The Essential

JAMES BUCHANAN

by Donald J. Boudreaux and Randall G. Holcombe

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Contents

We dedicate this little volume to the memory of
Jim Buchanan, Gordon Tullock, and their
administrative assistant extraordinaire, Betty Tillman.

Introduction: Who Was James M. Buchanan?

When he was born in rural Tennessee on October 3rd, 1919, James ("Jim") McGill Buchanan surely seemed an unlikely prospect for winning a Nobel Prize in Economics. Although not hardscrabble poor, the Buchanans were, as Jim described his family, "middle-class poor."

Because Buchanan's grandfather, John P. Buchanan, served—from 1891 to 1893—a term as Tennessee's governor, the Buchanans enjoyed some prominence, if not much privilege, in Rutherford County. Gov. Buchanan was elected on the ticket of the Farmers' Alliance, a party spawned by the populism then rampant in America's rural south. Although much tempered and refined by his own deep learning in economics, Jim Buchanan retained until his death his family's deep suspicion of elites, including those in what he called "the eastern-establishment universities."

Buchanan's distaste for elites was intensified by his military experience during World War II. Although he greatly admired US Navy Admiral Chester Nimitz on whose staff he served, the "overt discrimination" (his words) that Buchanan experienced in officer-training school in New York "radicalized" him. But it did so in ways that eventually led him to be deeply suspicious of all government power.

Buchanan's skeptical attitude toward political power was given solid grounding during his first few weeks of enrollment in the University of Chicago's economics PhD program. It was 1945 and Buchanan began his student days in Chicago as what he called "a libertarian socialist":

> But within six weeks after enrollment in Frank Knight's course in price theory, I had been converted into a zealous advocate of the market order. (Buchanan, 1999: 15)

And so Buchanan was to remain for the rest of his long life.

Also to remain for the rest of Buchanan's life was his deep admiration for Knight. Although Knight did not supervise Buchanan's dissertation research—that task fell to Roy Blough—Buchanan identified Knight as his greatest teacher. The only scholar to come close in Buchanan's estimation to Knight was the Swedish economist Knut Wicksell, whose work in government ("public") finance prompted Buchanan early on to think creatively about the nature, possibilities, and limits of collective decision-making.

After spending his early academic years as a faculty member at the University of Tennessee and immediately afterward at Florida State University, Buchanan moved in 1956 to the University of Virginia. It is impossible to imagine a more appropriate location. Admiring deeply UVA's founder, Thomas Jefferson, and even more deeply Jefferson's close friend and fellow Virginian James Madison, Buchanan assembled around him at Mr. Jefferson's "academical village" in Charlottesville what is surely one of history's most impressive departments of economics. It included during at least some part of his tenure there, in addition to Buchanan himself, the future Nobel laureate Ronald Coase, William Breit, Kenneth Elzinga, Warren Nutter, Gordon Tullock, Rutledge Vining, and Leland Yeager.

Academic politics at the university level eventually led Buchanan to move, with Tullock, to Virginia Polytechnic Institute ("VPI," or Virginia Tech) in Blacksburg, Virginia. This move occurred in 1969, after Buchanan spent an unhappy year on the economics faculty of UCLA. While at VPI, Buchanan, Tullock, and Charles Goetz, a former student from their UVA days, founded the Center for Study of Public Choice. One of us (Holcombe) earned his PhD in economics from VPI, with Buchanan serving as his dissertation supervisor.

Eventually university politics again disrupted Buchanan's research program, so in 1983 he moved, along with the Center for Study of Public Choice, from Virginia Tech to George Mason University in Fairfax, Virginia, near Washington, DC. George Mason is where the Center remains to this day, and it was to become Buchanan's longest and last academic home. He was on the GMU faculty when he was awarded the Nobel Prize in economics in 1986.

Buchanan formally retired from GMU's faculty in 1999, but he continued to conduct seminars for graduate students for several years afterward. And he continued to be a regular presence on campus until the very end. He was last on George Mason's campus in November of 2012 to help with an effort to raise money for the Center. He died in Blacksburg, after a brief illness, on January 9th, 2013, at the age of 93.

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As in the other "Essential Scholars" volumes, our goal in *The Essential James Buchanan* is to introduce the reader, with as much clarity as possible, to the essential ideas of Buchanan. Although both of us largely agree with Buchanan, positively and normatively, we do not agree with him on all points. Yet this volume is not an extension or critical assessment of his scholarship. As much as is humanly possible, we here present Buchanan's ideas as we believe *he* understood those ideas and not as we might understand them differently than he did.

Our sincere hope is that, were Buchanan somehow to read our little book, he would recognize the ideas described as the ones that he offered to the world.

Chapter 1

The "Organismic" versus the Individualistic Conception of Collective Choice

Vague and general terms, such as "social utility" and "social welfare," are of little use in the discussion of policy problems. The theoretical steps in the maximizing of social utility offer little or no direct guidance to governmental fiscal authorities.

— James M. Buchanan, "The Pure Theory of Government Finance" (1949)

In his intellectual biography *James M. Buchanan and Liberal Political Economy,* Richard Wagner, Buchanan's student, long-time colleague, and co-author, explains how all of James Buchanan's work is an offshoot of one of Buchanan's first professional publications: an article titled "The Pure Theory of Government Finance: A Suggested Approach." Published in 1949 in the prestigious *Journal of Political Economy*, this article's core ideas have grown from a sapling over the course of six decades into a massive and sturdy oak with countless limbs. And "countless" is only a slight exaggeration. Over the next 63 years—until just before he died in January 2013—Buchanan was an incredibly prolific scholar.

His *Collected Works,* which include nothing that he wrote after 2000, fill 19 thick volumes (not counting the volume that is the index). Nor do these works include a 1970 book (co-authored with Nicos Devletoglou) on the state of academia, or a basic economics textbook that Buchanan co-authored in 1954 with Clark Allen and Marshall Colberg, or Buchanan's own 1960 textbook on public finance. Also excluded are the many volumes that Buchanan edited, and all but a tiny fraction of Buchanan's vast correspondence. Yet, remarkably, the great majority of the many comments, speeches, articles, and books that Buchanan wrote over the course of his long scholarly career is an outgrowth of the fundamental insights that he offered in 1949.

Most foundational among these 1949 insights is this: because neither the state nor society is a singular and sentient creature, a great deal of analytical and policy confusion is spawned by treating them as such. Collections of individuals cannot be fused or aggregated together into a super-individual about whom economists and political philosophers can usefully theorize in the same ways that they theorize about actual flesh-and-blood individuals. Two or more people might share a common interest and they might—indeed, often do—join forces to pursue that common interest. But two or more people are never akin to a single sentient individual. A collection of individuals, as such, has no preferences of the sort that are had by an actual individual. A collection of individuals, as such, experiences no gains or pains; it reaps no benefits and incurs no costs. A collection of individuals, as such, makes no choices.

Instead, Buchanan contended, only individuals possess preferences. Only individuals experience gains and losses. Only individuals act and, hence, only individuals make choices.

Professional economists might shrug and say that Buchanan was merely avowing the importance of the scientific stance of "methodological individualism"—that is, the insistence that a proper understanding of all social phenomena requires that these phenomena be traced back to, or "reduced to," the choices of individuals whose actions give rise to the phenomena. Perhaps everyone—economists and non-economists—will regard Buchanan's insistence on this reality as nitpicky and arcane.

But the fact that Buchanan's article was published in a leading academic journal suggests that, at least in 1949, he was offering more than a fussy restatement of widely accepted truths. And indeed he was.

For starters, Buchanan insisted on the then-unusual stance that the same methodological individualism that economists use so productively to analyze commercial markets should be used also to analyze the operation of government and political decision-making. People are people are people; they don't change fundamentally when moving from the private sector to the political sector or vice-versa. And as we'll see in later chapters, Buchanan modeled political activities—or at least those in democratic societies—as being a means by which individuals can engage in exchange with each other, with each party to such exchanges aiming to improve his or her own or family's well-being.

In addition, Buchanan warned against imputing to any collective a singularity of purpose. You as an individual have preferences which you purposefully attempt to satisfy as fully as possible by using whatever means are at your disposal. Ditto for your next-door neighbour. But despite being residents of the same country (and province or state, and town, and neighborhood) you and your neighbor share no one, singular purpose. There is nothing—no one *thing* that is analogous to your individual preferences—for you and your neighbour to "maximize."

Furthermore, when analyzing the groups that individuals form when they come together to pursue collective outcomes, Buchanan insisted that close attention be paid to the details of how these individuals constitute themselves as a group—and most especially, to the decision-making procedures they choose for their group. The failure of economists and political scientists to analyze the details of how collective decision-making groups form, operate, and change denies to these scholars the ability to make sense both of how individuals in the groups act and of why collective outcomes are what they are.

Each of these three propositions in 1949 ran very much against the grain of academic thinking.

To understand why, consider two important features of the timing of Buchanan's arrival on the professional scene. First, by the late 1940s the style and content of economics that was ascendant was that of John Maynard Keynes (1883-1946). Second, the democratic United States had just helped to win a world war against fascist regimes and then found itself, along with other democracies, in a cold war against a totalitarian communist state. The combination of these two features made for some dubious economics and political philosophy.

Keynesianism

Among Keynesianism's contributions was the introduction of aggregative thinking—or, rather, its re-introduction, albeit in a much more sophisticated form—that had largely been exorcised from economics ever since Adam Smith exposed the fallacies of mercantilism. The adherents of this dusty and debunked doctrine—the popularity of which peaked roughly from 1600 until the publication in 1776 of Smith's monumental work *An Inquiry Into the Nature and Causes of the Wealth of Nations*—assumed that the interest of the state is identical to that of society. Thus, any policy that strengthened the state was believed to strengthen society.

Aggregative thinking lumps together a great many individuals into large categories such as "the nation" or "the government" and then treats each of these categories as if it is a unitary thinking, choosing, and acting individual. This manner of analysis, the spirit of which was revived by Keynesians, renders unnecessary the kind of economic analysis that was inspired by the work of Adam Smith (1723-1790). Analysis done in the tradition of Smith examines how multitudes of individuals, all pursuing their own individual interests and possessing only their own unique bits of knowledge, come to have their plans and actions coordinated—chiefly by adjustments in market prices and the resulting profits and losses—in ways that are not only economically orderly and highly productive of material goods and services, but also unplanned *and unplannable.*

With aggregative thinking, "the social welfare" is promoted by "the government," with the latter treated as if it's an organism possessing a brain, and as if that brain's main interest lies not in serving itself but, rather, in serving the nation. Overlooked are the processes—all churning with assorted incentives and constraints—that lead individuals with diverse interests to undertake actions such as forming governments, becoming government officials, and dealing with government both as citizens who receive benefits from it and who incur costs to sustain it and to affect its activities.

Buchanan called such aggregative thinking the "organismic" notion of collectives—that is, the collective as organism. From the very start, nearly all of Buchanan's lifetime work was devoted to replacing the organismic approach with the individualistic one—a way of doing economics and political science that insists that choices are made, and costs and benefits are experienced, only by individuals. As we will see in the next chapter, for example, Buchanan wrote his first sole-authored book to debunk a myth about government debt that had become widely accepted only because of Keynesianism's organismic assumptions.

Democracy's zenith

In the immediate post-WWII free world, widespread acceptance of the organismic conception of state and society was almost certainly encouraged by the use in those countries of regular elections—a key feature of democracy—as the means of choosing government leaders. The thinking was this: Because in a democracy the People choose government officials (and, thus, ultimately government policies), and because each voter has just as much say as every other voter, governments chosen democratically reflect the will of the People. Such governments, therefore, are good because they embody the general will.

Significantly, such governments are also the opposite of those of the West's evil Cold War enemies. Communist regimes in eastern Europe, east Asia, and Latin America were modern-day versions of seventeenth century monarchies whose leaders had the audacity to arrogantly pose as embodying their nations' wills. The only real difference between seventeenth century monarchs such as France's Louis XIV and twentieth century dictators such as the Soviet Union's Joseph Stalin (other than the latter's greater access to weapons of mass slaughter) is that the former boasted of being ordained by God while the latter declared themselves to be anointed by history.

Aware that tyranny and poverty were the common lot of all citizens of communist countries—a lot correctly understood to be diametrically opposite to that enjoyed by citizens of the democratic west—it was easy to recognize democracy's genuine and significant superiority to one-party, tyrannical rule. Trouble is, this correct recognition of democracy's superiority to autocracy morphed into an unrealistic and romantic fantasy about democracy's nature, abilities, and benefits.

Majority rule was believed then (and still believed by most people now) by its very nature to discover and implement the will of the People—as if a collection of people has a will in the same way that an individual has a will. From this organismic belief, it's a short step to the conclusion that as long as government officials are chosen democratically in regular, open, and fair elections, society will express its will, and government will carry it out.

Of course, just like any ordinary individual, the People occasionally make choices they later regret. And the government charged with carrying out the will of the People will occasionally err in performing its assigned task. But apart from these mundane imperfections, the results of democratic decision-making can no more be legitimately second-guessed or criticized than can an individual's choice of which kind of car to buy or which style of clothing to wear.

Just as those of us in the modern, liberal West respect the freely made choices of individuals, we must respect the choices that the People, as a collective, freely make and express through democratic processes. Such was the thinking when Buchanan began his career.

From its start, Buchanan's entire career can be understood as a constructive scholarly reaction to the analytical errors of Keynesianism on the one hand, and excessively romantic beliefs about democracy on the other.

Buchanan the democrat

Because much of what follows about Buchanan's scholarship might appear to careless readers to be an attack on democracy—or at least an expression of deep skepticism about it—it's important at the start to avoid this confusion. Although Buchanan was no capital "D" American Democrat (or capital "R" Republican) he was a *democrat* to his core. Buchanan believed deeply that each individual is morally equal to every other individual. Because no person is superior, ethically speaking, to any other person, no person's opinions or preferences should be given special advantage over those of other persons. As Buchanan repeatedly expressed this sentiment one way or another, "We cannot claim to play as God" (Buchanan, 1975a: 15).

Buchanan believed that this conclusion holds fast despite the undeniable fact that some individuals are smarter, or better educated, or wealthier, or higher-born than others. For Buchanan, society improves normatively the more reliably it gives to each individual, regardless of intelligence, wealth, rank, or any other distinction, an equal say in the affairs of government, with the scope and powers of government determined by the consent of the governed.

Buchanan's extensive investigations of majority-rule democracy and of other methods of collective decision-making revealed to him the many ways that, in practice, such decision-making can, and very often does, lead to outcomes that are at odds with the desires of voters. Majority-rule democracy, if not governed by sound constitutional rules, will produce outcomes that, ironically, harm majorities and satisfy only small minorities.

Buchanan sought to expose the flaws in majority-rule democracy not to discredit democracy but, instead, to persuade people to correct these flaws by crafting appropriate constitutional rules. Among Buchanan's normative goals was to strengthen democracy to better enable it to live up to what he believed were the admirable ideals of James Madison and others of America's founding generation.

Reconstructing public finance

In 1949, the fuller pursuit of these endeavors lay only in Buchanan's future. When he wrote "The Pure Theory of Government Finance: A Suggested Approach," Buchanan almost certainly didn't foresee the extent to which its few simple but powerful themes would later unify nearly all of his scholarly work. This early paper was in the rather narrow field of what economists call "public finance," the branch of economics devoted to the study of government budgeting. These days, public-finance scholars examine both the causes and consequences of government's taxing decisions and spending choices.

But in Buchanan's day, among mid-twentieth century English-language scholars of public finance, government was simply *assumed* to operate with the goal of promoting the public interest as fully as possible.[1] So they gave little attention beyond mere description to government spending decisions.

Analyses of the tax side of the budget were a bit better in the mid-twentieth century, although not much. Compared to the almost non-existent use of economic analysis to gain a deeper understanding of government's spending decisions, economists did dive more deeply into analyses of taxation. The major questions they asked included, "What are the different consequences of different taxes on the private economy?" "What consequences do different

1 We single out English-language scholars not because Buchanan was an American who spent his entire career at American universities, but because Buchanan himself contrasted Anglo-American public-finance scholarship with the works of many Italian scholars in the field. As we will see in Chapter 3, Buchanan found in the works of the Italians an approach far more realistic and therefore far more descriptive and useful than he found in the works of most English-language public-finance theorists.

systems of taxation have on income distribution?" and "What are the appropriate criteria for imposing taxes?" Nevertheless, as with its spending decisions, government was *assumed* in its taxation decisions to be motivated only by the goal of furthering the public interest.

Buchanan was unhappy with economists treating the spending and the taxation sides of the budget so differently. (In chapter 3 we'll look in more detail at how Buchanan proposed to remedy this problem.) But he was even unhappier with economists' failure both to critically investigate the motives of the flesh and blood individuals who make fiscal decisions, and to recognize the role that citizen-taxpayers play in prompting government officials to tax and to spend as they do.

George Mason University economist Richard Wagner summarizes Buchanan's 1949 paper nicely:

> Buchanan (1949) is a form of call to arms in which he sets forth a bottom-up approach to public finance wherein people are construed as governing themselves, in contrast to the orthodox approach to public finance where the state is treated as some inscrutable entity that magically injects taxes and spending into society, and with individuals responding to those injections but in no way causing them.... Buchanan wanted to reconstruct public finance to render it suitable for democratic regimes where people governed themselves as opposed to being governed by a class of rulers. (Wagner, 2017: 4-5)

You will see in the following chapters the common themes that resonate in all of Buchanan's work and that were first sounded in his pioneering 1949 paper.

Chapter 2

On the Burden of Government Debt

The essence of public debt, as a financing institution, is that it allows the objective cost of currently financed expenditure projects to be postponed in time. For the taxpayer, public debt delays the necessity of transferring command over resource services to the treasury.

—James M. Buchanan, "Confessions of a Burden Monger" (1964)

In 2021 a national government decides to build a hydroelectric dam at a cost of $25 billion. Three options are available to the government for financing this project. The government can (1) acquire the full $25 billion through taxation today; (2) borrow the $25 billion from willing creditors; or (3) print 25 billion new dollars. In reality, of course, the government can use some mixture of two or more of these options. But to keep the exposition straightforward, we'll here assume that no such mixing of financing options occurs.

Determining which option is best requires an assessment of a large number of considerations such as, but by no means limited to, the responsiveness of workers, businesses, and investors to higher taxes, the current relationship between the existing supply of money and the demand of people to hold part of their wealth in money, and the rate of interest. Let us assume that after weighing the merits and demerits of each option the government chooses to borrow the funds. Specifically, the government sells a $25 billion bond to a wealthy investor. The bond pays a five percent annual interest rate. In 2051, the investor or his heirs will submit the bond to the government in return for roughly $108 billion, which equals the $25 billion in principal plus accumulated interest.

