-group target to the next: non-repeated games between predator and prey. Alternatively, a *stationary* bandit plays a repeated game with a specific set of the out-group—*its* out-group—seeking to extract as much wealth as possible over those repeated interactions. Doing so involves activities that are not typically associated with a thief, such as providing security from the external threats and the adjudication of disputes internally. A stationary bandit still produces violence, but it also provides governance to its out-group that encourages it to create wealth. (Regarding the former, there is a shift in its direction away from "plundering" towards governance that is exchanged for "taxes".)

Using Olson's (1971 [1965], pp. 36–43) terminology, the governance being provided consists of *inclusive collective goods*. Inclusive collective goods are enjoyed nonrivalrously, in this case by the out-group. The governance increases the wealth base from which a stationary bandit can extract. When the wealth of its out-group increases by more than does the amount extracted, the governance provision is mutually advantageous to both in-group and out-group (Olson 1993; McGuire and Olson 1996).[8] The stationary bandit effectively becomes a government.

[7]Given a club where the in-group collectively produces violence towards obtaining plunder, the coordination of collective action and the minimization of shirking/free-riding is critical. Presumably, many in-group inputs will be complementary and concerns for metering and monitoring them in the context of team production will be at the fore (Alchian and Demsetz 1972).

[8]Demsetz (1970) recognized the potential for clubs that were organized to profit the in-group to also yield benefits to the out-group. A recent paper by Koyama (2012) provides such an example from nineteenth century England. Private prosecution associations provided members with crime detection, delivery to court of criminals, and payment of court fees. These activities generated benefits to non-members via deterrence effects.

Importantly, members of the stationary bandit are residual claimants to the returns of their governance provision. They become effectively shareholders in the territory within which the bandit has settled. Residual claimancy provides incentives for "good" governance (Salter 2015; Salter and Young 2017). The in-group benefits when the governance improves the lot of the out-group.

Settling Down

The roving-to-stationary bandit transition likely involves meaningful changes to the club, including its membership and the club goods that it produces. *First*, in-group membership will likely increase; *second*, that increase may be accompanied by the exclusion of erstwhile in-group members and inclusion of erstwhile out-group members (Young 2016). *Third*, the club will transition from producing only violence to also providing governance to its out-group; that may also involve the inclusion of erstwhile out-group members. I will consider each of these likely changes in turn.

Regarding an expansion of in-group size, intuition suggests that a roving group of marauders is not large enough to constitute the government of a "country-sized" territory. While intuition can be misleading, in this case it bears out. The violence provided is a club good but the end towards which it is produced (plunder/taxes) is rival. To regularize and scale up extraction to a large territory involves a proportionately larger in-group. To use language current in the economic development literature, the transition from roving to stationary bandit necessitates an increase in state capacity—in particular, *fiscal capacity*.

Furthermore, while the governance provided will exhibit a high degree of publicness, it will not be strictly nonrival. For example, the supply of security is not expected to expand one-for-one with an increase in out-group size. To provide security for a larger territory also involves a larger in-group. In the case of security against external threats, this will likely be the case for at least two reasons. First, a larger territory means more extensive borders. Second, a larger territory (and out-group) represents, all else equal, a greater source of wealth and temptation to external predators. The transition from roving to stationary bandit will then necessitate increases in another dimension of state capacity, namely *legal capacity* (i.e., infrastructure to structure interpersonal interactions). Increases in both fiscal and legal capacity will involve an increase in the size of a bandit's in-group.

The transition from a roving to a stationary bandit is also likely to involve both the exclusion of erstwhile in-group members and the inclusion of erstwhile out-group members. A roving bandit produces violence; a stationary bandit additionally provides governance to the out-group. There are likely to be difference between the skillsets appropriate to violence provision and those appropriate to governance provision. For example, effective governance involves the adjudication of disputes within a framework of well-understood and consistently applied laws. This is something that professional marauders may lack the skills to effectively perform. Inclusion of out-group members who do have those skills may be necessary.

Furthermore, while both roving and stationary bandits aim to extract out-group wealth, the means of wealth extraction in each case are different. A roving bandit plunders while a stationary one administers a system of taxation. While the line between plunder and taxation is not a bright one, the latter tends to be a more orderly operation than the former. Taxation is regularized and predictable; records must be kept; the application of actual violence must be minimized. A band of marauders may be ill-suited to carry out regularized, recorded, and relatively peaceful taxation.

Finally, being a member of a roving bandit likely involves a very different lifestyle than that of a stationary one. (Marauders may be very different breeds than police, judges, and tax collectors.) Individuals have different preferences for different types of labor. The leadership of a roving bandit group will decide to settle down only if the in-group's membership stands generally to gain: if settling down is in the group interest. However, this will not necessarily mean that every individual in-group member stands to gain. Some in-group members may find the roving-to-stationary transition undesirable. They may therefore be excluded, by their own choice or by the bandit's leadership.

A Historical Illustration: How the Visigothic Bandit Settled Down

The experience of the Visigoths in the fourth and fifth centuries provides an empirical illustration of a roving bandit transitioning into a stationary, governance-providing organization within a specific territory. The Visigoths were a confederacy of northern barbarian groups that had migrated to within the frontiers of the Roman Empire. Having formed in the Balkans, they then migrated into Italy, sacked Rome, and eventually settled in Aquitaine Gaul. They established the Visigothic Kingdom that would endure for over a century. I begin here with some background information on the Germanic peoples from which the Visigothic confederacy emerged: the Goths. I then provide an historical overview of the emergence of that confederacy, its migration, and its subsequent settlement and establishment of the Visigothic Kingdom.

The Goths

The Goths were a collection of eastern Germanic tribes. Relying in large part on the sixth century historian Jordanes, scholars once spoke confidently of two distinct Gothic tribes: the Visigoths (or Tervingi) and the Ostrogoths (Greuthungi). It was believed that these tribes could be clearly distinguished going back to at least the third century. However, most scholars now believe that the tribal/political affiliations of the Goths were much more fluid. A distinct Visigothic identity emerged probably only after the 376 AD settlement of a large group of Goths south of the Danube. These Goths were fleeing a Hunnic invasion the Asian Steppe. Imperial officials were abusive towards the settlement and, in as a result, a group of Goths coalesced under the leadership of a warrior named Alaric in 395 (e.g., Collins 2004, pp. 17–26; Grierson 1941, pp. 11–14; Heather 1998, pp. 130–151).

Up until the fourth century, there is little recorded of the Goths. During the early part of Constantine's rule, literary sources mention only occasional Gothic raids into the Roman provinces of Thrace and Moesia around the lower Danube (an area that included parts of Bulgaria, Greece, Macedonia, Serbia, and Turkey). The record of Gothic activity falls temporarily silent following a devastating campaign by Constantine north of the Danube in 332. That record picks up again during the reigns of the brothers Valentinian and Valens, when Goths were again raiding in Thrace and Moesia (Ammianus, Book 26, p. 322).

The brother emperors attempted to discourage such raids by granting certain Gothic groups status as federates (*foederati*) of the Empire. Federates were granted annual subsidies (clothing; grain; money) in exchange for their aid in defending the frontier. However, some of these federated Goths mistakenly sent 3000 warriors in support of a usurper named Procopious (Ammianus, Book 26, p. 332).[9] (In the later Roman Empire, distinguishing "true" emperors from pretenders/usurpers was no small task!) After Procopious was defeated, Valens (367–369) prohibited trade with the Goths and campaigned against them in the north for three years. He eventually defeated the Goths, who had confederated under a judge (*iudicem*) named Athanaric. The Goths sued for peace and Valens obliged. Famously, he and Athanaric concluded a treaty while afloat on the Danube—an arrangement made allegedly so that Athanaric could obey his father's command to never to set foot upon Roman soil (Ammianus, Book 27, pp. 336–337).[10]

Soon afterwards: "The race of the Huns, long shut off by inaccessible mountains, broke out in sudden rage against the Goths and drove them in widespread confusion from their old homes" (Orosius, Book 7, p. 373). This "savage horde of remote tribes" swept over the Black Sea from the Asian Step and into the region north of the lower Danube, "driven from their homes by some unexpected pressure" (Ammianus, Book 31, p. 416). In 376, as many as one million Goths appeared on

[9]In addition to the translation of Ammianus Marcellinus listed in the references, I have referenced the original Latin provided by http://www.thelatinlibrary.com/ammianus.html. I refer to the Latin, in particular, when various terms that imply subtly different things (e.g., *reges*, *duces*, and *principes*) are often translated into one English word (e.g., "kings").

[10]The standard translation involves Athanaric having sworn an oath never to set foot on Roman soil. Interestingly then, having been defeated by the Huns and his leadership abandoned by his Goths, Athanaric was later received by Theodosius I in Constantinople, where the erstwhile judge died. Wolfram (1975, p. 263) points out that the correct interpretation of the Latin is actually:

the Danube's northern bank, requesting permission to cross. Valens was in Antioch (modern day south-central Turkey), preoccupied with conflicts on the Persian frontier. Being in no position to actually do anything about it, Valens "permitted" the Goths to cross. Under the leadership of two judges, Fritigern and Alavius, these Goths were settled in Thrace.[11]

Two corrupt Roman generals, Lupicinius and Maximus, mismanaged the settlement. They denied the Goths promised food subsidies and instead "collected all the dogs that their insatiable greed could find and exchanged each of them for a [Gothic] slave, and among these slaves were some sons of the leading men" (Ammianus, Book 31, p. 418). Following this humiliation, Fritigern led the Goths south to Marcianople to complain to imperial authorities. Upon their arrival, Lupicinus invited Fritigern and other leading Goths to a feast at which several of them were murdered or taken as hostages. Fritigern escaped and organized a Gothic army that routed Lupicinus' troops in Marcianople. The Gothic War of 376–382 followed, ending with the defeat (and death) of Valens at the Battle of Adrianople in 378. Two thirds of Valens' army were massacred, the most stunning defeat Rome had ever suffered at the hands of northern barbarians.

Gratian (who succeeded in the West in 375 when Valentinian died) and Theodosius (who was elevated to the purple in the East in 379) picked up where Valens had left off. These emperors were generally

"the Gothic chief was bound by an especially severe oath *and* that a paternal order had forbidden him to set foot on Roman soil." If he did not break and oath, then, the passage begs the question of what exactly this sever oath was!

[11]As Ammianus (Book 31, pp. 416–417) dryly observes: "[T]he affair seemed matter for rejoicing rather than dread, and the practised flatterers in the emperor's entourage extolled in exaggerated terms the good fortune which unexpectedly presented him with a large body of recruits drawn from the ends of the earth. […] With these high hopes […] the greatest care was taken to ensure that […] none of those destined to overthrow the Roman Empire should be left behind." Orosius (Book 7, p. 373) is more concise: the Goths were "received by Valens without negotiating any treaty. They did not even surrender their arms to the Romans." Athanaric, having proved unsuccessful in his efforts to ward off the Huns, was disgraced and abandoned by most of his followers and remained north of the Danube. Later on, during Theodosius I's reign, Athanaric reappears (in disobedience to his father's command) within the Roman Empire. He was invited to Constantinople by Theodosius in 381 and, a few weeks later, was dead.

successful in their campaigns against the Goths, but the latter were still formidable enough to bring Theodosius to the negotiating table. A treaty was signed in 382, granting the Goths land to settle; they were also allowed to maintain their own laws and communal autonomy. In return, the Goths likely agreed to provide military services, both as federates and by providing recruits to the imperial army (Heather 1998, p. 137).

Despite Theodosius' efforts at diplomacy and the treaty, disputes eventually arose between him and the Goths. Theodosius called upon his federates to campaign against two separate usurpers (Maximus, who had murdered Gratian, and then Eugenius; both in the West). There was a Gothic revolt following the campaign against Maximus, but little came of it. Alternatively, there were reportedly as many as 10,000 Gothic casualties in the campaign against Eugenius.[12] This left a decidedly bad taste in the mouths of the Goths. Theodosius died in 395, leaving his young sons—Honorius (8 years old) in the West and Arcadius (12 years old) in the East—as co-emperors. A large group of Goths took advantage of this disruption of Roman authority to confederate under the leadership of a judge named Alaric.

The Visigoths

Alaric invaded Italy in 401 but was driven back by Stilicho, Honorius' *magister militum*. Following a second invasion, Alaric was able to extort increased subsidies in exchange for remaining peacefully in Illyricum (the province bordering Italy in the northeast and running down along the Adriatic Sea). However, members of Honorius' court came to suspect Stilicho of conspiring with Alaric. Stilicho was removed by a coup and fled to Ravenna where he was captured and executed in 408. In the aftermath, Roman soldiers "hearing of the death of Stilico [*sic*] fell upon

[12]Orosius (Book 7, p. 380) counts this a double victory for the Empire: "for the loss of these [the Gothic auxiliaries] was certainly a gain and their [the usurper and his followers] defeat a victory." The Gothic leading men may have found the federate status more beneficial than the Gothic rank and file, a point to which I will return to in section "A Historical Illustration: How the Visigothic Bandit Settled Down" below.

the women and children in the city, who belonged to the Barbarians[;] destroyed every individual of them [and] plundered them of all they possessed" (Zosimus, Book 5, p. 161). As a result, Zosimus reports that Alaric's (Visigothic) confederacy gained 30,000 new recruits.

The Visigoths invaded Italy once more in 410 and this time they sacked Rome itself. In the process, the Visigoths captured Honorius' sister, Galla Placida. Alaric's plan was to subsequently march the Visigoths south and then cross the Mediterranean into Africa, but he died before he could make the trip. In the event, the Visigothic confederacy held together with Alaric's brother-in-law, Athaulf, succeeding him as judge. Subsequent diplomacy between Honorius and the Visigoths went well enough that Athaulf took Galla Placidia as his wife in 411. Orosius (Book 7, p. 390) characterizes the marriage as a boon to imperial-Visigothic relations: it was "as if she had been a hostage given by Rome as a special pledge[;] through her alliance with the powerful barbarian king, Placidia did much to benefit the state."

Honorius' willingness to play nice with the Visigoths was undoubtedly motivated by his having to deal with other challenges to his authority. First, there was a usurper out of Britain, Constantine III, who declared himself emperor in the West in 407. No sooner than was Constantine III defeated, another usurper, Jovinus, claimed the purple in the Rhineland. Exploiting these distractions, Athaulf led the Visigoths out of Italy and into Gaul in 412.[13] He actually attempted negotiations with Jovinus, but the latter seems to have favored working with another Gothic (but not Visigothic) commander named Sarus. The Visigoths then aligned themselves decidedly with Honorius and defeated Jovinus in 413.

The Visigoths subsequently claimed rights to Toulouse and Narbonne in Gaul. Their relationship with Honorius became strained and the patrician Constantius (later the emperor Constantius III) was ordered to blockade the Mediterranean naval ports in Gaul. As a result, Athaulf

[13]This was much to the chagrin of Honorius who, "seeing that nothing could be done against the barbarians when so many usurpers were opposed to him, ordered that the usurpers themselves should be destroyed" (Orosius, Book 7, p. 393).

led the Visigoths into the northern Iberian Peninsula. He then, in 415, met his end by treachery at the hands of one of his own men. Following his death, a Visigoth named Segeric claimed command of the confederacy, but he apparently did not have broad support and was killed within a week a claiming power. The Visigoths then chose a warrior named Wallia to lead them. At the time, anti-imperial sentiment was running high amongst the rank and file and Wallia initially planned on marching south to invade Africa. However, he wavered and sought a peace the Empire.[14] He returned Galla Placidia to Honorius. The latter reciprocated, settling the Visigoths as federates in Aquitaine (western Gaul south of the Loire) around 418.

Wallia established a capital in Toulouse and, under his leadership, the Visigoths carried out campaigns in the Iberian Peninsula against the Vandals, Sueves, and Alans, as well as a usurper named Maximus. When Theoderic I succeeded Wallia in 419, he established a dynasty that would endure for more than 100 years. The Visigothic Kingdom had been established.

Roving-to-Stationary

In section "Roving Bandits as Clubs; Stationary Bandits as Governance-Providers" above, I discussed bandits as clubs in terms of club theory. A roving bandit is a club that produces violence to extract wealth from out-group members for the benefit of the in-group. A stationary bandit is a club that additionally provides governance to (a specific set of) the out-group, creating incentives for the out-group to produce wealth that can then be extracted. Having covered some history of the Visigoths, I here discuss how they fit the conceptual template of the bandit; also how their experience illustrates the roving-to-stationary transition as described in section "Roving Bandits as Clubs; Stationary Bandits as Governance-Providers".

[14]Orosius claims that "Wallia succeeded to the kingdom, having been chosen by the Goths to break the peace, but appointed by God to establish it" (Book 7, p. 396). A less romantic view is that the Visigothic rank and file found themselves on the wrong side of an agency problem.

To understand the emergence and nature of the Visigothic confederacy, one must begin with the fact that armed retinues were a fundamental part of Germanic societies east and north of the imperial frontiers. Their commanders organized warriors into clubs that sought profit opportunities and then provided leadership in pursuit of those opportunities. From the first century onwards, these commanders made up an increasingly important component of the barbarian elite, some of them coming to be recognized as kings (Young 2015).[15] Burials and literary sources suggest that retinues of about 200 men were typical (Heather 1998, pp. 66–68).

What sort of profit opportunities are we talking about here? In his *Germania*, Tacitus describes the organization of retinues as geared towards "war and plunder" (Chap. 14, p. 113). A warrior swore allegiance to a commander when the latter's organization and leadership yielded plunder:

> [A] large body of retainers cannot be kept together except by means of violence and war. They are always making demands on the generosity of their chief […]. Their meals […] count in lieu of pay. The wherewithal for this openhandedness comes from war and plunder. (Chap. 14, p. 113)

Tacitus describes a competitive labor market for warriors within which, if a particular commander failed to sufficiently remunerate his retinue, they would offer their services to another commander.

An armed retinue of two hundred men is probably not going to monopolize the use of force within a territory large enough to meaningfully be termed a kingdom. And the Visigoths obviously constituted a much large group. However, throughout the fourth century Gothic in-groups appear to have expanded when opportunities or threats arose. This occurred through the confederation of numerous individual retinues. For instance, during Valens' campaigns north of the Danube, Athanaric was able to pull various smaller groups together to deal with

[15]Heather (1998, p. 66) refers to "the rise of groups of specialist armed retainers was a social development of the greatest importance [and] weapon burials became common from at least the first century AD."

the threat. However, between episodes of major conflict contemporary literary sources become silent on the activities of large confederacies and, instead, we find reports only of small-scale raids. Thompson (2008 [1966], pp. 13–14) notes: “these bands [of raiding Goths] seem to have been local or tribal levies, retinues of Gothic optimates[,] not sent out by the central authority[.]”[16] Gothic retinues appear to have been *segmentary* (Durkheim 1933). Each retinue was self-contained and self-sufficient; yet they could at times combine to pursue common ends. “While segments can aggregate at a high level, they are prone to immediate fissioning [sic] once the cause of their union (such as an external threat) disappears” (Fukuyama 2011, p. 58).[17] During times when the Goths faced external threats, retinues aggregated to deal with them. Once a threat passed, the confederacy devolved into its constituent retinues; the latter were better suited for the small-scale raiding.[18] Likewise, Gothic retinues could combine opportunistically to undertake a larger scale raid and then devolve once the opportunity had passed.

[16]The ways that emperors dealt with these small-scale raids suggests that they did not think of them as centrally organized. For example, Gothic raids into Moesia and Thrace did not provoke overwhelming responses; Anonymous Valesianus (Chap. 5, p. 523) refers simply to Constantine’s “check of their attack”. Similarly, Valentinian and Valens did not offer any strong responses to sporadic raids into Moesia and Thrace. Alternatively, when a larger army of Goths (presumably a confederacy) attacked a group of Sarmatians (another barbarian group) with federate status in 323, Constantius (II; Constantine’s son and later co-emperor) carried out a winter campaign that resulted in “almost a hundred thousand of the Goths […] destroyed by hunger and cold” (Anonymous Valesianus, Chap. 6, p. 528). Even if this is an exageration, there is no doubt that Constantius crushed a sizeable enemy. Similarly, when 3000 Goths joined in support of the usurper Procopious, Valens responded with three years of campaigning across the Danube. This campaigning “reduced the barbarians to such want that they sent a number of delegations to beg for pardon and peace” (Ammianus, Book 27, p. 337). The reference to delegations also suggests that the emperor was dealing with a Gothic confederacy. This conclusion also is supported by Ammianus’ (Book 27, p. 332) statement that the initial 3000 Goths supporting Procopious were sent by “their kings, now reconciled to Rome[.]” That the plural, “kings”, is used indicates, again, a confederacy.

[17]Kurrild-Klitgaard (2003) and Baker and Bulte (2010) similarly describe the confederation of smaller Viking groups.

[18]This is consistent with Wickham’s view (2009, p. 45): “war encouraged the temporary development of alliances or confederacies of separate tiny tribes, each with its own permanent leader, but choosing a temporary leader for that confederation.” Contemporary Roman sources

The Visigothic confederacy that formed under the leadership of Alaric, however, represented an enduring enlargement of the in-group. This was certainly due in part to the Visigoths receiving federate status from the Empire. Under the treaty of 382, the Visigoths were entitled to imperial subsidies and also guaranteed significant autonomy. This provided incentives for the Visigothic confederacy to remain coherent.[19] These incentives were likely reinforced by the experience sacking Rome. The Visigoths got a taste of the sort of large-scale plunder that only a larger confederacy could pursue. Furthermore, the success of the sack gave the Visigoths increased bargaining power towards further imperial subsidies:

> [T]he so-called Visigothic confederacy in the Balkans after the treaty of 381 [sic] was a permanent military force in service of the emperor and was generally supplied by the imperial administration or was permitted to requisition the civilian population. (Collins 2004, p. 22)

To some extent, the Visigoths were offering military services in exchange for subsidies. However, in large part they were succeeding in an act of extortion: they were being paid to *not* plunder. At this point, the Visigothic confederacy was still a roving bandit but one that was exploiting economies of scale in providing (the threat of) violence.

---

understandably emphasize the larger military conflicts, leading some historians to emphasize the temporary confederacies relative to their constituent retinues. For example, Heather (1998, pp. 18, 57–58, 2006, p. 90) concludes: "By the fourth century… especially in areas close to the Roman frontier… smaller units had given way to fewer larger ones". However, Heather (2006 p. 81) also acknowledges: "in the fourth century, major conflicts also occurred only about once in a generation on Rome's European frontiers".

[19] Given that the confederacy was rooted in a general exodus of Goths—including women, children, and the elderly—it likely gave the Visigothic leadership some experience in governance beyond that narrowly applicable to an armed retinue. Thompson (1982, p. 38) remarks: "The actual division of land in Moesia [where the Goths crossing the Danube initially were settled] must have been carried out in the main under the direction of the chiefs and councils, and we may be sure that the optimates [leading men; elites] thereby obtained executive power which would hardly have been theirs in the normal course of tribal life. Again, the annual subsidies of grain and cash paid over at times during the years 382-418 by the Roman government were delivered in the first instance into the hands of the chiefs and councils, who then proceeded to distribute them, or part of them, to the tribesmen in general."

Once the Visigothic confederacy was settled in Gaul settled in 418 in Aquitaine, its transition from a roving bandit to a stationary one—at least in the sense of Olson (1993)—required it to begin providing governance that encouraged wealth creation by the out-group. Such governance exhibits a high degree of publicness from the perspective of the out-group within the territory being governed. From the perspective of the in-group, however, it is club good aimed at extracting wealth, the distribution of which can be made exclusive to the Visigothic providers of that governance.

The incentive for provision of that club good arose from the Visigoths recognizing an encompassing interest in the settlement region. Providing security and order created an environment that was conducive to wealth preservation and creation on the part of the out-group, in this case the Gallo-Romans. Consistent with this, the Visigothic Kingdom taxed moderately, defended its realm from external threats, and handed down law within it.[20] Consistent with this, Heather (1998, p. 183) observes:

> Fifth-century Aquitaine was extremely prosperous, in so far as prosperity can be measured by artistic production for its elite.... This elite prosperity must reflect at least the general conditions created by the Visigothic settlement[.]

Furthermore: "Salvian, a Gallo-Roman priest living in Marseilles, described at great length how, because of their tax burdens, rich and poor Romans alike had fled to the Goths" (Heather 1998, p. 185).

Furthermore, the actual settlements of Visigothic warriors were undertaken in a way that was conducive to the group recognizing an encompassing interest. They "were all regulated operations, presupposing the cooperation of barbarian leaders with the Roman authorities, conducted according to law" (Goffart 1980, p. 36). Each Visigothic

[20]Interestingly, following the first promulgation of laws (circa 480: the Code of Euric), in 506 King Alaric II promulgated his Breviary (*Lex Romana Visigothorum*) containing laws that applied specifically to Gallo-Romans. Hence, a distinction existed between laws applying to the in-group versus those applying to the out-group.

warrior was allotted a share of a particular Gallo-Roman's land or the tax revenues due from that land (Young 2018). (Legal codes and other sources make references to thirds, or *tertiae*.) These allotments essentially made Visigoths shareholders of the realm and residual claimants to the returns of governance (Salter 2015; Salter and Young 2016, 2018).[21]

The effective administration of a tax system was necessary for realizing those returns. This required sophisticated administrative structures than were foreign to the Visigoths' own political structures; staffed by individuals possessing human capital that the Visigoths lacked.

[The Visigothic] territories so annexed were run using a governmental system which was recognizably Roman in origin. Bureaucratic officers and their assistants, a tax system based on meticulous written records, and written law were all foreign to the Goths. The origin of these sophisticated tools of government was Roman, and, in the first place, Romans operated them for Gothic kings (Heather 1998, p. 196).

The Visigothic leadership turned to the Gallo-Roman nobles. They possessed the necessary human capital and were incorporated into the Visigothic government, especially after 450 (Mathisen 1993; Heather 1998, pp. 191–196). This represented a gradual inclusion of the Gallo-Roman nobility into the Visigothic in-group.[22]

The methods of settlement and additions to the in-group served to align incentives between the Visigoths and the Gallo-Romans. Gallo-Roman landowners and Visigothic warriors found themselves with *similar skin in the same game*. The incorporation of Gallo-Roman nobles into the nascent Visigothic government likewise served to align

---

[21]Goffart (1980, 2006, 2008, 2010) has provided the most detailed and comprehensive research on the barbarian settlements of the fifth- and sixth-centuries, including that of the Visigoths.

[22]Wickham (2009, p. 88) observes: "Visigothic […] kings legislated, taxed, shipped grain around, used Roman civilian officials, and created integrated Roman and 'barbarian' armies, including Roman generals." The Visigoths, then, also incorporated other elements of Gall-Roman society into their in-group. Regarding military offices, also see Heather (1998, p. 193).

incentives.[23] As such, Gallo-Romans and the Visigothic elite also gained similar skin in the same game.

The settlement of the Visigoths and the establishment of their kingdom also involved the exclusion of erstwhile in-group members. Some Visigoths had no taste for the stationary life and preferred to remain roving. Thompson (1982, p. 38) argues that "[a]s early as 378 the attitude of the Visigothic leader had diverged sharply from that of the Visigoths in general"; and that "[t]he dominating feature of Visigothic history between the time of Athanaric and that of Wallia [king, 415-419] is the growing conflict between the interests of… the optimates and those of the rank and file" (p. 52). Being a Marxist historian, Thompson is likely to overemphasize any evidence of class conflict. That being said, the evidence he assembles does suggest that a not-negligible number of Visigoths were displeased with the settlement and the relationship with Rome that came with it.

Conclusion

The provision of governance by non-government clubs has been the focus on much recent research. The relevant contexts include prison gangs (Skarbek 2010, 2011, 2012, 2016), motorcycle gangs (Piano 2017a, b), and private communities and homeowners associations (Chen and Webster 2005; Makovi 2018). The studies cited here are excellent illustrations of how clubs have emerged to provide governance given the absence or inadequacy of government.[24] However, they do not speak directly to whether actual governments (states) arose evolved from such emergent clubs.

[23]The incorporation of Gall-Roman nobles into the Visigothic administration is reminiscent of Leeson's (2007b, p. 306) study of "strategies employed by permanently weaker individuals to alter the incentive of stronger agents for trade versus banditry." By becoming essential components of that administration, Gallo-Romans were able to trade their services with the Visigoths, rather than be mere prey to them. Relatedly, Gallo-Roman nobles came also to dominate ecclesiastical positions. The spiritual authority of the Church provided a check on the secular authority of the (Christian) Visigoths (Mathisen 1993).

[24]As are several studies cited in section "Introduction" above.

Above I have focused on the *roving-to-stationary bandit* account of government formation (Olson 1993; McGuire and Olson 1996). This account has been influential amongst scholars and, I argue, can be interpreted as describing a club that initially produces violence towards the benefit of its membership and then evolves to also produce governance that mutually benefits members and non-members (within a specific territory) alike. Given the ubiquity of roving bandits groups (armed retinues) throughout time and place, Buchanan's (1965) club theory undergirds a compelling explanation of how governments may have historically arisen.

A fundamental difficulty in evaluating this explanation is that cases of government formation *ex nihilio* were generally either prehistoric or unobserved by societies that had entered their historic eras. (The historic coincidence of anarchy and written records is essentially nil. And observation of a prehistoric society by a historic one almost necessarily involves the influence of the latter's political institutions on those of the former.)

Here I have provided a case study of the Visigoths that illustrates the evolution of a roving banditry club into a stationary kingdom. Without doubt, the Visigothic experience does not represent the emergence of a *pristine state*, i.e., one that arises without the external influence of existing states (Trigger 2003). Rather, the Visigothic experience provides an example of a new state emerging in the midst of a preexisting state, i.e., in this case the Roman Empire. Indeed, the Visigoths in many ways sought to emulate Roman governance structures, not least through incorporating former imperial officeholders into their administration.

That being said, the Germanic societies did not have governments and the Western Empire was in the process of becoming what we would today call a failed state. Thus the Visigothic Kingdom was not the result of an imperial exercise in nation building. Though Roman influence is undeniable, the share of Visigothic bootstrapping in the formation of the Kingdom was large. Given this, the Visigothic experience is remarkable in that a roving, violence-oriented club was able to settle and fill a "country-sized" vacuum left by the declining Empire with governance.

To the extent that the late Western Empire was failing, the Visigothic experience may offer insights into the emergence of new governance institutions within present-day failed states. Bates (2008) has raised the question: In countries such as the Central African Republic, Liberia, Sierra Leone, and Somalia, why does competition between roving bandits fail to lead to non-predatory, governance-providing states?

As I have argued above, the establishment of the Visigothic Kingdom was characterized by the Visigoths recognizing an encompassing interest in Aquitaine and aligning their incentives with those of the Gallo-Roman nobility. Compare this to the case of modern day Somalia. Following the fall of Siad Barre's dictatorship in 1991, warlords and their retinues provided governance in the void (Powell et al. 2008). In seeking a solution to this "problem", commentators emphasized "a strong diplomatic strategy" and "dialogue among all political actors in the current conflict" (Little 2012, pp. 193–194); elites not only "need to genuinely reconcile, but they need to genuinely compromise as well" (Sanei 2014, p. 3).[25] Quite possibly, a diplomacy of "dialogue", "reconciliation", and "compromise" are not effective means towards achieving meaningful alignment of incentives across Somali elites.

In the case of failed states, it is unclear that policies that would actually yield such incentive alignment are feasible. The Visigoths (to some extent, perhaps, unwittingly) achieved it through broad and coercive reorganizations of claims to land in Gaul. Nation-builders who wish to establish non-predatory government and respect human rights are precisely those who will be loath to undertake similar policies, and understandably so. This is a sobering reminder that, a non-predatory government, though perhaps a "first-best", may not always be on the menu of feasible options (Leeson 2007d; Leeson and Williamson 2009).

[25]Leeson (2007c) provides evidence that key indicators of economic development actually improved in the wake of Barre's fall.

References

Alchian, A. A., & Demsetz, H. (1972). Production, Information Costs, and Economic Organization. *American Economic Review, 62*(5), 777–795.

Anderson, T. L., & Hill, P. J. (1979). An American Experiment in Anarcho-Capitalism: The Not So Wild, Wild West. *Journal of Libertarian Studies, 3*(1), 9–29.

Anderson, T. L., & Hill, P. J. (2004). *The Not So Wild, Wild West: Property Rights on the Frontier*. Stanford: Stanford University Press.

Anonymous Valesianus. (1939). *Chronica Minora I*. Cambridge: Loeb Classical Library, Harvard University Press. http://penelope.uchicago.edu/Thayer/E/Roman/Texts/Excerpta_Valesiana/home.html.

Baker, M. J., & Bulte, E. H. (2010). Kings and Vikings: On the Dynamics of Competitive Agglomeration. *Economics of Governance, 11*(3), 207–227.

Bates, R. H. (2008). *When Things Fell Apart: State Failure in Late-Century Africa*. Cambridge: Cambridge University Press.

Boardman, A. E., & Lave, L. B. (1977). Highway Congestion and Congestion Tolls. *Journal of Urban Economics, 4*(3), 340–359.

Buchanan, J. M. (1965). An Economic Theory of Clubs. *Economica, 32,* 1–14.

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

Buchanan, J. M., & Tullock, G. (1962). *The Calculus of Consent: Logical Foundations of Constitutional Democracy*. Ann Arbor: University of Michigan Press.

Chen, S. C. Y., & Webster, C. J. (2005). Homeowner Associations, Collective Action, and the Costs of Private Governance. *Housing Studies, 20*(2), 205–220.

Cicchetti, C. J., & Smith, V. K. (1976). *The Costs of Congestion: An Econometric Analysis of Wilderness*. Cambridge: Ballinger.

Coase, R. H. (1974). The Lighthouse in Economics. *Journal of Law and Economics, 17*(2), 357–376.

Collins, R. (2004). *Visigothic Spain: 409-411*. Oxford: Blackwell.

Congleton, R. D. (2004). Mutual Advantages of Coercion and Exit Within Private Clubs and Treaty Organizations: Towards a Logic of Voluntary Association. *Rivista di Politica Economica, 94*(4), 49–78.

Congleton, R. D. (2007). On the Feasibility of a Liberal Welfare State: Agency and Exit Costs in Income Security Clubs. *Journal of Public Finance and Public Choice, 25*(2007), 3–30.

Congleton, R. D. (2011). Why Local Governments Do Not Maximize Profits: On the Value-Added by the Representative Institutions of Town and City Governance. *Public Choice, 149*(1/2), 187–201.
Congleton, R. D. (2015). The Logic of Collective Action and Beyond. *Public Choice, 164*(3–4), 217–234.
Demsetz, H. (1970). The Private Production of Public Goods. *Journal of Law and Economics, 13*(2), 293–306.
Durkheim, E. (1933). *The Division of Labor in Society*. New York: Macmillan.
Fukuyama, F. (2011). *The Origins of Political Order: From Prehuman Times to the French Revolution*. New York: Farrar, Straus and Giroux.
Goffart, W. (1980). *Barbarians and Romans: The Techniques of Accommodation*. Princeton: Princeton University Press.
Goffart, W. (2006). *Barbarian Tides: The Migration Age and the Roman West, 376–568*. Philadelphia: University of Pennsylvania Press.
Goffart, W. (2008). Frankish Military Duty and the Fate of Roman Taxation. *Early Medieval Europe, 16*(2), 166–190.
Goffart, W. (2010). The Technique of Barbarian Settlement in the Fifth Century: A Personal, Streamlined Account with Ten Additional Comments. *Journal of Late Antiquity, 3*(1), 65–98.
Grierson, P. (1941). Election and Inheritance in Early Germanic Kingship. *Cambridge Historical Journal, 7*(1), 1–22.
Grossman, H., & Noh, S. J. (1994). Proprietary Public Finance and Economic Welfare. *Journal of Public Economics, 53*(2), 187–204.
Heather, P. (1998). *The Goths*. Oxford: Blackwell.
Heather, P. (2006). *The Fall of the Roman Empire: A New History of Rome and the Barbarians*. Oxford: Oxford University Press.
Jones, D. N., Burns, R. E., Darr, F. P., Eifert, M., Graniere, R. J., Lock, R. H. J. H., & Polling, R. (1992). *Regional Regulation of Public Utilities: Opportunities and Obstacles*. Columbus: National Regulatory Research Institute, Ohio State University.
Khanna, J., & Sandler, T. (1996). Burden Sharing in NATO: 1960–1992. *Defence and Peace Economics, 7*(2), 115–133.
Konrad, K., & Skaperdas, S. (2012). The Market for Protection and the Origin of the State. *Economic Theory, 50*(2), 417–443.
Koyama, M. (2012). Prosecution Associations in Industrial Revolution England: Private Providers of Public Goods. *Journal of Legal Studies, 41*(1), 95–130.
Kurrild-Klitgaard, P., & Svendsen, G. T. (2003). Rational Bandits: Plunder, Public Goods, and the Vikings. *Public Choice, 117,* 255–272.

Leeson, P. T. (2007a). An-*arrgh*-chy: The Law and Economics of Pirate Organization. *Journal of Political Economy, 115*(6), 1049–1094.
Leeson, P. T. (2007b). Trading with Bandits. *Journal of Law and Economics, 50*(2), 303–321.
Leeson, P. T. (2007c). Better Off Stateless: Somalia Before and After Government Collapse. *Journal of Comparative Economics, 35*(4), 689–710.
Leeson, P. T. (2007d). Efficient Anarchy. *Public Choice, 130*(1–2), 41–53.
Leeson, P. T. (2010). *The Invisible Hook: The Hidden Economics of Pirates*. Princeton: Princeton University Press.
Leeson, P. T. (2011). Government, Clubs, and Constitutions. *Journal of Economic Behavior & Organization, 80*(2), 301–308.
Leeson, P. T., & Williamson, C. R. (2009). Anarchy and Development: An Application of the Theory of Second Best. *Law and Development Review, 2*(1), 77–96.
Lipsman, M. A. (1994). A Theory of Transportation Clubs with Special Application to the Domestic Aviation System (Unpublished doctoral dissertation). Iowa State University.
Little, P. D. (2012, April). On the Somalia Dilemma: Adding Layers of Complexity to an Already Complex Situation. *African Studies Review, 55*, 191–195.
Makovi, M. (2018). Government vs. Governance: Libertarianism and Private Communities. *Journal of Private Enterprise* (forthcoming).
Marcellinus, A. (1986). *The Later Roman Empire (AD 354–378)*. London: Penguin Books.
Mathisen, R. (1993). *Roman Aristocrats in Barbarian Gaul: Strategies for Survival in an Age of Transition*. Austin: University of Texas Press.
McGuire, M. C., & 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.
Moselle, B., & Polak, B. (2001). A Model of a Predatory State. *Journal of Law Economics and Organization, 17*(1), 1–33.
Murdoch, J. C., & Sandler, T. (1982). A Theoretical and Empirical Analysis of NATO. *Journal of Conflict Resolution, 26*(2), 237–263.
Nordhaus, W. (2015). Climate Clubs: Overcoming Free-Riding in International Climate Policy. *American Economic Review, 105*(4), 1339–1370.
Olson, M. (1971 [1965]). *The Logic of Collective Action: Public Goods and the Theory of Groups*. Cambridge: Harvard University Press.

Olson, M. (1993). Dictatorship, Democracy, and Development. *American Political Science Review, 87*(3), 567–576.
Ostrom, E. (1990). *Governing the Commons*. New York: Cambridge University Press.
Piano, E. (2017a). Free Riders: The Economics and Organization of Outlaw Motorcycle Gangs. *Public Choice, 171*(3), 283–301.
Piano, E. (2017b). Outlaw & Economics: Biker Gangs and Club Goods. *Rationality & Society* (Forthcoming).
Powell, B., Ford, R., & Nowrasteh, A. (2008). Somalia After State Collapse: Chaos or Improvement? *Journal of Economic Behavior & Organization, 67*(3–4), 657–670.
Prüfer, J., & Walz, U. (2013). Academic Faculty Governance and Recruitment Decisions. *Publilc Choice, 155*(3/4), 507–529.
Robinson, J. A. (1999). *When is a State Predatory* (CESifo Working Paper No. 178). http://www.cesifo-group.de/portal/page/portal/DocBase_Content/WP/WP-CESifo_Working_Papers/wp-cesifo-1999/cesifo_wp178.pdf.
Salter, A. W. (2015). Rights to the Realm: Reconsidering Western Political Development. *American Political Science Review, 109*(4), 725–734.
Salter, A. W., & Young, A. T. (2017). *Polycentric Sovereignty: The Medieval Constitution, Governance Quality, and the Wealth of Nations* (SSRN Working Paper). http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2735963.
Samuleson, P. A. (1954). The Pure Theory of Public Expenditure. *Review of Economics and Statistics, 36*(4), 387–389.
Samuelson, P. A. (1955). Diagrammatic Exposition of a Theory of Public Expenditure. *Review of Economics and Statistics, 37*(4), 350–355.
Sandler, T., & Tschirhart, J. (1997). Club Theory: Thirty Years Later. *Public Choice, 93*(3–4), 335–355.
Sanei, A. (2014). *Post-Transition Somalia: Ingredients for Peace-Building* (ASA 2014 Annual Meeting Paper). http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2415255.
Skarbek, D. (2010). Putting the "Con" into Constitutions: The Economics of Prison Gangs. *Journal of Law Economics and Organization, 26*(2), 183–211.
Skarbek, D. (2011). Governance and Prison Gangs. *American Political Science Review, 105*(4), 702–716.
Skarbek, D. (2012). Prison Gangs, Norms, and Organizations. *Journal of Economic Behavior & Organization, 82*(1), 96–109.
Skarbek, D. (2016). Covenants Without the Sword? Comparing Prison Self-Governance Globally. *American Political Science Review, 110*(4), 845–862.

Stringham, E. P. (2002). The Emergence of the London Stock Exchange as a Self-Policing Club. *Journal of Private Enterprise, 17*(Spring), 1–19.
Stringham, E. P. (2015). *Private Governance: Creating Order in Economic and Social Life*. Oxford: Oxford University Press.
Tacitus, G. C. (1970). *The Agricola and the Germania* (H. Mattingly & S. A. Handford, Trans.). London: Penguin Books.
Thompson, E. A. (1982). *Romans and Barbarians: The Decline of the Western Empire*. Madison: University of Wisconsin Press.
Thompson, E. A. (2008). *The Visigoths in the Time of Ulfila*. London: Duckworth.
Tiebout, C. M. (1956). A Pure Theory of Local Expenditures. *Journal of Political Economy, 64*(5), 416–424.
Trigger, B. G. (2003). *Understanding Early Civilizations*. Cambridge: Cambridge University Press.
Wickham, C. (2009). *The Inheritance of Rome: Illuminating the Dark Ages 400–1000*. London: Penguin Books.
Wiseman, J. (1957). The Theory of Public Utility Price—An Empty Box. *Oxford Economic Papers, 9*(1), 56–74.
Wolfram, H. (1975). Athanaric the Visigoth: Monarchy or Judgeship. A Study in Comparative History. *Journal of Medieval History, 1*(1), 259–278.
Young, A. T. (2015). From Caesar to Tacitus: Changes in Early Germanic Governance circa 50 BC–50AD. *Public Choice, 164*(3–4), 357–378.
Young, A. T. (2016). What Does It Take for a Roving Bandit Settle Down? Theory and an Illustrative History of the Visigoths. *Public Choice, 168*(1–2), 75–102.
Young, A. T. (2018). Hospitalitas: Barbarian Settlements and Constitutional Foundations of Medieval Europe. *Journal of Institutional Economics* (Forthcoming).

38

Rules Versus Discretion in Criminal Sentencing

Daniel J. D'Amico

Introduction

The United States' prison population quintupled between the late 1970s and the early 2000s. With over two million incarcerated, the net amount of inmates within the U.S. at peak rivaled the historic cases of both the Soviet Gulag system and the Nazi concentration camps (Mitchell 1988; Applebaum 2003). In 2007, the U.S. hosted over 760 prisoners per 100,000 citizens—the largest per capita rate on planet Earth (UNODC 2018).

The comparative magnitude, rapidity, and obvious social relevance of mass incarceration have thus generated common concerns that the trend is excessive and demands reform. But, at the foundation of all such activist efforts sits the pressing need for a thorough operational understanding. Before society can hope to fix a supposed problem, we must first know its causes and consequences accurately. What shapes

D. J. D'Amico (✉)
Brown University, Providence, RI, USA
e-mail: daniel_damico@brown.edu

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_38

prison growth? Why do some nations incarcerate so many more individuals than others? What viable alternatives to the status quo could assure a more proportionate distribution of criminal punishments? These questions are intensely researched and debated across a variety of academic disciplines. But, the current status of these literatures remains uncertain, under specified, and incomplete.

One major area of debate surrounds a tension regarding how much criminal sentences should be determined by the rule of law or in contrast, the discretionary authority of judges and other criminal justice officials. Does a system of fixed punitive rules or an adaptive system of discretionary authority better assure proportionate outcomes? Do fixed rules or discretionary interventions better avoid the social consequences of mass incarceration? On the one hand, punishments and law enforcement efforts operate as offsetting incentives against criminal behavior (Becker 1968). Such equilibrating dynamics suggest a useful function for adaptations and interventions to better gauge punishment magnitudes and assure social efficiency. On the other hand, discretion begets capture and manipulation by special interests. Furthermore, a consistent and unbiased rule of law is a necessary condition for fairness and equity, especially when such a system is administered across a large and diverse population (Waldron 2016).

In recent decades, different streams of research have attributed rules and discretion in turn, each as contributing factors to over criminalization and mass incarceration. Racial and class biases were common features of policing, prosecution, and criminal sentencing in early American history (Alexander 2012). In response, criminal justice procedures and appeals became more formalized and subject to federal design throughout the twentieth century (Murakawa 2014). In their original intentions, federal sentencing rules and guidelines were aimed to supplant racial prejudice and excessive severity at the state and local level (Abramson 2000). More recently, research has apparently "come full circle," (Klein 2005, p. 1) now suggesting that these efforts tended towards greater severity, longer punishments, and larger prison populations.

This tension between rules and discretion is not unique to matters of criminal justice, as similar debates churned throughout macroeconomic research between the 1960s and 1990s. I argue that strong parallels exist across the rules versus discretion debates within monetary and criminal justice policy arenas. Substantial insight can be garnered from the former literature to inform the latter.

Monetary debates regarding rules versus discretion take one of three main argumentative positions. First, many recognize an obvious need for adaptive and stabilizing adjustments to the money supply via macroeconomic interventions.[1] Interest rates operate within the loanable funds market akin to ordinary prices in consumer markets. Hence, adaptable means of adjusting interest rates via monetary interventions are seen as critical methods to assure proportionate supplies and general market equilibration.

Second, Friedman (1948) argued against discretion-based monetary policy, as the long and variable lags of monetary policy outcomes provide poor incentives and feedback for authorities to optimize interventions. Dominantly accepted economic theory may call for monetary actions orthogonal to what electoral politics and embedded bureaucratic incentives promote. In so far as actors throughout the economy recognize this tension, nominal policy changes are unlikely to reshape real expectations or outcomes. Hence, Friedman proposed stable and transparent monetary rules akin to constitutional amendments.

Third, Buchanan (1983) in part transcended this debate by focusing upon the practical enforceability of rules and the incentives that govern over those entrusted to enforce them. In principle, Buchanan agreed with Friedman that rule-based monetarism was preferable, as discretionary authority created opportunities for rent seeking and ultimately the expectations of real market actors matter most. However, agents throughout the economy must believe that authorities will abide by the rules once they are in place. Rules only evoke stable expectations when agents perceive enforcers to be bound by credible commitments. Buchanan noted this challenge was uniquely difficult for monetary compared to other policy areas, as manipulating the money supply represents an extreme and unique potential for governmental expansion. Thus, even with a constitutionally inscribed monetary rule,

[1] See Simmons (1936), Lerner (1944), and Modigliani (1977).

governments are directly incentivized to manipulate the macro-economy for private and or political gain. In result, he viewed the challenge of efficient monetary policy to be ultimately about effective constitutional checks and balances. Such insight, begs the practical question as to how self-enforcing constitutions are best arranged? In turn, we must ask by what organizational structures might the different powers of government be arranged so as to assure good monetary rules and enforcements?

Similar ideas regarding credible commitments have been leveraged to understand the challenges of discretionary legal reforms (Rizzo 1980), the failures of full scale economic planning amidst Perestroika (Boettke 1993), and post war reconstruction (Coyne 2008). This essay represents an additional social arena wherein the core insights of constitutional political economy bear relevance. In short, the long and variable lags of punitive policies make for a similar tension between rules and discretion as is commonly discussed regarding monetary policy. While there are strong conceptual reasons to support rule-based sentencing policy over discretionary authority, the task of punitive policy making also lacks credible commitments akin to the self-seeking potentials of monetary power. Rule-based criminal sentencing proposals rely upon governmental decision makers to police themselves, thus it is not surprising that rule-based policies have historical results like over criminalization, police brutality, punitive severity, and mass incarceration.

The remainder of this paper is organized as follows. Section "Rules Versus Discretionary Monetary Policy" surveys the rules versus discretion debate amongst macroeconomists. Section "Rule-Based Versus Discretionary Criminal Sentencing" parallels section "Rules Versus Discretionary Monetary Policy" by surveying the similar arguments for rule-based and discretionary criminal sentencing. Section "The Long and Variable Lags of Sentencing Policy" explains how rule-based criminal sentencing similarly suffer Buchanan's critique in so far as they lack credible commitments. Given their currently hierarchical and relatively centralized organizational forms, criminal justice institutions lack effective checks and balances to offset political incentives towards bureaucratic growth, capture, and rent-seeking. Section "Conclusions" concludes.

Rules Versus Discretionary Monetary Policy

This section surveys the three main arguments within the rules versus discretion debates surrounding macroeconomic interventions. I label these as follows, (1) democratic or independent discretion, (2) the need for stable expectations via rule-based policy, and (3) the constitutional challenge of credible commitments. Each is summarized within its own brief sub section below.

1. Democratic or Independent Discretion

In the early twentieth century, Keynes (1936) displaced the classical vision of the self-adjusting macro economy via an alternative "hydraulic" framework. In addition to identifying a series of causal relationships to account for historic and contemporary outcomes, the Keynesian model also promoted a tool kit for adjusting national economic performance. Expanding the money supply, increasing public spending, or reducing taxes were all believed to increase aggregate output and visa versa. The macro economy was seen to be inherently prone to disequilibrium conditions and thus suffered systemic unemployment, underproduction, and bouts of cyclicality. Hence, the economic role of government came to be thought of as holding the discretionary responsibility and authority to both identify over or under performance and apply the appropriate policy lever(s) when needed.

The earliest debates regarding efficient macroeconomic management presumed the obvious potentials and needs of intervention, and thus focused primarily upon which sphere of authority would best manage discretionary power. Simmons (1936) surveyed and accepted the desirability of stable rule-based constitutions, but also admitted the necessity of timely efforts to adjust price levels, improve employment outcomes, and avoid recessions. Later, Modigliani (1977) argued for the potentials of intervention, but ceded the need for some independence of monetary authority apart from political interests. In short, the practical social needs of macroeconomic stabilization are distinct from the political interests of democratic decision makers. If political careers can be made or broken by leveraging cheap credit, targeted subsidies, and or debt-based financing (Wagner 1977), then there is little hope for fiscal or monetary interventions to be deployed optimally when they are needed. Thus, a Federal Reserve system, supposedly independent of democratic politics, can better align monetary policy with real economic needs rather than pander to political interests or populist demands.

2. The Need for Stable Expectations Via Rule-based Policy

By the mid-1970s, stagflation and the seeming inefficacy of Keynesian interventions weakened the belief that fiscal policy (taxing and spending) held more corrective potency relative to monetary policy (adjusting the money supply and interest rate).[2] Thereafter the monetarists, largely spearheaded by Friedman (1968), argued in contrast a greater influence from monetary policy. The presumed potentials of macroeconomic interventions remained intact. Hence, a subsequent debate evolved to address the relations between macroeconomic adjustments and expectations throughout the market economy.

A practical independence of monetary policy apart from political influence is easier said than done. First, spheres of political authority apart from the Federal Reserve also possess interventionist influence upon monetary and macroeconomic outcomes. Second, political authorities can and do impose real pressures upon Federal Reserve decision makers despite supposed Fed independence. Last, Federal Reserve officials like all other market actors are subject to their own interests and political biases. In result, some substantial political influence upon monetary policy is inevitable and ought to be taken into consideration by any broader interventionist framework.

Because investors seek to profit maximize through time, mere expectations of policy changes may suffice to reshape real macroeconomic

[2]Friedman and Shwartz's (1963) work also provided substantial historic empirics demonstrating the relatively strong role of monetary policy in shaping business cycles and macroeconomic outcomes.

outcomes. Small errors of estimating future interest rates or interest rate changes can have large effects on profits and losses. Inversely, policy efforts may fall flat if market participants do not genuinely believe they will persist or yield real results. Furthermore, the timing of politics is a wholly different process from the real fluctuations of macroeconomic phenomena and or the real changing needs for monetary interventions. Current office holders can implement policies while imposing costs onto future regimes. Similarly, present office holders may bear the force of negative or positive perceptions still remnant from long-past policy changes. Hence, Friedman focused upon the unique implications surrounding the "long and variable lags of monetary policy" (Friedman 1965).

In short, the omnipresence of these incentive structures creates an environment wherein political decision-makers face loose and indirect feedback regarding what macroeconomic problems exist, which interventions are effective, and how political constituents will approve or disapprove of outcomes. In stride, Friedman ceded the inevitability of political influence upon monetary pressure by conceptualizing and arguing for monetary rules to be framed as constitutional measures. Hence, Friedman is often summarized to have suggested an explicit constitutional amendment stipulating a constant 2% inflation rate. In short, it was believed that the benefits of reliability would outweigh the downsides of a fixed rate (Friedman and Goodhart 2003).

3. The Constitutional Challenge of Credible Commitments

Buchanan divided his framework of constitutional choice into two primary levels of analysis: the pre and post constitutional moments of decision-making. In other words, citizens face strategic incentives during ordinary post-constitutional processes within a relatively fixed setting of rules and enforcements, but they also face strategic opportunities during the rule making process itself or pre-constitutional moment (Buchanan 1977; Brennan and Buchanan 2000 [1985]). Hence, any policy change wherein individuals can foresee personal losses from a new rule creates a challenge of consent, as the constituency of losers has little incentive to support the rule change.

With regard to Friedman's constitutional proposal for monetary rules, Buchanan's dichotomy is most relevant. First, from the status quo condition, political authorities face a pre-constitutional dilemma that may obstruct the potential of presumably "good" monetary rules from being accepted and implemented. If current rules, or a lack thereof, benefit particular interest groups at the expense of social wellbeing, then those groups are inclined to impede or redirect reforms towards "better" rules. Second, even if accepted and implemented effectively, monetary rules are specifically at odds with many basic incentives governmental bureaucracies face: to grow and expand fiscal, monetary, and executive authority when possible (Niskanen 1971). Effective rules require that those entrusted with enforcement authority be well inclined to abide and actually enforce the rules.

Buchanan's insight thus refocuses the debates surrounding monetary policy towards the question of consistent enforceability. By what mechanisms of effective checks and balances might good monetary rules succeed in maintaining reliable expectations of credible enforcements. Or, more broadly, "what are the rules of rule-making?" (Buchanan 1987). In general, it is well acknowledged that organizational patterns matter (Williamson 1985) and that monopolistic hierarchies are more prone to rent seeking and capture than decentralized alternatives (Tullock 1967; Sah and Stiglitz 1986). Akin to the general market place, robust and adaptable institutional outcomes tend to coincide with more pluralistic and competitive environments (Ostrom 2005). Thus, the persistence of relative monetary stability can be attributed to the degree of effective jurisdictional competition in the global market for currencies.

Rule-Based Versus Discretionary Criminal Sentencing

The criminal sentencing debate between rules and discretion has a long and varied history. Current criminal sentencing practices and outcomes have been commonly perceived as excessive for several decades. However, causal frameworks for understanding these trends are varied, contested, and sometimes stand in contradiction to one another.

Both rule-based and discretionary policies have each been accredited for driving excessive imprisonments in America. Frankel (1972, p. 29) complained that "indeterminate sentences," lead to longer incarcerations and a vast prison growth. More recently, several writers blame the neoclassical paradigm and formal sentencing guidelines as a major cause behind increased incarceration rates.[3]

In their earliest stages, American colonies practiced the British system of determinate sentences. Crimes typically carried a specific penalty set by law (Friedman 1993). Thereafter, but still relatively early in American history, local judges were given far more discretion regarding punishment types and sentence lengths. During these latter colonial periods, the rehabilitation paradigm was widespread. It was believed that discretionary sentencing could help gauge punishments for the specific needs of criminals and their respective behaviors (Hirsch 1992, pp. 8–40; Rothman 1971, p. 49). Given the presumed roles of individual rationality and the potentials for incentive adjustments, excessively severe and sub-optimal punishments were recognized as socially dangerous. If punishments are not gauged proportionately across mild and severe crimes, excessively severe laws encourage rather than deter criminal behavior (Beccaria 1764; Bentham 1988 [1843]). Continuously adaptable punishments were seen as necessary to fit the unique conditions of criminal behavior across diverse localities and individuals. Thus, the debates at this time paralleled later monetary debates in that they accepted a presumed potential for discretion to achieve proportionate outcomes. But, what sphere of political authority will most effectively leverage such discretionary punitive authority remained uncertain. Should criminologist and psychological experts design penalties, or should political authorities adhere to public opinion (Comment 1950; Wright 1999)?

The first practical shift away from discretion came late with the development of parole boards and probation agencies at the dawn of the twentieth century. By 1942 every state and the Federal government utilized parole boards (Samaha 2005). Such was not intended as

[3]Braithwaite and Pettit (1990), Christie 2000 [1993], Tonry (1996), and Garland (2001).

opposition to judicial discretion per se, but these groups subsumed de facto sentencing authority from judges nonetheless, as they could release a prisoner early or change the type of penalty endured. Later the shift towards rule-based sentencing was more explicitly motivated against judicial power, as absolute discretion was seen as "terrifying and intolerable for a society that professes devotion to the rule of law (Frankel 1972, p. 8)". With few to no practical assurances against judicial bias, citizens had little reason to expect fair trials, stable rates of criminal deterrence, or consistent rectification when victimized. Crime rates and public opinions varied in stride; disjointed from policy trends and punitive magnitudes (Flanagan and Longmire 1996). Hence, the abilities of individuals to strategically optimize their personal and political investments across private and public security efforts suffered from systemic uncertainty.

From the 1970s through the 1990s American criminal sentencing shifted strongly towards rule-based sentencing guidelines. Sentencing grids were a codified attempt to make the sentencing process objective and predictable across diverse localities. The federal government designed and imposed pervasive system of guidelines in 1984 and the vast majority of states followed suit with individual systems shortly thereafter. Sentencing grids design indexes of criminal history and individual scales of criminal severity. Together these axes produce a formal and narrow sentencing range that judges are meant to stay within. There was no widespread opposition to the initial adoption of sentencing guidelines because previous paradigms had failed to produce significant and tangible reductions of crime rates (Martinson 1974). But since their inception, sentencing guidelines have received wide spread criticism, mixed results, and they have even been argued to have exaggerated disparity and prison growth.[4] Commentators infer that sentences are higher than they otherwise would be without guidelines. Thus, recent

[4]Klein and Steiker (2002), survey Thomson (1962), Nagel and Hagan (1982), Seidman and Zeisel (1975), Cook (1973), Wilkins et al. (1991), Nagel (1990), and Clancey et al. (1981) who all support sentencing guidelines as a response to disparity originating from judicial discretion. See also Campbell (1991) and Breyer (1988).

Supreme Court cases have re-awarded discretionary power to federal judges in criminal cases.

The Long and Variable Lags of Sentencing Policy

The process of establishing socially efficient criminal justice policies confronts many of the same challenges as those inherent to the task of designing optimal monetary interventions. In short, both monetary and criminal justice policies similarly endure long and variable lags. Hence, the political processes of identifying real needs for criminal justice reform, designing effective interventions, and implementing real policies all suffer from imperfect incentives and weak feedback mechanisms. Thus, conceptually citizens have little reason to expect predictability or stability from the criminal justice system writ large. Again, akin to monetary policy debates, a strong conceptual case can be made for formal codifications of criminal punishments via codified sentencing norms. However, the stabilizing effects of rule-based criminal sentences are easier to nominally implement than practically assure. First, the organizational structure of political decision making within the criminal justice system suffers long and variable lags comparable to monetary policy making. Second, the unique potentials for criminal justice authority to expand governmental size and authority lacks a credible commitment that fiscal and punitive contractions will be adhered to when needed. In result, the criminal justice system, much like monetary policy, conforms to a strong and persistence bias towards expansion and excess.

The long and variable lags of criminal sentencing policies stem from a variety of sources. Sentencing norms and outcomes can change through several procedural channels such new Supreme Court rulings, legislated acts, sentencing commission decisions, local policy changes, law enforcement norms, and internal parole board statutes. First there exists a lag between the real need for reform on the one hand, and the recognition or discovery of that need on the other. Second, between the recognition of a supposed need for adjustments, the effective design of adaptive policies, and the final application of reforms, time must

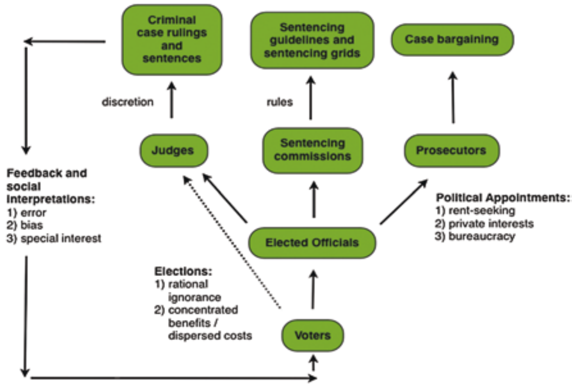


Fig. 38.1 The structure of decision making within American criminal justice

pass. Lastly, time also passes between a policy's inception and its actual effects.

The American criminal justice system is currently organized as a relatively vertical hierarchy of decision making. This arrangement inevitably carries with it lags and delays in implementing reforms. Figure 38.1 is a visual diagram of the flow of decision-making and the feedback at play within all local criminal justice jurisdictions.

At the base of the hierarchy, is the general public represented by voters. Voters participate in elections and choose political officials who they infer to be most in line with their political interests. The dotted-line between voters and judges is meant to indicate that some states select judges by independent voting whereas other states select judges by political appointment.

In the case of proportionate criminal punishment outcomes, voters would have to exert an explicit preference for a candidate concerned with this issue over alternative political goals. This is unlikely. First, because criminal sentencing issues are often second seat political concerns next to unemployment, economic welfare, health care, foreign policy etc. Second, the election process suffers from rationally ignorant voters and political coalitions. Voters have little incentive to be informed about political issues because they bear a direct cost significantly higher than their actual influence upon the election

(Congleton 2002). Special interest groups more easily resolve collective action problems, can vote in relative unison, and thus reap concentrated benefits for their particular coalitions while dispersing costs across the entire citizenry (Wagner 1989). Thus a motivated voter concerned with punitive proportionality would have to compete for coalition members amongst notably more popular political issues. Hence, the political process reveals a status quo bias, because the costs of implementing political reform are inhibiting to the creation of minimal winning coalitions to implement social change (Buchanan and Tullock 1962). The current political process expresses a bias towards growth and expansion in so far as special interest groups recognize direct incentives for punitive expansion and excess. Such examples likely include police and correctional officer unions, professional prosecutors, along with material contractors for police and prison equipment.

At the next level of the decision-making hierarchy, elected officials appoint decision makers in several separate but related fields of criminal sentencing. This is represented in Fig. 38.1 by the three arrows stemming from elected officials towards judges, sentencing commissions, and prosecutors. Different states rely upon different arrangements to structure their local criminal justice systems and the federal criminal court system has its own structure as well. In some states judges and sentencing commissions co-exist, which is to say judges reign over the trials of cases while commissions set formal rules that determine narrow possible ranges for judges to assign sentences within. States without commissions and guidelines award a greater role of discretion to judges. Hence the diagram labels the decision-making arrow from judges to case rulings as "discretion," and the decision-making arrow from sentencing commissions to guidelines and sentencing grids as "rules." Prosecutors are another set of key decision makers when it comes to criminal sentencing. Through bargaining before and during the trial process prosecutors shape the real outcomes of criminal sentences. Though prosecutors are not necessarily awarded a de jure level of discretionary authority, they do carry a significant level of de facto power to bias sentencing decisions upwards or to circumvent the formal rule systems of sentencing guidelines with mitigating evidence—also biasing the level of criminal sentences upwards (Pfaff 2017).

The process of political appointments allows for further time lags and systematic tendencies that depart from optimal criminal justice outcomes. Once in authority an official has the opportunity and the incentives to maximize the budgets of his particular bureaucracy (Tullock 1965, pp. 120–220; Niskanen 1971). He is also inclined and capable to promote his private interests regardless of social welfare (Tullock 1967). Available resources within the provision of criminal sentences get allocated apart from proportionate optimality—some are wasted as expended efforts to curry political favor, some are wasted as bureaucratic inefficiency, and some are captured for private interests.

Finally, the actual decision making of each of the three appointed official types takes time and erupts further systematic political interests at odds with proportionality. Actual cases can take several years from the initial application of criminal charges through the trial process, verdict, and appeals and finally sentencing. Sentencing commissions have been known to take several years in order to formally be developed, meet with one another, agree upon a system of sentencing guidelines or sentencing grids, draft those proposals and finally implement them into stable policy. In fact the majority of states that have attempted to create sentencing grids out of sentencing commissions have failed to do so even after several years of deliberation (Tonry 1991). These long lags allow for opportunism and rent-seeking much like the process of political appointments in so far as they have been observed to bias the sentencing process upwards. As Zimring (1976) has noted "asking legislators to develop fine-tuned sentencing standards offers an irresistible opportunity for political posturing and pandering to get-tough sentiments." Lastly prosecutors use bargaining power to influence the actual outcomes of criminal sentences. As rational maximizing agents, prosecutors seek to maximize their convictions and strategically offer high initial sentencing requests in order to induce plea-bargaining.

Notice that there is no significant difference between the incentives invoked under discretionary judicial sentencing compared to rule-based sentencing by commission guidelines. In both cases the actual results must be re-interpreted as feedback perceived by the voting public. The public can either accept the outputs of the criminal justice process or they can perceive a problem and express their own dissatisfaction.

In the case of the latter, individuals face significant costs to organize and express their refined political opinions. This process itself carries its own lag and systematic effects against proportionality.

These long and variable time lags suggest that rule-based criminal sentencing has some preferable potential to assure proportionate outcomes. The time delays associated with criminal sentencing policies imply a bias that they will be either ineffective, or if effective unaccepted. By selecting stable and generally applicable rules, citizens, criminals, security entrepreneurs and even political agents would have a better estimation of future criminal sentencing policies and could therefore invest in long term production plans and allocations of criminal justice resources to ensure that the level of criminal punishments reflected societal preferences as revealed by the market prices of those resources. Unfortunately so long as criminal justice institutions are arranged in similarly centralized hierarchies, decision makers face no self-enforcing constraint from breaking and perpetually reforming the allegedly established rules. The broader incentives for bureaucratic growth and expanded authority transcend temporal and practical needs for punitive reductions or fiscal constraint.

Conclusions

Theoretical arguments were surveyed from the debate within macroeconomics regarding the potentials and limitations of rule-based relative to discretionary monetary interventions. Despite the presumed potentials of monetary interventions to maintain efficient economic output, the long and variable lags of monetary policies create a strong theoretical case that rules rather than discretions provide a superior environment for the maintenance of reliable expectations. Market actors need clear and reliable indicators of profitability via interest rates over time to plan accordingly. However, implementing effective monetary rules is easier said than done.

As Buchanan's public choice approach brought to light, the organizational authorities responsible for designing and enforcing monetary rules are often one and the same. Given the extreme potentials for capture and rent seeking embodied within monetary authority, nominal rules create and confront explicitly bad incentives for decision makers to abide and or enforce rules once in place. The challenge of effective monetary rule enforcement is ultimately about understanding how the organizational structure of constitutions promotes effective checks and balances.

Similar arguments were identified and summarized within the criminal justice arena. Criminal sentencing policies are similarly characterized by long and variable lags. Individuals living within any given criminal justice regime have unreliable sources of information and indirect incentives for investing private and political efforts optimally towards maintaining efficient and proportionate punishment outcomes. Regardless of the nominal commitments to rule-based or discretionary sentencing policies the incentives towards bureaucratic growth, rent seeking and capture are ultimately shaped by the consistently hierarchical structure of criminal justice decision-making.

This model accords to the available historical record. Criminal justice resource allocations and key phenomena like mass incarceration, over criminalization, and police militarization have persistently tended towards expansion despite wide variations of policy intents. Further research is needed to investigate and understand the relationship between the organizational patterns of criminal justice institutions, political decision making within the criminal justice system, and patterns of punishment outcomes across variously organized institutional settings.

References

Abramson, J. (2000). *We, the Jury: The Jury System and the Ideal of Democracy*. Cambridge, MA: Harvard University Press.

Alexander, M. (2012). *The New Jim Crow: Mass Incarceration in the Age of Colorblindness*. New York: The New Press.

Applebaum, A. (2003). *Gulag: A History*. New York: Random House.

Beccaria, C. (1764). *Of Crimes and Punishments* (E. D. Ingraham, Trans.). Philadelphia, PA: Nicklin Printer.

Becker, G. (1968). Crime and Punishment an Economic Approach. *Journal of Political Economy, 76*(2), 169–217.

Bentham, J. (1988 [1843]). *Principles of Morals and Legislation, Fragment on Government, Civil Code, Penal Law*. Indianapolis, IN: Liberty Fund.

Boettke, P. (1993). *Why Perestroika Failed: The Politics and Economics of Socialist Transformation*. New York: Routledge.

Braithwaite, J., & Pettit, P. (1990). *Not Just Deserts: A Republican Theory of Justice*. Oxford: Oxford University Press.

Brennan, G., & Buchanan, J. M. (2000 [1985]). *The Reason of Rules: Constitutional Political Economy* (Collected Works of James Buchanan, Vol. 10). Indianapolis, IN: Liberty Fund.

Breyer, S. (1988). The Federal Sentencing Guidelines and the Key Compromises Upon Which They Rest. *Hofstran Law Review, 17*(1), 1–50.

Buchanan, J. (1977). *Freedom in Constitutional Contract*. College Station and London: Texas A&M University Press.

Buchanan, J. (1983). Monetary Research, Monetary Rules, and Monetary Regimes. *Cato Journal, 3*(1), 143–146.

Buchanan, J. (1987). The Constitution of Economic Policy. *American Economic Review, 77,* 243–250.

Buchanan, J., & Tullock, G. (1962). *Calculus of Consent, Logical Foundations of Constitutional Democracy*. Michigan: University of Michigan Press.

Campbell, A. (1991). *Law of Sentencing (Criminal Law Library)*. New York: Clark Boardman Callaghan.

Christie, N. (2000 [1993]). *Crime Control as Industry: Towards Gulags, Western Style.* London: Routledge.

Clancy, K., Bartolomeo, J., Richardson, D., & Wellford, C. (1981). Sentence Decision Making: The Logic of Sentence Decisions and the Extent and Sources of Sentence Disparity. *The Journal of Criminal Law and Criminology, 72*(2), 524–554.

Comment. (1950). Consideration of Punishment by Juries. *University of Chicago Law Review, 17*(2), 400–409.

Congleton, R. (2002). The Median Voter Model. In C. K. Rowley & F. Schneider (Eds.). *The Encyclopedia of Public Choice*. Norwell, MA: Kluwer Academic Press.

Cook, B. (1973). Sentencing Behavior of Federal Judges: Draft Cases—1972. *University of Cincinnati Law Review, 42,* 597–615.

Coyne, C. (2008). *After War: The Political Economy of Exporting Democracy*. Stanford: Stanford University Press.

Flanagan, T., & Longmire, D. (Eds.). (1996). *Americans View Crime and Justice, A National Public Opinion Survey*. London: Sage.
Frankel, M. (1972). Lawlessness in Sentencing. *Cincinnati Law Review, 41*(1), 1–54.
Friedman, L. (1993). *Crime and Punishment in American History*. New York: Basic Books.
Friedman, M. (1948). A Monetary and Fiscal Framework for Economic Stability. *The American Economic Review, 38*(3), 245–264.
Friedman, M. (1965). A Program for Monetary Stability. In M. Ketchum (Ed.), *Readings in Financial Institutions* (pp. 189–209). Boston: Houghton Mifflin.
Friedman, M. (1968). The Role of Monetary Policy. *The American Economic Review, 58*(1), 1–17.
Friedman, M., & Goodhart, C. (2003). *Money, Inflation and the Constitutional Position of the Central Bank*. London: Institute for Economic Affairs.
Friedman, M., & Schwartz, A. (1963). *A Monetary History of the United States, 1867–1960.* Princeton, NJ: Princeton University Press.
Garland, D. (2001). *The Culture of Control: Crime and Social Order in Contemporary Society*. Oxford: Oxford University Press.
Hirsch, A. (1992). *The Rise of the Penitentiary: Prisons and Punishment in Early America*. New Haven: Yale University Press.
Keynes, J. (1936). *The General Theory of Employment, Interest and Money*. Basingstoke: Palgrave.
Klein, S. (2005). The Return of Federal Judicial Discretion in Criminal Sentencing. *Valparaiso University Law Review, 39,* 693–741.
Klein, S., & Steiker, J. (2002). The Search for Equality in Criminal Sentencing. *The Supreme Court Review, 2002,* 223–272.
Lerner, A. (1944). *The Economics of Control: Principles of Welfare Economics*. London: Macmillan.
Martinson, R. (1974). What Works?—Questions and Answers About Prison Reform. *Public Interest, 25,* 22–35.
Mitchell, O. (1988). *Hitler's Nazi State: The Years of Dictatorial Rule, 1934–1945*. New York: Lange.
Modigliani, F. (1977). The Monetarist Controversy or, Should We Forsake Stabilization Policies? *The American Economic Review, 67*(2), 1–19.
Murakawa, N. (2014). The First Civil Right: How Liberals Built Prison America. Oxford: Oxford University Press.
Nagel, I. (1990). Forward: Structuring Sentencing Discretion: The New Federal Sentencing Guidelines. *The Journal of Criminal Law and Criminology, 80*(4), 883–943.

Nagel, I., & Hagan, J. (1982). The Sentencing of White-Collar Criminals in Federal Courts: A Socio-Legal Exploration of Disparity. *Michigan Law Review, 80*(7), 1427–1465.

Niskanen, W. (1971). *Bureaucracy and Representative Government*. Chicago: Aldine-Atherton.

Ostrom, E. (2005). *Understanding Institutional Diversity*. Princeton, NJ: Princeton University Press.

Pfaff, J. (2017). *Locked In: The True Causes of Mass Incarceration and How to Achieve Real Reform*. New York: Basic Books.

Rizzo, M. (1980). Law Amid Flux: The Economics of Negligence and Strict Liability in Tort. *Journal of Legal Studies, 9*(2), 291–318.

Rothman, D. (1971). *The Discovery of the Asylum, Social Order and Disorder in the New Republic*. New Brunswick, NJ: Transaction.

Sah, R., & Stiglitz, J. (1986). The Architecture of Economic Systems: Hierarchies and Polyarchies. *American Economic Review, 76*(4), 716–727.

Samaha, J. (2005). *Criminal Justice*. Belmont, CA: Wadsworth Publishing.

Seidman, D., & Zeisel, H. (1975). Sentencing Councils: A Study of Sentence Disparity and Its Reduction. *The University of Chicago Law Review, 43*(1), 109–149.

Simons, H. (1936). Rules Versus Authorities in Monetary Policy. *The Journal of Political Economy, 44*(1), 1–30.

Thomson, R. (1962). Sentencing in Income Tax Cases. *Federal Probation, 26,* 10–13.

Tonry, M. (1991). The Politics of and Processes of Sentencing Commissions. *Crime and Delinquency, 37*(3), 309–329.

Tonry, M. (1996). *Sentencing Matters*. New York: Oxford University Press.

Tullock, G. (1965). *The Politics of Bureaucracy*. Lanham, MD: University Press of America.

Tullock, G. (1967). The Welfare Costs of Tariffs, Monopolies, and Theft. *Economic Inquiry, 5*(3), 224–232.

United Nations Office on Drug and Crime. (2018). http://www.unodc.org/unodc/en/data-and-analysis/crime-and-criminal-justice.html.

Wagner, R. (1977). Economic Manipulation for Political Profit: Macroeconomic Consequences and Constitutional Implications. *Kyklos, 30,* 394–410.

Wagner, R. (1989). *To Promote the General Welfare*. San Francisco: Pacific Research Institute.

Waldron, J. (2016). The Rule of Law. *Stanford Encyclopedia of Philosophy*. https://plato.stanford.edu/entries/rule-of-law/.

Wilkins, W., Newton, P., & Steer, J. (1991). The Sentencing Reform Act of 1984: A Bold Approach to the Unwarranted Sentencing Disparity Problem. *Criminal Law Forum, 2*(2), 359–362.
Williamson, O. (1985). *The Economic Institutions of Capitalism*. New York: Free Press.
Wright, R. (1999). Review: Rules for Sentencing Revolutions. *The Yale Law Journal, 108*(6), 1355–1387.
Zimring, F. (1976). *A Consumer's Guide to Sentencing Reform* (Occasional Paper #16). University of Chicago Law School.

39

Diagnosing the Electorate: James Buchanan in the Role of Political Economist

Solomon M. Stein

Reading James Buchanan's 2005 essay "Afraid to be free: Dependency as desideratum" is profoundly depressing. Buchanan envisions a rather gloomy future, where despite the intellectual bankruptcy of socialism there will be a steady expansion of the sphere in which state control is exercised over individual choice. The incoherence between the political norms of classical liberal political systems and the fiscal burdens of the welfare state will increase to a breaking point where one or the other must be repudiated. To the extent this involves restricting the generality of welfare entitlements, these programs will be increasingly be seen as dispensations to particular factions, and contestation over the capacity for redistribution will increasingly dominate political life. "The increasing corruption that must necessarily accompany any expanding range of collective-political control," will, Buchanan (2005a, p. 20) suggests, "simply be tolerated and ignored". The possibility for 'repentance' and

S. M. Stein (✉)
F. A. Hayek Program for Advanced Study in Philosophy, Politics, and Economics, Mercatus Center at George Mason University, Fairfax, VA, USA
e-mail: sstein@mercatus.gmu.edu

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_39

the aversion of fiscal apocalypse, he writes, is entertained (2005a, p. 20) "as much from a sense of moral obligation to believe that constructive reform is within the possible as it does from any realistic prognosis of elements which are discernible beneath the surface of that which may now be observed". Any hope for classical liberalism as a political project in the current moment is in essence a profession of faith.[1]

Buchanan's explanation is of even less comfort than his predictions. The source for this trend towards increasing collectivization of society, even in the face of the fiscal realities involved, Buchanan suggests, is the polity itself. Alongside the more familiar managerial, paternalist, and egalitarian justifications for exercising collective control over individual actions, Buchanan suggests an additional source of support, a desire for what he labels (2005a, p. 23) "parentalism… the attitudes of persons who seek *to have values imposed upon them* by other persons, by the state or by transcendental forces." Buchanan views this attitude as widespread: "it seems evident that many persons do not want to shoulder the final responsibility for their own actions. Many persons are, indeed, afraid to be free." Both to abdicate responsibility and to reduce uncertainty, these individuals look to religion, community, and ultimately (following the Enlightenment) the State to stand *in loco parentis*. "For persons who seek, even if unconsciously, dependence on the collectivity," Buchanan (2005a, p. 27) writes, "the classical liberal argument for independence amounts to negation." The presence of a widespread parentalist fear of liberty, and the attendant consequences upon the political fortunes of liberalism is in part a failure of the intellectual class. Buchanan (2005a, p. 27) chastises "adherents of classical liberalism, and especially economists, [who] have not been sufficiently concerned with preaching the gospel of independence."[2] If Buchanan's analysis in

[1]It is possible that Buchanan's description of the moral obligation as being 'to believe', which suggests this interpretation, is an inadvertent misrepresentation of his position. What could be obligatory is not belief as such, but rather to act as if one believed that reform were possible: to not withdraw from political and intellectual engagement. This obligation could flow from the need to forestall classical liberalism being extinguished in the kind of behavioral cascade Buchanan (1968a) worried could result from sufficiently large minority defections from a previously shared norm in "A Behavioral Theory of Pollution."

[2]C.f. Buchanan's similar charge in his essay from several years earlier, The Soul of Classical Liberalism (Buchanan 2000).

'Afraid to be free' is correct,[3] there is certainly cause for despair among proponents of classical liberalism regarding future institutional changes (though they might be obligated to believe otherwise, or at least appear to). More fundamentally, a substantial portion (possibly even the majority) of humanity being *afraid* of their own agency would be a tragic fact about the human condition.

It is particularly troubling, in addition, coming from Buchanan's pen. Should this change how we understand his view of individual choice as open-ended self-authorship, reflected in the poetic "Man wants liberty to become the man he wants to become" of 'Natural and Artifactual Man' (Buchanan [1978] 1999, p. 259)? Buchanan makes clear that he, personally, has not changed his position on the nature of choice and normative desirability of individual liberty. What has changed is an empirical judgment that "the thirst or desire for freedom, and responsibility, is perhaps not nearly so universal as so many post-Enlightenment philosophers have assumed" (Buchanan 2005a, p. 24). This includes Buchanan's earlier thought as well, although he does not say so explicitly.[4] Indeed, given how dramatic a reversal this represents from the classical liberal tradition, Buchanan offers us relatively little insight into how he arrived here. Given the intentionally general and speculative nature of the essay, it is understandable that Buchanan does not recount his intellectual journey or provide more empirical perspective than to indicate a few suggestive circumstances from recent historical experience. However, their absence makes it difficult to evaluate the basis for a claim—viz. a widespread aversion

[3] I would argue Buchanan's diagnosis is incorrect, for reasons which would take another essay to develop fully. Two brief objections: (1) Buchanan's notion of parentalism conflates desire to avoid consequences (the protective role of the parent taken on by the state) with the desire for meaning and meaningful communities not predicated upon market interactions (the family outside of the parent/child relation, the church, etc.), simultaneously exaggerating the extent of the former and misunderstanding the nature of the latter (2) Buchanan both underestimates the continued relevance of paternalistic control over individuals and, in viewing dependency as a product of 'bottom-up' desire to abdicate responsibility, does not account for the 'top-down' reinforcement of dependency not motivated by paternalistic substitution of elite preferences for those of others, but by a desire on the part of elites for others to be dependent upon them, another source which mitigates the extent to which we ought to view the 'mass polity' as motivated by a desire to abdicate responsibility.

[4] A topic we will consider in more detail in the following sections.

to the responsibilities of liberty—that would, if true, be of immense importance. Every perspective from which Buchanan could have been coming from is not equally amenable to, or deserving of, an extensive engagement.

One possible explanation would be to look at 'Afraid to be Free' as primarily an expression of general disaffection for the current state of affairs rather than an analytic turn in Buchanan's worldview—'you kids get off my lawn', Buchanan edition. Were this the case we could dismiss the argument relatively comfortably. However, this is a difficult interpretation to sustain. 'Afraid to be Free' is not an isolated outpouring of intergenerational scorn, but a continuation of Buchanan's commentary on contemporary political life in the previous half-century, in which the assessment of the general mood of the electorate is a common motif. The remainder of this essay explores some of this preceding material, and builds upon it to suggest that 'Afraid to be Free' might be best understood as the result of Buchanan following the prescriptions of his own methodological recommendations regarding the potential role for economic science in public life.

Buchanan on Contemporary Political Life

While it would be odd to describe Buchanan's work in public finance, public choice, and constitutional political economy as not 'political' in character, it only engages with the level of what might be thought of as day-to-day politicking intermittently. By his own admission, Buchanan was not particularly comfortable as a policy wonk, noting (Buchanan 1971, pp. 8–9) that "personally, I find myself very unhappy when, by some miscalculation or oversight, I am forced into this [advocacy] role. My most embarrassing moments as a professional economist have been precisely those on the Washington scene where I have felt myself forced to take one side or the other on a particular policy issue, an issue about which I know very little, and where this ignorance was fully shared by all participants to the discussion." As a result of this inherent unease, Buchanan's major forays into policy are (with a few exceptions[5]) episodic, in moments when the perceived need is sufficiently dire. The most dramatic illustration of this comes from Buchanan's reaction to the social unrest of the late 1960s, the intensity of which was amplified by proximity, as his time on the faculty at UCLA coincided with the confrontation between the economics department and campus radicals including an attempted bombing. The most obvious product of Buchanan's alarm and outrage at both the rise of violent radicalism and impotent university administration is his writing of *Academia in Anarchy*.[6]

Buchanan's 1968 lecture "Can Public Funds Save Our Cities?" captures his impressions of contemporary events at their most despairing.[7] As a social scientist and economist, Buchanan suggests (1968b, p. 29), "I really feel like I am out of business… our whole reason for existing is really based on the presumption that men are rational and, at least within certain limits, behave rationally. We believe that as men we can sit down in an atmosphere of rational discussion and mutual tolerance, that we can try to convince each other, that we are at least tolerant enough to allow more discussion…. At present, however, I feel like I do not have any reason for existing; we seem to be in a world characterized by collective insanity rather than rational discussion…. In my own career and in my own lifetime the only time that I remember which affected me psychologically at all like this was 1941." Buchanan notes that he had previously been optimistic about the individualistic, anti-authoritarian strands of the New Left. In his description of the

[5]A few of these more isolated examples include Buchanan's work as a consultant for the Council of Economic Advisors under Eisenhower and his participation in an ICC test-case dealing with pricing in transportation economics in the late 1950s.

[6]The experience of the UCLA year may be the most significant influence upon the direction of Buchanan's research program subsequent to his years at Chicago: beyond Academia in Anarchy, his theoretical papers during this period all have antecedent roots in the same events (discernable for instance in both A Behavioral Theory of Pollution and The Samaritan's Dilemma), as does much of his work in the first half of the 1970s.

[7]Although this lecture was prior to his move to UCLA (which was pending at the time of his remarks), it was also prior to the election season the results of which, as we will discuss later, formed part of Buchanan's shift towards renewed optimism over time.

transition from that optimism to despair, he develops some of the key themes in Buchanan's description of parental socialism in Afraid to be Free.[8] Remarkably, those themes had previously been the core of an *optimistic* projection:

> I have another talk that I have given to businessmen, business groups especially, that I call 'The Death of the Second God.' That has essentially an optimistic outlook, because I, for one, am happy that the second god is dead. By this I mean the nation state. The socialistic god is dead. No longer will people devote patriotism, loyalty, devotion to the nation state, and in a way this is healthy, given my basic value judgments. I had hoped that, given the death of this god, we might see the prospect of getting back to a rational, realistic attitude, where we could start talking about inventing and creating new institutions, where we could channel many of these underlying elements of the New Left and related movements into something that would be meaningful; some return, hopefully, to something like eighteenth century rationality. But I have now changed my outlook and I think we may be plunging straightforwardly into chaos.
>
> We are really searching for a new Jesus. I am not a historian, I am not a historical scholar, and I defer to those who are more expert than I; but there must be many, many parallels between the Roman world in the century before Jesus and now. It seems to me that we as a people (and this applies to the Western world generally and not only to America) are desperately searching for a new God, one that will take on responsibility. We do not want to use our own critical intelligence. We are refusing to use our own critical intelligence. What we want to do is shift responsibility. We want to adopt or to find some new God that will be a decision rule for us. We want to shift everything off and say, 'You take the lead and I will be committed.' (Buchanan 1968b, p. 30)

However, other work suggests that Buchanan's view was not that a generally illiberal populace had flooded into the academy, but rather, as he expresses in his 1970 essay "The 'Social' Efficiency of Education," that the radicalism within the universities was at risk of leaking out

[8]The connection between these two essays does provide some support for the 'Get Off My Lawn' interpretation. Yet the rhetorical intensity present here is missing from Afraid to be Free.

into society at large. Education, particularly the academy, Buchanan (1970a, pp. 655–656) suggests has always been inherently subversive: "Here is the institutional location for the free spirits, for the intellectual gadflys, for the heretics of all ages. The advantages of unrestricted freedom to follow 'truth where it may lead' were secured precisely because the potential excesses were contained, so to speak, in the intellectual cocoon that was the university… The 'ivory tower', the 'walls of ivy', the 'groves of academe'—these are not idle metaphors. They accurately describe what the university was supposed to be in its ideal type image as it formed a part in an ordered society. In this protected, cloistered educational process, students could, and did, examine, adopt and espouse almost all conceivable heresies." Society tolerates and subsidizes this safe harbor for dissent, Buchanan (1970a, p. 658) explains, because it provides "a useful social function. It allowed for, and encouraged, open criticism of and overt dissent to prevailing value standards and existing institutions…. Reform was accomplished by allowing the heretic to advance revolutionary notions, well contained within the academe, which might then be pragmatically translated into practical policy improvements."

The stability of this arrangement rests upon the assumption that the institutions of the social order are sufficiently powerful to be able to dictate the terms of engagement with academic criticism. For Buchanan, society's ability through the family, the church, and the law, to compel individuals to conform to existing values is key to understanding the stability of a social order based upon classical liberalism despite widespread opposition to its basic tenants among intellectuals throughout the nineteenth and twentieth centuries. "As they operated," Buchanan explains (1970a, pp. 654–655), "at least until the middle of this century, the functional role of these institutions was one of preserving and enforcing the rules of civil order….In all three institutions, the fear of punishment, once instilled, led to habitual patterns of behavior which embodied adherence to established rules." As the ability of these institutions to engage in this compulsion erodes, individuals are increasingly able to act in society at large upon the oppositional and subversive ideas tolerated previously only within the academy. This, Buchanan contends (1970a, p. 653), may be the cause of the increasingly disruptive nature of the university: the students, no longer deterred by other social institutions, "are acting out, in word and deed, what they have been taught in classrooms from elementary schools through the university postgraduate schools, what they have seen on their television screens, what they have read in the newspapers, from the underground rags through the *New York Times*."

The relationship between the academy and society once these institutional stabilizers have ceased to function changes dramatically. The support offered by the public for the academic sphere that was previously an investment in the vitality of the overall system are now social contributions towards their own annihilation. The natural response Buchanan suggests (1970a, p. 660) is for those contributions to cease: "If society does not think that it is getting its money's worth from the educational processes as they exist, if the admitted advantages of free inquiry are more than outweighed by the negative effects of direct political action by militant groups centering their headquarters on the nation's campuses, why not simply close down the universities?" Buchanan's explanation (1970a, p. 660) for the general public's reluctance in this case is not based in any disagreement with the diagnosis, rather "despite all of his misgivings… he acquiesces in the continuing deterioration that he sees all about him [because] economic affluence has placed modern man in what I call the 'Samaritan's dilemma'. He is simply unwilling to force those who refuse to join the system to exist wholly outside the system. He is quite willing to allow for the existence of parasites… this is essentially what the student class has already become." The general public, in this account, is not avoiding responsibility but in an excess of charity, preventing others from bearing the responsibility for their own (socially destructive) activity.[9]

Buchanan was concerned that the general public's passivity towards academic unrest would be catastrophic but simultaneously observed a

[9]Exactly how blameworthy the charitably motivated but socially harmful choices by the Samaritans are in Buchanan's view is unclear. That university administrators had, by their complete and total failure to resist campus radicals forced this dilemma onto the general public perhaps mitigates their culpability, as might be inferred from the dedication of *Academia in Anarchy* 'To the Taxpayer.'

growing electoral opposition to yet further expansion of government spending—a 'taxpayer's revolution'. Along with Marilyn Flowers, Buchanan (Buchanan and Flowers 1969, p. 349) suggests that "something other than the ancient and continuing complaint of a reactionary minority seemed to have appeared," for which they both offer a framework to describe the taxpayer's disequilibrium position with respect to the current supply of public goods and suggest possible sources of that disequilibrium. "Perhaps the most plausible source of the taxpayer revolt," in their analysis (1969, p. 354), "is found in the shift in the subjective terms-of-trade between public goods and private goods, terms-of-trade that describe the utility function of the representative members of the community." Taxpayers could come to believe that they are no longer getting what they are paying for, due to decreases in quality (as an example, they cite university education), or dissatisfaction with the distribution of benefits. They note (Buchanan and Flowers 1969, p. 355) that "budgetary reallocations aimed at making public services more fully available to those 'in need' may cause taxpayers not qualifying under the selective criteria adopted to man the barricades. The partially-observed emphasis on the replacement of generality with selectivity in the distribution of public service benefits provides, in itself, one source of taxpayer discontent," one which as we saw before, Buchanan remains concerned about in Afraid to be Free, 35 years later. Their conclusion (Buchanan and Flowers 1969, p. 359) stresses they did not aim at "presenting and testing any particular set of hypotheses concerning the apparent shift in attitudes of American taxpayers toward the fiscal structure," but as this wording suggests, Buchanan viewed such a shift as having already taken place. The change in public attitudes may be inadequately reflected in adjustments to public spending however, as "individual taxpayers may be a in a position precisely analogous to that faced by potential public-goods beneficiaries in the world drawn in the Galbraithian image. In the latter world of excess collectivization, however, few economists have found it useful to stress the comparable necessity for governmental, political action aimed at reducing budgetary expansion. The argument is symmetrical." This is more than simply a rhetorical point, as it returns as part of the analytical scaffolding for Buchanan's perspective in the following years.

Buchanan articulates that perspective most fully in the short essay "Political Economy and National Priorities, A Review Essay of the Economic Report of the President and the Annual Report of the Council of Economic Advisers." (Buchanan 1970b) Of particular interest to Buchanan in these reports is the introduction of an explicit discussion of 'national priorities' in a way that is basically explanatory: "the underlying theme is that we had best forget the romantic dreams of some inexhaustible source from which all 'needs' might be met" (Buchanan 1970b, p. 487). While appreciative of this recognition "after years of Kennedy-Johnson big talk," Buchanan faults the absence of "a more explicit and positive political program along with its economic rationale…. This amounts to saying that the initial economic report of the Nixon Council is *not political enough*" (Buchanan 1970b, p. 487, italics original). The previous reports from the Kennedy and Johnson administrations were written with a clear intent to serve as advocacy for the administration's preferred economic policy reflected, to Buchanan, (1970b, p. 487) that their authors "understood the function of the agency and the office more thoroughly." In contrast, Buchanan (1970b, p. 488) points to the "surprisingly neutralist stance" in the report's making the observation that choices regarding national output have costs, and that differences of opinion regarding those choices are resolved through the democratic process, without expressing an opinion for what those choices should be and advancing a policy program for reflecting them. The timidity of the report, Buchanan suggests, is more reflective of the professional economists involved in its production rather than an accurate reflection of the economic policy ambitions of the Nixon administration: "The Council's Report is, I think, an honest reflection of these economists' *own* views. The hiatus lies in the fact that their views are not, or may not be, at all representative of these of the majority of the votes in the Republican camp. The Council, both in its membership and in its senior staff, mirrors an economic philosophy that is moderately, and modestly, 'conservative' within the halls of academe and the pseudo-intelligentsia of the media. It may, however, be far from the median value position of the American voter" (Buchanan 1970b, p. 491).

"It does not take an expert in political dynamics," Buchanan (1970b, pp. 488–489) comments, "to recognize that a rotating membership characterized by the contrasting attitudes of the Heller [Kennedy] and the McCracken [Nixon] reports will bias results in favor of programs advanced by the liberals. If the Council of one administration-party presents plausibly defensible arguments in support of specific expansions in federal programs only to be followed by a Council of an alternative administration-party that does little more than emphasize the opportunity cost of too-rapid change, we shall surely get a step-function expansion and in those particular programs that the more courageous leadership advances." The Council of Economic Advisors' equivocations prevent it from serving as a potential source of political/entrepreneurial action intended to overcome the collective-goods problem of budget reductions. Along with generating a generally increasing level of government expenditure over time, which is problematic on its own, it represents a structural breakdown in the turn-taking features of cyclical majorities. For Buchanan the election of Richard Nixon *was* a decision by the electorate between competing priorities: The 'silent majority' "may want something more than a mere de-escalation of rhetoric. It may want disengagement internally as well externally. It may be fed up with the federal bureaucracy. It may be skeptical of continued attempts to convert the American taxpayer into a beast of burden to be residually saddled with the overload costs of programs dreamed up by professional intellectuals. Such 'may be's' may be real. Experience with state-local bond and tax referenda and with federal and state-local tax legislation in 1969 and 1970 suggest that they are" (Buchanan 1970b, p. 489). The taxpayers *were* revolting, but the intellectual support and political agenda of that revolution were ill-served when, "in their zeal to satisfy their professional colleagues in economics… the Council members have forgotten their necessary identification with a Nixon presidency" (Buchanan 1970b, p. 487).

The validity of this entire critique depends upon the accuracy of Buchanan's assessment of the overall disposition of the electorate, as he recognizes (1970b, p. 492): "I should allow for the possibility that my own reading of the tea leaves of current American politics reflects the private and personally eccentric prejudice of one who hopes that the silent majority does, in fact, exist." The landslide victory for Nixon in 1972 was strong evidence in favor of the reality of the silent majority.

As it became increasingly clear over the course of 1973 that Watergate had crushed any hopes for a major economic policy initiative, even if it did not ultimately result in a change of administration, Buchanan's concern shifted away from the present political moment.[10] Buchanan's concerns regarding American politics shifted towards the broader structural problems responsible for the discontinuity between the expressed preferences of voters and the resulting policy outcomes.

Arguably, even before the writing was on the wall with respect to Watergate, there may have not been much cause for optimism. Buchanan's argument implied it would be difficult to translate even overwhelming electoral results into institutional reforms in the continued absence of a political/intellectual cohort able to operationalize that sentiment into a policy program. More than merely a paucity of advocates, popular sentiments regarding the desire for a reduction in government as reflected in the results of democratic decision-making were subject to outright hostility among the overwhelming majority of intellectuals. Another defect in the timidity of the Nixon Council of Economic Advisors, Buchanan (1970b, p. 491) argues, is that it "lends support to the arrogance of the intellectual elitists who deny that economically legitimate arguments can be presented for the 'other side.' The elitist will be confirmed in their judgements that only they have the direct line to the fountain of truth, and that the boobs and bigots who make up the great electorate should be ignored to the maximum feasible extent."[11]

Buchanan's efforts in late 1973 and 1974 at institutional entrepreneurship reflected in his project on "The Third Century" (Buchanan 1973)

---

[10]At least on this particular analytical margin: his criticism of public debt as a macroeconomic lever, concerns regarding campus politics, and his work in public finance with policy relevance all continued in parallel to the work at issue here.

[11]For an essay critical of economic reports from 1970, this essay is of remarkable contemporary salience (would this quotation have appeared out of place in a discussion of Brexit?). Buchanan also gestures towards the potentially corrosive effects on political legitimacy resulting from a failure of a change of administration to result in any change in policy outcomes: "must [the voter] conclude that an 'establishment' really does run things for us all and that no genuine change can be expected from political party rotation? Must this voter, if he exist, agree then with the new barbarians whose own naïve prejections[sic] of an 'establishment' seem to be spun from pure fantasy?" (Buchanan 1970b, p. 489).

are explicitly grounded in this diagnosis of both the underlying preferences expressed in the electorate and the mechanisms that frustrated their realization.[12] The widespread disagreement with the electorate within the academic and intellectual spheres left the sort of intellectual-political advocacy required to promote a political program underprovided by the groups specialized in doing so. This role could be filled by an organized counter-intelligentsia, but this organization faces difficulties. Chief among the factors complicating this effort is the prevalence within the academic and intellectual spheres not only of disagreement with the electorate, but a temptation to conclude (perhaps on the basis of an absence of intellectual and academic proponents…) that any view which *does* agree with the people is presumptively illegitimate, and therefore that any group organized on the basis of those views must be of nefarious origin and purpose.[13] Although the specific organizational form Buchanan proposed under the 'Third Century' frame (which would have included significant public prizes and the formation of a newspaper in one iteration, among other ideas) never came to pass, Buchanan's diagnosis of the composition of the electorate and the need for countervailing intellectuals certainly would have again appeared vindicated by the Reagan Revolution.

Buchanan's relationship with the Reagan administration was surprisingly distant, both from the perspective of outside observers given Buchanan's prior contact with Reagan as governor of California and the prevalence of his students within the administration, and no doubt to Buchanan as well. In remarks published in 1988 (Buchanan 1988, pp. 32–34), Buchanan comments that he was approached by the transition team for ideas as to early reforms and suggested a commission on reform of the Federal Reserve and monetary authority in general, which despite initial interest did not materialize due to the staunch opposition of Arthur Burns. Additionally, Buchanan, although not always

[12] The introductory materials Buchanan composed for this project begin with a series of premises and implications which summarize the perspective discussed in the preceding essays.

[13] This kind of interpretative framework can lead to perverse results, such as that an effort to organize a movement of like-minded individuals to counteract a counter-majoritarian tendency in American political and social institutions is attacked as anti-democratic.

successful, sought to avoid using his receipt of the Nobel Prize as a basis for political statements.[14] Buchanan's thought across a wide range of topics evolved or changed direction over the intervening fifteen years between the middle of Watergate and the close of the Reagan administration, of course, including an increasing emphasis upon constitutional political economy as the appropriate vehicle for constraining political activity. The desires of the 'silent majority' and the Reagan revolution were simply unattainable purely via post-constitutional politics: if they were, Buchanan (1995, p. 348) notes, "there might be some expectation that, with electoral rotation, those who stand for fiscal integrity might eventually replace those who are fiscally profligate. However, such expectation could only be utopian. The fault lies not in ourselves, as participants in the ordinary politics of modern majoritarian democracy, but in the structural rules within which this politics takes place." In retrospect, Buchanan (2005b) suggests that the Reagan era was a missed opportunity for constitutional reform to fiscal rules.

Conclusion: Buchanan as 'Political Economist'

Afraid to be Free represents both a continuation and a departure from his prior observations on contemporary politics. It continues the underlying intellectual project involved, one pursued from the perspective of a 'political economist' as diagnostician of the political situation in the sense Buchanan developed in his "Positive Economics, Welfare Economics, and Political Economy" (Buchanan 1959 [1999]). This aspect of his work is one often downplayed (not least by Buchanan himself) compared to his contributions as predictive scientist or moral philosopher. The Political Economist, in contrast to the role assumed by the conventional welfare economist as advisor to the omniscient fiscal brain, Buchanan (1959 [1999], p. 195) argues should describe someone

[14] The Nobel Prize itself was also a cause of some rustled feathers: again given the intellectual connections, there had been an unspoken expectation that Buchanan would be invited to the White House in recognition of his award, but this took place only quite belatedly. When that point finally arrived, Buchanan declined the invitation due to the ongoing Iran-Contra scandal.

whose "task is that of diagnosing social situations and presenting to the choosing individuals a set of possible changes. He does not recommend policy A over policy B. He presents policy A as a hypothesis subject to testing. The hypothesis is that policy A will, in fact, prove to be Pareto-optimal." Society as a whole provides the test conditions, as Buchanan (1959 [1999], p. 196) explains: "Propositions in political economy find empirical support or refutation in the observable behavior of individuals *in their capacities as collective decision-makers*—in other words, in politics."

Advancing a policy as a proposed Pareto-improvement ought to presuppose understanding the consequences of that policy,[15] but explanation of the likely effects is insufficient for a political economic hypothesis, which must also include the claim that those effects are valued by those considering the policy. "In a sense," Buchanan notes (1959 [1999], p. 207) "the political economist is concerned with discovering 'what people want'." Political economics can remain a strictly positive endeavor of the same status as scientific economics, despite that positive content, coming as it does as proposals for public policy, making the line between analysis and advocacy often difficult to assess. Along with the political economist's hypothesis of 'social diagnosis, therefore policy A', there is policy advocacy which Buchanan (1959 [1999], p. 208) describes as "beyond the area of 'positive political economy, there may be room for the individual to serve in a normative capacity as an especially well-informed citizen. Here his own ethical evaluations may be explicitly introduced… but this behavior must be sharply distinguished from his professional role, either as positive economist or as political economist." The imperfect extent to which Buchanan adhered to this distinction in the work considered here is indicative of the difficult and perhaps impossible nature of this task. One might suggest that the act of advancing a political-economic hypothesis in this sense cannot help

[15]Although, as Buchanan (1971, p. 6) noted among his criticisms of macroeconomists, even this was not always the case (i.e. "Macroeconomists simply do not know what the tradeoffs are, much less what proper social weights are to be placed on the conflicting objectives for national policy").

being a contribution to the political dialogue, no matter how carefully value-free the analytics.

Although part of this same project of political economics, the descriptive analysis Buchanan provides in Afraid to be Free departs from much of his past work. As documented in the previous section, Buchanan earlier viewed particular institutional features of the contemporary political environment as frustrating the ability to implement existing popular demand for reductions in the size and scope of collective control. In Afraid to be Free, the preferences of the general populace are instead one (and possibly the most important) source of demands for collective control.[16] This is not purely an ad hoc reversal to his position from the depths of 1968: following the approach of the political economist as Buchanan himself describes, the failure of the Balanced Budget Amendment in the middle of the 1990s, for which he was certainly both political economist and normative advocate, was evidence against the underlying hypothesis regarding social values upon which the policy was offered. That individuals are Afraid to be Free, therefore, might be understood within Buchanan's perspective as the unwelcome but possible conclusion from experience. Although perhaps simply acting on the basis of his moral obligation to believe, Buchanan did continue to treat even this perspective as a provisional hypothesis. "Perhaps," he comments, (2005b) "the culture of dependence is so entrenched in public attitudes that a large and cumbersome nonproductive welfare state remains in prospect [despite constitutional reforms] . The test should be carried out, nonetheless, before proposals are advanced that reflect abandonment of the fundamental democratic faith." There remains, Buchanan suggests (2005c), "a residue of understanding that government should live within its means, that persons should be treated equally, and that government should not interfere with our liberties."

[16]As well as presenting a new hypothesis regarding the preferences of the electorate which, as empirical claim is of significant for his prior political economic proposals, the bulk of his analysis is of the underlying causes for the (new, or perhaps newly recognized) state of the world.

References

Buchanan, J. M. (1959). Positive Economics, Welfare Economics, and Political Economy. *Journal of Law and Economics, 2*, 124–138. Reprinted 1999 in *The Collected Works of James M. Buchanan Volume 1: The Logical Foundations of Constitutional Liberty* (pp. 191–209). Indianapolis, IN: Liberty Fund.

Buchanan, J. M. (1968a). A Behavioral Theory of Pollution. *Economic Inquiry,* 6(5), 347–358.

Buchanan, J. M. (1968b). Can Public Funds Save Our Cities? In I. Allen (Ed.), *Our Cities in Crisis: Review and Appraisal* (pp. 28–36). Bureau of Business and Economic Research, Georgia State College.

Buchanan, J. M. (1970a). The 'Social' Efficiency of Education. *Il Politico, 35*(4), 653–662.

Buchanan, J. M. (1970b). Political Economy and National Priorities, A Review Essay of the Economic Report of the President and the Annual Report of the Council of Economic Advisors. *Journal of Money, Credit, and Banking, 2*(4), 486–492.

Buchanan, J. M. (1971). Economists, Government, and the Economy. In A. K. Ho & A. Arbor (Eds.), *Economic Policies in the 1970s; Six Lectures on Current Economic Issues Given at Western Michigan University Under the Sponsorship of the Department of Economics* (pp. 1–14). Bureau of Business Research, Graduate School of Business Administration, University of Michigan.

Buchanan, J. M. (1973). The Third Century. James M. Buchanan Papers, C0247, Special Collections Research Center, George Mason University Archives.

Buchanan, J. M. (1978). Natural and Artifactual Man, *What Should Economists Do*? Indianapolis, IN: Liberty Fund. Reprinted 1999 in *The Collected Works of James M. Buchanan Volume 1: The Logical Foundations of Constitutional Liberty* (pp. 246–259). Indianapolis, IN: Liberty Fund.

Buchanan, J. M. (1988). Comment by Dr. Buchanan. In *Prospects for a Monetary Constitution, Economic Education Bulletin* (Vol. XXVIII, No. 6). Great Barrington, MA: American Institute for Economic Research.

Buchanan, J. M. (1995). Clarifying Confusion About the Balanced Budget Amendment. *National Tax Journal, 48*(3), 347–355.

Buchanan, J. M. (2000). The Soul of Classical Liberalism. *The Independent Review, 1*(1), 111–119.

Buchanan, J. M. (2005a). Afraid to be Free: Dependency as Desideratum. *Public Choice, 124,* 19–31.

Buchanan, J. M. (2005b). Three Amendments: Responsibility, Generality, and Natural Liberty. *Cato Unbound*. Accessed May 31, 2018. https://www.cato-unbound.org/2005/12/04/james-m-buchanan/three-amendments-responsibility-generality-natural-liberty.

Buchanan, J. M. (2005c). Response to Comments. *Cato Unbound*. Accessed May 31, 2018. https://www.cato-unbound.org/2005/12/14/james-m-buchanan/response-comments.

Buchanan, J. M., & Flowers, M. (1969). An Analytical Setting for a 'Taxpayers' Revolution. *Economic Inquiry, 7*(4), 349–359.

40

From Models to Experiments; James Buchanan and Charles Plott

Gil Hersch and Daniel Houser

Introduction

James Buchanan's contribution to economics in general, and public choice in particular, cannot be overstated. Many works examine and discuss Buchanan's contributions. Buchanan's most noted contribution—for which he received the Nobel Memorial Prize in Economic Sciences—was "his development of the contractual and constitutional bases for the theory of economic and political decision-making" (https://www.nobelprize.org/nobel_prizes/economic-sciences/laureates/1986).

Buchanan's focus on political players as rational actors, his focus on institutional arrangements, and his distinction between the constitutional level and the postconstitutional level, enabled him to provide a

G. Hersch (✉)
Department of Philosophy, Virginia Tech, Blacksburg, VA, USA
e-mail: hersch@vt.edu

D. Houser
Department of Economics, George Mason University, Fairfax, VA, USA

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_40

novel framework for understanding the political world. The *Calculus of Consent*, which he wrote with Gordon Tullock, is considered one of the most influential works in public choice. Much of the attention the *Calculus of Consent* receives is for the importance it places on rules that determine the process for setting the rules (Romer 1988). However, one of the most interesting insights in the *Calculus of Consent* has to do with decision making under majority rule, and specifically on the market for votes, or logrolling. Our goal in this chapter is to add a specific context through which to view Buchanan's contribution to the field of public choice—focusing on Buchanan's influence on one of his most prominent students and a pioneer in his own right of another field (experimental economics)—Charles Plott.

Charles Plott is the William D. Hacker Professor of Economics and Political Science at Cal Tech. He pioneered the field of experimental public choice, developing and executing a variety of novel experiments and experimental methods in the 1970s. His focus throughout his career has been on finding the principles that govern behavior as guided by institutions in general, either occurring naturally or constructed in laboratory settings (Plott 2001). His work has been shaped by a belief that both general economic laws of market behavior exist and a belief that such laws govern behavior in social settings that are not traditionally viewed as markets. The main thrust of Plott's work has been to discover whether these laws can be observed in simple economic laboratory experiments. At Caltech, Plott founded the Laboratory for Experimental Economics and Political Science (EEPS), which serves as a model for experimental economics labs around the world. Plott's recent work has focused on designing information aggregation mechanisms, and on experimenting on complex systems that can operate successfully in situations that often result in market failures (http://www.hss.caltech.edu/content/charles-r-plott).

In this paper we discuss Buchanan's contribution in the narrow domain of understanding committee voting under majority rule. We then go on to discuss Plott's seminal experimental work on the topic that sparked a wave of public choice experimental work. However, given Plott's claims that Buchanan influenced him significantly, it is puzzling that his work with Morris Fiorina explores a question outside of those which Buchanan and Tullock found interesting. We suggest several ways to resolve this tension. Our chapter concludes by discussing a lacuna in the experimental public choice literature in which Buchanan was particularly interested—logrolling, or vote trading.

Buchanan's Contribution to Collective Decision-Making

Buchanan and Tullock's main focus in the *Calculus of Consent*, as their subtitle makes clear, is developing logical foundations for constitutional democracy. In developing their conceptual framework, Buchanan and Tullock make clear their application of methodological individualism in the realm of politics, and the value of framing the political sphere as a type of market that consists of political decision makers motivated by their own private interests (Haight et al. 2011). Using this foundation, Buchanan and Tullock analyze collective decision-making.

In collective-decision arrangements unanimity insures the least imposition of society on individuals but comes at great decision-making costs. The other extreme of dictatorship comes at little decision-making costs but allows society to impose large costs on individuals. No rule is optimal for all situations. Nevertheless, only unanimity can achieve Pareto-optimality. This leads Buchanan and Tullock to propose unanimity as necessary at the constitutional level, since it provides legitimacy to the rules. The high decision-making costs of unanimity is thus only required at the constitutional level, allowing for less costly decision-making to be used thereafter. While the book is replete with novel and interesting ideas, we focus here on what Buchanan and Tullock say regarding decision making under simple majority rule. The reason we do so (as will be made clearer in §2) is to explore the influence Buchanan (and Tullock) had on Plott's subsequent experimental research.

For the purpose of discussing decision making under simple majority rule, Buchanan and Tullock assume the existence of a constitution that provides the background for group decision making. Further, they assume the individual is motivated by his own interests and to maximize his own expected utility. Buchanan and Tullock begin by focusing only on cases in which an individual chooses directly among alternatives of collective action. They view such a model, however, as having limited applicability to natural environments, suggesting that it might be relevant only to cases such as New England town meetings.

Buchanan and Tullock discuss decision making under simple majority rule as a single shot game only as a prelude to an issue about which Buchanan and Tullock have greater interest—collective decision making over time. This interest is due to the importance they attach to the interactions among voters in a repeated game setting. In particular, they find it more insightful to analyze decision-making rules in terms of the results they produce over an extended period of time rather than within a single shot game. Viewing the collective decision-making process as extending over time gives rise to an analysis that one-shot models cannot recognize—the potential for gains from trade.

Recognizing that individual votes are scarce resources highlights their economic value. Viewing this value in the context of time enables an analysis of vote trading, or 'logrolling' as distinct from 'immoral' or 'corrupt' behavior. Since each individual vote has economic value, a market will emerge unless a strong prohibition, either legal or moral, against such trade exists. Ultimately, Buchanan and Tullock are primarily interested in analyzing voting rules when vote trading, or 'logrolling,' can occur. This, they believe, will offer a much more realistic and useful analysis of the collective decision-making process.

To demonstrate the limits of a one-shot voting game, Buchanan and Tullock suppose that a group is required to make only a single decision—how to divide manna from heaven. The group consists of five members and a constitution dictates that collective decisions be made by simple majority rule. In this case Buchanan and Tullock argue that whatever group of three individuals forms a coalition first will be the de facto decision makers. By using this example Buchanan and Tullock show that voting rules can be viewed as a means of rationing, one which might distribute the goods in a way that is unrelated to individual evaluations, and consequently will not maximize overall social utility.

In fact, Buchanan and Tullock believe that concentrating on single issues, taken one at a time and separately, for example the way

Downs (1957) and Black (1958) have done, may not be particularly helpful when trying to analyze the choice of voting rules themselves:

> These contributions [by Downs and Black] have been important ones, but the political process has been drastically simplified by concentration on single issues, taken one at a time and separately. Such an approach appears to have only a limited value for our purpose, which is that of analyzing the operation of voting rules as one stage in the individual's constitutional-choice problem, that of choosing the voting rules themselves. (Buchanan and Tullock 1999, p. 132)

Plott's Early Experimental Work on Majority Rule Decision Making

Charles Plott was one of James Buchanan's most prominent graduate students at the University of Virginia. His first appointment was at Purdue University, and he is currently the Edward S. Harkness Professor of Economics and Political Science at Caltech. He was a central figure in what was at the time the fledgling field of experimental economics. A key focus of Plott's research has been on finding the principles that govern behavior as guided by institutions in general, either occurring naturally or constructed in laboratory settings (Plott 2001). His work has been shaped by a belief that both general economic laws of market behavior exist and a belief that such laws govern behavior in social settings that are not traditionally viewed as markets. The main thrust of Plott's work has been to discover whether these laws can be observed in simple economic laboratory experiments.

In several papers in which Plott reflects on his own past influences, he discusses Buchanan in detail. In all of these he is clear that Buchanan was a significant influence both on him and on experimental public choice more generally. In Plott (2012), Plott discusses the *Calculus of Consent* and how Buchanan and Tullock were open to institutions being constructed in any form (not only those that maximize the social good). This openness allowed Buchanan and Tullock to consider the performance of different decision procedures. Plott (2014) states:

> The importance of the "rules of the process" had an enormous influence on the development of laboratory experimental methods. As someone who was deeply associated with the transition from the very first, I appreciate the opportunity to report on the subtle ways in which public choice theory contributed to the basic science and my participation along the way. (Plott 2014, p. 332)

While much attention was paid to procedures and methods in developing experimental work, "an equally large part was focused on institutions, which clearly reflected the influence of Buchanan and what would be latter be called the constitutional political economy strand of Public Choice research" (Plott 2014, p. 341).

Plott adds that "[t]he development of experiments in the early 1970s was driven by curiosity about the power of institutions to shape collective choice, much of which was stimulated by the work of James Buchanan and Gordon Tullock together with the broad issues of public choice and political science" (Plott 2014, p. 351). According to Plott, his experiment with Levine (Levine and Plott 1977) demonstrated the critical role institutions and procedures, such as agendas and agenda formation, play in determining the final outcome. This kind of experiment provides evidence that theoretical models that emphasize, in this case the centrality of agenda setting, are useful models (Plott 2012, p. 297). Nevertheless, Plott admits that he does not know whether "Buchanan and Tullock share that view, but in classes and in discussions with graduate students, neither hesitated to allow the conversation to wander off into the hypothetical and imaginary. Indeed, the *Calculus of Consent* is built on that methodology" (Plott 2012, p. 298).

One of Plott's most influential papers, an experimental work on majority rule decision making, was conducted early in his career. In their seminal paper "Committee Decision under Majority Rule: An Experimental Study" (a description used by McKelvey and Ordeshook [1990]). Fiorina and Plott examine in a laboratory setting the decisions a committee makes under majority rule (Fiorina and Plott 1978). Interestingly, however, this work does not investigate what Buchanan considered to be of particular value—how vote trading, or logrolling, works.

In their experiment, Fiorina and Plott create the following simplifying conditions:

a. There is no uncertainty about the consequences of any decision;
b. There is no indifference or lack of personal interest on the part of committee members;
c. The committee uses majority rule but little or no additional formal procedure such as an agenda; and
d. There are no caucuses or extra-committee meetings among members of the committee.

What Fiorina and Plott actually did was create five-person committees, induce preferences for outcomes among the committee members, and give them a decision rule—majority rule (578). They then ask whether there is a model which will predict the decision of a group under these conditions (590). What they find is that if an equilibrium exists and preferences are strongly held, the committee's choice is predicted by the model's equilibrium.

But when Fiorina and Plott set out to conduct their experiment, they were not expecting such a result:

> In all candor, we suspected that formal models of committee processes had little to recommend them other than logical rigor. This negative presumption went by the board rather quickly-after a few pilot experiments. Some of the models actually appeared to work. Thus, our task changed from the easy one of generating negative results to a more difficult and painstaking one of determining why some models work, and when. (Fiorina and Plott 1978, p. 590)

Fiorina and Plott do clearly recognize that their one-shot game might miss out on important aspects of bargaining in committees:

> [I]f the committee decision is regarded by the members as only one stage in a sequence of games, might behavior in the committee reflect strategic considerations from the larger game? If so, a model which explains the

> behavior in the larger game might produce implications for the committee stage which differ substantially from those implied by models successful in explaining the processes of isolated committees. (593)

This is one of the limitations of the experiment. Fiorina and Plott agree that:

> One can gradually (and carefully) complicate a research design to make it more analogous to real-world political processes. By doing so, we can determine whether the complications destroy the applicability of models which work in simpler contexts.

When considering their own work, however, Fiorina and Plott do not consider their work to be irrelevant to the real-world context, merely that it might be only a first step, and additional experimental work is needed.

Despite Plott having been a student of Buchanan's, despite his claims to be significantly influenced by Buchanan, despite his working on decisions under majority rule early in his career, and despite his recognition that treating committee decisions as part of a multi-shot game might be a better model of the real-world, there is reason to be skeptical regarding whether Buchanan and Tullock's *Calculus of Consent* influenced Plott's experimental work. In particular, because Buchanan and Tullock skip quickly past one-shot collective decision games, it seems that Fiorina and Plott's paper sheds very little light on Buchanan and Tullock's main area of interest. Where then, is evidence for the influence of Buchanan on Plott? In the next section we discuss the move from theoretical models to laboratory experiments and discusses several possible explanations for this apparent puzzle.

From Models to Experiments

Plott considers laboratory experimental methodology as inherently relevant to developing the theoretical principles in public choice because it allows one to test whether these principles work in a simple and controlled setting:

> While laboratory success by no means implies field study success for a model, laboratory failure raises grave doubts about a model's applicability in field studies. Thus, while we reject the suggestion that the laboratory can replace creative field researchers, we do maintain that it can help them decide which ideas deserve further consideration. (576)

This was not, at the time, nearly as obvious to many in the economics community as it might seem today. Chris Stramer made this abundantly clear through some quotes he collected from prominent economists (Starmer 1999):

> [U]nfortunately, we can seldom test particular predictions in the social sciences by experiments explicitly designed to eliminate what are judged to be the most important disturbing influences. (Friedman 1953, p. 10)

> It is rarely, if ever, possible to conduct controlled experiments with the economy. Thus economics must be a non-laboratory science. (Lipsey 1979, p. 39)

> Economists … cannot perform the controlled experiments of chemists or biologists because they cannot easily control other important factors. Like astronomers or meteorologists, they generally must be content largely to observe. (Samuelson and Nordhaus 1985, p. 8)

> One of the weaknesses in the claim that the social sciences are sciences at all is their inability to conduct controlled experiments. Physicists can create vacuums, chemists can establish sterile environments, even doctors can conduct blind trials. But economists, sociologists, political scientists and those who study management find their subject matter will never stand still. (Kay 1997)

Plott takes laboratory experiments as primarily aimed at refuting hypotheses made by different public choice theories. In Plott (1979), he discusses what he calls the "fundamental equation":

$$\text{Preferences} \bigcirc \text{institutions} \bigcirc \text{physical possibilities} = \text{outcomes}$$

The problem Plott raises is that obtaining information about the different elements of the fundamental equation outside of the laboratory setting is "very difficult, expensive, and sometimes impossible to uncover the historical situations against which the relative accuracy of competing models can be gauged" (139). Instead, one can turn to laboratory experimental methods, which can help overcome some of these challenges. To do so requires relying on two axioms that are inherited from economics:

1. The behavior of various modes of organization is independent of the *sources* of preferences as long as the preferences themselves remain unchanged.
2. The relationship between outcomes, preferences, and institutions is (supposed to be) independent of the nature of the social alternatives.

When these two axioms are combined with the induced value theory (Smith 1976), it follows that the fundamental equation can be studied in the laboratory.

To understand the move Plott made from models to experiment it is helpful to turn to the philosophy of economics literature regarding the relationship between models and theories. Mäki argues that for all intents and purposes, economic experiments and economic models (depending on the literature, 'theories' might also be an adequate term to use) play a similar role in the process of economic science (Mäki 2005). The central difference between experiments and models is that experiments rely on material manipulations to achieve the requisite isolation for maintaining control whereas models do this through a reliance on an explicit a set of assumptions.

Morgan, by contrast, argues that the ontological difference between models—which are artificial worlds meant to represent a phenomenon in the real world—and experiments—which capture a version of the real world within an artificial laboratory environment—leads to an epistemic advantage for experiments in our ability to draw inferences from them to the real world (Morgan 2005). Guala adopts a similar position to Morgan's, emphasizing that both theoretical models and laboratory experiments in nonlaboratory sciences (such as economics) ""stand for" the target systems of interest," and both require an external validity hypothesis regarding their relationship to the target system (Guala 2005).

The extent to which models and experiments are similar and different has direct implications for what is required when moving from theoretical models of the kind Buchanan and Tullock develop, to the type of laboratory experiments that Fiorina and Plott design and implement. One way to understand this move is as an expansion of the potential for independent action by the players. In a theoretical model the actions a player chooses is deductively given by the assumptions of the model. The move to an experimental setting expands the freedom the players (now real humans) have in choosing their actions, or their "agency". In a laboratory experiment players are not constrained to those actions normally understood as rational, self-interested, and utility maximizing. However, this expanded freedom comes at the expense of experimenter control. In particular, it becomes less clear in relation to formal models whether players understand and are motivated by the rules of the game (Santos 2009).

Interestingly, Plott clearly states that Buchanan and Tullock were influential in the development of experimental methodology, not only in experimental public choice, but in general:

> The new approach to laboratory experimental methods was constructed on public goods so the generalization to experiments with externalities existed at the very base… Much of modern experimental methods in economics and political science was influenced by the *Calculus of Consent*. (Plott 2012, p. 297)

This only emphasizes our puzzle. Considering the purported influence Buchanan had on experimental public choice in general and on Plott in particular, why would Plott conduct experimental work focused on a question that Buchanan thought had not much value, rather than conducting experiments on issues in which Buchanan had interest?

A first possible explanation is that single-shot games offered Fiorina and Plott low hanging experimental fruit. While a repeated game might be a more realistic representation of the way in which committees make decisions under majority rule, it is clearly easier to design an experiment in which there is only a single instance of interaction rather than a repeated one. Since prior to Fiorina and Plott's experiment there were no laboratory experiments testing committee behavior under the conditions Fiorina and Plott examined, a single-shot game experiment was sufficiently novel to not only produce a publishable paper, but to produce a highly influential one. In view of this, it is sensible that Fiorina and Plott would first grab the low hanging fruit. What this explanation fails to address is why would Fiorina and Plott not then go on to pick the slightly higher hanging fruit if they recognize the potential importance of examining more complex scenarios (593). Of course, there might be a whole host of reasons for this, be it insufficiently novel in their eyes, institutional obligations, or other more interesting research each had in mind.

This leads us to a second possible explanation—it might simply be that Plott was developing his own independent experimental research agenda. This explanation is plausible given that one of Fiorina and Plott's chosen models is that of Voting Equilibrium, which was introduced by Black (Black 1958; Black and Newing 1951) and formally developed by Plott in an early theoretical paper (Plott 1967). While Plott thanks Buchanan in (Plott 1967), he does devote an entire paper to develop formally a model that Buchanan did not view as having much value. Evidently, Buchanan and Plott disagreed regarding the relative importance of Black's work. Of course, since Buchanan was thanked by Plott in that paper, it is reasonable to assume that Buchanan's comments, regardless of his view of the relative importance of the research project, were valued by Plott as he developed his own ideas leading to that paper.

A third possible explanation is that a technological barrier prevented Fiorina and Plott from working on vote trading—the main topic of interest in majority decision making for Buchanan. Such a barrier might exist due to the fact that experimental economics was still in its infancy in the 70's, and experimental methods to test some economic models were neither well understood nor well designed. It is clear that in their specific paper Fiorina and Plott turn to laboratory experiments in order to resolve the competition "between closely related but competing general principles" (Plott 1979, p. 141) regarding the best model of committee decision making under majority rule in a single-shot game. But at the time there were also competing models of vote trading. In 1981 Ferejohn reviews the then current state of theoretical literature on vote trading and laments the status of theoretical work on vote trading (Ferejohn 1974). Ferejohn's discussion of work by Bernholz (1973), Coleman (1966), and Wilson (1969), among others, implies that it would have been useful to resolve experimentally competition between competing theories in the context of vote trading as well.

More importantly, Mckelvey and Ordeshook published their experimental results on vote trading (Mckelvey and Ordeshook 1980) merely two years after Fiorina and Plott's (1978) paper. This suggests that it was not a technological barrier that prevented Fiorina and Plott from working on vote trading. Mckelvey and Ordeshook were testing an apparent paradox, raised by Riker and Brams, that while logrolling is individually advantageous for the traders, the sum of trades is disadvantageous for everybody (Riker and Brams 1973). Mckelvey and Ordeshook do not find support for Riker and Brams's claims. Bearing in mind the dangers of committing a false dichotomy, one could view Mckelvey and Ordeshook findings as giving a little support (however miniscule) to Buchanan and Tullock's claims regarding the efficiency enhancing nature of logrolling.

Finally, and perhaps most compellingly, we might simply trust Plott's words, as noted above:

> In all candor, we suspected that formal models of committee processes had little to recommend them other than logical rigor. This negative presumption went by the board rather quickly-after a few pilot experiments. Some of the models actually appeared to work. Thus, our task changed from the easy one of generating negative results to a more difficult and painstaking one of determining why some models work, and when. (Fiorina and Plott 1978, p. 590)

This type of statement is somewhat unusual within the context of a scientific contribution. Perhaps they included this because Plott had been substantially influenced by Buchanan, so much that he (and Fiorina) felt that a quick easy paper was available by running experiments that would cast doubt on one-shot models of collective-decision making, thus offering a clear path to future research in more sophisticated environments. If that was the intent, then perhaps the above statement can be understood as something of an apology to Buchanan. An explanation that Plott undertook this in an effort to show Buchanan correct, and was surprised to find otherwise.

Experimental Work on Vote Trading

In view of the above, it is interesting to inquire how scholars should evaluate the usefulness of a single-shot game model of majority rule. Are Buchanan and Tullock right that such a model is of little use, or are Fiorina and Plott, following Black and many others, correct in seeing the utility of these models? In fact, the vast experimental work on elections and committee decisions under majority rule games makes clear that this is an area Buchanan and Tullock seemed too quick to dismiss (McKelvey and Ordeshook 1990; Ordeshook 1997; Palfrey 2009). But the sparsity of experimental work on vote trading offers a puzzle. Vote trading, as Buchanan and Tullock and other conceive of it, clearly offers a worthwhile topic of analysis, yet very few (predominately Mckelvey and Ordeshook, and later Casella with coauthors), have devoted attention to it.

Vote buying in its various forms has received much attention in experimental work, but the concept of vote trading as logrolling has not. There is some experimental work on the topic of vote buying/selling (Dekel et al. 2008, 2009), though this work does not address trading among the voters themselves. There is also work on vote buying and selling for money (Casella et al. 2014), though again different from a focus on logrolling, which entails trading votes in one election for votes in another. Two experimental papers on vote trading as logrolling are (Mckelvey and Ordeshook 1980) from almost four decades ago, and (Casella and Palfrey 2016), a working paper. This paucity of work is in itself surprising, as the concept of logrolling is obviously of great interest.

One possible reason for this lacuna in the literature was raised by Casella et al. (2012). Casella et al. argue that a market for votes differs from classic markets since votes are indivisible, they have no intrinsic value, votes held by one voter can affect the payoffs to other voters, and payoffs are discontinuous at the point at which majority changes. Since there has been so little theoretical work on vote trading since the early 1970s there is no reason to expect experimental work to develop as well. As Ferejohn puts it: "The recent literature on logrolling or vote trading has been quite long on intuitive argument and carefully constructed examples, and short on general theorems" (Ferejohn 1974, p. 1). This points to the lack of sufficiently developed theoretical models of vote trading. Buchanan and Tullock's model is insufficiently developed to provide clear guidance on how one might develop such experiments. Ferejohn discusses this lacuna in the 1980s, yet the lacuna remains.

This, then, is a puzzle, this time with respect to Buchanan and Tullock's influence on experimental public choice—why has the topic of logrolling, which they find as interesting and important as they do, not sparked relatively little theoretical or experimental activity? We are certain and Buchanan and Tullock would agree that there remains much space for more work to be done in this area.