Put in terms of this hypothetical example, the central question explored by James Buchanan in his 1958 book, *Public Principles of Public Debt*, is "Who pays for this dam?" If the mid-twentieth century consensus among economists were correct, the dam is paid for fully in 2021. That's because in that year, $25 billion worth of real resources—land, bulldozers and other construction machinery, along with concrete and steel and wiring and other materials, and human labour—are devoted to building the dam. It is in 2021 that whatever else could have been built or done with these inputs and labour was *not* done in order that these inputs and labor could instead be devoted to the building of the dam.

This consensus by mid-twentieth century economists that debt-financed projects are paid for by citizen-taxpayers at the time the projects are undertaken rather than by future generations Buchanan called "the new orthodoxy." It was an orthodoxy because it was widely taken to be obviously true, and it was new because it sprung from Keynesian economics, which in 1958 was only 22 years old.

Until John Maynard Keynes published his *General Theory of Employment, Interest, and Money* in 1936, most economists—from Adam Smith in the mid-eighteenth century through economists in the early twentieth century—understood that the costs of government projects funded with debt are passed on to the future generations who, as citizen-taxpayers, must repay the debt. This understanding was rejected by the new orthodoxy and replaced with the insistence that projects funded with borrowed money are, just like projects funded with currently collected taxes, paid for at the time the projects are undertaken.

The new orthodoxy does recognize that debt financing nevertheless leaves a legacy for future citizen-taxpayers. In the case of the hypothetical hydroelectric dam built in 2021 with borrowed funds, citizens are obliged in 2051 to repay the debt that was incurred 30 years earlier. To do so they must, in 2051, pay more in taxes or suffer cuts in government programs (or some combination of the two) to the tune of about $108 billion. Retiring this bond might impose a net burden on citizens if the bond were owned and submitted for redemption by a non-citizen. In such a case, nationals in 2051 would, as a group, be made $108 billion worse off, with foreigners being made $108 billion better off.

But, the new orthodoxy continues, if the bond is owned and submitted for redemption by nationals, then apart from some relatively negligible costs incurred in carrying out the process of transferring the funds from citizen-taxpayers to citizen-bondholders, redemption imposes no *net* burden on nationals. Although those citizens who pay the debt are worse off as a result of paying more in taxes or receiving less in government services, other citizens—those who receive repayment of the debt—are better off by the same amount. Just as a household is made neither richer nor poorer if a wife transfers money to her husband, a nation is made neither richer nor poorer if one group of citizens transfers money to another group of citizens.

Using the phrase that mid-1950s economists employed to describe this situation, nationals in 2051 might say, "We owe it to ourselves."

Buchanan's insight

Although he accepted the new orthodoxy early in his career, Buchanan soon rejected it once he'd studied the public-finance writings of Italian scholars. These scholars, for all the differences that sometimes separated them from each other, nearly all worked under the presumption that the state often has interests that are at odds with those of it citizens. For the Italians—unlike for the majority of public-finance scholars in English-speaking countries—the state was not seen as generally a natural and faithful extension of a unified will of the People. This "Italian" perspective reinforced Buchanan's skepticism of the organismic view of government and society, and further encouraged him to work consistently as a methodological individualist—that is, as a scholar who pays close attention to the incentives that prompt different individuals, in different capacities, to choose and act as they do.

This scientific perspective is responsible for what Buchanan remembered as being the only real flash of major, road-to-Damascus-like inspiration that ever occurred to him. In early 1957, after breakfast one morning in Rome, Buchanan suddenly "saw" the core fallacy in the new orthodoxy. He immediately turned to fleshing out his new understanding. The result is *Public Principles of Public Debt,* a slim yet thorough volume of tightly reasoned analysis.

According to Buchanan, the new orthodoxy's fatal flaw is its insistence that the costs of debt financing are incurred in the periods when the debt-financed programs are undertaken. And if this insistence is wrong, then the older, pre-Keynesian understanding is correct that programs funded with debt today are paid for by citizen-taxpayers tomorrow. Therefore, by using debt to finance government programs, we, today's citizen-taxpayers, can indeed consume at the expense of our children and grandchildren.

The old-time fiscal religion

The key insight in Buchanan's criticism of the new orthodoxy and, hence, of his revitalization of the older, classical view is the realization that creditors who lend money to the government do so voluntarily. Yes, by transferring some of today's spending power to the government, these creditors reduce their own ability to spend today. But these creditors lend to the government only because they believe that the interest payments they will receive in exchange make such loans worthwhile for them.

These creditors do not think of themselves as paying for whatever projects are funded with the borrowed money. And they are correct in that thinking. These creditors are not the purchasers of the debt-financed projects; instead, they are purchasers of future interest payments that make it worthwhile for them to sacrifice their consumption today. Thus, debt-financed government projects are not paid for by the government's creditors.

Similarly, today's citizen-taxpayers are not paying for debt-financed projects such as the hypothetic hydroelectric dam project mentioned earlier. After all, the very reason the government in 2021 borrows the funds to build the dam is to relieve today's citizen-taxpayers from having to pay for it.

Yet *someone* has to pay for the dam! Who? Buchanan's answer is that the dam is paid for by citizen-taxpayers in 2051, who are obliged to repay the debt. These individuals are the ones who must reduce their consumption or wealth from what it would be in the absence of their having to repay the debt. The debt repayment comes in the form of more taxes paid or the receipt of fewer goods and services from the government.

This shifting of the burden of paying for debt-financed projects to future citizen-taxpayers is not in the slightest affected by whether or not the bondholders are fellow nationals or foreigners. The decisive fact is that to repay the debt in 2051, some citizen-taxpayers that year will have to reduce their consumption or wealth.

Adherents of the new orthodoxy respond by saying that if the debt is repaid to fellow citizens, there is no net reduction in aggregate national wealth. The repayment, they maintain, is merely a transfer, as if from the left hand to the right. Buchanan, however, argued that this reasoning is mistaken. If the creditors in 2021 had not loaned $25 billion to the government, they would have done something else with their money—something else of nearly equivalent value to lending to the government—such as, for instance, lending $25 billion to private companies.

Buchanan assumed, not unrealistically, that credit markets are competitive. From this assumption it follows that the attractiveness to creditors of lending to the government is only marginally greater than (that is, is largely equivalent to) the attractiveness of using their money in other ways.

And so when in 2051 the government's creditors are repaid, they are made no better off (or worse off) than they would have been had they used their money differently in 2021. Repayment of the debt does not make the repaid creditors anything but marginally richer than they would have been had they instead invested their money in alternative projects. But repayment *does* make the citizen-taxpayers who foot the bill poorer by the full amount of the repayment.

Dam or ditch? Money or muscle? It doesn't matter

Buchanan's demonstration that debt financing of government projects is paid for by future citizen-taxpayers can be challenging to grasp. So here is a slightly different way to see what Buchanan was driving at.

Suppose that the government of the town of Musgrave hires 10 workers, all citizens of Musgrave, to dig a drainage ditch. It will take these workers five 10-hour workdays to finish digging the ditch. They start on Monday morning and complete the job on Friday afternoon. The government promises to pay each worker $10 for each hour he or she works. If all workers work the entire 50 hours, each will receive a payment on Friday afternoon of $500. The government will acquire the full $5,000 needed to pay all 10 workers by collecting $5,000 in tax revenues from the citizens of Musgrave on Friday afternoon.

From the time the workers start digging on Monday morning until the moment before they receive their pay on Friday afternoon, these workers extend credit to the government. In effect, by agreeing to work starting on Monday morning and not be paid until Friday afternoon, the workers lend the government their time and effort for the week. Until the government pays the workers, it is indebted to each worker for the wages that that worker has earned.

But clearly it isn't the workers who pay for the drainage ditch. They correctly don't think of themselves as purchasing the ditch, and no one else thinks of them as doing so either. This is so despite the fact that the workers have loaned the government real resources—500 hours of their work effort—before being paid. The people who pay for the ditch are the citizens whose taxes are raised in order for the government to obtain the $5,000 that it then pays to the workers.

In this example it's clear that the drainage ditch is paid for by citizen-taxpayers rather than by the workers who loaned resources to the government during the (brief) time government borrowed the resources it consumed to carry out the project. Just because none of the workers are paid at the end of, say, Monday's digging, no one would conclude that the responsibility for paying for the portion of the ditch that was dug on Monday is not shifted ahead to the citizen-taxpayers whose taxes are raised on Friday afternoon.

And on Friday afternoon when Musgrave's citizens' taxes are raised, these citizens, as a group, are out $5,000 worth of spending power that they would otherwise not be out were their taxes not raised. Furthermore, it's also clear that once the workers receive this $5,000, even though it is a transfer of $5,000 from some citizens of Musgrave to other citizens of Musgrave, that does not mean that the drainage ditch cost Musgrave nothing. Obviously, it cost Musgrave $5,000. (More precisely, the ditch cost the citizens of Musgrave whatever else they would have purchased with the $5,000 had they not had to pay for the ditch.)

Buchanan's key insight applied here is that the workers hired to dig the ditch were hired at the going wage rate—$10 an hour in this example—and had the government not hired the workers to dig the ditch, each worker would have been employed in some other productive job. Whatever work they did to earn the money, each worker's weekly income would have been $500. So when these workers receive $5,000 as payment from the government's treasury, their receipt of this income does not offset the loss of the $5,000 in taxes paid on Friday afternoon by Musgrave's citizens.

Wasteful or productive?

Note that Buchanan's argument that each debt-financed project is paid for by the future citizen-taxpayers who must service the debt holds regardless of whether the project is wasteful or productive. We might agree that our hypothetical hydroelectric dam built with borrowed funds is an unambiguously excellent use of resources, one that yields enormous benefits for many future generations. But even productive projects are not free; someone must pay for them. And because the construction of the dam is financed with borrowed funds, those who will pay for it are future citizen-taxpayers. Those future citizens might unanimously agree that the value they receive from the dam is worth the price they are obliged to pay for it, but they, and only they, must nevertheless still pay for it.

Buchanan's argument should not, therefore, be interpreted as counselling against any and all debt financing. He explicitly recognized that it is appropriate to finance some projects with debt rather than with current taxation. Projects that yield benefits to future citizen-taxpayers are appropriately paid for by those future taxpayers rather than by current taxpayers who derive no benefits from such projects. In such cases, debt financing is a vehicle for handing the bill to those who will receive the benefits.

But precisely because debt financing is a means of presenting the bill for projects undertaken today to future generations, the availability of the debt-financing option gives to today's taxpayers the opportunity to consume at the expense of tomorrow's taxpayers. We correctly understand that if Jones is given the ability to spend money belonging to stranger Smith, the likelihood is high that Jones will spend excessively. This understanding holds firm regardless of whether Smith is Jones's contemporary or is not yet born when Jones is spending his money.

This ability of current taxpayers to use debt financing to free-ride on the wealth of future generations led Buchanan to worry that government today will both spend excessively and fund too many projects with debt. Tomorrow's citizen-taxpayers, after all, are not today's voters. Thus, the interests of these future generations are under-represented in the political process.

To reduce the magnitude of this problem, Buchanan endorsed constitutional rules that oblige governments to annually keep their budgets in balance. His fear that the opportunity for debt financing of government projects and programs would be abused was so acute that it led him to endorse a balanced-budget amendment to the US Constitution. His participation in a political effort to secure such an amendment is one of the very few specific, ground-level policy battles that he actively joined. We will see in Chapter 9 the logic of Buchanan's argument in support of constitutional rules.

Chapter 3

The Individualistic Approach to Fiscal Policy

The state has its origin in, and depends for its continuance upon, the desires of individuals to fulfil 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.

—James M. Buchanan, "The Pure Theory of Government Finance: Suggested Approach" (1949)

The previous chapter on Buchanan's analysis of the public debt features an example of his individualistic approach to fiscal policy. When analyzing the activities of government, the costs and benefits of government policies fall on individuals, not on aggregates or groups. The argument that domestically held public debt is no burden because "we owe it to ourselves" is revealed as fallacious once we recognize that the aggregate—ourselves—is really composed of many individuals, some of whom will pay the taxes to finance the debt repayment, and some of whom will receive the proceeds when they redeem the bonds they hold.

To appropriately analyze the process of fiscal exchange in which debt is issued to finance current expenditures, one must look at the costs and benefits borne by individuals, not collectives. This rule applies to the analysis of all types of fiscal policies, not just debt. This approach is, for the most part, how economists analyze taxation. If the tax system is made more progressive, that is, if upper-income people are taxed more to finance redistribution of resources to lower-income people, economists explicitly recognize that costs are imposed on some individuals for the benefit of others. Buchanan simply argued that the same type of explicit recognition be given to the costs and benefits imposed on others when financing is done with debt. Ultimately, individuals, not groups, pay taxes; and individuals, not groups, benefit from government expenditures.

The Wicksellian Influence

Near the start of his Nobel Prize lecture, James Buchanan told a story that, both in conversation and in print, he told often.

> One of the most exciting intellectual moments of my career was my 1948 discovery of Knut Wicksell's unknown and untranslated dissertation, *Finanztheoretische Untersuchungen*, buried in the dusty stacks of Chicago's old Harper Library. Only the immediate post-dissertation leisure of an academic novice allowed for the browsing that produced my own dramatic example of learning by serendipity. Wicksell's new principle of justice in taxation gave me a tremendous surge of self-confidence. Wicksell, who was an established figure in the history of economic ideas, challenged the orthodoxy of public finance theory along lines that were congenial with my own developing stream of critical consciousness. (Buchanan, 1986)

Although historians of Buchanan's thought debate the accuracy of this story's details, its core is indisputably true: Buchanan was very impressed with the work of the Swedish economist Wicksell (1851–1926), and especially with his approach to public finance. Buchanan believed that the explanatory power of and the normative implications drawn from Wicksell's theory of government taxing and spending were far superior to anything offered by English-language public-finance scholars of the mid-twentieth century.

When Buchanan was just beginning his professional career, Anglo-American public-finance theory was overwhelmingly devoted to exploring the effects of different systems, types, and rates of taxation upon the behaviour of citizens in private markets. How do citizens trade off leisure for labour in one tax regime compared to in other tax regimes? How much of the burden of a sales tax legally imposed on retailers is shifted onto consumers? And the biggest question of all: how can government raise $X amount of revenue while imposing the least harm on its citizens?

Yet those Anglo-American scholars were doing virtually no positive theorizing about how government officials actually go about making fiscal decisions. In the Anglo-American tradition, government was implicitly assumed to be an agent hovering above the citizenry and motivated to tax and spend independently of any preferences that citizens might have over fiscal matters.

Governments, at least those in democratic countries, were assumed to tax, or advised to tax, in ways that satisfy the independent criterion of equity. Taxation is horizontally equitable if all citizens who have the same income or wealth are taxed alike; taxation is vertically equitable if the burden of taxation rises evenly as income or wealth rises. As for spending, government officials might—and in democratic countries perhaps do—make such decisions with the intention of promoting the greater good.

The Anglo-American public-finance scholars were making no effort to develop a positive, descriptive theory of fiscal decisions. In the mid-twentieth century economists typically assumed that government decision-makers act to further the public interest, without analyzing the process by which those decisions actually are made. In contrast, Buchanan recognized that those who design public policy often take their own interests into account, which are not necessarily the same interests as those of their constituents, and, therefore, politicians' actions might *or might not* promote the public welfare.

Influenced by Wicksell, and later by his immersion in the works of Italian public-finance scholars, Buchanan worked to craft a positive theory of fiscal decision-making. This positive theory aimed at explaining observed outcomes and would, in turn, underpin Buchanan's formation of normative guidelines for government spending and taxation.

As we saw in Chapter 1, Buchanan rejected the assumption that the state is a benevolent overlord of the individuals who comprise the governed. In his theory of fiscal choice, Buchanan sought to explain government spending and taxing decisions as arising from the same individualistic motives that economists assume guide spending and consumption decisions in private markets. The difference between the two settings, of course, is that governments make collective decisions—decisions that all members of the political community must live with. Buchanan showed, however, that the same analysis of the decision-making logic at work in private markets can be fruitfully used to analyze the way that citizens in democratic polities make collective choices.

Two features of Wicksell's approach to public finance are especially relevant to Buchanan's work. The first is Wicksell's insistence that, at least in democratic societies, government budgeting should be analyzed as what Buchanan called "fiscal exchange." Government spends money to produce various goods and services for citizens, and it obtains this money, mostly through taxation, from citizens. Therefore, whether the government's whole budget or any of its individual components are worthwhile depends upon citizens getting their money's worth. It follows that public-finance theorists should assess the merits of budgetary outcomes and budgetary proposals from the perspective of the citizens who are taxed to pay for government expenditures and who then receive government-supplied goods and services in exchange.

Wicksell's second foundational contribution to Buchanan's thought is his rejection of the benevolent-despot model of government. If the government's budget appropriately emerges from fiscal *exchange*, budgets are not imposed on the populace. They are agreed to through a collective decision-making process that begins with the citizens who are to live under those budgets. Government has no interest of its own; it is merely an organizational tool that citizens use to achieve their collective goals.

Fiscal decisions and democratic politics

In our democratic age this conception of government perhaps sounds obvious. But from it follows the conclusion that the state is not an agency existing independently of citizens. The state has no greater knowledge than is possessed by its citizens. Nor is the state—or the officials chosen to execute this process of fiscal exchange—driven by motives more benevolent than are the motives that drive the self-interested citizens who, in Buchanan's ideal world, would bargain with each other to create the state.

Economists often depict government as an omniscient organization that implements policies to maximize social welfare. But this depiction falls short in at least two ways. First, there is no such thing as "social welfare" beyond the welfare of each of the individuals who make up the society. Second, recognizing that government is not omniscient, there is no way for policy makers to know what policies would benefit those who are affected by them beyond discovering the preferences of its citizens as revealed by those citizens themselves. The provisions of such a revelation is an important role of the democratic process; democratic debate, compromise, and decision-making reveal the preferences of citizens who should realistically expect to be net beneficiaries of government actions.

Herein lies the great challenge of collective decision-making. Because there is no such thing as the general will or social welfare beyond the welfare of each of the individuals in the group, the challenge is to design democratic institutions so that they reflect the preferences of the citizens as closely as possible. Simple majority-rule voting on all issues has the obvious shortcoming that it allows a majority to impose costs on the minority, thus requiring institutions to be designed to safeguard against this outcome. Here again, Buchanan took inspiration from Wicksell, who noted that if unanimous approval is required for government to act, the approval of everyone means that everyone's welfare is improved and the decision is in the public interest because it is in the interest of everyone who makes up that public.

Later chapters will consider nuances around this idea of requiring unanimous agreement. The subject was one that occupied a great deal of Buchanan's attention throughout his career. Meanwhile, note that for taxes to be generally agreed to in an informed way, citizens must know beforehand how those tax revenues will be spent.

Buchanan emphasized that the desirability of taxes cannot be evaluated independently of how that tax revenue is to be spent. The common sense behind this insight is that if individuals are asked if they want to pay a particular tax, they usually say no, because a tax imposes a cost on them. On the other hand, if they are asked whether they favour paying a tax on gasoline to finance road construction, they are more likely to agree to it, weighing the costs to them of the proposed tax against the benefits that they anticipate the road would provide. The merits of any particular tax cannot be evaluated independently of how the tax revenues will be spent.

This seemingly straightforward insight is rarely recognized by public-finance economists even in the twenty-first century. The economics of taxation commonly depicts taxes as revenue that goes to the state, with the idea that the state should extract this revenue in a manner that is least painful to taxpayers. Rarely does the economics of taxation recognize that revenues will be used to pay for collective goods that benefit taxpayers. Too often, taxes are analyzed as if they are a penalty levied on people for earning income or having wealth. Buchanan's approach views taxes as the price people pay for government-supplied goods and services.

Ricardian equivalence

Ricardian equivalence, a concept based on the work of David Ricardo (1772-1823), is the idea that there is effectively no difference between financing government expenditures through taxation or through debt. This argument differs from the one addressed in the previous chapter, which insists that, because future resources cannot be used for current projects, the burden of projects today funded with government debt cannot be passed on to future generations. Ricardian equivalence also differs from the "we owe it to ourselves" argument.

The idea behind Ricardian equivalence is that rational individuals recognize that when government finances today's spending with debt, the tax obligations of people in the future will rise. This debt, of course, must be serviced and repaid. If today's taxpayers care about their future selves and about their children and grandchildren, they will—if they are fully rational—increase their savings today so they or their heirs will have on hand enough money to pay the higher taxes that are destined to be imposed tomorrow. Or so goes the argument of economists who believe in the reality of Ricardian equivalence.

David Ricardo discussed this idea in his *On the Principles of Political Economy and Taxation*, first published in 1817; thus the name "Ricardian equivalence." But while Ricardo explored the argument, he ultimately rejected it. Buchanan also rejected it. His reasoning again shows the merits of taking an individualistic approach to fiscal policy.

The *non*-equivalence argument, which Buchanan defended, is that if people's taxes are reduced and government spending is instead financed by debt, people will spend at least some of the additional disposable income they receive from lower taxes on consumption goods today. Therefore, financing through debt rather than through taxes shifts resources toward more consumption spending. Taxation and debt are *not* equivalent methods of public finance, because debt financing, unlike tax financing, shifts expenditures toward current consumption.

Buchanan's rejection of Ricardian equivalence does not rest on any assertion that individuals irrationally fail to recognize that increased government indebtedness entails higher future tax burdens. Rather, his individualistic approach to public finance takes account of the fact that the lower taxes that individuals enjoy today (as a result of debt financing of today's expenditures) are a sure source of additional disposable income today. But these same individuals do not know if they or their heirs will be the particular taxpayers in the future who will have to service the debt.

If they or their heirs have low incomes in the future, they will not pay much in taxes and the burden of the debt will therefore be borne by others. Because no one knows when he or she will die or can predict exactly what his or her taxable income will be when the debt must be repaid, the value of a dollar that with certainty is not taxed away today is higher than is the value of a dollar that only *might* be taxed away tomorrow. Each of today's citizen-taxpayers is thus made to feel wealthier with debt financing than with tax financing. Each person, in turn, is prompted by debt financing to spend more today on consumption items.

In contrast to Buchanan's individualistic focus, the Ricardian equivalence argument effectively aggregates everyone into a single taxpayer. This aggregate individual would get from debt financing a tax cut today in exchange for higher taxes tomorrow. If such an infinitely lived aggregate individual were real, he or she would rationally save the funds from today's tax cut in order to pay those future taxes. But the individualistic approach recognizes that there are many distinct taxpayers today and there will be many distinct taxpayers in the future. It is reasonable to expect rational individuals to devote at least some of the money they reap from a tax cut to consumption.

Buchanan's critique of Ricardian equivalence is noteworthy because it shows the insights that can be gained by taking an individualistic approach to fiscal policy. Buchanan shows that there is good reason to question economic analysis that treats aggregate groups as though they are individuals.

The fiscal-exchange model of government

Buchanan's fiscal-exchange model of government depicts government as an organization through which individuals come together collectively to produce goods and services they cannot easily acquire through market exchange. Just as individuals trade in markets for their mutual benefit, government facilitates the ability of individuals to engage in collective exchange for the benefit of everyone. This fiscal-exchange model is an ideal, of course; Buchanan was well aware of the possibility that those who exercise government power can and often do abuse it for their own benefit at the expense of others. Much of his work was devoted to understanding how government can be constrained in order to keep this abuse to a minimum. When those constraints are effective, collective action through government can further everyone's well-being.

The fiscal-exchange model is based on the idea that taxes are the price citizens pay for government goods and services. And just like prices in the marketplace, the value of the goods and services government supplies should exceed the prices citizens pay, in the form of taxes, for these goods and services. As a public-finance economist, Buchanan's work is founded on this idea, but this idea also naturally raises the question of how institutions can be designed to assure that government output is worth its cost. Buchanan here drew on Wicksell's insight that if individuals are required to agree unanimously to the taxation and expenditures, everyone will benefit.

In the fiscal-exchange model, government's purpose is to enable citizens to organize in order to take collective action, and to bargain with each other to determine which particular activities will be undertaken by government and at what and whose expense. If everyone agrees, government action is in the public interest, because it is in the interest of all of the individuals who make up the public. Trite as Wicksell's point might sound, it ran—and still runs—counter to the prevalent Anglo-American view of government budgeting.

Chapter 4

Subjective Costs

Cost is that which the decision-taker sacrifices or gives up when he makes a choice.

—James M. Buchanan, *Cost and Choice: An Inquiry In Economic Theory* (1969)

Cost is, as Buchanan explains in the above quotation, the direct result of making a choice. When someone makes a choice, that person incurs a cost in the form of the value, to him or her, of what he or she forgoes as a result of making that choice. Someone who spends $15 to go to a theater to watch a movie forgoes the opportunity to spend that $15 to go to a restaurant to have lunch. Costs are often summarized in monetary terms, which obscures the fact that the true cost is not giving up the money itself, but, rather, giving up what else could have been purchased with the money. It's easy, as a shorthand expression, to say that the cost of the movie is $15. The actual cost, however, is the satisfaction the person expects he or she would have enjoyed had he or she chosen instead to have lunch.

The fact that cost is often expressed in terms of money allows people to make quick comparisons. For the same amount of money, the individual could watch a movie *or* go to a restaurant for lunch *or* buy a few gallons of gasoline. Once an individual chooses how to spend the $15, the cost incurred is the forgone experience of the most highly-valued alternative that the individual gives up. After the choice has been made to spend the $15 on a movie, the individual can evaluate the enjoyment from watching the movie, but he or she can only *conjecture* about how much enjoyment he or she would have experienced from the meal or from putting $15 worth of gasoline into the car's tank.

Cost is subjective. One person might choose to spend the money to watch the movie while another might decide that having lunch at a restaurant would yield more satisfaction. In making these assessments, both individuals could be correct, but there's no way to know for sure. Individuals know how satisfied they are with the choices they actually make, but they can only guess about how satisfied they would have been had they chosen differently. An individual might have enjoyed the movie, but how much that individual would have enjoyed the lunch instead can only be a conjecture because the individual did not actually experience the lunch.

You can surely identify with this description of cost from your own personal experience. Haven't you done some things that, after the fact, you enjoyed much more than you expected? Similarly, haven't you done other things that, after the fact, you found to be less satisfying than you expected? And either way, no matter how much or little you ended up enjoying the movie that you chose to watch, you can only conjecture about how much you would have enjoyed the lunch that you chose to forgo.

Cost is incurred at the time a choice is made

If someone is in a situation in which he or she has no choice, then no cost is incurred, because that person is giving nothing up. Consider the straightforward example of someone who signs an unbreakable lease for an apartment, agreeing to pay $1,000 a month for 12 months. To keep the example simple, assume that there is indeed no way to get out of the lease.

A few months into the lease the individual would like to move, but thinks, "If I move, it will cost me $1,000 a month in rent for the apartment that I would no longer occupy." Yet further reflection shows that this conclusion is incorrect. Because of the unbreakable lease, the individual has no choice but to pay that $1,000 every month. So by choosing to move the renter does not forgo this $1,000. This $1,000 must be paid every month regardless of what the individual does. The cost was incurred at the time the choice was made to sign the lease when the renter agreed to give up $1,000 every month for 12 months. The day the lease is signed, the renter incurs the $12,000 cost, to be paid in 12 monthly installments of $1,000.

One reason a renter might decide to move despite such a lease is that the renter has received an offer for a much better job in another city. The renter weighs the costs and benefits of moving, including having to rent another apartment in the other city, and might decide that the benefits of moving exceed the costs. But the renter will still have to pay $1,000 a month for the old apartment whether or not the renter moves. The renter cannot escape the obligation to pay rent by choosing either to move or not to move, so the obligation to pay this rent is not a cost of moving.

The renter might be able to sublet the old apartment for $750 a month to another person, but if so, wouldn't the renter lose $250 a month on the apartment? No. That's because the renter has to pay the $1,000 in rent in any event, so subletting would *gain* the original renter $750 a month over what the renter otherwise would have had.

Should the renter move? Given the choice, some people would take the job in the new city; others would remain in the old job and current apartment, perhaps because the new job did not look like such a good opportunity after all, or perhaps because of connections and friendships that the renter values more highly than the new job. Or perhaps the new job won't pay enough to enable the person to afford to pay rent on two apartments, even for a few months. Regardless of the reason, because costs are subjective, there is no way for an outside observer to say which is the better option.

Costs are unseen

Because each cost is the subjectively experienced value of a forgone alternative when a choice is made, costs are difficult to perceive. This is true even for the chooser. The person watching the movie experiences the pleasure of seeing it, but that person does not experience the pleasure that would have come from eating the forgone lunch.

It's easy, for example, to see that a tariff on imports of wheat causes increased wheat production at home and higher employment and wages on wheat farms. But these benefits are not free. They come at a price, which in this case (because the purpose and effect of the tariff is to raise the price of wheat at home by reducing the supply available to consumers) includes reduced availability at home not only of wheat but also of other goods and services. The resources that the tariff draws into wheat production at home are no longer available to produce the rye, the roads, and the other goods and services that these resources would otherwise have been used to produce. And because the very purpose of the tariff is to make wheat at home scarcer, home-country residents also have less wheat to consume.

While all choices have costs, to insist on the reality and recognition of costs does not, of course, argue against actions that have costs. To do so would be also to argue against actions that have benefits. Inaction itself has costs—namely, the forgone benefits that would otherwise have been enjoyed by taking action. But the inescapable reality of scarcity means that if our well-being is to be enhanced rather than lessened, we should strive to act only in ways that yield benefits greater than costs. To the extent that we succeed in this endeavor, our well-being improves. We benefit on *net*. We benefit on net not by avoiding costs, which is impossible, but by choosing actions that we anticipate will yield benefits greater than costs.

Costs arise because of scarcity

James Buchanan insisted that the common practice, even among modern economists, of reckoning costs in physical or monetary terms or—as some older economists did—in terms of "pain," is often misleading. In his 1969 book *Cost and Choice,* which separates him most radically from mainstream economists of his day, Buchanan argued that costs are purely subjective, unmeasurable, encountered only by individuals rather than by groups, and exist only at the moment of choice.

In the first two paragraphs of the Preface to this slim volume Buchanan nicely summarized his understanding of cost:

> You face a choice. You must now decide whether to read this Preface, to read something else, to think silent thoughts, or perhaps to write a bit for yourself. The value that you place on the most attractive of these several alternatives is the cost that you must pay if you choose to read this Preface now. This value is and must remain wholly speculative; it represents what you now think the other opportunity might offer. Once you have chosen to read this Preface, any chance of

> realizing the alternative and, hence, measuring its value, has vanished forever. Only at the moment of choice is cost able to modify behavior.
>
> If you decided a few moments ago that your valuation of the alternative exceeded that expected from reading this Preface, you will have missed this economist's pedestrian prose. But, having rejected it at the outset, you can never know what you will have missed. The benefits that you are now securing from reading the Preface are not comparable with the costs that you would have suffered on choosing the most attractive alternative. These benefits, if there are any, exist. They can be evaluated *ex post*. Costs that are influential for behavior do not exist; they are never realized; they cannot be measured after the fact. (Buchanan, 1969: vii)

Buchanan's readers could have used their time to do something other than read his Preface. But time is scarce and the time used to read the Preface remains forever unavailable to be used to do something else.

Consider again the person who gives up a restaurant lunch to watch a movie. The cost of one is the forgone value of the other. If the person could both watch the movie *and* have the lunch, then obviously the lunch would not have to be forgone in order for the person to watch the movie. But the world doesn't afford us unlimited opportunities. Even people who have lots of money have limited amounts of time, and choosing to watch a movie, or choosing to have lunch at a restaurant, always means forgoing the opportunity to do something else instead.

In short, costs are the consequence of making choices. Costs are the chooser's anticipated benefits of the alternatives that are sacrificed. These anticipated benefits exist only in the mind of the chooser; they cannot be seen or otherwise sensed by outside observers. Costs are subjective, not objective. And not being objective means that costs are not measurable on some external scale as, say, is someone's height or weight and, hence, cannot be determined objectively.

Individuals incur costs

Because only individuals make choices, only individuals experience costs, and then only those individuals who make the choices that yield the costs. But as mentioned earlier, even the individual who incurs a cost by choosing option A rather than option B can never know for certain if it was worthwhile to incur the cost. This person will experience whatever benefits flow to him or her as a result of having chosen option A. Yet because option B is forever lost, this person cannot objectively know what would have been the benefits that he or she would have enjoyed had he or she instead chosen option B.

Groups can be said to make collective choices—for example, by voting. But the group *as such*, the group as an entity, makes no choices, for the group as such—we say yet again—has no brain. The collective choice is arrived at by each individual in the group voting and then having these votes processed into an outcome through some voting rule. The collective decision is determined by aggregating individual choices. Groups do not take actions. Only individuals do—a reality that doesn't change when individuals join together into a group.

Here's Buchanan's own summary of the implications of what he calls a "choice-bound conception of cost":

> 1) Most importantly, cost must be borne exclusively by the decision-maker; it is not possible for cost to be shifted to or imposed on others.
> 2) Cost is subjective; it exists in the mind of the decision-maker and nowhere else.
> 3) Cost is based on anticipations; it is necessarily a forward-looking or *ex ante* concept.
> 4) Cost can never be realized because of the fact of choice itself: that which is given up cannot be enjoyed.
> 5) Cost cannot be measured by someone other than the decision-maker because there is no way that subjective experience can be directly observed.
> 6) Finally, cost can be dated at the moment of decision or choice. (Buchanan, 1969: 43)

Buchanan's radically subjective conception of cost is fully shared almost exclusively by Austrian economists (including F.A. Hayek (1899–1992)) and by economists who taught in the early and mid-twentieth century at the London School of Economics, the LSE. It is not now and never has been fully embraced by mainstream economists, partly due to its subtlety, but mostly due to some unwelcome implications it has for standard economics and for economic policy.

If costs are subjective and borne only by individuals, it is not possible to aggregate costs and benefits across individuals in order to come up with some measure of social welfare, or to objectively identify "the" public interest. Experts cannot truly "scientifically" discover welfare-maximizing policies. Buchanan was interested in identifying ways of aggregating individual preferences to make collective choices that enhance the individual welfare of those who make the choices. Public policies, in his view, should be the result of collective choices made by individuals affected by those policies, rather than by policy experts.

The choices of some affect the opportunities of others

By insisting that cost is borne only by the decision-maker at the moment of choice and can never be shifted to or imposed on others, Buchanan was *not* saying that a decision made today by Jones will have no negative impact on third parties Smith and Jackson. Choices affect the course of events both for the chooser and for many others. Choices made by Jones indeed can affect the options and well-being of others.

Further, Buchanan explicitly acknowledged that individuals can, when making choices, attempt to take into account the consequences their choices are likely to have for other people. Buchanan recognized that in fact individuals make such attempts quite often. Yet the reality remains that no one can read another person's mind or experience another person's subjectively felt sensations. When Jones is choosing between option A and option B, he might sincerely attempt to account for how his choice will affect Smith. But this attempt by Jones is not Smith participating in Jones's choice; it is Jones *imagining* how Smith might feel. Ultimately, Jones has only his own subjectively felt assessments to guide him in choosing. This fact is so regardless of how sincerely and carefully Jones attempts to take into account the interests of others when making choices.

The obvious impact that our choices have on others as well as on our future selves led Buchanan to distinguish between "choice-influencing costs" and "choice-influenced costs." Choice-influencing costs operate at the moment of choice in each decision-maker's mind, leading that decision-maker to choose one option over another. Choice-influenced costs are existing constraints that were created by choices made in the past. A hypothetical illustration will be useful.

Jones is today considering whether or not to buy a pet dog. He imagines, to the extent that he can and that he believes worthwhile, all of the benefits (for him) of owning a dog and all of the costs. These costs include not only the purchase price of the dog but also his expectation of what he likely must sacrifice in the future as a consequence of owning the dog—for example, how much he'll have to pay for dog food and veterinary services, as well as whatever inconvenience might be in store for him, such as when he must walk the dog on bitterly cold mornings.

If Jones choses to buy the dog, he is aware that this choice will entail him incurring costs (and enjoying benefits) in the future. And indeed in the future such costs emerge. While walking his dog on a frigid January morning Jones will likely feel some discomfort from having made the choice to buy the dog. This discomfort—the inconvenience, irritation, and other downsides that Jones experiences as a result of walking the dog—is an example of "choice-influenced costs."

Jones might well discover that the costs of owning a dog are higher than he anticipated when he chose to buy it. By owning the dog, he discovers that he must give up more valued opportunities than he anticipated. As a result, Jones might now choose to sell or to otherwise get rid of the dog. But his experience with the dog—these choice-influenced costs—cannot undo Jones's earlier choice to buy the dog. All costs that *influence* choices are anticipations of imagined forgone benefits; such costs are not the actual experiences that the chooser later encounters as a result of having made the choice.

Unlike choice-influencing costs, choice-influenced costs can fall not only on the chooser but also on other persons. If the barking of Jones's dog irritates Jones's neighbor Smith, Smith experiences a negative impact of Jones's choice to buy the dog. Upon hearing Jones's barking dog, Smith must make choices that she would otherwise not have to make. Complain to Jones or not? Build a sound-absorbing fence or not? Summon the police or not? Move to a different neighborhood or not? Jones's choice to buy the dog clearly influences the choices that Smith must make and, hence, influences the costs that Smith incurs.