References

Bernholz, P. (1973). Logrolling, Arrow Paradox and Cyclical Majorities. *Public Choice, 15,* 87–96.

Black, D. (1958). *The Theory of Committee and Elections*. Cambridge: Cambridge University Press.

Black, D., & Newing, R. A. (1951). *Committee Decisions with Complementary Valuations*. London: William Hodge.

Buchanan, J. M., & Tullock, G. (1999). *The Calculus of Consent* (Vol. 3). Indianapolis: Liberty Fund (Original Work Published 1962).

Casella, A., & Palfrey, T. (2016). An Experimental Study of Vote Trading, Working Paper.

Casella, A., Llorente-Saguer, A., & Palfrey, T. R. (2012). Competitive Equilibrium in Markets for Votes. *Journal of Political Economy, 120*(4), 593–658.

Casella, A., Palfrey, T., & Turban, S. (2014). Vote Trading with and Without Party Leaders. *Journal of Public Economics, 112,* 115–128.
Coleman, J. (1966). The Possibility of a Social Welfare Function. *American Economic Review, 56,* 1105–1122.
Dekel, E., Jackson, M. O., & Wolinsky, A. (2008). Vote Buying: General Elections. *Journal of Political Economy, 116*(2), 351–380.
Dekel, E., Jackson, M. O., & Wolinsky, A. (2009). Vote Buying: Legislatures and Lobbying. *Quarterly Journal of Political Science, 4*(2), 103–128.
Downs, A. (1957). An Economic Theory of Political Action in a Democracy. *The Journal of Political Economy, 62*(2), 135–150.
Ferejohn, J. A. (1974). *Sour Notes on the Theory of Vote Trading*. Social Science Working Paper, California Institute of Technology, 41 (June, 1974).
Fiorina, M. P., & Plott, C. R. (1978). Committee Decisicis Under Majority Rule: An Experimental Study. *American Political Science Reiwew, 72*(2), 575–598.
Friedman, M. (1953). *Essays in Positive Economics*. Chicago: University of Chicago Press.
Guala, F. (2005). *The Methodology of Experimental Economics*. Cambridge: Cambridge University Press.
Haight, C. E., Gramajo, A. M., & Wenzel, N. G. (2011). The Calculus of Consent: 50th Anniversary Introduction. *Laissez-Faire, 30*(35), 83–85.
Kay, J. (1997, January 3). A German Lesson. *Financial Times*.
Levine, M. E., & Plott, C. R. (1977). Agenda Influence and Its Implications. *Virginia Law Review, 63*(4), 561–604.
Lipsey, R. (1979). *An Introduction to Positive Economics* (5th ed.). London: Weidenfeld and Nicholson.
Mäki, U. (2005). Models Are Experiments, Experiments Are Models. *Journal of Economic Methodology, 12*(2), 303–315.
Mckelvey, R. D., & Ordeshook, P. C. (1980). Vote Trading: An Experimental Study. *Public Choice, 35*(2), 151–184.
McKelvey, R. D., & Ordeshook, P. C. (1990). A Decade of Experimental Research on Spatial Models of Elections and Committees. In J. M. Enelow & M. J. Hinich (Eds.), *Advances in the Spatial Theory of Voting* (pp. 99–144). Cambridge: Cambridge University Press.
Morgan, M. S. (2005). Experiments Versus Models: New Phenomena, Inference and Surprise. *Journal of Economic Methodology, 12*(2), 317–329.
Ordeshook, P. C. (1997). The Spatial Analysis of Elections and Committees: Four Decades of Research. In D. Muelller (Ed.), *Perspectives on Public*

Choice: A Handbook (pp. 247–270). Cambridge: Cambridge University Press.
Palfrey, T. R. (2009). Laboratory Experiments in Political Economy. *Annual Review of Political Science, 12*(111), 379–388.
Plott, C. R. (1967). A Notion of Equilibrium Under Majority Rule. *American Economic Review, 57*(4), 787–806.
Plott, C. R. (1979). The Application of Laboratory Experimental Methods in Public Choice. In C. S. Russell (Ed.), *Collective Decision Making: Applications from Public Choice Theory*. Baltimore: John Hopkins University Press.
Plott, C. R. (2001). *Public Economics, Political Processes and Policy Applications* (Vol. 1). Cheltenham: Edward Elgar.
Plott, C. R. (2012). Personal Reflections on the Influence of Buchanan, Tullock, and "The Calculus of Consent". *Public Choice, 152*(3/4), 293–298.
Plott, C. R. (2014). Public Choice and the Development of Modern Laboratory Experimental Methods in Economics and Political Science. *Constitutional Political Economy, 25*(4), 331–353.
Riker, W. H., & Brams, S. J. (1973). The Paradox of Vote Trading. *American Political Science Review, 67*(4), 1235–1247.
Romer, T. (1988). Nobel Laureate on James Buchanan's Contributions to Public Economics. *Journal of Economic Perspectives, 2*(4), 165–179.
Samuelson, P., & Nordhaus, W. D. (1985). *Principles of Economics* (12th ed.). New York: McGraw-Hill.
Santos, A. C. (2009). Behavioral Experiments: How and What Can We Learn About Human Behavior. *Journal of Economic Methodology, 16*(1), 71–88.
Smith, V. L. (1976). Experimental Economics: Induced Value Theory. *The American Economic Review*, Vol. 66, No. 2, Papers and Proceedings of the Eighty-eighth Annual Meeting of the American Economic Association. (May, 1976), pp. 274–279.
Starmer, C. (1999). Experiments in Economics: Should We Trust the Dismal Scientists in White Coats? *Journal of Economic Methodology, 6*(1), 1–30.
Wilson, R. (1969). An Axiornatic Model of Logrolling. *American Economic Review, 59,* 331–341.

Part VI

Money, Debt, and the Rule of Law

41

Rules Versus Authorities: Buchanan and Simons and Fiscal Policy

Marianne Johnson

The most fundamental economic questions of the 1940s centered on the merits of economic planning. Planning captured the attention of Alvin Hansen, Oscar Lange, Abba Lerner, Erik Lindahl, Edwin G. Nourse, A. C. Pigou, Lionel Robbins, Herbert Simon, and Jan Tinbergen; the number of articles on planning constituted "a virtual epidemic" (Neal 1940, p. 246). Some, such as Frank Knight, considered planning nothing more than an "appealing synonym for state socialism" (1946, p. 451). Alfred C. Neal warned that "the road to dictatorship may well be paved with the good intentions of economic planners" (1940, p. 254). In *Road to Serfdom*, Friedrich von Hayek foresaw that abandoning the competitive market system for planning would have dire political consequences (1944). Barbara Wootton responded with

M. Johnson (✉)
Department of Economics, University of Wisconsin Oshkosh,
Oshkosh, WI, USA
e-mail: johnsonm@uwosh.edu

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_41

Freedom Under Planning (1945); J. M. Clark proposed *Alternatives to Serfdom* (1948).[1]

The planning debates cast a long shadow over economic theory and practice, and nowhere was it more obtrusive than in considerations of fiscal policy. Many found it difficult to disentangle the two—the "'partial planning' in fiscal policy" (Neal 1940, p. 247).[2] Though most often associated with Hansen, fiscal policy in the United States largely emerged out of the public finance literature and considerations of taxation, government spending, and public debt. Fiscal policy remained enmeshed within public finance well through the 1950s, providing the backdrop of James M. Buchanan's education in economics and early years of public finance practice.

To better understand Buchanan's views on fiscal policy and on the economics of John Maynard Keynes (Buchanan 1958, 1959, 1962; Buchanan and Wagner 1977; Buchanan et al. 1978), I examine Buchanan's graduate training in public finance and fiscal policy as well as his early work in fiscal federalism. Two important themes emerge. First is the striking influence of Henry C. Simons, "a radical and firm supporter" of participatory democracy (Taylor 1948, p. 652). Simons' influence on Buchanan has often been obscured by that of Frank Knight, Knut Wicksell and Antonio de Viti de Marco. But it is at the intersection of fiscal policy and public finance that Simons' role can best be seen. Second, Buchanan's treatment of Keynesianism and fiscal policy must be understood within the context of the choice between "rules versus authorities." Beginning with his 1948 dissertation, Buchanan consistently emphasized the importance of incorporating democratic processes directly into economic models rather than relying on omniscient and benevolent social planners or other authorities.

---

[1]According to Knight, Wootton's book "combines informed good sense and real wisdom with superficiality and pretentious (one might almost say, fraudulent) irrelevance, economic and political—all presented with verve and charm" (1946, p. 451). Hayek's view, according to Wootton, "seems hardly to amount to more than the statement that socialized planning is 'irrational' because it is incompatible with the free market determination of prices" (1935, p. 348).

[2]Richard Musgrave's work, for example, was characterized as "a 'planning approach' in public finance" (Neal 1940, p. 247).

Though some such Bradley Bateman worry that "from top to bottom, Buchanan and Wagner get it wrong as regards John Maynard Keynes" (Bateman 2005, p. 186; see also Bateman 2007; Subrick 2007), this mistakes Buchanan's interest and emphasis. As Buchanan argued, "our critique of Keynesianism is concentrated on its political presuppositions, not on its internal theoretical structure" (Buchanan and Wagner 1977, p. 5).[3] While the correctness of textual interpretations has a role in the history of economic thought, the debate over fiscal policy goes well beyond its mechanics and questions of the accuracy of various readings—for example, whether Keynes actually advocated for on-going deficits. Rather, discussions of fiscal policy reveal how the larger context of the post-war period shaped economic thinking. Fiscal policy was part of a fundamental discussion about how to delineate the appropriate boundaries of the economic role of government and the necessity of planning. Interwoven into this story is a related discussion about democracy—its meaning, its operationalization, and its relation to the market economy. That was what interested Buchanan.

Fiscal Policy, Public Finance, and Planning

Fiscal policy emerged from the turmoil of the Great Depression and Second World War, to become "the central topic" in economics (Hansen 1945, p. 382), "the vital center of attention" (Buchanan 1958, p. 20). Many notable public finance scholars worked at the intersection of fiscal policy and taxation, including Robert Murray Haig (1938), Richard Musgrave (1939, 1941, 1945, 1948), Paul Samuelson (1942), Carl Shoup (1943), and Henry Simons (1942b, 1945). Mabel Newcomer's book combined *Taxation and Fiscal Policy* (1940). Richard Lindholm authored *Public Finance and Fiscal Policy* (1950), "a comprehensive text exploring all the fields usually covered in an undergraduate course

[3]"We are not interested here in examining either the logical coherence or the empirical validity of the description of the national economy that is embodied in this most basic of Keynesian models. Our emphasis is on the attitudes of those who accepted such a model of economic reality as the ground upon which to construct policy prescriptions" (Buchanan and Wagner 1977, p. 82).

in public finance" (Newcomer 1950, p. 685). Musgrave's (1959) classic public finance textbook set the task for government as "allocation, distribution and stabilization," devoting a quarter of the book to public debt, the liquidity aspects of fiscal policy, fiscal dynamics and growth.

An important subset of this research existed at the juncture between public finance, fiscal policy, and welfare economics (Homan 1932; Lutz 1935; Leland 1937; Pigou 1948), what Walter Salant et al. (1948) referred to as the "pure theory of fiscal policy." Musgrave's (1939) criticism of the voluntary exchange theory of public goods as presented by Erik Lindahl (1919) provides a classic example. Musgrave concluded that economic planning was the preferred solution to the difficulties of estimating collective demand, the compulsory nature of taxation, and the complications of pricing public goods. The article was well-debated in the planning literature over the next several years (Neal 1940; Simon 1941; Musgrave 1941). It was this discussion that provided Buchanan's entrée into professional public finance, as he sought to rehabilitate the voluntary exchange theory as a democratic solution to the problem of public goods (Buchanan 1949).

Fiscal Policy at Chicago[4]

To understand Buchanan, it is first necessary to understand the place of fiscal policy at Chicago in the 1940s. Throughout the 1930s, Jacob Viner, Lloyd Mints, Knight, Simons and other members of the "old Chicago School" had propagated their own particular approach to monetary policy as a response to the Great Depression, largely eschewing fiscal policy proscriptions and New Deal spending plans (Buchanan 2010; Burns 2016; Nerozzi 2009).[5] Though holding a deep antipathy

[4]Parts of this section were published as a plenary talk (see Johnson 2018b).

[5]Simons' "monetary-fiscal doctrines were very individual, neither traditional nor currently popular, and in one sense radical (extreme or drastic). Their general quality may be gathered even from the 'Laissez Faire' pamphlet just discussed—readers familiar with that will recall its advocacy of the one hundred percent reserve idea, and a fixed quantity of money. But the present volume offers a much fuller and better presentation of his entire position in this field, in four additional

for economic planning and limitless deficit spending, the Chicago economists did accept limited counter-cyclical deficits to counter deflation. Their support, however, was conditional on the requirement that debts be retired as immediately as possible (Samuels 2005).

Simons' course on the "Economics of Fiscal Policy" (EC 361) debuted in the midst of the Great Depression, the same year as his *A Positive Program for Laissez Faire* (1934a). In that "frankly propagandist tract," Simons (1934a, pp. 1 and 2) argued that the most fundamental economic problems were monopolization and mistaken regulation. The role of the state should be to establish the rules of the game and to create institutions that would allow for markets to work efficiently. Recommended policies included "the maintenance of competitive conditions in industry; the control of the currency (of the quantity and value of the effective money); the definition of the institution of property (especially with reference to fiscal practices" Simons 1934a, p. 3). In this, Simons was in agreement with Knight, who emphasized the careful delineation of "rules of the game" as an antidote to technocrat planning (Knight 1946, p. 451).[6]

Having completed Knight's price theory course during the winter quarter of 1946, Buchanan enrolled in Simons' fiscal policy course

essays: 'Rules versus Authorities in Monetary Policy'—the 'key' article in this group; 'Hansen on Fiscal Policy—a vigorously hostile, critical review of Professor Hansen's *Fiscal Policy and Business Cycles*; 'On Debt Policy'—a short paper on the federal debt problem; and 'Debt Policy and Banking Policy'" (Taylor 1948, p. 654).

[6]Simons has routinely confounded historians' ability to clearly summarize the positions of the "old Chicago School." It was perhaps these seeming inconsistencies that led Buchanan to relegate Simons to the fringe of his consciously identified influences. Taylor (1948, p. 652), attempting to summarize Simons, stated that his "'Credo' is his strong advocacy of a marked reduction of existing inequalities of wealth and power, to be achieved through sufficiently progressive taxation, appropriate governmental spending for mass education, public health, consumer subsidies, etc., and through anti-monopoly policies—not through direct regulation of wages, prices, and profits or 'interference' with the 'free market system.' His peculiar faith that highly progressive taxation and redistributive fiscal policy as a whole, in complete contrast with governmental efforts to influence wages, prices, etc., for the same egalitarian purpose, need have no harmful effects at all on the vigorous functioning of the business economy, is a piece of economic theory I would question here if I had the space. But it is one of many evidences that his heart lay with 'the people,' not with 'the interests'".

in the spring as part of the sequence for specializing in public finance (Buchanan 2007, p. 70). The course description promised

> A study of fiscal practices with reference to (1) booms and depressions (budget-balancing), (2) distribution of income (inequality), and (3) composition of the national income (incidence). The latter weeks will be devoted to study of particular kinds of taxes, especial attention being given to problems of income taxation.[7]

Assigned readings included Simons On Debt Policy (1944), his Rules Versus Authorities in Monetary Policy (1936), his critique of the Beveridge Program (1945) and his *Personal Income Taxation* (1938). Also on the list were several works by Hansen; one can imagine Simons treatment of Hansen's "monumental misconceptions" (Simons 1942a, p. 44). Compared to Hansen's fiscal policy seminar at Harvard, Simons placed significantly more emphasis on public finance and significantly less on unemployment policies and business cycle theory. In fact, Simons believed that "the sooner we quit talking about cycle theory as a major field of inquiry, the better" (1942a, p. 163).

Buchanan matriculation in Simons' fiscal policy course was coincident with the roll out of the Employment Act of 1946. The act represented the culmination of a decade-long shift in economic thinking, enshrining the idea that "…economies were not self-correcting but needed constant government guidance to avoid the twin perils of depression and hyperinflation" (Buchanan and Wagner 1977, p. 13). Nothing could have been further from Simons' position on national economic management, which identified "the real enemies of liberty" as "the naïve advocates of managed economy or national planning" (Simons 1934a, p. 10).

Simons' views on fiscal policy can be best understood in his opposition to Hansen and policies like the Employment Act. Simons disliked

[7]University of Chicago. (1945, June 15). *Announcements: The College and the Divisions, Sessions of 1945–1946*, *XLV*(7), 219. The readings list of Simons' 1946 fiscal policy course can be found at Irwin Collier's *Economics in the Rearview Mirror*. Available at http://www.irwincollier.com/chicago-henry-simons-last-course-fiscal-policy-1946/.

Hansen's proclivity to historical analysis, his lack of empirical evidence, and his reliance on so-called "real" factors that eschewed recourse to "purposive action or policy" (Simons 1942a, p. 45). Devoting thirty pages in a "vigorously hostile, critical review" (Taylor 1948, p. 641) designed to "bury" Hansen's *Fiscal Policy and Business Cycles*, Simons complained of his "preposterous," "irrelevant and misleading" theories (Simons 1942b, pp. 165 and 166). Simons was not more kind to the "sophistries…propagated by Mr. Keynes" (1938, n. 23).

Simons (1943, 1944, 1945, 1946) saw two dangers in the sustained public debt of the post-war period. The first was the obvious and well-identified risk of inflation. The second was more insidious, the danger to democracy arising from governmental policies enacted by bureaucrats rather than voters or their elected officials. To protect against both, Simons proposed the dramatic and speedy retirement of war debt in a manner that was transparent to voters and where the distribution of the burden could be clearly identified (1944 and 1946). He argued that "it is essentially improper and undemocratic (Schachtian) to confuse issues by proposing and using a miscellany of debt forms", arguing that there is never "any sense in an elaborate structure of federal debt" (1944, p. 356). That deficit financing was opaque to voters was particularly problematic for democracy. In the end,

> We might have lower morbidity, valuable public assets, a larger tax base, and other good things to show for it. But the magnitude and the rate of increase of internal debt is a measure of political instability and exposure to revolution. We cannot indefinitely and continuously add to the transfer of obligations of our political system without jeopardizing political order. (Simons 1942b, p. 174)

As a companion course, it is difficult to imagine one that would reinforce the lessons of Knight's price theory course more effectively, particularly for someone like Buchanan who "had always been anti-state, antigovernment, antiestablishment" and who placed a "high residual value on individual liberty" (2007, pp. 5 and 72).

The lurking authoritativeness inherent in fiscal policy was a recurring theme in Simons' writings. Simons emphasized the danger of the deferral of policy-making to technocrats; the central problem was that it separated decision-making from both democratic process and public input. Simons claimed

> There is imminent danger, however, that actual governmental policies will undermine irreparably the kind of economic and political life which most of us prefer to the possible alternatives. This danger manifests itself mainly…in measures and policies which involve delegation of legislative powers and the setting-up of authorities instead of rules. (Simons 1936, p. 2)

Always a favorite soapbox, Simons believed that the "in this simple distinction," between rules and authorities, "lies the choice between democracy and fascism, between freedom and authority" (1934b, p. 797). The theme was reprised in Simons EC 360 public finance course (Simons in Samuels 2005) as well as his *Economic Policy for a Free Society* (1948).[8]

Worried that "Hansen favors large abdication of fiscal powers by Congress in favor of special agencies and their experts" Simons saw too much room for technocrats to "use the powers for consolidating their own position and that of their patron faction" (1942b, pp. 179–180).

> What [Hansen] proposes, if you will, is collectivism via fiscal policy or fiscal stabilization whose implementation is promiscuous socialization, letting functional minorities do their worst until the socialized sector, grown too large to live parasitically and irresponsibly, itself cries out for protection. (Simons 1942b, p. 181).

In fact, "the liberal creed demands the organization of our economic life largely through individual participation in a game with definite rules. It calls upon the state to provide a stable frame-work of rules within

[8]"There remains one point which has not been properly emphasized, namely, that genuine liberal reform must aim primarily at explicit changes in the rules of the economic game and must minimize reliance on control or regulation through nominally administrative bodies with large discretionary, policy-determining powers" (Simons 1948, p. 322, n. 13).

which enterprise and competition may effectively control and direct the production and distribution of goods" (Simons 1936, p. 1). Rather than relying on experts, Simons argued that "only with rules of policy can common national interests be protected against minorities" (Simons 1942b, p. 179). Buchanan would turn this idea on its head and argue that only with rules—such as Wicksellian unanimity—could minorities be protected from majorities in a democratic system.

Fiscal Equity in a Federal State

Buchanan's dissertation considered *Fiscal Equity in a Federal State* (1948).[9] Two articles emerged from the project. Buchanan (1949) extended the continental-European literature on benefit taxation and voluntary exchange; Buchanan (1950) provided a fairly traditional treatment of federalism and fiscal equity as a problem of resource allocation (Feld 2014; note that Buchanan 1951 and 1952a extend his argument for fiscal federalism).[10] In the dissertation, Buchanan wrestled with whether "this fiscal problem of the federal state"—fiscal disparities across subordinate units—can "be resolved within the political framework given" (1948, p. 3), e.g., within the existing rules of the game. Buchanan argued that it was indeed possible and outlined a federalist system based on states' rights and revenue sharing. He claimed his

[9]It is not clear why Buchanan chose this topic for his dissertation. One can speculate that the ambitious and motivated Buchanan, anxious to get started, chose the topic during his first quarter at Chicago while enrolled in Simeon Leland's State and Local Taxation course. Leland had been central member of the New Deal group at Chicago in the 1930s, whose expertise was in the problems of the coordination of fiscal units in a federalist system. In one instance, however, Buchanan seems to self-reflect on "the pedestrian parade of factual detail which often epitomizes the published doctoral dissertation reflects the forced mating of reluctant author and uninspiring material" (1958, p. v).

[10]The departure of Leland for a deanship at Northwestern followed by the death of Simons, all during the spring quarter of 1946, left Buchanan with Roy Blough as the only possible dissertation advisor in public finance. Though Simons had held a high opinion of Blough as a practicing economist and supported bringing him onto the Chicago faculty, Buchanan was less impressed, failing to share Blough's interest in the technical details of administering policy (see Johnson 2014). For a more detailed exposition of Buchanan's education at Chicago, and Johnson (2018a) on Blough's approach to economics.

philosophy "follows in the 'Nineteenth Century Liberal' tradition that government should be based upon the rule of law, that it should operate in a limited and well-defined area, and that the directions made by government over the economic life of a nation should be general and not particularistic" (1948, p. 18). In the corresponding footnote, Buchanan (1948, p. 18) noted "the general position taken in this study concerning the role of government in the economy follows that expressed by the late Professor Henry C. Simons. Cf. *A Positive Program for Laissez Faire.*"

More political economy than public finance or welfare economics, Buchanan considered Jeffersonian and Hamiltonian theories of the federal state and whether governments necessarily tend toward centralization of power, including continuously increasing control over the economy. Given the backdrop of the New Deal and Second World War, as well as the corresponding rise of economic planning, Buchanan worried about the political implications of reduced economic freedom that come from the concentration of economic activity with the federal government. Despite the claims by planners, Buchanan argued that "efficiency is neither the sole ideal nor even one of the most important ones in a democracy…[democracy] places individual freedoms high within its hierarchy of values. It truly fears a 'tyranny of the majority' if governmental powers are left unchecked by the law of the Constitution" (Buchanan 1948, p. 11).

Federal systems have two fundamental problems to work out, concluded Buchanan. The first is that of fiscal justice, or that states with lower fiscal capacities are unable to provide the same kind and quality of public goods as states with greater fiscal resources. At the individual level, this meant that an individual in a low-capacity state would suffer a higher fiscal burden than an equivalent individual in a high-capacity state. "The whole fiscal structure should be as neutral as possible in a geographic sense" (1950, p. 589); without neutrality, individuals would have an incentive to move to high-capacity, high-income states, leading to a distortion of resources. In the end, "the laissez-faire result will be the ultimate centralization of a larger share of effective political power" (Buchanan 1950, p. 599). The second problem relates to determining the appropriate scale and scope of governmental goods and services to be provided. At all levels, there had been a vast expansion of government activity over the past three decades. Buchanan warned that these activities consumed greater and greater amounts of economic resources and effectively "increased the amount of real income redistribution accomplished by the operation of the fiscal system" but without the overt consent of voters (Buchanan 1950, p. 584).[11]

Buchanan (1948) sought to counter the increased centralization of spending and tax policy, arguing that the same objectives could be achieved in a more federalist system that primarily relied on markets to organize economic resources. For, either you believe that an economic problem can "best be solved by a competitive free enterprise system operating within the limits of defined 'rules of the game'" or you accept the basic tenet "asserting that a freely competitive system is not the ultimate means and that instead greater political direction of economic life is required for the optimum solution of the economic problem" (Buchanan 1948, pp. 6–7). This was related to a deeper and more philosophical question of how to model government in a democratic society. Buchanan was highly dissatisfied with the traditional "organistic" approach that represented government as a monolithic and benevolent decision maker, preferring instead the "individualistic" voluntary exchange models of Wicksell and Lindahl (Buchanan 1949; see also Buchanan 1952b, 1954)[12] and the political models of the Italian public finance economists (Buchanan 1958). Buchanan was particularly drawn to Wicksell who had rejected the "outdated political philosophy

[11]Buchanan was always highly suspicious of redistribution through the fiscal mechanism and preferred to place it outside the scope of his analysis (e.g., Buchanan 1951, p. 358; see also Buchanan 1952a). His choice to exclude redistribution from positive economic analysis underpinned many of Buchanan's objections to Musgrave's approach, which included redistribution as one of the three fundamental obligations of government, along with allocation and stabilization. Buchanan also differed significantly from Simons on redistribution through the fiscal mechanism; Simons viewed "taxation as the proper means for mitigating inequality" (1938, p. v).

[12]Wicksell had argued that the benefit principle was most consistent with "modern tax administration, specifically the parliamentary approval of taxes" (1967, p. 72). His unanimity rule required that all new expenditures be paired with tax schemes for consideration by parliament. Representatives would vote on successive expenditure-tax pairs, until one received unanimous consent. This guaranteed each individual would receive benefits commensurate to the cost (Wicksell 1967, pp. 89–90).

of absolutism… [of an] enlightened and benevolent despotism" for voluntary exchange and "progress toward parliamentary and democratic forms of public life" (Wicksell 1967, pp. 84 and 87).

The voluntary exchange model required that taxes (costs) and expenditures (benefits) be considered simultaneously at the individual level; voters would thus make fiscal choices based on a quid pro quo basis. Echoing Wicksell's tax-expenditure scheme, Buchanan argued that "both the level of tax burden and the range of publicly provided services must be included" for individuals to make an appropriate evaluation (1950, p. 586). To counter the naysayers who had rejected both the benefit principle and the voluntary exchange theory as unrealistic, Buchanan authored a series of papers that demonstrated how they could be applied to public-goods type problems, from marginal-cost pricing of government services to highway construction (Buchanan 1951, 1952a, b).

Public Finance and Public Debt

Already, by the early 1950s, many of the fundamental ideas were in place that would later form the basis of Buchanan's critique of Keynesian fiscal policy. We have seen that these included the importance of institutional design, the necessity for government action in the economy to conform to democratic principles, and government modeled as voluntary exchange or quid pro quo. The fourth leg of attack—and the one that is perhaps most directly attributable to the influence of Simons—was public debt as a problem of public finance and politics rather than of macroeconomics (Wagner 2014). Richard Wagner (2014) provides a cogent discussion of the technical aspects of Buchanan's public debt theory. Rather than retreading the same ground, the focus here is on the philosophical underpinnings of Buchanan's public debt concerns.

Buchanan turned to the question of public debt in the early 1950s, motivated by the practical and immediate concerns of how to pay for a national highway system (Buchanan 1958). Theoretical underpinnings were developed during Buchanan's Fulbright year in Italy.[13] Though Simons and Buchanan held opposing views of the merits of ability-to-pay versus benefit taxation, as well as to the usefulness of the Italian public finance tradition,[14] both agreed that public debt was a part of public finance and hence should be governed by the same concerns as decisions about taxation and government spending. In this, Buchanan diverged from the pre-Depression Progressives who had identified the growing public debt with the provision of social services and a "quickened moral sensitiveness and philanthropic sympathy" (Adams 1887, p. 14) and from the post-war Keynesians who accepted deficits as necessary to maintain economic stability and full employment.[15]

Buchanan saw individual participation in the revenue-expenditure process as a hallmark of democratic decision-making. Consistency required that public debt conform to the same cost-benefit calculation as other types of government expenditures. Buchanan had foreseen the problem when writing on fiscal federalism.

> Had the role of government remained 'protective,' and thus the fiscal system conformed more closely to the benefit or quid pro quo principle, richer units would have needed greater governmental expenditures. Only when the 'social' state appeared did the divergence between need and capacity become clear. As more government services were provided

[13]On the importance of Buchanan's Fulbright year in Italy (1955–1956), see Buchanan (1958, 2007), Eusepi and Wagner (2013), Marciano (2009), and Medema (2005).

[14]Buchanan makes few personal references to Simons; an exception was an interview with Manuela Mosca in Blacksburg, Virginia on June 27, 2008 (Mosca 2011). The focus was Antonio de Viti de Marco, and Buchanan was asked about Simons' highly critical review (Simons 1937) of the English translation of *First Principles of Public Finance* (1936). Buchanan thought Simons was "very sharp, very bright" but too locked into the English-language public finance viewpoint.

[15]Though claiming that he had "for many years…[accepted]…the 'new orthodoxy,'" of Keynesian deficit financing, during his Italian year, Buchanan began to struggle with the issue of public debt within the context of his politics-as-exchange paradigm (1958, pp. v–vii). The initial claim is rather doubtful, as there is no evidence in Buchanan's writings that he ever accepted Keynesian-style management of the macro-economy and a lot of evidence to suggest that Buchanan was always highly suspicious of government/technocrat interference. Buchanan would undoubtedly respond that "if there is no evidence of the 'new orthodoxy' in my published papers, this reflects a full and unquestioning integration of the doctrine in my own thinking rather than the reverse" (1958, p. v).

> equally to all citizens, or upon some basis of personal need, the discrepancies between the capacities and needs of the subordinate units arose. (Buchanan 1950, p. 585)

Social welfare spending was troublesome because it could not be easily reconciled with the benefit principle and the premise of government as voluntary exchange. Similarly difficult were public debts, one of the few exceptions Wicksell allowed to the applicability of his unanimity rule. Wicksell argued that previously incurred public debts had to be paid as a matter of principle, regardless of the current distribution of benefits; future debts should be avoided except in cases of exigency (1967, pp. 93–95).

Buchanan also found public debts problematic. Financing federal public spending—whether social welfare programs or highways—directly through taxation maintained at least some of the benefit connection and encouraged the careful weighing of costs. Deficit financing obscured the relationship.

> Governments increasingly enact public expenditure programs that confer benefits on special segments of the population, with the cost borne by taxpayers generally. Many such programs might not be financed in the face of strenuous taxpayer resistance, but might well secure acceptance under debt finance. The hostility to the expenditure programs is reduced in this way, and budgets rise; intergroup income transfers multiply. (Buchanan and Wagner 1977, p. 21)

Much like Simons who had argued that “legislatures can be trusted to spend if required to tax accordingly” and that “borrowing has little place in sound policy” (Simons 1942b, pp. 178 and 174), Buchanan distrusted decisions based on deferred costs. Incurring debt meant that benefits were not considered simultaneous to the costs, or worse, that benefits were enjoyed without corresponding costs. This becomes clear if you ask “who suffers if the public borrowing is unwise and the public expenditure wasteful?” (Buchanan 1958, p. 40). By deferring payment, the government shifts the burden of the spending: “Put starkly, debt finance enabled people living currently to enrich themselves at the expense of people living in the future" (Buchanan and Wagner 1977, p. 11).

Buchanan's *Public Principles of Public Debt* (1958) was part traditional textbook—reviewing historical approaches, developing a working theory of public debt, considering the special cases of depression and war financing—and part persuasive tract highlighting the dangers the "new orthodoxy" in economics that accepted ever-increasing levels of debt. However, it was not until the appendix that Buchanan attempted to provide a solution to the problem of retiring public debt. With minor modifications, "the revaluation proposed here is a means of accomplishing the purpose desired by Simons without necessarily undertaking the drastic steps which he suggested" (Buchanan 1958, p. 214). At a more fundamental level, Buchanan argued that the solution required "some clearly defined and predictable rules for policy… Economic stability should be a predictable outcome of the rules of the system, rules which are constructed once and for all" (1958, p. 195). Thus, on public debt, Buchanan (1958) can be seen as the intellectual heir to Simons (1944) which, though cloaked in the economic language of money and banking, sees public debt fundamentally as a problem of democratic decision-making.

Rules Versus Authorities

In "Rules versus Authorities" (1936, pp. 1 and 2), Simons reframed the Progressive and New Deal push for government management of the economy as a choice between the "orderly functioning of a system based on economic freedom and political liberty" arising from well-defined rules of the game and "authoritarian collectivism," which abandons democratic principles for expertise. In the same vein, Buchanan (1949) offered his own approach to governing rules for public finance with a rehabilitation of the benefit principle, a defense of Knut Wicksell, and an attack on Musgrave's (1939) planning as a solution to the problem of public goods. Like Wicksell and Simons, Buchanan was sensitive to the democratic implications of his economics.

As was true for much of traditional public finance, Keynesian fiscal policy also assumed the state to be a monolithic and benevolent institution, with a well-conceived and uniformly-shared vision of macroeconomic policy objectives.[16] Buchanan's contemporaries, Hansen, Musgrave and Samuelson, accepted the monolithic and activist state as a factual representation of reality, with government management of the economy as necessary for a civil and well-functioning society. With that came an inescapable fact that "a social system cannot function without some degree of compulsion" (Musgrave 1941, p. 320). Rather than an institution to be minimized, government ought to be used effectively to maximize social welfare and promote economic stability. Samuelson agreed, generally preferring to err on the side of an over active government rather than a passive one. For all, a theory of government was unnecessary to operationalize policy.

Buchanan argued that government must be seen as an amalgam of special interests, politicians, and bureaucrats, rather than a uniform enterprise that could make strategically calculated decisions. Paraphrasing Simons' *Economic Policy for a Free Society* (1948), Buchanan claimed that the vested interests of bureaucrats and politicians, particularly those at the federal level, make harmony of interests both unlikely and unrealistic (1948, p. 259). "To a reviewer familiar with the American political structure, the idea of a single government decision-maker deliberately manipulating the various State action parameters to maintain both full employment and price-level stability seems far removed from reality" (Buchanan 1959, p. 267).

While it may be possible for an "an idealized set of policy prescriptions" to be "formulated for a truly benevolent despotism…this set may be far distant from the ideal prescriptions for the complex 'game' of democratic politics" with its complicated set of actors (Buchanan and Wagner 1977, p. 76). In fact, we should expect the democratic outcome

[16]While economists such as Hansen and Musgrave were "preoccupied with the economics of fiscal policy" few recognized that "the 'politics of fiscal policy'…may turn out to be the crux of the problem" (Spahr on Musgrave in Salant et al. 1948, p. 409).

to be different from what would be chosen by Keynes' "small and enlightened group of people" (ibid., 76).[17]

> Some might…suggest that basic choices on macroeconomic policy should be taken away from the decision-making power of ordinary politicians and entrusted to a small group of 'experts', 'economic technocrats', 'planners', who would, it is assumed, be able to 'fine tune' the national economy in accordance with the true 'public interest' and wholly free of political interference. This naïve approach begs all questions concerning effective incentives for the 'experts', and ignores the demonstrated informational difficulties in forecasting and controlling. Various arguments for incomes policies and national economic planning, which now seem to be re-emerging, represent in reality an effort to replace our democratic political institutions with non-democratic institutions more consonant with Keynesian presuppositions. (Buchanan et al. 1978, p. 79)

The problem was one of incentives. As Simons had previously warned, "perpetual deficits and uninterrupted increase in the federal debt…are heavenly music to political leaders as opportunists" who have incentives to spend without paying as a path to remaining in office (Simons 1942b, p. 162). A similar sentiment was echoed by Buchanan, Burton and Wagner, who pointed out that

> We should not be surprised at the contemporary fiscal and economic record. Once the last vestiges of the Classical norm of the balanced budget were removed, nothing was left to constrain the spending proclivities of politician, and, indirectly, those of the voters themselves…the policies derived from Keynesian economics cannot be applied within representative democracy (1978, p. 225)

[17] "But two separate and divergent routes to reform may be taken, one which we may label 'democratic,' the other clearly as 'nondemocratic.' Unfortunately, those who tend to be most critical of democratic politics tend to support structural changes that will, if implemented, remove economic decisions from democratic controls" and place them in the hands of a small group of elite decision makers (Buchanan and Wagner 1977, p. 89).

Not only was this image of a monolithic and benevolent government decision-maker wrong, it was dangerous: "we cannot indefinitely and continuously add to the transfer obligations of our present system without jeopardizing political order" (Simons 1942b, p. 174).

Buchanan argued that the presumption that market fluctuations required a government response was flawed because government should be subject to the same evaluative criteria as the market. Buchanan thus sought to undermine the premise of orthodox public finance that government could succeed where markets failed. Buchanan particularly objected to political actions that place restraints on private behavior as a way to mitigate fluctuations. In contrast, the solution identified by both Buchanan and Simons rested in the establishment of clear rules of the game. "These remarks will suggest, I hope, the overwhelming importance of consensus upon general rules or norms of democratic fiscal policy" (Simons 1943, p. 183). Simons thus called for a constitution "grounded in expert and popular approval" to constrain policy makers and bureaucrats (ibid.).[18]

How individual-government interactions are modeled says a lot about how economists think and what sorts of policies they are willing to accept; these views are often rooted in deeper precepts. Thus we see a story that positions free markets and voluntary exchange as democratic processes on one side, arrayed against social management and compulsion on the other. Yet, it goes even deeper. Hansen, Musgrave and other Keynesians would certainly prefer democratic government to any alternative, but they are largely satisfied by what they saw as the outcomes of majority-rule democracy and significant reliance on bureaucratic expert decision making. They worried less about coercion and more about the implications of decisions being made by non-experts, preferring a world of government technocrats. In contrast, Buchanan warned that "from a democratic point of view, there are strong objections to any such removal

[18]See also Simons (1944, p. 179): "The importance of rules, and of focusing democratic discussion on general principles of policy, calls for emphasis…Only with rules of policy can common national interests be protected against minorities…only by adherence to wise rules of action can we escape a political opportunism which jeopardizes and destroys what we wish to protect and preserve."

of decision-making power from our elected representatives" (Buchanan et al. 1978, p. 79). Rather than the technical details, Buchanan focused on how fiscal policy and public debt intersected with political economy, the modeling government-individual decision-making, and the connection between market economics and democracy in the post-war era.

Conclusions

Much has been written on Buchanan's debt theory and his critique of Keynesian fiscal policy (Alvey 2011; Bateman 2005, 2007; Feld 2014; Marciano 2009; Mueller 2014; Wagner 2014, 2017). I argue that Buchanan had little interest in textual exegesis or epistemological considerations of Keynes's writings. Rather, "Keynesianism" was a convenient term to encompass what Buchanan saw as a philosophical shift in economics theory and practice. Faith in markets was replaced by faith in, or the perceived necessity of, technocrat management of the economy through the manipulation of taxes, spending, and deficits. This chapter thus considers Buchanan's critique of Keynesianism by focusing on Buchanan's underlying philosophical complaint—the inherent authoritarianism of fiscal policy. In doing so, we see the starting influence of Henry C. Simons in Buchanan's emphasis on rules over authorities/experts and his insistence on incorporating democratic decision-making into economic models. As Buchanan reminds us, "we are democrats here not autocrats" (Wagner 2014).

It should be clear at this point that Buchanan's treatment of Keynesian fiscal policy had as much to do with larger political-social-economic context of the post-war period as it did the internal mechanics, realism or functionality of the theory. Buchanan's contribution to the fiscal policy debates brought into the open questions about how to model individual-government decision making, the role of technocrats, and the appropriate scope for government in the economy. The choice between rules and authorities provided a logical internal consistency to Buchanan's works, from his dissertation though his early work in public finance and public debt theory to the eventual evolution of public choice and constitutional political economy.

References

Adams, H. C. (1887). *Public Debts: An Essay in the Science of Finance*. New York: Appleton & Co.

Alvey, J. (2011). James M. Buchanan on the Ethics of Public Debt and Default. *Journal of Markets and Morality, 14*(1), 85–101.

Bateman, B. (2005). Scholarship in Deficit: Buchanan and Wagner on John Maynard Keynes. *History of Political Economy, 37*(2), 185–190.

Bateman, B. (2007). Did Buchanan and Wagner Misrepresent Keynes? A Rejoinder. *History of Political Economy, 39*(4), 741–743.

Buchanan, J. M. (1948). *Fiscal Equity in a Federal State* (Doctoral dissertation). University of Chicago.

Buchanan, J. M. (1949). The Pure Theory of Government Finance, a Suggested Approach. *Journal of Political Economy, 57*(6), 496–505.

Buchanan, J. M. (1950). Federalism and Fiscal Equity. *American Economic Review, 40*(4), 583–599.

Buchanan, J. M. (1951). Fiscal Equity in the Unequal Treatment of Unequals: A Rejoinder. *Journal of Political Economy, 59*(4), 358–359.

Buchanan, J. M. (1952a). Federal Grants and Resource Allocation. *Journal of Political Economy, 60*(3), 208–217.

Buchanan, J. M. (1952b). Wicksell on Fiscal Reform: Comment. *American Economic Review, 42*(4), 599–602.

Buchanan, J. M. (1954). Social Choice, Democracy, and Free Markets. *Journal of Political Economy, 62*(2), 114–123.

Buchanan, J. M. (1958). *Public Principles of Public Debt: A Defense and Restatement*. Homewood, IL: Richard D. Irwin.

Buchanan, J. M. (1959). Review: *The Economic Theory of Fiscal Policy* by Bent Hansen. *Economica, 26*(103), 266–267.

Buchanan, J. M. (1962, February). Politics, Policy, and the Pigouvian Margins. *Economica* 29, 17–28.

Buchanan, J. M. (2007). *Economics from the Outside*. College Station, TX: Texas A&M University Press.

Buchanan, J. M. (2010, June 2). *Chicago School Thinking: Old and New*. The Summer Institute for the History of Economic Thought, Richmond University. Available at https://www.youtube.com/watch?v=7_atDse06r4.

Buchanan, J. M., & Wagner, R. (1977). *Democracy in Deficit*. New York: Academic Press.

Buchanan, J. M., Burton, J., & Wagner, R. (1978). *The Consequences of Mr. Keynes*. London: Institute of Economic Affairs.

Burns, S. (2016). Old (Chicago) School, New Century: The Link Between Knight and Simons' Chicago Plan to Buchanan's Constitutional Money. *Constitutional Political Economy, 27*(3), 299–318.
Clark, J. M. (1948). *Alternatives to Serfdom*. New York: Knopf.
De Viti de Marco, A. (1936). *First Principles of Public Finance*. New York: Harcourt, Brace and Company.
Eusepi, G., & Wagner, R. (2013). Tax Prices in a Democratic Polity: The Continuing Relevance of Antonio de Viti de Marco. *History of Political Economy, 45*(1), 99–121.
Feld, L. (2014). James Buchanan's Theory of Federalism: From Fiscal Equity to the Ideal Political Order. *Constitutional Political Economy, 25*(3), 231–252.
Haig, R. M. (1938). Fiscal Policies. *American Economic Review, 28*(1), 132–135.
Hansen, A. (1945). Three Methods of Expansion Through Fiscal Policy. *American Economic Review, 35*(3), 382–387.
Hayek, F. (1944). *Road to Serfdom*. London: Routledge.
Homan, P. (1932). Economic Planning: The Proposals and the Literature. *Quarterly Journal of Economics, 47*(1), 102–122.
Johnson, M. (2014). James M. Buchanan, Chicago, and Post War Public Finance. *Journal of the History of Economic Thought, 36*(4), 479–498.
Johnson, M. (2018a). Institutionalism and Fiscal Policy at Midcentury. *Journal of Economic Issues, 52*(1), 103–116.
Johnson, M. (2018b). Rules Versus Authorities. *Public Choice, 175*, 219–228. Available at https://doi.org/10.1007/s11127-018-0544-2.
Knight, F. (1946). Review: *Freedom Under Planning*. *Journal of Political Economy, 54*(5), 451–454.
Leland, S. (1937). Debt Retirement and the Budget. *American Economic Review, 27*(1), 75–85.
Lindahl, E. (1919). *Die Gerechtigkeit Besteuerung*. Lund: Gleerupska.
Lindholm, R. (1950). *Public Finance and Fiscal Policy*. New York: Pitman Publishing Corporation.
Lutz, H. (1935). State Supervision of Local Finance. *Journal of Political Economy, 43*(3), 289–305.
Marciano, A. (2009). Buchanan's Constitutional Political Economy: Exchange vs. Choice in Economics and in Politics. *Constitutional Political Economy, 20*(1), 42–56.
Medema, S. (2005). Marginalizing Government: From la Scienza delle Finanze to Wicksell. *History of Political Economy, 37*(1), 1–25.

Mosca, M. (2011). *Una storia degna di memoria, in Antonio de Viti de Marco. Una storia degna di memoria, a cura di Manuela Mosca* (pp. 7–14). Milano: Bruno Mondadori.
Mueller, D. (2014). Constraining Leviathan. *Constitutional Political Economy, 25*(1), 88–102.
Musgrave, R. (1939). The Voluntary Exchange Theory of Public Economy. *Quarterly Journal of Economics, 53*(2), 213–237.
Musgrave, R. (1945). Alternative Budget Policies for Full Employment. *American Economic Review, 35*(3), 387–400.
Musgrave, R. (1948). Fiscal Policy in Prosperity and Depression. *American Economic Review, 38*(2), 383–394.
Musgrave, R. (1959). *The Theory of Public Finance*. New York: McGraw-Hill Education.
Musgrave, R. A. (1941). The Planning Approach in Public Economy: A Reply. *Quarterly Journal of Economics, 55*(2), 319–324.
Neal, A. C. (1940). The 'Planning Approach' in Public Economy. *Quarterly Journal of Economics, 54*(2), 246–254.
Nerozzi, S. (2009). Jacob Viner and the Chicago Monetary Tradition. *History of Political Economy, 41*(3), 575–604.
Newcomer, M. (1940). *Taxation and Fiscal Policy*. New York: Columbia University Press.
Newcomer, M. (1950). Review: *Public Finance and Fiscal Policy* by Richard W. Lindholm. *American Economic Review, 40*(4), 685–686.
Pigou, A. C. (1948). Central Planning and Professor Robbins. *Economica, 15*(57), 17–27.
Salant, W., Spahr, W., Vickery, W., & Groves, H. (1948). Fiscal Policy in Prosperity and Depression—Discussion. *American Economic Review, 38*(2), 404–416.
Samuels, W. (2005). F. Taylor Ostrander's Notes on Henry Simons's Course on Public Finance, Economics 360, University of Chicago, 1933–1934. *Research in the History of Economic Thought and Methodology, 23,* 240–301.
Samuelson, P. (1942). Fiscal Policy and Income Determination. *Quarterly Journal of Economics, 56*(4), 575–605.
Shoup, C. (1943). Problems in War Finance. *American Economic Review, 33*(1), 74–97.
Simon, H. (1941). The Planning Approach in Public Economy: Further Comment. *Quarterly Journal of Economics, 55*(2), 325–330.
Simons, H. C. (1934a). *A Positive Program for Laissez-Faire* (Public Policy Pamphlet No. 15). Chicago, IL: University of Chicago Press.

Simons, H. C. (1934b). Economic Reconstruction: The Columbia Report. *Journal of Political Economy, 42*(6), 795–799.
Simons, H. C. (1936). Rules Versus Authority in Monetary Policy. *Journal of Political Economy, 44*(1), 1–30.
Simons, H. C. (1937). Review: *First Principles of Public Finance* by Antonio De Viti De Marco. *Journal of Political Economy, 45*(5), 712–717.
Simons, H. C. (1938). *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy*. Chicago, IL: University of Chicago Press.
Simons, H. C. (1942a). Review: The Structure of the American Economy, Part II: Toward Full Use of Resources by Gardner C. Means, D.E. Montgomery, J.M. Clark, Alvin H. Hansen, and Mordecai Ezekiel. *Review of Economics and Statistics, 24*(1), 44–47.
Simons, H. C. (1942b). Hansen on Fiscal Policy. *Journal of Political Economy, 50*(2), 161–196.
Simons, H. C. (1943). Postwar Economic Policy: Some Traditional Liberal Proposals. *American Economic Review, 33*(1), 431–445.
Simons, H. C. (1944). On Debt Policy. *Journal of Political Economy, 52*(4), 356–361.
Simons, H. C. (1945). The Beveridge Program: An Unsympathetic Interpretation. *Journal of Political Economy, 53*(3), 212–233.
Simons, H. C. (1946). Debt Policy and Banking Policy. *Review of Economics and Statistics, 28*(2), 85–89.
Simons, H. C. (1948). *Economic Policy for a Free Society*. Chicago: University of Chicago Press.
Subrick, J. R. (2007). Did Buchanan and Wagner Misrepresent Keynes? *History of Political Economy, 39*(4), 735–739.
Taylor, O. H. (1948). The Economics of a 'Free' Society: Four Essays. *Quarterly Journal of Eocnomics, 62*(5), 641–670.
Wagner, R. (2014). James Buchanan's Public Debt Theory: A Rational Reconstruction. *Constitutional Political Economy, 25*(3), 253–264.
Wagner, R. (2017). *James M. Buchanan and Liberal Political Economy: A Rational Reconstruction*. New York: Lexington Books.
Wicksell, K. (1967). A New Principle of Just Taxation (1896 J. M. Buchanan, Trans.). In R. Musgrave & A. Peacock (Eds.), *Classics in the Theory of Public Finance* (pp. 72–118). New York: St. Martin's Press.
Wootton, B. (1935). Review: *Collectivist Economic Planning* by F.A. von Hayek: *Economic Planning in Soviet Russia* by Boris Brutzkus. *Economica, 2*(7), 348–350.
Wootton, B. (1945). *Freedom Under Planning*. Durham: University of North Carolina Press.

42

The Quest for Fiscal Rules

Lars P. Feld

There will be no escape from the protectionist-mercantilist regime that now threatens to be characteristic of the post-socialist politics in both Western and Eastern countries so long as we allow the ordinary or natural outcomes of majoritarian democratic processes to operate without adequate constitutional constraints. (James M. Buchanan 1990)

Introduction

James Buchanan was concerned with problems of public debt throughout his academic career. Starting with his first monograph *Public Principles of Public Debt* (Buchanan 1958) via *Democracy in Deficit* (1977), his book with Richard Wagner, to papers in the 1990s (e.g., Buchanan 1997), he analyzed the incidence of public debt, the Keynesian shift in fiscal policy, their meaning for political

L. P. Feld (✉)
Walter Eucken Institut, University of Freiburg,
Freiburg, Germany
e-mail: feld@eucken.de

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_42

decision-making processes and the necessity for constitutional restraints on public debt. Indeed, his insights on public debt incidence, the question that, according to Brennan in his foreword to Volume 2 of *The Collected Works*, came to him as a flash of inspiration, only provided for a starting point of subsequent analyses. If public debt constitutes a burden to future taxpayers, it might induce decision-makers in current politics to incur excessive indebtedness and reveal a deficit bias in fiscal policies. Such deficit bias should be restrained by constitutional rules in order to avert harm from future generations. Buchanan's theory of public debt thus provided the foundation for an extensive and still growing public choice literature on the political economics of public debt.

His thinking on public debt is embedded in his theory of fiscal exchange (Buchanan 1949, 1967). Buchanan's basic concern was that the democratically constituted Wicksellian link between public spending and revenue raising could be fundamentally harmed if today's taxpayers vote for themselves expenditures on the expense of future generations. Access to public debt thus necessarily has an impact on the conduct of democratic politics. And Buchanan feared that this impact will not be a beneficial one.

In this paper, I will analyze to what extent Buchanan clearly and farsightedly anticipated the problems emerging from excessive indebtedness by starting with a brief look at the development of public debt across time and space. This is followed by remarks on different aspects of the sustainability of public debt. In the next section, I discuss the reasons for public debt in the sense of a positive analysis, in particular focusing on the extensions of Buchanan's thinking about excessive debt that finally lead to the quest for fiscal rules. In section "Institutional Restraints on Public Debt", the effects of such restraints on public debt are summarized. Concluding remarks follow in the final section.

Public Debt in Time and Space

Buchanan's reasoning about public debt, at first glance, implies the existence of a deficit bias in fiscal policies leading to increasing debt across time. Figures 42.1 and 42.2 exhibit the development of debt

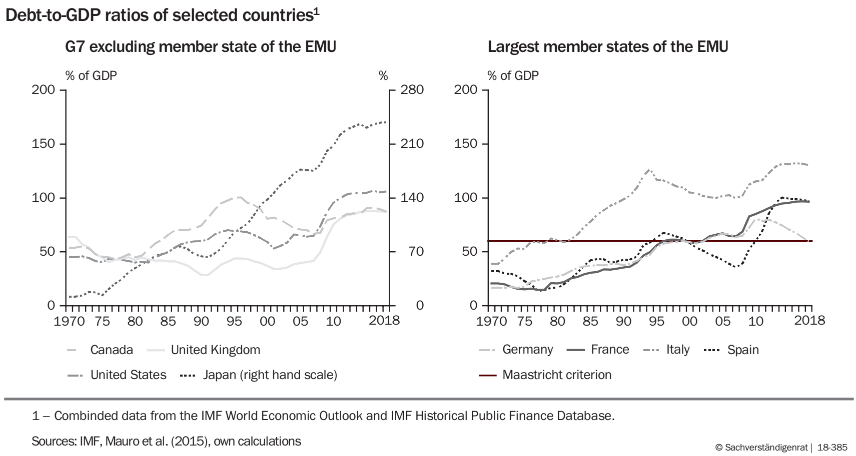


Fig. 42.1 Debt to GDP ratios of large OECD countries, 1970–2017 (*Source* German Council of Economic Experts)

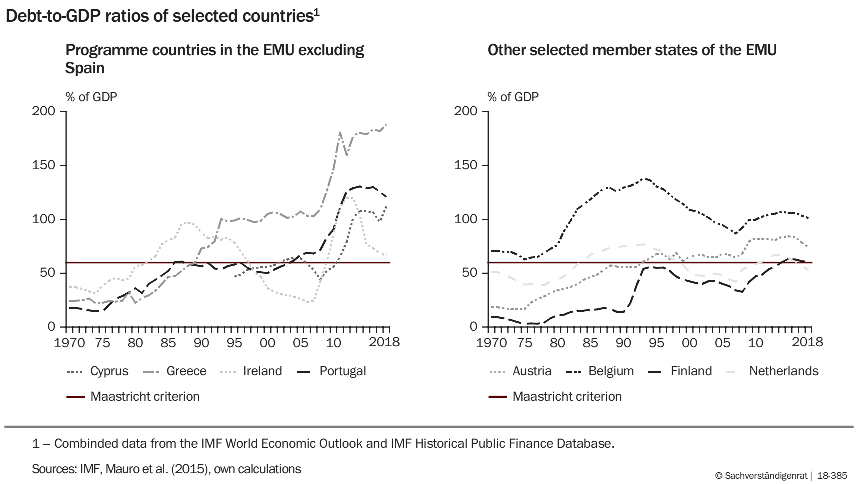


Fig. 42.2 Debt to GDP ratios of small OECD countries, 1970–2017 (*Source* German Council of Economic Experts)

to GDP ratios from the 1970s to 2017. In Fig. 42.1 (left panel), the four member countries of the G7 which are not member states of the European Monetary Union (EMU) are displayed, while Fig. 42.1 (right panel) shows debt to GDP ratios of the four large EMU countries, i.e., the remaining G7 countries plus Spain. I have taken the debt to GDP ratio because it plays a role in the discussion about debt sustainability. Real debt would even show a more dramatic time pattern.

Figure 42.1 shows that the development of debt to GDP ratios of the G7 countries and Spain since the 1970s differs considerably between these countries. The increase is most markedly in Japan which actually demands an own (the right-hand) scale in the left panel of Fig. 42.1. At almost zero percent in 1970, Japanese public debt rose with little consolidation in the second half of the 1980s to about 250% of GDP in 2017. In the U.S., total government debt of all levels of government rose from about 1980 with consolidation in the second half of the 1990s to about 100% today. In Canada, this increase since 1980 was even stronger, consolidation in the 1990s until the Great Recession more thoroughly and the subsequent increase less considerable than in the U.S., such that the Canadian debt to GDP ratio is at about the same level as the U.K's. The U.K. has mainly suffered from the increase of the debt to GDP ratio induced during the Great Recession.

Regarding EMU member countries, an increasing trend is most obvious in France with almost no consolidation during these 47 years. Spain and Italy display increasing trends in their debt to GDP ratios until entering EMU, consolidating more or less, respectively, until the Great Recession, giving way for increasing debt again afterwards. While Italy with 132% has one of the highest levels of public debt to GDP in EMU, Spain and France have arrived at levels of almost 100%. Germany shares France's increasing trend of public debt to GDP until the Great Recession, but deviates after 2009 with considerable consolidation of almost 20 percentage points.

Figure 42.2 shows the debt to GDP ratios of eight small member countries of EMU with the so called program countries, those countries that underwent an adjustment program during the Eurozone crisis, displayed in the left panel of Fig. 42.2, and four other members of EMU in the right panel. The strong increases in debt to GDP ratios in Greece, Portugal and Cyprus are obvious, not only after the Great Recession, but also during the 1970s and 1980s. Ireland had a similar experience in the 1970s and 1980s, but started a period of strong consolidation in the second half of the 1980s that endured until the eve of the Great

Recession. The tremendous increase of its public debt to GDP ratio during the Eurozone crisis has been followed by remarkable consolidation afterwards.

In Austria and Finland, debt to GDP ratios rose since 1970 with some fluctuations, but without clear-cut consolidation (see Fig. 42.2, right panel). This is different in the Netherlands and Belgium which both experienced strong increases in government debt until the middle of the 1990s, considerable consolidation until 2007, a further surge in public debt after the Great Recession and some consolidation of its fiscal policies recently. The Netherlands managed to keep these fluctuations around the threshold of 60% debt to GDP ratio stipulated by the Maastricht Treaty and the Stability and Growth Pact. Belgium, however, started with a debt to GDP ratio of about 140% into EMU and reduced it to about 90% until 2007. Belgian debt meanwhile is at 100% of GDP.

This comparative exercise underlines several facts. First, there is an overall increasing trend in government indebtedness in percent of GDP in OECD countries. Almost all countries start from lower levels of debt to GDP in 1970 than they arrive at in 2017. Secondly, there are remarkable differences between those OECD countries. Debt to GDP ratios vary between 60% in Germany and the Netherlands and 250% in Japan. In Switzerland (not shown), it is even 35% only. Thus, the question emerges what is the reason for this variation and for the increasing trends. Alesina and Perotti (1995) arrived at the same observations and the same questions more than 20 years ago. Not much seems to have changed since, despite all fluctuations across time—except that the levels of the debt to GDP ratios are higher. These are only first impressions of a possible deficit bias in fiscal policies of OECD countries that must be further addressed in this paper. Before we consider this question, it is however necessary to look at the sustainability of public debt.

The Sustainability of Public Debt

Analyses on debt sustainability provide insights as to the extent to which public debt is shifted to future generations because they include many relevant aspects discussed in the old debate about burden shifting.

If public debt is used for productive government spending, it can increase growth in the long-run, facilitating payments of interest and principal. The term productive spending avoids classifying it into public investment or public consumption as both can be productive or unproductive depending on what the government actually spends money. Paying teacher salaries can economically be an investment in school children's human capital as higher teacher salaries may attract better teachers, but it legally is public consumption. A bridge to nowhere is however unproductive although it is investment spending.

Of course, such a perspective does not fully acknowledge the different arguments brought forward in the burden shifting debate, in particular not Buchanan's (1958, 1964) arguments. Yet, it indicates whether a country runs into the danger of exploding debt levels leading to sovereign default or sovereign debt restructuring. The most recent examples of Greece or Argentina illustrate what default implies for current generations if past governments of their countries followed irresponsible fiscal policies. The hardship current generations in these countries have had to undergo impressively illustrates what a burden of public debt means: Excessive public debt heavily reduces the fiscal space of those generations.

Economists have been concerned with the sustainability of public debt for a long time (see Domar 1944; Blanchard et al. 1990; Blanchard 1993). These analyses start from the intertemporal government budget constraint according to which a state, in contrast to private households or firms, will have to repay its debt only in the very long-run, i.e., in infinity. Public finances will be sustainable if

$$d_0 = -\sum_{t=1}^{\infty}\left(\frac{1+y}{1+r}\right)^t p_t + \lim\nolimits_{T\to\infty}\left(\frac{1+y}{1+r}\right)^T d_T \qquad (42.1)$$

with y as the growth rate of real GDP, d the debt to GDP ratio, r the real interest rate, p the primary balance and t the respective time period. This equation can be expressed in nominal terms allowing for an additional analysis of seigniorage.

Accordingly, government finances are sustainable if future primary surpluses in an infinite time horizon can cover government debt accumulated in the past. The ability to generate primary surpluses depends on real economic growth, i.e., the potential to raise revenue, and is counteracted by the real interest rates that must be paid to service debt. Already Domar (1944) shows that the necessity to generate primary surpluses depends on the relation between interest rates and economic growth. If the growth rate of GDP is higher than the interest rate, the debt to GDP ratio declines across time without primary surpluses. If the interest rate is higher than the growth rate of GDP, government must realize primary surpluses. Otherwise, the debt to GDP ratio will grow with continuous acceleration until the system collapses.

Figures 42.3, 42.4, 42.5, and 42.6 illustrate the movement of both time series, i.e., nominal interest rates and the growth rates of nominal GDP for Germany. Figure 42.3 covers the years between 1974 and 2010. During this time-period, Germany experienced notable economic shocks, namely the oil price and unification shocks, and entered a period of moderate economic growth. Aside yearly movements, the nominal interest rate was higher on average than the growth rate of real GDP. Given that during the same period an increasing trend in the debt to GDP ratio has obtained, it is natural that policymakers have become concerned with this development and introduced a debt brake into the German constitution (the Basic Law) in 2009.

The situation was quite different in the two decades before (see Fig. 42.4). After the Second World War, in its economic miracle years, the German economy grew with much higher rates, partly due to a rebuilding of the economy and other catch-up effects. Figure 42.4 shows that on average the growth rate of nominal GDP was higher than the nominal interest rate. The debt to GDP ratio remained flat despite the budget deficits that occurred from time to time. Public debt appeared to be financed by the growth of the economy.