To the extent that a decision-maker accurately accounts for future consequences, the choice made now will lead to fewer "regrettable" choices having to be made later by him and by other individuals. If Jones takes account of the annoyance that Smith would suffer from hearing his dog bark, Jones might make a different decision. He might choose to buy a dog from a breed less likely to bark, or to buy a dog more suitable for living indoors, or perhaps to not buy a dog at all.

Profit maximization

Economists often assume that firms maximize profits, but there is no way to tell whether firms actually succeed at doing so. The individuals who run firms make choices, and those choices might turn out to be profitable. But it's impossible to tell whether those choices have *maximized* profits, because it's impossible to identify the value of forgone alternatives.

Consider the hypothetical example of an entrepreneur who wants to open a bakery and is deciding between two locations to rent as a storefront. The baker could rent a location on Elm Street that has high visibility for $2,000 a month, or a lower-traffic location on Oak Street that would get fewer walk-in customers, but that rents for only $1,000 a month. Which location is the profit-maximizing one?

Assume that the baker believes the Elm Street location to be not worth the higher rent, so he instead rents the Oak Street location for $1,000 a month. The business is successful and the baker earns a profit. But did the baker choose the profit-*maximizing* location? It's possible that the additional business the baker would have enjoyed in the other location would have more than compensated for the higher rent. Yet there's no way to tell because the baker didn't choose the other location. One can only speculate about whether that other location would have been more profitable.

An implication of the subjective nature of cost is that one can never know whether firms are actually maximizing profits because one cannot know how profitable firms would have been had their managers made different choices. One can tell whether or not a firm is profitable, that is, whether or not a firm earns enough revenue to survive, but one cannot tell whether a firm's profits are at a maximum.

Some implications

As mentioned, economists often assume that that firms maximize profits and that individuals maximize utility—that is, seek maximum satisfaction from their actions. But one clear implication of the subjective nature of cost is that no one can tell whether this is the case—not outside observers making those assumptions or even the individuals who are making the choices themselves. The cost of a choice is the value of the highest-ranked *forgone* alternative. Yet precisely because that alternative is forgone, there is no way to know how much utility or how much profit it would have yielded had it been chosen. Individuals realize the utility they get from the options that they choose. But these same individuals can only *conjecture* about the utility they would have received had they chosen differently. Firms can tell whether they are profitable, but they cannot know whether they would have been more (or less) profitable had their managers made different decisions.

Because cost is subjective, different individuals might make different choices in the same situations, and both could be the best choices for those individuals. To take a trivial example, when offered the choice between vanilla or chocolate ice cream, two individuals could make different choices, each of which might be best choice for the individual who makes it. The principle applies to more complex decisions, such as whether to rent or buy a home, whether to take a higher-paying but more stressful job, or whether or not to get married.

Similar implications apply to public-policy measures. The impossibility of observing and objectively measuring costs means that the kinds of corrective taxes that most economists recommend to deal with carbon emissions and other such externalities cannot be conclusively justified. Consider a smoke-emitting factory polluting the air of those who live nearby. Some people might view the smoke as a major imposition while others barely notice it. Any external cost is purely subjective.

It's important to note that the impossibility of objectively measuring costs didn't lead Buchanan to throw his hands up in despair and conclude that we should not act in the face of externalities. He did not believe that we can never sensibly judge whether one policy is better or worse than any other. Among the policies that he supported are those that enhance the ability of all affected parties to bargain with each other, with each party possessing the right to reject offers that that party finds unappealing. Such bargaining allows each affected individual to reveal, through his or her own choices, whether or not he or she finds some cost to be worth paying.

Put differently, the important implication of Buchanan's theory is that, whenever possible, disputes and conflicts are best handled by having affected individuals bargain among themselves rather than by having third parties—in practice, by having government officials—impose "solutions." This recommendation that individuals bargain amongst themselves raises the question of how they can actually do so in order to resolve conflicts and to produce collective goods. Much of Buchanan's research dealt with exactly this challenge.

Chapter 5

Clubs and Externalities

While it is evident that some goods and services may be reasonably classified as purely private, even in the extreme sense, it is clear that few, if any, goods satisfy the conditions of extreme collectiveness.

—James M. Buchanan, "An Economic Theory of Clubs" (1965)

The term "public goods" is often used to describe goods that, once produced, can be consumed with equal enjoyment or satisfaction by many people. The premier example is national defense. If the government provides military protection to some individuals in a geographic area, others in that area will be equally protected. Another example is roads. Streets and highways built for some drivers can be used by others. Libraries are another example, in that a library built for some people can then be used also by other people. Parks, once produced, can be open to everyone. This way of looking at goods divides them sharply into two distinct categories: public goods and private goods.

Private goods, like a sandwich, are consumed by one person. If you eat a sandwich, it is not available for anyone else to eat. In contrast, public goods, once produced, can be consumed by many people. Yet reflecting on the examples in the previous paragraph, it is apparent, as Buchanan says in the quotation that opens this chapter, that there are few goods that can be classified as *pure* public goods. There are two reasons for this. First, most goods that are used collectively can eventually become congested or overused, lowering the benefit people get from consuming them. Congestion can become so heavy that it prevents additional users from having access to that good altogether. Second, people often must be in the proximity of the good to use it, which means that it is not really available to everyone.

Consider a road. When it is uncongested, additional drivers have access to the road and can use it along with those who are already on it. This scenario fits the traditional definition of a public good. But as more traffic enters the road, there will come a point at which additional users slow everyone down. When congestion sets in, the benefit to each individual user declines. Eventually, roads can become so congested that an additional driver cannot enter the road until an existing driver leaves it. A congested road is not a pure public good. The same is true for a congested park and a congested library.

Similarly, people not in proximity to the public good are unable to use it. A library or park that is available to residents of one community is of little use to people who live hundreds of miles away. Even national defense—the archetypal "pure" public good—can, in practice, provide more defense to one area of a nation, leaving other areas more susceptible to invasion.

To fill in the broad gap between purely private and purely public goods, Buchanan developed his theory of clubs. Goods owned by a club are consumed by many individuals but, realistically, become congested if too many people join the sharing group. This is one reason why most clubs limit their membership.

The theory of clubs

Consider a swimming pool. Is it a private good or a public good? Some people do own their own pools individually, but others, while they would like to swim, do not feel that having their own pool is worth the cost, or they might want to use a pool larger than the one that they are willing to own personally. Some swimmers who want to do laps might find a typical backyard pool too confining, while others might prefer to join a group at a club pool rather than swim alone in a private pool. For diverse reasons, people join swim clubs and use the club pools collectively.

Members of the club must collectively answer two questions. First, how big a pool should the club build? Second, how many members should the club have? These two issues are interdependent. The larger the pool, the larger will be the group that can comfortably share its use. And the larger the membership, the larger the pool must be to accommodate the members.

Buchanan analytically derived an answer for these two questions—an answer meant to identify both an optimal quantity or "size" of the club good and an optimal number of users to share it.

Up to some point, people will prefer a larger pool despite the fact that the costs of building and maintaining a pool rise with its size. But the costs of the pool are divided among all of its members, so more members will bring the cost per member down. For a given membership size, there will be an optimal size of the club good. Similarly, for a given size of the club good, there will be an optimal size of the club's membership. Buchanan solves these two issues simultaneously to show that the club has an optimal membership size and an optimal quantity, or size, of the club good.

In this way, Buchanan's theory of clubs provides a more realistic and complete depiction of the "publicness" of various goods. Viewed as an explanation of actual clubs, Buchanan's theory sheds light on the reason they are organized as they are. His theory of clubs also sheds some light on the way that collective organizations, more generally, should be designed.

Clubs and governments

Buchanan develops his theory explicitly around clubs, but it's clear that the theory applies also to governments and lays a foundation for a theory of federalism. Club goods have an optimal size and an optimal sharing group, and different goods have different optimal sizes and sharing groups. Thus, his theory provides a sound rationale for having a federal system of governance with governments at different levels.

A park or a library can be shared by people who live nearby, so the optimal sharing group typically will be smaller than the optimal sharing group for national defense—a good that exhibits significant economies of scale. Bigger armies with more powerful weapons have an advantage over smaller armies, so the optimal sharing group for national defense is larger than for parks and libraries.

Similarly, the optimal sharing group for higher education is larger than for elementary education, so elementary education is produced at the local level while higher education is often produced at the state or national level. Some nations, and some states and provinces, have governments that are more centralized than others. If government is going to produce goods for collective consumption, Buchanan's theory of clubs offers guidance on the optimal degree of centralization, and at what level various collectively consumed goods are most efficiently produced. The first question to answer is: What is the optimally sized sharing group for that particular good?

Federalism

Buchanan refers to federalism as "an ideal political order" with several advantages. First, federalism pushes government production toward having more market-oriented characteristics. Consider a supermarket analogy. Shoppers can enter the supermarket and choose among many items to put into their market baskets for purchase. Each shopper can choose, individually, which items to buy and which not to buy. No two shoppers need make the same selections. In contrast, whatever market basket a government provides is provided to everyone within that government's jurisdiction. Of course, politicians run for office by offering different political platforms to voters—different market baskets—but all voters end up with the particular market basket that the winner of the election supplies.

Federalism offers citizens more choice, because citizens can choose among jurisdictions. Obviously this choice is not exactly like filling one's own individualized supermarket basket. But if a person has many jurisdictions to choose among, she can choose the particular jurisdiction, or basket, that comes closest to satisfying her desires. As Buchanan says, "The principle of federalism emerges directly from the market analogy" (Buchanan, 2001: 69).

Buchanan also saw federalism as a mechanism for constraining the actions of governments. Most obviously, under federalism people can move from one local or provincial jurisdiction to another. Eager to keep and to attract citizens, governments at the same level in a federal system thus each have stronger incentives to provide a mix and pricing of public goods that is attractive to large numbers of people.

In addition, federalism can encourage governments at *different* levels to police each other. This outcome is most evident in contemporary society when higher-level governments constrain the activities of governments below them. But Buchanan also sees a potential role for lower-level governments to monitor and police governments at higher levels. To this end, he recommends the possibility of secession. If lower-level governments have the right to secede from the jurisdiction of a higher-level government, the higher-level government has stronger incentives to govern wisely and effectively than if secession were impossible. The United States was formed in this way when the colonies seceded from Great Britain. More recently, and similarly, Great Britain seceded from the European Union.

There is also a connection between federalism and individual liberty because federalism gives individuals a choice of government jurisdictions. The choice itself is beneficial, but the fact that the choice exists also helps prevent governments from abusing their power, because abused citizens can more easily leave. Buchanan gave much thought to optimal constitutional design, as will be discussed in Chapters 8 and 9, and federalism was one component of constitutional design he advocated. It provides citizens with both greater choices and offers a constraint on government power.

Externalities

An externality exists when the actions of some people impose costs or convey benefits to others not involved in those actions. One common example is smoke from a factory that pollutes the air that nearby individuals breathe. The typical remedy suggested by economists is to tax the externality-generating activity, or if that is not feasible, to impose a regulation that reduces the external cost—the cost that's imposed on third parties.

Buchanan's views on the existence of externalities conform to those of mainstream economists, but he departed from those scholars on the desirable remedies for externalities. He maintained that when externalities cause resources to be used inefficiently, individuals have an incentive to find ways to remedy these inefficiencies on their own. If some people impose external costs on others, both parties have an incentive to negotiate to remedy those inefficiencies on their own. After all, even if Jones has a clear legal right to perform an activity that results in harm to Smith, Jones will quit that activity if Smith pays him enough to do so. And if the harm to Smith from Jones's activity is greater than is the gain that Jones gets from that activity, Smith has an incentive to offer to pay Jones to quit—and Jones has an incentive to accept Smith's offer.

There is a parallel between Buchanan's views on externalities and his theory of clubs—the latter being, you'll recall, an explanation of how people voluntarily form clubs to produce collectively consumed goods. In both cases there is the prospect that resources can be allocated more efficiently, with all parties able to adjust their actions to create mutual gains. Because externalities are rarely global in nature, Buchanan's discussion of federalism reveals that it is possible for people to have the option of moving out of jurisdictions where external costs are high and into jurisdictions where these costs are lower.

Also important to keep in mind is that using taxes or regulation to mitigate externalities brings its own problems. Buchanan noted that the theoretical remedies recommended by economists would work only if industries are what economists call "perfectly competitive."

Under perfect competition, industry output of goods or services is said to be at the maximum level that economic conditions permit. That is, output isn't too low. But output *is* too low when an industry isn't perfectly competitive. And when output is too low, society is harmed. Buchanan showed that government action meant to reduce pollution from such industries, by causing those industries' outputs of goods or services to fall even further, might inflict even more harm on society. That is, it's possible that the benefit society gets from the reduced pollution is more than offset by the harm it suffers from the reduced output of goods or services.

This conclusion applies more generally. The complexities of real-world markets mean that in the absence of actual market prices for external effects, there is no good way to find *the* optimal allocation of resources. Costs are subjective, as the previous chapter explains, so without an accurate measure of external costs, any policy prescription will be based on guesswork. Externalities might result in inefficiencies, but there is no guarantee that matters would be improved by a government-directed remedy. As we noted earlier, this fact did not lead Buchanan to advocate against all government responses to pollution and other externalities, but it did prompt him to advise politicians and the public to temper their enthusiasm about governments' abilities to improve matters with interventions.

Of course, the problem with externalities, as the name suggests, is that resources are used in ways that some affected persons don't bargain for—as happens, for example, when a factory emits pollutants into the air that is breathed by all the town's residents and, thus, harms these residents. If (say) the town council had a clear property right in the town's airspace, the factory could negotiate with the council and offer to pay to it a sum to compensate the town for whatever amount of pollution the factory emits. Such a bargain would benefit both the town and factory. But if there is no clear definition of property rights in the air, then the factory will be reluctant to negotiate with the town council. It will likely simply continue to pollute without the town being compensated to bear the cost of the pollution.

Clearly defined property rights thus promote bargaining to mutual advantage—that is, toward greater efficiency of resource use—while the absence of such rights stymies such bargaining. In *The Calculus of Consent*, Buchanan and Tullock say

> If property rights are carefully defined, should not the pure *laissez-faire* organization bring about the elimination of all significant externalities? ... After human and property right are initially defined, will externalities that are serious enough to warrant removing really be present? Or will *voluntary co-operative* arrangements among individuals emerge to insure the elimination of all relevant external effects? (Buchanan and Tullock, 1962/1999: 44)

The question here is just what activities are best undertaken in the private sector, through voluntary negotiation among individuals who have incentives to strike mutually agreeable bargains, and what activities are best undertaken by government, which has the power to force people to comply with its mandates. Buchanan recognized the existence of externalities, but he argued that in many cases inefficiencies that mainstream economists assume can only be rectified through government intervention are, in reality, better addressed through voluntary arrangements.

Air pollution is a classic example of an externality. Imagine that you are enjoying a back-yard picnic when your neighbour begins burning leaves. The smoke drifts into your yard, spoiling your picnic. Is government intervention warranted? One private solution would be for you to invite your neighbour to join your picnic and burn those leaves another day. This example might scale up to neighbourhood associations negotiating with nearby neighbours to reduce nuisances. Buchanan believed that the potential for private negotiation to address externalities was insufficiently recognized by economists.

Externalities in politics

A central reason for Buchanan's caution in recommending government intervention to remedy externalities was his recognition that democratic politics carries with it a built-in externality. If one thinks of an externality as a third-party effect—that is, some people impose costs unilaterally on others—one should then see that when collective decisions are made by majority rule, the majority imposes external costs on the minority. The majority gets what it wants, forcing the minority to accept what it, the minority, does not want. This reality further reinforced Buchanan's reluctance to recommend government remedies for externalities. Government action would replace one externality with another.

This point warrants emphasis: politics contains a built-in externality. Government policies apply to everyone, whether or not they agree, unlike market exchange which only takes place if and when all parties to the exchanges agree. The nature of government means that whatever it does, it unilaterally imposes costs on some people. As Buchanan explains,

> The minimum-size effective or dominating coalition of individuals, as determined by the voting rule, will be able to secure net gains at the expense of other members of the political group.… In the simple majority-rule model, this involves, in the limit, fifty plus percent of the total membership in the dominating coalition and fifty minus percent, of the total membership in the losing or minority coalition. (Buchanan, 1999: 64-65)

Buchanan's point is partly theoretical. This outcome could happen. But his point is also partly practical. If democratic political institutions *could* be used in this way, individuals then in fact *have* incentives to use them this way because they can. It is naïve to think that some people can possess the power to manipulate the political process for their own gain without understanding that some people actually *will* exercise this power in that way.

This reasoning points directly to Buchanan's overall approach to analyzing political action. Economists, even in the twenty-first century, tend to evaluate government action as if government officials apolitically implement optimal public policies. Economists derive the theoretical optimal allocation of resources and then *assume* that government will act to achieve this optimal allocation. Buchanan's fundamental contribution was to note that just as resources are not typically allocated in markets with perfect efficiency, neither are they typically allocated by government with perfect efficiency.

Economists tend to benchmark real-world problems of market allocation of resources against a theoretical ideal that, in reality, is never attainable. Buchanan argued that the same tools and assumptions that economists use to analyze the operation of markets should also be used to analyze political decision-making, so that real-world markets are compared to real-world government allocations, rather than comparing actual market outcomes to unattainable government-engineered ideals.

Government failure

"Market failure" is the term economists use to describe market outcomes that are not perfectly efficient according to some textbook standard. Buchanan used the term "government failure" to point out that government-engineered allocations of resources are not perfectly efficient either. Therefore, if the choice is between market allocation of resources and government allocation of resources, the imperfect real-world market should be compared only with the imperfect real-world government.

Government failure arises from two problems. First, in many cases the *information* necessary to allocate resources efficiently is not available to policy-makers. Second, even if the information necessary to implement optimal policies is available, policy-makers often do not have strong enough *incentives* to implement such policies.

Buchanan's discussion of externalities provides an example of a situation in which sufficient information is not available to implement the theoretically optimal policy. In theory, there is an optimal corrective tax that could be placed on an externality to produce an efficient outcome. In practice, though, the information necessary to discover this optimal tax is unavailable. Even if policy-makers want to implement an optimal tax, they lack the information necessary to do so.

Buchanan, however, placed special emphasis on the fact that even if all the necessary information were available, policy-makers often have poor incentives to implement optimal policies. Elected officials and government employees act to further their own interests, just like everyone else. Elected officials often undertake actions designed to boost their popularity leading up to an election, and government bureaucrats often make decisions motivated by what would give them pay increases or would increase their agencies' budgets.

The protective state and the productive state

The study of public finance can be divided into expenditure theory and revenue theory. This chapter deals with public-expenditure theory, which analyzes the justifications for allocating resources through government rather than through markets. Traditional public-expenditure theory focuses on market failures—that is, on why the market does not allocate resources as efficiently as is theoretically possible—and develops theoretical models to explain how, in theory, resources could be allocated more efficiently.

Buchanan takes a different approach to public-expenditure theory. First, he divides government's functions into two conceptual categories: the protective state and the productive state. The first justification Buchanan offers for public expenditures is to *protect* its citizens. Beyond that, the *productive* state can provide collectively consumed goods in situations in which the market might perform inadequately. Chapter 7 provides more detail on Buchanan's approach, in which he envisions politics as exchange.

Two big areas in traditional public finance that cite market failure as a reason for government action are externalities and public goods, and in both of these areas, Buchanan offers a distinctive approach in which he analyzes how individuals can cooperate with each other to allocate resources more efficiently. His theory of clubs analyzes public goods by looking at the groups that consume them rather than by analyzing the goods themselves. This approach depicts public goods more realistically—as existing on a continuum between public and private goods rather than being at one extreme or the other. It also shows how individuals can *cooperate* to produce public goods. Buchanan also analyzes externalities by examining the ways in which individuals can cooperate to allocate resources more efficiently rather than relying on government-imposed solutions.

In drawing a parallel between market failure and government failure, Buchanan's insight is that democratic political systems create their own inevitable externalities. Some people can use the system to impose costs on others. This reality is a sufficient reason to raise questions about any government action ostensibly meant to "correct" a market failure. Such action unavoidably carries the risk of government failure. Buchanan concluded that when evaluating public policy, any imperfections in market activity must be compared against the inevitable imperfections inherent in government action. Such a comparison does not inevitably lead to the conclusion that government action is never warranted, but it does avoid the bias in favour of government action created by the standard assumption that government officials are fully informed and always act apolitically and exclusively in the public interest.

Chapter 6

Ethics and Economics

The normative individualist whose ontology is subjectivist operates on the presumption that by their very being as individuals, members of humankind are and must be treated as responsible for their own choices.

—James M. Buchanan, "The Foundations for Normative Individualism" (1991)

Buchanan saw a close connection between economic analysis and the political philosophy of classical liberalism. The connection begins with his individualistic approach to economics. Individuals have their own goals and desires, and the purpose of economic activity is to enable them to cooperate with each other so they can further those goals. As economists depict it, individuals have "utility functions" and they make choices that enable them to maximize their utility. What this means in more common language is that individuals have their own goals, which each individual understands better than does anyone else. And the subject of economics, as Buchanan saw it, is to analyze how individuals interact for their mutual benefit in furtherance of those goals.

Individuals gain utility from accomplishing their goals, but to do so requires that they be free to pursue their goals as *they* see fit. Buchanan says that "A motivating element is, of course, the individual's desire for liberty from the coercive power of others—an element that may be almost universally shared" (Buchanan, 2000: 117).[2] But he goes on to note that a requirement for individuals to have this liberty is that they must lack the ability to exert power over

2 Buchanan's view on this matter changed in his later years. In a series of papers published during the final decade of his life, Buchanan observed, and lamented, the rise of what he called "parentalism"—which he defined as the desire to be relieved of the responsibility of making one's own life choices (Buchanan, 2006).

others. One advantage of a market order is that it relies on voluntary exchange. Individuals can opt out of transactions if they do not see the transactions as likely to further their interests. A market order allows people to interact with each other for *mutual* gain and helps prevent some from gaining at the expense of others.

While some economists see a clear division between positive and normative analysis—between describing the facts of the world and making value judgments about those facts—Buchanan sees a close relationship between the two. While a common argument is that interjecting value judgments into economic analysis is not scientific, Buchanan argues otherwise, saying that "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, 1962/1999: 308).

Social welfare

The concept of social welfare, or the public interest, or the general will, or any similar collectivist visions of welfare depicts some concept of a common interest that stands above individual interests. But Buchanan's individualistic approach emphasizes that there is no such thing as the welfare of a group beyond the welfare of the individuals who compose the group. To say that something improves the welfare of a group can mean nothing more than that it improves the welfare of at least some members of that group without reducing the welfare of any other members of that group. Social welfare is a faulty collectivist concept. Welfare applies to individuals, not to groups.

Value and utility are subjective concepts, as Chapter 4 noted, so there is no way to compare the well-being of some individuals against the well-being of others. It would be illegitimate to say that if some public policy benefits person A more than it harms person B, the policy is in the public interest. The utility of A cannot be compared to the utility of B, so policies that harm some for the benefit of others cannot be said to be in the public interest. This idea motivates Buchanan's ideas on politics and constitutional rules, which are discussed further in chapters 8 and 9.

Even if comparisons of utility between individuals could be made, it would still be illegitimate to base public policy on such comparisons, because those policies restrict the liberty of some individuals to further the interests of others. To take an extreme example, if individual A would gain more utility from owning a slave than person B would lose from being a slave, this would not justify person A enslaving person B. To take a less extreme example but one that often forms the basis of public policy, if taking a dollar from A to give to B would give B more utility than A would lose, this fact alone does not justify taking the dollar from A and giving it to B.

The virtues of market exchange over political decision-making become more evident when taking this individualistic approach. Market exchanges make all participants better off, which enhances social welfare because these enhance the welfare of all parties to the exchanges. In contrast, political decision-making often imposes costs on some for the benefit of others. As the previous chapter discussed, political action carries with it a built-in externality, so there is no guarantee that it advances social welfare.

Adam Smith's system of natural liberty

Buchanan, who regarded himself as a classical liberal, drew on what Adam Smith called the "obvious and simple system of natural liberty" to explain his own ideas. In *The Wealth of Nations*, Smith said

> According to the system of natural liberty, the sovereign has only three duties to attend to; three duties of great importance, indeed, but plain and intelligible to common understandings: first, the duty of protecting the society from the violence and invasion of other independent societies; secondly, the duty of protecting, as far as possible, every member of the society from the injustice or oppression of every other member of it, or the duty of establishing an exact administration of justice; and thirdly, the duty of erecting and maintaining certain public works and certain public institutions, which it can never be for the interest of any individual, or small number of individuals, to erect and maintain… (Smith, 1776/1937: 651)

One can see, in Smith's vision of natural liberty, the foundation for several of Buchanan's ideas. First, Buchanan's functional division of government into the protective state and the productive state (discussed in the previous chapter) echoes Smith, who limited the duties of the sovereign to protecting the society from outside invasion and from internal oppression—the protective state—and producing public works—the productive state. Smith saw the protective and productive state as being essential to a system of natural liberty. That points to the second commonality between Smith and Buchanan: the *advocacy* for a system of natural liberty.

To quote Smith again, in this system of natural liberty, "Every man, as long as he does not violate the laws of justice, is left perfectly free to pursue his own interest in his own way, and to bring both his industry and capital into competition with those of any other man, or order of men" (Smith, 1776/1937: 651). Smith's system of natural liberty clearly encompasses free markets, and prohibits some from coercing peaceful others.

In an article titled "The Justice of Natural Liberty," Buchanan quotes this passage from Smith:

> To hurt in any degree the interest of any one order of citizens for no other purpose but to promote that of some other, is evidently contrary to that justice and equality of treatment which the sovereign owes to all different orders of his subjects. (1976: 6)

Buchanan makes use of Smith's idea in two ways. The first is the clear notion that there is no such thing as social welfare beyond the welfare of the individuals who compose society. It is unjust to impose costs on some for the benefit of others. Second, Buchanan emphasizes, drawing on Smith, that markets and market exchange have an *ethical* justification that supersedes any efficiency justification. Markets are grounded ethically in the fundamental principle of justice that declares that people should deal with each other through cooperative action rather than by force.

In the twentieth century and into the twenty-first there has been an ideological divide separating advocates of free markets from advocates of central economic planning. This division has turned largely on different beliefs about which system allocates resources more efficiently. The collapse of the

Soviet Union and Eastern European economies in the early 1990s gave a clear answer to this question. The dismal performance of those centrally planned economies offers persuasive evidence that markets work better than government planning to allocate resources.

Both Buchanan and Smith envisioned a role for the productive state in cases in which collective action could further individual interests better than market transactions alone. But the productive state does not have the same ethical foundation as the market economy. One challenge Buchanan's research program addressed was how collective institutions could be designed to draw on the ethical foundations underlying market exchange.

Liberty as the fundamental value

Buchanan described an ideal of classical liberalism that "is built on the central, and simple, notion that 'we can *all* be free'… A motivating element is, of course, the individual's desire for liberty from the coercive power of others—an element that may be almost universally shared." Liberty is an end in itself. This desire for freedom complements the operation of the market mechanism as a way for individuals to cooperate to achieve their individual goals.

Buchanan saw the market mechanism as a spontaneous order in which individuals cooperate for the mutual gain of all who engage in voluntary exchanges. Those exchanges further the welfare of the individuals who participate in them; the evidence being that they voluntarily choose to exchange. Thus, Buchanan says, "For the scientist in the academy, understanding such principles does, or should, translate into reasoned advocacy of classical liberal policy stances" (Buchanan, 2000: 114).

Armed with an understanding of economics, Buchanan saw a *scientific* basis for promoting a classical-liberal social order. By allowing individuals the liberty to make their own choices, and by enabling them to cooperate with others to achieve their goals, individuals are best able to improve their own welfare while not infringing on the liberty of others to do likewise. The social sciences, which study how people interact with each other, treat liberty as an instrumental value—that is, as a means to a higher end. About this treatment of liberty Buchanan wrote:

> Classical liberals themselves have added confusion rather than clarity to the discussion when they have advanced the claim that the idealized and extended market order produces a larger "bundle" of valued goods than any socialist alternative. To invoke the efficiency norm in so crude a fashion as this, even conceptually, is to give away the whole game. (Buchanan, 2000: 116)

Buchanan understood the strong temptation to make this efficiency argument. It is, after all, correct. But to make this argument shifts the terms of the debate to that of socialists and other critics of the market order. Yes, a market order is indeed more productive. Yet for Buchanan the *ultimate* and sufficient justification for a market order is that it is essential to protect individual liberty.

Ultimately, individuals want to make their own choices. They do not want others to tell them what to do. Fortunately, a market order allows them to make their own choices. In addition, a market is more productive than is a system in which some persons force their decisions on others. But this efficiency advantage should not distract the classical liberal from advocating liberty as a fundamental value.

Small versus large numbers

A market order works well when the cooperation of only a few individuals is needed for them to achieve their goals. The protective state is sufficient to ensure an environment in which people interact with each other voluntarily, for their mutual benefit. When a large group of individuals is required to accomplish some goals, such as producing the public works that Adam Smith mentioned, the productive state has a potential role to play at coordinating the actions of everyone in the large group.

Buchanan uses the same benchmark of mutual agreement to evaluate the role of government. Individuals should be in agreement on the government's actions. Is it ethical for governments to coerce people into paying taxes, or to force them to obey government regulations? Buchanan argued that if government actions are truly in the public interest, people would agree to grant the government that coercive power. Taking this concept of mutually agreeable exchanges to the large-numbers case and to the coercive actions of government was a big part of Buchanan's lifetime research program. He said, "Improvement 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 idea" (Buchanan, 1986).

The Samaritan's dilemma

An ethical problem arises for charitable individuals ("Samaritans") wishing sincerely to use their resources to improve the well-being of less fortunate persons who cannot currently provide fully for themselves (who we will call "recipients"). If Samaritans refuse to extend charity today, they might well deny recipients the resources they need to get on their feet in order to become more productive tomorrow. Yet an extension of charity risks giving recipients incentives to remain needy and dependent. It's a dilemma.

One way around this dilemma is for the Samaritan to attach to the receipt of any charity a clear rule establishing that the charity cease at some specific date in the future. The recipient, while receiving needed help today, nevertheless is given a strong incentive to become self-supporting before the charity runs out. If the charity runs out and the recipient is still needy, the Samaritan might feel bad—even to the extent of overriding the rule that terminates the charity. To avoid this temptation, Buchanan suggested that the Samaritan delegate the charitable activity to an agent with clear instructions on limits to the handouts.

Buchanan offers a dramatic application of the Samaritan's dilemma: an aircraft hijacking. The plane's captain can give in to the hijacker's demands, thereby reducing the risk to passengers on the current flight. Yet in so doing the captain increases the likelihood of future hijackings. In contrast, a captain who refuses to give in to the hijacker's demands, while putting his current passengers at greater risk, improves the welfare of future passengers by decreasing the prospect of future hijackings. Buchanan wrote: "Strategic courage exercised by a single captain or crew member may generate spillover benefits to all others who might face hijacking threats" (Buchanan, 1975b). Buchanan offered this example in 1975, but after the 9/11 hijackings in 2001, it is plausible that the actions taken by passengers on one flight—United Airlines #93 that crashed into the ground in Shanksville, Pennsylvania—resulted in a significant deterrent to future hijackings.

Buchanan's discussion of the Samaritan's dilemma includes a warning: "The phenomenon analyzed here takes on its most frightening aspects in its most general biological setting. A species that increasingly behaves, individually and collectively, so as to encourage more and more of its own members to live parasitically off and/or deliberately exploit its producers faces self-destruction at some point in time."

Ethics and economics

Ethics and economics, as Buchanan understood them, cannot be separated from each other, despite the efforts of some to make economics more "scientific" by removing from it any value judgments. The purpose of the social sciences, including economics, is to identify ways to improve people's well-being by gaining a better understanding of the ways that people do and might interact. Buchanan's individualistic perspective is based on two insights. The first is that individuals know their own interests better than does anyone else, so they should be responsible for making choices to further their goals. The second and more foundational insight is that liberty is a fundamental value in its own right, and so institutions should be designed to promote and preserve individual liberty.

Once again, this individualistic perspective implies that the welfare of a group can mean nothing more than the welfare of all of the individuals in the group. To further individual welfare, institutions should be designed to facilitate individual cooperation so that all individuals agree that their actions improve their well-being. Market institutions are ethical because they are based on the voluntary cooperation of individuals who engage in exchange. Buchanan judged political institutions by the same standards. Those who are subject to them should be in agreement that those institutions further their welfare.

The ethical problem that arises with governmental institutions is that, ultimately, they are based on force rather than on agreement. The threat always exists that a protective state strong enough to protect individual rights, and a productive state extensive enough to supply public goods, can expand beyond their boundaries and violate the very individual rights that it is meant to protect. If such an abusive institution emerges, it is what Buchanan called "the predatory state." An ethical government is one that citizens agree furthers their own individual ends. Much of Buchanan's work focuses on determining when this is the case, and how governmental institutions can better conform with this norm of voluntary agreement without abusing its powers. Chapters 8 and 9 consider Buchanan's views on political institutions in more detail.

Ultimately, Buchanan says,

> 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 live. (Buchanan, 1999: 288)

Chapter 7

Politics, Science, and Subjectivism

[T]he subjective elements of our discipline are defined precisely within the boundaries between the positive, predictive science of the orthodox model on the one hand and the speculative thinking of moral philosophy on the other....

—James M. Buchanan, "The Domain of Subjective Economics: Between Predictive Science and Moral Philosophy" (1982)

The positive predictive model that Buchanan refers to in the quotation above qualifies economics as a science, because economics is based on an underlying theory of human behaviour. At its simplest, this theory of human behaviour is summarized in the economist's downward-sloping demand curve. Specifically, if something becomes costlier, people will do—or "demand"—less of it; if something becomes less costly, people will do or "demand" more of it. This basic tool of economic science enables analysts to make predictions about human behavior, and opens the door to a greater understanding of a wide range of human behaviour and social institutions.

Consider a straightforward example of legislating a price ceiling to hold a price below that which would otherwise exist in a market—a cap on the price of home heating fuel, for example. Economic science conveys considerable understanding about how market prices adjust so that, in each market, the quantity supplied of a good tends to equal the quantity demanded of that good. This understanding, in itself, offers a great deal of insight. Markets coordinate the activities of buyers and sellers so that mutually advantageous exchanges occur and goods go to those persons who value them most highly. If government imposes a price ceiling on some good, however, that lower-than-market price will make demanders want to buy more of it, but will also make sellers less willing to sell it. The predictable result is a shortage. Mutually advantageous exchanges that would otherwise have occurred are blocked. Understanding this process is economic science at work.

The tools of economic science provide a great deal of insight into the nature of social interaction, and a substantial amount of predictive ability, making them "scientific" in the same way as the natural sciences are. One important difference between the social sciences and the natural sciences, however, is that social scientists are also a part of the subject matter of their studies. All of the sciences have many unanswered questions, so scientists must choose which questions to ask and address. The fact that social scientists are a part of their subject matter can, and surely does, influence the particular questions they pose.

Buchanan himself is a good example. In his autobiography, he wrote, "Those of us who entered graduate school in the immediate postwar years were all socialists, of one sort or another.... To us, the idealized attractions of populist democracy seemed preferable to those of the establishment controlled economy. It was this sort of young socialist, in particular, who was especially ready for immediate conversion upon exposure to teaching that transmitted the principle of market coordination" (Buchanan, 1992: 5). As noted earlier, Buchanan attributes his conversion to his teacher, Frank Knight (1885-1972).

This quotation directly refers to the science of economics and its ability to persuasively explain the coordination of economic activities that we observe in markets. This understanding of the way markets work is evidence of the predictive and explanatory power of economics as a science, which was essential to Buchanan's rapid conversion from a self-described socialist to a classical liberal. But this conversion leaves the classical liberal with the question of the proper role of government in a liberal social order. One answer is libertarian anarchy: In a free society, government has no place. But Buchanan rejected this option as unworkable. He said,

> To the individualist, the ideal or utopian world is necessarily anarchistic in some basic philosophical sense.... The anarchist utopia must be acknowledged to hold a lingering if ultimately spurious attractiveness. Little more than causal reflection is required, however, to suggest that the whole idea is a conceptual mirage. (Buchanan, 1975a: 3)

Why? Because without the protective state to ensure that individuals' rights are protected, society would dissolve into, to quote Thomas Hobbes (1651), a "war of all against all." That left Buchanan with the question of reconciling the institutions of government, the operation of which is based on force, with his classical-liberal inclinations.

He found the answer in the work of Knut Wicksell. Recall from Chapter 3 Buchanan telling of his excitement when, in 1948, he stumbled upon Knut Wicksell's *Finanztheoretische Untersuchhungen*. In this book Wicksell outlined a process by which individuals who pay for and consume government output could agree on what the government would produce and how much each person would be taxed to finance it.

Wicksell offered a connection between economic science and classical-liberal values founded on agreement and voluntary action. For Buchanan, a classical-liberal economist who saw the need for a protective state to preserve liberty, Wicksell's framework offered a foundation for the work of his entire career.

Buchanan was more than a disinterested scientist in his choice of a research program. He wanted to provide an understanding of collective-choice processes that could lead to an improvement in political institutions. His choice of topics was guided by the fact that, as a social scientist, he was a part of the subject matter that he studied.