It is difficult to judge whether the period between 1974 and 2010 or that between 1953 to 1973 is normal for Germany. It is essential for the sustainability of public finances that the interest rates in the intertemporal budget constraint, which are used to discounting the future values of the aggregates in Eq. (42.1), are high enough to obtain finite present values of these aggregates such that the infinite series of these flows converge absolutely (Homburg 1991). This is usually the case if

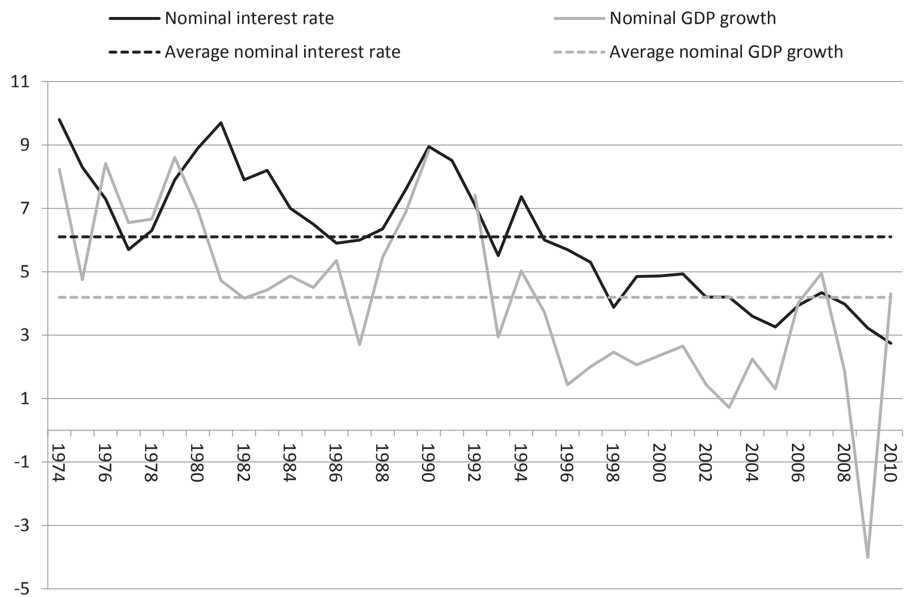


Fig. 42.3 Nominal interest rates and growth rates of nominal GDP in Germany, 1974–2010 (*Source* Burret, Feld and Köhler (2013))

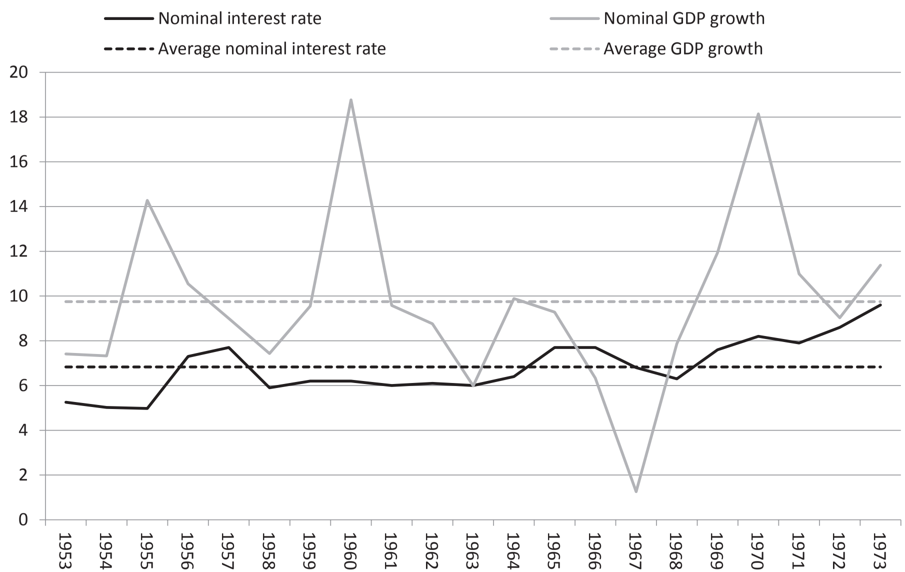


Fig. 42.4 Nominal interest rates and growth rates of nominal GDP in Germany, 1953–1973 (*Source* Burret, Feld and Köhler (2013))

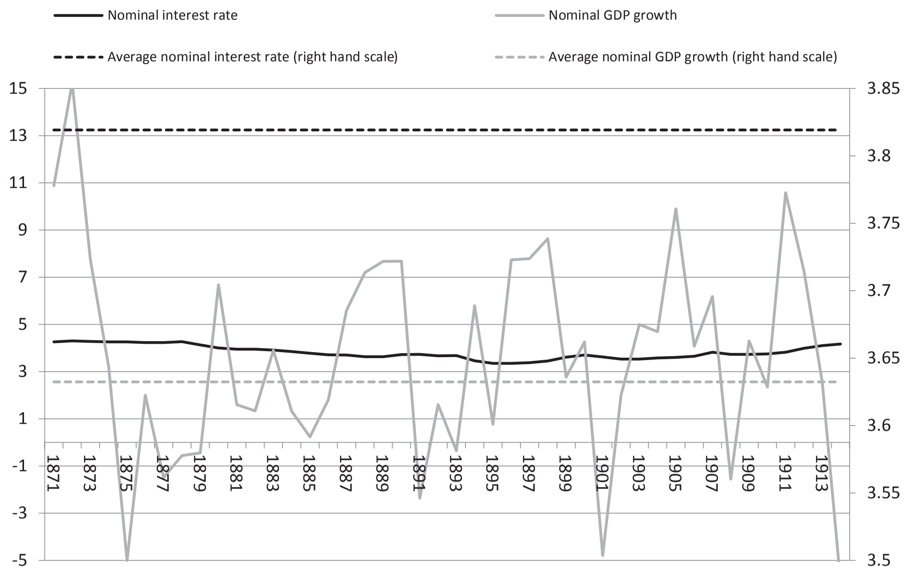


Fig. 42.5 Nominal interest rates and growth rates of nominal GDP in Germany, 1871–1914 (*Source* Burret, Feld and Köhler (2013))

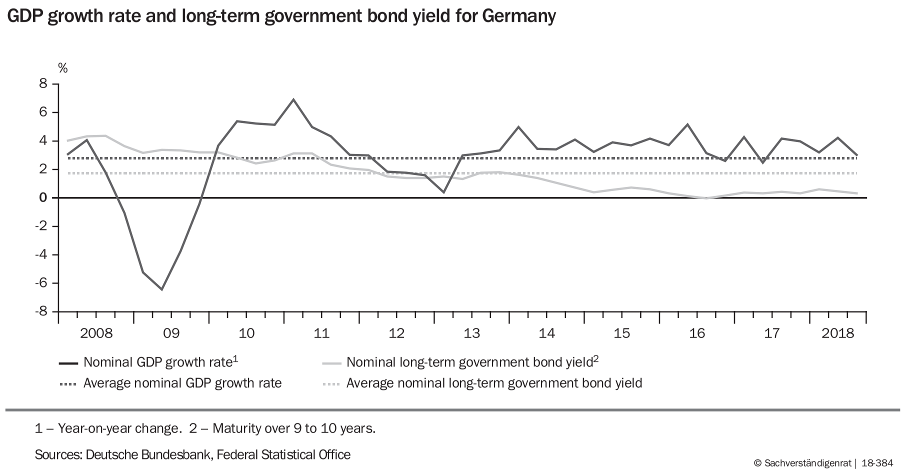


Fig. 42.6 Nominal interest rates and growth rates of nominal GDP in Germany, 2008–2016 (*Source* German Council of Economic Experts)

the interest rate is higher than GDP growth, but not if the interest rate is lower. Theoretically, thus, much speaks in favor of the later period to reflect a rather normal situation. Figure 42.5 picks up the time before the First World War between 1871 and 1914 showing that during the gold standard, Germany had higher interest rates than GDP growth on average. This may serve as an additional illustration of the theoretical arguments.

However, infinity is a sequence of finite steps. Economic shocks may hit the flows of fiscal aggregates frequently and thus require fiscal counter-action to help the economy recover from a shock. Figure 42.6 shows the German experience from 2008 to 2016. The German economy was hit by two shocks, first, the Great Recession in 2008 and, second, an interest rate shock as Germany has served as a safe haven during the Euro-crisis. On average, nominal interest rates are therefore somewhat lower than GDP growth since the financial crisis, allowing for a consolidation that relies on lower interest payments and higher public revenue.

Against this background, there are several test strategies in the empirical literature assessing fiscal sustainability ex post. One test strategy consists in stationarity tests on public debt and budget deficits. Public finances are sustainable if these series are stationary. In addition, cointegration tests of public debt and budget surpluses on the one hand or between public revenue and spending on the other hand are conducted. The estimation of Vector Error Correction Models (VECM) helps to identify long-run relations and short-term deviations. The question underlying these analyses is whether current public debt is equivalent to discounted future primary surpluses, i.e., the intertemporal budget constraint. The necessary condition for fiscal sustainability is thus tested. Burret et al. (2013, 2016, 2017) report such analyses for Germany and conclude that neither total government finances nor those of the Laender (states) are sustainable.

A second test strategy estimates linear fiscal reaction functions. If there is a positive reaction of primary balances on the level of public debt, then a sufficient condition of fiscal sustainability obtains (Bohn 1995, 1998, 2008). The basic idea of this test strategy is compatible with the argument that such reactions reflect the ability of governments to redeem their debt in the future. This ability also includes the possibility to overcome political economy problems. Potrafke and Reischmann (2015) test sustainability of German Laender finances using this approach and find out that they are sustainable if the German fiscal equalization system is considered, while Feld et al. (2018) suggest that they only partly meet the criteria for fiscal sustainability even in the case with fiscal transfers.

The third test strategy follows a structural approach using Dynamic Structural General Equilibrium (DSGE) Models (D'Erasmo et al. 2016). Economic growth and interest rates are endogenous in these models. The endogeneity of interest rates to the fiscal and the economic situation of a country is reflected in the expectations of market participants. If theoretical arguments are taken seriously, in a situation of interest rates higher than GDP growth, a government cannot redeem its loans by issuing new debt forever. If market participants doubt the repayment of a country's loans, potential creditors only hesitantly buy government bonds inducing interest rates to rise, leading to further creditors to withdraw and so on (Calvo 1988; Morris and Shin 1998). It is obvious that the possibility for a state to play a Ponzi game is restricted and depends on its credibility. If credibility is lost, financial markets quickly switch from a situation in which government finances look sustainable to a situation with sky-rocketing refinancing costs and fully unsustainable finances. This credibility rests on political economy and institutional environments.

Explanations of Public Debt

Given this pattern of the development of public debt across OECD countries and the discussion of the sustainability of public debt, it is important to find out what are the economic and institutional factors explaining public debt and thus shape its sustainability. For Buchanan (and many other public choice scholars), based on experience with public debt in OECD countries at earlier times (Buchanan 1968, 1997; Buchanan and Wagner 1977), it may have been obvious that the evidence alluded to in the previous two sections supports the notion of excessive indebtedness. His Keynesian critiques would however hold that much of the movements of public indebtedness are due to the cyclical movements of the economy and are needed to contribute to economic stabilization.

Can cyclical movements indeed explain the variation of public debt of OECD countries across time and space? Standard textbook knowledge suggests that business cycles certainly play a role, at least when the built-in-flexibility of government budgets is allowed to work. In a recession, public revenues decline and expenditures increase. A recession involves less aggregate income of an economy, hence less (personal and corporate) income tax revenue and social security contributions. On the spending side, higher unemployment rates, for example, trigger higher aggregate spending for the unemployed if there are unemployment insurance schemes. Usually, such automatic stabilizers are supposed to work without the government trying to counteract them with tax increases or spending reductions, as this would potentially deteriorate the economic situation further. Moreover, the extent of automatic stabilizers is different in different countries. European welfare states have more automatic stabilization at their disposal than the U.S. for example.

A recent prominent explanation of the variation of public debt across time and countries consists in financial and banking crises. Schularick and Taylor (2012) provide evidence that such shocks play an important role for cyclical movements. In contrast to other demand or supply shocks, banking crises are frequently accompanied by longer periods of moderate economic growth because the consolidation of the banking sector takes time.

Another obvious reason for higher government debt consists in singular events that hit a country like a purely economic shock. Wars and violent conflicts belong into this category as do natural disasters like, e.g., earthquakes, extreme weather events, floods or draughts. In the case of Germany that featured as an illustrative case in previous sections, unification of West and East Germany in 1990 was such a singular event leading to an increase of debt because of immediate financing requirements that would have been difficult to obtain via tax increases.

Other traditional explanations for public debt are public investment and demographic change. According to the golden rule of public investment, a government should finance its investment projects with debt because the resulting public infrastructure serves future users as well. A distribution of the costs of public infrastructure across time requires future users to pay their fair share of an infrastructure that is useful for them. The golden rule actually is a normative argument like the recommendation to let automatic stabilizers work. Both additionally provide positive explanations regarding the extent to which public debt can be explained by business cycles and public investment. In the case of demographic change, the positive question dominates as to whether ageing societies are under pressure to finance larger parts of social security with higher indebtedness. Given that demographic change will mainly take place in future decades in most OECD countries, with the notable exception of Japan, it has probably less explanatory power for past public debt increases.

Empirically, these traditional economic approaches explain the increasing trend of government debt and its variation across countries to some extent. In particular, economic shocks in the sense of cyclical movements, singular events or banking crises are important explanatory factors. This does not hold with respect to public investment. The increasing trend of public debt since the 1970s is accompanied by a decreasing trend in public investment in most OECD countries. Demographic change has some explanatory power in the case of Japan, but less in other countries in which ageing sets in later.

Still, such explanations of the variation in public debt are incomplete. In particular, the question emerges as to why public debt increases in recessions or due to singular events, but is not reduced in booms or when the economic effects of singular events are overcome. What are the factors preventing a government from consolidating its budget in better times? Buchanan and Wagner (1977) hold Keynesianism responsible for excessive indebtedness. In the early days of Keynesian macroeconomic policy, when the U.K. and the U.S. endorsed it in the 1950s and 1960s, the effects on public debt were still low, partly because of relatively high inflation in both countries, partly because of overall stronger economic growth. When Keynesian recipes were applied in the 1970s, after the breakdown of the Bretton Woods system, stagflation emerged, showing how such policies can fail, also giving way to the increasing debt dynamics shown in section "Public Debt in Time and Space". However, this reasoning is also incomplete as it is particularly the lacking consolidation in good times that requires an explanation. Keynesianism may have abolished the informal (moral) rules of sound fiscal policy that existed before and thus provided the general environment for profligacy (Buchanan 1985, 1987). As an explanation for actual debt variations it is insufficient.

This leads to the more recent analyses in political economics. Alesina and Pessalacqua (2016) provide a comprehensive survey on the political economy of government debt. They ask whether the observed pattern of government indebtedness is excessive. Optimal debt is obtained on the basis of tax smoothing that proposes to cope with transitory shocks by allowing for budget deficits instead of tax rate changes in order to minimize the excess burden of taxation (Lucas and Stokey 1983). Alesina and Pessalacqua (2016) conclude that optimal debt theory is not supported by the data implying that government debt is excessive, i.e., there is a deficit bias in fiscal policy. Consequently, they consider different arguments from political economics to close the explanatory gap between actual (excessive) debt and optimal debt levels.

Without providing a comprehensive account, two different political forces play a particularly important role: Elections and common pool problems. Elections could have two different effects. On the one hand, governments have incentives to spend before elections in order to ensure voter support (see, e.g., De Haan and Klomp 2013; Foremny et al. 2018). After elections, some of this additional spending is partly compensated for by a budget consolidation that is however weak, for example, because of tax resistance. Overall, public debt may increase across time. On the other hand, governments may act strategically before elections. Anticipating that it is probably not reelected, a governing party may leave its successor less fiscal space restricting its ability to keep its election promises, hence increasing reelection of the current governing party at the next election (see, e.g., Pettersson-Lidbom 2001). Strategic government debt may require highly rational policy-makers, but it can also potentially explain increasing trends in public indebtedness because excessive debt of the current government to bind the next government does not prevent the latter from trying to keep as many of its election promises as fiscal space allows.

Common pool problems are another powerful public choice explanation of excessive public spending and public debt. The basic idea is going back to Buchanan and Tullock (1962), but is more fully examined by Weingast et al. (1981) regarding spending and Velasco (1999, 2000) regarding public deficits and public debt. A common pool problem emerges if different groups have access to a common resource, in our case the budget, and try to obtain as many favors as possible. Each group exerts its demand for public funds until the marginal benefits of obtaining such funds equals the marginal costs of the financial contribution of the group to the budget. A spending bias emerges because some groups have better access to the budget than others such that benefits are concentrated and financing costs are distributed over a larger population. Improved access is obtained through log-rolling between legislators or coalitions between parties. If the financing of current spending that triggers benefits for those groups can be spread to future taxpayers who cannot participate in today's decisions, the incentives for excessive spending may even be higher. Such excessive spending is accompanied by excessive indebtedness. Moreover, this reasoning offers a particular twist regarding fiscal consolidation. In case, a government wants to consolidate the budget, the different beneficiary groups will oppose it and obstruct the consolidation goals.

The common pool problem has different faces. It might be the result of log-rolling between legislators in parliament, an exercise common in U.S. Congress, but frequently present in other political systems too (for the not fully conclusive evidence, see, e.g., Egger and Köthenbürger 2010 versus Pettersson-Lidbom 2012). The role of fragmented government is also discussed regarding coalition governments (Roubini and Sachs 1989a, b; De Haan and Sturm 1994; De Haan et al. 1999) or regarding cabinet size (Perotti and Kontopoulos 2002; Schaltegger and Feld 2009a; Fritz and Feld 2015). In the previous case, the coalition treaty between the government parties is a form of explicit log-rolling. In the latter case, each spending ministry induces the overuse of the fiscal commons while the finance ministry is supposed to have a gate-keeping role.

Buchanan (1997, p. 497) summarizes the basic problem why ordinary politics cannot balance the budget formidably:

> Government spending for a wide array of "goods" may be authorized, and every one of these "goods" may be valued positively by some or all constituents. The approval of these rates of spending may, however, proceed without explicit regard to the genuine opportunity cost that must ultimately be measured in the sacrifice by someone, sometime, of other values that might have been produced. It is not the public spending, as such, that is the proper focus of attention here. … That which makes the existing rules generate patterns of outcomes that we deem to be irresponsible is the political agents' authority to spend without taxing. Little or no sophistication is required to recognize how different the dynamics of the fiscal choice would be in a constitutional setting that forced politicians to levy taxes to cover outlays.

He further emphasizes again that the opportunity costs of public spending are shifted to future generations because those who give up resources today, i.e., the lenders do so in exchange for valued claims, e.g., government bonds, against future taxpayers, who will have restricted fiscal space to serve their own spending needs. The interaction between burden shifting of government debt, with which Buchanan's analysis started 60 years ago, and the political economics of public debt is obvious from these quotes. The conclusion that must be drawn from this analysis is also straightforward: The constitutional setting must be changed.

Institutional Restraints on Public Debt

If public choice mechanisms are a reason for the deficit bias in fiscal policies, institutions must indeed play a role for the variation in public debt to GDP ratios that is observed across time and countries. Moreover, institutions should affect the expectations of financial markets regarding the sustainability of public debt in the sense that a country is willing and able to service its debt. Such reasoning offers chances for positive analysis, but also leads to the normative question as to how a democratic regime should be designed in order to induce sound fiscal policies.

The first step of such a positive analysis is a comparison of public debt between different constitutional systems. Persson and Tabellini (2003) hypothesize the different incentives in majoritarian vs. proportional representation systems and in presidential vs. parliamentarian democracy as well as the interactions between these regimes. They argue that public debt will be higher in parliamentarian and proportional representation systems because these systems favor broad-based redistributive systems and higher political rents. The evidence regarding differences between these systems is however inconclusive as, e.g., neither Funk and Gathmann (2013) nor Pfeil (2017) can support their analysis. A reason may be that log-rolling and pork-barrel politics may be similarly strong, though different in those systems.

The evidence is much more conclusive regarding the comparison between direct and representative democracy. The literature focuses on the effects on particular referendums, for example, the Swiss fiscal referendum as a veto instrument. If spending exceeds a certain threshold, a fiscal referendum must be held. The type of spending that usually induces such fiscal referendums is investment spending which is often financed by public debt. More generally, however, the possibilities for log-rolling and pork-barrel politics are lower in referendums and initiatives as compared to parliament. It is thus no surprise that evidence speaks in favor of a lower deficit bias in direct democracy (Kiewiet and Szakaly 1996; Feld and Kirchgässner 2001a; Blume et al. 2009; Feld et al. 2011).

Federalism vs. unitarianism provides for another prominent system comparison. The difficulty in that comparison results from the many characteristics of the different federalisms around the world. There are systems of cooperative federalism in which tax and spending responsibilities are not properly assigned such that liability and control deviate at the different government levels. An example is Germany with its strongly egalitarian fiscal equalization system, highly centralized taxing and decentralized spending powers. In systems with taxing and spending powers assigned to each level of government, a stronger fiscal competition results. Such types of competitive fiscal federalism do not restrict consolidation efforts of governments and have lower public debt (Schaltegger and Feld 2009b; Foremny 2014; Asatryan et al. 2015).

Aside from these overall system comparisons, fiscal rules figure prominently in the discussions about institutional constraints on excessive spending and excessive indebtedness. The early literature on balanced budget rules in the U.S. is ambiguous with respect to its spending effects (Kirchgässner 2002), but more conclusive regarding public debt (Bohn and Inman 1996; Burret and Feld 2014). These early analyses on the effects of fiscal rules show that much depends on their design. Simple rules, rules that are too crude, offer many possibilities to circumvent them (Von Hagen 1991). Bohn and Inman (1996) have thus offered a list of characteristics of balanced budget rules in the U.S. that seemed to have worked. One such characteristic is that they are fixed at the constitutional level, a proposal that Buchanan has supported again and again.

Similarly, the more recent discussion about second generation fiscal rules asks for sophisticated rules, like the Swiss or German debt brakes (Eyraud et al. 2018). Both fiscal rules, having a broad coverage in general, require an (almost) balanced budget across the business cycle, i.e., structural budget balance, such that automatic stabilizers are allowed to work. They allow for well-defined escape clauses as additional, but clearly defined exceptions to the rule in which deficits may be higher. Budgeting mistakes are accounted for on a separate adjustment account and must be balanced after a certain time. And, following Buchanan (1997), they do not allow for deficits to cover investment spending.

The Swiss federal debt brake has been inspired by cantonal fiscal rules that effectively restrain cantonal public debt (Feld and Kirchgässner 2001b, 2008; Krogstrup and Wälti 2008; Burret and Feld 2018a, b). Feld et al. (2017) provide evidence that these cantonal debt brakes, in addition to the credible no bailout clauses, reduce risk premia of the Swiss cantons. Pfeil and Feld (2016), using the Synthetic Control Method, present evidence that the Swiss federal debt brake reduced the cyclically adjusted budget balance. In a meta-analysis, Heinemann et al. (2018), considering 25 studies with 889 observations, show that fiscal rules have a significantly negative correlation with primary deficits and budget deficits. Overall, this broad research outcome strongly supports Buchanan's (1997) claim for a balanced budget amendment.

Conclusion

James Buchanan pioneered the political economics of public debt. Buchanan (1958) was concerned with a shifting of the debt burden to future generations, Buchanan and Wagner (1977) accused Keynesianism of being responsible for fiscal profligacy. Keynesian follies undermined the informal (moral) rules of fiscal prudence that prevailed before the Keynesian revolution set in (Buchanan 1985, 1987). Buchanan's (1997) conclusion was straightforward: Informal rules that shaped fiscal policy in many countries until the 1960s should be replaced by formal rules, i.e., balanced budget amendments to constitutions or, in general, fiscal rules.

In this paper, we have traced the development of public debt in OECD countries across time raising first concerns of excessive indebtedness in those countries. A discussion of the sustainability of public finances indicates that there is a shift of public debt to future taxpayers in particular when they face the danger of financial markets withdrawing their confidence in a country's willingness or ability to pay. There are traditional economic reasons for public debt (business cycle, public investment, particular single events (unification, natural desasters)), but they cannot explain lacking consolidation in better times. Two political-economic explanations particularly add to the understanding of excessive debt: Elections and common pool problems. Institutional rules influence whether such political economics mechanisms more or less severely affect fiscal policy. According to the recent evidence, well-designed fiscal rules help to obtain sound public finances.

In sum, it seems as if Buchanan's thinking about public debt had finally convinced policy-makers and constituencies around the world. Many countries, in particular in Europe, have introduced fiscal rules or improved existing rules. However, Leviathan lives on and particularly fights back since the Great Recession. Anyway, I found out that Jim Buchanan was in a good intellectual neighborhood to one of the leading classical liberals in Switzerland in the nineteenth century. In his book, *Weltgeschichtliche Betrachtungen* Jakob Burckhardt (1921, p. 132, my translation) wrote: "*We should anyway shut up against the middle ages, as those times did not bequeath public debt to their successors*."

References

Alesina, A., & Passalacqua, A. (2016). The Political Economy of Government Debt. In J. B. Taylor & H. Uhlig (Eds.), *Handbook of Macroeconomics* (Vol. 2, Ch. 33, pp. 2599–2651). Amsterdam: North Holland.

Alesina, A., & Perotti, R. (1995). The Political Economy of Budget Deficits. *IMF Staff Papers, 42,* 1–31.

Asatryan, Z., Feld, L. P., & Geys, B. (2015). Partial Fiscal Decentralization and Sub-National Government Fiscal Discipline: Empirical Evidence from OECD Countries. *Public Choice, 163,* 307–320.

Blanchard, O. J. (1993). Suggestions for a New Set of Fiscal Indicators. In H. A. A. Verbon & F. Van Winden, (Eds.), *The Political Economy of Debt*. Amsterdam: North Holland.

Blanchard, O. J., Chouraqui, J.-C., Hagemann, R. P., & Sartor, N. (1990). The Sustainability of Fiscal Policy: New Answers to an Old Question. *OECD Economic Studies, 15,* 7–36.

Blume, L., Müller, J., & Voigt, S. (2009). The Economic Effects of Direct Democracy—A First Global Assessment. *Public Choice, 140,* 431–461.

Bohn, H. (1995). The Sustainability of Budget Deficits in a Stochastic Economy. *Journal of Money, Credit and Banking, 27,* 257–271.

Bohn, H. (1998). The Behaviour of U.S. Public Debt and Deficits. *Quarterly Journal of Economics, 113*, 949–963.

Bohn, H. (2008). The Sustainability of Fiscal Policy in the United States. In R. Neck & J. Sturm (Eds.), *Sustainability of Public Debt* (pp. 15–49). Cambridge and London: MIT Press.

Bohn, H., & Inman, R. P. (1996). Balanced-Budget Rules and Public Deficits: Evidence from the U.S States. *Carnegie-Rochester Conferences Series on Public Policy, 45,* 13–76.

Buchanan, J. M. (1949). The Pure Theory of Government Finance: A Suggested Approach. *Journal of Political Economy, 57,* 496–505.

Buchanan, J. M. (1958). *Public Principles of Public Debt: A Defense and Restatement*. Homewood, IL: Richard D. Irwin.

Buchanan, J. M. (1964). Public Debt, Cost Theory, and the Fiscal Illusion. In J. M. Ferguson (Ed.), *Public Debt and Future Generations* (pp. 150–163). Chapel Hill: University of North Carolina Press.
Buchanan, J. M. (1967). *Public Finance in Democratic Process*. Chapel Hill: The University of North Carolina Press.
Buchanan, J. M. (1968). *Debt, Public, International Encyclopedia of the Social Sciences* (Vol. 4, pp. 28–34). London and New York: Macmillan.
Buchanan, J. M. (1985). The Moral Dimension of Debt Financing. *Economic Inquiry, 23,* 1–6.
Buchanan, J. M. (1987). Budgetary Bias in Post-Keynesian Politics: The Erosion and Potential Replacement of Fiscal Norms. In J. M. Buchanan, C. Rowley, & R. D. Tollison (Eds.), *Deficits* (pp. 180–198). New York: Blackwell.
Buchanan, J. M. (1990). *Socialism Is Dead, But Leviathan Lives On* (The John Bonython Lecture, CIS Occasional Paper 30). Sydney: Centre for Independent Studies. Quoted According to the Republished Version In *The Logical Foundations of Constitutional Liberty*, *The Collected Works of James Buchanan* (Vol. 1, pp. 179–188). Indianapolis, IN: Liberty Fund, 1999.
Buchanan, J. M. (1997). The Balanced Budget Amendment: Clarifying the Arguments. *Public Choice, 90*, 117–138. Quoted According to the Republished Version In *Debt and Taxes*, *The Collected Works of James Buchanan* (Vol. 2, pp. 493–518). Indianapolis, IN: Liberty Fund, 2000.
Buchanan, J. M., & Tullock, G. (1962). *The Calculus of Consent*. Ann Arbor: University of Michigan Press.
Buchanan, J. M., & Wagner, R. (1977). *Democracy in Deficit: The Political Legacy of Lord Keynes*. New York: Academic Press.
Burckhardt, J. (1921). *Weltgeschichtliche Betrachtungen* (4th ed.). Stuttgart: W. Spemann.
Burret, H. T., & Feld, L. P. (2014). Political Institutions and Fiscal Policy: A Note on Budget Rules and Fiscal Federalism. *CESifo DICE Report, 1,* 3–11.
Burret, H. T., & Feld, L. P. (2018a). (Un-)Intended Effects of Fiscal Rules. *European Journal of Political Economy, 52,* 166–191.
Burret, H. T., & Feld, L. P. (2018b). Vertical Effects of Fiscal Rules: The Swiss Experience. *International Tax and Public Finance, 25,* 673–721.
Burret, H. T., Feld, L.P., & Köhler, E.A. (2013). Sustainability of Public Debt in Germany—Historical Considerations and Time Series Evidence. *Jahrbücher für Nationalökonomie und Statistik* [Journal of Economics and Statistics], *233*, 291–335.
Burret, H. T., Feld, L. P., & Köhler, E. A. (2016). (Un-)Sustainability of Public Finances in German Laender: A Panel Time Series Approach. *Economic Modelling, 53,* 254–265.

Burret, H. T., Feld, L. P., & Köhler, E. A. (2017), The Fiscal Sustainability of the German Laender: Time Series Evidence. *Finanzarchiv* [Public Finance Analysis], *73*, 103–132.
Calvo, G. A. (1988). Servicing the Public Debt: The Role of Expectations. *American Economic Review, 78,* 647–661.
D'Erasmo, P., Mendoza E. G., & Zhang, J. (2016). What Is a Sustainable Public Debt? In J. B. Taylor & H. Uhlig (Eds.), *Handbook of Macroeconomics* (Vol 2, Ch. 32, pp. 2493–2597). Amsterdam: North-Holland.
De Haan, J., & Klomp, J. (2013). Conditional Political Budget Cycles: A Review of Recent Evidence. *Public Choice, 157,* 387–410.
De Haan, J., & Sturm, J.-E. (1994). Political and Institutional Determinants of Fiscal Policy in the European Community. *Public Choice, 80,* 157–172.
De Haan, J., Sturm, J.-E., & Beekhuis, G. (1999). The Weak Government Thesis: Some New Evidence. *Public Choice, 101,* 163–176.
Domar, E. D. (1944). The 'Burden of the Debt' and the National Income. *American Economic Review, 34*, 798–827.
Egger, P., & Köthenbürger, M. (2010). Government Spending and Legislative Organization: Quasi-Experimental Evidence from Germany. *American Economic Journal: Applied Economics, 2,* 200–212.
Eyraud, L., Debrun, X., Hodge, A., Lledó, V., & Pattillo, C. (2018). *Second-Generation Fiscal Rules: Balancing Simplicity, Flexibility, and Enforceability* (IMF Staff Discussion Note SDN/18/04). Washington, DC: IMF.
Feld, L. P., Kalb, A., Moessinger, M.-D., & Osterloh, S. (2017). Sovereign Bond Market Reactions to Fiscal Rules and No-Bailout Clauses—The Swiss Experience. *Journal of International Money and Finance, 70*, 319–343.
Feld, L. P., & Kirchgässner, G. (2001a). Does Direct Democracy Reduce Public Debt? Evidence from Swiss Municipalities. *Public Choice, 109,* 347–370.
Feld, L. P., & Kirchgässner, G. (2001b). The Political Economy of Direct Legislation: Direct Democracy and Local Decision-Making. *Economic Policy, 16,* 329–367.
Feld, L. P., & Kirchgässner, G. (2008). On the Effectiveness of Debt Brakes: The Swiss Experience. In R. Neck & J.-E. Sturm (Eds.), *Sustainability of Public Debt* (pp. 223–255). Cambridge, MA and London: MIT Press.
Feld, L. P., Kirchgässner, G., & Schaltegger, C. A. (2011). Municipal Debt in Switzerland: New Empirical Results. *Public Choice, 149,* 49–64.
Feld, L. P., Köhler E. A., & Wolfinger, J. (2018). *Modeling Fiscal Sustainability in Dynamic Macro-Panels with Heterogeneous Effects: Evidence from German Federal States* (CESifo Working Paper No. 6976). Munich.

Foremny, D. (2014). Sub-National Deficits in European Countries: The Impact of Fiscal Rules and Tax Autonomy. *European Journal of Political Economy, 34,* 86–110.
Foremny, D., Freier, R., Moessinger, M.-D., & Yeter, M. (2018). Overlapping Political Budget Cycles. *Public Choice, 177*, 1–27.
Fritz, B., & Feld, L. P. (2015). *The Political Economy of Municipal Amalgamation: Evidence of Common Pool Effects and Local Public Debt* (CESifo Working Paper No. 5676). Munich.
Funk, P., & Gathmann, C. (2013). How Do Electoral Systems Affect Fiscal Policy? Evidence from Cantonal Parliaments, 1890–2000. *Journal of the European Economic Association, 11,* 1178–1203.
Heinemann, F., Moessinger, M.-D., & Yeter, M. (2018). Do Fiscal Rules Constrain Fiscal Policy? A Meta-Regression-Analysis, *European Journal of Political Economy, 51,* 69–92.
Homburg, S. (1991). Interest and Growth in an Economy with Land. *Revue canadienne d'Economique* [Canadian Journal of Economic], *24*, 450–459.
Kiewiet, D. R., & Szakaly, K. (1996). Constitutional Limitations on Borrowing: An Analysis of State Bonded Indebtedness. *Journal of Law Economics and Organization, 12,* 62–97.
Kirchgässner, G. (2002). The Effects of Fiscal Institutions on Public Finance: A Survey of the Empirical Evidence. In S. L. Winer & H. Shibata (Eds.), *Political Economy and Public Finance: The Role of Political Economy in the Theory and Practice of Public Economics* (pp. 145–177). Cheltenham: Edward Elgar.
Krogstrup, S., & Wälti, S. (2008). Do Fiscal Rules Cause Budgetary Outcomes? *Public Choice, 136,* 123–138.
Lucas, R. E., & Stokey, N. L. (1983). Optimal Fiscal and Monetary Policy in an Economy Without Capital. *Journal of Monetary Economics, 12,* 55–93.
Mauro, P., Romeu, R., Binder, A., & Zaman, A. (2015). A Modern History of Fiscal Prudence and Profligacy. *Journal of Monetary Economics, 76*, 55–70.
Morris, S., & Shin, H. S. (1998). Unique Equilibrium in a Model of Self-Fulfilling Currency Attacks. *American Economic Review, 88,* 587–597.
Perotti, R., & Kontopoulos, Y. (2002). Fragmented Fiscal Policy. *Journal of Public Economics, 86,* 191–222.
Persson, T., & Tabellini, G. (2003). *The Economic Effects of Constitutions: What Do the Data Say?* Cambridge and London: MIT Press.
Pettersson-Lidbom, P. (2001). An Empirical Investigation of the Strategic Use of Debt. *Journal of Political Economy, 109,* 570–583.
Pettersson-Lidbom, P. (2012). Does the Size of the Legislature Affect the Size of Government? Evidence from Two Natural Experiments. *Journal of Public Economics, 96,* 269–278.

Pfeil, C. (2017). *Electoral System Change and Spending: Four Quantitative Case Studies* (Doctoral dissertation). University of Freiburg, Freiburg.

Pfeil, C. F., & Feld, L. P. (2016). *Does the Swiss Debt Brake Induce Sound Federal Finances? A Synthetic Control Analysis* (CESifo Working Paper No. 6044). Munich.

Potrafke, N., & Reischmann, M. (2015). Fiscal Transfers and Fiscal Sustainability. *Journal of Money, Credit and Banking, 47,* 975–1005.

Roubini, N., & Sachs, J. D. (1989a). Political and Economic Determinants of Budget Deficits in the Industrial Democracies. *European Economic Review, 33,* 903–938.

Roubini, N., & Sachs, J. D. (1989b). Government Spending and Budget Deficits in the Industrial Countries. *Economic Policy, 8,* 99–132.

Schaltegger, C. A., & Feld, L. P. (2009a). Do Large Cabinets Favor Large Governments? Evidence on the Problem for Swiss Cantons. *Journal of Public Economics, 93*, 35–47.

Schaltegger, C. A., & Feld, L. P. (2009b). Are Fiscal Adjustments Less Successful in Decentralized Governments? *European Journal of Political Economy, 25*, 115–123.

Schularick, M., & Taylor, A. (2012). Credit Booms Gone Bust: Monetary Policy, Leverage Cycles, and Financial Crises. *American Economic Review, 102,* 1029–1061.

Velasco, A. (1999). A Model of Endogenous Fiscal Deficits and Delayed Fiscal Reforms. In J. M. Poterba & J. von Hagen (Eds.), *Fiscal Institutions and Fiscal Performance* (pp. 37–57). Chicago: University of Chicago Press.

Velasco, A. (2000). Debts and Deficits with Fragmented Fiscal Policymaking. *Journal of Public Economics, 76,* 105–125.

Von Hagen, J. (1991). A Note on the Empirical Effectiveness of Formal Fiscal Restraints. *Journal of Public Economics, 44,* 199–210.

Weingast, B. R., Shepsle, K., & Johnson, C. (1981). The Political Economy of Benefits and Costs: A Neoclassical Approach to Distributive Politics. *Journal of Political Economy, 96,* 132–163.

43

The Irresistible Attraction of Public Debt

Vito Tanzi

Introduction

Until the decade of the 1940s public debt had not enjoyed a particularly good reputation with economists, even though they were aware that in particular situations, such as major wars or major catastrophes, public borrowing might become unavoidable, as it had in England, during the Napoleonic Wars, and, perhaps, in the USA, during the years of the Second World War. In those war years the share of public debt into GDP reached very high levels. However, in more normal times, public spending was expected to be financed by current taxes and by other ordinary sources of public revenue (fees, fines and so on). Therefore, public debt was expected to remain controlled.

In *The Wealth of Nations* (1937 [1776]), Adam Smith discussed public borrowing and was highly critical of governments that engaged in

V. Tanzi (✉)
Former Director of the Fiscal affairs Department of the IMF
and Honorary President of the International Institute of Public Finance,
Munich, Germany

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent
Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_43

that activity. He dedicated many pages to public debt and (on p. 883) concluded that: "all states…have on some occasions played this very juggling trick [the "trick" of replacing tax revenue with borrowing]". He continued: "When national debts have …been accumulated to a certain degree, there is scarce… a single instance of their having been fairly and completely paid. The liberation of public revenue, if it is ever been brought about at all, has always been brought by bankruptcy: sometimes an avowed one, but always a real one, …..". Thus, Smith was concerned with the issue of debt sustainability, and also with the impact of debt default on the creditors who had lent money to the government.

David Hume, a contemporary of Adam Smith, introduced a more explicit "public choice" angle to the issue. He wrote that: "It is tempting to a minister to employ such an expedient [i.e. public borrowing], as it enables him to make a great figure during his administration without overburdening the people with taxes, or exercising immediate clamors against himself. The practice, therefore, of contracting debt will almost infallibly be abused in every government". This can be considered the "fatal attraction" of public debt. Therefore, "…. the consequences [of contracting public debt]….must indeed be one of….two events; either the nation must destroy public credit, [by repaying it with tax revenue and relying on taxes], or public credit will destroy the nation" (Hume 1970, p. 92).

Hume was thus concerned about the negative impact that high public debt could have on a "nation". His position anticipated to some extent some of the views held later by "public choice" economists, including James Buchanan, as Buchanan outlined them in Part VI of his 1970 textbook—*The Public Finances* (1970)—, and in some other writings on the issue. As he put it, "… debt creation provides one way of financing public services without *current* costs" (see p. 304, italics added).

Over the last three centuries, and until the 1940s, most economists had shared Smith's and Hume's negative view of public borrowing. See, for example, several chapters in Volume 2 of Paul Leroy-Beaulieu's 1888, encyclopedic treatise on public finance. Others, as for example De Viti De Marco (1936), had called attention to the importance of the use to which the borrowed money is put by the government, in judging the merit of (limited) public borrowing. Prominent political figures, including Napoleon, George Washington and some others, also, had made statements criticizing the practice of public borrowing. George Washington, for example, believed that: "there is no practice more dangerous than that of borrowing money".

The attitude of economists toward public borrowing and towards the accumulation of public debt in normal times started to change, as a consequence of the "Keynesian Revolution", especially in the 1940s, when Keynes' views on countercyclical fiscal policy became popular, and after the dramatic experience of the Great Depression, in the 1930s. The Great Depression had pushed the unemployment rate in the USA to 25% and had reduced output by an even larger percentage. It had also created some strong arguments in favor of governmental intervention to stabilize an economy.

The growth in public spending and in public debt, that had occurred during the Second World War, largely financed by debt, was credited, by Keynesian economists, as having pulled the US economy out of the Great Depression. Keynes' writings had convinced an increasing number of economists and politicians, including F. D. Roosevelt, that an economic policy associated with the creation of significant fiscal deficits during economic slowdowns, and the accumulation of public debt, could help reduce the pain of recessions. When the Keynesian Revolution became popular, fiscal deficits came to be seen in a new light: they became tools that governments could use to promote full or fuller employment. See, on this, especially the 1962 *Economic Report of the President*. As a consequence, the accumulation of public debt ceased to be feared, or to be considered a sin, as it had been in the past, and Keynesian economists dismissed the significance of public debt because they assumed that it was a debt that a nation owed to itself.

After the "Great Recession" of 2008–2010, and its impact on output and employment, several well-known and highly vocal economists pushed governments, in the USA and in Europe, to abandon what they called "austerity", and to increase public spending, using borrowed money to do so. They also encouraged central banks to provide cheap credit (see Tanzi 2013, 2015). Similar advice had been given to Japan in the 1990s, when its rate of growth had slowed down, and to some countries from Southeast Asia, during the 1997–1998 financial crisis in that region (see Tanzi 2008, pp. 122–125).

"Austerity", that in the past had been universally considered a public virtue, came to be seen by some as a serious sin, and its pursuit by governments was sharply criticized by some economists, including Paul Krugman, Joseph Stiglitz, and others. The "Keynesian Revolution" had clearly performed the remarkable miracle of transforming a sin, that in the past was assumed to lead to an economic Hell, into a virtue, that would lead countries to an economic Heaven. If that Revolution had been a person, it would have merited Sainthood in the Catholic Church.

Reasons for Public Borrowing

Countries borrow when they wish to spend more money that they get from taxes and from other ordinary revenue. This often happens during major wars and catastrophes. In addition to wars and catastrophes, depressions and recessions can lead to, or can be used to justify, public borrowing by reducing revenue or putting pressure for more public spending. With the passing of time, other potential justifications for borrowing have been suggested by economists and politicians. After World War Two, when the pursuit of growth and economic developments became explicit and development economics and growth theory became important branches of economics, some economists theorized that development and growth could be promoted with government spending, or with other policies, such as tax incentives and an accommodating monetary policy. Fiscal deficits and public debt became new, important policy tools available to, and increasingly used by, governments.

Various reasons were introduced to justify public borrowing. These included the pursuit of economic developments and of full employment. Some economists also argued that major public investment projects (associated with what was called a "big push" in infrastructure building), to be made in a relatively short time period, would justify borrowing, in order to make future generations (that would benefit from the use of the new infrastructure), pay, or help pay, for them. However, there was disagreement among economists on whether *routine*, annual, investment spending, as distinguished from "a big push", should be financed by debt.

A so-called "golden rule", a rule supported by some economists and occasionally used by some governments, promoted the view that public investments should be financed by debt. Furthermore, some economists proposed also that the "golden rule" should be used to estimate the size of annual fiscal deficits. That rule required that investment spending should be excluded from the calculation of annual deficits, when fiscal rules constrained the size of those deficits. The use of the "golden rule", thus, made the fiscal accounts, of countries that engaged in investment spending, look healthier than they might actually be. There are, of course, some potential problems with the use of the "golden rule". Its proponents tended to ignore them, or to assign to them only marginal importance. Let us mention some of them.

First, there is no firm agreement (among public accountants or among economists), on what kind of public spending should be clearly classified as "investment". Different countries seem to use different criteria for making that determination. In the presence of a domestically or externally imposed fiscal rules (as, say, the Maastricht Rule, or a balanced budget rule) that put limits to the size of the fiscal deficit, this lack of agreement can lead to intentional misclassification of some spending.

Second, regardless of classification, some public investment is or might not be productive. Therefore, they do not contribute to economic growth. However, if the investment has been financed by debt, it must still be serviced in future years. The lower is the productivity of an investment, and the higher is the cost of borrowing, the greater can be the future debt servicing problems. Evidence from many countries indicates that, often, public investments are undertaken in the absence of competent and objective cost benefit analysis of the projects. Therefore, for political or other reasons, public investments tend to include what are called "white elephants", "cathedrals in the desert", or "roads to nowhere".

Third, some spending, that is not classified as investment (such as "operations and maintenance", or "research and development") may be more productive than what is officially classified as investment. This spending might be penalized by a rule that gives more importance to "investment", or that excludes investment spending from the measurement of the fiscal deficit but includes "operation and maintenance".

The spending on unproductive public investments is not just the consequence of honest mistakes, or bad choices, in the selection of projects. It is also the result of corruption in the choices of projects and in the process of actually making the investments. Various studies have indicated that corruption often finds a fertile ground in investment decisions (see, for example, Tanzi and Davoodi 1998). The Italian Corte dei Conti (the Italian Accountability Office), in 2014, reported that up to 40% of spending in public investments in Italy might be attributed to the payment of bribes and to other corruption-related expenses. Similar results have been reported for other countries. This kind of "public investment", and the "public debt" that it creates, contribute neither to economic growth nor to higher, future public revenue, that could help pay for the debt. However, it still contributes to the future, higher government costs to service the (higher) public debt that they generate.

Many modern economists would agree that fiscal deficits (and the increase in public debt that they cause), which are generated by the natural action of "built-in stabilizers", during genuine economic recessions, could and should be financed, in the short run, by public borrowing. However, many of them would disagree with a view—pushed in recent years by Larry Summers, Paul Krugman and some others—that the American economy may be suffering from "secular stagnation". Therefore, its rate of growth has fallen below the country's long run growth potential. In the view of Summers and Krugman, this fall would justify a *sustained* fiscal injection that would increase the size of the public debt at least over the short run.

Apart from the questionable assumption that the potential growth rate is higher than the actual, the problem with the above view is that high public debt inevitably creates greater uncertainly, including that associated with the possibility of future tax increases, or future fiscal crises. And higher public debt and more uncertainty, inevitably, have a negative impact on economic growth (see Tanzi 2015) and Tanzi and

Chalk (2000). Some measures of uncertainty have become available in recent years. They have indicated that uncertainty has grown in recent years, as a consequence of greater fiscal activism and higher public debt levels (see Baker et al. 2013).

Some years ago, Robert Barro had advanced the hypothesis that "tax smoothing" may be a justification for contracting public debt. In the face of a "temporary" increase in public spending, or a "temporary" fall in tax revenue, debt accumulation to finance the fiscal deficits might allow the statutory tax rates to remain (almost) constant. That is, debt would become a substitute for increasing the tax rates. The constancy in tax rates in the short run is supposed to reduce the disincentive effects that might accompany an increase in those rates, in the absence of public borrowing.

Barro's tax smoothing hypothesis can be criticized on at least two grounds. First, a temporary expenditure could be financed by exceptional, once-for-all taxes on wealth, on incomes, or on sales. These temporary taxes should not be expected to have strong disincentive effects, because those effects take time to materialize because they require changes in economic behavior (such as changes in Jobs), and those changes take time. The disincentive effects of high tax rates are likely to grow with time. The shorter the time, the less significant they are likely to be.

The above discussion has indicated how, over the years, economists have added more reasons for governments to rely on public debt, to achieve an increasing number of objectives. This has become a normal trend in government behavior (see Tanzi 2018). Like the traditional "snake oil", that was supposed to cure many diseases, fiscal deficits and the debt that they generate have become increasingly popular features of modern economies to deal with various goals.

Introducing an Explicit Public Choice Perspective

As David Hume anticipated three centuries ago, and as James Buchanan stressed in some of his writings, there is likely to be an important public choice perspective in the governments' reliance on public debt.

Buchanan believed that a government had no justification to spend today while passing the burden on future citizens, who have not participated in the decisions. This public choice perspective, of course, always existed, as Hume recognized. However, it became more evident in recent decades, for various supply or demand reasons. It would be difficult to explain the phenomenal growth in public debt around the world in recent decades, a growth that cannot be attributed to major wars or catastrophes, without recognizing the public choice perspective. That perspective helps us understand why governments, especially in democratic countries with market economies, that regularly have to face elections, seem to have a fatal attraction for public debt.

That attraction was strengthened in recent decades, when the supply of credit that many governments faced became more elastic and more accommodating, while citizens' resistance to higher taxes also increased. Available statistics from OECD indicate that, since the beginning of the new millennium, the tax levels of most advanced countries have not increased, while the public debts of those countries have grown considerably. It must have become easier and cheaper for governments to replace tax increases with more borrowing, in making decisions about additional spending or about cutting tax levels.

The greater elasticity of the supply of credit was generated, in recent decades, by the globalization of the financial market, by the growing sophistication of those who operate in it, and by the role played by central banks in providing easy credit, partly due to the belief, since the 1980s, that monetary policy can be a powerful instrument in preventing economic downturn, or deflation. This latter belief is relatively new. It did not exist during the years of the Keynesian Revolution when fiscal policy was expected to play the leading role.

The attraction of public borrowing for governments reflects the normal and inevitable conflict that exists between *political* decisions, that tend to be influenced by short run considerations, and good *economic* decisions, that should be influenced by a longer time perspective, and not by short run, political, objectives. This conflict between the short run and the long run is common in many areas of economics. However, the role and the importance of different time lags on the effects of policies on the economy has rarely been explicitly recognized by economists, when they recommend policies. Democratic governments, that must face elections in the not too distant future, recognize and are aware of the fact that they can gain *short run* political benefits (such as winning votes in the next elections) if they can generate short run gains for the citizens, while pushing the costs, or the negative, economic consequences of their policies, into the future, and possibly on other governments.

Economists have not appreciated enough how the different timing of the impact of the costs and the benefits of policies often determines, or influences, the choice of governmental actions. Policies that provide benefits in the short run, but that push the costs to the longer run, tend to be preferred, as Hume, and later Buchanan and others, recognized. Spending money with borrowed funds achieves exactly that objective, especially when interest rates are low and maturities can be lengthened.

During the early years of the Reagan Administration, when, because of high fiscal deficits and high interest rates, that Administration was borrowing a lot of money, making the US public debt grow rapidly, James Buchanan was one of the few voices among economists that criticized that development. He did not like red ink and was a firm believer in "pay as you go". Another similar voice at that time was that of Jacques de Larosiere, then the Managing Director of the IMF (see de Larosiere 2018, pp. 127–128). It should be mentioned that, at that time, the US debt and those of most advanced countries were still low and much lower than they are today.

Some Statistics on Public Debt

Developments in the accumulations of public debts in recent decades have been alarming. In April 2018, an IMF study reported that, in 2016, global debt (both public and private) had reached $164 trillion, or 225% of global GDP (IMF 2018)! The public debt of advanced economies had reached 105% of their GDPs. Of the total debt (public and private), 63% was non-financial private debt, while 37% was public debt.

In several countries, including the United States, the ratio of public debt to GDP in 2016 exceeded 100%. In some cases—Japan and Greece—it exceeded that level by very large amounts.

These are extraordinary figures, especially considering that they were reached during a period that did not have major wars or catastrophes. Much of the increase had come after 1980 and, especially, in the last decade. It should be added that the cost of servicing the debt has been kept modest by the extraordinary monetary policies that the central banks have been following in recent years. Given the current debt levels, should interest rates return to historical levels, the weight of the debt would become crushing and several countries would face bankruptcy.

The current level of public debt points to likely future fiscal difficulties for several countries, including the USA, in spite of some optimistic analyses (see, for example, Auerbach and Gorodnichenko 2017). For the USA, growing concerns about the sustainability of its fiscal policy have been raised from several quarters. The US fiscal deficit has been estimated, by the Congressional Budget Office, to reach one trillion dollars in 2019, and to continue growing in future years. This growth has been coming at a time of full employment, and after many years of economic expansion of the American economy. The future growth of the US public debt may have been accelerated by the 2018 tax reform, that cut tax revenue for future years. The short run political benefit of that reform has been bought at the expense of the longer run cost of a faster growing public debt, unless economic growth picks up more than most experts expect. A sudden and significant increase in interest rates, and/or a significant recession, could soon make the US debt burden unsustainable.

Public choice considerations and the increasing elasticity of the supply schedules of available credit, made, to a large extend, more elastic by the actions of central banks, help explain the growth of public debt in recent decades. It should be repeated that, in the first two decades of the new millennium, the tax levels of advanced countries did not increase, because of growing resistance to taxes in those countries. This must have encouraged government to take the easier road of more public borrowing.

Following David Hume, two phases can be recognized in the public debt story:

1. *a happy phase*, the phase when governments obtain and spend the extra resources through borrowing, and, as Hume observed, "[make] a great figure…without overburdening the people with taxes…". This is the time when the short run political benefits of contracting debt are most evident and most felt. This *happy phase* is often followed by
2. *a painful phase*, when the debt must be serviced (often, at higher interest rates), or must be repaid, by increasing the tax burden on the citizens, or, when that is difficult, by reducing public spending which is equally difficult. Several countries started to have to face this *painful phase* in recent years. However, if current policies are not changed, the worst may still come later, and it may be more painful.

Obviously, the shorter is the time perspective of a government, the greater is the value that it attributes to the "happy phase", and the less importance it attributes to the, more distant, "painful phase". A government that believes that it will remain in power for a long time may be less influenced by these public choice considerations and many governments tend to suffer from some forms of optimism about the future. For example, they may believe that increasing public spending and fiscal deficits today, or by reducing taxes, even when they cannot afford to do so, they will stimulate enough the future economic growth and the growth of tax revenue to avoid, or to be able to deal with future fiscal difficulties. This optimism was at the center of many countries' fiscal policies after the "Great Recession". And some economists that should have known better, inspired and encouraged it. It was a clear contributor to the growth in public debts (see Tanzi 2013, 2015).

The better is the use made of borrowed funds, during the "happy phase", the less damaging is likely to be the "painful", or the "repayment", phase. If, during the "happy phase", the borrowed funds have been used efficiently, in investments that have a high rate of return; or, in the case of countercyclical fiscal policy, if they have truly and significantly stimulated the economy, promoting a fast expansion, the future income of the country will increase, thus facilitating the servicing and/or the repayment of the debt. This outcome would reduce the need for imposing painful policies, such as raising taxes or cutting spending, later. However, as Adam Smith recognized three centuries ago, this is not what often happens. Often, the borrowed funds, obtained to buy votes, stimulate the economy less than hoped: or they are not used in activities with high rates of return. See the examples of Argentina and Greece.

The concept of *efficiency* in the use of borrowed resources refers to their ability to raise the productive capacity of an economy, and not to its ability to solve some social problems; as important as those problems may be. The solution of social problems should be achieved with the use of ordinary revenue and not with debt. Therefore, a government should not borrow to, say, improve the distribution of income, or to pursue general social objectives, such as improving health and educational services, unless this action can be shown to lead to higher economic growth, and in a time short enough to facilitate the servicing of the public debt. Dealing with strictly social objectives will normally not facilitate the repayment of debts.

The government should also not borrow for *unproductive* investments, such as the building of "white elephants", even when these may seem to be prestigious, and thus politically attractive. Some of these investments have been financed because of their political attraction. They come to resemble public monuments: politically important but economically useless. Too many people and economists continue to believe that spending for what are called public investments always produces higher economic growth.

The preceding comments may seem trivial to many experts. Unfortunately, their message is often forgotten or ignored by the politicians who make the economic decisions. The fact that borrowing is often abused and is used for non-productive activities is evident from the frequency of defaults, and from the fiscal difficulties experienced by many countries.

In addition to the *happy phase* and a *painful phase*, the public debt story, at times, has a third phase. It could be called the *default phase.* That phase can be long, complex and painful, while it goes on, as the experiences, in recent years, of Argentina, Greece and some other countries have shown. This phase is too complex to be discussed in this paper.

On Different Forms of Borrowing

Domestic Borrowing

In past decades, when the countries' economies were mostly close and the financial markets were mostly national in character, there was little cross-countries' capital movement. The little that there was, resulted from direct investments, from loans obtained from international organizations, and from foreign aid, provided by some richer countries to poorer countries. Therefore, most of the borrowing by countries' governments came from domestic sources and, often, from their central banks, in addition to some forced loans, to the government, from domestic pension funds, public enterprises. and some other sources.

Domestic borrowing was inevitably constrained by the low saving rate of a country, and by the lack of sophistication of its financial market. When countries ran into debt problems, as it occasionally happened, it was due to the fact that they had borrowed too much from their central banks, through what was called "inflationary finance". Simply put, the central bank had printed money and had loaned it to the government that spent it. As that term implies, the borrowing often generated inflation and balance of payments difficulties. The reason was that the monetary expansion, associated with the public borrowing, generated aggregate demand, but did not contribute much to increasing the country's aggregate supply, making prices go up (see Tanzi 1978).

Foreign Borrowing

When, starting in the late 1970s, and especially in the 1980s and 1990s, countries became more open and capital flows across countries increased and became important, the possibility of borrowing from foreign sources increased in scope. In this new situation, the amount of borrowing, that a country's government could obtain, increased dramatically, until the country got into financial difficulties, that discouraged lending to it. High saving rates in China and in some other, especially Asian, countries, and more relaxed monetary policies pursued by the US Federal Reserve Bank, the European Central Bank and other central banks, increased the availability of funds that an increasingly sophisticated global financial market could make available to the governments that wanted to borrow. For reasons explained earlier, there were always governments that wanted to borrow.

The outcome from the changed conditions was that many governments (and also many private institutions) started to borrow more than they had done in the past from foreign sources. As mentioned earlier, over recent decades public borrowing and public debts increased considerably in many countries. Not surprisingly financial crises became also more frequent. At times, these crises became serious, as those of 1997–1998, in Southeast Asia, that of 2002 in Argentina, the 2004 crisis in Mexico, and the more global and more threatening crisis of 2008–2009, that affected many countries and that sharply increased the fiscal deficits of many countries.

A mystery that has remained without a convincing explanation, at least to this author, is why, so far, the increased borrowing has not led to high inflation, as might have been expected by the large increase in credit and in debt. In a strange and at times puzzling development, in recent years, policymakers have worried more about deflation than about inflation. The fact that countries' economies are no longer close, and that the impact of a credit expansion in a country is diffused to much of the world by globalization, must be part of the explanation; but it cannot be the full explanation. The possibility that lags may also be playing a role cannot be discounted so that inflation may raise again its ugly head in the future.

In a world with increasingly sophisticated private institutions, such as investment banks, hedge funds, private pension funds, and others, all eager to lend money to governments which seem to be in normal economic conditions, and not too risky, the supply of credit can become and has become highly elastic, at some rate of interest, for many countries.

There have been occasions when the ministers of finance of some borrowing countries have commented about the lines of bankers offering loans that form outside their hotel rooms, when they travel abroad. In these situations, it must have become increasingly difficult for some countries' policymakers to resist these offers. At times, governments have also manipulated their official statistics to give to the creditors a more favorable impression of the real situation of their fiscal accounts. All this has made the public choice explanations of borrowing highly plausible.

Foreign borrowing is also encouraged by fixed and possibly overvalued exchange rates that make foreign loans look cheap for some countries. The foreign debt crises of countries (some within the European Monetary Union) can be traced to a few elements, such as: (a) lack of good and reliable statistics; (b) a fixed exchange rate; (c) low maturity of the loans received; (d) the unproductive use of the resources obtained; and (e) mismatches between the maturity of the loans obtained and the time when the investments made with the funds borrowed begin to generate an economic return. The fact that borrowing is often in foreign currency (mostly in dollars or euros) when the exchange rate is fixed, makes a country particularly exposed to changes in the exchange rate and in interest rates. Past financial crises had led to some improvements in the quality of the statistical information. However, as the Greek experience indicated, statistics can still be manipulated by a government.

Concluding Comments

This paper has focused on developments in public debt. The paper has discussed the fact that in recent decades it became more difficult for many countries to increase their tax levels, because of increasing taxpayers' resistance to higher taxes and because of difficulties arising from globalization. At the same time credit has become cheaper and more available for many countries. Given this situation it is not surprising that, as price theory teaches us, governments have been more willing to buy more of the cheaper product. Public choice considerations have also encouraged this shift from taxes to debt especially if the market is underpricing the risks associated with more debt (Tanzi 2016). It should also be mentioned that the collection of taxes is accompanied by short run costs, such as costs of administration, for the government, and compliance costs, for taxpayers, that are absent when government uses loans. When the loans have long maturity and the interest rates are low, credit must be seen as a bargain especially to a government mostly focused on the short run.

References

Auerbach, A. J., & Gorodnichenko, Y. (2017, August 29). Fiscal Stimulus and Fiscal Sustainability. *Mimeo*.

Baker, S. R., Bloom, N., & David, S. J. (2013, January 1). Measuring Economic Uncertainty. *Mimeo*.

Buchanan, M. J. (1970). *The Public Finances*. Homewood, IL: Richard D. Irwin.

Congressional Budget Office. (2018). *Budget and Economic Outlook*. Washington, DC: Congressional Budget Office.

de Larosiere, J. (2018). *50 Years of Financial Crises*. Paris: Odile Jacob.

De Viti De Marco, A. (1936). *First Principles of Public Finance*. London: Jonathan Cape.

Hume, D. (1970). *Writings on Economics* (E. Rotwein, Ed.). Madison: The University of Wisconsin Press.

International Monetary Fund. (2018, April). Capitalizing on Good Times. *Fiscal Monitor*.

Smith, A. (1937 [1776]). *The Wealth of Nations.* New York: The Modern Library.

Tanzi, V. (1978). Inflationary Finance: Theory with an Application to Argentina. *IMF Staff Papers, 25*(4), 417–451.

Tanzi, V. (2008). *Peoples, Places and Policies: China, Japan and Southeast Asia.* New York: Jorge Pinto Books.

Tanzi, V. (2013). *Dollars, Euros and Debt*. London: Palgrave Macmillan.

Tanzi, V. (2015). Fiscal and Monetary Policy During the Great Recession: A Critical Evaluation. *Comparative Economic Studies, 57*, 243–275.

Tanzi, V. (2016). Pleasant Dreams or Nightmares, in the Public Debts Scenarios? *Ifo Schnelldienst, 9*, 27–36.

Tanzi, V. (2018). *The Termites of the State: Why Complexity Leads to Inequality*. New York: Cambridge University Press.

Tanzi, V., & Chalk, N. (2000). Impact of Large Public Debt on Growth in EU: A Discussion of Potential Channels. In *Public Debt and Fiscal Policy in EMU, European Economy* (Reports and Studies No. 2). European Commission.

Tanzi, V., & Davoodi, H. (1998). Corruption, Public Investment and Growth. In H. Shibata & T. Ihori (Eds.), *Welfare State, Public Investment and Growth*. New York: Springer.

44

Can There Be Such a Thing as Legitimate Public Debt in Democracy? De Viti de Marco and Buchanan Compared

Giuseppe Eusepi

> In public finance alone, debates over tax incidence, tax capitalization, public debt burden, and the role of cost-benefit analysis can be partially resolved when protagonists accept common concepts of cost.
>
> J. M. Buchanan, *Cost and Choice*, p. ix.

Introduction

In a private conversation with James Buchanan on the occasion of the centennial celebrations of the Faculty of Economics at Sapienza University of Rome in 2006, in which he was presented a parchment award in recognition of a fifty-year effort to inject into English-language fiscal theory insights central to the Italian School of Public Finance, he said that initially he had underestimated de Viti's influence on his

G. Eusepi (✉)
Faculty of Economics, Sapienza University of Rome, Rome, Italy
e-mail: Giuseppe.Eusepi@uniroma1.it

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_44

analysis. Central to our discussion was the role of public expenditure in debt treatment. His cogent reflections stimulated me to poke around the legitimization of public expenditures in order to weigh how and when they can be financed through debt.

This chapter analyzes the role of public expenditures by contrasting the Italian democratic tradition in Public Finance and the Anglo-Saxon tradition. The former trend of thought, whose leading scholar is Antonio de Viti de Marco, carried on the view that the basis of public finance was to be found in the fiscal price and the benefit principle; the latter trend of thought had its basis on the ability to pay principle and the related theory of sacrifice, which strongly inspired the Ricardian equivalence theorem. In particular, section "Constitutional Approach vs. Standard Approach on Public Debt" outlines major issues dealing with the microeconomic and macroeconomic approaches to the theory of public debt, while section "De Viti vs. Ricardo and Buchanan vs. Keynes" focuses on the critique of the mainstream theories, particularly de Viti's critique of Ricardo and Buchanan's critique of Keynes. But sections "Contractarian Constitutionalism and Debt" and "Contractarianism, Debt and Default" advocate what appears to be a thoroughly working out of de Viti's thought in Buchanan's works, especially *in Cost and Choice*. Section "A Final Thought" offers some concluding remarks.

Constitutional Approach vs. Standard Approach on Public Debt

In order to see whether there is a rationale for the creation of a legitimate public debt within constitutional political economy, this work investigates the similarity between de Viti de Marco and Buchanan from the standpoint of a contractarian approach. Although there is no absolute dividing line between de Viti and Buchanan, *prima facie* they might be thought of as different due to the completely different settings in which their ideas grew out. While de Viti's thought emerged out of a context permeated by the doctrinal body of the Machiavellians,[1] in Buchanan's case, it was self-government that gave a stamp to his analytical way of thinking. However, like all great thinkers, de Viti cannot be put in the strait jacket of classifications. He travels along both paths by developing the theory of the cooperative state, although as an ideal model, and of monopolistic state, which is at the basis of real democracies.

One might think that the diversity of their cultural background, worked as a barrier between de Viti and Buchanan. Yet, those who are familiar with these two scholars are not at all inclined to doubt that de Viti exerted an influence on Buchanan's elaboration of fiscal theory. To take De Viti's and Buchanan's contractarian views one step further, it is useful to highlight the two scholars' semantic consonance on fundamental aspects such as the protective and productive state, the centrality of exchange, tax price and, more importantly, the subjective theory of opportunity cost for its application in the analysis of public debt.

However, de Viti de Marco's contractual view makes us think that the creation of public debt, under particular budget conditions, such as those with the heaviest tax burdens and the emergence of new public needs, does not violate any constitutional principle. If it were so, Buchanan's propensity to justify default would involve a violation of the fundamental principles of constitutional logic, at least within the specific boundaries of this sphere. The point that becomes a legitimating element in my analysis is the quality of public expenditures as a justification of public debt. Postulating this, in order to understand the concept of the quality of expenditures I contrast the Anglo-Saxon tradition and the Italian school of Public Finance.

While the Anglo-Saxon tradition stressed the revenue side and ignored the expenditure side, the Italian democratic tradition in Public

[1]A select group of thinkers that included also Mosca (1939 [1896]) and Pareto (1935 [1923]). Mosca (1939 [1896]) enthusiastically developed the notion of "the few govern the many" and Pareto developed the distinction between logical and non-logical actions. See Burnham, J. (1943), *The Machiavellians: Defenders of Freedom.* New York: The John Day Company Inc.

Finance stressed the expenditure side and de Viti's anti-Ricardian position came as a powerful reinforcement to the sound finance principles, as Eusepi and Wagner (2013, 2017, 2018) have extensively written. It is worth while to recall that arm-in-arm with de Viti's critique of the dominant thinking is Buchanan (1958, 1968, 1969). Hence it would be in the spirit of clarity to suggest that there is a de Viti vs. Ricardo and a Buchanan vs. Keynes.

The shifting of focus from the expenditure side to the revenue side operated by the standard approach leads to the fallacy of believing that public debt is an unavoidable necessity and not a simple possibility. It is exactly this dogmatic presupposition that impedes the legitimacy problem from emerging. I want to clarify that with standard approach I mean both the Ricardian and the Keynesian positions since the former implicitly, the latter explicitly rest upon a macro approach.