Subjectivism and economic science

A major difference between the social sciences and the physical sciences is that the objects of study in the physical sciences behave exactly as prescribed by the laws of nature. The challenge in the natural sciences lies in discovering those laws. The social sciences face this same challenge—there are indeed laws of social behaviour, such as the law of demand. But in the social sciences there's an additional challenge: Its subjects—human beings—make *choices* about how they will behave. Predictions in the social sciences, therefore, can never be as precise, or as replicable, as predictions in the physical sciences.

As Chapter 3 described, when faced with a choice, individuals will select the alternative that they believe will best improve their well-being. The choices they make in what seem to be identical situations can vary. An individual might choose to consume chocolate ice cream today, but in seemingly identical circumstances tomorrow might choose strawberry. People might choose differently because they have a preference for variety, or as a result of something they have learned. In this simple example, someone who chose chocolate might not have enjoyed it as much as anticipated, and so might decide next time to choose a different flavour. More to the point of Buchanan's work, people might perceive the effects of some government policy and respond to what they learn by changing their behaviour.

The Samaritan's dilemma, discussed in the previous chapter, gives an example. Policies that aid the needy give people an incentive to be needy—an unintended consequence of charitable acts. Sometimes consequences are intended. A tax deduction for dependent children gives people an incentive to have children. Estimating the precise magnitude of these effects is impossible. Some people will choose to have more children because of the tax incentive, while others will not. Some people will choose to remain needy to collect government subsidies; others will not. And the same people could make different decisions at different points in time. People can, and often do, change their minds and alter their behaviour.

Are policies such as tax deductions for dependent children in the public interest? Value is subjective, so there's no way to reliably measure the policy's costs and benefits. Whether or not a policy is in the public interest is determined by the *subjective* values placed on that policy's consequences by all individuals who are affected by it. This group includes both those who are targeted as the policy's beneficiaries and those who must pay the taxes to finance it. Because value is subjective, policies that benefit some but impose costs on others cannot be determined to be good or bad by weighing (undiscoverable) costs and benefits. The only way to draw a definite conclusion that a policy is in the public interest is if everyone affected by it agrees that it is.

This unanimity of agreement is an advantage of market exchange, as viewed from the perspective of economic science. Everyone who is party to a market exchange voluntarily agrees to it, providing strong evidence that that exchange is in the public interest, because it is in the interest of all of its participants.

Individual choice in voting and the market

The title of this chapter, "Politics, Science, and Subjectivism," is the title of an article Buchanan published early in his career, in 1954. He grappled with the issues he raised in this article throughout his career. He noted the advantages of market exchange, as just described. Everyone benefits, the evidence being that they actually agree to participate in the exchange. For several reasons, this situation stands in contrast to the political allocation of resources.

One difference between choosing by voting versus choosing in the market is that, in the market, each individual actually gets what he or she chooses. If some people choose Coke and others Pepsi, everyone gets what they choose. In voting, by contrast, those on the winning side generally get what they voted for, while those on the losing side have to take what those who win at the voting booth prefer.

Another important difference is that people who make market choices get what they chose *immediately*, whereas in voting even those who voted for the winning side only get a promise that they will eventually get what they voted for. Voters choose what they hope to get in the future rather than what they will get in the present. Therefore, in politics, even those on the winning side might not ever actually get what they voted for. One only need think of recent candidates for political office who have run on platforms promising balanced government budgets. Voters can vote for a balanced budget, but even if the candidate supporting that option wins, there is no guarantee that voters will actually see the budget being balanced.

Yet another difference is that when individuals vote, they are expressing preferences for social outcomes to be applied to everyone. In contrast, when individuals engage in market transactions, they are making choices only for themselves. And an individual's social preferences might differ from his or her personal preferences. Buchanan offers a somewhat dated example by noting that a person might vote for alcohol prohibition but at the same time buy alcoholic beverages for personal consumption. Such behaviour is not necessarily inconsistent, Buchanan points out, because people's preferences for rules that apply to everyone might legitimately differ from their personal consumption preferences.

Other differences between politics and markets arise because, except when the number of voters is tiny, the likelihood that any individual voter will cast a decisive vote is vanishingly small. This fact means that individual voters do not choose outcomes, as they do in the market. Instead, individual voters are expressing a preference for one outcome over another. In the market, if one chooses Coke, one gets a Coke. If one instead chooses a Pepsi, one gets a Pepsi. But when voting, the outcome is very likely to be the same regardless of how any single individual votes, or whether the individual even casts a vote at all.

This reality has several important implications. First, individuals have less of an incentive to vote than they do to make market choices. If they make no choice about what to have for lunch, they go without lunch. If they do not vote, they get the same political outcome as they would had they voted. And because one vote will not be decisive, people have little incentive to learn enough to cast informed votes should they decide to vote. If a diner makes a poor choice about what to have for lunch in a restaurant, that person gets a bad lunch. If that person makes a better choice, he or she is served a better lunch. In contrast, regardless of the quality of the choice the voter makes, he or she is served whatever public policies follow from the outcome of the election.

Buchanan described yet another difference between individual choice in voting and individual choice in the market as "perhaps one of the most important." This difference is found "in the nature of the alternatives offered the individual in each case." In the market, people are free to choose a variety of goods, and can make adjustments by taking a little more of some goods in exchange for a little less of others. But in voting, people choose between alternatives that are more or less mutually exclusive. Voting for one candidate's platform means voting for everything in it, rather than voting for everything in a competing candidate's platform.

Imagine a shopper in a supermarket choosing specific items to put in his or her cart. Each shopper gets exactly the mix of goods that he or she prefers. And it is highly unlikely that the contents of any two shoppers' carts will be the same. But if the choice of what groceries someone is taking home is instead made by voting, candidates would fill up shopping carts, and then voters would vote only for whether they would rather have the bundle of goods in one candidate's cart or the bundle in another candidate's cart.

As already noted, some voters would end up with the basket of goods that they did not vote for. But even voters who do choose the "winning" basket will surely get with this basket some particular goods—that is, policies—that they do not want. Further, there will be policies they wish they had more of, but which aren't in the winning basket. One unfortunate result of what we might call "the bundling effect" is that no candidate really knows just why he or she won the election—or why other candidates lost the election. The difference is between having a bundle of goods that individuals choose themselves, as in the market, or a bundle of goods chosen by someone else.

Even with this fact in sight, voting looks better than it really is. Voters can see the goods at the top of the basket, but there might be goods lower down in the cart that voters do not see and do not want. Voters can only see part of the basket when they are voting. Once winners are elected, what they actually deliver to voters can differ in important ways from what voters thought they were choosing when they voted.

Buchanan offers many reasons why people are better off with institutions that allow them to make their own individual choices rather than having to accept outcomes that are collectively chosen. Yet he also sees that in some cases it is necessary to have collective choices to further individual welfare through the protective and productive state. Thus, when political decision-making is necessary, he calls for institutions to be designed so that they resemble as closely as possible the desirable characteristics of market institutions.

The science of politics

When Buchanan began his career in the mid-twentieth century, the nineteenth-century discipline of political economy had been clearly divided into economics and political science. Economic analysis of public policy consisted of discovering possible inefficiencies in the way that markets allocated resources and deriving theoretically "optimal" policies to reallocate resources more efficiently. Buchanan emphasized that real-world market allocations of resources appear inefficient only because these are being compared to theoretical ideals, with no assurance that what might be ideal in theory can ever be accomplished in practice.

Buchanan argued that it is inappropriate to compare real-world markets to a theoretical but likely unobtainable optimum. Rather, the same tools that economists use to analyze the market allocation of resources should be used to analyze political decision-making. Real-world market outcomes should be compared with real-world political outcomes to evaluate whether government intervention in the allocation of resources could result in an improvement. This method was at the foundation of the public choice revolution.

Public choice looks at the information available to government decision-makers—often they do not have the information necessary to find that theoretical optimum—and the incentives that government decision-makers face. Even with perfect information, political decision-makers might find it in their interests to make decisions that benefit themselves and their cronies rather than to work to further the interests of their constituents.

The same tools developed by economic science can, and should, be applied to analyze political decision-making. Mid-twentieth century political science had gone part-way toward this type of analysis in that it did recognize that powerful individuals could, and did, use the political system to their personal advantage. But at that time political science was largely descriptive and lacked the theoretical foundation that economic science, when done well, can provide. While Buchanan was a leader in pushing this public choice approach to analyzing political decision-making, many political scientists also saw its advantages. One result is that the public choice revolution has had at least as large an impact on political science as it has on economics.

Politics and science

Yet while science can and should be used to *study* society, Buchanan warned against believing that there are scientifically discoverable objective truths about the particular ways that society should be ordered and about how it should operate. Strongly influenced by his revered teacher at the University of Chicago, Frank Knight, Buchanan rejected the notion—one that was and remains popular especially among progressives—that problems that emerge in society can be solved purely by the application of science.

A purely scientific "solution" to the problem of appropriately allocating resources among different individuals presumes not only that there exists for society *an* ideal allocation of resources, but also that such an allocation can, in principle, be identified objectively by a third party, such as an observing economist or government official. But economics makes clear that, as the economist Thomas Sowell (1987) puts it, "there are no solutions, only trade-offs." Increased access to health care is possible only by enduring reduced access to transportation vehicles and other valuable goods and services. The benefits enjoyed as a result of preserving forests from being razed and replaced by housing developments come at the cost of a lower supply of housing.

How much health care should be supplied? How much forest land should be preserved? The answers depend upon individuals' subjective preferences, not upon facts objectively discoverable by professors, politicians, or bureaucrats.

Individuals also have subjective preferences for matters commonly regarded as non-economic, or "political." How much freedom of speech should be sacrificed in order to decrease the risk of violent urban rioting by 10 percent? And how much, if any, additional sacrifice of freedom of speech is justified in order to decrease the risk of such rioting by another five percent? Jennifer's answers to these questions will likely differ from Jason's, and each of their answers will likely differ from Jocelyn's. Because both freedom of speech and urban peace are goods valued by nearly everyone, questions such as these have no objectively correct answers.

It follows that not even the most ideal economic or political outcomes are akin to objective, scientific truths. Economic and political outcomes are *compromises* among people with legitimate differences in their preferences. These outcomes can never be correct or incorrect in the same way that an answer to the question "What is the speed of light?" is correct or incorrect. The correct answer to the question about the speed of light is not a compromise among different answers offered by different physicists—the speed of light is what it is, objectively, regardless of physicists' estimates of it. But the "correct" allocation of resources and "correct" level of protection of free speech are indeed nothing more than the compromises that emerge from the economic and political bargaining of many individuals, each with different preferences.

In short, said Buchanan, politics is about finding peaceful agreements among people with different preferences on collective outcomes. Politics, unlike science, is not about making "truth judgments." The challenge is to discover and use the set of rules that best promotes the making of compromises among people with different preferences. Legitimate scientific inquiry and judgment can play a role in assessing how well or poorly some existing or proposed set of rules will serve this goal. Even here, though, Buchanan warned that people's differences in fundamental values means that there is no universal one "best" set of rules, scientifically discoverable, for all peoples and for all times. In the end, the best set of rules is that which wins the unanimous approval of the people who will live under it.

Chapter 8

Politics as Exchange

Collective action is viewed as the action of individuals when they choose to accomplish purposes collectively, rather than individually, and the government is seen as nothing more than the set of processes, the machine, which allows such collective action to take place.

—James M. Buchanan and Gordon Tullock, "The Calculus of Consent" (1962)

Individuals engage in market exchange because it is mutually advantageous for them to do so. They voluntarily agree to trade because all parties to each exchange view it as a way for each party to further his or her own individual interest. The most familiar kind of market exchange is the simple "two-party" exchange: you give me some fish in exchange for some of my bananas. But much exchange involves many individuals, each still seeking his or her own gain, consciously organizing together to pool their resources and efforts. Thus, individuals often work together through collective organizations to carry out those mutually advantageous activities. Some organizations, such as clubs and firms, are voluntary, but other kinds of collective action are taken through government. When government is used ideally, people exchange with each other *politically* in order to accomplish ends that they could not accomplish individually or through market exchange.

Individuals who want to drive from one city to another, or who just want to drive from their homes to do local shopping, each acquire an automobile through standard market exchange. But these individuals do not acquire the roads on which they drive through standard market exchange. Individuals, as such, are not in a good position to buy their own roads. Buchanan's theory of clubs, discussed in Chapter 5, helps us to understand why the optimal number of people who share the use of a road is a number large enough to warrant collective action. Government consists of a set of institutions that, *if well-designed*, enable large numbers of individuals to engage in exchange *collectively* for their mutual benefit.

In Buchanan's division of government activities into the protective state and the productive state, it is the productive state that best embodies his idea of politics as exchange. One hopes that the activities of the protective state meet with the approval of each and every one of the state's citizens. Buchanan shared Thomas Hobbes's view that without the protective state, life would be a war of all against all. To create the protective state, individuals agree only to not violate each other's rights, with the state enlisted to enforce this agreement. The productive state does more than the protective state. As Buchanan envisioned it, the productive state arises from an agreement among citizens to pool their resources to collectively produce goods and services that would be difficult to produce individually or through standard market activity.

Ideally, the outputs of the productive state result from collective agreement in which individuals exchange their tax payments for the collectively produced outputs—outputs such as pollution abatement, roads, and municipal parks. But how can citizens determine the size and range of duties of the productive state that will be most welfare-enhancing? How can they ensure that the state does what the people wish it to do and *only* what they wish it to do? As already noted, Buchanan's answer was to limit the activities of the state to those that command agreement from all of its constituents. But this benchmark of consensus on state activities presents a challenge. In the real world, people have not agreed to the activities of the state. Under what conditions could people be depicted as being in agreement with institutions to which they have not actually agreed? This chapter discusses the conditions that Buchanan identified as ones that would enable all individuals to be legitimately described as being in agreement with government actions.

Agreeing to the exchange

Buchanan extended the market-exchange logic—one in which all parties to an exchange voluntarily agree to it—to collective activity. The activities of the state would benefit everyone if *everyone* agreed to them. It follows that the voting rule that would make political exchange fully analogous to market exchange is unanimity. Despite the widespread tendency to view the ideal of democracy as embodied in simple majority-rule voting, Buchanan understood majority rule as being just one of many possible and justifiable political decision-making rules.

Groups can agree by two-thirds majority, 75 percent majority, 90 percent agreement, whatever-percent majority. But any voting rule short of requiring unanimous consent leaves open the possibility of political "externalities"—some people imposing costs on nonconsenting others. Whether it's a simple majority imposing costs on a minority, or two-thirds of the voters imposing costs on the other third, in the absence of a requirement of unanimity some people will impose costs on others. The differences among any voting rules—again, other than one requiring unanimous consent—are just a matter of degree. Only by requiring unanimous consent can voters be assured that whatever they approve is truly in everyone's interest.

Buchanan's insistence that all political activity ultimately be grounded in unanimous consent follows from his individualistic approach. Individuals only, not groups, possess preferences. Furthermore, as Chapter 7 noted, value is subjective, so it's impossible for one person to know the mind of another. If a public policy benefits one individual but harms another, there is no way to determine if the benefit to the one person outweighs the harm suffered by the other.

The only way to be sure that any public policy is in the best interest of a group of people is if it is in the best interest of every member of the group. Therefore, the only way to determine if particular public policies are in the public interest is to have them approved unanimously.

But of course it's impractical to require that literally everyone consent to each and every proposed government action before that action is taken. With such a requirement, government would get nothing done. Yet Buchanan, convinced that people do indeed want both a protective state and a productive state, understood that people want government to be able to act. They want government to protect their persons and rights, and to supply collective consumption goods and services such as roads and wastewater treatment.

Is there a way to ensure that government truly acts with the consent of the governed without bogging it down in the difficulties of having to secure unanimous consent for every action that it takes? Addressing this question consumed much of Buchanan's time and energies. And his answer is embodied in his (re)formulation of social-contract theory.

A social contract

Social-contract theory has a long history. It dates back at least to Thomas Hobbes's 1651 tract, *Leviathan*, which provides a starting point for Buchanan's thinking on the social contract. Hobbes conjectured that without government life would be a lawless war of all against all, and that everyone therefore benefits by agreeing to obey a government committed to preventing such strife. Hobbes argued that society can be made orderly and productive only by a powerful government in possession of a great deal of discretionary authority to issue commands. In his 1975 book, *The Limits of Liberty: Between Anarchy and Leviathan*, Buchanan considered the notion of an ideal stateless society, but, agreeing with Hobbes, dismissed orderly anarchy as unworkable. For society to be orderly, Buchanan insisted that the protective state is necessary.

The social contract, as Buchanan viewed it, is the set of rules and constraints to which everyone would agree. The legitimacy of the specific terms of the social contract is defined by the benchmark of unanimity. The theory is plausible, if somewhat open-ended. For example, almost everybody would agree that we should not assault or kill each other. Even murderers recognize that they are violating this social norm that commands broad agreement.

Most people would agree that we should not steal each other's property, although some gray areas might appear because there can be legitimate disagreement over what constitutes rightful ownership. (Is a patent on an invention from 30 years ago a legitimate property right?) But the principle behind the social-contract theory of the state is that people generally agree that they have certain rights and obligations toward each other, and, in addition, that they should cooperate, through government, to ensure the production of collective goods such as roads. The unanimously agreed-upon rules according to which a government will act as it performs these tasks constitute the social contract.

In reality no such contract exists. People living under the jurisdiction of a government are subject to that government's mandates without necessarily having agreed to them. Even if in principle they would agree, they had no actual opportunity to express their agreement or disagreement. This fact leaves two big questions for the social contractarian. First, in what sense could people be said to be in agreement with a social contract when there is no actual agreement? Second, what can usefully be said about the terms of that contract?

Hypothetical agreement

In *The Limits of Liberty* Buchanan began his approach to answering these questions by imagining Hobbesian anarchy. The relevance of this hypothetical journey to anarchy is that people in that situation lose all social status. In an anarchic condition, there are no social or economic institutions that determine how people interact with one another. No one is a legislator, a corporate CEO, a Princeton alumnus, a factory worker, or a welfare recipient. To design institutions that create social order and a foundation for productive activity, people hypothetically bargain with each other in a situation of relative equality.

Buchanan imagined individuals negotiating a social contract from Hobbesian anarchy, and he imagined the likely outcome of such a negotiation. There is uncertainty about the detailed terms of an actual renegotiated social contract, but Buchanan argues that an individual hypothetically agrees with a social contract if its terms fall within the bounds of what might reasonably be expected as a result of such a negotiation from anarchy.

Buchanan built his social-contractarian framework on this foundation of hypothetical unanimous agreement reached from anarchy. He counts people as being in agreement with the social contract if they would agree under these hypothetical conditions. We could imagine, for example, that some financially secure individuals in the real world would not agree to a highly progressive tax system that would transfer a lot of their income to people with lower incomes. But in the hypothetical state of anarchy, people would be very uncertain about their income levels once a social contract was negotiated and life commenced under it. If those individuals would agree, while in a hypothetical state of anarchy, to income transfers under the social contract, then they are in agreement with such transfers in the real world, according to Buchanan's criterion.

Such mental exercises do not actually identify specific terms of the social contract. Buchanan recognized that we cannot know which particular contractual terms all individuals in hypothetical anarchy might agree to. But reasoning in this way can give some idea of the general "appropriate" scope of government. For example, because, as noted earlier, almost everyone would agree that people should not murder each other, the social contract would certainly empower government to prosecute and punish murderers. Almost as uncontroversially, most people would agree that a majority should not be empowered, absent good reasons, to appropriate the property of a minority—and so the social contract would feature restrictions on such majoritarian actions.

Chapter 9 looks at Buchanan's further application of the principle of unanimous agreement that underlies his vision of politics as exchange.

The limits of liberty

The title of Buchanan's book, *The Limits of Liberty: Between Anarchy and Leviathan*, summarizes the issue that most concerned him throughout his career. His normative goal was to preserve liberty, and he saw threats to liberty coming from two opposite directions. On one side, if government's power is too constrained, anarchy will arise and create a society that is a war of all against all, where no one's liberty is protected. On the other side, if government's power is insufficiently constrained, it will grow into a Leviathan that itself violates the liberty of its citizens. The challenge, one that Buchanan explicitly took from the American founding father James Madison, is to design a government that is sufficiently powerful to protect individual rights and to produce collective goods, but one that also is sufficiently constrained that it does not violate the individual rights that it is created to protect. The limits of liberty lie between anarchy and Leviathan.

Buchanan felt strongly that individuals should not be compelled to live under rules that are imposed on them unilaterally by others. To be legitimate, government must enjoy the consent of *everyone* under its power. The requirement of this consent lies at the foundation of the idea of politics as exchange. The practical problem, of course, is that government would get nothing done if it had to get unanimous consent for every policy change. The costs of arriving at collective decisions would prevent bargains from taking place if everyone were required to agree. Thus, Buchanan was interested in exploring institutional arrangements to which everyone would agree if decision-making costs did not stand in the way. That is the reason he suggested the types of arrangements people would agree to in a hypothetical renegotiation of the social contract from a state of anarchy.

Can individuals agree to be coerced?

The chief problem that exists with many collective activities that are potentially beneficial to all is that each individual has an incentive to free ride off of the contributions of others. This problem exists whenever it is difficult to exclude those who don't pay for some good or service from using it. Under such a circumstance, each person has the incentive not to pay for the good, hoping that others will pay for it. The result is that there will be too few contributions toward the good's financing. A good that everyone wants to consume will be underprovided.

In this situation, individuals might agree to be forced to pay toward financing the good if everyone else is also forced to pay. Everyone could hold the same opinion, saying they do not want to pay unless everyone is forced to pay, but they would all agree to a policy that forces everyone to pay. People could agree to be coerced.

The idea that people could agree to be coerced lies at the foundation of the social-contract theory of the state. Even though there is no actual contract, people would agree to give the state the authority to coerce those who violate its mandates, if everyone was bound to the same contract provisions. According to social-contract theory, because people *would* agree to be coerced for their own benefit, the exercise of such coercion violates no individual's rights.

The role of the economist

In one of his earlier papers, "Economics, Welfare, and Political Economy," published in 1959, Buchanan identified two distinct yet related roles that the economist can legitimately play. The first is that of the "economist" as such; the second is that of the "political economist."

The sole role of the economist *per se* is to improve humankind's understanding of the workings of the economy, including how economic activity is likely to be altered when changes in the economic environment occur. These might be policy changes, such as changes in tax rates or new regulations, but these might instead be changes in other factors, such as adverse weather that cuts crop yields. Economists pursue this goal through research and analyses that permit them to make predictions about the effects of such changes in the economic environment.

In contrast, when the economist steps into the role of political economist, the reason for doing so is to help citizens choose better rules under which they live. Nevertheless, like the economist, the political economist's task is not to impose his or her own values or preferences on others. It is not the job of either the economist or the political economist to recommend, much less insist upon, this policy or that. Such a role, Buchanan believed, is reserved for individuals only in their capacity as citizens.

The political economist's function is merely to propose changes in rules and institutions to which individual citizens can either agree or disagree—accept or reject. Ideally, in Buchanan's view, agreement would require unanimity, or something very close to it. If all, or nearly all, people must agree to a change in rules, then any proposed rule change that is approved by such a vote can confidently be assumed to be one that is truly socially beneficial rather than one that benefits some individuals at the expense of others. That is the essence of the idea of politics as exchange.

A rule change that is approved by such a vote would almost of necessity involve exchange among different groups. For example, a proposal to strip government of the power to levy protective tariffs might win approval only if this proposal includes also some provision to compensate parties who expect to lose as a result of the elimination of government's power to levy tariffs. The compensation need not take the form of monetary payments; it might instead take the form of some other rule change—say, a restriction on government's ability to tax corporate profits. Either way, if this (or any other) proposed rule change wins the approval of all or nearly all citizens, we can be certain that it is worthwhile as judged by the only criteria that matter: the preferences and judgment of the people subject to the rule.

Buchanan believed that economists' knowledge of economic processes makes them especially able to identify two opportunities. The first relates to rule changes that, if adopted, would increase the size of the economic pie (and, thus, in principle potentially make everyone better off). The second opportunity relates to how to structure the details of proposed rule changes in order to ensure that whatever gains arise from the changes are shared by all citizens. Once the economist, in the role of political economist, offers a menu of such rule changes, however, he or she has no more say on the matter than does any other citizen.

Buchanan's vision of politics as exchange depicts individuals deciding what they want and negotiating with each other for their mutual benefit, just as happens with market exchange. Economists and other policy "experts" can participate in the process through policy analysis, advising citizens that if policy A is adopted, they can expect B to happen as a result. But it is up to citizens themselves to decide on the desirability of various policy alternatives. Buchanan recognized that, by the very nature of government, this mutually agreeable bargaining does not always happen. Those who have political power can use the force of government to impose their will on others who do not comply. The role of the political economist is to devise institutions that constrain the power of government to prevent oppression by Leviathan government and to create governing institutions based on consent.

Chapter 9

Constitutional Economics

Constitutional political economy is a research program that directs inquiry to the working properties of rules, and institutions within which individuals interact, and the process through which those rules and institutions are chosen or come into being.

—James M. Buchanan, "The Domain of Constitutional Economics" (1990)

We cannot have everything we want, so we must choose how to allocate scarce resources to best satisfy our many needs and desires. Economics excels at shedding light on the ways that individuals make choices when subject to different sorts of "constraints" and opportunities—that is, different sorts and mixes of sticks and carrots. It is therefore no surprise that James Buchanan came to use economics to shed light on the process of choosing among rules, which by their very nature are constraints that determine the opportunities open to individuals.

Rules are constraints that we impose on ourselves, as distinct from limits on the availability of resources and other such constraints that are imposed on us by nature. The whole set of such self-imposed rules is often called "institutions." Many of these rules arise naturally in the course of human interaction. An example is the expectation that parents will care for their young children. Other of these rules, however, are consciously designed and imposed. Most obviously here are legislation and public policies. These rules affect the opportunities that each of us has and, thus, the choices that each of us make. Either way, whether a rule arises "naturally" or is designed and imposed, it can be changed.

Buchanan observed that economic analysis, for the most part, examines the choices people make subject to *given* rules. Constitutional economics, in contrast, examines the choice of rules themselves. Buchanan calls decisions on what those rules should be "constitutional decisions," while decisions that people make *within* some set of rules are called "post-constitutional decisions." Using a sports analogy, Buchanan likens constitutional rules to the rules of the game, and post-constitutional decisions to those that are made within the rules of the game. Constitutional decisions are the decisions that determine the rules under which the game is played.

Basketball, for example, is played within certain rules that constrain the choices open to players and coaches—and, importantly, to referees. Players, coaches, and referees all make a series of post-constitutional decisions within the rules. For instance, the rules define which actions are fouls. The rules also specify the penalty for each kind of foul. Sometimes players will deliberately commit fouls when they anticipate that the benefit of doing so outweighs the resulting penalty. Referees play the role of third-party enforcers of the rules, rather like government officials, and—when they, too, follow the rules—referees do their best to detect when rules have been violated and then to identify and appropriately punish the violators. Each and every one of these decisions made by coaches, players, and referees during a game is "post-constitutional."

Yet these rules of the game can be changed, as they were, for example, in 1979 by the National Basketball Association ("NBA"). Prior to that year, all successful non-foul shots made from the floor scored two points. Then, in 1979, the NBA added a three-point line. Since that time, all shots successfully made beyond this line scored three points. This rule change altered the constraints and opportunities confronting players and coaches. Many long shots that would not have been attempted prior to 1979 became, with this rule change, attractive to attempt. A change in the rules of the game led to changes in the post-constitutional decisions that players made subject to those constitutional rules, and, hence, also to changes in the outcomes of the games.

Interestingly, the now-defunct American Basketball Association ("ABA") introduced the three-point shot 12 years before the NBA did so. The NBA's adoption of this rule change was therefore likely the result of competition among different rule-making regimes—that is, competing professional-basketball leagues. Seeing the popularity of the three-point shot in the ABA, NBA rule-makers adopted it for their league. While in his work on federalism Buchanan devoted much attention to competing governmental jurisdictions, he paid surprisingly little attention to the role that competition among jurisdictions might play in crafting constitutional rules.[3]

Choosing desirable rules

Buchanan's approach to constitutional economics had a heavy normative slant. He sought to identify the contents of desirable rules, as well as the most desirable (what we might today call the most "inclusive") means of implementing rule changes. His criterion for identifying desirable rules is that they should be able to garner unanimous agreement by everyone who is to be governed by them. Desirable rules are ones that potentially work to the advantage of everyone, and desirable rule *changes* are those that are endorsed by everyone, that is, unanimously.

The logic behind the benchmark of unanimity was explained in the previous chapter. Buchanan's ideal was for all constitutional rules to be agreed to unanimously. He understood, though, two important features of reality: First, unanimity is impractical for *all* policy decisions to be approved unanimously; second, individuals who are considering constitutional rules also understand the impracticality of having all policy decisions approved unanimously. Therefore, Buchanan reasoned, when choosing constitutional rules, individuals would agree unanimously to conditions under which policy choices made *within* these rules may be approved with less than unanimous consent.

Majority rule and other decision-making rules

Of course, almost no collective decisions are made unanimously. Majority rule is common, with other qualified majorities (such as two-thirds) sometimes used. These less-than-unanimous decision rules can be desirable given that reaching unanimous agreement is quite costly. A rule of unanimity, in short, entails very high decision-making costs. Government would do very little if

3 We thank an anonymous referee for alerting us to the role the ABA likely played in prompting the NBA to change an important rule of its game.

every action it proposed to take required unanimous agreement from all of its citizens, or even from all of their elected representatives.

Collective decisions involve two types of costs, and the lowering of one cost raises the other. Each cost, therefore, must be weighed against the other. To use Buchanan's and Gordon Tullock's terminology, "external costs" are costs that people expect to bear when collective decisions go against them, such as when the person who votes for more spending on education must accept the majority's vote against such spending.

"Decision-making costs" are costs that people expect to bear in the process of negotiating to arrive at collective decisions. Decision-making costs are not the costs that each individual incurs to decide his or her preferences for collective action. Rather, decision-making costs are those that individuals incur as they participate with fellow citizens in the actual process of reaching collective agreement.

External costs would be zero if all decisions had to be approved unanimously. The requirement of unanimous approval gives to every member of the group veto power, so a collective decision could never be made that harms the interest of any group member. The lower the threshold for agreement—that is, the smaller the portion of voters who must agree to the policy change—the more likely it is that a decision will go against a particular group-member's interest.

For example, if 90 percent approval was required, decisions could be made that would go against the interests of as much as 10 percent of the group. If two-thirds approval was required, up to a third of the group could find decisions going against their interests. If the only criterion in choosing a voting rule was to keep these external costs as low as possible, groups would always require that all collective decisions be approved unanimously.

The problem with a high approval threshold is that the cost of negotiating an agreement rises the larger is the portion of voters needed for approval. In other words, the greater the proportion of the group required to agree, the higher are the decision-making costs. It will be more difficult, and hence costlier, to arrive at an outcome requiring 90 percent approval than one requiring two-thirds approval, and it will be more difficult to arrive at an outcome requiring two-thirds approval than one requiring the approval of a simple majority.

Very few roads would be built, for example, if unanimous agreement were required for the approval of each and every road project. People want roads. But people also want parks and police protection. To lower decision-making costs and, thus, to facilitate worthwhile collective action, people are willing to risk bearing higher external costs (in the form of decisions that go against them) in exchange for lower decision-making costs (which facilitates the reaching of collective decisions).

Constitutional and post-constitutional decisions

Following this framework, the voting rule to be used for making day-to-day "post-constitutional" decisions should, Buchanan argued, be chosen at the constitutional stage. If the constitutional rule is chosen unanimously, there is unanimous agreement to bear whatever costs might arise from the post-constitutional decisions that do not require unanimous approval.

At the constitutional stage of decision making, the opportunity exists to make post-constitutional choices as easy or as onerous as constitutional decision-makers choose. For example, a common constitutional rule for facilitating approval of a government budget is that the proposed budget be approved by a majority of the legislature. Yet in the United States there is an additional constitutional constraint: The president has the option of vetoing the budget bill, although Congress then has the option of overriding such a veto with a vote of at least two-thirds of the members of each house of Congress.

The straightforward logic is that people can, at the constitutional stage, unanimously agree to have post-constitutional ("day-to-day") decisions made by different decision-making rules, including, of course, simple majority rule. If decision-making rules for the post-constitutional stage receive unanimous agreement at the constitutional stage, then the use at the post-constitutional state of rules requiring less-than-unanimity do not infringe on anyone's rights, because everyone agreed to these rules.

But, argued Buchanan and Tullock, at the constitutional stage people will treat government activities that threaten to impose unusually high external costs differently than they treat activities that likely will impose low external costs. For example, a collective decision to seize people's homes is more ominous—has higher "external costs"—than does a collective decision to restrict the number of billboards along a stretch of highway. And so people at the constitutional stage will likely require that decisions to seize residential property receive a higher percentage of votes than is required for decisions about whether or not to change the policy about highway billboards.

A real-world example is jury trials for criminal cases. Being convicted of a crime carries very serious negative consequences. Therefore, it's unsurprising that in both Canada and the United States conviction of crimes requires jurors' unanimous consent. It is, of course, also true that the number of jurors is quite small, so the decision-making costs of reaching unanimous decisions aren't excessive. Yet despite the relatively low cost of having jurors reach unanimous decisions, in some civil trials in the United States—trials in which no criminal conviction or punishment is possible—jurors can reach binding decisions with less than unanimous agreement. This latter fact is an example that shows that when the external costs of decisions are lower, as they generally are in civil trials compared to criminal trials, incurring the higher costs of reaching unanimous agreement might not be worthwhile.

While these examples emphasize voting rules, they apply to public policies more generally. Constitutional rules determine how all types of collective action are undertaken and, hence, according to which particular post-constitutional decision-making rules. Constitutional rules constrain how legislators might create bureaucratic agencies, and which sorts of rules legislators may impose on the operation of these agencies.

No matter how far removed a particular day-to-day decision is from the constitutional stage, a well-designed constitution that receives unanimous approval can be interpreted as bestowing unanimous agreement to live peacefully with the procedures followed by—and with the policies pursued by—the legislature or the agency.

Buchanan was well aware that rules cannot be properly judged by how they operate in any particular circumstance. The very nature of a rule is that it is a guide to action under conditions of uncertainty.

To explain the importance of judging rules by their performance over time and in many situations (rather than in any one situation), Buchanan often used a simple but revealing example that he took from the Nobel-laureate economist Ronald Coase (1910–2013), who was for many years his colleague at the University of Virginia. The example is of a traffic light to regulate the flow of automobile traffic at intersections.

If a driver arrives at an intersection when the light is red and there is no other traffic in the vicinity, the requirement is that the driver nevertheless remain stopped until the light turns green. In this particular instance, the driver suffers a cost with no offsetting benefit. However, "the reason of rules" (to use the title of Buchanan's 1985 book, co-written with Geoffrey Brennan) is grounded in human ignorance. If the rule instead were to let motorists drive through red lights whenever they believed that there was no on-coming traffic, too many motorists would err. Traffic accidents and fatalities would be higher than otherwise. And so the small cost of requiring that motorists always obey traffic signals is a rule that, over the long run and over many instances, improves the welfare of all motorists.

Status quo

Buchanan attributed special significance to the status quo. As he said often, "We start from here." The idea is that any proposal to change the rules necessarily is done against the background of whatever benefits and costs people are experiencing under existing rules. If the rules are to be modified in a way that makes everyone better off, everyone who votes on the proposed new rules will compare them to those currently in place.

Everyone should favour changes that make everyone better off, whereas changes that make some persons better off but others worse off will face opposition from those who stand to be harmed.

Despite Buchanan's practical emphasis on the status quo as the starting point for constitutional change, he did recognize that it was possible for the status quo to contain injustices. Thinking back to the previous chapter—specifically, to Buchanan's idea of a social contract being negotiated from a position of hypothetical anarchy—the status quo could convey advantages to some people that they would lose if a social contract were negotiated. If so, people would be justified in rejecting the status quo as a starting point.

If current institutions give some people unjust advantages over others, then insisting that everyone agree to changes in the status quo would perpetuate those unjust advantages. Examples might be Apartheid in South Africa, India's caste system, and slavery in the American South. Thus, the unanimous agreement that Buchanan advocated was a hypothetical agreement from anarchy (discussed in the previous chapter) in which no individuals have institutionally based advantages over others.

Buchanan and Tullock viewed their 1962 book, *The Calculus of Consent*, as a theoretical exploration of concepts of governance that had a practical parallel in the development of American political institutions. Along these lines, the Declaration of Independence is largely a list of grievances against the King of England, detailing many ways in which Americans' rights had been violated, thus giving to the colonists the right to form their own independent government. When viewed through Buchanan's constitutional-economics framing, Thomas Jefferson's argument implied that the status quo in the American colonies in 1776 was not within the bounds of any set of rules that would have received unanimous agreement had the Americans and the British negotiated a social contract from a condition of anarchy. The importance of unanimity as the criterion for agreement appears in the Constitution of the United States, which states that it was "Done in convention by the unanimous consent of the states present..."

Desirable rules are those that meet with the unanimous approval of those who will be governed by them.

Generality and durability

When thinking about actually designing rules, any change from the status quo will probably benefit some people while imposing costs on others. How can rules be designed so that they will meet with the approval of everyone? Such an outcome is more likely the more *general* are the proposed rules. By "general," we mean that the rules apply to everyone rather than only to particular kinds of people. A rule that requires that *all* income earners pay income taxes is a more general rule than one that requires that income taxes be paid only by people of Swedish and Italian descent.