Indeed, my reading does not prove wrong simply because Ricardo (1821) switches from the aggregate to the representative individual as a way of shifting to micro. The representative individual is the quintessence of the macro approach, which prevents an individual from indebting and defaulting on himself. Moreover, the ability-to-pay principle considers the tax side only; in so doing the state behaves in an arbitrary way, unless the ability-to-pay principle is assumed to be objectively measurable. By whom? And how? In reality, if political or ideological motivations are excluded, the only real reason for the ability-to-pay principle to have taken and still taking "the lion's share", also in contemporary fiscal systems, was clearly identified by Morgenstern more than 50 years ago.[2] According to him, the popularity of the ability-to-pay principle has to be ascribed rather to its ambiguities, which allow anyone to use this principle either in a destructive or supportive way in the assessment of the distribution of the tax burden, than to its alleged objectivity. In sum, the ability to pay principle was incompatible with De Viti's logic. De Viti builds up an exchange relationship between taxpayers and the fisc. This is certainly a key turning point for

[2]O. Morgenstern (1968).

a democratic relationship based on tax price, which I do not hesitate to connect with de Viti's unique vision of the state as a productive factor. On the contrary, for the standard approach public debt is a primitive datum, and public debt is analyzed in relation to other macro variables such as GDP, growth and any other aggregate magnitude.

While the concept of sovereign debt has a place within both Ricardian and Keynesian frameworks, it is oxymoronic when transplanted into a democratic setting where there is no room for a sovereign in the flesh with his own budget. When it comes to democracy, politicians can issue debt without being liable for its repayment, for they are simply intermediaries.

In democracy, ideology, as distinct from the practice of state activity, is inspired by the generality principle (Buchanan and Congleton 1998),[3] which impacts on both the revenue and expenditure sides. On the revenue side, proportional taxation works better than progressive taxation because prevents governments from discriminating minorities by maneuvering tax rates. On the expenditure side, the generality principle bears with it that public goods be provided with an eye to productivity rather than to government transfers. It is clear that resorting to debt for consumption purposes violates the generality principle. My investigation aims at seeing whether expenditures for investments fit the generality principle and if under particular conditions can be financed resorting to debt.[4]

A cursory reading of de Viti (1893, 1898) and Buchanan (1958) may leave the reader with the wrong impression that the two authors have very little in common. De Viti defines himself as the Italian Ricardo just because he takes the Ricardian equivalence theorem as a mere starting point. A deeper reading, however, reveals his anti-Ricardian posture on both taxation and public expenditure, as Buchanan (1960, 1969) has clearly explained.

---

[3]The generality principle is invoked in the text to highlight that in democracy nobody suffers a negative result.

[4]On this point see further sections "Contractarian Constitutionalism and Debt" and "Contractarianism, Debt and Default".

Although contemporary Italian scholars still embrace the Italian Ricardo story, I believe that this interpretation is untenable not only for the cogent reasons that Eusepi and Wagner (2013, 2018) have emphasized, but also for the opposite view that Ricardo and the Viti had as to taxation, which inevitably led Ricardo to work out his theory in a pre-democratic setting and de Viti in a democratic setting.

De Viti's critique of the Anglo-Saxon's approach, on which the Ricardian equivalence theorem rests, does not leave any room for doubts. It will suffice to note that the ability to pay principle was distasteful to him and throughout his works there runs the idea that such a principle is incompatible with the democratic vision of the state. In his 1898 paper, he clarifies: "When Ricardo says that for the taxpayer a payment of a tax in perpetuity equals to a reduction in capital value of his property, he completely separates citizens' private economy from that of the State. He takes into account only the net share of the property and does not consider the share that the taxpayer contributes to the State as if it were never produced" (own translation).[5]

Against this background, the centrality of public expenditure is a key element in de Viti's thought and explains the role of the state as a productive or organizational factor. De Viti argues that since the state is a productive factor, each unit of income produced has a built-in tax. As a consequence, if one unit of income escapes taxation it produces undue charges on the other units of income that are taxed.

More nuanced is Buchanan's posture. It is true that he successfully criticizes the Keynesian paradigm in his *Public Principles of Public Debt*.[6] But his methodological argument is not brought out clearly. His methodological individualism is spurious because it is inappropriately applied to generations. Yet we must not omit to note that de Viti severely criticizes Ricardo on the equivalence matter and Buchanan capsizes the theory of intertemporal shifting of costs through the creation of public debt.

---

[5] De Viti de Marco (1898, Section 23, p. 114).

[6] J. M. Buchanan (1958).

De Viti vs. Ricardo and Buchanan vs. Keynes

A legitimacy problem is faced only in democratic institutional settings where decision-makers and the matter to be decided are both in the foreground and where public debt is originated by budgetary processes rather than necessity. This last element rules out choice and does not allow making use of a microeconomic approach.

In his equivalence treatment, Ricardo was unable to focus on the expenditure side exactly because the Anglo-Saxon approach misses to draw a bright line between pre-democratic and democratic settings. This omission is reflected in the ability to pay principle, which replaces the absence of an explicit relationship between taxpayers and the State. De Viti gets the point and shows how Ricardo's attitude is inconsistent with the democratic approach where the ability-to-pay principle is replaced by the tax-price principle. De Viti's critique is destructive:

> One [the ability-to-pay principle] is the tendency of those who build their system on the arbitrary element and enlarge it step by step, until they arrive at the affirmation that the tax is an act of the sovereign will of the State, independent of the economic substance of the exchange of tax payments for public services……..The other tendency [that based on the benefit principle] is that of those who, starting from the exchange-relationship between taxes and public services, build on the natural play of economic forces, reducing as much as possible the margin of what is arbitrary, in order to achieve a more stable political equilibrium.[7]

Although this aspect received little attention in the literature, the problem of debt legitimacy raises the question as to how setting a process, if any, for legitimizing public debt. The issue cannot be considered as captious, so much so that de Viti clearly shows the procedure by distinguishing between cooperative and monopolistic state.

Let us now proceed to meet Buchanan on this issue. Buchanan's critique of the then dominant Keynesian theory, which separates

[7]A. de Viti de Marco (1936, pp. 116–117).

drastically public and private debt, can be found in Public Principles of Public Debt.[8] Prima facie, Buchanan's title may lead the reader to think that there is a shared consensus on the new "public principles" of public debt. But after a few pages one realizes that what Buchanan rails against is what he defines as the new orthodoxy, which was responsible for the overturning of the ethical and political bases of balanced budget and public debt principles. Budgets constraints were turned into a balance wheel by governments.[9]

His thought is encapsulated in the three following propositions:

1. The creation of public debt does not involve any transfer of the primary real burden to future generations.
2. The analogy between individual or private debt and public debt is fallacious in all essential respects.
3. There is a sharp and important distinction between an internal and an external public debt.[10]

Subsequently, he criticized the above propositions with the following three:

1. The primary real burden of a public debt is shifted to future generations.
2. The analogy between public debt and private debt is fundamentally correct.
3. The external debt and the internal debt are fundamentally equivalent.[11]

The nucleus of Buchanan's critique has to be traced to what I have defined as marginal differences between private and public debt if compared to Keynes' categorical differences that are responsible for overturning the principles of the classical doctrine. Buchanan is due some of the credit for working out a theoretical framework able to contrast the

[8] J. M. Buchanan (1999 [1958]).

[9] See G. Eusepi and R. E. Wagner (2017), especially Chapter 1.

[10] J. M. Buchanan (1999 [1958], p. 5).

[11] J. M. Buchanan (1999 [1958], p. 26).

presuppositions of the new orthodoxy by rediscovering classical political economy. Thus, it is no wonder that Buchanan goes arm in arm with de Viti on this issue, and this is why I have found it convenient to analyze them together.

The two authors agree when they examine internal debt, external debt and intertemporal shifting of the debt. Although briefly, let's examine the three points separately. In case of internal debt, the amount of the taxes paid and the interests received are identical in the aggregate. Yet, the debt exists, despite the adage "we owe it to ourselves". But tearing or burning debt bonds would give rise to a default and would not be neutral from a contractarian viewpoint. De Viti's famous thesis of public debt self-extinction is valid only in a cooperative state. In a monopolistic or democratic state, self-extinction is replaced by debt default. De Viti's self-extinction envisages a zero sum also at a disaggregate level; conversely a zero sum only at an aggregate level involves a redistributive failure and, hence, default. De Viti and Buchanan see external debt in a similar fashion; although each of them starts from a different point of departure, they reach the same results. While Buchanan, in criticizing the new orthodoxy, is more concerned with showing continuity between internal and external debt, de Viti tries to extend his cooperative model—made up of three individuals with the same income, but coming from different sources (liquid assets, landowners and professionals)—to the case of external debt. De Viti pays little heed to the occurrence that the owner of liquid assets is external to the polity, and hence he is not a taxpayer but a voluntary external buyer essentially interested in securing his returns. Eusepi and Wagner (2018) question this tenet and underline that the government cannot equally treat an internal taxpayer, who is forced to pay taxes, and an external bond buyer.

Let us now examine the intertemporal issue. Here the analogies between de Viti and Buchanan are very close, especially after *Cost and Choice*,[12] where Buchanan sweeps off the ambiguity surrounding the concept of generations, a trap in which de Viti never fell. Thus, de Viti

[12] J. M. Buchanan (1969).

wrote: "…..ancestors turn private goods into public goods following the value principle, so as to produce, if there was any error in calculation, an overall rise in utility to be shifted to their heirs or future generations. These latter, in fact, inherit private and public goods in such a quantity and proportion as their fathers thought the most advantageous to them" (own translation).[13]

Hence, a prospective evaluation of the mixture private/public goods among individuals in different periods of time can be viewed as a problem in terms of efficiency between private and public sectors. It is on this point that de Viti criticizes Ricardo whose equivalence principle is valid only under the requirement of equality in efficiency in the two sectors. Moreover, de Viti does not raise only the cost problem, but analyzes also the changes that value undergoes with the passing of time.

If future individuals receive an endowment of private and public goods equal to the one that they would choose behind a veil of ignorance, the ancestors' choice passes the efficiency test. Yet, given the uncertainty and the variations of values, for both de Viti and Buchanan this result is implausible. It is this implausibility that induces me to see with a critical eye the financing of a public good in deficit even if it is one destined to avert the tragedy of global warming for the benefit of the environment.

According to de Viti, it is likely that future individuals will prefer to inherit a larger liquid capital even if this involves a lower quantity of public goods or public goods of lower quality. All this is clearly explained by the opportunity cost theory that is strictly connected with choice; the existence of liquid capital allows present individuals to choose according to their opportunity costs. If the choice were to be made by past individuals, present individuals would suffer objective utility losses. As this chapter argued above, it is crucial for de Viti and Buchanan that the expenditure to be covered features in the debt-taxation alternative. De Viti deals with this issue in his 1893 paper, where he evaluates public debt in terms of subjective relationships between individuals living in the past and those living in the present,

[13] A. de Viti de Marco (1898, Chapter 4, Section 24, p. 116).

or we might say, individuals living in an extended present, which allows the analysis of the same individual instead of a generation.

The quality of the expenditure is an issue discussed by de Viti in Section 23.[14] He postulates that the very indispensable requirement is efficiency and underlines that the measuring rod of efficiency in public expenditures is represented by a parallel efficiency obtained by employing the same resources privately. This construction allows de Viti to link the cost of public goods with the cost of the contributed goods they replace. Nor is that the entire story. The expenditure allows de Viti to analyze also changes of utility or value through time. Here he points out that utility can be measured by interconnecting present and future taxpayers and by examining possible misconduct by those ancestors who gave rise to the crises and force present individuals to downward adjustments.

However, to de Viti, crises result neither from intentional choices, nor from intergenerational conflicts. Conversely, they are the result of an excessive provision of public goods compared to those which future taxpayers would have preferred. But de Viti went further by associating crises also to variations in intertemporal utilities. This makes de Viti very topical. The changing in values that de Viti associates with intertemporal variations of public debt represents a significant stride toward an outdoing of Ricardo's equivalence. De Viti's explicit individualistic approach allows the distinction between an aggregate budget, as a fictitious primitive datum, and the aggregate as a sum of individual budgets. The former hides individual real budgets for it overlooks all interpersonal transfers, including those that give rise to debt and default as a devious form of redistribution consequent to the breach of the contract.[15] De Viti wrote: "The day in which public debt were to be nationalized and were to be shared among the whole citizenry in such a manner that each taxpayer receives in interests the same amount as he paid in taxes, the big book of public debt could be suppressed without any harm or benefit for anyone….Compensation has taken place for all

[14] A. de Viti de Marco (1898).

[15] G. Eusepi and R. E. Wagner (2018).

and everyone" (own translation).[16] Of course, this is true only in the cooperative state.

Contractarian Constitutionalism and Debt

As has been said herein before, Contractarianism is a shared fundamental element in both de Viti and Buchanan. The contractarian approach hinges upon consensual stable rules but when the received picture changes there must be the possibility for them to be amended. It is exactly the amendment possibility that impelled Buchanan to define the body of contractual constitutional rules as relatively absolute absolutes.[17] Although the stability of rules is a crucial point, the impossibility to amend them would make the contract a purely deceitful logical expedient.[18]

What is relevant in contractarian constitutionalism is the crucial role played by the balanced budget requirement strenuously advocated by Buchanan and less vigorously by de Viti. An explanation for this different attitude has to be found in the different intellectual environments the two were living in. While Buchanan lived in a world bewitched by Keynes' paean to an ever-increasing deficit spending that unbridled governments in Western countries, including US government, de Viti lived in a setting in which the old-time fiscal religion was still in the air, so to say. The consequence is that Buchanan conceived of public debt as expenditures for consumptions. De Viti was prone to see public debt as a mode to facilitate expenditures for investments. The problem is that of establishing whether the two options are equivalent or not. If they are equivalent, Buchanan's view has a general value; if not, what is valid for expenditures in consumption cannot be extended to expenditures for

[16]A. de Viti de Marco (1898, Book 3, Section 20, p. 107). This point was popularized in the USA by Samuelson (1948), who, however, misses to observe that self-extinction requires a cooperative state and is not a common occurrence. *Economics—An Introductory Analysis*. New York: McGraw-Hill Education.

[17]J. M. Buchanan (1989, Chapter 4, pp. 32–46).

[18]Brennan and Eusepi (2016, pp. 55–73).

investments. Whatever option is chosen, a legitimacy argument clearly stands out from both an ethical and a political point of view. However, investments have decreasing returns and the legitimacy requires that expenditures be *productive* vis-à-vis alternative uses. But when bureaucrats and politicians interfere in the process, productive expenditures become unproductive and, hence, the debt cannot be considered as an option any longer.

Underlying these themes, it is easy to detect a similarity between de Viti and Buchanan. De Viti's justification of public debt is rested on two grounds: the expenditure quality and the combined mix private goods/public goods that the ancestors shift to their heirs. A further argument may be drawn from his works. The anticipation of benefits and the postponement of costs must be regarded as a violation of the constitutional logic. Expenditures for investments, instead, tend to nuance future uncertainty and, hence, they can be considered as a kind of public good for all individuals.

The absence of limits to indebtedness or of rules forbidding indebtedness does not solve the problem of whether to choose consumption or investments. My chief concern here is with the qualitative dimension of the expenditures rather than with their quantitative dimension such as the amount of debt that a government is allowed to run.

In his own words De Viti clarifies that in the face of a budget that does not allow for further revenues: "The prevailing opinion is that when the total tax burden is at the upper income-brackets, recourse to borrowing is the only way to meet the urgency of new public needs" (own translation).[19] Prohibition to run into debt could prevent a government from implementing futile expenditures, but, at the same time, it could refrain a government from implementing choices that could benefit public infrastructures and social services.[20]

Again, he says: "Going back to the effect of unproductive expenses on descendants, the value principle, applied to financial economics, allows us to formulate the following law: future prosperity is best

[19]De Viti de Marco, A. (1893, p. 1).

[20]On this see A. de Viti de Marco (1893, p. 42).

guaranteed if present available resources are limited to the satisfaction of those public needs that are more urgent presently. In this way, a larger amount of liquid capital is shifted to future generations to satisfy the needs that will emerge with maximum degree of urgency. This principle, however, does not apply to loans, but only to public expenditures" (own translation).[21]

The de Viti/Buchanan relationship must be analyzed in terms of the subjective theory of cost as formulated by Buchanan in *Cost and Choice*. It seems to me clear that acquisitions that have important practical implications especially for public debt would have never been reached without the methodological purification of the cost theory as has been emphasized in the epigraph.

It is worthwhile to recall that the distinction between "before choice" and "after choice" was not yet developed when Buchanan wrote *Public Principles of Public Debt* in 1958, which is the most Italian-flavored of his books. There, Buchanan distinguished between taxpayers' costs and government's costs, but the analysis was carried out in terms of maximization of these two agents. The absence of a choice-influenced cost did not allow linking the inter-temporal connections between choice-influencing cost and choice-influenced cost.

As has been suggested above, the most persuasive point linking de Viti and Buchanan can be found in *Cost and Choice* where Buchanan not only makes a distinction between the two costs, but he underlines also the difference between the subjective cost of the choosing individual and the objective consequences of that choice in terms of objective losses of utility, which are always the results and never the causes of choice.

Buchanan's stance can be made explicit as follows: who bears the objective cost of a public good financed through public debt? His answer is straightforward: it is borne by all individuals living in a period subsequent to the one in which the choice was made. It might be thought that the provision of a public good preventing a public bad such as global warming legitimates deficit spending, without any

[21] A. de Viti de Marco (1898, p. 13).

violation of the principles of contractarian constitutionalism. Since beneficiaries are future individuals, according to the benefit principle, they should pay the costs. This is a case that Buchanan does not explicitly reject. If this public good that materializes in the future were, instead, financed through taxation, present taxpayers would be unduly taxed while future taxpayers would take advantage of it.

Buchanan rejects the case that features benefits enjoyed in the present with costs postponed into the future. Hence, all individuals suffer utility losses regardless of whether they have decided on the expenditures or not. This means that utility losses are not intergenerational transfers. So much we all owe to Buchanan. Yet, I must not to omit to note that not only is the concept of generation inappropriate, but it is also wrong.

This point underlines that neither intergenerational conflicts, nor intergenerational altruism *à la* Barro are appropriate to solve the problem simply because relationships are not among generations, but among individuals through time. No doubt de Viti's contribution on this is particularly clear when he classifies the crises as outcomes resulting from individuals' errors.[22]

Contractarianism, Debt and Default

The Keynesian revolution, which departed from the old time fiscal religion, assigned moral suasion a catalyst role in support of deficit and public debt.[23] Its success was due not much to the goodness of this theory, but to the fact that it was widely acclaimed by governments that saw in it a sort of authorization to disregard budget constraints. Keynes, alas, penetrated also the academia, where a new breed of scholars was more inclined to consultantships for the government than to teaching. In the atmosphere of easy spending, the new apostles' recipe for full employment produced soaring public deficits and debts over the years.

---

[22]See J. M. Buchanan (1969, p. 55). See also G. Eusepi (1991, pp. 144–145).

[23]On this point see J. M. Buchanan and R. E. Wagner (1977).

In the analytical account of the contrasting points between Keynes and Buchanan, the matter can be put as follows. Buchanan seems to reason in this way: if the government violated systematically previous governments' debts, a sovereign debt market would not exist and, hence, there would not be a crisis of sovereign debt. Constitutional political economy espouses this position on condition that all kinds of debt are illegitimate. As already said above, my contention is that this is questionable.

It is important to analyze de Viti's position on the private vs. public debt issue. De Viti argues that entrepreneurs may fail because of technical errors in their evaluations. From this follows that incompetent entrepreneurs would never fail if they were forbidden to resort to private debt. Consequently, private credit market should be safeguarded against those who failed by either intentional or negligent wrongdoing. But who is empowered to exert such a protective role? When extended to public ordering, the consequences are even more pervasive since governments, like some private incompetent entrepreneurs, tend to over-indebtedness. Hence the whole credit, private and public, should be cancelled and entrepreneurs should use only their savings and governments only their revenues. This conclusion is patently absurd because it runs against the most basic tenets of political economy, according to which credit goes in the hands of those who are able to use it at the best.[24]

Basically, de Viti and Buchanan consider the nature of the expenditures in order to establish whether a debt is legitimate. Buchanan considers expenditures in consumption, De Viti deals with expenditures in investments. Since to Buchanan expenditures in consumptions financed through debt violate the constitutional logic, he recognizes no limits to defaulting. Simply put, financing consumption through debt is bad, failure to repay the debt is good. Of course, restoring an ethical

[24]A. de Viti de Marco (1893, pp. 42–43). What stated in the text applies to private credit, which is a simple dyadic voluntary exchange. It does not apply to governments where exchange is forced or triadic.

behavior by disregarding contractual commitments contravenes any well-established concept of rule.

I do not indulge here on what I emphasized in the past (Brennan and Eusepi 2002). What I am interested in here is to see whether de Viti's expenditures in investments can be legitimately financed through debt. If the answer were in the affirmative, the consequence would lead to the reverse conclusion: default is illegitimate while debt in itself is legitimate. The conclusion to which these reflections unmistakably point is that to Buchanan debt financing might be legitimate if expenditures are not employed in present consumptions.

The quality of public expenditure in a constitutional setting and even its financing through debt find their underpinnings in the distinction between legitimate and illegitimate expenses and the impact that this distinction has on the ethics of debt and default. Buchanan assigns responsibility of default to bond holders and not to the beneficiaries of the public expenditure for which government resorted to the debt. The legitimacy/illegitimacy of the whole operation has to be calibrated on the expenditure side; hence a problem of public debt legitimacy originates from expenditure legitimacy and not from the circumstance that bondholders receive interests. On this point, de Viti paves the way to Buchanan.

As already mentioned, prima facie, Buchanan's posture on the balanced budget requirement is stricter than that of de Viti's. A deeper reading shows that his view of deficit is associated with expenditures in consumption, while de Viti conceives of deficit as a way to finance investments.

In fact, de Viti's distinction between productive and unproductive expenditures and his treatment of the role that bureaucrats and politicians play within these two alternatives is much closer to Buchanan than it appears. When productive expenditures are turned into unproductive expenditures the entitlement to debt financing falls down. This induces some reflections associated with a dual budgeting system. The strategic use that politicians and bureaucrats make of this form of budget may lead to classify under the rubric of investment expenditures for the enhancement of future public services what in reality are rent seeking activities.[25]

The impact of this kind of reasoning is that of drastically reducing the role of investments, which in practice are *quasi-consumptions*. Moreover, since bureaucrats and politicians have no residual claimancy, they have no incentives in keeping costs low or in cutting them. The constraint on unproductive expenditures set by de Viti is extended also to the strategic use of investments, which can be viewed as additional consumptions.

On this respect, de Viti's and Buchanan's conclusions are very close once again. De Viti's unproductive expenditures have pretty much the same role as the budget constraint requirement has in constitutional political economy. Thus, what seemed to lead to very contrasting options on whether to finance consumptions or investments in deficit leads, instead, to similar conclusions. Public investments that would pass the efficiency test would be very few. If this reading is correct, we face the opposite case envisaged in *Cost and Choice*: there, the word cost had two very different meanings, here the words consumption and investments, which are conflicting on the market, transplanted into the political scenario, overlap.

A Final Thought

The foregoing analysis has highlighted the similarities between de Viti de Marco and Buchanan. This has involved taking two different routes through my discussion: first, I began by introducing de Viti's critique of Ricardo and Buchanan's critique of Keynes; second, I showed that the conflicting views of the Italian tradition and the Anglo-Saxon tradition did not prevent Buchanan from seeing the virtues of de Viti's work. It is against this background that I tried to de-Ricardianize de Viti and strip away Ricardo's veneer that made de Viti appear as a mere conveyor

[25]On this point see Eusepi and Wagner (2018, pp. 13–15).

of the Ricardian doctrine. No doubt this twisted image of de Viti was abetted by de Viti himself and also by Italian academics, who simply ascribed to Griziotti[26] a position on non-equivalence that belonged to de Viti first.

Consciously or unconsciously de Viti defined himself as the Italian Ricardo not only because he had somehow become enchanted by Ricardo, but simply because he might have thought that dealing with a subject matter that had a mesmeric appeal to large a part of economists could help disseminate his theories. This, however, did the very opposite—that is it contributed to put de Viti into Ricardo's shadow. The aim of this chapter was to take de Viti out of that shadow.

Throughout my chapter, I made reference to specific sections of de Viti's 1898 essay because they mark the watershed between de Viti's deference to the great master and the search for a satisfactory solution of a problem that Ricardo had left out of account. In sum, de Viti's Ricardianization is evident throughout the first 21 sections of his essay and the real de Viti stands out only when he introduces public expenditure into his analysis.

Even though he is formally Ricardian in dealing with the equivalence problem, he is substantially anti-Ricardian for being theoretically on a different footing. De Viti's equivalence has behind it a democratic setting, while Ricardo is silent on the institutional setting. But the moment public expenditure is introduced, de Viti's role of modern Ricardo cannot be invoked any more. Hence, all is left to do for the pundits of this fallacious assumption is to keep hiding de Viti's radically different analytical and practical views under Ricardo's long shadow. A further incompatibility with Ricardo is de Viti's posture about the shifting of debt burden, which emerges most clearly in de Viti's individualistic model. This model exercised a strong hold over Buchanan's thought as illustrated in particular in *Cost and Choice*, which is the most complex and rigorous formulation of the individualistic approach to public finance, as well as to economics in general.

---

[26]B. Griziotti (1917).

References

Brennan, G., & Eusepi, G. (2002, November). The Dubious Ethics of Debt Default. *Public Finance Review, 30*(6), 546–561.

Brennan, G., & Eusepi, G. (2016). Hobbesian and Contractarian Constitutions. In A. Marciano & G. B. Ramello (Eds.), *Law and Economics in Europe and the U.S.: The Legacy of Juergen Backhaus* (pp. 55–73). New York: Springer.

Buchanan, J. M. (1958). *Public Principles of Public Debt*. Homewood, IL: Richard D. Irwin.

Buchanan, J. M. (1960). "La Scienza delle Finanze": The Italian Tradition in Fiscal Theory. In *Fiscal Theory and Political Economy. Selected Essays* (pp. 24–74). Chapel Hill: The University of North Carolina Press.

Buchanan, J. M. (1968). *The Demand and Supply of Public Goods*. Chicago: Rand-McNally.

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

Buchanan, J. M. (1989). *Essays on the Political Economy*. Honolulu: University of Hawaii Press.

Buchanan, J. M., & Wagner, R. E. (1977). *Democracy in Deficit: The Political Legacy of Lord Keynes*. New York: Academic Press.

Buchanan, J. M., & Congleton, R. D. (1998). *Politics by Principle, Not Interest: Towards Nondiscriminatory Democracy*. New York and Cambridge: Cambridge University Press.

Burnham, J. (1943). *The Machiavellians: Defenders of Freedom*. New York: The John Day Company Inc.

De Viti de Marco, A. (1893). *La pressione Tributaria dell'Imposta e del Prestito*. Bologna: Tipografia Fava e Garagnani.

De Viti de Marco, A. (1898). Saggi di economia e finanza. In *Giornale degli Economisti* (pp. 61–123). Roma.

De Viti de Marco, A. (1936). *First Principles of Public Finance*. London: Jonathan Cape.

Eusepi, G. (1991, March). Before and After Cost and Choice. *Journal des Economistes et des Etudes Humaines, 2*(1), 135–149.

Eusepi, G., & Wagner, R. E. (2013, Spring). Tax Prices in a Democratic Polity: The Continuing Relevance of Antonio de Viti de Marco. *History of Political Economy, 45*(1), 99–121.

Eusepi, G., & Wagner, R. E. (2017). *Public Debt. An Illusion of Democratic Political Economy*. Cheltenham, UK and Northampton, MA: Edward Elgar.

Eusepi, G., & Wagner, R. E. (2018). De Viti De Marco vs. Ricardo on Public Debt: Self-Extinction or Default? In G. Eusepi & R. E. Wagner (Eds.), *Debt Default and Democracy*. Cheltenham, UK and Northampton, USA: Edward Elgar.

Griziotti, B. (1917). La diversa pressione del prestito e dell'imposta. *Giornale degli Economisti e Rivista di Statistica, 54*(3), 313–334.

Morgenstern, O. (1968). Antonio De Viti de Marco. In D. L. Sills (Ed.), *International Encyclopedia of the Social Sciences* (Vol. 4). New York: Macmillan Publishers and The Free Press.

Mosca, G. (1939 [1896]). *The Ruling Class*. New York: McGraw-Hill Education.

Pareto, V. (1935 [1923]). *The Mind and Society*. New York: Harcourt Brace.

Ricardo, D. (1821). *On the Principles of Political Economy and Taxation*. London: John Murray.

Samuelson, P. A. (1948). *Economics—An Introductory Analysis*. New York: McGraw-Hill Education.

45

Consequences of the Anachronism of Fractional Reserve Arrangements

Leonidas Zelmanovitz

> The macroeconomics of money is complex because the institutions in existence reflect a fundamental misunderstanding of economic process. (Buchanan 1989, p. 299)

Buchanan's Much Needed Help on Monetary Reform

Since the 2008 financial crisis, an interest in proposals for financial and monetary reforms has understandably increased in the public arena and in the academia. The crop of proposals put forward since then has varied along many dimensions; for instance, they have varied from ways to improve existing arrangements to proposals radically revamping them, and they have varied from being purely theoretical to acknowledging

L. Zelmanovitz (✉)
Liberty Fund, Carmel, IN, USA
e-mail: lzelmanovitz@libertyfund.org

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_45

social and political realities. However, proposals for monetary reform detached from the reality they are meant to perfect, and without solid theoretical base to understand the problems with existing arrangements, are unlikely to be of much use. The intent with this chapter is to explore the relevance for current debates on monetary reform of Buchanan's realistic views and solid theoretical grounding on monetary matters, which allowed him to identify proper goals for monetary arrangements and therefore, for their reform.

Buchanan's ideas about money will be shortly described on section "Buchanan on Money". On section "Predictability by Constitutionalization", special attention will be given to his claims on fractional reserves, first as argued by Buchanan and Brennan (1981) and restated by Buchanan more recently (2010). On section "Classical Public Debt Theory", some logic conclusions from Buchanan's ideas are presented and discussed.

Buchanan on Money

The purpose of monetary institutions for Buchanan is to foster economic efficiency. Because the collaboration among the economic agents is coordinated spontaneously by the price system in order to reduce transaction costs, the production of money with stable value, which allows for stability of the price level, is the desired outcome of an ideal monetary system. The purpose of Buchanan's monetary musings is therefore to find a way to provide money with stable value of the unit of account (Buchanan 2010, p. 256), not as an end in itself but as an instrument to foster greater economic efficiency in society by easing spontaneous coordination through money of stable value.

Buchanan departs from the idealization of money by economists as merely a veil on the real economy, only to immediately acknowledge that changes in the quantity of money have real world consequences: "(U)npredicted changes in the aggregate amount of money can, however, exert negative effects on the real values generated in the nexus" (Buchanan 2010, p. 255); so, one of the important elements in Buchanan's monetary prescriptions has to do with mechanisms to prevent unexpected changes in amount of circulating media.

In order to produce the most useful money possible, that is, one of stable value, something achievable, among other means, by keeping the amount of currency from changing unexpectedly, Buchanan developed a number of interesting contributions to monetary theory: (i) the need for the constitutionalization of money, (ii) a proposal for a brick standard, (iii) a proposal for a labor standard, and (iv) the insight that fractional reserve arrangements became anachronistic as the ultimate argument for "narrow banking."

Predictability by Constitutionalization

In his chapter for Yeager's book, Buchanan advocates for predictability instead of stability (Buchanan 1962, p. 157) because he argues that against predictability, there is no dispute, while against stability there are doubts, in practice, not only in regard to its merits but also in regard to its attainability.[1] In any case, Buchanan advocates predictability as an appropriate norm for monetary policy, as an instrument to "improve" the efficient use of resources (Buchanan 1962, p. 158); all his four proposals for monetary arrangements discussed here have that in mind: "What we want a monetary framework to produce is predictability in the value of money" (Buchanan 1962, p. 163).

For Buchanan, predictability in the absolute price level, or in the price *index* as he calls it, may be achieve at constitutional level in two ways as pointed out by Boettke and Smith (2016). The first way is to have that goal as the criterion of policy and to entitle political agents to manipulate other economic variables in order to achieve it. The second way is to allow the operations of the market to produce such result. That may be summarized as the difference between a managed and an automatic system (Buchanan 1962, p. 164). For Buchanan, in order to compare the two possible features of monetary systems in regard to

[1] For Buchanan, "(I)f the predictability norm is accepted as appropriate for monetary policy, and if it is accepted that this represents a meaningful and conceptually attainable norm, the next question to be faced involves the choice of means to implement it" (Buchanan 1962, p. 162).

how to achieve stable money value (automatic and managed), we need first to conceive two "ideal" models. The ideal managed model leaves open questions about the incentives of the political agents and about the limitations of their knowledge, while the ideal automatic system would require a commodity representative of the "whole economy" as money, with the same elasticity of the economy as a whole, a merchandize whose relative price to all other goods would follow the price index, that is, the absolute price level (Buchanan 1962, p. 168).

Predictability under an ideal automatic system would be achieved once "(T)he economy would, as a result, be operating on a basis of monetary predictability, since the decentralized and impersonal forces of the competitive mechanism could be depended upon to produce and to destroy 'money' as the economy required" (Buchanan 1962, p. 168).

Buchanan, in "Reductionist Reflections on the Monetary Constitution" (Buchanan 1989, p. 297) uses an analogy with a playground to describe the vision of the economy as an *order* and with a ship to describe the vision of the economy as an "*organic* unit" respectively. It is only under the latter conception that it makes sense to believe that the absence of management means anarchy and that is not Buchanan's position. For Buchanan, anarchy means "(T)he discretionary powers of the existing monetary authorities," (p. 298) that is, the absence of constitutional constraints. Such discretionary powers allow the authorities to pursue their preferred goals, steering the entire society as the ship captain would do, while for Buchanan what is necessary is to have meta-norms to regulate the behavior of the individual member of the community in the cooperation with one another in the pursue of their individual goals, or as Buchanan puts it "(T)herefore, we will not succeed until and unless we effectively excise economic macropurpose from the listing of tasks appropriately assigned to agents of the state" (p. 298).

Conceptually, Buchanan thinks that both an automatic system and a managed one can work or fail, what is necessary is a "constitutional attitude," an agreement about basic rules and the disposition to follow them (1962, p. 182). His advocacy of the independence of the central bank as part of the constitutionalization of money, for instance, has that goal in mind, too; it is one more rule aimed at the "de-politicization" of money, not a good in itself.

Boettke et al. agree that Buchanan, in his 1962 article on "Predictability" for Yeager's book (Buchanan 1962), would favor an automatic system to define the price of money instead of a managed system in real conditions, since, an ideal managed system is not likely to materialize (Boettke et al. 2016, p. 11). For Buchanan, if men were angels, a managed system would be the "ideal," since that is not the case, an automatic one seems better (Buchanan 1962, p. 164); Buchanan's argument for constitutionally ruled production of money, instead of either anarchical or political (at an infra-constitutional level), therefore, does not mean a rejection of competitive production of money under a general rule of law, quite the opposite. "Removing the production of money from the post-constitutional level" (Horwitz 2011, p. 332) does not imply necessarily a rejection of laissez faire in money production. The monetary constitutional order may well be limited to the minimal framework necessary to have a competitive gold standard, for instance; the establishment of such regime should be part of a constitutional decision if it is to be credible and last longer than any ephemeral governing coalition.

It is true that the "Chicago-Virginia Constitutional Political Economy perspective" of Henry Simons, and Brennan and Buchanan prescribes for a monopoly in the money production (ending fractional reserve arrangements) but that is because they do not conceive a real life fractional reserve monetary system without central banking and, for them, a system with such a feature means "anarchy," not "laissez faire."

Contrary to claims that laissez faire arrangements have evolved historically in the West and were able to produce money of stable value (Horwitz 2011, p. 335); For Buchanan and other authors with the same perspective, there is really no alternative to the monetary prerogatives of the state, as there is no alternative to the coercive powers of the state from which those prerogatives derive. Cases of laissez faire or "free banking" were rare and limited to cases in which there were no military needs to be financed, such as the cases of Scotland and Canada while under the protection of the British monarchy financed by the Bank of England (Zelmanovitz 2015). If it were believed that governments may relinquish their monetary prerogatives and allow for laissez faire in money, an alternative to politicization of money for Buchanan would be laissez faire, as already referred. Therefore, interpretations that for Buchanan "the provision of money does not belong in the market" (Burns 2016, p. 312) seem unwarranted. Buchanan and Brennan are skeptical, not that laissez faire in money could produce stable money, but that the state would ever relinquish their monetary prerogatives, therefore, their call for constitutionalization of money.

Classical Public Debt Theory

The call for the constitutionalization of money can only be understood against the background of Buchanan and Wagner research on fiscal profligacy brought about by the acceptance of Keynes' ideas in the political sphere as something to be limited by constitutional reform, both fiscal reform (with balanced budgets) and monetary reform (with all the above) (Buchanan and Wagner 1977).

Brennam's and Buchanan's skepticism about the state ever relinquishing its monetary prerogatives are informed by Buchanan's and Wagner's claims about the impossibility of insulating monetary authorities from politics, "(E)ven if a nominally independent monetary authority should try initially to immunize itself from political pressures, its attempt must come under increasing strain through time. Permanent insulation of an effective monetary authority from politics is not something upon which hopes for rescue should be based" (Buchanan and Wagner 1977, p. 124). The reasons for that are clear: money creation has revenue implications, and, for Buchanan and his co-authors, not even a constitutional norm could impose absolute limits on that, as noted by Boettke and Smith (2016).

That also explains Buchanan's prescription for the return to the "classical public debt theory" with a constitutional change "to include a prohibition of debt financing of outlay on currently consumed publicly provided goods, services, and transfers" (Buchanan 1988, p. 12), in order to avoid the "juggling trick" mentioned by Smith in Book 5, Chapter 3, of WN "of Public Debts" (Smith 1982, p. 929).

Buchanan seems somewhat less skeptical about the possibility of a constitutional change to include certain rules to produce monetary predictability, Buchanan agrees with Bernholz's argument that the dynamics of the inflationary process may be conducive to "a convergence of debtor and creditor interests on a shift in structure toward a regime that embodies predictability in the value of the monetary unit" (Buchanan 1988, p. 14). However, if, on one hand, the changes in monetary policy known as "the great moderation" are understood as an evidence that they were right; on the other hand, the financial crisis of 2007 may be pointed out as evidence that "stability in the value of money" is not enough to guarantee monetary equilibrium, if for that it is understood as stability in the "price index."

It is possible to quote David Ricardo in regard to the limits that should be imposed on the government in regard to its funding—"(I)f Government wanted money, it should be obliged to raise it in the legitimate way; by taxing the people; by the issue and sale of exchequer bills, by funded loans; or by borrowing from any of the numerous banks which might exist in the country; but in no case should it be allowed to borrow from those, who have the power of creating money" (Ricardo 2004 [1824], p. 283). Here Ricardo gives an example of what could be a "monetary constitutional constraint" once the stability of the value of money is considered the ultimate goal of monetary policy. Such rule would put a limit on the Keynesian proclivities of politicians as pointed out by Buchanan and Wagner. As pointed out by Boettke, Salter, and Smith (p. 24), many authors show the link between fiscal needs and monetary accommodation. Buchanan simply acknowledges that, and it is from that judgment of reality that he departs to propose constitutionalization of money.

The Common Brick Standard

Buchanan's presentation of how his proposal[2] for a common brick monetary system would work is sufficiently brief to be quoted in its entirety:

[2] The common brick proposal was originally formulated by Prof. C. O. Hardy, who never published it in a formal paper (Buchanan 1962, p. 173); so, we are not attributing the idea of a brick standard in itself to Buchanan, but his particular design of such a system, and, of course, its publicizing.

> At the same time that this price is announced, a public authority, which we shall call the Mint, announces its willingness to buy and sell units of common brick at the specified price in unlimited amounts. Money is issued from the Mint only in exchange for common brick, and money proceeds from the sale of common brick by the Mint are impounded in the Mint. Every individual has the assurance that he can, at any time, take a common brick, or any quantity of common brick (or a certificate of ownership of brick) to the Mint and receive in exchange a monetary unit, say, a paper dollar. He also knows that he can, at any time and in any desired amount, go to the Mint and purchase, for paper dollars, common brick of the specified quality. No additional monetary or fiscal policy need take place. (Buchanan 1962, p. 173)

Truthful to his adherence to the "old fiscal religion", Buchanan describes his version of the common brick system as one in which the government would only be able to raise revenue by taxation and "real" borrowing.[3] Truthful to his agreement with the principles of the *Chicago Plan*, his thought experiment with a common brick standard would result in a monetary system in which the banks would be required to operate under 100% reserves, although, he concedes, that last feature is not essential to the system (Buchanan 1962, p. 174).

From the description above, it is clear that the common brick standard is a proposal for the return to a monetary system based on a commodity; and one reason for the common brick standard proposal is to show that the commodity money does not need to be a precious metal (Buchanan 1962, p. 175). For Buchanan, the criterion to assess a commodity money is whether it possesses the features of an ideal commodity standard, and "(I)t is in this sense that the use of a common brick as the standard commodity should be considered" (Buchanan 1962, p. 172).

His argument about why the common brick makes for an ideal monetary commodity starts with the geographical spread of possible production sites, the moderate scale of the plants to produce them, the easiness to put together the technology, the inputs and labor necessary

[3]However, allowing, as Buchanan does (1962, p. 177), the government to use the bricks for the construction of government's buildings is to bring inflationary finance by the back door, with the money supply being leveraged by the government.

to produce common building bricks; for Buchanan, all those features would "ensure that the elasticity of the supply would be reasonably high" (1962, p. 176).

Another important advantage of the common brick, for Buchanan (1962, p. 177), is that the common brick standard would not be suitable as a foundation for an international standard and therefore it would fit nicely with floating exchange rates. Such insightful comment shows, incidentally, Buchanan's acknowledgement of the hard reality of nation states as the *locus* in which political decisions are made. In an ideal world, where monetary prerogatives were not exercised by sovereign states, a common international money would make sense. However, in a world where different sovereigns frequently follow their own political reasons to intervene in their national monetary systems (or at the best, their regional monetary systems), floating exchange rates become a factor adding flexibility and preventing violent ruptures that a more rigid system could cause, instead of being a factor for instability.

To summarize, his common brick standard proposal is for a commodity money with 100% reserve for banknotes (not necessarily for bank deposits), where the common brick is not only the unit of account, but also base money. It is, however, a base money that is produced by the market as a result of the perceived demand for cash balances. Given this "inside" nature of base money in this proposal, it also makes sense to require 100% reserves on bank deposits, and it seems odd that, in face of his adherence to the principles of the Chicago plan, Buchanan would consider that a "non-essential" feature of the system.

As it will be discussed at the conclusion of this paper, this nature of "inside" money that base money has under the common brick standard proposal is also the "solution" for the main question left unanswered by proposals to eliminate fractional reserve banking (FRB) as the Chicago plan.

The Labor Standard

In his contribution to Yeager's book (Buchanan 1962, p. 179), Buchanan describes Armen Alchian's suggestion of money machines (in which someone would get some defined quantity of money for the energy spent cranking or pumping a pedal) as a model for a "common labor" standard of value. Arguably, the labor standard he proposes does not have the heuristic characteristics of his common brick standard proposal and therefore, it is not so helpful a thought experiment as the other one; reason why, albeit mentioned, it will not be analyzed here.

Buchanan on Fractional Reserve Arrangements

There is an initial criticism of FRB in a paper with Geoffrey Brennan in which they state: "(T)here seems to be nothing in the competitive-market structure to keep the supply of money in the economy from being expanded too rapidly in "fair weather" and contracted too sharply in "foul weather." Because of the peculiarities of money, the competitive market will "fail." A government role in defining and/or regulating the value of the monetary unit seems to follow from the demonstration" (Brennan and Buchanan 1981, pp. 17–18).

Later, after the financial crisis of 2008, Buchanan introduces the theme of FRB, linking it to the negative effects on the quantity of money above mentioned: "And these effects may be multiplied if differing instruments are valued as money in separate accounts and if owners-users of such accounts switch as among entries" (Buchanan 2010, p. 255).

Buchanan's ideas on fractional reserves may be considered part of a Chicago's tradition starting with the 1933 Chicago Plan, Simons (1936), Friedman (1960), and Cochrane (2014). Buchanan concedes that there are some different ways to achieve "predictability" in money value; but it will be difficult to achieve that if you do not take into consideration the causes of unpredictability first. Fractional reserve arrangements, under some circumstances, are one of them, and to have from the profession an acknowledgment of that, and to act accordingly, that is as much as what he wants to accomplish in raising the issue.

Buchanan attributes the explanation for the 2008–2009 financial crisis and for the Great Depression to the feature of fractional reserve. For Buchanan, "(T)he ultimate villain is the leveraging of monetary accounts, which allows for the transmission of initial shocks over many sectors of the inclusive economy" (Buchanan 2010, p. 255).

In a system of “pure paper or fiat unit of exchange and account,” Buchanan explains, the value of money is kept only by control of its quantity, a responsibility of the authority in charge of its production. The problem is that, with fractional reserve arrangements, the quantity of money in circulation can be increased by the commercial banks, an expansion over which the issuing authority has only indirect control.

Buchanan’s argues here that those arrangements are anachronistic: “(B)ecause money, as such, has no intrinsic value and because it is nearly costless to produce (printing paper), there is no economic reason for economizing on usage, as would be the case if money were defined in terms of a designated commodity, which has nonmoney use value and which requires resources to produce” (Buchanan 2010, p. 255).

Fractional reserve arrangements have become outdated once the nature of base money has changed. As Buchanan puts it “(R)ecognition of this elementary but crucial difference between commodity-based and fiat (paper) money has profound implication for institutional-constitutional design and operation. Since under a fiat system, there is no efficiency logic for economizing on money, as such, there is no justification for traditional banking that allows for the generation of multiple account values from fractional reserve bases. The central logic of leverage banking, of any sort, is absent under the operation of a pure fiat money system” (Buchanan 2010, p. 255).

Once making explicit the claim for prohibiting FRB, Buchanan justifies that with the following reasoning: “(W)hy not? Because to allow separate banks to create short-term liabilities to a multiple of the base money on the asset side of the account removes from the issuing authority some of the control of the aggregate amount of that value treated as money in the economy without offsetting benefits, thereby making the financial structure vulnerable to unpredictable shifts among instruments, which, in turn, generate changes in real values” (Buchanan 2010, p. 255).

Buchanan concludes his argument by saying that “(T)he system in existence emerged from a historical process, the characteristics of which were partially appropriate for a monetary standard defined in terms of some commodity base, but which, ultimately, make no sense under a fiat system” (Buchanan 2010, p. 256).

Improving on Buchanan's Arguments

Buchanan's advocacy of 100% reserves in the tradition of the *Chicago Plan* can be understood as part of his idea of constitutionalization of money, of creating a meta-norm for the use of money in society as he explained in a 2012 conference compiled in "Renewing the Search for a Monetary Constitution": "Henry Simmons's (1936) earlier admonitions concerning discretionary authority were almost totally ignored as establishment economists imagined themselves in position to manipulate macroeconomic magnitudes as dictated by well-defined end objectives" (Buchanan 2015, p. 51).

It is in this context that his proposal attempting to make the value of the unit of account independent of infra-constitutional politics should be understood. It is obviously a step forward from the anarchy, the ad hoc decisions that politicized money provides most of the time. Yet, arguably, it is not sufficient in order to provide stable money, unless the constitution of money stipulates how that money may be produced in certain ways. That is, it is not any constitution of money that would do.

Two essential features of a possible monetary constitution are: first, the extent in which the production of both internal and external money is allowed; and second, the relation between the medi(um)a of exchange and the unit of account. The way in which the monetary constitution stipulates in regard to these features will determine the quality of the money produced under that constitution.

For Buchanan, our current banking architecture in most of the world is a consequence of historical developments. Our banking arrangements evolved from the time in which base money was expensive, usually a precious metal, such as gold or silver, and in order to economize on the money provided from outside the market by the mint (usually a state monopoly), from inside the market, private banks used to create money substitutes in the form of banknotes, checks, and bank account credits. In the absence of political interference in competitive banking, either limiting entrance or supporting established banks, one can count with the profit motivation of the bankers and the need for prudent management of their credit portfolios in order to limit the creation of inside money to the existing opportunities for profitable lending in the market. Be that as it may, there are two problems with fractional reserve arrangements, under which private banks multiply credits over a certain amount of base money. First, the stock of money in circulation, which is derived directly from a composite between the supply of external money (the monetary base) and internal money (bank credit), may diverge suddenly and substantially from the demand for liquidity in the economy, which may fluctuate due to factors *external* to strictly economic considerations, such as wars, political upheavals, or natural disasters. The tendency towards a price of equilibrium for money, that is, the interest rates, may need to fluctuate considerably for such "equilibrium" to be restored and that has important consequences for the level of economic activity. That is why Buchanan argues that fractional reserve arrangements are a "fair weather" sort of arrangement. Such inconvenience, this inherent instability that *political* interventions and other *non-economic* factors impose on fractional reserve arrangements, is the reason for Buchanan to argue that since base money is no longer expensive, once it became paper money or electronically generated figures in the bank ledgers, it makes no economic sense to live with banking arrangements which are inherently prone to instability as the ones we have today[4] that we have inherited from a time when they used to make economic sense.

However, the solution proposed by the Chicago Plan and all its derivations of eliminating inside money and resorting exclusively on external money leave two key questions unanswered: first, how may the supply of money match the demand of money automatically? And second, how to funnel operational capital to productive endeavors?

Under current fractional arrangements, ideally, bank credit is generated by the banks in order to match a perceived demand for profitable lending opportunities. Under those arrangements, the supply of money

[4]It resides outside the scope of this essay to discuss whether commodity money, with or without fractional reserve arrangements, could provide a "better" monetary system than any fiat money arrangement discussed by Buchanan and analyzed here. The short answer to that is that, no, the tendency to economize on base money, once it is expensive, will necessarily create the sort of bad incentives seen in the historical developments which resulted in the movement away from those arrangements. A more extensive treatment of that may be found elsewhere (Zelmanovitz 2015, p. 324).

is "automatically" regulated in order to match the demand for money and, at the same time, resources are directed to borrowers who will likely employ them profitably.

The real-world problems Buchanan is keenly aware of are the ones created by political interventions and other non-economic factors, but the proposed solution of limiting the supply of money to external money makes no allowance of how the monetary authorities would overcome their limitation of knowledge about how much money should be supplied, nor how to limit the creation of credit only to profitable market lending.

We can see that clearly if we think about how, under those arrangements, the central bank would supply the market with liquidity: they would buy and sell securities in a sort of "open money market operation" at a given interest rate whose determination would be severely limited by the absence of an independent "prime rate" since the banks would not be allowed to generate loans other than with funds supplied by the central bank in one way or other. If the securities traded on the "open market" are limited to treasuries, it means that all liquidity in the economy will be funneled to float the public debt and none will go to fund private productive activities. If the central bank accepts to buy private bonds, the government will be in the business of allocation of credit, hardly a solution to avoid political interference in monetary matters.

Buchanan's claim, therefore, that fractional reserve arrangements are anachronistic is unassailable; as much as one may point out that the alternative proposed by the *Chicago Plan* in its many old and new iterations creates another set of problems. The question, then, is to see whether it is possible to find another alternative to fractional reserve arrangements which addresses those other problems.

The problem created by FRB is the multiplication of claims in the form of inside money over a limited amount of external money, and the solution proposed by the *Chicago Plan* is to eliminate inside money. Such solution creates a problem that once all money becomes external money, the matching of supply and demand for liquidity ceases to be done "automatically" by the interaction of the agents in the market and becomes decided by fiat by the monetary authorities, reducing the efficiency of economic coordination given their limitations of knowledge. The obvious answer to this problem is a system in which *all* money becomes inside money.

Although, to my knowledge, Buchanan was never explicit about that, the common brick proposal is one possible system in that category. Under a common brick standard, all base money is produced competitively by the market in response to profitable opportunities created by the demand for liquidity in the economy and, under such arrangement for the production of base money, there is no need for FRB in order to supply the market, automatically, in order to match the demand for cash balances.

Such system, using Buchanan's criteria for what constitutes the good in terms of money, would be undoubtedly an improvement over the arrangements we have today. However, violent swings in the demand for money caused by events outside the market would continue to potentially affect the ratio between cash balances and available goods in the economy which the value of the unit of account depends on.

It may be understood that no "better" arrangement is possible in the real world; but in theoretical terms, as learned from some historical episodes (from "imaginary money" in the Middle Ages to "indexation" in developing countries in the second half of the twentieth century), there is a solution for that problem too and that solution is the separation of monetary functions.

So, aside from the common brick standard proposal, there are other alternatives for the problems that may come as a consequence of how a monetary constitution may dispose of the relation between the medi(um)a of exchange and the unit of account.

For most of recorded history, money has been the social institution performing simultaneously all three primary monetary functions of medium of exchange, unit of account and reserve of value. There are many historical and economic reasons for that,[5] although there are also many examples of separation of monetary functions in history, and we can understand from those episodes the circumstances in which it makes sense for individual economic agents to use different instruments to perform different monetary functions.[6]

[5]See Zelmanovitz (2015, p. 20).

[6]See footnote 21 on Einaudi's classical paper on "Imaginary money" (Zelmanovitz 2015, p. 51).

One of the main problems that "New Monetary Economics" hopes to solve with the proposal of separation of functions is to provide a unit of account whose value does not need to change in relative terms with all the goods and services available in the economy (the price level) when changes in the relative proportion of goods in the market and the stock of money do change (Cowen and Kroszner 1994, p. 30). The aim of the separation of monetary functions is, therefore, to have a unit of account that is representative of the price level in the economy, usually measured by the price of a basket of representative goods and services, being that a common brick, a Big Mac, or the Consumer Price Index (CPI), and to allow the amount of medium (or media) of exchange to vary (ideally) according only to the fluctuations in the demand for cash balances.

The reason why Buchanan settled for predictability instead of stability of the purchasing power of money is that Buchanan did not contemplate the possibility of separation of functions as a solution to the problems that stability of value may create in the minds of some people, preventing them from agreeing with stability as a desirable goal for monetary policy.

If you abstract the problems resulting from inflexibility of the money supply that may be created having as the main criterion of monetary policy the stability of value of the unit of account; stability and not predictability would be the preferred goal. That is the case, obviously, because of its benefits to economic efficiency, which is the (meta) criterion used by Buchanan to define the criterion for monetary policy (Buchanan 1962, p. 156). However, you can only achieve the goal defined by the criterion of price stability, without compromising the "ultimate goal" of political economy of providing the conditions for economic efficiency, if the purchasing power of the unit of account is not determined by the changes in the relative quantity of the media of exchange versus the availability of goods and services in the economy, that is, only when we have separation of monetary functions.

The goal of economic efficiency is, therefore, better served with separation of functions than by any other monetary arrangement that does not allow for that. Such separation may well be put in force by accepting the common brick standard as the unit of account.

However, Buchanan's version of the common brick standard is not that as seen above. His proposal is for common brick to be used as base money, performing at the same time all monetary functions.

Summarizing the discussion in this section, it is found among Buchanan's contributions to monetary theory: (i) his approach of institutional economics used as a tool to understand complex social realities (which, needless to say, go beyond just economic considerations); (ii) his use of such theoretical apparatus, and the evidences from reality so analyzed, to prescribe improvements to social arrangements; (iii) the proposal for the constitutionalization of money in order to avoid both chaos and politicization; and (iv) the proposal to end fractional reserves given the loss of its economic sense due to technological advancements in the provision of money.

However, proposals in the same direction as this last one have failed to offer a solution to the problem of politicization of external money, the only money that would exist under those arrangements. In Buchanan's contributions to monetary theory we find a solution to that problem, though: a provision of base money that is not external money, but inside money. Such proposal, however, does not address a topic raised by the New Monetary Economics, that is, the advantages that separation of monetary functions may bring to an ideal monetary system, by making available a unit of account of relatively more stable purchasing power.

Following therefore Buchanan's criteria, tools and prescriptions, an ideal monetary system takes form: A constitutionalization of money under which there will be competitive provision of inside money, no external money, there will be a 100% bank reserve requirement for any banking activity, separation of functions, and the unit of account will be an "index" of goods of services mimicking the broad economic activity. Such system may be defined as a "free banking" sort of arrangement, with the "privatization of money" (no government's issued money), no "monetization of public debt," and yet, it will be regulated by constitutional rules and granted under the acknowledgement of the monetary prerogatives of the sovereign.

In a book review of Kotlikoff's *Jimmy Stewart Is Dead*, Richard Wagner explains that the bad qualities of human nature that led to the "horrible mess" described by Kotlikoff in our financial arrangements cannot be cushioned by regulation, "(T)o the contrary, that cushion is provided by ordinary prudence reinforced by institutional arrangements that market participants have crafted in light of those prudential concerns" (Wagner 2011, p. 321). And he concludes, "(T)he road out of that mess, however, runs through an expansion in the domain of liberty and responsibility and not through feeding steroids to new regulatory agencies" (Wagner 2011, p. 322). Based on this review of Buchanan's contributions to monetary theory, it seems reasonable to conclude that he would agree with that, and I would second him on that.

References

Boettke, P. J., & Smith, D. (2016). Evolving Views on Monetary Policy in the Thought of Hayek, Friedman, and Buchanan. *The Review of Austrian Economics, 29,* 351–370.

Boettke, P. J., Salter, A. W., & Smith, D. J. (2016). *Money as Meta-Rule: Buchanan's Constitutional Economics as a Foundation for Monetary Stability* (Working Paper Number 16–49). Department of Economics, George Mason University.

Brennan, H. G., & Buchanan, J. M. (1981). *Monopoly in Money and Inflation* (Hobart Paper #88). London, UK: Institute of Economic Affairs.

Buchanan, J. M. (1962). Predictability: The Criterion of Monetary Constitutions. In L. B. Yeager (Ed.), *In Search of a Monetary Constitution* (pp. 155–183). Cambridge, MA: Harvard University Press.

Buchanan, J. M. (1988, May). Prolegomena for a Strategy of Constitutional Revolution. In *Prospects for a Monetary Constitution*, *Proceedings of an International Monetary Conference*, Lugano, Switzerland: Progress Foundation.

Buchanan, J. M. (1989). Reductionist Reflections on the Monetary Constitution. *Cato Journal, 9,* 295–299.

Buchanan, J. M. (2010). The Constitutionalization of Money. *Cato Journal, 30,* 251–258.

Buchanan, J. M. (2015). The Value of Money as a Constitutionalized Parameter. In *Renewing the Search for a Monetary Constitution*. Washington, DC: Cato Institute.

Buchanan, J. M., & Wagner, R. E. (1977). *Democracy in Deficit: The Political Legacy of Lord Keynes*. New York: Academic Press.

Burns, S. (2016). Old (Chicago) School, New Century: The Link Between Knight and Simon's Chicago Plan to Buchanan's Constitutional Money. *Constitutional Political Economy, 27,* 299–318.

Cochrane, J. H. (2014, April 16). *Toward a Run-Free Financial System*. Available at SSRN https://ssrn.com/abstract=2425883.

Cowen, T., & Kroszner, R. (1994). *Explorations in the New Monetary Economics* (p. 1994). Cambridge, MA: Wiley-Blackwell.

Friedman, M. (1960). *A Program for Monetary Stability*. New York, NY: Fordham University Press.

Horwitz, S. (2011). Do We Need a Distinct Monetary Constitution? *Journal of Economic Behavior & Organization, 80*, 331–338.

Ricardo, D. (2004 [1824]). Plan for the Establishment of a National Bank. In Piero Sraffa (Eds.), *The Works and Correspondence of David Ricardo, Volume IV, Pamphlets and Papers, 1815–1823*. Indianapolis, IN: Liberty Fund.

Simons, H. (1936). Rules Versus Authorities in Monetary Policy. *Journal of Political Economy, 44,* 1–30.

Smith, A. (1982 [1776]). *An Inquiry into the Nature and Causes of the Wealth of Nations* (Vol. II). Indianapolis, IN: Liberty Fund.

Wagner, R. E. (2011). Laurence J. Kotlikoff Jimmy Stewart Is Dead: Ending the World's Ongoing Financial Plague with Limited Purpose Banking. *Review of Austrian Economics, 24,* 319–322.

Zelmanovitz, L. (2015). *The Ontology and Function of Money—The Philosophical Fundamentals of Monetary Institutions*. Lanham, MD: Lexington Books.

Part VII

Buchanan in Relation to Other Prominent Scholars

46

Italian Influences on Buchanan's Research Program

Alain Marciano and Manuela Mosca

Introduction

The relationship of James Buchanan with the Italian tradition in public finance—usually referred to by its Italian name as the *scienza delle finanze*—and even with Italy and Italians in general has already been the subject of many essays, some by Buchanan himself[1] and by other protagonists and direct witnesses that we shall meet in the course of this chapter. Let us simply mention here the excellent studies by Domenico Da Empoli (1989, 1993, 2003, 2004, 2013a, b) and Richard Wagner

[1] In his autobiography (1992, Chap. 6, pp. 82–92).

A. Marciano
Faculté d'Économie, MRE and Université de Montpellier,
Montpellier, France
e-mail: alain.marciano@umontpellier.fr

M. Mosca (✉)
Università del Salento, Lecce, Italy
e-mail: manuela.mosca@unisalento.it

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_46

(2003, 2017).[2] The purpose of this chapter is not to add much factual details about that history. We will rather try, first, to survey the existing literature about Buchanan and the Italians and then, second, to supplement it with some new archival sources and interviews, to allow a better understanding of the Italian influences on Buchanan's research program. We thus show that Buchanan had not really been interested in Italian economists before he went to Italy. Or, to be more precise, he knew their work and was interested in what they had written and had used it to establish the bases of his own theoretical framework in public finance. But it was not before he went to Italy that he realized how important the work of—certain of—these Italian economists was.[3] This was partly due to the readings Buchanan made when he was in Italy in 1955–1956 but also the consequence of the discussions he had with Italian scholars.

Buchanan's First Works: Scarce References to Italian Economists

In Buchanan's attitude towards the economists of the so-called Italian public finance tradition, there is obviously a before and an after 1955. Before 1955, Buchanan did not pay much attention to these economists. He cited or quoted them rarely. He mentioned them in his dissertation for the first time and then again in "The Pure Theory of Government Finance" (1949). But not in any of the nine other articles he wrote during this period.

But, one must start with Buchanan's dissertation—*Fiscal Equity in a Federal State* (1948)—to find the first mentions to these economists.

[2]The Italian tradition in public finance has also largely been studied. See in particular the following references: Medema (2005), Giardina and Mazza (2016), Backhaus and Wagner (2005a, b), and Eusepi and Wagner (2013).

[3]In 1960, in a comment to his 1949 paper, he said: "This paper was written before the author was familiar with the Italian fiscal theory. The Italian literature is characterized by a much more careful consideration of the political presuppositions" (Buchanan 1949, 1960, p. 8, fn. 1).

These mentions are scarce. Buchanan referred to the Italian public finance economists when he came to discuss the benefit theory of taxation. He first noted that this theory had been discarded. That, he could not ignore. Indeed, one of the opponents to such a theory of taxation was Henry Simons, with whom Buchanan seems to have been quite close during the first semester of 1946, that is when Buchanan arrived at Chicago, followed one of Simons's courses and before Simons's died in June 1946. In his teaching, as well as in his writings, Simons had been very clear that a general theory of taxation could not be based on benefits. More precisely, he agreed that benefits could be used to determinate taxes in very specific cases—precisely when benefits could be identified and measured but, in most cases, Simons claimed, those benefits could not be identified. He had clearly stated the reasons for his disagreement in *Personal Income Taxation* (1938) as well as in a very negative review of Antonio de Viti de Marco's *First Principles of Public Finance*.

Simons found the thesis defended in the book to be "a rigid, if not explicit, sort of benefit doctrine" (1937, p. 714). He linked this aspect with de Viti de Marco's conception of the "co-operative state" (1937, p. 714), that is a conception of the state in which "[i]ndividuals 'demand' public goods" (1937, p. 714) and "taxes are the prices against which people set the utilities of these goods" (1937, p. 714). To Simons, de Viti de Marco's "attempt to illuminate the political phenomena of taxation and expenditure by vaguely analogical application of the terminology and axioms of traditional price-theory" failed. Indeed, its "central argument appears to involve all the faults of naive marginalism in matters of political action" (1937, p. 714).

At some point, Buchanan contrasted this review with the one written by Frederic Benham, an Australian economist who taught at the London School of Economics (1934a), that praised de Viti de Marco for having written, with *Principii di Economia Finanziaria*, "probably the best treatise on the theory of public finance ever written" (1934a, p. 364). And Buchanan came to think that "Simons was totally wrong" about de Viti de Marco but "Benham was right" and that "he understood the impact of [de Viti de Marco's] book" (Buchanan, in Mosca 2016, p. 129). What Buchanan found interesting in de Viti de Marco—and beyond, in the analyses of the Italian public finance economists—was exactly what Simons rejected.

First, that they treated taxes and expenditures simultaneously, as two sides of the same phenomenon—that is, to put it in other words, that they adopted a general rather than a partial equilibrium approach of taxation. They precisely could do that because they considered that taxes were or should be linked to the benefits individuals make when they consume public goods and services. Certainly, Buchanan agreed, benefits would not be easy to determine and calculate. They were subjective and consisted in gains in utility individuals would make. But, that should imply that a benefit theory of taxation should be discarded. What was important was what such a theory would teach us about the nature of the relationships between individuals and the state. Indeed, if individuals could be said to receive benefits when consuming public goods and services, that would then imply that they would pay taxes because of these benefits as they would do for private goods. This, then, would mean that there was an exchange between the state—supplying goods and services—and the individuals—who demand them. In other words, a benefit theory of taxation implied or was closely connected with the voluntary exchange theory and a contractual theory of the state—precisely what Simons disagreed with and what Einaudi (1929), after Pantaleoni (1883) and de Viti de Marco (1936),[4] had argued.[5] That deserves to be noted: to Buchanan, it was the connection between the benefit theory of taxation the Italians had developed and their conception of the state that really mattered to him.[6]

[4]1936 is the date of publication of de Viti de Marco's book in English. De Viti's handbook was widely used for many years, starting from 1886 to 1887, in the form of lithographed handouts, then in 1923 it was printed in a limited edition, and lastly published in 1928.

[5]Buchanan explicitly made a connection between these theories in his dissertation, referring to social contract theorists—namely, Hobbes et al. (1948, Chap. 2). He removed these references in the published version of "The Pure Theory of Government Finance" (1949).

[6]One may add that Buchanan used their works to develop an "individualist" theory of the state, that he opposed to an "organismic" theory of the state (1948, Chap. 2, 1949; see also, Marciano 2016). In his dissertation, he justified the term "organismic" with a reference to the Swedish economist, Erik Lindahl. Domenico da Empoli (1989, p. 16) suggested that the opposition between the organismic and the individualistic theories of the state also reflects De Viti's dual model of the state. As we have shown elsewhere (Marciano 2019), Benham (1934b) precisely

Buchanan made that claim in his dissertation and repeated in "The Pure Theory of Government Finance. A Suggested Approach" (1949). He had thus built a theoretical framework—around fiscal justice and an equal treatment for equals, a benefit theory of taxation and the existence of a voluntary exchange relationship between the state and citizens—that would "enable the results of policies to be evaluated" (1949, p. 505). The works of Wicksell, Lindhal, Sax and, obviously, Pantaleoni and de Viti de Marco had been important for him in this regard.[7] But he did not refer to these economists for a few years. However, one of the themes upon which he worked—the financing of highways and roads—will eventually and indirectly bring him back to them. Again, as we have suggested elsewhere (Marciano 2019), the connection is through Benham.

Financing Roads and Highways: Marginal Cost Pricing

In an article published in 1934—"Notes on the Pure Theory of Government Finance" (1934b)—that was actually a review essay of Einaudi's *Contributo alla Ricerca dell' "Ottima Imposta"* (1929), Benham had introduced references to the work of de Viti de Marco—of whom Einaudi was a disciple—and made a connection with Wicksell. Now, Benham illustrated his analysis of how a benefit principle or a voluntary exchange theory of the state could be used with the case of roads. Roads and highways had been a topic of interest to Buchanan for some years. In his master essay, he had claimed users should pay for the financing

insisted on the importance of a cooperative theory of the state in his comment of Einaudi's *Contributo alla Ricerca dell' "Ottima Imposta"* (1929).

[7]Surprisingly, Buchanan referred to Einaudi's work in his dissertation as well as in the preliminary version of "The Pure Theory", where he wrote "Professor Einaudi, Italy's current President, is a representative of this school in his work on fiscal theory's" (1949, p. 25)—directing his readers to Benham's article rather than to Einaudi's work. But the name and reference disappeared in "The Pure Theory" where the only Italian economists mentioned were Pantaleoni and de Viti de Marco.

of roads and had defended the idea of a gasoline tax (Marciano 2018). Reading Benham, and then Wicksell, Buchanan understood that there were economists who developed ideas that could be used to formalize and justify theoretically intuitions he had had when he was younger.

In 1951, after having read the two articles Nancy Ruggles (1949–1950a, b) had written on the debates about the use of marginal cost pricing for decreasing costs industries, Buchanan wrote an article on Wicksell and marginal cost pricing. In this article, he presented, discussed and defended the rule Wicksell had laid about the pricing of public goods and services. That rule consisted in saying that public firms with decreasing costs should price the goods they produce at the marginal cost of production and should cover the deficit—caused by the difference between the marginal and average costs—by taxing users. The latter, because they receive benefits from consuming those goods, are expected to voluntarily pay the taxes they are asked to pay. Wicksell had suggested that the rule could be used for various types of infrastructures. Buchanan immediately claimed how Wicksell's rule was important and that it should be used to finance the use of roads and highway services.

That road users should be asked to pay a price equal to the marginal cost was the central idea of "The Pricing of Highway Services" (1952). To be more precise, not only the price for road services have to be set at the level of the marginal costs of production and taxes should be added to cover for the rest of the costs, but also "spillover" costs should be added to the price each user would have to pay. Indeed, the quality of the services they provide depends on the number of users; congestion reduces this quality and creates a ""spillover" cost represented in poorer service provided all users" (1952, p. 100). Thus, the "correct price" for highway services corresponded, to Buchanan, "to the marginal *social* cost incurred in providing a unit of that type of service" (1952, p. 100, emphasis added; see more details in Marciano 2013).

Buchanan repeated the same argument in a note he wrote in 1954—and that can be viewed as a preliminary version of his 1956 article, "Private Ownership and Common Usage: The Road Case

Re-Examined": "it is necessary that the prices of highway services be set equal to the marginal *social* costs of providing such services" (1954, p. 6; emphasis added). Which means, Buchanan added to avoid any misunderstanding, that it is necessary that the price also "includes the incremental costs (or reduced enjoyments) imposed upon other road users!" (1954, p. 6). Then, again, in "Painless Pavements" (1955a)—an unpublished paper he drafted at the beginning of 1955—and in *Traffic, Tolls and Taxes. The Economics of the Nation's Highway Problem* (1955b)—an unpublished book written also in 1955—Buchanan repeated his claim—"[t]he answer to the whole highway problem lies in 'pricing' the highway correctly" (1955a, p. 15). Which also meant that asking the users to pay for the units of roads they consume would also "provide more than adequate revenues to finance [the] expansion" (1955a, p. 16) of the highway system.

That was not however the policy that was then favored "in these post-Keynesian years" (Buchanan 1955a, p. 2) and that consisted in increasing public spending. To Buchanan this was problematic in that, first, it was completely disconnected from the revenues required to cover the expenditures and, second, that it ignored the costs it would impose on the society. This was, in particular, the case with what had been proposed to finance the expansion of the highway network by issuing bonds.[8] One of the alleged advantages put forward by the promoters of that policy was that the increase of public expenditure would neither increase taxes nor the national debt. Which, to Buchanan, was impossible. He stressed that no one could believe that "all governmental 'good things' such as super-super highways may come to us without our having to bear either the burden of taxation of the sufferings of conscience over increasing national debt" (1955a, p. 2). Hiding or ignoring

[8]The proposal was made by the Clay Committee—an Advisory committee on a National Highway Program, chaired by general Lucius D. Clay and established by the then president of the U.S.A., Dwight Eisenhower, to suggest mechanisms to finance the expansion and modernization of the highway network. The bonds issued by the government would be managed, the Committee proposed, by a Federal Highway Corporation.

this was, at best, a mistake. Buchanan insisted that these costs should be taken into account and not hidden below the board (1955a, p. 16).

Besides Buchanan's focus on the need to price public goods as it is done with private goods—because it may indicate an analogy between the public and private system that one finds in the works of the Italian public finance economists to whom Buchanan did nonetheless not refer—, one must note that Buchanan did insist on the costs that would have taxes or loans. But, and this is important, he did not distinguish the costs that each of these two means of financing the expansion and modernization of the highway system or, more broadly, public goods. In other words, these costs were not supposed to be different. Or, still in other words, that they could be different had apparently not crossed Buchanan's mind. At least, in 1955.

It was in 1957 that Buchanan put forward the distinction. In the preface of *Public Principles of Public Debt*, that was published in 1958 but was completed by the end of 1957,[9] Buchanan explained that he had to stop writing a book on highways because he had "reached a point at which an appropriate chapter on 'Taxes versus Loans' should have appeared" (1958, p. xvii) and could not write it. The point was precisely to ask which system should be chosen to finance the construction of highways, an increase of taxes or an increase of the debt: "[s]hould taxes be increased sufficiently to cover the full current outlay from currently collected funds, or should public borrowing be accepted as an appropriate means of financing?" (1958, p. xviii). And he did not treat it because he had not found in the literature the means that could allow to do so. He had thus realized that "economists seemed to be able to contribute surprisingly little to the solution of this problem" (1958, p. xviii). The "conception of the public debt which has achieved dominance among economists during the last twenty years and which characterizes economic thought today was useless in the full-employment world of the 1950s" (1958, p. xviii). In other words, the standard

[9] The preface itself is dated from December 1957.

theory in public finance—that he called the "new orthodoxy" (1958, Chap. 2)—did not provide any means to answer the question, and therefore to write the chapter.

What explains the change between the end of 1955 and the end of 1957 was that Buchanan had spent one year in Italy on a Fullbright scholarship.

Studying Italian Economists in Italy

Buchanan left in September 1955 to Italy where he stayed until September 1956. He had drafted a preliminary working program—the more detailed project, he must certainly have had to write to obtain the scholarship, is however no longer available. Buchanan planned to deepen his knowledge and understanding of these economists he had already read, studied, cited and even quoted in his dissertation and in "Pure Theory" (1949) without seeming to have a precise research agenda in mind. He simply "hop[ed] to examine the major works in the area of government finance" (1955c).

This meant the "[t]hree figures [who] loom large in the field of Italian fiscal theory… These are Pantaleoni, de Viti de Marco, and Einaudi" (1955c). More precisely, since de Viti de Marco's work had already been translated in English, Buchanan would rather start with Panaleoni's and then Einaudi's. Then, after this had been done, he would move on to study a few other Italian economists whose works would be interesting to read—he listed the names of forty-two economists.[10] Among them, Buchanan listed the name of Benvenuto Griziotti because he "is mentioned several times, and he has done much writing" (1955c). But he was not convinced that it would be useful—he added "I get the

[10]In his autobiography, Buchanan cited the following names: "Ferrara, Mazzola, de Viti de Marco, Pantaleoni, Ricca-Salerno, Puviani, Montemartini, Barone, Einaudi, Fasiani, Fubini, Cosciani, Griziotti, De Maria, Arena—and many others" (1992, p. 87).

impression, however that it is of little value" (1955c). Griziotti would prove to be more important than Buchanan had anticipated.

As planned, Buchanan spent most of his time in Rome, reading and working at the library of the Bank of Italy (see also, Forte 2013b, p. 62). He made a few trips, to Paris, London and, above all, to Pavia, where he went to meet Griziotti and to benefit from the very rich collection of books at the University's library. Buchanan was invited by Parravicini to give lectures there. Griziotti, then 72 years old and without a chair, asked Francesco Forte to assist Buchanan (Forte 2013b, p. 65). That was the beginning of a long friendship—Buchanan and Ann, his wife, got on very well with Forte and his wife—and fruitful intellectual collaboration.[11] The explanation can also be found in the fact that Buchanan and Forte had common interests. Forte, thus, had written his dissertation on the benefit principle in taxation and on the fiscal rents and had then written an article based on the idea that the gasoline tax could be viewed as a form of price for the use of highway services (2013b, p. 66). In other words, they obviously shared the same conception of how to price highway services. In addition, it was Forte who introduced him to Griziotti's ideas—and, from what Forte recalls—corrected his views. Thus, to Forte, "Griziotti maintained that the fiscal choices are different from the market choices because the state consists of flows of individuals of different generations" (2013b, p. 71). This claim may have sounded familiar to Buchanan who, in "Individual Choice in Voting and the Market" (1954), had differentiated political and market choices because, among other differences, individual do take the consequence of their actions on others when they make political choices. To a certain extent, fiscal choices—like political ones—involve taking others into account. The part that was missing in his 1954 article is the one about individuals from different generations.

That was exactly what he introduced in his analysis of the public debt and led him to write what represents one of the most important outcomes of Buchanan's stay in Italy, *Public Principles and Public Debt*.

[11]"For three decades, we [his wife and himself] have counted Francesco and Carmen Forte among a relatively small number of friends for life" (Buchanan 1992, p. 89).

A New Approach to Public Debt: The Role of Italian Public Economists

Even if he admitted that the Italian public economists he read in 1955–1956 could be said—at least to a certain extent—to be wrong,[12] he also insisted that their works were particularly helpful and important for him. They actually not only allowed him to elaborate a new theory of public debt but, above all, led him to realize how important the question was.[13] Up to the point that, now, Buchanan decided to—and could—give up writing his book on the financing of highways. There was a more urgent and more important task to complete: to show what was wrong with the "new orthodoxy", and the "new economics", and to propose a new theory of public debt.

What had triggered Buchanan's understand was that he found that "Italian scholars have devoted much attention to the Ricardian proposition that taxes and loans exert identical effects upon an economy" (1957b, p. 1038). Put differently, that proposition meant that "[t]he creation of public debt does not involve any transfer of the primary real burden to future generations" (1958, p. 5). That was, Buchanan also found out, the most important of the "three basic propositions … the new orthodoxy of the public debt is based upon" (1958, p. 5). This corresponds to what is now well known as the Ricardian equivalence theorem—a term Buchanan coined (see Toso 1992, p. 819; Buchanan 1976, p. 337)—and also as the Ricardo-de Viti-Barro theorem. That reference to de Viti de Marco is certainly not a surprise: he was one of the many Italian economists who "accepted and elaborated this proposition" (Buchanan 1957b, p. 1038; see de Viti de Marco 1893; 1936, pp. 377–398).

---

[12]In the preface of *Public Principles*, Buchanan wrote: "[i]n a specific sense, none of the Italian theorists appears to have formulated a fully acceptable theory of public debt" but, even more, "the dominant theory in Italy, even prior to the 1930s, has much in common with that which characterizes the 'new economics'" (1958, p. xix).

[13]Thus, he noted, their "approach to the whole problem of public debt was instrumental in shaping my views as they now stand, and I should, therefore, acknowledge this influence" (1958, p. xix).

In his elaboration, though, de Viti de Marco did not answer "[t]he major objection which has been raised to the proposition … that individuals do not fully discount future taxes" (1958, p. 36). Indeed, the Ricardian proposition requires that an individual who owns capital assets "write[s] down the value of his assets and transmit[s] them to his heirs at the reduced value" (1958, p. 36). The problem was then twofold. First, there was no certainty that individuals did discount future tax payments—the individual "may convert this capital into income at any time, without in any way removing the tax obligation on his heirs which is necessitated by the debt service" (1958, p. 92)—which implies that part of the debt would actually be paid by the future generations. Then, and that was the second problem, there were individuals—the "lower income or laboring classes"—who own no capital. The latter will "escape fully the burden of the extraordinary tax" but they "may … in future time periods … bear a portion of the burden of the public loan" (1958, p. 91). Again, the conclusion was that "the burden must rest on "future generations," at least to some degree" (1958, p. 36).

It now happens that it was in the work of this economist that Buchanan had believed to be "of little value" Griziotti, that Buchanan found these two criticisms against de Viti de Marco and that may have led him to realize that and why this proposition should be discarded. Griziotti was the one who had put forward this idea that became central in Buchanan's analysis and theory of the debt, namely the idea that "public debt creation does involve a shifting of the real burden to future generations of taxpayers" (1958, p. viii). Buchanan acknowledged that in his 1957 review of a collection of Griziotti's articles gathered in a volume—*Studi di scienza delle finanze e diritto finanziario*—published in 1956. He praised Griziotti for having defended the "common view" about the shifting of the tax burden (1957b, p. 1038). In his 1958 book, Buchanan detailed the limits of Ricardo's and de Viti de Marco's analyses and of Griziotti's criticism. To Buchanan, Griziotti, "may take its place alongside the works of Bastable and Leroy-Beaulieu in helping to re-establish what is, essentially, the 'correct' classical formulation of debt theory" (1957b, p. 1038).

If this proposition was rejected, the two other related propositions upon which rested the "new orthodoxy" had to be rejected too:

"[t]he analogy between individual or private debt and public debt is fallacious in all essential respects" (1958, p. 5), as the "sharp and important distinction between an internal and an external public debt" (1958, p. 5). It was actually this last proposition that Buchanan put forward his first criticism of the "new orthodoxy" in a paper that was published in 1957 (1957a) that he revised to link it to the criticism of the two other propositions and included it in the *Public Principles of Public Debt*. This time, he was inspired by Pantaleoni, Buchanan tells us in the preface of his 1958 book (p. xix), even if he did not refer to Pantaleoni or to an Italian economist in his article or in the chapter of the book. Then, and that was another insight he got from the Italian economists, Buchanan "came to realize that the analogy between the public economy and the private economy is applicable to most of the problems of the public debt" (1958, p. viii).[14] In other words, Buchanan had a theory of the public debt. It rested on the opposite of the three propositions he had criticized in his book. He owed that to the year spent in Italy.

Francesco Ferrara and Fiscal Illusion

Most of Buchanan's energy while in Italy was spent on writing the essay entitled "*La scienza delle finanze*: The Italian tradition in Fiscal Theory" (1960). The essay was actually completed in 1959 and Buchanan expected it to be published earlier—as he wrote Einaudi in March 1959—but its publication was delayed after *Public Principles of Public Debts* was published.[15] Buchanan had benefitted from comments from

[14]Wagner (2014) also linked this book to Buchanan's main interests and methodology, however he stated that Buchanan "failed to carry forward fully his insights from highway finance to public debt more generally" (260). For an analysis of Buchanan's work on public debt, see also Templeman (2007) and contextualized in a history of ideas perspective by Salsman (2017).

[15]"I am hopeful that the long essay of my own in which I summarize the development of Italian fiscal theory will be published this year" (Buchanan to Einaudi, 3 March 1959), Fondazione Einaudi, Archivio Luigi Einaudi.

Einaudi, for which Buchanan thanked him.[16] He then sent him a copy after its publication:

> I presume that you have received the copy of my book *Fiscal Theory and Political Economy*, that I sent to you some months ago. I shall be interested to learn of the general Italian reactions to the essay on "La Scienza delle finanze: The Italian tradition in Fiscal Theory" that the book contains.[17]

We have not found any reviews of Buchanan's book in the Italian press of the early 1960s, but the essay is certainly known to have had a huge influence on Italian scholars in the following decades.

From his letters to Einaudi we also discover that Buchanan intended to spend another long period in Italy, with the aim of studying the masterpieces of the father of the Italian school, Francesco Ferrara, and translating them into English. In his 1960 essay he had judged them "extremely important" (1960, p. 25)[18]; according to him, Ferrara deeply influenced the Italian public economists through his orientation toward a general approach to economic theory which included the state, through his subjective-value theory, his individualism applied also to collective choice, his dual model of the state,[19] "his recognition of the tax as a price and of the productivity of public services" (1960, p. 29). For all this Buchanan defined Ferrara the "fountainhead of ideas" and stated that "a good dose of Ferrara" would have been "helpful

---

[16]Buchanan wrote him: "You were kind enough to make some comments on this essay for me about two years ago through the office of my good friend, Professor Parravicini". Buchanan to Einaudi, 3 March 1959.

[17]Buchanan to Einaudi, 27 January 1961.

[18]"My long range plans include a second long stay in Italy within the next five years. During this period, I shall plan to concentrate on Ferrara who has been almost completely neglected by English speaking economists. I should hope to sponsor and organize an English translation of several of his famous Prefaces" (Buchanan to Einaudi, 3 March 1959). And also: "I hope to return for an additional year's research in Italy soon to learn more about the life and work of Ferrara. He is an economist who seems to have been seriously neglected by English-language scholars, and I should like to organize, if possible, an English translation of some of his critical prefaces. These are, in my opinion, very good works" (Buchanan to Einaudi, 27 January 1961).

[19]Ferrara contrasted an "economic" model of the state with an "oppressive" one: the former was regarded as an ideal, the latter as the form existing through history.

to modern fiscal Marshallians" (1960, p. 71). In his 2008 memories he underlined again the importance of Ferrara, attributing much of the Italian tradition in fiscal theory to the "tremendous contributions made by Ferrara". He specified: "that was a very, very important discovery for me … He was the dominant force in ideas in that period" (Buchanan in Mosca 2016, p. 130). However, he never carried out this project.

A second project was mentioned in his letters to Einaudi: Buchanan hoped "to work further on 'the fiscal illusion' developed by Puviani and Fasiani, and to apply this conception to some of the American fiscal institutions".[20] Buchanan had already mentioned the risks that individuals would be victims of a form of "tax illusion" (1950, p. 596) because of which they "respond more quickly to tax burden differentials (especially direct taxes) than to differentials in public service standards" (1950, p. 596). This would lead them to prefer less taxes (and less public goods) to more taxes (and more public goods) even if the second situation is more favorable to them. Now, in 1960, he was focusing on a different aspect of the problem, namely the role of government that could create fiscal illusion in order "to hide the burden of taxes from the public and to magnify the benefits of public expenditures" (1960, p. 60). Unlike his first project, Buchanan managed to carry out the second one. In the academic year 1961–1962, in continuity with his previous research on public debt, he wrote a paper whose first question was: "To what extent does the presence or absence of 'public debt illusion' affect the temporal location of debt burden" (Buchanan 1964, p. 150).

In 1962 he returned to Italy, invited by Francesco Forte, to give seminars in the Political Economy Workshop (Laboratorio di Economia Politica) in Turin (Giardina 2017, p. 396). In one of them he presented the first version of this paper, arguing that "Public debts probably generate fiscal illusion … [but] the presence or absence of illusion does not affect the temporal pattern of resource payment which debt issue must involve" (1964, p. 161). This essay was the subject of a long discussion with Emilio Giardina in 1962 and later in their correspondence of

[20] Letter from Buchanan to Einaudi, 27 January 1961. This project was already envisaged in Buchanan (1960, p. 64, fn. 39): "It is along these lines that I hope to do considerably more work".

1963–1964.[21] In one of his letters to Giardina, Buchanan wrote that initially he thought that the shifting of the burden was due purely to the fiscal illusion, but then he realized that it also took place without it.[22] Finally, in 1967, after having regretted that "'fiscal illusion' [had] not been more thoroughly analyzed" (1999 [1967], p. 127), Buchanan developed a general analysis of the phenomenon, extending its examination to both sides of the fiscal account and to the fiscal systems of his time.[23] In this detailed and exhaustive analysis of the government's behavior aimed at creating the fiscal illusion, one can clearly see how Buchanan had absorbed the skeptical attitude of the Italians towards the government and politics in general.[24]

Crossing the Borders of Continents and Disciplines

After his first stay, Buchanan returned to Italy several times but for short periods only, much to his regret. Let's recall some of his visits. In 1961, just one year before he went to Turin as said above, he participated in the Stresa "Conference on local government and the construction of European Unity". In 1983 in Rome he presented the first issue of the new *Journal of Public Finance and Public Choice—Economia delle scelte pubbliche*, to which he contributed several papers over the years. In 1987 he was guest of honor at the annual conference of European

[21]Buchanan thanked Giardina: "I have benefited from several discussions with my colleagues, James Ferguson and Emilio Giardina" (1964, p. 150).

[22]This part of their correspondence was in Italian: "Quando ho scritto il mio libro credevo che il trasferimento del peso al futuro dipende dalla presenza dell'illusione sull'individuo non 'capitalizing' l'imposta in futuro"—"When I wrote my book, I believed that the transfer of the burden to future generations depend on the existence of the illusion on the individual not 'capitalizing' the tax in the future" (our translation).

[23]Chapter 10 of the book is in fact entitled "The fiscal illusion".

[24]In his words: "One very important influence of the Italian year on me it was not only the reading this material, it was also living there, living in the culture, becoming a part of the culture, the attitude of the Italians toward politics, politicians and the state. You are much more skeptical, much more cynical, much less idealistic, much less romantic about the state, and that influenced me, influenced me a great deal" (Buchanan's interview in Mosca 2016, p. 131).

Public Choice Society in Reggio Calabria (Da Empoli 2013a); in 1990, he went to Turin, again, and gave a talk at the research center named after Einaudi, with whom he had an active working relationship, like the participation in the 1991 conference *Le vie della libertà. Il liberalismo come teoria e politica negli anni novanta (The roads to freedom. Liberalism as theory and politics in the 1990s)* organized in Rome by the Fondazione Luigi Einaudi. Since 1991 he was also a member of the Accademia dei Lincei, the most prestigious Italian cultural institution. In 1993, he was in Rome to receive an honorary degree in political science (Da Empoli 2013a), which was only one of the many honorary doctorates he was awarded in Italy.

As well as this, Buchanan managed to maintain a close relationship with Italy by inviting various Italian scholars to the USA, some of whom had considerable influence on his research activity. In 1959, he granted Forte a post-doctoral fellowship "with a political economy program" (Forte 2013b, p. 73). As a result, Forte spent the 1960–1961 academic year at the Thomas Jefferson Center for the Study of Political Economy at the University of Virginia. Forte (2013a) recalls that Buchanan had started up a new line of research, making an economic analysis of public decision-making. Indeed, this was the moment when Buchanan—with Tullock, in particular—was giving birth to non-market decision making, that is Public Choice.[25]

When in Virginia, Forte worked with Buchanan. After writing their first article together—it bore on the evaluation of public services (Forte and Buchanan 1961)—, Forte was appointed associate professor in that University. Buchanan wrote Einaudi, telling him that Forte would certainly "carry on in an excellent fashion the outstanding Italian tradition in this particular field of scholarship."[26] One of the effects of this very positive assessment was that Einaudi awarded Forte the top place

[25]On the Italian origins of Public Choice (see Giuranno and Mosca 2018).

[26]Letter from Buchanan to Einaudi, 27 January 1961. Here is the full passage: "During last year and for a part of this year, we have been fortunate in having here at the University of Virginia as visitor one of the outstanding young Italian scholars in public finance. I refer to Dr. Francesco Forte, with whom I believe you are acquainted. Forte and I have done some joint research, and we have further studies projected. I feel certain that Forte will carry on in an excellent fashion the outstanding Italian tradition in this particular field of scholarship".

in a public exam in Italy. This probably incited Forte to return home, after his stay at the University of Virginia. Later, he enjoyed a successful political career, along with his academic one.[27]

After that article, Buchanan and Forte continued to work together (Buchanan and Forte 1964), now using the new approach contained in *The Calculus of Consent* (Buchanan and Tullock 1962) to tackle fiscal problems like the choice between direct and indirect taxation. Forte recently underlined the influence that Italy had over Buchanan also in the field of the foundation of constitutional economics. He recently recalled that it was in Italy that Buchanan came into contact with the possibility to apply economic analysis to public finance legislation.[28] Especially developed by Griziotti, as suggested in section "Financing Roads and Highways: Marginal Cost Pricing", this sub-discipline also included the analysis of constitutional fiscal rules, and in fact in those years many Italian scholars, like Forte himself and also Giardina, wrote articles on the fiscal dimensions of the Italian constitution—a constitution that had been implemented in Italy just after the end of WWII.[29] Still according to Forte, it was in Italy that Buchanan came to understand more clearly the connections, he had already read about in Benham (1934b) (see Marciano 2019), between Wicksell's and de Viti de Marco's rules for political decision-making,[30] namely the need to use unanimity principle at the constitutional level, and the possibility to rely on a majority principle at the post-constitutional level.[31] The friendship and collaboration with Forte lasted for decades,[32] the last

[27]Forte was MP in various legislatures, and Minister from 1982 to 1986.

[28]In an interview given to Manuela Mosca on 18 June 2018.

[29]The Italian Constitution was enacted in 1947.

[30]Buchanan later wrote: "I was … fortunate that these complementary 'readings' occurred during residence in Italy" (1992, p. 91). In fact, as we have argued elsewhere (Marciano 2019; see also Section 3 of this paper), Buchanan probably made the connection between Wicksell and the Italian public economists by reading Benham (1934b). This explains why he talked of "complementary" readings.

[31]However, Forte doesn't underestimate the influence of Buchanan's master Frank Knight on this point.

[32]For example, in 1974 Forte published the Italian translation of Buchanan's essays in edited volumes.

example being the symposium held in Frankfurt, where Forte discussed the role of ethical values in Buchanan's approach and his research on "the return to increasing returns as sources of human flourishing in a progressing society" (Forte 2008, p. ix).

In 1963 another post-doctoral fellowship brought Emilio Giardina to the Thomas Jefferson Center for Political Economy. There, as we know, Giardina continued his work on public debt, but he also wrote on clubs, therefore indirectly contributing to develop Buchanan's theory. Buchanan acknowledged him as "the most important" of those who discussed with him early versions of his 1965 article, "An economic theory of clubs" (Buchanan 2008, p. 7) which, according to Tollison, "created an industry of further applications to such topics as alliances and fiscal federalism" (2008 [2004], p. 100).[33] We have already mentioned Giardina's correspondence with Buchanan, we can only add that Giardina critically developed many of the paths mapped out by Buchanan in different realms such as collective decision-making, public goods, public debt, local government finance, history of public finance thought (Giardina 2008). It was Giardina who, in 1994, delivered the address for Buchanan's honorary doctorate at the University of Catania.

A third Italian scholar who was important for Buchanan and with whom he interacted regularly was Bruno Leoni. A lawyer, Leoni was not only interested in law—he published in the early 1960s a book, *Freedom and Law* (1961) that became seminal and played an important role for Hayek[34]—but also in political decision making. In the late 1950s and early 1960s, Leoni published a few articles about economic analyses of politics. He was in particular interested in, and laudatory of, Buchanan's distinction between political and economic decisions discussed in his 1954 article on "Individual Choice in Voting and the Market". There were thus many reasons that explain that Buchanan and Leoni become close. But Leoni wrote his articles and

[33]In the first footnote of the paper Buchanan writes: "Special acknowledgement should be made for the critical assistance of Emilio Giardina of the University of Catania and W. Craig Stubblebine of the University of Delaware" (1965, p. 1).

[34]See Zywicki (2015) or Modugno (2017).

book after Buchanan came to Italy (Leoni 1957; see also Leoni 1961; Leoni and Stoppino 1960). In addition, during his first stay in Italy, Buchanan was primarily interested in public finance. It is therefore not surprising that Buchanan and Leoni did not meet during Buchanan's first stay in Italy (see Buchanan 1992, p. 89).[35] It came later when, as Buchanan recalled, after he found the "courage" to—definitively and more completely—cross "the disciplinary threshold" of economics—that he had already actually started to cross—, and to cultivate his new interests in "legal and political philosophy" (1992, p. 89). Leoni was then frequently invited in Virginia.

In *The Calculus*, Leoni was mentioned among those who made "serious attempts … to analyze collective-choice processes from … an 'economic approach' … [and who were] of direct relevance to both the methodology and the subject matter under consideration in this book" (Buchanan and Tullock 1962, p. 5).[36] The authors found that for Leoni "individuals entering into a political relationship exchange power, each over the other", and that this approach had much in common with their approach to political process (Buchanan and Tullock 1962, p. 38). Buchanan also recognized that Leoni had

> argued persuasively for the superiority of 'law' over 'legislation', developing in the process the interesting analogy between the structure of law, the legal order, that emerges from the separate making of independent judges … and the spontaneous economic order that emerges from the separate decision making of independent demanders and suppliers, each of whom acts on the basis of the limited information set that he confronts. The result, in both cases, is an order willed by no single decision maker. (Buchanan 1977, p. 46)[37]

---

[35]Bruno Leoni was professor of philosophy of law and political science at the University of Pavia during Buchanan's Italian year.

[36]Leoni is also acknowledged among those critics of the book who "disturbed, disappointed, provoked, and stimulated" the authors by their constructive comments (Buchanan and Tullock 1962, p. 9).

[37]Leoni reciprocated, speaking of "his friends, Buchanan and Tullock, with whom [he] had the pleasure of discussing recently and publicly of these themes in Virginia" (1962, p. 746).

Buchanan frequently contributed to *Il politico*, a journal founded by Leoni. It was especially the case in the 1960s,[38] with articles on democracy, economic policies, growth and education.

This was not the only case of Buchanan's support for Italian publishing initiatives: we know that he inaugurated and contributed to the *Journal of Public Finance and Public Choice—Economia delle scelte pubbliche* founded by Da Empoli in 1983, mainly with articles on the situation and the history of the discipline and also as referee (Da Empoli 2013b, p. 79; Wagner 2017).[39] In the 1990s he was in the scientific committee of *Biblioteca della libertà*, the journal of Centro Einaudi, where he published articles on constitutional economics, among other subjects. In general Buchanan has always been a generous and supportive reference point for the Italian scholars of a liberal orientation.

Conclusion

"I don't think public choice or the approach that I took in a lot of my other research would have ever got off the ground, certainly not in the same way, had it not been for the Italian influence". This is what Buchanan himself declared in 2008 (Buchanan in Mosca 2016, p. 127). In this chapter we have examined some less known cases that confirm his statement. But there are many other instances in Buchanan's work in which he cited Italian names and concepts, such as Pareto's principle interpreted as a Wicksellian unanimity rule, Gaetano Mosca's theory of the ruling class, Pantaleoni's applications of the marginalist method to the public sector, de Viti de Marco's economic models of the state in all their forms, Barone's criticisms to the Anglo-Saxon utilitarian approach, Mazzola's theory of public goods, Einaudi's "hailstorm tax", and many others. He cited this stream of political realism originating with Machiavelli so often throughout his life that we can detect Italian influences in most of his ideas.

[38]Bruno Leoni died in 1967.

[39]The journal was re-launched in 2018 by Giampaolo Garzarelli and Emma Galli.

Acknowledgements We thank the Fondazione Einaudi for two letters from the Archivio Luigi Einaudi. We also thank Francesco Forte for all his help.

References

Backhaus, J. G., & Wagner, R. E. (2005a). From Continental Finance to Public Choice: Mapping Continuity. *History of Political Economy, 37*(Suppl.), 314–332.

Backhaus, J. G., & Wagner, R. E. (2005b). Continental Public Finance: Mapping and Recovering a Tradition. *Journal of Public Finance Public Choice, 23*(1/2), 43–67.

Benham, F. C. (1934a). Review Principii di Economia Finanziaria by A. De Viti de Marco; Grundlehren der Finanzwirtschaft by A. De Viti de Marco. *Economica, 1*(3), 364–367.

Benham, F. C. (1934b). Notes on the Pure Theory of Public Finance. *Economica, 1*(4), 436–458.

Buchanan, J. M. (1948). *Fiscal Equity in a Federal State* (PhD dissertation). University of Chicago.

Buchanan, J. M. (1949). The Pure Theory of Government Finance. *Journal of Political Economy*, *57*(6), 496–505. Reprinted in *Fiscal Theory and Political Economy* (pp. 8–23). Chapel Hill: University of North Carolina Press.

Buchanan, J. M. (1950). Federalism and Fiscal Equity. *American Economic Review, 40*(4), 583–599.

Buchanan, J. M. (1952). The Pricing of Highway Services. *National Tax Journal, 5*, 97–106.

Buchanan, J. M. (1954). Individual Choice in Voting and the Market. *Journal of Political Economy, 62*(4), 334–343.

Buchanan, J. M. (1955a). *Painless Pavements* (Mimeo, James M. Buchanan Papers, C0247). Special Collections Research Center, George Mason University Libraries.

Buchanan, J. M. (1955b). *Traffic, Tolls and Taxes. The Economics of the Nation's Highway Problem* (Mimeo, James M. Buchanan Papers, C0247 [Box] [Folder]). Special Collections Research Center, George Mason University Libraries.

Buchanan, J. M. (1955c). *Preliminary Plan of Work* (Mimeo, Buchanan Archives: James M. Buchanan's Archives). Special Collections Research Center, George Mason University Libraries, George Mason University.

Buchanan, J. M. (1957a). Internal and External Debt. *American Economic Review, 47*(6), 995–1000.
Buchanan, J. M. (1957b). Review of Studi di scienza delle finanze e diritto finanziario by Benvenuto Griziotti. *American Economic Review, 47*(6), 1037–1038.
Buchanan, J. M. (1958). *Public Principles of Public Debt*. Homewood: Richard D. Irwin.
Buchanan, J. M. (1960). "La scienza delle finanze". The Italian Tradition in Fiscal Theory. In *Fiscal Theory and Political Economy* (pp. 24–74). Chapel Hill: University of North Carolina Press.
Buchanan, J. M. (1964). Public Debt, Cost Theory, and the Fiscal Illusion. In J. M. Ferguson (Ed.), *Public Debt and Future Generations*. Chapel Hill: The University of North Carolina Press.
Buchanan, J. M. (1965). An Economic Theory of Clubs. *Economica, 32*(125), 1–14.
Buchanan, J. M. (1999 [1967]). *Public Finance in a Democratic Process: Fiscal Institutions and Individual Choice*. In *The Collected Works of James M. Buchanan* (Vol. 4). Indianapolis: Liberty Fund.
Buchanan, J. M. (1976). Barro on the Ricardian Equivalence Theorem. *Journal of Political Economy, 84*(2), 337–342.
Buchanan, J. N. (1977). *Freedom in Constitutional Contract*. College Station, TX and London: Texas A&M University Press.
Buchanan, J. M. (1992). *Better Than Plowing and Other Personal Essays*. Chicago: University of Chicago Press.
Buchanan, J. M. (2008). The Market as a Club. In E. Giardina (Ed.), *Scritti scelti (1960–2007)* (pp. 7–13). Milano: Angeli.
Buchanan, J. M., & Forte, F. (1964). Fiscal Choice Through Time: A Case for Indirect Taxation? *National Tax Journal, 17*(2), 144–157. Italian Translation Scelte fiscali attraverso il tempo: una argomentazione a favore delle imposte indirette. *Studi Economici*, 1965.
Buchanan, J. M., & Tullock, G. (1962). *The Calculus of Consent*. Ann Arbor: University of Michigan Press.
Da Empoli, D. (1989). Introduzione. In J. M. Buchanan (Ed.), *Stato, mercato e libertà*. Bologna: II Mulino.
Da Empoli, D. (1993). Public Choice in Italy. *Public Choice, 77*(1), 75–84, also in C. Rowley, F. Schneider, R. D. Tollison (Eds.), *The Next Twenty-Five Years of Public Choice* (pp. 75–83). Boston: Springer.
Da Empoli, D. (2003). Equity Issues in the Italian Public Finance Tradition. *Pensiero economico italiano, 11*, 159–169.

Da Empoli, D. (2004). The Italian Public Finance Contribution to Public Choice. In *The Encyclopedia of Public Choice* (pp. 329–332). Boston: Springer.

Da Empoli, D. (2013a). Il "paradigma" italiano di finanza pubblica. In *Gli economisti italiani. Protagonisti, paradigmi, politiche*. Roma: Atti dei Convegni Lincei, 2015.

Da Empoli, D. (2013b). In Grateful Remembrance of James Buchanan. *Journal of Public Finance and Public Choice—Economia delle scelte pubbliche, 31*(1–3), 77–80.

De Viti de Marco, A. (1893). La pressione tributaria dell'imposta e del prestito. *Giornale degli Economisti, 4*(VI) January, 38–67; March, 216–231.

De Viti de Marco, A. (1936). *First Principles of Public Finance*. London: Jonathan Cape.

Einaudi, L. (1929). *Contributo alla Ricerca dell' "Ottima Imposta"*. Milan: Università Bocconi Editrice.

Eusepi, G., & Wagner, R. E. (2013). Tax Prices in a Democratic Polity: The Continuing Relevance of Antonio de Viti de Marco. *History of Political Economy, 45*(1), 99–121.

Forte, F. (Ed). (2008). *Money, Markets, and Morals, Proceedings of a Symposium at the Frankfurt School of Finance and Management, HfB*. February 2007. Munchen: Accedo.

Forte, F. (2013a, January 10). Un viaggio italiano al fianco (e in memoria) di James Buchanan. *Il Foglio*.

Forte, F. (2013b). On James Buchanan's Public Choice Enterprise. *Journal of Public Finance and Public Choice, 31*(1–3), 61–75.

Forte, F., & Buchanan, J. M. (1961). The Evaluation of Public Services. *Journal of Political Economy, 69*(2), 107–121.

Giardina, E. (2008). *Scritti scelti (1960–2007)*. Milano: Angeli.

Giardina, E. (2017). Discutendo con James M. Buchanan di onere del debito pubblico. *Rivista di Diritto Finanziario e Scienza delle Finanze, 76*(4), 395–409.

Giardina, E., & Mazza, I. (2016). Public Choice, Economics of Institutions and the Italian School of Public Finance. In I. Rizzo & R. Towse (Eds.), *The Artful Economist. A New Look at Cultural Economics* (pp. 51–66). New York: Springer.

Giuranno, M., & Mosca, M. (2018). Political Realism and Model of the State. Antonio de Viti de Marco and the Origins of Public Choice. *Public Choice, 175*(3–4), 325–345.

Leoni, B. (1957). Natura e Significato delle Decisioni Politiche. *Il Politico, 22*(1), 3–26.
Leoni, B. (1961). *Freedom and the Law*. Princeton: Van Nostrand.
Leoni, B. (1962). Oggetto e Limiti della Scienza Politica. *Il Politico, 27*(4), 741–757.
Leoni, B., & Stoppino, M. F. (1960). *Decisioni Politiche e Regola di Maggioranza* [Political Decisions and Majority Rule]. *Il Politico, 25*(4), 711–733.
Marciano, A. (2013). Why Market Failures Are Not a Problem: James Buchanan on Market Imperfections, Voluntary Cooperation, and Externalities. *History of Political Economy, 45*(2), 223–254.
Marciano, A. (2016). Buchanan's Non-coercive Economics for Self-interested Individuals: Ethics, Small Groups and the Social Contract. *Journal of the History of Economic Thought, 38*(1), 1–20.
Marciano, A. (2018). Buchanan and Public Finance: The Tennessee Years. *Review of Austrian Economics*, 1–26. Available at https://doi.org/10.1007/s11138-018-0419-2.
Marciano, A. (2019). From Highway to Clubs. On Buchanan and the Pricing of Public Goods. In R. E. Wagner (Ed.), *James M. Buchanan: A Theorist of Political Economy and Social Philosophy*. New York: Palgrave Macmillan.
Medema, S. G. (2005). 'Marginalizing' Government: From la scienza delle finanze to Wicksell. *History of Political Economy, 37,* 1–25.
Mosca, M. (2016). *Antonio de Viti de Marco a Story Worth Remembering*. New York: Palgrave Macmillan.
Modugno, R. A. (2017). Liberty Versus Democracy in Bruno Leoni and Friedrich Von Hayek. *Libertarian Papers, 9*(2), 233–247.
Pantaleoni, M. (1883). Contributo alla teoria del riparto delle spese pubbliche. *La rassegna italiana, 15*(October), 25–60. Partial English translation in R. A. Musgrave & A. T. Peacock (Eds.), *Classics in the Theory of Public Finance* (1958). London, 1994, pp. 16–27.
Ruggles, N. (1949–1950a). The Welfare Basis of the Marginal Cost Pricing Principle. *Review of Economic Studies, 17*(1), 29–46.
Ruggles, N. (1949–1950b). Recent Developments in the Theory of Marginal Cost Pricing. *Review of Economic Studies, 17*(2), 107–126.
Salsman, R. M. (2017). *The Political Economy of Public Debt*. Cheltenham: Edward Elgar.
Simons, H. C. (1937). Review of First Principles of Public Finance by Antonio De Viti de Marco and Grundlehren der Finanzwirtschaft by A. De Viti de Marco. *Journal of Political Economy, 45*(5), 712–717.

Simons, H. C. (1938). *Personal Income Taxation. The Definition of Income as a Problem of Fiscal Policy*. Chicago: The University of Chicago Press.
Tempelman, J. H. (2007). James M. Buchanan on Public Debt Finance. *The Independent Review, XI*(3), 435–449.
Tollison, R. D. (2008 [2004]). James M. Buchanan (1919–). In C. K. Rowley & F. Schneider (Eds.), *Readings in Public Choice and Constitutional Political Economy* (pp. 97–108). New York: Springer.
Toso, S. (1992). The Italian School of Public Finance at the Turn of the Twentieth Century and the Ricardian Equivalence Theorem. *History of Political Economy, 24*(4), 819–841.
Wagner, R. E. (2003). Public Choice and the Diffusion of Classical Italian Public Finance. *Pensiero Economico Italiano, 11,* 271–282.
Wagner, R. E. (2014). James Buchanan's Public Debt Theory: A Rational Reconstruction. *Constitutional Political Economy, 25*(3), 253–264.
Wagner, R. E. (2017). James M. Buchanan and the "Journal of Public Finance and Public Choice": Extending the Classical Italian Tradition of Public Finance. *Journal of Public Finance and Public Choice, 33*(1), 5–17.
Zywicki, T. (2015). Bruno Leoni's Legacy and Continued Relevance. *Journal of Private Enterprise, 30*(1), 131–141.

47

Paretian Fiscal Sociology

Michael McLure

Introduction

The intellectual relationship between Vilfredo Pareto and James Buchanan is bifurcated in relation to issues of collective action. On one side, Pareto's name is associated prominently with ideas that Buchanan either reacted against or qualified so substantially that their meaning was substantially altered. But on the other side, there is a remarkable complementarity between Pareto's treatment of the 'concrete phenomenon' and the public choice tradition.

In terms of contrast, Pareto laid the foundation for the first and second laws of welfare economics as it applies to outcomes using the criterion that we now associate with Pareto optimality. Pareto also formalised the idea of ranking for welfare assessments (Pareto 2008 [1900a]), with Pareto's contributions to the economics of welfare and ordinalism becoming cornerstones for Social Choice and its focus on different social states or outcomes. Buchanan (1962), however, used the criterion

M. McLure (✉)
University of Western Australia, Perth, WA, Australia
e-mail: michael.mclure@uwa.edu.au

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_47

of Pareto optimality in relation to processes and rules rather than outcomes. Pareto (1980 [1913]) also introduced the notion of social utility as a basis for his development of a social welfare function, with a view to investigating issues associated with maximising social utility (Pareto 1913). The very notion of social utility is, however, a far cry from Buchanan's rigorously individualistic approach to collective action.

But in his treatment of the 'concrete phenomenon', Pareto's critical, sober and almost Machiavellian account of politics, and political processes, are consistent with the analysis of politics associated with public choice. This was evident in many of Pareto's brutal and critical commentaries on Italian politics, published in the *Giornale degli Economisti* in the mid-1890s under the banner of the *Cronaca* (Chronicle). But it is most fully articulated in Pareto's studies of the 'concrete economic phenomenon' in his *Manual of Political Economy* (2014 [1906, 1909]). And even the sociological work of older Pareto, who, in the early twentieth century had lost faith in the possibility that individual liberty would prevail over special interest in the sphere of politics, includes public choice elements. As was first made clear by Jürgen Backhaus (1978), Pareto's sociology of public finance is primarily a study of 'non-logical' action, which is not a specific methodological claim of public choice.

Buchanan himself appeared to be more inclined to accentuate the theoretical than the concrete aspects of Pareto's work as he did not attempt to associate his own work with those aspects of Pareto's approach, or that of the Paretians, that resonate with the public choice approach. Moreover, he distanced himself from Pareto by underlining the point that, as advocates of a sociological approach to the study of public finance, Pareto, and his follower Gino Borgatta,

> reject any attempt to use economic analysis in the explanation of fiscal activity. To Pareto and to Borgatta, state decisions are made by a different sort of calculus, and there is no such thing as a 'science of finance' analogous to economic science. The explanation for fiscal activity should be sought instead in the murky science of sociology. (Buchanan 1960, p. 36)[1]

---

[1]The two classic accounts of the Italian fiscal tradition are Mauro Fasiani's "*Der gegenwärtige stand der reinen theorie der finanzwissenschaft in Italien*" (1980 [1932–1933]) and James Buchanan's

In this chapter I seek to honour the memory of James Buchanan by clarifying the meaning of Pareto's fiscal studies. Consideration is given to what 'Pareto The Economist' and what 'Pareto The Sociologist' had to say on the topic. The chapter is structured in three sections. It commences with a discussion of "Pareto 'The Economist'" and how he treated fiscal arrangements within the subject of economics. Attention is given to Pareto's *Cronaca* for the *Giornale degli Economisti* and his application of the idea of successive approximations when placing fiscal phenomena within the overall context of the economic phenomena. His most mature 'economics of public finance' emerges, not in economic theory, but in his applied treatment of the 'concrete economic phenomenon'. It continues with a discussion of "Pareto 'The Sociologist'" and the role of his distinction between 'logical' and 'non-logical' action in his mature study of public finance, policy and welfare. The mature work of Pareto culminates in the emergence of a fiscal sociology, one which was subsequently adopted and developed in Gino Borgatta (1920) and Guido Sensini (1932). The chapter concludes with a discussion of the current relevance of Paretian fiscal sociology. It is, among other things, suggested that Paretian fiscal sociology can be viewed as a companion to the modern, public choice inspired, variant of fiscal sociology that emerged in Richard Wagner's (2007) exploratory essay.

Pareto 'The Economist'

Pareto's long association with the *Giornale degli Economisti* started in the years between his career as the managing-director of an iron works company, which ended in 1890, and his academic career at the University of Lausanne, which commenced in 1893. While his early contribution to that journal featured works on pure economic theory (Pareto 2007 [1892–1893]), those contributions soon broadened to include practical

"'*La Scienza delle Finanze*': The Italian Tradition in Fiscal Theory" (1960). Fasiani's influence on Buchanan's thinking about the Italian fiscal tradition is readily evident from his paper, including his acknowledgement of Fasiani, but there is a significant difference in their respective assessments of the Paretians. Fasiani, in the abovementioned paper and in a subsequent work (Fasiani 1949), was much more appreciative of Pareto's sociology than was Buchanan.

commentaries on Italian politics and public finances as the author of the Journal's *Cronaca* between 1893 and 1897. The context for many of Pareto's 'chronicle' articles concerned the role of government in Italy, at a time when Italy's national governments were active in catching up with the other major European powers in regard to industrialisation and the development of colonial empires (McLure 2010).

As a result, many issues presented in Pareto's chronicles concerned 'protection' for the purposes of fostering industrialisation in general, protection and public spending to enhance Italy's naval capabilities by subsidizing the development of defence industries, the expense of colonial activities, public spending and the size of government generally, and taxation and debt. He was, by and large, a critic of the government on all these issues. Perhaps the main analytical theme underlying his comments concerned the broader cost to the society of providing benefits through political patronage. The basic fiscal attribute of Italian government decisions is that the interaction between revenue raising, debt and public spending involves transfers of funds from one part of society to another part.

The political dimension to collective decisions that reward patronage via a fiscal process reflects some of the political realism of what is now known as public choice. Buchanan, of course, stripped the romance from the discussion of democracy by shifting his focus onto transactions undertaken by governments. This too is reflected in Pareto's chronicles but, unlike public choice, Pareto did not attribute this to the institutional context by which individual interest is pursued in political environment. Rather, the sarcasm and harshness of Pareto's assessment in his chronicles are indicative of a contempt for the self-interest of politicians and a moral outrage at the patrons-client relationships between government members and special interests outside parliament. He sought to expose such action and persuade others that such action is being undertaken at the expense of the general good. In that regard, Pareto of the 1890s is a committed radical liberal who regards *laissez-faire* as the best starting point for policy considerations.

In his first major book, the *Cours d'Économie Politique* (Pareto 1971 [1896–1897]), Pareto constructs a framework based on the notion of successive approximations in which political influences on the economy, transmitted via fiscal and monetary instruments, fall outside the 'first' approximation to the economic phenomenon. The first approximation is reserved for 'pure' economics, which is fundamentally Walras's theory of general equilibrium, with the equilibrium state being the primary phenomenon of economics. All other aspects of the economic phenomenon, including the influence of public choices on collective decision making, fall to the second approximation provided by applied economics. When the economic phenomenon is also influenced by broader social phenomena, insights from the other disciplines of the social sciences—be they politics, law or sociology—it is then necessary to derive a third approximation to the economic phenomenon which accounts for interactions between the laws of pure and applied economics and laws established in the other social sciences.

For the purposes of this chapter, the main implication to be drawn from Pareto's successive approximation approach is that fiscal decisions are a subject for the second and third approximations to the economic phenomenon. The state of the economic equilibrium is the primary phenomenon of economics, and it is studied with respect to voluntary choice predicated on an initial allocation. In the phraseology of Pareto's *Manual*, it was a balance between forces associated with 'tastes' to be satisfied and 'obstacles' to their satisfaction, such as budget constraints, production constraints, and the impact of the demand of others. As fiscal decisions are not the result of voluntary actions and give authority to alter the initial allocations, they are excluded from Pareto's first approximation. A similar situation applies to the relationship between politics and fiscal decisions in Pareto's sociology. According to his political sociology of elites, which emerged in comprehensive and coherent forms in "Un'Applicazione di Teoria Sociologiche (An Application of Sociological Theory)" (Pareto 1980 [1900c]) and *Les Systèmes Socialistes* (*The Socialist Systems*) (Pareto 1974 [1902]), fiscal issues are secondary to the primary political phenomenon, which concerns the transitory character of political authority because elites 'rise and fall'. The fiscal arrangements are considered at the level of the second approximation, as one of the instruments that a ruling elite uses in the context of patron client relations. To the sociologist, fiscal arrangements are significant for the light they shed on the stability of the political equilibrium, when elites endure, and instability in the political equilibrium, when the continuity of existing elites is threatened or ends.

But, irrespective of his assignment of fiscal arrangements to the second or third approximations for the purposes of general social science, Pareto's economic discussion of fiscal issues in the concrete context remains insightful. This is perhaps most important in Chapter IX of the *Manual*, "The Concrete Economic Phenomenon", which asserts that "writers who discuss 'fiscal equity' are mere dreamers; so far, no such thing has ever been seen in the whole wide world" (Pareto 2014 [1906, 1909], p. 238) because "the economic phenomenon always tends to be governed by the interests those classes of society which predominate in the government" (Pareto 2014 [1906, 1909], p. 239). In other words, the *realpolitik* presented in *Cronaca* is retained, but, by the early twentieth century, Pareto's hope for improved action by politicians had been replaced by a brutal, largely positivist, recognition that self interest lies at the heart of the political phenomenon and that this must be incorporated directly within theory when considering the relationship between fiscal choices and the broader economic and political phenomena.

In that regard, Pareto was aware of Australia's *Customs Tariff Act 1906*, which imposed tariffs on the importation of agricultural machinery, and the *Excise Tariff Act 1906*, which imposed an excise tax on Australian manufacturers of agricultural machinery that did not pay employees a 'fair and reasonable' wage, as determined by the Parliament or the Courts.

> [Australian] manufacturers of agricultural machinery have been granted a prohibitive tariff against the import of American machinery, but on the condition that if they do not pay 'fair and reasonable' wages to their workers, they will have to pay an amount on their products equal to one half the duties imposed by the customs tariff. (Pareto 2014 [1909], p. 251)

Pareto's general point is that a new equilibrium will be attained under such policy, but some groups must be harmed under this new equilibrium because an advantage given to one is necessarily a disadvantage for everyone else. In this specific case, the new equilibrium yields a benefit for some Australian workers (those who work in the Australian agricultural machinery industry and obtain 'fair and reasonable' wages[2]) and some Australian entrepreneurs and some owners of capital (those agricultural manufacturers that pay 'fair and reasonable' wages), but it imposes a cost on all other entrepreneurs and capitalists (those not in the agricultural machinery business), all other workers or would be workers (those not employed in the agricultural machinery industry) and, of course, all consumers.

For the study of public finance, the issue foremost in Pareto's mind was that fiscal policy is the primary instrument through which a desired redistribution of income, concurrent with the consequent 'destruction of wealth', creates economic privileges or rents for a protected class of individuals at the expense of others in society: "protection does not present itself in pure form, but is always bound up in fiscal measures" (Pareto 2014 [1906, 1909], p. 262). This example also indicates the tension between the normative goal (such as 'fair and reasonable' wages in the agricultural machinery sector) and the positive effects of realizing a particular normative goal (such as a reduction in the real income of all other workers).

But to complement, and perhaps to offset, his highly critical views on public finance, Pareto also laid the foundation for the New Welfare Economics that we typically associate with Sir John Hicks. Most important in that regard was his first paper on welfare economics, "The Maximum of Utility given by Free Competition" (Pareto 2008 [1894]). This paper is important for several reasons. First, it provided the basic framework by which value judgements are largely removed from economic consideration. Specifically, value judgement is retained as legitimate in economics up to the point where an increase in aggregate

[2]When hearing this matter, Justice Henry B. Higgins, President of the *Commonwealth Court of Conciliation and Arbitration* (and formerly a Member of the Australian Parliament for the 'Protectionist Party'), ruled that the "provision for 'fair and reasonable' remuneration … must be meant to secure to them (employees in the industry) something which they cannot get by the ordinary system of individual bargaining with employers. … the standard of 'fair and reasonable' must therefore be something else, and I cannot think of any other standard appropriate than the normal needs of an average employee, regarded as a human being in a civilised community" (Higgins 1907, p. 3). From that principle, Higgins ruled on the value of a fair and reasonable wage rates for the purposes of the *Act*.

output is recognised as desirable provided no one is harmed by the increase or, if any individuals are harmed, then the collective has the capacity to compensate those individuals who are harmed. Secondly, value judgements that suggest that any redistribution of product is desirable lie outside the scope of economics. That role is allocated to the "Ministry of Justice".

The economic issue of importance to Pareto was how any such redistribution should be effected, not the extra-economic question of what the redistribution should be. Specifically, if the Ministry of Justice concludes that the income of workers must rise to achieve distributive justice, should that be achieved by increasing wage rates to levels above those attained in equilibrium under free competition?

Pareto's answer was an unequivocal no because the utility (profit) maximising producer will reduce the co-efficient of production for labour (use less labour in the production of each unit of output due to the increase wage) and increase the coefficients of production for the other factors of production (more non-labour factors of production used in the production of each unit of output), which increases the unit cost of production and reduces the real value of aggregate production compared to that obtained under free competition. Invoking the compensation principle, he argued that policy to maximise the real value of output from resources is always the correct goal for the Ministry of Production (a public body with policy authority over factor prices) to aim for. When the Ministry of Justice has particular goals for distributive justice that are inconsistent with factor prices that maximise output, efficient factor prices can be maintained and non-distorting transfer payments can be introduced to achieve the redistributive goal. As such, 'pure protection' of the poor associated with action of the Ministry of Justice depends on transfer payments being funded from taxes that do not disturb the coefficients of production (i.e. taxes that don't distort the distribution of income).

In subsequent work, Pareto set about introducing ordinal analysis to the formal pure theory of economic equilibrium, in "Summary of Some Chapters of a New Treatise on Pure Economics" (Pareto 2008 [1900a]), and extending and systematically generalising what may be termed the 'laws of welfare economics' approach in "On a New Error in the Interpretation of the Theories of Mathematical Economics" (Pareto 1902) and the *Manual* (Pareto 2014 [1906, 1909]).

Pareto 'The Sociologist'

Pareto 'The Sociologist' does not repudiate the views of Pareto 'The Economist' on the fiscal phenomenon. The characterization of fiscal effects presented in his "The Concrete Economic Phenomenon" is embraced by his sociology, not denied by it. What Pareto The Sociologist tried to do was to provide a more nuanced and comprehensive explanation of the phenomena than he had previously attained through applied economics. And it was the distinction between 'logical' and 'non-logical' action, which Pareto first introduces in "Sul Fenomeno Economico" (1900b), that provides the key to Pareto's shift to fiscal sociology.

The distinction between logical and non-logical action was partly introduced because of his dissatisfaction with another author's distinction between 'logical' and 'illogical' action. This is important because it underlines the point that Pareto's non-logical action does not extend to illogical action. Rather, non-logical action is simply action motivated by feelings or sentiments, which largely defy objective characterization. He first defined his theory of action in "Un'Applicazione di Teoria Sociologiche" (Pareto 1980 [1900c]), with the logical or non-logical division of action considered with respect to the relationship between the subjective assessment of the phenomenon associated with action and an objective account of that phenomenon. Specifically, action is 'non-logical' when the a priori subjective assessment of the expected objective outcome of action and the a posteriori subjective assessment of that objective outcome are different, which reveals an interdependence between the subjective and objective forms of a phenomenon. Logical action, in contrast, reveals a consistency between an expected outcome and the a priori and ex post subjective assessment of that objective outcome.

In the *Manual*, Pareto discussed non-logical action at some length, but primarily for the purposes of deliberately excluding such action from pure economics. He revisited the issue again in detail in 'Le Azioni Non Logiche' (1910), which was a preparatory work for his definitive characterization of the distinction between logical and non-logical action outlined in the *Trattato di Sociologia Generale* (Pareto 1935 [1916]). There are several dimensions to Pareto's final distinction between logical and non-logical action in that work, but, at the most fundamental level, it can be reduced to two relationships: (i) the nexus between means and an end; and (ii) the relationship between the objective and the subjective forms of the end being pursued.

A logical nexus between the means applied to achieve an end and the achievement of that end is a necessary and sufficient condition for Pareto's logical action. But a logical means-end nexus is only possible when the subjective assessment of the end of an action, or of a series of actions (the subjective end), is identical to, or perfectly conformed to, the objective form of the end that is undertaken by an action or a series of actions (the objective end). In modern parlance, we could say that Pareto's logical action is equivalent to decisions made within a path independent utility field. No matter what location a person is within his or her utility field, the dimensions of which are defined by quantities of commodities, the expected utility maximization given at any particular coordinate will be attained by simply moving to that point. And his conception of non-logical action is largely equivalent to decisions made with reference to a path dependent utility field. In that case, one's assessment of utility changes with movement in utility space, so subjective assessment of utility maximization at a particular coordinate will alter when moving to other points in the utility space, thereby precluding a logical means-ends nexus.

Voluntary choice in markets falls within the scope of Pareto's logical action, at least as a first approximation. Specifically, at the level of first approximation, exchange and production are the outcome of logical action. As a result, market phenomena can be considered with respect to the idea of an economic maximum. But Pareto did not regard fiscally directed activities that impact the economic equilibrium as falling within the category of logical action. There is an attempt to align fiscal means with policy ends in an efficient manner, but the subjective perspective of the policy end and the objective form of that policy end are typically not perfectly conformed. Each individual engaged in non-logical action may regard his or her actions as logical because means are employed logically to achieve the desired end and because, a priori at least, he or she does not recognize that the ex post subjective assessment of the objective end will be different from that subjective assessment a priori.

For politically directed collective action, the interconnected points in the means-end chain are prolonged and encompass actions by many different individuals acting within different groups. Material interest may well be at the heart of many political actions that culminate in fiscal decisions, but consistency of choice is not reflected in actions of individuals that form groups to govern, let alone for those who are governed. Given all the complexities of the extended political means-end chain that is facilitated through public finances, the fundamental, and perhaps the defining, feature of fiscally directed political action in Pareto's assessment is its non-logical character—the difficulty of applying a logical means-ends relationship to fiscal choices.

In regard to the positive aspect of fiscal action, Pareto The Sociologist reprised the issue of patron-client relationships and fiscally inspired redistribution by political elites to reward supporting economic elites. The objective outcome is a fiscally directed redistribution of income from the many to the few. On this issue Pareto made an important point in his first major book on sociology, *Les Systèmes Socialistes*, that anticipated a fundamental underlying proposition of Mancur Olson's *The Logic of Collective Action* (1965):

> There is a curious circumstance, which warrants attention: one often observes that men act with much more energy to appropriate the goods of others than to defend their own goods.[3] In a country of thirty million inhabitants, suppose that, under some pretext, it is proposed that each citizen be made to pay one franc per year and to distribute the total sum to thirty people. Each of the despoiled people pays one franc, each of the

[3]After the first sentence of this quote, Pareto is citing his own numeric example from the *Cours* (1971 [1896–1897], pp. 1086–1089).

> people doing the despoiling receives one million. The actions of the two parties [in relation to the proposal] will be very different. The people who hope to earn a million a year will never rest, by day or by night. …. On the side of the people being despoiled, activity will be much less. Money is needed to undertake an electoral campaign, which presents insurmountable material difficulties because they would have to go to each citizen and ask for a few cents. (Pareto 1974 [1902], p. 226)

Pareto's sociology is an attempt to establish the regularities of the non-logic of collective action,[4] including when that action is directed to the material welfare of subsets of individuals of society. New equilibrium states associated with an implemented public policy proposal need not have been reached by logical means, for reasons already mentioned, and those who gain do so at the expense of others. That is essentially a restatement of Pareto 'The Economist' to account for non-logical actions. But Pareto 'The Sociologist' would also add that the extent of any gain (or loss) realized depends on sociological influences. Specifically, it depends on the success, or otherwise, of manifestos or policies designed to persuade the public that they should support a specific proposal; and manifestos are only effective at persuading when they blend quasi-logic with a good deal of the value laden terms that have no precise objective meaning.

Consequently, non-logic not only takes prime place for the theory of action, it also takes prime place for understanding the processes by which people are persuaded to accept policies, even if those policies result in loss for those being persuaded. Pareto referred to such manifestos or doctrines as 'derivations'. They are effectively doctrines in which logic is interrelated with sentiments that the authors either hold to be true or trust that others hold to be true and, therefore, helpful in securing public support for the proposed outcome. Once the strictly

[4]Giovanni Busino suggests that Pareto is, in his sociology, concerned with "discovering the logic of non-logic" (Busino 1994, p. 10). In relation to public finances, that means that Pareto's fiscal sociology is concerned with discovering the logic, in the form of general regularities and uniformities, of fiscally directed redistributions (including debt as a fiscal device that redistributes income) for that does not comply with the strict meaning of a logical means-ends relationship, along the lines defined earlier in this chapter.

logic aspects of a 'derivation' has been stripped away, a 'residue' remains which is a statement or expression of sentiment, or a combination of sentiments, that social scientists can identify. The greater the extent to which a fiscal outcome depends on the use of a 'derivation' and 'residues', the lesser it can be suggested that that outcome is the result of a strictly logical process.

The net effect of the above is that, while the motivation for fiscal action may be the same as that adopted in economics (gaining a material benefit), the means of obtaining that benefit are non-logical. Borrowing Busino's phrase, a good politician or political advisor must draw on the 'logic of non-logical' reasoning when developing derivations designed to persuade through 'spin'. As a consequence, Pareto favored a sociological approach to the study of public finances. Indeed, his position on this matter was so strong that he was openly hostile to the very idea of an economics of public finance. It is now well understood that the early marginalist Italian literature on 'public goods', which was literally referred to in Italian as 'public needs', was much more advanced at the time than it was in the contemporaneous English literature.[5] But Pareto saw no scientific merit in any of that literature, nor in any of the burgeoning Italian literature on the Ricardian equivalence between taxation and public debt, nor in any of the general Italian literature seeking to develop an economic science of public finance.[6]

Sociological forces associated with fiscal decisions were also significant to Pareto because they adjust the prediction of economic laws. Pareto's own work on the first law of welfare economics indicated that a destruction of wealth (i.e. reduction in the value of production) results when the relative prices of the factors of production are changed from those prevailing under free competition. But when the non-logical basis of collective action is considered, Pareto recognized that fiscal redistribution places capital in the hands of others. He also recognized that the destruction of wealth that initially results from the economic

[5]See Fausto (2006) and Fossati (2006).

[6]A detailed account of Pareto's reaction against the economics of public finance can be found in McLure (2007).

effects of fiscal redistribution may, indirectly, be more than fully offset by the sociological consequences of fiscal redistribution. The difficulty, however, was that these sociological results were indeterminate. The destruction of wealth from protection may be aggravated further by the sociological consequences of fiscal redistribution, it may be unaffected by the sociological consequences of fiscal redistribution and it may be partially, fully or more than fully offset by the sociological effects. To get a handle on this problem, Pareto distinguished between rentiers and speculators and asked whether fiscal redistribution would increase or decrease the value of capital in the hands of those two groups.

Rentiers are presented by Pareto as timid and cautious when: holding money (by accepting low interest rates when holding money safely and typically being unwilling to borrow); undertaking entrepreneurial activity (by undertaking secure low risk activities); being employed as a worker (by seeking tenured employment with lower remuneration for lower risk); accumulating capital (by acquiring capital goods with values that don't fluctuate over time so depreciation can be managed and replaced in an ordered manner); holding land (by seeking low long term returns). The unifying factor is, of course, that rentiers seek very limited exposure to risk in all the economic activities they undertake. They reveal, in other words, a low discount rate. Conversely, speculators are presented by Pareto as being willing to accept high risk in all the economic activities they undertake. In effect, they reveal a high discount rate. In that regard, speculators are vigorous and active when: holding money (by seeking high returns and capital gains from financial assets and being more than willing to borrow); undertaking entrepreneurial activities (by being innovative by combining capital goods to create new products and/or seeking rents through strategic pricing and exploiting monopoly power); accumulating capital (by seeking capital gains, even in the short term); and holding land (by high returns and capital gains).

Transferring income between rentiers and speculators may have obvious short term implications. It may either exacerbate or smooth business cycles, depending on the direction of the transfers. But Pareto also saw such transfers as having longer term implications. The great prosperity of the nineteenth century associated with the effects of the industrial revolution was, in Pareto's assessment, largely due to the combined effect of a large share of productive capital being placed in the hands of speculators at the same time as when a large proportion of the masses of the population are rentiers seeking employment as workers. Speculation and innovation are correlated and linked to increasing prosperity, provided there are enough rentiers for the financial system to fund the speculators; and a good proportion of the workforce is employed in the innovation oriented firms controlled by speculators.

Pareto, however, did not limit his study of collective action to individuals acting within the political institutions of the collective to achieve personal economic gain. His sociology also accounts for altruistic and even paternalistic motivations associated with non-logical action. For example, one may associate a particular a priori objective end with the subjective end of 'distributive justice', but once the objective state is altered to attain that objective end, one may no longer regard it as representing a state of 'distributive justice' because the objective end and the subjective end are interdependent such that a stable equilibrium is not attained.

But Pareto also recognized that the individuals who comprise the collective are heterogeneous. Not only do individuals act differently—with some people initiating new activities, others repeating routine activities and a distribution of behaviors in between those two extremes; and some people acting to introduce change to the prevailing social state, others acting to preserve the existing social arrangement plus a distribution of individual behaviors between those two extremes—they also have different views about the welfare of other members of the collective. To the positivist in Pareto, this presented a serious methodological problem. Firstly, 'social' preferences, or preferences that individuals hold in relation to the welfare of other members of the collective, cannot be readily observed. Not just because action is non-logical, but because each individual's social preferences cannot be observed and even if they could, they would change with objective circumstances. Furthermore, action regarded as leading to a 'just' distribution of income, or some other social goal, is undertaken by the institutions of the state, not by individuals themselves.

Recognition of this had two implications for Pareto. First, and most significantly from the perspective of positive science, sentiment pertaining to the wellbeing of others can be readily exploited politically by groups acting politically who are acting in the economic interest of themselves. That is, it may culminate in persuasive 'derivations', as discussed earlier. Second, to the extent that sentiment pertaining to the wellbeing of others is significant, the economic maximum of the collective obtained under the first law of welfare economics will not be a maximum when utility is social.

In regard to the first point, consider the 1907 Australian case of tariff and excise on agricultural machinery mentioned earlier. That was a policy presented as a mechanism for improving the living standard of the working people. But, within Pareto's Fiscal sociology, that was a subjective assessment designed to persuade; whereas the objective end is a negative sum policy game (i.e. wealth is destroyed) that enhances the material wellbeing of workers, capitalists and entrepreneurs within one industry (domestic producers of agricultural machinery) while reducing the material wellbeing of workers, capitalists and entrepreneurs in all other industries.

But the existence of preferences for social outcomes also means policy to maximize economic outcomes on the assumption that all individuals are *homo œconomicus* will not be welfare maximizing in a social sense. In view of this, Pareto reflected on what a political group might do if its goal was to devise a policy that actually maximizes welfare in a sociological sense. To that end, he specified a two-step process by which a Government that truly wishes to maximize the welfare of the collective could do so. First, the government must know each individual's social utility function. In practice, this means that it must establish how much weight each individual assigns to the welfare of every individual within the collective. Second, the government would then weight, discriminatingly, each individual's social utility function to derive a social utility function. The result will, of course, change with government. In effect, the government acts this way to impose a social utility function on the community from which a logical nexus between the subjective end of policy, of maximizing social utility, and the objective outcome associated with that subjective end, can be derived.

The overall scheme of Pareto's sociology is united under the concept of 'social equilibrium', the internal elements are given by the interrelationship between a number of key elements: residues, derivations, heterogeneity (i.e. the distribution of people within a society is characterized by heterogeneity), economic interests and elites (i.e. people within a society tend to form groups, with the best elements within those groups emerging as elites). But that is a rather abstract formulation that tends to conceal the significance of Pareto's notion of social equilibrium. To modern scholars, it is perhaps simpler to view Pareto's notion of 'social equilibrium' as an overarching concept that is, itself, comprised of three sub-categories of equilibria: a 'political equilibrium', which is the balance in the collective obtained between the individualism and collectivism; an economic equilibrium, which concerns the balance in the collective between producing wealth and appropriating wealth produced by others; and a socio-behavioral equilibrium, which concerns the balance in the collective between the forces of social continuity and the forces of social change.

Significantly, the political and economic equilibria of Pareto's social equilibrium are interdependent, with the role of political elites in achieving a balance between individualism and collectivism interrelated with the role of economic elites in producing wealth or appropriating it for others. As such, the variable aspects of social equilibrium are associated with the interplay between the political and economic equilibria, through the interplay between agents of the political elite and agents of the economic elite. The socio behavioral equilibrium, however, is much less variable because it is constrained significantly by residues that favor continuity or change, with the distribution of those residues largely given by people's psychological make up and, as such, is a force for continuity.

The evolution of the social equilibrium is largely a result of the equilibrium becoming unstable, with competition between competing economic and political elites resulting in a new equilibrium emerging in conjunction with the circulation of elites. That is, with the change of government and the change of patron client relations, with the rentiers and speculators assuming greater or lesser roles under each state of social equilibrium. The form of the social equilibrium may change, with new institutions emerging or the significance of existing institutions changing, but there is a socio-behavioral floor under any such change that is given by the distribution of individual psychological propensities for continuity or for change.

On the Current Relevance of Paretian Fiscal Sociology

The Paretian episode in fiscal sociology had ended by the 1930s and, if a case is to be presented in favor of the current relevance for Paretian fiscal sociology, one must first establish why it ended. In that regard, the great problem it failed to successfully address was not the rationale for introducing non-logical action to the analysis of fiscal studies per se. Indeed, modern studies of path dependence and independence in economics serve to underline the relevance of Pareto's analytical dualism. Rather, it concerned the extent to which regularities could be generalized in a way that altered or qualified economic conclusions.[7] For a start, much of Pareto's applied economic treatment of 'the concrete economic phenomenon' is reflected in his fiscal sociology. Consequently, some of the results of fiscal sociology, based on non-logical action, don't change from early analysis that pre-dates the focus on non-logical action. For example, although Pareto's general theory of social equilibrium indicated that fiscal redistribution could destroy wealth, as predicted in economics generally and Pareto's economics more specifically, the sociological effects could be change in anything depending on the circumstances. Using an analogy with statistics, the introduction of a sociology of public finance was sometimes regarded as akin to an analysis of 'statistical noise'. Such criticism goes too far because it does not account for Pareto's discussion of the role of rentiers and speculators in generating regularities associated with fiscal redistribution.

Nevertheless, it must be accepted that the success of Pareto and his followers in generating fiscal regularities through sociology was limited. When it was attained, it was typically at very high levels of

[7]The Paretian episode in fiscal sociology and its end is discussed by McLure (2007); and the relevance of that episode for historians is examined very thoughtfully by Italo Magnani (2008).

generalization. This suggests that perhaps the greatest potential value of a modern Paretian fiscal sociology would be in the area of applied fiscal studies, such as national and subnational fiscal histories (although no major studies along that line have been undertaken thus far). But it would also, I believe, be wrong to close the book completely on Paretian fiscal sociology for offering nothing of relevance for current fiscal theorists. In my assessment, there are four main reasons why some aspects of Paretian fiscal sociology have current relevance.

First, the motivation for Pareto's initial rejection of the economics of public finance in the case of Ricardian equivalence is of continuing importance as it underlines the proper scope of fiscal theory. In particular, Pareto regarded the prevailing mix of debt and taxation as the means by which a government can spend more than if it relied on taxes alone. Comparing the economic effects of raising a 'given' sum of money by one means or another appeared pointless to him, when direct observation confirmed that government revenue raising is not a case of 'either' tax 'or' debt, but a case of how much can be obtained when both methods are used. He also regarded the characterization of taxpayer/saver/consumer as logical in an intertemporal (and intergenerational) manner as fundamentally flawed because it imposes a standard of behavior that is not observed. The first of these points not only has relevance for modern treatments of Ricardian equivalence, it also has relevance for any form of public finance analysis that seeks to consider the revenue side of the budget as something that is separate from the expenditure side of the budget. If nothing else, Paretian fiscal sociology underscores the interdependence between revenue funding and expenditure decisions as fiscal redistribution is a net concept, because governments typically wish to increase expenditure.[8]

Second, the appropriate balance to strike between precise determinism and broad generalizations, which results from Pareto's divide between economics and sociology, is relevant to the construction of

[8]A Paretian explanation of Western Australian Government's public finances is presented in McLure (2017), which shows that the increase in revenue raising capacity from the millennium mineral boom led to a massive increase in net public debt because the Government treated a transitory increase in royalty and tax revenue as a permanent increase in its capacity to fund ongoing growth recurrent expenditures.

modern fiscal theory. Specifically, Pareto's economics culminates in a deterministic result (e.g. the exact equilibrium point in commodity space is determinate if a logical means-ends applies applies) whereas his sociology only yields broad uniformities (e.g. the exact change in allocations attributed to fiscal redistribution is not determinate a priori, because a logical means-ends nexus does not apply, but the emergence of fiscal redistribution of some kind as a result of interactions between economic and political elites is predictable even when action is non-logical). The scientifically valid level of determinism was a first order question to Pareto; and that same question should also be a first order question for modern fiscal theory.

Pareto's binary classification as either logical or non-logical may have been unnecessary restrictive when applied in all circumstances because it precludes a broader range of phenomena from logical and deductive analysis. Perhaps the balance lies elsewhere, but Pareto's concern with the limits of logical deductive theorizing on fiscal matters is as relevant today as it was when he lived. Curiously, Pareto's most prominent followers were Gino Borgatta (2007 [1920]) and Guido Sensini (2007 [1932]) and neither of these men adopted Pareto's extreme opposition to the science of public finance as a form of pure economics. They attempted to create more room for the economic theory of public finance than that permitted by Pareto, partly by suggesting that there are intermediate points between the binary poles of logical and non-logical action. Sensini, for example, felt that logical and non-logical actions were often 'mixed' in public finance, with some of those mixed actions being reasonably approximated by logical action. Borgatta adopted a similar line, wanting issues such as the incidence of taxation to be studied economically. In other words, they both accepted the importance of complementing the economics of public finance with fiscal sociology. There clearly appears to be greater scope for an economics of public finance than Pareto suggested, but his concern about the limits of strictly deductive analysis, and its nexus to the logical means-ends relationship, remains important for the scientific limits of modern deductive fiscal theory.

Third, Pareto's focus on the means-ends relationship and its link between logical and non-logical action also serves to illustrate how precarious it is to consider the welfare of individuals in the collective as if the state were a collective entity. His sociological approach to collective maximization recognizes the practical need for the governing authorities to balance individuals' competing, and often inconsistent, views on social welfare. When Pareto addresses this issue, he does so in the full knowledge that he has converted an inherently non-logical system of relations into a quasi-logical arrangement (i.e. an arrangement whereby a 'logical' mean-ends nexus is forced) by imposing a politically determined welfare function. This process has the advantage of transparency, in that it makes it absolutely clear that the idea of a social welfare function depends, in the final analysis, on a politically imposed decision on the weights to be imposed on individual social preferences. As such, it suggests one comparative static resolution of the problem of individuals living collectively and, of course, scholars and policy makers are open to reject such a social welfare formulation for the very reason that it ultimately privileges the political decision required to form the welfare function. But reflection on how to resolve these problems, in light of Pareto's attempted solution, is useful for modern fiscal theory.

Finally, Paretian fiscal sociology is a complement to the fiscal sociology that has been recently developed by Richard E. Wagner (2007) and Giuseppe Eusepi and Wagner (2011, 2013). They focus on the 'ecologies' of political enterprise and the associated action between and within the public and private squares. While the 'conjunctive' vision of the relationship between the market and the state portrayed by Wagner and Eusepi is not motivated by the ideas of Pareto, the sociological interconnection they associate with the theory of public finance can be incorporated with Pareto's broad sociological treatment of non-logical action. This is primarily the case because both approaches accept that the subjective phenomena impacts on the objective phenomena and vice versa. As Wagner puts it, "I regard both mind and society as real categories of existence, in that society cannot be reduced to an individual even though society cannot exist without individuals" (2007, p. 21). This is entirely consistent with Pareto's core position, outlined in his "L'Individuale ed il Sociale" (Pareto 1980 [1904]).

Paretian fiscal sociology is more abstract than Wagner's and it has limited focus on entrepreneurs per se or enterprises. But Pareto's discussion of the interrelationships between speculators and rentiers and political elites, using Pareto's speculators and rentiers, and his use of Machiavelli's analogy between foxes (as cunning political personalities who confront problems indirectly) and lions (as strong and principled politicians who confront issues directly) for the political equilibrium, are also broad enough to accommodate the more specific linkages between entrepreneurs, enterprises, the public square and the market square, as developed by Wagner and Eusepi. Furthermore, Pareto's treatment of debt and political equilibrium as a balance between centripetal and centrifugal forces are also themes in Pareto's sociology that resonate with the approaches of Wagner and Eusepi to the topics of public debt and decentralization.

In short, Paretian fiscal sociology continues to offer a range of insights that are worthy of consideration by modern fiscal theorists. It also appears to constitute a suitable framework for the development of economically and politically oriented fiscal histories of national and/or subnational governments.

References

Backhaus, J. (1978). Pareto on Public Choice. *Public Choice, 33*(1), 5–17.

Borgatta, G. (2007). The Scientific Study of Fiscal Phenomena. In M. McLure (Ed.), *The Paretian School and Italian Fiscal Sociology*. Houndmills and Basingstoke: Palgrave Macmillan. Originally published in 1920 as Lo Studio Scientifico dei Fenomeni Finanziari. *Giornale degli Economisti e Rivista di Statistica, 31*(60), 1–24, 81–116.

Buchanan, J. (1960). 'La Scienza delle Finanze': The Italian Tradition in Fiscal Theory. In J. Buchanan (Ed.), *Fiscal Theory and Political Economy* (pp. 24–74). Chapel Hill: The University of North Carolina Press.

Buchanan, J. (1962). The Relevance of Pareto Optimality. *Journal of Conflict Resolution, 6*(4), 341–354.

Busino, G. (1994). Prefazione. In M. L. Maniscalco (Ed.), *La Sociologia di Vilfredo Pareto e il Senso della Modernità* (pp. 7–10). Milano: Franco Angeli.

Eusepi, G., & Wagner, R. E. (2011). States as Ecologies of Political Enterprises. *Review of Political Economy, 23,* 573–585.

Eusepi, G., & Wagner, R. E. (2013). Tax Prices in a Democratic Polity: The Continuing Relevance of Antonio de Viti de Marco. *History of Political Economy, 45*(1), 99–121.

Fasiani, M. (1949). Contributi di Pareto alla Scienza delle Finanze. *Giornale degli Economisti e Annali di Economia, 8*(3–4), 129–173.

Fasiani, M. (1980 [1932–1933]). La Teoria della Finanza Pubblica in Italia [Der gegenwärtige stand der reinen theorie der finanzwissenschaft in Italien]. In *Il Pensiero Economico Italiano 1850–1950* (pp. 117–202). Bologna: Cappelli.

Fausto, D. (2006). The Italian Approach to the Theory of Public Goods. *European Journal of the History of Economic Thought, 13*(1), 69–98.

Fossati, A. (2006). Needs, the Principle of Minimum Means, and Public Goods in de Viti de Marco. *Journal of the History of Economic Thought, 28*(4), 427–443.

Higgins, H. B. (1907). *Ex parte H.V. McKay* (pp. 1–25). Melbourne: Commonwealth Court of Conciliation and Arbitration. Available at http://www.aph.gov.au/binaries/library/intguide/law/harvester.pdf.

Magnani, I. (2008). Note a Margine di una Recente Opera sull'Indirizzo Sociologico della Scienza delle Finanze Italiana. *Rivista di Diritto Finanziario e Scienza della Finanza, 67*(2), 165–199.

McLure, M. (2007). *The Paretian School and Italian Fiscal Sociology*. Houndmills and Basingstoke: Palgrave Macmillan.

McLure, M. (2010). Pareto's Chronicles: Liberty, the Left and Sociology. *Review of Political Economy, 22*(3), 439–458.

McLure, M. (2017). Ricardian Equivalence, the Italian Fiscal Tradition and Western Australia's Government Net Debt. *Agenda, 24*(1), 5–20.

Olson, M. (1965). *The Logic of Collective Action: Public Goods and the Theory of Groups*. Cambridge, MA: Harvard University Press.

Pareto, V. (1894). Il Massimo di Utilità dato dalla Libera Concorenza. *Giornale degli Economisti, 4*(9), 48–66. Translated into English by John Cairncross (and edited by John Chipman) as The Maximum of Utility Given by Free Competition. *Giornali degli Economisti e Annali di Economia*, *67*(3), (2008), 387–403.

Pareto, V. (1900a, March, June). Sunto di Alcuni Capitoli di un Nuovo Trattato di Economia Pura del Prof. Pareto. *Giornali degli Economisti*, *2*(20), 216–235, 511–549. Translated into English by John Cairncross (and edited by John Chipman) as Summary of Some Chapters of a New Treatise on Pure Economics by Professor Pareto. *Giornali degli Economisti e Annali di Economia, 67*(3), (2008, December), 453–504.

Pareto, V. (1900b). Sul Fenomeno Economico. *Giornale degli Economisti, II*, 139–162. Translated as On the Economic Phenomenon: A Reply to Benedetto Croce. *International Economic Papers* (Vol. 3, pp. 180–196), (1953). London: Macmillan; and Reproduced in Vilfredo Pareto: Critical Assessments (Vol. 1, pp. 245–261), (1999). London: Routledge.

Pareto, V. (1900c, July). *Un'Applicazione di Teoria Sociologiche* (pp. 401–456). Reprinted in G. Busino (Ed.). (1980). *Vilfredo Pareto Œuvres Complètes 22: Écrits Sociologiques Mineurs* (pp. 178–238). Genéve: Librairie Droz.

Pareto, V. (1902). Di un Nuovo Errore nello Interpretare le Teorie dell'Economia Matematica. *Giornale degli Economisti, 12*(15), 401–433. Translated into English by John Cairncross (and edited by John Chipman) as On a New Error in the Interpretation of the Theories of Mathematical Economics. *Giornali degli Economisti e Annali di Economia, 67*(3), (2008, December), 515–544.

Pareto, V. (1904). L'Individuale ed il Sociale. Reprinted in G. Busino (Ed.). (1980). *Vilfredo Pareto Œuvres Complètes 22: Écrits Sociologiques Mineurs* (pp. 268–278). Genéve: Librairie Droz.

Pareto, V. (1910, May–August). Le Azioni Non Logiche. *Rivista Italiana di Sociologia, 14*, 305–364. Reprinted in G. Busino (Ed.). (1980). *Vilfredo Pareto Œuvres Complètes 22: Écrits Sociologiques Mineurs* (pp. 345–408). Genéve: Librairie Droz.

Pareto, V. (1935 [1916]). *Mind and Society [Tratatto di Sociologia Generale]*. New York: Harcourt, Brace and Company.

Pareto, V. (1971 [1896–1897]). *Corso di Economia Politica [Cours d'Économie Politique]*. Torino: Unione Tipographico-Editrice Torinese.

Pareto, V. (1974 [1902]). *Les Systèmes Socialistes*. Paris: Giard et Briére. Translated into Italian as *I Sistemi Socialisti*. Torino: Unione Tipografico-Editrice Torinese.

Pareto, V. (1980 [1913]). Il Massimo di Utilità per una Collettività in Sociologia. In *Écrits Sociologiques Mineurs*, *Œuvres Complètes* (pp. 601–605). Genéve: Librairie Droz.

Pareto, V. (2007 [1892–1893]). *Considerations on the Fundamental Principles of Pure Political Economy*. London: Routledge. Translated into English by V. Savini and J. Kinder (and edited by R. Marchionatti and F. Mornati) from 'Considerazioni sui Principii Fondamentale dell'Economia Politica pura' Parts 1 to 5. *Giornale degli Economisti*, 1892–93, 2(4), 389–420, 2(5), 119–157, 3(6), 1–37, and 3(7), 279–321.

Pareto, V. (2014 [1906 and 1909]). *Manual of Political Economy: A Critical and Variorum Edition* (A. Montesano, A. Zanni, L. Bruni, J. S. Chipman, & M. McLure, Eds.). Oxford: Oxford University Press.

Sensini, G. (1932). *La finanza sociologica. Studi di Scienze Sociali* (Vol. 1, pp. 232–252). Roma: Casa Libraria Editrice Italiana.

Wagner, R. E. (2007). *Fiscal Sociology and the Theory of Public Finance: An Exploratory Essay*. Cheltenham: Edward Elgar.

48

Artefactual and Artisanship: James M. Buchanan and Vincent Ostrom at the Core and Beyond the Boundaries of Public Choice

Paul Dragos Aligica

Towards the end of the 1970s James Buchanan and Vincent Ostrom were engaged in an attempt to create a joint project uniting what were latter to be called the "Virginia School of Public Choice" and the "Bloomington School of Public Choice" (Mitchell 1988; Aligica and Boettke 2009) into a distinctive approach to Constitutional Political Economy and Social Philosophy. The letters exchanged in this process between the two scholars (as preserved in the James Buchanan Archives at George Mason University) capture not only the institutional and personal challenges they faced in this (failed) attempt to shift the Public Choice program to a new stage, but also the intellectual efforts those two main figures of the Public Choice movement made to clarify and articulate the common position they held. The archives capture some of their remarkably frank effort at intellectual self-understanding. A letter written by Buchanan and dated March 18, 1977, encapsulates the essence of what Buchanan and Ostrom considered to be the

P. D. Aligica (✉)
George Mason University, Fairfax, VA, USA
e-mail: pdragos@mercatus.gmu.edu

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_48

distinctiveness of their joint position, as seen in comparison to other schools of thought which were part of the same intellectual family:

> There are two basic articles of faith in our position: (1) Institutions matter; (2) Institutions can be constructed. We face opposition on both these counts. The reason George Stigler and the modern Chicago crowd object to so much of my own stuff is that they explicitly and implicitly deny the former of these two articles. We face opposition from the "evolutionists" (Hayek, Oakeshott, Popper, etc.) on the second article of faith. And, in a sense, we might use something like this simple two-article test to determine just who might be among the group that might ultimately be assembled. (Buchanan 1977)

What is remarkable about this document is that in it Buchanan goes beyond the standard conceptual and theoretical aspects of a research program. In doing that, he reveals something essential about the deeper dimensions of the position assumed by him and Vincent Ostrom. Their stance is not just about theoretical proportions, it is also about attitudes, values and norms, including the attitudes, values and norms of the scholars themselves:

> (…) In a sense [we] argue for a different attitude toward politics, toward governance, what I have called a "constitutional attitude," based on the two articles of faith noted. This attitude is extremely important, and no one could have stressed this more than I have done. And the critical objective for us is to get attitudes turned around. But, and here you face precisely the problem that I have faced and have not succeeded in resolving, namely, how can we talk about attitudes independently of precise normative content. (Buchanan 1977)

It is evident that once the theoretical apparatus they bring to the table is taken into account, the Buchanan–Ostrom stance, as sketched above, is rather distinctive not only in the broader context of mainstream social sciences of those times, but also in the context of the Public Choice movement. Yet, this distinctiveness is rather elusive and open to misunderstandings and misinterpretations. The defining underlying themes uniting Buchanan and Ostrom into their joint position were rarely, if ever, explicitly and properly recognized in the literature.

This paper is an attempt to deal with this problem. Its thesis is that the particular nature of the Buchanan–Ostrom approach is fully revealed only if we focus on one key concept, which despite its lack of salience in the Public Choice theory and the intellectual histories of the field, captures best the gist of their core insights and attitudes: The concept of "artefactual" and through it, an entire cluster of related notions such as "artefact", "constructivism" and "artisanship". Thus, this paper, will use the concept of the "artefactual" as the preeminent vehicle helping us to revisit and get a more nuanced understanding of the Buchanan–Ostrom system of ideas, while staying very close to the textual evidence supporting the working thesis at the core of the paper.

It is interesting and telling that both Buchanan and Ostrom are crediting each other for the use of the concept. For instance, Vincent Ostrom (1993a, p. 163) notes in a programmatic article that the progress of the Public Choice paradigm to new frontiers will come in the future less from the application of "economic reasoning to nonmarket decision making" but more from insights inspired by "James Buchanan's emphasis on the artifactual character of human individuality". At his turn, James Buchanan (1979, p. 107) notes that his "usage of the word artifactual is borrowed directly from Vincent Ostrom, who has repeatedly emphasized the necessity of considering the political constitution as an artifact, to be categorically distinguished from an evolved legal order".

The idea of "artefactual" and its associated notions operate both at the core and at the frontier of the Public Choice program. At the core, they provide the basic vision, the foundational metaphor underpinning the idea of a system of order in which human deliberation and choice have a significant role to play. At the frontier, they provide the impetus to refine and expand the program. Buchanan notes that the failure to understand the complexity of the act of choice and the multifaceted dimensions of the choice process, with its facets, objects and conditions (including the choices an individual is making in the investment to construct his or her own identity, to change according to a vision or imagined ideal), inhibited and undermined our ability and willingness to understand some of the individual and social problems of our time:

> By implicitly refusing to consider man as artefactual we neglect the 'constitution of private man' which roughly translates as 'character' as well

> as the ‘constitution of public men’, which translates into the necessary underpinning of a free society, the ‘character’ of society, if you will… (Buchanan 1979, p. 102)

The notion of artefactuality offers thus a series of insights regarding the foundations of social and political order. At the same time, that has major normative implications linking the individual self with the public choice and governance arena. As Vincent Ostrom put it, a self-governing society has to be based

> …on a universality of artisanship in which each person first becomes one's own governor -one's own master- and then, in the course of coping with problems that inevitably arise in interdependent patterns of artisanship-artefact relationship, becomes capable of working out associated arrangements with others. (Ostrom 1997, p. 202)

To sum up, thinking in terms of “artisanship” and “artefactual” brings to the table both a fresh analytical potential and a normative dimension. The link between private and public choice gets illuminated. Both the core and the frontier of the program receive a renewed boost. In brief, ideas such as “artisanship” and “artefactual” open up a unique insight into the universe of ideas defining the Buchanan–Ostrom position. The rest of the paper will try to reconstruct and present their position, illuminating and explaining some of its main conceptual elements.

Constructivism and the Realm of the Artefactual

The notions of “artefact” and “artisanship” which are implied in the second “article of faith” outlined in Buchanan's letter of March 1977 to Ostrom, with its insistence that “institutions could be constructed”, requires us to take seriously the very notion of “construction” or “constructivism”. And indeed, once we are alerted, and we take at a closer look at Buchanan's writings in this light, we cannot fail to note that constructivism as such is not just assumed but expounded in rather forthright terms by the 1986 Nobel Prize in economics winner. First of all, is a recognition of the significance of "organization" in attaining the modern social system, with its freedoms and prosperity. The recognition of "organization" is also a recognition of the significance of the elements of design and constructivism implied by it. We need to acknowledge, writes James Buchanan,

> … that without the benefits of social-legal-political organization, very few of us would be here today. We could not exists; the physical world would support only a tiny fraction of its population if we were forced to live in the almost unimaginable state of Hobbesian anarchy, or even under the tribal organization that described most of human history. We live now by the graces of those persons and forces that designed, constructed, maintained and secured the institutions of order within which we live, work and play. (Buchanan 1991, p. 250)

In a sense, Buchanan's "constructivism" could be seen as a mere restatement and a response to the well know challenge of the Federalist papers, according to which the crucial question of politics is "whether societies of men are really capable or not, of establishing good government from reflection and choice, or whether they are forever destined to depend, for their political constitutions, on accident and force." Buchanan's response is that, indeed, when it comes to governance and institutional arrangements, humans do have a choice. They have degrees of freedom to choose the constraints within which they operate both in public and private life. Through the choices that they make among rules and institutions, they could avoid conflict, create social order and cooperative relationship and increase their level of well-being:

> …the rules of social order are not exclusively the product of some process of social evolution, rules that we have inherited and that we abide by without understanding their purpose or function. At least within limits the presupposition is that rules are deliberately constructed from the choices of those persons who are to be subject to the constraints that these rules embody. (Buchanan 1991, p. 231)

The most important aspect of the specific way in which the idea of "constructivism" is approached, is that Buchanan distinguishes and emphasizes two related but different forms of constructivism: moral constructivism and constitutional constructivism. This is crucial for understanding his general position, especially as the conventional wisdom is to associate him with the public choice theory of constitutionalism and regard his concerns with ethics, morality, attitudes and culture as secondary, mostly a footnote or even an deviation from the core of his theory.

Constitutional constructivism is about rationally choosing to impose constraints on our own behavior along with that of other members of the community or society (Buchanan 1991, pp. 233–240). Those constraints are rationally accepted to operate in a system in which they will be enforced independently of our own volition. It is thus accepted that those constraints will be imposed coercively. Behavior is changed by the creation of rules limiting its range, and by the external enforcement of (rationally selected or validated) rules. It is a rational calculus in which, as Buchanan puts it, "we deliberately chose to restrict our own freedom of action so long the choices of others are similarly constrained". At a deeper level it is not just mechanical rational calculation but a progressive understanding that social order is possible only when individual behavior is confined with appropriately defined limits. At the same time, people use their imagination to find ways in which to create and enforce collectively such limits. It is a collective or public choice, a process that is driven by an interplay of rationality, imagination and expectations at the level of the social group or community.

Moral constructivism looks inward. It, as well, seeks to modify behavior but it is doing it by focusing on the internal norms, values, attitudes and sentiments governing the individual. It operates the behavioral changes via the morality of the social actor. Again, it is assumed that norms, values, attitudes are not rigidly determined and out of the control of the human reason and volition. There is a space of choice when it comes to the "moral constitution" of each of us: "Individual chose dispositions or personal behavioral rules for themselves that will direct their patterns of choice behavior in a sequence of interactions with others" (Buchanan 1991, p. 233). In a sense, this may be seen as a form of constitutional logic for the self, a general principle of operation of the self in relationship to others. As any constitutional choice, it is a choice of "alternative constraints rather than alternative end states" to be obtainable "in particularized situations" (Buchanan 1991, p. 233).

Constructionism, both moral and constitutional, operate in a basic space of rationality. Nonetheless the non-rational elements play a sizeable part. Hence the individual acts as an artisan of the constitution of order, both at the level of the self and of the society, working with both rational and non-rational elements. The result is a space of the artefactual, a complex architecture of rules supporting each other, internally and socially, as "law and morals are both complements and substitutes, one for the other" (Buchanan 1991, p. 234). The structure of constraints has both rational and non-rational foundations. Discussing this, Buchanan even attempts a typology of the three sources of constraints, "one of which is nonrational, the two of which have rational choice foundations". These are: (1) "It is wrong to steal" as a norm, internalized as a non-rational value; (2) "It is rational to choose a disposition not to steal from persons who reciprocate in their moral attitudes"; and (3) "It is rational to choose an enforceable law against stealing applicable for the whole community of persons" (Buchanan 1991, p. 234).

Turning to Vincent Ostrom, we could note a similar set of arguments and ideas. Ostrom gives a special place in his thought to the idea of constitutional choice. In fact it makes it a general principle of social order. For him, the artefactual nature of human organizational forms is in a sense coextensive with the idea of constitutional choice (Ostrom 1986, 1997, 2008). Moreover, his "constitutional choice" views have inspired a recognition of the "constitutional level of analysis" even in analytical institutionalism, where he contributed to the conversion of the idea of "constitutional decision" into an analytical and heuristic tool (McGinnis 2005; Ostrom and Ostrom 2004, 2014). Thus according to the institutional analysis approach he developed together with Elinor Ostrom, three levels of rules cumulatively affect the patterns and outcomes of actions and interactions in any setting: the operational level, the collective-choice level and the "constitutional" or "constitutive" decisions level. Constitutional or "constitutive" decisions are the most basic and consequential, as they are decisions about rules governing (potential, future) collective decisions and they determine who and under what conditions may be eligible to decide. Institutional analysis has to start by identifying such rules about rues and their creation and maintenance, what are the rules to be used in crafting the set of collective choice rules (Ostrom 1986; Ostrom 1993b, Ostrom and Ostrom 2004). Their effects diffuse through collective choice rules to the entire system, up to the level of operational choices. Hence they should be at the core of any empirical research of institutional analysis.

As in Buchanan's case, Vincent Ostrom comes to recognize the importance of the internal, moral dimension and of the combination of internal and external rules at work in sustaining the artefactual realm of social order: "While customs, norms and rules can be presumed to exist as features or attributes of a community, they also exist in each individual's mind and become habituated in the ways that people relate to one another" (Ostrom 1997, p. 286). Habituated routines, habits of the heart and mind, grounded in the moral and intellectual tradition are to be considered in conjunction with the rules based in rational analysis and calculus:

> Viable democracies are neither created nor destroyed overnight. Emphasis on form of government and the binding character of legal formulations are not sufficient conditions to meet the requirements of democratic societies. The moral and intellectual conditions of those who constitute democratic societies are of essential importance. This is why building common knowledge, shared communities of understanding, patterns of accountability and mutual trust is as essential as producing stacks and flows of material goods and services. (Ostrom 1997, p. 114)

To sum up, Buchanan and Ostrom's views converge in a complex theoretical territory associated to the notion of the "artefactual" and the constructivism implied and assumed by it. Both the textual analysis of their argument and their explicitly assumed intellectual stance and identity, point out to the validity of an interpretation which sees them engaged in articulating and defending a joint position, which could be described more under the label of the "constructivism of the artefactual" than the “emergence of the artefactual”. Yet, as the next section will show, the “emergence of the artefactual” aspect is not entirely absent when it comes to the phenomena in case.

The Limits of Constructivism

The Buchanan–Ostrom “constructivism of the artefactual” has a second dimension which is crucial for a correct understanding of the real nature of the intellectual tradition or perspective the two scholars aim to advance. This dimension emphasizes the limits of the capacity of predicting, designing and controlling institutional arrangements. In other words, their approach it is based on the recognition of, on the one hand, “the potential for deliberately organized change in the institutional order” and on the other hand, of “the limits that history, human nature, science, technology, resource capacity impose on efforts to move towards the betterment of humankind” (Buchanan 1991, p. 239). In a context in which (be it for ideological or analytical reasons) the logic of either/or is dominant, these dimensions complicate things, creating the potential for both criticisms and misunderstandings.

Indeed Buchanan and Ostrom have to confront an ongoing internal tension and an inherent vulnerability because a position like theirs could always be mired by criticisms from both sides. On the one side, were those that—as the above quoted letter of 1977 illustrates—, as “evolutionists” embraced the spontaneous order perspective emphasizing the constraints and limits of choice. One the other side, those which were convinced when it comes to their planning and design capacities, humans could have the upper hand, and could overcome almost by definition, the limits imposed by history and evolution.

Out of the two, the most interesting and sensitive is the line questioning the understanding or commitment that the Buchanan–Ostrom “artefactual constructivism” has regarding the phenomena associated to spontaneous order, invisible hand, the market process, that is to say, evolutionary processes that challenge the core of the artefactual. At this stage of our discussion the emphasis has thus to be on the very idea of “limits”. That will help us to (a) illuminate a major difference between an approach framed in terms of the "constructionism of the artefactual" and an approach based on "social engineering" and (b) help us to identify the Buchanan–Ostrom position as a middle of the road attempt to navigate the two extremes.

In this respect, the first thing to be mentioned is that Buchanan and Ostrom are fully aware of and actively engaged in theorizing the limits of constructivism (and for that matter of social engineering). Both Buchanan and Ostrom have a good grasp of and engagement with the Hayekian paradigm. Let us start with Buchanan (1979, 1999) who, while developing his notion of "artefactual man", took in fact Hayek's views as a benchmark. The dichotomy between "natural" and "artefactual" man, he writes,

> …does not imply that I equate "natural" wholly with biological or genetic elements. I accept the importance of what Hayek calls the "culturally evolved man" which in a sense is neither "natural" nor "artefactual". In the measure in which individuals are bound by culturally evolved rules of conduct or modes of behavior, these elements would make up part of human nature or better stated "non-artifactual man". (Buchanan 1979, p. 95)

Only after this caveat has been put forward, Buchanan starts to build from there, always careful to give the Hayekian perspective its due. Given that Buchanan's position is better known (or at least it is less under the suspicion of betraying the spontaneous order tradition) Vincent Ostrom's take deserves a greater attention. Inspecting his views, one could get a better understanding of the strengths of what may be seen as "the weaker link" in the Buchanan–Ostrom position on spontaneous order.

The first step is to simply revisit V. Ostrom's understanding of market economics as well as his understanding of the market as a public choice phenomenon. As one may expect, both issues are approached from a "constructivist artefactuality" angle. Ostrom recognizes the distinctive contribution of neoclassical economic theory presuming perfect competition and fully informed agents. He notes that "as a purely abstract intellectual enterprise, neoclassical economic theory in the

Anglo-American tradition has considerable merit". But both his criticism of its "seriously limiting assumptions" and his sympathies towards the alternative offered by Austrian theorizing which overcomes some of those assumptions, place him again, closer, to Buchanan. But the most important thing is that he goes beyond neoclassical economics (in either of its forms) to focus on "the *necessary* conditions for the constitution and operation of a market economy". The market, he explains, requires "the proper operation and performance of a political system, an epistemic [knowledge and information] system, and a moral order." Moreover, human reflexivity, that is to say, "self-conscious awareness of the way that economic, political, epistemic, and moral contingencies may work in complementary ways" regarding these conditions, is essential (Ostrom 1997, p. 99).

When it comes to the market—seen as litmus test of one's attitude towards the invisible hand and spontaneous orders–, Vincent Ostrom, always sensitive to the ordoliberal ethos- takes as a reference point Walter Eucken's analysis of comparative economic systems. Eucken notes that all systems of economic order require some forms of planning, deliberation and choice, based on the use of knowledge and information in specific configurations of incentives and motivation. If Eucken is right, argues Ostrom (1993a, p. 163), and some form of planned action takes place in all economic activities and systems, then, we need to nuance our understanding with regard to

> … Friedrich von Hayek's use of the concept of "spontaneity", and Adam Smith's concept of the "hidden hand", in the creation and maintenance of social orders. Are such terms to be applied to relationships viewed as "brute facts" or "institutional facts" that reflect self-organising and self-governing capabilities among knowledgeable and intelligible human beings? Can "hidden hands" be expected to work spontaneously in the constitution of order in human societies viewed as systems of natural order–"brute facts"? Ostrom (1997, p. 98)

In other words, Ostrom points out to both John Searle's social ontology and to what Richard Wagner (2016) has latter called "entangled political economy". Invisible order processes are not purely natural in their genesis, they require the existence of “institutional facts” and those “facts” imply some aspects of deliberation and choice, some measure of intentionality and planning. Some form of artefactuality has to be involved in the institutional facts of spontaneous order. We are deep into the territory of entangled political economy (Wagner 2016).

It is important to note that in developing these arguments, Ostrom explicitly assumed a Public Choice stance. His views come from a programmatically assumed Public Choice angle. That is facilitated by the fact that the problems of “social facts” and “entangled political economy” morph naturally into Public Choice themes and frameworks, and the other way round:

> If Hayek’s spontaneity and Smith’s hidden hand depend on the intelligent use of the arts and sciences of association among the members of societies, we in the Public-Choice tradition, bear a substantial burden in elucidating and making use of the sciences and arts of association. Coming to terms with problems of institutional weaknesses and failures depends on the development of analytical capabilities commensurate with the sciences and arts of human association. (Ostrom 1997, p. 98)

There is a major element of artefactuality in the very institutional framework of the market process. In a letter to James M. Buchanan, dated October 10, 1977, Vincent Ostrom writes that the analysis of the market order is incomplete without taking into account “The place of knowledge and of information, the place of a moral order as constitutive of fiduciary relationships, the place of law and the requirements of justice, and the requirements of intelligibility in human artisanship”. Understanding of market as a public choice phenomenon implies a concern “with maintaining the institutional integrity of a market, including the security of property rights, enforcement of contracts, and the community of interest which market participants share in common”.

To sum up, the Buchanan–Ostrom position tries to give equal attention to two patterns of order operating concurrently. On the one hand, is the spontaneous order. On the other hand, is the order generated by deliberation and choice in relationship to the public goods and collective action situations. Each induce a different but interrelated patterns. That being said, we need to reemphasize that there is an essential tension or challenge looming in regard to the Buchanan–Ostrom "constructivist artefactuality". As already noted, it remains always vulnerable to being challenged from both sides. The simplicity and apparent consistency of the hard core planning/social engineering positions (which consider the limits just a transient problem to be dealt with by technological or moral-cognitive progress) and of the positions that emphasize the evolutionary-spontaneous nature of institutions and social order, are a challenge to any formula which assumes "two patterns of order operating concurrently" and then tries to work out the details of how is that possible and feasible. The Buchanan–Ostrom "constructivism of the artefactual" requires a balancing act, involving political judgement in determining the limits of the choice space, charting the territory of the possible, and within the realm of the possible, the intersection of the feasible and the desirable.

However, when all is said and done, in the end, caught between Anarchy and Leviathan, the main concern remains the threat coming from the failure to recognize the limits of social organization. As a matter of principle, recognizing the limits and thus avoiding the harm created by the attempts to infringe them, is as important as "recognizing the potential that may be achieved within those limits". And when it comes to more concrete and practical terms, the priority of the historical moment is given by the fact that "the organized politics of the nation states and the association of these states one with another, must be kept within the boundaries of the potential and of the possible" (Buchanan 1991, p. 250). To respond these challenges, that combine thinking about theoretical frameworks and normative criteria, requires an engagement which goes way beyond the mere theories of organization and spontaneous orders. The next section focuses on that.

Ontology, Epistemology and the Realm of the Artefactual

The "constructivism of the artefactual" has significant but underdeveloped philosophical dimensions. Once the ideas of "artefact" and "artefactuality" are conceptualized and theorized, the ontology and epistemology luggage they bring with them becomes apparent.

Both Buchanan and Ostrom note that there is a difference between social science and natural science. But they also note that there is a difference between social sciences in general and the sciences of the artefactual. Ontological differences imply differences in the theoretical and methodological approach. What Buchanan calls the "public artifactuality of the constraints" that we observe as the domain for inquiry in Public Choice, requires us to rethink and calibrate the epistemological and normative framework used. To approach the problems of social and political order with a framework shaped inspired by the frameworks based on the physical-natural order is a mistake. The key observation in this respect is that "there is no natural order within which we, as human animals, must confine our activities, one with another. We remain necessarily in a set of artificially constructed, or historically evolved, 'zoos'" (Buchanan 1991, p. 240).

The ontological dimension is one of the themes which Vincent Ostrom has tried insistently to draw attention to. We have noted that Buchanan (1979, p. 107) himself noted that his usage of the word "artefactual" was largely inspired by Vincent Ostrom, who has repeatedly theorized "the political constitution as an artifact, to be categorically distinguished from an evolved legal order". Given the leading role Ostrom took in trying to delineate the realm of the artefactual, let us focus at this juncture on his contribution.

The "facts" of interest in social and political sciences, argues V. Ostrom (1979, pp. 294–295) following John Searle, are "institutional facts". They are "artifacts", "patterns of order" having a distinctive ontological status at the intersection between individual subjectivity and intersubjective objectivity. We cannot rely on "brute empiricism" when dealing with them. Intentions and normative ideals matter (Ostrom 1979, p. 20; 1997, p. 295). But if we manage to avoid "brute empiricism", argues V. Ostrom, and "if political experience is conceived to be artifactual (i.e., created by reference to human knowledge)", then that recognition of the artifactual character of institutions brings to the fore an entire ontological realm (Ostrom 1997, p. 295). The "artifactual" of social systems is a distinct ontological realm. It is a result of the process of evolution, it emerges out of the biological realm, it evolves via the social realm and takes a dynamic of its own. Ostrom treats it not so much as a metaphysical but as an evolutionary phenomenon.

> The earth has been transformed into a human habitat that is a visibly different "reality" than the earth in its "natural" condition. Pierre Thielhard de Chardin characterizes this transformation as a noosphere, a sphere shaped by human knowledge which has its analogue in the biosphere, a sphere shaped by the existence of life. Artifacts cannot be understood as natural occurrences. In explaining artifactual constructions, we are required to account for human artisanship and the conceptual-computational considerations that entered into the design and creation of artifactual constructions. (Ostrom 1979, p. 19)

Be it interpreted through evolutionary or metaphysical lenses, or both, the point is that missing the significance of the ontological reality of institutions and governance arrangements leads to methodological and epistemological problems. Hence a vicious circle. Ostrom warns that we need "to reconsider the epistemological and metaphysical grounds on which we stand". Through history "human beings have been agents in an extraordinary transformation of the world of nature into an artifactual realm". This artifactual realm "uses the materials and processes of nature and transforms them through the use of human knowledge and artisanship to serve human purposes" (Ostrom 1979, p. 19). We cannot access the realm of artisanship using just the epistemic strategies developed to explain the natural order.

In brief, humans and their social-political order are part of a great evolutionary process generating an entire new realm created by intentionality, knowledge and artisanship. The multiple combinations possible in the interplay between on the one hand, human intentionality and cognition and on the other hand, the environment in its evolution, may generate a variety of forms of order and governance systems. The differences between these systems are essential, and to assess them requires a concrete normative engagement.

In this respect, Ostrom draws attention to a crucial distinction. Within the diversity of possible governance systems there are some which are based on notions of citizenship aiming at self-governance.

They are radically different in their telos from systems in which "Governments exercise tutelage over Societies and steer and direct those Societies." Both are part of the realm of the artefactual but generate different structures and trajectories, and are associated to different normative dimensions and standards. There are many rooms in the house of the artefactual and Vincent Ostrom is particularly interested in one of them. At one point in human history, he notes, a certain "conceptual computational logic", pivoting on citizenship and the collective capacity of citizens to design and self-govern institutions, reaches a threshold in diffusion and influence. Its influence in practice leads to a particular form of social order, something relatively novel in history.

> When Tocqueville wrote Democracy in America, he recognized that a new conceptual-computational logic was required for the constitution of democratic societies if human beings under conditions of increasing equality were to achieve and maintain substantial freedom in their relationships with one another. He was persuaded that alternatives were available so long as human beings might have recourse to a science of association in the conceptualization and design of human institutions. (Ostrom 1979, p. 20)

Again, Buchanan's views are converging with Ostrom's on this issue as well: The American experience, wrote Buchanan, is "perhaps unique in history", as it expresses "the attitude that we create the institutions within which we interact, one with another, that we construct the rules that define the game we all must play" (Buchanan 1979, p. 107). And thus, in the long history of humankind, "a threshold was crossed in the eighteenth century when we learned how the rule of law, stability and private property and the withdrawal of political interference with private choices could unleash the entrepreneurial energies…. The modern age was born…" (Buchanan 1991, p. 250).

The underlying point is that to understand the nature and significance of these momentous developments, one needs appropriate conceptual tools. The "constructivism of the artefactual" is an attempt to offer such theoretical lenses. It helps us to grasp these structural differences between types of atefactual constructs as well as the historical evolutions associated to them. And thus we have to go back to the crucial role social and political sciences have in obscuring or to illuminating the distinctiveness of the realm of the artefactual. One of the major concerns of Buchanan and Ostrom was the distorting and obscuring nature of the mainstream theoretical and methodological approaches shaped by the positivist philosophy of science:

> The application of natural science methods to the study of political phenomena during the twentieth century has meant the abandonment of any serious preoccupation with the critical problems of [choice and cognition] that inform the artisanship inherent in the design and alteration of systems of governance as these are constituted and re-constituted. Political science in the twentieth century has become a science without an explicit understanding of the critical role of theory as a system of conceptual-computational logics that applies to the design of different systems of government. (Ostrom 1979, p. 19)

We are at the core of what Vincent Ostrom (1993a) calls the "epistemic choice" problem: "the choice of conceptualizations, assertions, and information to be used and acted on in problem-solving modes". It is not just about separated theories and concepts, it is about an entire vision or system of though. Artifactual man, explains Buchanan (1979, p. 102), along with the associated institutions of social order, "was embodied in the wisdom of the eighteenth century, a wisdom that modern man has seemed in danger of losing altogether" (Buchanan 1979, p. 105). Scientism is not just an academic issue, to be settled by more or less technically correct epistemic choices. Neither are the stakes just about abstract normative theory. What is at stake, argues in very stark terms Buchanan, is the very foundation of liberal democratic governance experiment:

> We shall indeed revert to the jungle if we continue on our present course, whether in our private behavior patterns, or in our collective-governmental-institutional dynamics, aided and abetted by the make work of the so called social sciences. If we twiddle around with our 'scientistic' economics and political science, if we remain so enraptured by esoteric puzzles, if we place exclusive faith in empirical demonstrations or in evolutionary processes, we are contributing to the process of deterioration. (Buchanan 1979, p. 105)

The Public Choice movement itself, seen as an intellectual program, has to be seen as a response to these challenges, an attempt to recover the lost vision at the roots of the modern era, with its experiment in democracy and liberalism:

> Public choice did not emerge from some profoundly new insight, some new discovery, some social science miracle. Public choice, in its basic insights into the workings of politics, incorporates an understanding of human nature that differs little, if at all, from that of James Madison and his colleagues at the time of the American Founding. The essential wisdom of the 18th century, of Adam Smith and classical political economy and of the American Founders, was lost through two centuries of intellectual folly. Public choice does little more than incorporate a rediscovery of this wisdom and its implications into economic analyses of modern politics. (Buchanan 2003)

These insights and the attitude inspiring them go obviously beyond mere positive science and the problems of conceptualization and verification. In the measure in which it is about "artisanship" and "artefactual", epistemic choice has also to be about normative and ethical criteria. It is a formidable intellectual and practical challenge. We live, notes Buchanan (1991, p. 240), in a universe in which the ethical dimension is left to us to articulate. And in this process science (as commonly understood based on the model of natural sciences) has very few insights to offer: "There is no ideal order that is revealed to us transcendentally, revealed to us as if it embodies the truth of scientific discovery." The normative challenge looms large.

The Normative Dimension

Even if we do not want to "construct" or design institutional arrangements and we need only to assess their performance, we still need standards. Normativity is intrinsic to institutions and to the ways we think about institutions. In the narrow space of institutional choice or choice of rules, we need to operate with criteria and standards. But that leads directly to a major problem in modern political philosophy: The problem of values and normative standards in a secular society in the wake of the positivist and logical empiricist intellectual revolution. James Buchanan, succinctly defines the problem in Public Choice terms. At the core of the Public Choice program is the idea that "the set of constraints that define the limits on human interaction in a society must be chosen from among a subinfinity of alternatives" in the condition in which the dominant intellectual climate postulates that "there is no external standard –either embodied in nature or transcendental revealed- that would single out one alternative as 'objectively' best." If that is the case, the question is not merely to apply preexistent standards but identify or constructing them. Where are they coming from, how should one deal with the criteria of choice?

The first merit of the Buchanan–Ostrom position is simply that they acknowledge the significance of the problem of normativity (including its design implications) as opposed to circumventing it under the rhetorical common places of positivism. At the foundation of their standpoint is a stark repudiation of positivism. They recognize the role of norms, values, beliefs, in straightforward terms and they tie that with their criticism of positivism and its negative influence on political science and practices. A letter of October 1977, written by Vincent Ostrom to Buchanan, describes that stance in unambiguous terms.

> Constitutional principles do not work by themselves but depend upon the shared beliefs and shared values held by the members of a community that has recourse to particular types of political settlements. The instruments don't work unless activated by people who know how to make proper use of them and who appreciate their limits. It is precisely this set of beliefs that has eroded under the force of logical positivism where political phenomena are treated as though they were natural phenomena rather than artifacts created to serve human purposes. Thus, the political theory of the Founding Fathers had important normative components: justice was an important value to be realized and if essential characteristics of the human animal were not taken into account, justice could not be realized… To the extent that we feel that we can contribute to a revival of constitutional understanding, it seems to me that we also shall be

> contributing to a moral regeneration of a society that begins to appreciate that we can never have the best of all possible worlds. (Ostrom 1977)

That being said, it is noteworthy that both Buchanan and Ostrom are careful to separate the moral problem from the social organization and constitutional one. Both are components of the normative dimension, but their treatment is different. Constitutional arguments, decisions and rules operate at a metalevel. The decisive feature of the metalevel, as imagined in their constitutional political economy, is a strive towards a certain type of neutrality in regards to the vision of the good. When it comes to constitutional and public choice decisions, claims Buchanan, "the position that I advance is neutral with respect to ideological or normative content". This is a very important point. The consent and voluntary contractual basis of the "constructivist artefactuality" needs to take place in a setting which is as neutral as possible. The result is in fact a reiteration of the liberal ideal of a metalevel system of rules within which individuals are free to define their own vision of the good.

This is an open society perspective, of a system based on the preferences and decisions of the individuals in which the systemic goals are largely left open to individuals to negotiate and implement. The focus is "on the institutions, the relationships, among individuals as they participate in voluntarily organized activity, in trade or exchange, broadly considered" (Buchanan 1979, p. 36). What counts is the rules of the game which are framing those activities and exchanges. No predefined optimal governance formula is assumed. No normative label is attached, such as "public" equals "good", "private" equals "bad", or the other way around. What is assumed instead, is a dynamic formula, largely left open to individuals to decide, negotiate and implement:

> People may … decide to do things collectively. Or they may not. The analysis, as such, is neutral in respect to the proper private sector-public sector mix. I am stating that economists should be 'market economists,' but only because I think they should concentrate on market or exchange institutions, again recalling that these are to be conceived in the widest possible sense. This need not bias or prejudice them for or against any particular form of social order. (Buchanan 1979, p. 36)

To sum up, on the one hand the Buchanan–Ostrom "constructivism of the artefactual" recognizes the essential relevance of the moral and normative aspect of social order. On the other, it embraces a meta-theory of liberal neutrality towards the normative objectives. We could easily recognize a classical liberal position, and its typical predicament: i.e. the tension between, on the one hand, a standard of liberal neutrality and, on the other, the need to have liberal values as goals orienting the system's operation and functioning in a co-dependent way with the virtues and morality for citizens. The goal of this paper is to simply outline the contours of the Buchanan–Ostrom position, not to try to solve its internal tensions. At this juncture, it is important to simply point out to this tension at the core of the Buchanan–Ostrom normative perspective. That being said, the discussion of the implications of the normative stance at the applied level does not hinge so much on the solution to that problem. One may not be able to answer it via a guaranteed solution, but one may at least point out and weed out false solutions, guaranteed to lead to more, not less problems. For instance, could it be the case that scientific expertise in the way to resolve the problem? A model in which experts plus their science are inserted at the center of the governance process comes to many as the most facile and common response to the challenge.

Reacting to that, James Buchanan (1991, pp. 240–241) sketches a "thought experiment" and follows it through, to its troubling implications. Let us imagine a governance system, one based on scientific discovery and technological application by experts. What does that mean, more precisely, in terms of governance and institutional arrangements? The answer is simple: we like it or not, it means a form of totalitarian regime with experts as elites, separated from the rest of the society by an institutional wall created by the authority given by their epistemic expertize. The elites are controlling and directing the rest, towards goals decided by elites and using means decided by elites. "Science" becomes the legitimacy principle of an essentially nondemocratic system. This is the mindset of totalitarian social engineering. Irrespective of how one may want to label or frame it, the essence is the same. Two classes of citizens, two arenas of public choice or decision making: the epistemic elites and the rest.

On the other hand, suggests Buchanan, we could engage in an alternative thought experiment: we could imagine a system in which no elite could claim to know what the ideal social arrangement should be in abstract, irrespective of individuals' preferences, values, beliefs etc. If we acknowledge that the ultimate judges are the individuals who are to be the very subjects of those arrangements, then only one solution remains: Create a collective/public institutional arrangement geared towards "securing agreement among those who participate in the complex network of human social interactions" (Buchanan 1991, p. 241). With that comes a radical shift of focus: not on "truth" and "scientific search and establishment of the truth", as the defining principle of governance, but on rules, institutions, and procedures. That is precisely the core of the "constructivist"/constitutional political economy/epistemic choice approach that Buchanan and Vincent Ostrom were advocating.

It is important to note that, ultimately, Buchanan and Ostrom are advocating a very modest, humble attitude, shunning the hubris of omniscience and scientism. Even when they offer institutional design solutions, they insist that the solution should be seen as tentative ideas, observations and suggestions. The "suggestions advanced", explains James Buchanan

> …may be treated as hypotheses about the working properties of certain rules as well as about what persons may consider as preferable, hypotheses to be tested in the continuing dialogue in which all persons participate under self-imposed limits of reciprocity and mutuality of respect. (Buchanan 1991, p. 243)

The Public Choice scholarship, the Constitutional approach are thus seen as a contribution to an ongoing social experiment based on democratic dialogue, learning, deliberation and choice. They are an intrinsic part of the realm of the artefactual and of its internal dynamics, driven by the "combinatorics" of ideas. Hypotheses regarding alternative governance systems and alternative institutional arrangements are advanced for consideration in the political practice of democratic communities. Reflection and analysis of the trials, errors and learning, associated to these working hypotheses leads to some tentative principles. But those principles need to be always re-tested and re-calibrated, interpreted and applied in function of evolving historical circumstances. All of the above are strongly connected to the normative dimension, and more precisely to the moral one. But even in that we should keep an open-ended perspective, we should adopt a prudent, tentative attitude. As Buchanan (2005, 1991, p. 249), put it "the active support of constitutional structural reform implementing these principles may, but need not require, a new morality of public interest". Constitutional constructionism may be in the end dependent on moral constructionism but that is something conjectural, not certain.

With that, we have come full circle to moral constructivism and the responsibilities and implications brought to the fore by it. Focusing on the notion of "artefactual" and its associated ideas of "artisanship", "constructivism" and "artifact", illuminates in fresh ways the distinctiveness of the Buchanan–Ostrom position. One could see their thinking at work, trying to navigate the internal tensions of their system as well as the outside challenges to it. We see at work two genuine scholars, following the logic of their inquiry, notwithstanding disciplinary, methodological or conceptual challenges. We see them revisiting and sometimes even rethinking some of the ideas, assumptions and arguments they themselves developed in the earlier stages of building the Public Choice program.

Last but not least, it is noteworthy that both wanted to anchor Public Choice in larger philosophical and intellectual traditions and frameworks. James Buchanan, in the political economy tradition—mostly Continental, Italian, Austrian and Swedish schools of political economy and fiscal sociology. Vincent Ostrom, in the public administration literature and the eighteenth century and nineteenth century governance theories and social philosophies. Both had in view an even larger intellectual horizon, shaped by the political philosophy tradition of Hobbes, David Hume, Adam Smith, The Federalists and (in Ostrom's case) Tocqueville. Together, James Buchanan and Vincent Ostrom represent a way of understanding the core of the Public Choice program as something much more than the mere application of "economic reasoning" to "nonmarket decision making". And indeed, once Public Choice had taken roots and had stabilized as an institutionalized and well-recognized school of thought, they renewed their efforts to push inquires to new challenges that arise at its frontier. The idea of "artefactual",—due to its preeminent role both at the core and at the frontier of the program—offers us a unique window to the nature and significance of these efforts.

References

Aligica, P. D., & Boettke, P. J. (2009). *Challenging Institutional Analysis and Development: The Bloomington School*. New York: Routledge.

Buchanan, J. M. (1977). *Letter to Vincent Ostrom, 18 March 1977, James Buchanan Archives*. George Mason University.

Buchanan, J. M. (1979). *What Should Economists Do?* Indianapolis: Liberty Press.

Buchanan, J. M. (1991). *The Economics and the Ethics of Constitutional Order*. Ann Arbor: University of Michigan Press.

Buchanan, J. M. (1999). Natural and Artifactual Man. In *The Collected Works of James M. Buchanan, Volume I: The Logical Foundations of Constitutional Liberty* (pp. 246–259). Indianapolis: Liberty Fund.

Buchanan, J. M. (2003). *Public Choice: The Origins and Development of a Research Program*. Fairfax: Center for Study of Public Choice, George Mason University.

Buchanan, J. M. (2005). Afraid to Be Free: Dependency as Desideratum. *Public Choice, 124*(1–2), 19–31.

McGinnis, M. D. (2005). Self-Governance, Polycentrism, and Federalism: Recurring Themes in Vincent Ostrom's Scholarly Oeuvre. *Journal of Economic Behavior & Organization, 57*(2), 173–188.

Mitchell, W. (1988). Virginia, Rochester and Bloomington: Twenty Years of Public Choice and Political Science. *Public Choice, 56*(2), 101–119.

Ostrom, E., & Ostrom, V. (2004). The Quest for Meaning in Public Choice. *American Journal of Economics and Sociology, 63*(1), 105–147.

Ostrom, E., & Ostrom, V. (2014). *Choice, Rules and Collective Action: The Ostrom's on the Study of Institutions and Governance* (F. Sabetti & P. Aligica, Eds.). Colchester: ECPR Press.

Ostrom, V. (1977). *Letter to James Buchanan, October 10 1977, James Buchanan Archives*. George Mason University.

Ostrom, V. (1979). A Conceptual-Computational Logic for Federal Systems of Governance. In D. J. Elazar (Ed.), *Federalism and Political Integration*. Ramat Gan, Israel: Turtledove Publishing.
Ostrom, V. (1986). *The Constitutional Level of Analysis: A Challenge* (Workshop Working Paper Series). Bloomington: Workshop in Political Theory and Policy Analysis, Indiana University.
Ostrom, V. (1993a). Epistemic Choice and Public Choice. *Public Choice, 77*(1), 163–176.
Ostrom, V. (1993b). Opportunity, Diversity and Complexity. In V. Ostrom, D. Feeny, & H. Picht (Eds.), *Rethinking Institutional Analysis and Development: Issues, Alternatives, and Choices*. San Francisco: ICS Press/ Institute for Contemporary Studies.
Ostrom, V. (1997). *The Meaning of Democracy and the Vulnerability of Democracies: A Response to Tocqueville's Challenge*. Ann Arbor: University of Michigan Press.
Ostrom, V. (2008). *The Political Theory of a Compound Republic* (Rev in.). New Brunswick, NJ: Transaction (found Lanham: Lexington Books).
Wagner, R. E. (2016). *Politics as a Peculiar Business: Insights from a Theory of Entangled Political Economy*. Cheltenham: Edward Elgar.

49

The Calculus of Consent and the Compound Republic

Robert L. Bish

James Buchanan and Gordon Tullock and Vincent Ostrom produced major works on constitutional choice: *The Calculus of Consent* (1962) and *The Political Theory of a Compound Republic* (1971).[1] Constitutional choice had been neglected in political science in favor of policy analysis, and public choice theory was just emerging. These two works have brought the importance of constitutional choice to the forefront because it is the rules set forth in the constitution of an organization that set the incentives for decision-makers and hence play a major role in the policies that emerge. Their analyses are relevant to the constitutions of all governments, including state and local, not just national ones, and has been applied to quasi-governmental organizations such as home owner associations and condominiums that provide public

[1]The focus of this paper is on the two early public choice works on constitutional choice. All scholars went on to produce many more related analyses, and Buchanan's later work on federalism, which he labeled "competitive federalism" was similar to Ostrom's (Feld 2014).

R. L. Bish (✉)
University of Victoria, Victoria, BC, Canada
e-mail: rbish@uvic.ca

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_49

services to their residents. It is the objective of this paper to show how the works of Buchanan and Tullock and Ostrom complement each other's and where there are significant differences. Examples will also be provided where their work provides a framework, not only for scholarly analysis, but also for understanding constitutional arrangements and guiding constitutional change.

The most important similarity between their works is that each builds from the eighteenth century Scottish Enlightenment, with methodological individualism and the assumption that individuals know and act in their own self-interest as they perceive it with important predecessors for all being Hume and Smith. While Buchanan and Tullock move forward in the tradition of Knight, Mises and Hayek, Ostrom builds from Hamilton and Madison in *The Federalist* and Tocqueville. While different political scientists have produced different interpretations of *The Federalist*, Daniel Elazar credits Ostrom with "rediscovering the political theory of *The Federalist*" (although that theory was implicit and not explicitly stated). Furthermore, that theoretical framework is essentially the same as that of Hume, Smith, Knight, Mises and Hayek, and, in Vincent Ostrom's view, Tocqueville. Thus we have three of the founders of the Public Choice Society, two economists and one a political scientist, working within the same paradigm to examine constitutional choice. They each view constitutional rules as rules under which subsequent actions will be undertaken. They also share the same objective: to develop theory that facilitates predicting the consequences of constitutional rules and constitutional change.

Buchanan and Tullock: *The Calculus of Consent*

Published in 1962, at the beginning of the Public Choice era, Buchanan and Tullock devote considerable effort to explaining the logic of the Public Choice approach. Their objective in this analysis, however, is to work though the logic of what kind of rules a rational self-interested individual would agree to be bound by for making binding decisions as part of a group. They also describe how this approach relates to the problems faced in the Constitutional Convention, where participants were engaged in writing a new Constitution in the face of failure of the Confederation agreement. Equally important, they indicate that the logic presented also applies other organizations, including local governments, which must deal with local services, common pools or externalities.

The Calculus of Consent is a work with many references to other works and political decision-making issues, but the real conclusions come from straightforward specification of assumptions and deductive logic, including with the use of game theory models. They relate to: The tradeoff between decision-making costs and political externality costs,[2] majority rule voting, and a bicameral legislature. Throughout, their benchmark criteria is Pareto Optimality, that is, can we design constitutional rules where everyone gains, or at minimum, at least one person gains and no one loses. This is a very strict standard, but there is also a section where the analysis uses a welfare criterion of whether or not net gains to some individuals exceed losses to others.[3]

Buchanan and Tullock create a novel way to examine the expected costs of constitutional rule based decision making. They compare the expected costs to an individual of getting agreement among individuals to undertake an action to the expected costs created by group members agreeing to take an action which would impose costs with which the individual disagrees. If any single person could commit the group to an action, decision-making costs would be zero. As the number (or proportion of individuals) required increases, decision-costs rise. The rise is likely to be higher as a rule closer and closer to unanimity is approached because hold-outs could demand a disproportionate share of benefits for their agreement. Both kinds of costs are also expected to be lower in a homogenous group than a heterogeneous one.

---

[2]These costs are as perceived by the individual analyzing the situation. Reasons are given why they might vary, including for organizations with different kinds of authority, but their content is never really specified.

[3]This insertion is a surprised because Buchanan was a strict subjective value theorist who did not believe the welfare of different individuals can be compared without them revealing their preferences.

While decision costs are zero with anyone allowed to make a decision for the group, political externality costs are likely to be very high under that rule, e.g., any individual could expect to end up paying for many actions they do not value. At the other extreme, if the decision rule was unanimity, political externality costs would be zero because no actions could be undertaken without every individual's consent. The decision rule a rational individual would prefer is one that minimizes the sum of decision plus political externality costs.

The basic logic is very important: when entering into a constitutional arrangement where the individual will be bound by subsequent decisions a rational individual will pay attention to the benefits of reducing decision costs by being able to have actions undertaken without the high cost of getting everyone to agree to every action, while at the same time, paying attention to potential political externality costs being imposed on him or her by actions other members of the group agree to undertake with which he disagrees. Some of the most important variables the individual will consider are the size of the group, the homogeneity of the group, and the kind of actions the group can undertake. The nature of specific actions also leads to different rules for different action within a group. For example, any one person is generally allowed to request the fire department to come to a fire. Time is critical and the overall cost is low. A more costly activity such as paving a street is likely to require a significant number of residents to agree: time is not as important and the costs are large. Individuals may also want to consider how costly it is to exit the organization if it turns out their estimate of benefits from membership was wrong. An individual would not make an agreement to participate in a constitutional arrangement unless they estimate that over a series of actions, even if they do not agree with every one, they will receive net benefits. The constitution itself, specifying the rules (which may be different for different kinds of actions) should be agreed upon by everyone—i.e. the rule for making a constitution should be unanimity.

There are two very important observations about the analysis of constitutional rules. One is that the logic applies to any organization where an individual can be bound to participate in action, not just a "constitution" of a national government as the founding fathers adopted in 1777 or that of a state government. Thus we can extend this logic to local governments, homeowner associations,[4] and clubs. Rational individuals only agree to bear the costs of decisions with which they disagree if overall they expect benefits from actions with which they agree to be greater. A second observation is that there is nothing in this logic that concludes that majority vote is the voting rule that an individual should prefer for most, let alone all, decisions.

Following presentation of a model that demonstrates the logic of an individual agreeing to participate in actions where one bears net costs in order to reduce decision costs for actions where one benefits, Buchanan and Tullock turn to the complications of actual decision-making and majority rule. Some complications occur in a direct democracy (citizens vote on each issue); others are important in representative democracy where citizens elect representatives to make the decisions on what actions to undertake for the group.

A problem that is present in all forums is that of individuals having different intensity of preferences for actions. As there is no easy way to distinguish the intensity of an individual's preference for a public good, all votes are weighed equally. This means that losers may actually have stronger preferences (higher "value") than the "winners" who may have only weak preferences (lower "value"). The problem of accounting for different preference intensity plagues any constitutional system. It leads Buchanan and Tullock back to the value of unanimity in decision-making as the only rule than can "guarantee" Pareto Optimality or even net welfare gains. It should be pointed out, however, that applying the rule of unanimity to assure Pareto Optimality may have very high opportunity costs by precluding actions where a large number of the members would benefit.

A different problem occurs in a representative democracy under majority rule. It is that a 51% majority of the members in an assembly that were elected by 51% of the voters in each district would only represent 25% of the population. The combination of the inability to

[4]One of the best empirical tests of Buchanan and Tullock's framework is the application to a large sample of condominium associations (Barzel and Sass 1990).

account for differences in the intensity of preferences, plus the possibility that a majority of the representative assembly could represent many fewer members than 51% raises serious questions about majority rule.

Buchanan and Tullock pose three suggestions that make improvements, none of which are guaranteed to resolve the difficulty of taking the intensity of preferences into account or the deficiencies of majority rule. First, and most important, is to undertake activities in groups at the smallest scale possible. Smaller groups are likely to be more homogenous, so both decision-making and political externality costs will be lower and there is less chance there will be a minority interest group attempting to impose its preferences on the larger group. Second is logrolling within the assembly. Logrolling is vote trading where voters with low preferences on an action trade their votes to representatives who have a high preference on that issue in exchange for votes on something the second group values more highly. With vote trading the sum of benefits to individuals will be higher on any single issue—leading to higher net benefits for individuals in the group engaged in the vote trading. However, individuals not included in the vote traders may incur significant costs so vote trading can only be assured to achieve net benefits if everyone is involved—which is essentially a return to unanimity and its high decision-costs.

The third conclusion is that having a bicameral legislature where each assembly has to vote for an action will reduce political externality costs as long as the assembly representatives are elected from different constituencies, e.g. population-based districts for the House and States for the Senate, or perhaps population-based districts for state representatives and counties for state senators. Having two assemblies raises decision-costs but lowers political externality costs.

Buchanan and Tullock do more than present their models and include descriptions of relationships to other scholars and a limited number of illustrative examples—but it is their basic framework of the trade-off between decision making and political externality costs, with identification of the relevant variables that affect those costs-size, homogeneity of the group and nature of the actions that is most illuminating. They also demonstrate the deficiencies of majority rule and provide some directions that lessen those deficiencies. Equally important is a very important observation: constitution making is not limited to the national or state governments. It is relevant for all organizations where members are bound by less than unanimity decisions, especially local governments. Finally, it should be recognized that their model and conclusions are derived from reasoning through what a rational individual should want to consider when agreeing to a constitution for a group where they would benefit from being a member.

Vincent Ostrom: *The Political Theory of a Compound Republic*

Prior to the emergence of major Public Choice literature in the early 1960s,[5] Vincent Ostrom had significant publications on water resources and local government, including what is now a classic with Charles Tiebout and Robert Warren, "The Organization of Government in Metropolitan Areas." in 1961. Vincent had also assisted with the drafting of the natural resources section of the Alaska State Constitution, which had rekindled his interest in constitutions and *The Federalist* (Allen and Lutz 2009). Following the emergence of the Public Choice literature, he and Economics Professor Herbert Kiesling presented a joint Economics-Political Science seminar on Public Choice Theory at Indiana University in 1967. It was following this work that Vincent returned to the eighteenth century classical liberal literature and authored *The Political Theory of a Compound Republic: A Reconstruction of the Logical Foundations of American Democracy as Presented in "The Federalist"*.[6] He attributed his new understanding of the theory inherent in *The Federalist* to the Public Choice literature, especially to *The Calculus of Consent*. For other scholars who wish to understand the political theory underlying *The Federalist*, he

[5]Buchanan and Tullock's *Calculus of Consent* in 1962; Mancur Olson's *The Logic of Collective Action* and Gordon Tullock's *The Politics of Bureaucracy* in 1965.

[6]It was after this seminar that Vincent began referring to himself as a "political economist". For an overview of his work beyond that of the theory of a compound republic (see Bish 2013).

recommended that they begin with Kuhn's *The Structure of Scientific Revolution* to understand how difficult it is to understand a new paradigm, and proceed to Buchanan and Tullock's *Calculus of Consent* before reading *The Federalist*. He also recommended Mancur Olson's *Logic of Collective Action* as a supplement and then following up with Tocqueville's *Democracy in America* to understand how the political theory of a compound republic includes local government. Daniel Elazar, the most widely published scholar on federalism, attributes to Vincent "the rediscovery of the political theory of *The Federalist*" which Vincent ultimately labels the political theory of a compound republic.[7] He also came to label it "polycentric federalism" to emphasize that it included multiple governments; not just the two levels traditionally labeled federalism. This is consistent with Buchanan and Tullock's approach.

It is important to recognize that Vincent was already familiar with *The Federalist*, public goods, external effects and common pools and had used the term "polycentric political system" in the analysis of local government in Los Angeles County along with Charles Tiebout and Robert Warren in 1961.[8] What followed the Public Choice literature was his explicit return to a focus on constitutional decision-making and the distinction between constitutional decision-making and operational decisions made within the constitutional rules,[9] all in relation to *The Federalist*.

The starting point for Buchanan and Tullock: what constitutional rules would a rational self-interested individual agree on to receive net benefits from collective action parallels the starting point of *The Federalist*: "Are Societies of men really capable or not of establishing good government from reflection and choice…" (p. 3). Ostrom then points out that *The Federalist* starts with individuals who seek their

[7]Elazar puts Vincent's work into the context of the study of federalism in the "Forward" to the second edition of the *Compound Republic* in 1987.

[8]In a much neglected article, Robert Warren went on to put the Los Angeles polycentric system into a market theoretical framework (1964). Warren's "local governments as consumer co-ops" is further developed in Bish (1999).

[9]This distinction became an important part of work at the Ostrom's Workshop in Political Theory and Policy Analysis at Indiana University. It was also an important component of Elinor Ostrom's work, for which she received the Nobel Prize in Economics in 2009.

relative advantage[10] when examining political institutions. Ostrom traces this paradigm back to the classics and at this point shows no references to or awareness of the work of Knight, Mises or Hayek to which Buchanan and Tullock refer. The issues that Vincent considers essential to reconstruct the theory, however, have a significant degree of overlap with Buchanan and Tullock.

Buchanan and Tullock point out that size of the group is important, where smaller groups are likely to be more homogeneous, lowering both decision-making and political externality costs. Vincent, especially after working with Tiebout, supports this position. However, he adds an additional consideration. Vincent points out that only one person in a meeting can talk at once, so the size of a group in direct democracy or a representative forum is limited if they are going to engage in serious deliberation. He also points out that it is impossible for a representative to represent a large heterogeneous group. If either direct democracy or a representative forum is too large it will be taken over in an oligarchic manner by a small number of members. The size problems he elaborates pose a serious dilemma for a large country. To the extent there is a solution, it is polycentricity—many different governments operating independently in response to their citizens. This is a major reason why Ostrom includes local governments in his polycentric federalism. Ostrom provides the details for the Buchanan and Tullock argument for small groups. I believe that Ostrom believed that the size problem was the most significant problem for governing a large republic based on democratic principles. This is why he devotes considerable analysis to the relationships among governments in a polycentric system, analyses missing from Buchanan and Tullock.

A second important issue is "factions", which as described by *The Federalist* are self-interested groups whose interests are inimical to the public good. Individuals organized into these groups pose a real puzzle. They clearly have an intensity of preference that is greater than that of

---

[10]Ostrom tended to avoid the term "self-interest" in favour of the term "self-interest rightly understood." By this he meant that individuals were capable of considering their interests in relation to the interests of others within a longer time horizon.

the average citizen. Can their preferences be met by logrolling, or are they manipulating the voting rules to obtain advantages at the expense of others—as Buchanan and Tullock reason could happen in a representative assembly where representatives for as few as 25% of citizens vote benefits for them at the expense of others. Buchanan and Tullock go on to illustrate control of decision-making by a minority faction is less likely with a bicameral legislature. That is probably about as far as one can go with their style of deductive logic, including game theory. Vincent goes further, but in the style of a political scientist there are more general statements and while logical, it is a richer analysis.

The Federalist takes two directions for preserving liberty against tyranny and factions. One is the separation of powers within the national government. The other is compounding the republic with multiple governments. Vincent describes the arguments for the separation of powers and having separate constituencies for the House and Senate provide for a bicameral legislature in the Buchanan and Tullock mode. The presidency has a still different constituency, and the courts still another. The requirement for legislation to pass muster in all branches was to prevent tyranny—which means much higher decision-making costs for potentially lower political externality costs.

Ostrom describes Madison as expecting majority voting and getting approval though the House, Senate and presidency to control minority factions. It was also anticipated that it would be difficult for a majority faction to capture all branches at once. If that were to happen, individuals bearing costs would need to seek recourse with other governments. This requires some overlapping among activities of the different governments. This conclusion has major implications for understanding federal systems. Other scholars of federalism, especially economists working with a public goods approach such as Oates (1972), define federalism as two levels of government with a separation of jurisdiction between them.[11] Ostrom and *The Federalist* both reject this approach because a strict separation of jurisdiction does not leave opportunities

[11]For a critique of federalism as two levels of government dividing jurisdiction so each has a monopoly over its share see Bish (1987b).

for individuals bearing costs or foregoing opportunities at one level to appeal to the other level of government. *The Federalist* expected both cooperation (perhaps on tax administration) and rivalry between the levels of government, with citizens choosing the one they preferred for different activities.

The size principle and polycentricity both indicate the potential for minority factions to impose political externality costs on majorities. As indicated previously, a large direct democracy or large representative assemblies are likely to end up being directed by a small group that Ostrom had labeled the oligarchic principle. There is no reason to anticipate that their decisions will be more than self-interested on their own behalf. For many smaller governments to be created to resolve the size problem, the constitutional rules under which the smaller governments operate are very important. The most important were presented in the Ostrom–Tiebout–Warren article on metropolitan government: The group must simultaneously include those who make the decision, those who benefit from the decision and those who pay for the decision. These criteria would come to be called “fiscal equivalence” by Mancur Olson (1969). Without fiscal equivalence in a polycentric system it can turn into a competition where different groups attempt to gain benefits at the expense of others and there is no reason for any individual to anticipate net benefits.

The problem of minority factions seeking benefits at a cost to a majority has come to be called “rent seeking”.[12] It occurs both within and among governments. Within a large government, factions treat the treasury as a commons to be exploited. In a polycentric system the smaller governments always have a reason why a larger government should give them a grant—which means that local governments treat the state and national treasuries as a commons, and states do the same for the national. Without fiscal equivalence at every level of decision-making, political externality costs can be very high. Essentially, the

[12]The term is attributed to an early article by Anne Krueger and Gordon Tullock used the term in 1967. Buchanan, Robert D. Tollison and Gordon Tullock edited a substantial volume of essays on rent seeking in 1980.

compounding of the republic does assure citizens that no one faction will take over the country, which was the kind of tyranny that concerned the drafters of the Constitution. However, Buchanan, Tullock and Ostrom all raised concerns about what has come to be called rent seeking that is associated with the huge scale of the national government and the number of programs that have been created that finance factions.

Buchanan, Tullock, and Ostrom share identification of the key variables affecting decision-making and political externality costs: scale, homogeneity of the group, and the nature of the activity. However, *The Federalist* and Ostrom raise two additional issues that relate directly to decision-making and political externalities. They are assumptions about information and innovation, and they are closely related.

Economists are schizophrenic when it comes to the treatment of information. In Micro Theory, the assumption of perfect information is used as demand and supply curves are drawn and the logic of changes is worked through. In Comparative Systems, the conclusion is drawn that only a market system can produce the information producers and consumers need to make efficient resource allocation decisions. The Buchanan and Tullock model follows the micro tradition and does not treat information as a special problem: it is assumed individuals have the necessary information to act in their self-interest. In contrast, *The Federalist* takes an approach similar to that of a Comparative Systems economist. Their main conclusion is that if an action to achieve a desired result is debated in multiple forums, those debates will bring out much more information about the consequences of the action and its costs and benefits. Thus, not only are political externality costs reduced from the requirement of multiple approvals (as from Buchanan and Tullock's bicameral legislature) but also benefits may be increased. This makes incurring the higher decision-making costs of multiple forums even more worthwhile. Ostrom adds that increases in the knowledge of consequences of the action may go so far as to result in innovation, that is, newly discovered ways to achieve an objective or even revealing other objectives that could provide benefits for the group. Ostrom's consideration of polycentricity and its implications is the single most important difference from Buchanan and Tullock in their consideration of constitutional arrangements.

The assumptions about information in all institutional analysis are extremely important and the approach in comparative systems economics and Ostrom's, where learning can occur, appears more fruitful. In Robert Warren's market model of metropolitan organization, we have a polycentric government system that includes both rivalry among municipalities to attract residents and business, and cooperation in the provision and production of public services (1964). Warren actually describes it as a market system where the local governments are characterized as "consumer co-ops" where their elected councils make decisions on *what* will be provided, *how* it will be provided (many use contracts with private firms or other governments), and how *they will pay for it*. There is a very high degree of fiscal equivalence in that the municipalities represent their citizens, make decisions on benefits to be provided, and collect money from those benefitting to pay for the services. The system worked because of the high degree of fiscal equivalence, and from all evidence available those citizens residing in the "contract cities" had a higher level of satisfaction than did the citizens in the giant city of Los Angeles, with its many differing neighborhoods and large bureaucracy for producing services (Bish 1971, Chap. 5). Elinor Ostrom's national studies of the police industry yield a similar conclusion based on much stronger evidence (McGinnis 1999). An extremely important conclusion of these studies is that the most efficient providers of policing services are relatively small municipalities that produce police patrol but contract for overhead services such as information systems, training and homicide investigation with larger producers, including joint agencies, larger municipalities, the county sheriff or the state police. This is what makes polycentric systems like a market, where the information upon which decisions are based is produced in its normal operation.

The Combined Framework

Buchanan and Tullock provide a simple model analogous to a microeconomic model of supply and demand for a product. There you begin with supply, demand, and the most likely variables to influence demand: income or wealth and prices of complements and substitutes. It is simple, but it is an extremely powerful starting point for a multiplicity of analyses. No other social science has at its base such a simple yet powerful framework[13] to start an analysis.

Buchanan, Tullock and Ostrom have clarified the logic of constitutional decision making and have given us a model equivalent to the standard microeconomic model to begin an analysis of a constitutional arrangement. We have decision-making costs (now generally called transaction costs) and political externality costs, and each may be affected by size, homogeneity (which covers potential for factions), the scope of actions, information, and recourses (including exit) to other branches or governments to advance one's interests or avoid political externality costs. The option of seeking recourse to other units is an important characteristic of federalism as presented in *The Federalist* but generally neglected in Buchanan and Tullock and two-tier models. Ostrom, in his analysis of *The Federalist*, has also provided much more information about each variable, especially in his discussion of the size principle and opportunities for minority factions and oligarchic takeovers as size and heterogeneity increase. He also makes us aware that benefits from an action may be increased with increases in information that are generated in the decision-making process itself.

There is also another aspect of Ostrom's work that is simply different from Buchanan and Tullock's. While Buchanan and Tullock continually refer to the welfare criterion of Pareto Optimality, Ostrom criteria are much more general and implied rather than explicit. To achieve "good government," he derives "basic rules for the design of political institutions" from *The Federalist* that make the achievement of good government more likely, not guaranteed, but more likely (Ostrom 1971, pp. 44–53). He labels the rules "propositions", the first of which is *Every man is presumed to be the best judge of his own interests.*

[13] I prefer the Ostrom Workshop designations for framework, theories and models. Framework includes potentially relevant variables from which you select the ones that apply for any specific analysis. Theories are tested relationships among variables (e.g. the theory of demand), and the Model is the organization of the selected variables with their theories to make predictions for a specific analysis.

A second proposition is *No man is a fit judge of his own cause in relation to the interests of others.* Both of these are consistent with Buchanan and Tullock and Buchanan's Subjective Value criteria (Buchanan 1969). They illustrate that the theory and conclusions found in *The Federalist* provide insights into the design of constitutional arrangements that are consistent with, but go far beyond, Buchanan and Tullock's model.

Examples and Observations

In a paper presented at the 25th anniversary of publication of *The Calculus of Consent*, Gordon Tullock (1987) expressed disappointment that in spite of having sold a lot of books for classroom use, he did not see as much follow-up research as he had hoped. There is, however, considerable research that builds on *The Calculus*, Mancur Olson's *Logic of Collective Action*, and the Ostrom work. The *Public Choice Journal* continues to publish relevant research and the journal *Constitutional Political Economy* was directly stimulated by the Buchanan and Tullock work. *Publius: The Journal of Federalism* also includes many articles with a public choice/new institutional economics approach. Most applications to local governments appear in other outlets, including separate monographs on specific metropolitan areas or issues such as local government consolidations. It is useful to examine some of the research stimulated by Buchanan, Tullock and Ostrom following their revival of constitutional analyses.

The National Government

One can almost view the ultimate conclusions of Buchanan and Tullock's *Calculus of Consent* as demonstrating the difficulty (impossibility perhaps) of designing a constitutional system from the perspective of a rational self-interested individual to obtain benefits from group action that would not be overcome by factions and impose greater political externality costs on the individual. This led Buchanan to continue to think and search for institutional arrangements based on voluntary consent in the tradition of Wicksell. Equally related was the treatment of factions in an increasingly large body of literature on rent seeking. Adam Smith had warned about the efforts of businessmen to collude with government to prevent competition and create monopolies (Smith 1937). Following *The Calculus of Consent* and Tullock's article on rent seeking, this topic has exploded, unfortunately in both successful rent seeking and analysis of it. There has even been a non-profit law firm network, The Institute of Justice, fully engaged in bringing court cases against rent seeking, with a special focus on removing occupational licensing by state governments and abuse of eminent domain to provide sites for private business at the local level. Stephen Teles has done significant research on rent seeking through congressional committees and recently co-authored a book with Brink Lindsay, *The Captured Economy: How the Powerful Enrich Themselves, Slow Down Growth, and Increase Inequality* (Lindsay and Teles 2017) dealing with multiple national, state and local governments.

Vincent Ostrom's continued research and thinking followed from his analysis of the size principle in designing a constitutional system for a very large country. His solution had been "polycentricity" so that no government itself became so large that it succumbed to oligarchic principles and was taken over by a faction. Ostrom had been involved in previous research that indicated that a polycentric system of local governments with fiscal equivalence could work quite well. Elinor Ostrom's research on community governance of commons problems (for which she received the Nobel Prize in Economics) also indicated that small governments could work very well. What Vincent Ostrom observed was the increasing nationalization of activities that were better done by state or local governments, and that as a consequence the national government of the United States was plagued by the size problem: House districts were too large for representatives to represent their citizens on the multiplicity of issues the national government had taken on; there was no way legislation could be written for such a diverse country, and bureaucracies had become legislatures because the volume of work was too much for either the House or Senate. Oligarchic factions had basically taken over the national government.

Ostrom argued that a major reason for the expansion of the national government, both in size and scope, was due to the failure of people to understand the logic of the American constitutional system as presented in *The Federalist*. They had instead substituted the monocentric paradigm of advocates such as Woodrow Wilson, who believed that all power of a government had to be concentrated in one place—not dispersed among different branches or among different units in a federal system. Ostrom's other classic; *The Intellectual Crisis in American Public Administration* (1973) directly confronted this issue.

Ostrom also followed up on another aspect of constitutional analysis, and one that Tullock had advocated in his 25th year article: that of comparative constitutional analysis. Ostrom did not do this work himself but entertained a series of visiting scholars at the Workshop at Indiana University to undertake such analyses. These scholars included Mark Sproule-Jones (Canada), Filippo Sabeti (Italy), Robert Netting (Switzerland), Brian Loveman (Spanish America), James Wunsch (Central Africa), Dele Olawu (Nigeria), Sheldon Gellar (Senegal), Amos Sawyer (Liberia), Alexander Obolonsky (Russia), Antoni Kaminsky (communist regimes), and Tai-Shuenn Yang (China). This was a major effort that continued his previous work on constitutional analysis.

The most important impact of the constitutional analyses of Buchanan and Tullock, closely complemented by Vincent Ostrom, is the identification of problems that are derived directly from both the logic of a self-interested individual trying to design a constitution and the political theory of polycentric federalism from *The Federalist*. Awareness of those problems for the overwhelming large national government has led to significant scholarly research and even some public understanding. However, from the perspective of many scholars, solutions remain to be discovered.

State and Local Governments

Buchanan and Tullock indicated that their framework applied to local governments. Tullock later wrote an article which examined the tradeoff between the number of activities a government has jurisdiction over and the number of governments an individual would be a citizen of and a monograph applying the idea of multiple governments in a federal system to Canada (1969, 1994). *The Federalist* also refers to the system of governments within each state as part of the federal system. However, it is Ostrom's work that fully developed the logic of polycentric federalism. Toward this end, he added Alexis de Tocqueville's 1848 *Democracy in America* (1945) as one of his most important predecessors.

While Vincent's most cited work on local government is the Ostrom et al. "The Organization of Government in Metropolitan Areas" in 1961, which introduced the concept of polycentricity, Ostrom continued to write on local government, specifically using a public choice theory approach with Bish in *Understanding Urban Government: Metropolitan Reform Reconsidered* (1973) and again using a public choice theory approach in Vincent Ostrom, Robert Bish and Elinor Ostrom *Local Government in the United States* (1988). This book was able to include the policing research led by Elinor to add more empirical evidence to the understanding of how a polycentric public economy worked.

Several of Vincent Ostrom's students also continued to publish using the public choice polycentric federalism framework, including Bish's *The Public Economy of Metropolitan Areas* (1971), which began as a paper in the Ostrom-Kiesling seminar on Public Choice Theory. Most of Bish's work has continued in this tradition and includes articles and books, the most recent of which is *Governing Greater Victoria* (2016).[14] This volume provides a detailed case study of how 13 municipalities, most of which have homogeneous populations, both cooperate to provide services efficiently and compete to attract residents and business. This study was done because local residents viewed having 13 municipalities as chaotic instead of understanding the logic of the system within the framework of polycentricity. Other works from Ostrom's students on local government include Ronald Oakerson's *Governing Local Public*

[14]Beginning in 1987 virtually all local government managers in British Columbia have been introduced to the public choice/polycentric federalism approach through 4 editions of Bish's *Local Government in British Columbia* (1987a). Also published in Korean in 2015.

Economies (1999), one of many studies that emerged from Oakerson's and colleague Roger Park's work at the Advisory Commission on Intergovernmental Relations.

Buchanan and Tullock also had students who applied constitutional choice to the analysis of local governments. One excellent analysis is by Richard Wagner and Delores Martin on constitutional rules for creating new municipalities (1978). It includes a cross-sectional analysis for all states and a longitudinal analysis within California which (unsurprisingly) found that restrictions on new incorporations are associated with both higher costs and higher increases in costs each year for existing municipalities. This work fits directly into Robert Warren's market model approach as well. The Barzel and Sass study of condominium rules was previously cited, and *The Voluntary City* (2002), a collection of essays on innovative approaches to resolving urban problems, includes a section applying constitutional analysis.

Work explicitly based on the polycentric federalism framework for sub-national governments is not limited to that on local government. Mark Sproule-Jones has done extensive work on managing the great lakes (2002) and Elinor Ostrom used the framework for a constitutional based analysis of the creation of the West Basin Ground Water District in her doctoral dissertation at UCLA (1965). Following her police studies, she returned to focus on community management of natural resources within the framework. Her *Governing the Commons: The Evolution of Institutions for Collective Action* (1990) is her most widely read work and it was also most highly cited for her Nobel Prize in Economics. She and her students have done extensive additional scholarly work developing the Institutional Analysis and Development framework to assist with the creation of sustainable natural resource governance institutions (2016).

A second important area of work using the polycentric federalism framework is work by Bish and the Tulo Centre for Indigenous Economics (Cassidy and Bish 1989)[15] to integrate First Nations into

[15]The Tulo Center organizes and arranges for the teaching of university credit courses in administration, economic development and land management for First Nations at Thompson Rivers University in British Columbia. Research publications are found on its web site at www.tulo.ca.

the Canadian Federal system. This work has been ongoing since 1985 and has had major success, first getting amendments to the Federal *Indian Act* to enable First Nations to levy taxes and assume responsibility for services on their lands, and subsequently facilitating their integration into the British Columbia Local Government system for service provision and production. National First Nation institutions have emerged from this work, including the First Nations Tax Commission. They in turn provide a regulatory structure for individual First Nations much like a Provincial government does for its municipalities. These developments can most easily be understood within the framework of polycentric federalism and because they have been created to include fiscal equivalence, it is a system that is working well.

Buchanan and Tullock would be pleased at how their sophisticated yet simple framework has been used at the constitutional level for setting the rules that are the constitution for local governments, community resource management agencies, and First Nations. Because fiscal equivalence can be built into the design of smaller governments more easily than it can for state or national governments, use of the framework is leading to better institutional arrangements and not just the impossibility of creating fair and efficient institutions as seems to be the case for state and national governments. Buchanan, Tullock and Ostrom's recommendation to undertake government activities at the smaller government level appears to be an accurate recommendation for successful institutions.

Concluding Observations

In *The Calculus*, Buchanan and Tullock used 39 pages to explain that the assumption that rational self-interested individuals could be used as the basis for an analysis of constitutional decision-making. Ostrom faced a similar problem in his work, devoting an entire book, *The Intellectual Crisis in American Public Administration*, to making the same argument, and pointing out that it was the paradigm used in classical political economy and the design of the United States Constitution. Their work, complemented by other early public choice scholars like

Mancur Olson, has made a major contribution to returning the paradigm of classical political economy to normal science, and is now widely used by both economists and political scientists. There is no better example of breaking down the barrier between the two disciplines that a "political scientist", Elinor Ostrom, receiving the Nobel Prize in Economics for her application of Buchanan, Tullock, Olson and Vincent Ostrom's work to analyzing constitutional arrangements for sustainable natural resource management.

The examination of the relationship between Buchanan and Tullock's *Calculus* and Vincent Ostrom's *Compound Republic* indicates that they should be read together. Buchanan and Tullock make the basic framework clear: the tradeoff between decision-making costs and political externality costs and the most important variables that affect those costs: size, homogeneity and the potential areas for decisions. It is, however, Ostrom's *Compound Republic* and polycentric federalism that fill out the details of the size principle and add the importance of information, incentives to seek new solutions, and opportunities to exit or seek recourse through other institutions including other governments. Buchanan and Tullock's equivalent to the economists' demand and supply model needs to be married to Ostrom's *Compound Republic*, which parallels the economists' comparative systems approach, to fully understand the value of the constitutional level of analysis. This is especially important for the United States where the paradigm allows one to understand the logic that underlies the United States Constitution as well as its system of state and local governments. Many scholars have built on their work. Many more will continue to do so.

References

Allen, B., & Lutz, D. (2009). Experience Guides Theory: Discovering the Political Theory of a Compound Republic. In F. Sabetti, B. Allen, & M. Sproule-Junes (Eds.), *The Practice of Constitutional Development: Vincent Ostrom's Quest to Understand Human Affairs*. Lanham, MD: Lexington Books.

Barzel, Y., & Sass, T. R. (1990, August). The Allocation of Resources by Voting. *Quarterly Journal of Economics, 105*(3), 745–771.

Belto, D. T., Gordon, P., & Tabarrok, A. (Eds.). (2002). *The Voluntary City: Choice, Community and Civil Society*. Ann Arbor: University of Michigan Press.

Bish, R. L. (1971). *The Public Economy of Metropolitan Areas*. Chicago: Markham.

Bish, R. L. (1987a). *Local Government in British Columbia* (Subsequent editions 1990, 1999 and 2008. 3rd and 4th ed. joint with E. G. Clemens). Richmond: Union of British Columbia Municipalities.

Bish, R. L. (1987b). Federalism: A Market Economics Perspective. *The Cato Journal, 7*, 377–396.

Bish, R. L. (1999). Federalist Theory and Polycentricity: Learning from Local Governments. In D. P. Racheter & R. E. Wagner (Eds.), *Limiting Leviathan* (pp. 201–220). Cheltenham, UK: Edward Elgar.

Bish, R. L. (2013). Vincent Ostrom's Contributions to Political Economy. *Publius: The Journal of Federalism, 44*, 227–248.

Bish, R. L., & Filipowicz, J. (2016). *Governing Greater Victoria*. Vancouver: The Fraser Institute.

Bish, R. L., & Ostrom, V. (1973). *Understanding Urban Government: Metropolitan Reform Reconsidered*. Washington, DC: American Enterprise Institute.

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

Buchanan, J. M., Tollison, R. D., & Tullock, G. (1980). *Toward a Theory of the Rent-Seeking Society.* College Station: Texas A&M University Press.

Buchanan, J. M., & Tullock, G. (1962). *The Calculus of Consent: The Logical Foundations of Constitutional Democracy*. Ann Arbor: University of Michigan Press.

Cassidy, F., & Bish, R. L. (1989). *Indian Government: Its Meaning in Practice*. Lantzville, BC: Oolichan Books and Halifax; The Institute for Research on Public Policy.

Feld, L. P. (2014). James Buchanan's Theory of Federalism: From Fiscal Equity to the Ideal Political Order. *Constitutional Political Economy, 25,* 231–252.

Hamilton, A., Jay, J., & Madison, J. (n.d.). *The Federalist: A Commentary on the Constitution of the United States*. Indianapolis: Modern Library.

Kuhn, T. S. (1964). *The Structure of Scientific Revolution*. Chicago: University of Chicago Press.

Lindsay, B., & Teles, S. (2017). *The Captured Economy: How the Powerful Enrich Themselves, Slow Down Growth, and Increase Inequality*. New York: Oxford University Press.

Martin, D., & Wagner, R. (1978). The Institutional Framework for Municipal Incorporation. *Journal of Law and Economics, 21,* 409–425.

McGinnis, M. D. (Ed.). (1999). *Polycentricity and Local Public Economies: Readings from the Workshop in Political Theory and Policy Analysis*. Ann Arbor: University of Michigan Press.

Oakerson, R. (1999). *Governing Local Public Economies*. Oakland: Institute for Contemporary Studies.

Oates, W. E. (1972). *Fiscal Federalism*. New York: Harcourt Brace Jovanovich.

Olson, M., Jr. (1965). *The Logic of Collective Action: Public Goods and the Theory of Groups.* Cambridge, MA: Harvard University Press.

Olson, M., Jr. (1969). The Principle of Fiscal Equivalence: The Division of Responsibilities Among Different Levels of Government. *American Economic Review, 59*, 479–487.

Ostrom, E. (1965). *Public Entreneurship: A Case Study in Ground Water Basin Management* (PhD dissertation). UCLA Department of Political Science.

Ostrom, E. (1990). *Governing the Commons: The Evolution of Institutions for Collective Action*. Cambridge: Cambridge University Press.

Ostrom, E. (2016). Beyond Markets and States: Polycentric Governance of Complex Economic Systems. In P. J. Bottke, S. Haeffele-Balch, & V. Henry Storr (Eds.), Reprinted in *Mainline Economics: Six Nobel Lectures in the Tradition of Adam Smith*. Arlington, VA: Mercatus Center, George Mason University.

Ostrom, V. (1971). *The Political Theory of a Compound Republic: A Reconstruction of the Logical Foundations of American Democracy as Presented in "The Federalist"*. Blacksburg, VA: Public Choice VPI&SU (2nd ed., 1987. Lincoln: University of Nebraska Press; 3rd ed., 2008. Lanham, MD: Lexington Books).

Ostrom, V. (1973). *The Intellectual Crisis in American Public Administration.* Tuscaloosa: University of Alabama Press.

Ostrom, V., Bish, R., & Ostrom, E. (1988). *Local Government in the United States*. Oakland, CA: The Institute of Contemporary Studies.

Ostrom, V., Tiebout, C., & Warren, R. (1961). The Organization of Government in Metropolitan Areas: A Theoretical Inquiry. *American Political Science Review, 55,* 831–842.

Smith, A. (1937). *The Wealth of Nations* [1776]. New York: Modern Library.

Sproule-Jones, M. (2002). *Restoration of the Great Lakes: Promises, Practices, Performances*. Vancouver: University of British Columbia Press.

Tocqueville, A. d. (1945). *Democracy in America* (P. Bradley, ed., 2 vols.). New York: Vintage Books.

Tullock, G. (1965). *The Politics of Bureaucracy.* Washington, DC: Public Affairs Press.

Tullock, G. (1967, June). The Welfare Costs of Tariffs, Monopoly and Theft. *Western Economic Journal, 5*, 224–232.

Tullock, G. (1969, March). Federalism: Problems of Scale. *Public Choice, 6*(1), 19–29.

Tullock, G. (1987). The *Calculus* Postscript After 25 Years. *The Cato Journal, 7*, 313–321.

Tullock, G. (1994). *The New Federalist.* Vancouver, BC: The Fraser Institute.

Warren, R. (1964). A Municipal Services Market Model of Metropolitan Organization. *Journal of the American Institute of Planners, 30,* 193–204.

50

Why James Buchanan Kept Frank Knight's Picture on His Wall Despite Fundamental Disagreements on Economics, Ethics, and Politics

Ross B. Emmett

> *Living is an art; and art is more than a matter of scientific technique, and the richness and value of life is largely bound up in the "more."*
>
> (Knight 2013)

Two photographs, both traditional black-and-white, 8-by-10-inch headshots, hung on the office wall of Nobel laureate James M. Buchanan. One was of Knut Wicksell, the other of Frank H. Knight. Anyone familiar with Buchanan's work will know his frequent references to the importance of both economists to his own perspective (for example, see Buchanan 1986, pp. 15–16). Thus, you may imagine my surprise when I recently re-read Buchanan's Nobel lecture and found not a single reference to Knight or his work. Wicksell, on the other hand, is all over the text of the lecture, in spirit and in word. Indeed, each section begins with a quotation from the Swedish master. But not a single mention

R. B. Emmett (✉)
Center for the Study of Economic Liberty,
Arizona State University, Tempe, AZ, USA
e-mail: Ross.Emmett@asu.edu

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3_50

of Knight or his work. Lest you wonder, even Knight's expression "relatively absolute absolutes" does not appear, despite being a Buchanan favorite, and the title of the essay which was placed immediately before his Nobel lecture in his collected works (Buchanan 1989).

Perhaps I should not have been surprised. After all, the Nobel citation was for Buchanan's "development of the contractual and constitutional bases for the theory of economic and political decision-making" (Nobelprize.org 1986), a program to which Knight contributed only tangentially. Buchanan himself once remarked that "Wicksell's was perhaps the most significant influence," although he did acknowledge that Knight's teaching about market coordination prepared him well, because without it "Wicksell's message might not have been so compelling to me" (Buchanan 1992, p. 24). But we can go further. The methodological, economic, ethical, and political assumptions behind Buchanan's constitutional economics research program generally ran counter to Knight's own views on these topics. Methodologically, Knight rejected the "methodological individualism" (Buchanan 1987a, p. 244) central to Buchanan's program. In terms of economic approaches, Buchanan repeatedly criticized Knight for remaining within the standard constrained maximization, neoclassical framework, rather than adopting the catallactic perspective Buchanan favored. Ethically, Knight rejected the *de gustibus non est disputandum* assumption that went hand-in-hand among economists with methodological individualism, and argued that we needed social consensus about our common values. And philosophically, Knight's theory of democratic politics was centered on "democracy as discussion" rather than choice, contract, and constitution (see Emmett 2007).

Thus, despite their friendship and the legacy of Knight's teaching, there is almost no social scientific reason why Buchanan would identify Knight as important to his work. Why then, you might reasonably ask, would Buchanan have Knight's picture on his wall, and so frequently refer kindly to his former professor? Was Buchanan mistaken, or had he been so besotted with his professor earlier in his career that he simply continued to mention him without real cause?

The latter cannot be the case, because three times in his career Buchanan considered Knight's work explicitly, and each time came away critical of it.[1] In both "What Should Economists Do?" (Buchanan 1964) and in an essay about Knight's "The Ethics of Competition" Buchanan (1987b), criticized Knight's continued appreciation for the constrained maximization approach to the economic analysis of markets, arguing that Knight's economic work would be better if he were to take up Buchanan's catallactic approach instead. And in an essay comparing Knight's theory of "democracy as discussion" with Michael Polanyi's theory of democracy as a "republic of science," Buchanan (1967) ended up aligning himself with Knight, but criticizing both authors on the grounds of a contractarian theory of politics. Why then, if Buchanan's references to Knight were not simply expressions of fondness for a former professor, and if Knight's influence on his program was not similar to that of Wicksell, did he return again and again to Knight's work and mention his influence?

What Should Economists Do, and What Role Might Ethics Play?

The first essay in which Buchanan explicitly criticizes his former teacher was his Presidential Address to the Southern Economic Association, entitled "What Should Economists Do?" (Buchanan 1964). The purpose of the essay is to argue that the focus on "the economic problem" of satisfying human wants within the constraints of existing resources led economists to limit their study of market activity to problems solvable via constrained maximization. Buchanan believed that economists could carry their analysis to a larger field of study. He reminded his audience of what Frank Knight had told them at the beginning of his little textbook *The Economic Organization* (2013): that the purpose of economic analysis was to contribute to the solution of the problem of social organization. The economic problem was an important part

[1]There is a fourth essay in which Buchanan evaluates Knight's work (Buchanan 1976), but the essay does not tell us much about Buchanan's own evaluation of Knight. Instead, the essay asks how the differences between Knight's views and those of his friend Clarence Ayres on methodology and ethics in economics would translate into criticisms of 1970s-style economics.

of that larger problem, but not its totality. But then Buchanan chided Knight himself for settling on an economics defined by the limitations that constrained maximization imposed. A catallactic approach to the study of market exchange would be more fruitful, Buchanan argued, because it focused economists' attention on the institutional context within which exchange occurred. A catallactic approach, first suggested by Richard Whately (1832) back in the 1830s and revived in the Austrian tradition, provided economics with a means to broaden the scope of their attention to the larger question of social organization while bringing their tools of analysis with them.

Buchanan (1987b) expanded this criticism of Knight in a later essay focused on Knight's famous essay "The Ethics of Competition." Twenty years had passed since "What Should Economists Do?," and Buchanan's own analysis had expanded into constitutional political economy, which saw the problem of social organization as a two-tier problem. At one level, members of society chose the rules that would govern market exchange; while at another level, they participated in the market exchange within the context of those rules. Buchanan called the first level constitutional, and the second post-constitutional. It had been tempting in the 1960s and 1970s to use the American constitutional moment two hundred years earlier as the reference point. The constitutional moment defined the rules by which post-constitutional life was lived. But by the late 1980s, Buchanan saw both as more open-ended: constitutions can be revisited and revised; post-constitutional life is continually reshaping informal rules and norms, and providing new problems that may require constitutional decisions.

In this context, Buchanan revisited an essay of Knight's that, if not part of the assigned reading for Chicago economics students, was certainly read by many during the 1940s when Buchanan was a student there. Don Patinkin provides the best description of the impact of Knight's "The Ethics of Competition" on Chicago economics graduate students like himself during the 1940s:

> But for the modern economist Knight was … a far more effective radical than Marx: for in contrast to Marx, Knight understood the workings of the market system, but he went on by a deeper analysis of these workings

> to deny the ethical foundations of this system. Indeed, there is little in the writings of the modern day "radical economists" … that was not more trenchantly said by Knight in his famous essay … on "The Ethics of Competition" (1923, especially pp. 45–58). To my mind, these thirteen pages are among the most radical ever written in economics …. (Patinkin 1973, p. 798)[2]

Buchanan himself must have thought something similar, because when he returns to Knight's essay in the 1980s, he is struck again at how harsh its criticism of the market system was. To make peace with Knight's argument, Buchanan ties together the ethical assessment it presents of the competitive order with Knight's overly narrow conception of economic analysis. Buchanan's argument, then, is that Knight's entanglement of economizing behavior with social ethics led him to be unnecessarily harsh in his estimation of the ethical status of economic action.

> It is easy to understand Knight's expressed concern about the limits of economic explanation once his methodological ambiguity is clarified. If, indeed, a "social" value scale is established in the economy, and if rationality dictates using scarce resources to maximize value, Knight's worry about there being no room left for an independent ethics seems fully justified. If, however, a catallactic perspective is taken and inquiry is focused on the exchange process per se and on behavior in that process, there is a natural barrier to the extension of the rationality norm. With a prospective exchange a trader may, of course, treat others as instruments or means toward furtherance of his own purposes. He does so, however, in the knowledge that others are behaving reciprocally toward him. Rationality norms apply only to the attempts to satisfy each individual trader's own purposes, constrained by the behavior of other traders. Such norms cannot be extended upward, so to speak, to evaluate the outcomes or results of trade, as such.

[2]While Patinkin cites the original publication date of Knight's essay (Knight 1923), the page references are to the republication of the essay in the volume of essays collected by Knight's students upon his fiftieth birthday, and bearing the title of this essay (Knight 1935).

> As previously stated, there is no social value scale, as such, established in market exchange (Buchanan 1987b, p. 66).

Were Knight to have adopted a catallactic approach to the study of market exchange, his ethical criticisms would be almost entirely avoided, according to Buchanan. Thus, "… Knight never wholly escaped from the straitjacket that his conception of economics imposed upon his thought" (Buchanan 1987b, p. 74).

In his Nobel lecture, Buchanan argued that the core methodological assumption of his research program was methodological individualism. "The economist simply commences with individuals as evaluating, choosing, and acting units. Regardless of the possible complexities of the processes or institutional structures from which outcomes emerge, the economist focuses on individual choices" (Buchanan 1987a, p. 244). In methodological terms, all economic explanations ultimately come back to the choices individuals make, and behind them, to the tastes and values they possess and the constraints or costs that they face (see Robbins 1932). But economists seldom accept an explanation that reverts to "well, that individual just changed their tastes." Methodological individualism gets the economist most of the way to a solid methodological foundation, but it is useful to add an assumption that Buchanan's fellow Chicago graduates Gary Becker and George Stigler (1977) called the "*de gustibus non est disputandum*" assumption. All the "*de gustibus*" assumption adds is the subsidiary requirement that the economist assume tastes are constant across choices. With that assumption in place, methodological individualism reduces to the requirement that economic explanations will be rooted in the constraints and/or costs that individuals face. Buchanan's public choice and constitutional political economy explanations utilized the *de gustibus* version of methodological individualism, assuming satisfactory explanations require only the response of individuals to the costs/constraints imposed by political structures and processes or the choice of constitutional rules.

Knight had long opposed both methodological individualism and the *de gustibus* assumption. In response to their original statement by Lionel Robbins in the early 1930s, Knight had responded privately to Robbins with the following reflection:

> The more I think about it the more I am inclined to say that the fundamental principle stressed so much in your book, of an absolute contrast between judgments of facts and judgments of value, is actually the basic error…. Stating it another way, I am inclined squarely to review the maxim, *De gustibus non [est] disputandum*, in this regard, and hold that only judgments of value can be discussed, facts as such not at all. That is, when we disagree about a fact it seems to me we disagree about the *validity* of observation or evidence, and that every disagreement is essentially a difference in evaluation. (Knight to Lionel Robbins, quoted in Emmett 2009a)

Needless to say, Knight's response was not widely accepted: forty years later two of his students enshrined the *de gustibus* rule in economic methodology (Stigler and Becker 1977).

Buchanan's research, however, continued to move him toward more open-ended versions of constitutional political economy, and hence, toward issues that intersected with Knight's. As he began to write about ethics and economics, his initial steps did not violate methodological individualism, but they did allow for changes in the evaluation of values and norms. "[F]ormal constraints on behavior … can never alone be sufficient to insure viability in social order. An underlying set of ethical norms or standards seems essential …" (Buchanan and Musgrave 1999, p. 25). In much of his work, he conceptualized norms and values as constraints upon individual choice, constraints chosen, as it were, by the chooser (Buchanan 1994). After his Nobel award, when his work with Yong J. Yoon (Buchanan and Yoon 2015) began to explore the implications of increasing returns for his evaluation of market vs. collective efficiency, he began to consider the implications of social (or what Knight would call "super-individual") ethics, such as the role of a societal "work ethic" and "the normative vision of classical liberalism" (Buchanan and Musgrave 1999, p. 25; Buchanan 2005). Thus, while he never adopted Knight's view, Buchanan did shift his consideration of ethical values and norms, especially after his Nobel Prize. We can't be certain what role Knight's ideas played in this, but we can certainly say that Knight is more present in the later work than Wicksell. Consideration of economics and ethics also brings us to the question of social ethics and democracy. For that, we stop first at Buchanan's third review of Knight's work.

Scientific Knowledge and Politics

The third essay of Buchanan's to consider is his evaluation of Knight and Michael Polanyi on the relation of scientific knowledge to democratic political choices. Buchanan admired Polanyi's defense of a free society, but the more he thought about, he tells us, the more he found himself agreeing with Knight's (1949) criticism of Polanyi's argument (with some caveats). At the core of Polanyi's argument were three statements that he took to be true: (a) scientific truth is the gold standard for human knowledge; (b) science operates with a model of the pursuit of truth that is inherently unplanned, open and democratic, with competing claims adjudicated by repeated testing and use in the scientific community; and, therefore; (c) the "republic of science" (Polanyi 1962) should be a model for democratic society. Shortly after meeting Polanyi at the first Mont Pelerin Society meeting and amidst discussions about the possibility of Polanyi moving to The University of Chicago,[3] Knight (1949) reviewed a couple of his works, both on academic freedom (Polanyi 1946, 1947). Whether Buchanan knew of Polanyi amidst these Chicago discussions or not (he was a student there at the time), his reflection on Knight's commentary on Polanyi twenty years later (Buchanan 1967) move us away from the economic issues that divided him from Knight to consideration of the nature of democratic decisions.

Not surprisingly, Knight and Polanyi shared concerns about the defense of a free society in the aftermath of the world war, and Knight

[3]Originally from Vienna, Polanyi had ended up in the United Kingdom during the interwar years. In the aftermath of World War II, Polanyi's participation in the Mont Pelerin Society led several of its members to seek ways to bring him to the United States. The University of Chicago's Committee on Social Thought was a logical place for him (as it was for F. A. Hayek, also from Vienna via the U.K.), but he was only allowed to visit occasionally because of his previous political activities in Europe. Knight was a founding member of the Committee on Social Thought, but was not involved in it during the latter part of the 1940s.

recognized that Polanyi was also seeking to conceptualize a new defense of liberal democracy. But Knight was very concerned about Polanyi's defense, because he thought it violated one of his own concerns at the time, the quest for scientific control of social problems, something he labelled scientism (to mirror the moralism he saw in the quest for moral control of society).[4] Amongst social scientists, Knight believed that their epistemic claims regarding the scientific status of social, political and economic knowledge were made, in part, to bypass democratic decision-making. Democracy was not government by a socially benevolent ruler who based policy on scientific knowledge, but rather, "government by discussion." As such, no knowledge (even that of science) or morals (even those of religion or ancient codes) held a place of privilege a priori in democratic decision-making. In Polanyi's work, Knight found a subtle twist to the scientistic/moralistic argument. Rather than seeking to argue that scientific epistemology granted special status to scientific knowledge in democratic decision-making, Polanyi argued that, because science embodied a true form of democracy (a "republic of science"), it helped us to see that democracy itself was the search for truth in politics. Science and politics are parallel processes.

But Knight argued that Polanyi's "republic of science" argument made democracy itself un-social.

> Polanyi offers little concrete treatment of the society side of the relation; he writes mostly about science and faith or science and such things as intuition of reality, conscience, freedom, free discussion, tradition, and authority. It seems that no definition of society or of a social problem, or discussion of procedure in this field, is called for beyond what is said about science and elaboration of the assertion of parallelism. (Knight 1949, p. 276)

For Knight, the social nature of democracy meant that we pursue discussion in order to reach consensus about how we can maintain

[4]The labels moralism and scientism emerged from Knight's mid-1940s attempts to characterize the difference between the social philosophies of John Dewey (scientism) and Robert Hutchins (moralism) (see Knight 1982).

individual freedom while doing those things in common that we agree (again, by consensus) need to be done. In such a social discussion, in "real time" we say today, it is necessary that some ideas and values have to be taken as "true" for the moment, with the promise as a society that we can revisit them in future discussions. But they are not "true" in the scientific epistemological sense. As Buchanan puts it in his summary of Knight's view,

> Knight refrains from either asking or answering the question concerning the existence of some ultimate and unchanging reality. "Truth" is measured only be agreement or consensus among informed persons, despite the acknowledged questions that this definition begs. Whether or not there is reality behind the models becomes essentially an irrelevant question. In this Knightian context, the pictures, the models of science, are "true," at any given epoch, within the relatively absolute limits defined by general agreement among the informed. (Buchanan 1967, p. 304)[5]

In the end, Buchanan clearly sides with Knight on the impossibility of drawing parallels between scientific truth-seeking and democratic decision-making. Politics is compromise, not the search for truth, and hence tolerance is necessary. Even at the constitutional level, which Buchanan acknowledges is the only one in which we might say that we are searching for the "best" rules for human interaction, the notion of a scientific pursuit of truth is inappropriate (Buchanan 1967, p. 309) because the discussion is already happening within a background set of cultural rules and norms that are not expunged from consideration.

Buchanan (1968, p. 90) once said that, "Knight is the economist as philosopher, not the economist as scientist." After mentioning David Hume as a possible comparison, Buchanan went on to identify what he meant:

[5]Buchanan (1967, p. 309) recognizes that Polanyi's framing of democracy as truth-seeking is not distorted if we say that "he conceives discovery in the political-social realm as the revelation of God's design." Buchanan is certainly right to add that, "In relatively sharp contrast, Knight remains highly dubious about God, and he is unwilling to go beyond man's own competence to judge on the basis of his own criteria."

> Knight has no "disciples" as such, and those who have been most influenced by his work are as likely to criticize him as others are. This is because as a teacher he has been almost uniquely willing to look for merit in all questions and because he has refused to accept any final answers. His attitude always been that all principles have their limits, that most of them are both right and wrong, that they more or less, and that judgment can never be dispensed with. (Buchanan 1968, p. 93)

By constantly pushing to think outside the analytical confines of standard economics, to question all ethical and political principles, and improve the quality of democratic discussion, Knight sought an intelligent basis for democratic action. Years ago, I identified his philosophical orientation as "therapeutic" rather than system-building. Richard Rorty used "therapeutic" to distinguish the work of John Dewey and Frederich Nietzsche from system-building philosophers of the nineteenth century.

> The therapeutic philosophers were not primarily interested in the construction of progressive philosophical research programs, but rather in the edification of the intellectual community. Their purpose was to upset the course of normal philosophical discourse and remind [us] … of the need for humility in the face of the dynamic complexity and novelty of human experience. (Emmett 2009b, p. 33)

Knight had a therapeutic effect on Buchanan, and the latter returned to Knight's work whenever the constraints of his research program led him to seek to restate his approach. Naturally, Buchanan did not adopt Knight's own search as his own. Rather, Knight nudged him toward more open-ended forms of analysis. Their conflicting views on standard economic analysis reflect their different theoretical approaches. Buchanan moved to a catallactic approach; Knight stayed within the constrained maximization framework. For Knight's purposes, the latter was sufficient for a democratic people to understand the contribution markets make to human betterment. Buchanan kept methodological individualism and its concomitant ethical assumption of *de gustibus non est disputandum*; Knight, always thinking ahead to higher levels of conversation, refused to accept that we couldn't talk about our values, and therefore also refused to consider democracy as exchange. It was, for him, like Viscount James Bryce (1889), a discussion. "The problem of democracy," he told us, "is to establish a consensus, by genuine discussion, with intellectual appeal to super-individual norms." Ruefully, he added that this meant that "democratic action is hard" (Knight 1951, pp. 15 and 28; see also Knight 1982).

One reason democracy is hard is because all ideas and assumptions were up for grabs at some point. In the moment, we have to decide, which will require us to accept some values, and some scientific knowledge, as "truth." But only for the moment. When we return to the discussion, we will have more knowledge and have thought about the relevance of other values. Those "truths" therefore, are "relatively absolute absolutes" (Buchanan 1989). For Buchanan, the discussion needed to be separated into two parts: the constitutional decision to take certain rules and norms as "absolutes" for the purpose of understanding the legislation that emerged from political exchange.

Should Buchanan Have Removed Knight's Picture from the Wall?

The root of the answer to that question provided in this paper comes from Richard Wagner's (2017) recent study of Buchanan's work. There, Wagner suggests that Buchanan shared with Knight a political economy that, while adopting the strictures of contemporary economics, always wished to hold open the path to considering political economy as an open-ended, emergent, and dynamic system. Knight maintained the idealization of constrained maximization in perfect competition; Buchanan maintained methodological individualism and the *de gustibus* assumptions despite moving toward a catallactic view of market exchange. When Wagner pushed Buchanan to move forward toward open-ended analysis more quickly, Buchanan responded by suggesting that it was always wise to use methodological frameworks familiar to contemporary economists if one sought to speak to the discipline. Thus, despite Buchanan's own appreciation for the market as a catallactic system, he had cast the analysis of *Calculus of Consent* (Buchanan and Tullock 1962) in the standard constrained maximization approach of the economics profession. As the economics discipline moved toward game-theoretic analysis, Buchanan's constitutional analysis adopted that analysis as a means of expressing both the nature of constitutional decisions and their similarities and differences with post-constitutional choices. And when the discipline opened its analysis to greater reliance on increasing returns, he began to explore the implications of increasing returns for our evaluation of market vs. collective efficiency (Buchanan and Yoon 2015).

Buchanan's openness to societal changes in norms and values brings us to the second point he emphasized in conversation with Wagner. For most of his career, Buchanan conceptualized ethical norms and values as constraints upon individual choice that were chosen by the chooser. For example, in his Nobel address, he closed with a question: "How can we live together in peace, prosperity, and harmony, while retaining our liberties as autonomous individuals who can, and must, create our own values?" (Buchanan 1987b, p. 50). *Autonomous individuals* must choose the values that form their market choices: the parallel with constitutional and post-constitutional analysis is obvious. But after being granted the Nobel prize, as he began to consider the consequences of an increasing returns world, ethical issues such as the role of a societal "work ethic" and "the normative vision of classical liberalism" began to occupy his attention (Buchanan and Musgrave 1999, p. 25; Buchanan 2005). The context of increasing returns prompted him, perhaps, to consider such issues as more than just a matter of individual choice. Frank Knight (1960) argued consistently throughout his later work that the family was the fundamental unit of social analysis, not the autonomous individual. Again, Knight presaged ideas that Buchanan begins to consider after the Nobel Prize.

Wagner's point was that any evaluation of Buchanan's work should consider its evolution in terms of the tension between the contemporary discipline's closed-system discourse and the open-ended nature of markets and politics. The argument here is that, for Buchanan, Knight was someone whose work he returned to again and again because it led Buchanan to consider that tension in productive ways. Knight had not contributed directly to Buchanan's research program in public choice or even constitutional political economy, but he did continually challenge Buchanan to consider economics, politics, and ethics as open-ended systems which are inter-related.

In short, Knight's place on Buchanan's wall was always secure.

References

Bryce, J. (1889). *The American Commonwealth*. London: Macmillan.

Buchanan, J. M. (1964). What Should Economists Do? *Southern Economic Journal, 30*(3), 213–222.

Buchanan, J. M. (1967). Politics and Science: Reflections on Knight's Critique of Polanyi. *Ethics, 77*(4), 303–310.

Buchanan, J. M. (1968). Knight, Frank H. In *Ideas, Persons, and Events* (pp. 86–94). Collected Works of James M. Buchanan 19. Indianapolis, IN: Liberty Fund.

Buchanan, J. M. (1976). Methods and Morals in Economics: The Knight—Ayres Discussion. In W. Breit & W. P. Culbertson Jr. (Eds.), *Science and Ceremony: The Institutional Economics of C. E. Ayres* (pp. 163–174). Austin: University of Texas Press.

Buchanan, J. M. (1986). Better Than Plowing. In *The Logical Foundations of Constitutional Liberty* (pp. 11–27). Collected Works of James M. Buchanan 1. Indianapolis, IN: Liberty Fund.

Buchanan, J. M. (1987a). The Constitution of Economic Policy. *American Economic Review, 77*(3), 243–250.

Buchanan, J. M. (1987b). The Economizing Element in Knight's Ethical Critique of Capitalist Order. *Ethics, 98*(1), 61–75.

Buchanan, J. M. (1989). The Relatively Absolute Absolutes. In *Essays on the Political Economy* (pp. 32–46). Honolulu: University of Hawaii Press.

Buchanan, J. M. (1992). From the Inside Looking Out. In M. Szenberg (Eds.), *Eminent Economists: Their Life Philosophies* (pp. 98–106). Cambridge: Cambridge University Press.

Buchanan, J. M. (1994). Choosing What to Choose. *Journal of Institutional and Theoretical Economics, 150*(1), 123–135.

Buchanan, J. M. (2005). *Why I, Too, Am Not a Conservative: The Normative Vision of Classical Liberalism*. Cheltenham, UK: Edward Elgar.

Buchanan, J. M., & Tullock, G. (1962). *The Calculus of Consent: Logical Foundations of Constitutional Democracy*. Ann Arbor: University of Michigan Press.

Buchanan, J. M., & Musgrave, R. A. (1999). *Public Finance and Public Choice: Two Contrasting Visions of the State*. Cambridge, MA: MIT Press.

Buchanan, J. M., & Yoon, Y. J. (2015). *Individualism and Political Disorder*. Cheltenham, UK: Edward Elgar.

Emmett, R. B. (2007). Knight's Challenge (to Hayek): Spontaneous Order Is Not Enough for Governing a Liberal Society. In L. Hunt & P. McNamara (Eds.), *Liberalism, Conservatism, and Hayek's Idea of Spontaneous Order* (pp. 67–86). New York: Palgrave Macmillan.

Emmett, R. B. (2009a). De Gustibus Est Disputandum: Frank Knight's Reply to George Stigler and Gary Becker's 'De Gustibus Non Est Disputandum,' with an Introductory Essay. In *Frank Knight and the Chicago School in American Economics* (pp. 135–144). London: Routledge.

Emmett, R. B. (2009b). The Therapeutic Quality of Frank H. Knight's Risk Uncertainty, and Profit. In *Frank Knight and the Chicago School in American Economics* (pp. 31–47). London: Routledge.

Knight, F. H. (1923). The Ethics of Competition. *Quarterly Journal of Economics, 37*(4), 579–624.

Knight, F. H. (1935). The Ethics of Competition. In *The Ethics of Competition and Other Essays* (pp. 41–75). New York: Harper & Bros.

Knight, F. H. (1949). Virtue and Knowledge: The View of Professor Polanyi. *Ethics, 59*(4), 271–284.

Knight, F. H. (1951). The Role of Principles in Economics and Politics. *American Economic Review, 41*(1), 1–29.

Knight, F. H. (1960). *Intelligence and Democratic Action*. Cambridge, MA: Harvard University Press.

Knight, F. H. (1982). The Sickness of Liberal Society. In *Freedom and Reform: Essays in Economics and Social Philosophy* (pp. 440–478). Indianapolis, IN: Liberty Press.

Knight, F. H. (2013). *The Economic Organization*. New Brunswick, NJ: Transaction Publishers.

Nobelprize.org. (1986). *The Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel 1986*. Nobel Foundation. www.nobelprize.org/nobel_prizes/economic-sciences/laureates/1986/.

Patinkin, D. (1973). Frank Knight as Teacher. *American Economic Review, 63*(5), 787–810.

Polanyi, M. (1946). *Science, Faith, and Society*. London: Oxford University Press.

Polanyi, M. (1947). *The Foundations of Academic Freedom*. Oxford: Society for Freedom in Science.

Polanyi, M. (1962). *The Republic of Science*. Chicago: Roosevelt University.

Robbins, L. (1932). *An Essay on the Nature and Significance of Economic Science*. London: Macmillan.

Stigler, G. J., & Becker, G. S. (1977). De Gustibus Non Est Disputandum. *American Economic Review, 67*(2), 76–90.
Wagner, R. E. (2017). *James M. Buchanan and Liberal Political Economy: A Rational Reconstruction*. Lanham: Lexington Books.
Whately, R. (1832). *Introductory Lectures on Political Economy* (2nd and enlarged ed.). London: B. Fellowes.

Index

R. E. Wagner (ed.), *James M. Buchanan*, Remaking Economics: Eminent Post-War Economists, https://doi.org/10.1007/978-3-030-03080-3