An important feature of a rule that contributes to its generality is its durability. The more durable a rule is—that is, the longer it is expected to remain in force—the less will people know how that rule will affect them in their particular circumstances as opposed to how it will affect them simply in their capacity as "citizen."

Consider, for example, a proposal to make income tax rates more progressive. If citizens believe this proposal will last for only a year or two, nearly all of today's high-income citizens are more likely to oppose it than if they believe this proposal will last for decades. That is because many of today's high-income earners understand that their incomes might be lower in the future. Therefore, by supporting the proposal for increased tax progressivity, today's high-income people are not necessarily supporting a proposal to raise their taxes forever.

Similarly, today's low-income people are more likely to support increased income tax progressivity if they believe the proposal is temporary than if they believe it to be long-lasting. After all, many of today's low-income people have reasonable hopes of being among tomorrow's high-income people.

While we can't predict whether the chances of any such proposal to be approved will rise or fall as it becomes more durable, we *can* say that the consideration that people will give to the rule will be less biased toward their own individual interests the greater is the rule's durability.

The optimistic vision of Buchanan's constitutional economics

Buchanan's goal in his constitutional-economics research program was not just to discuss the function of constitutional rules, but to search for ways to improve them. His unanimity benchmark was a big part of this effort. At the same time, he recognized that in many cases the rules under which people are governed do not satisfy his benchmark. In *The Limits of Liberty* he says:

> I have come to be increasingly disturbed by this basically optimistic ontology. As several of our right-wing critics have recognized, the "theory of public choice" can be used to rationalize almost any conceivable decision rule or almost any specific outcome under preselected rules.… Increasingly, I have found myself describing what I observe as "constitutional anarchy" rather than any institutional translation of individual values into collective outcomes.… Zero-sum and negative-sum analogues yield better explanatory results in many areas of modern politics, and I find myself, like Pareto, more and more tempted to introduce nonlogical models of individual

> behavior along with nondemocratic and nonconstitutional models of public choice. (Buchanan, 1975a: 7)

Buchanan's constitutional political economy is hopeful in its search for constitutional rules that improve everyone's well-being, but at the same time Buchanan was realistic in admitting that, often, actual political institutions fall far short of his constitutional ideal.

Constraining Leviathan

Returning to the theme sounded in the title of *The Limits of Liberty: Between Anarchy and Leviathan*, Buchanan was looking for a set of rules that would enable government to protect people's rights so they could escape a lawless war of all against all, but that also would constrain government so that a government powerful enough to protect people's rights would not be able to use that power to violate people's rights.

To this end, Buchanan often employed the assumption that government is a revenue-maximizing and power-maximizing Leviathan. While admitting that this assumption does not always describe reality in full, he defended the assumption by noting that government institutions must be designed to prevent opportunistic individuals from abusing government power. Institutions must be designed with the understanding that unfit people—people mad for power, people concerned more with being popular than with doing what's right, even people who are malevolent—will sometimes gain political office. It is prudent and wise to constrain all government officials to prevent the harm that would otherwise be unleashed by the worst government officials.

One application of this idea is found in his 1980 book, *The Power to Tax: Analytical Foundations of a Fiscal Constitution*, co-authored with Geoffrey Brennan. Conventional public-finance theory suggests that tax *bases,* that is, *what* is taxed, should be broad so that any given amount of revenue can be raised with tax *rates* that are as low as possible. This recommendation would be valid if those who in the real world design the tax system truly wish to further the public interest. But what if those in power want to maximize the revenue collected by government? In this case, broad tax bases allow revenue maximizers to collect tax revenues well in excess of what is in the public interest. Thus, constitutional rules that limit the size of tax bases can be welfare-enhancing.

This idea takes on practical relevance, obviously, when politicians propose expanding the tax base. There has been much talk recently about supplementing income taxes by creating wealth taxes. In the United States there's talk also of adopting a value-added tax—a species of taxation that has spread since the 1970s to most countries around the world. Was the widespread adoption around the world of value-added taxes welfare enhancing, or would a constraint prohibiting governments from taxing that tax base have been preferable? Buchanan's arguments point to the benefits of constraining the government's power to tax.

Chapter 10

What Should Economists Do—and Not Do?

Man's behavior in the market relationship, reflecting the propensity to truck and barter, and the manifold variations in structure that this relationship can take; these are the proper subjects for the economist's study.... The elementary and basic approach that I suggest places "the theory of markets" and not the "theory of resource allocation" at center stage.

—James M. Buchanan, "What Should Economists Do?" (1964)

James Buchanan devoted his presidential address to the Southern Economic Association to answering the question "What should economists do?"—also the title of his talk. To non-economists, this question probably seems silly, or at least surprising. Don't professional economists already know what they should do? And isn't the answer obvious—namely, study the economy?

Well, yes, of course. But what, exactly, *is* the economy? "The economy" is a familiar enough phrase, regularly used by economists and non-economists alike. But the very familiarity of the phrase likely inhibits those who hear it from thinking deeply about just what it refers to, and hence, about what exactly it is economists should study. Buchanan argued that economists had become seriously misled by their failure to think carefully about just what the economy is and what it does.

Economics as the study of choice

Textbook definitions of economics typically come from one that the British economist Lionel Robbins (1898-1984) offered in the 1930s: "Economics is a science which studies human behavior as a relationship between ends and scarce means which have alternative uses" (Robbins, 1932). A few years later, the American economist Paul Samuelson (1915–2009) in his highly influential introductory textbook offered a similar definition, elaborating considerably on the nature of those choices: "Economics is the study of how men and society end up choosing, with or without the use of money, to employ scarce productive resources that could have alternative uses, to produce various commodities and distribute them for consumption, now or in the future, among various people and groups in society" (Samuelson, 1973).

These definitions portray economics as a discipline for studying how people and societies choose. Resources are scarce, and both individuals and societies can put them to many alternative uses. Thus the question: How should society allocate its limited resources to satisfy as many as possible of its desires?

Buchanan saw two problems with this approach to economics.

The first problem is that in the twentieth century economists came to assume that each individual has a set of preferences, what economists call a "utility function," that is fixed and fully known to him or her. But, Buchanan noted, if this assumption accurately describes reality, then individuals would not truly choose. If you know with 100 percent certainty that eating the peach will give you greater satisfaction than eating the pear, "choosing" the peach over the pear is a purely mechanical act. Popular language recognizes this fact with the phrase, "It's not much of a choice," as in, for example, saying "It's not much of a choice" when confronted with the "choice" to pay $5 for a glass of beer or $6 for that same glass of beer. For Buchanan, the act of human choice necessarily involves some uncertainty about the merits of one option over another. As he concluded: "If I know what I want, a computer can make all of my choices for me. If I do not know what I want, no possible computer can derive my utility function since it does not really exist" (Buchanan, 1964: 217).

Buchanan emphasized the open-endedness of choice even further by insisting that human preferences do not exist independently of the very choices that individuals make. In his 1979 paper "Natural and Artifactual Man," Buchanan observed that individuals often want to become tomorrow people different in some details from who they are today. Individuals, for example, want to lose weight, to finish college, to become better spouses. And so, in a very real way, individuals often choose to change their preferences. Further, because the person today cannot fully know what it will be like to be the "different" person tomorrow, the choices that a person makes today change his or her preferences in ways that he or she cannot fully foresee.

Nothing said above implies that the simple textbook logic of how individuals with given preferences choose among a given set of options is useless. But this logic is only the starting point of economic analysis, not its core subject-matter. At the core is, or ought to be, analysis of how individuals interact with each other to accomplish their ends, whatever those ends might be.

A second problem with the standard textbook approach to economics is more serious. It judges how well or poorly resources are being used as if society itself is a sentient creature with its own preferences. That is, economists treat society as an individual with preferences, and then they ask if society uses ("allocates") its resources in ways that best satisfy its preferences.

But as noted earlier, Buchanan was insistent that society isn't a creature with a mind. Society has neither preferences nor the ability to choose. Only each of the many individuals who comprise society possesses preferences, and only individuals have the ability to choose.

The aggregate way of thinking that prompted economists to lose sight of the fact that groups, as such, have no preferences became popular among economists in the mid-twentieth century, especially through the influence of John Maynard Keynes. Again, it was Keynes who introduced the notion of "aggregate demand," which treats society as a whole as the demander of goods and services. Along the same lines, economists developed "representative agent" models in which everyone is "represented" in the model by a single decision-maker whose preferences are assumed to be those typical of the group.

In earlier chapters we saw that in his work on Ricardian equivalence and on the burden of government debt Buchanan rejected such aggregate thinking. But his larger concern was to better understand the wide variety of ways that individuals can and do engage with each other—how individuals *exchange* with each other—to achieve their goals.

Economics as the study of exchange

In the quotation at the start of this chapter, Buchanan insisted that the focus of economic analysis should be on markets, that is, on institutions of exchange, rather than on resource allocation. Buchanan says of economists who "are wholly concerned with the allocation of scarce resources among competing ends or uses… that theirs is not legitimate activity for practitioners of economics, as I want to define the discipline" (Buchanan, 1964: 216).

The reason Buchanan insisted on this distinction—one that might strike non-economists as pointless—is that to conceive of economic activity as an exercise in resource allocation is to unwittingly assume that society is rather like a giant sentient individual with preferences all its own. Given its preferences and its income, society has only one "correct" way to "choose"—that there is one optimal allocation of resources. But, as already noted, society is not a giant sentient individual with its own preferences and brain for choosing. Society is the complex interactions of many individuals each in pursuit of his or her own goals. To understand what occurs in society requires that we understand why and how diverse individuals interact and exchange. And they do not interact with the intention of achieving "the" optimal allocation of resources in society.

An "economy," Buchanan observed, is the name that we give to the on-going process of many *different* individuals (and other organizations, including households and firms) pursuing their own individually chosen goals but with no overarching *shared* goal such as "the goal of the national economy." Unlike a household which has an income that it spends according to the consciously chosen plan of an individual (or of a "committee," such as mom and dad), what we call "the economy" has no such income that is spent according to any consciously chosen plan.

Each of the economy's members—as individual persons, and as households and firms voluntarily formed by individuals—has preferences and goals. But, Buchanan warned, it is a mistake to draw from this fact the conclusion that the economy *itself* has purposes.

What, then, *should* economists do? Buchanan's answer is that economists should return to doing what Adam Smith first set economists on course to do. Economists should study *exchange*. According to Smith, our "propensity to truck, barter, and exchange one thing for another" separates us from all other species. And this propensity should mark off the boundaries of economists' proper subject-matter.

Importantly, all trade is voluntary. This fact means that in each exchange *all* parties to it must gain, or, at least, to anticipate gain. Because no one can be forced to trade, each person as a trader must figure out how to help make his or her potential trading partners better off while simultaneously making himself or herself better off. Exchange, therefore, often calls forth creativity.

What kinds of exchange do people engage in? What are the limits of people's ability to exchange? What policies and institutions promote exchange and which discourage it? What patterns of cooperation, conflict, production, and consumption emerge from exchange? These and similar questions are the ones that economists should ask and attempt to answer.

And if economists focus on these questions, they'll likely avoid the error of mistaking the economy for a single decision-making unit. In an economy, resources are directed to their various uses by the countless different commercial exchanges that people carry out, but with no overarching goal to reach or plan to satisfy.

By studying the many different ways that individuals exchange, Buchanan argued, economists will no longer slip unawares into the role of social engineer. The economist will avoid thinking of himself or herself as someone who advises the government on how to best achieve the fulfillment of some national economic "plan" or "purpose"—a plan or purpose that, at least in market-oriented economies, does not exist.

Put somewhat differently, by heeding Buchanan's advice, the economist will not slip into the error of thinking of the market as a means of achieving some higher social purpose. As Buchanan himself summarized it,

> 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. This is all there is to it. Individuals are observed to cooperate with one another, to reach agreements, and to trade. The network of relationships that emerges out of this trading process, the institutional framework, is called "the market." It is a setting, an arena, in which we, as economists, as theorists (as "onlookers"), observe men attempting to accomplish their own purposes, whatever these may be. (Buchanan, 1964: 219)

In Buchanan's view, "there is no explicit meaning of the term *efficiency* as applied to aggregate or composite results. It is contradictory to talk of the market as achieving 'national goals,' efficiently or inefficiently" (Buchanan, 1964: 219).

So what?

The non-economist can be forgiven for asking "So what? What's the point?" Part of the answer is that the engineering perspective of the economy, the perspective that Buchanan warned against, gives the mistaken impression that the economy is serving some *particular* overall social goal. In turn, this mistaken impression naturally suggests that it is the responsibility of government to stand by and monitor the performance of the economy. To the degree that the economy falls short of serving this goal, it would appear to follow that the government's responsibility is to tinker with the economy in order to improve its operation—in order to ensure that it comes closer to achieving *the* optimal allocation of resources.

The engineering perspective that Buchanan warned against leads to individuals and firms being seen as mere cogs in a great machine, as a means for helping the economy achieve some grand outcome. As a value judgment, Buchanan, working as he did in the individualist, classical-liberal tradition, rejected this understanding of individuals.

In addition, as an objective matter of economic science, Buchanan pointed out that this engineering conception of the economy is simply incorrect. Because the economy isn't a sentient creature with purposes, *it* has no goals that can be pursued and met. The economy is nothing more than that which emerges, undesigned and unintended, when countless sentient individuals, in pursuit of their own goals, exchange with each other. And so the economist should study the many ways that individuals exchange, as well as study the unplanned order that emerges from these exchanges.

The flip side of Buchanan's advice that economists study exchange is his criticism of economists for focusing exclusively on only one kind of exchange. Economists excel at studying bilateral market exchanges—exchanges that occur in supermarkets, the trading of corporate shares on the New York Stock

Exchange, the buying and selling that comprise the market for petroleum, the exchange of labour hours for wages. These exchanges are of privately owned, highly divisible property rights—ten and a quarter of my dollars for one bottle of your wine, or twenty tons of Canadian lumber for three dozen new Japanese-made pick-up trucks. These and other familiar kinds of commercial exchanges, exchanges in which, in each case, one buyer exchanges with one seller, are of course important.

But these commonplace kinds of market exchanges do not begin to exhaust the range of exchange possibilities. Yet by coming to see exchange as consisting only of that which occurs in private-property markets, economists become blind to the ways in which humans' propensity to truck, barter, and exchange lead them to devise, or to have the possibility of devising, more complex exchange relationships. The "economic" objectives that humans have include some that cannot be solved if exchange is limited to the kinds that occur in grocery stores and in other familiar private-property markets. Fortunately, observed Buchanan, humans have the capacity to devise exchange relationships that can meet these more complex challenges.

Buchanan offered as an example a community of people near a mosquito-infested swamp. If the swamp were drained, everyone in the community would benefit. Unfortunately, no one person or family in the community has the incentive to incur the full cost of draining the swamp. And because each community member will enjoy the benefit of the drained swamp whether or not he or she helps to pay for the drainage, no community member has adequate incentives to help to pay for drainage. According to standard economics, therefore, the market fails to provide the "public good" of draining the swamp. The only possible solution—as mainstream economists see it—is for government to drain the swamp, and to pay for this service by taxing the community.

Notice how this government "solution" involves no exchange. It's an instance of social engineering. The government *somehow* determines that the social value of draining the swamp would be greater than the cost of doing so. And so government undertakes this effort.

But Buchanan identifies another possibility. According to him, humans' propensity to exchange might lead residents of the community

> to search voluntarily for more inclusive trading or exchange arrangements. A more complex institution may emerge to drain the swamp. The task of the economist includes the study of all such cooperative trading arrangements which become merely extensions of markets as more restrictively defined. (Buchanan, 1964: 219).

Perhaps the community members will form a neighbourhood swamp-draining association and agree to pay dues and be bound by its rules. Or, alternatively, a private developer might offer to buy out all the residents, drain the swamp himself, and then build new houses in the community which he sells at higher prices because mosquitos are no longer a problem there.

The point is that exchange possibilities are not confined to the simple bilateral exchanges on which economists traditionally focus nearly all of their attention. When this truth is recognized, many familiar features of the real world are seen in a more revealing light. Clubs, homeowners' associations, business firms, churches, philanthropic organizations—these and other voluntary associations are arrangements in which individuals choose to interact and exchange with each other in ways more complex than simple, one-off, arm's length, bilateral exchanges.

These "complex" exchange relationships are an important reality for economists to study. But they are more than mere subject matter for research. They are also evidence that human beings who are free to creatively devise and experiment with alternative organizational and contractual arrangements have great capacity to do so. Where the conventional economist sees "market failure," humans on the spot often see opportunities for mutually advantageous exchange. The itch to call on government to *impose* a "solution" should be resisted, although, in Buchanan's view, not altogether ignored.

Conclusion

Buchanan rejected, on scientific grounds, what by the mid-twentieth century had become economists' dominant perspective. In doing so he encouraged economists to abandon the role of social engineer and instead to study how individuals perceive the challenges they confront and how they creatively form exchange relationships to meet these challenges. Societies do not make choices;

individuals do. Given the preferences of individuals, the focus of economics should be on how individuals creatively interact to further their well-being.

Buchanan's focus on exchange rather than on choice applies to all areas of economics, but one can see that this focus offers challenges to the economist when one looks at resource allocation through collective action—through government or through voluntary collective organizations like clubs and homeowners' associations. Buchanan made some of his most significant contributions by recognizing that exchange is often central to the formation and operation of collective organizations. Rather than depicting government as an omniscient benevolent despot who maximizes social welfare, he depicted "politics as exchange," which allows individuals to accomplish collectively what they cannot accomplish individually or through simple market exchange.

He was well aware that government often falls short of his ideal. He therefore looked for ways to design institutional constraints to encourage this cooperative effort while simultaneously preventing government officials from abusing power. James Buchanan's research program in this area is rooted in the idea that economists should focus their attention on exchange rather than on resource allocation. And as we hope this introduction to his work has made clear, it is a research program that produced fundamental advances in our understanding of economics and politics.

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Suggestions for Further Reading

Unlike F.A. Hayek and Milton Friedman, two other scholars whose works are featured in the Fraser Institute's Essential Scholars series, James Buchanan seldom wrote for popular audiences. With rare exception, he wrote for fellow academics. Nevertheless, many of his articles and speeches are accessible to intelligent non-specialists.

The list below is divided into two sections. The first is recommendations of key yet accessible pieces written by Buchanan (sometimes with co-authors). The second section is of pieces written either about Buchanan's work or about public-choice scholarship.

Books and articles by James M. Buchanan

Better than Plowing (1992) University of Chicago Press. This is Buchanan's autobiography and is the most accessible of all of Buchanan's books. It supplies an excellent introduction not only to the man but to his key ideas.

"The Soul of Classical Liberalism," (Summer 2000) *Independent Review*. Buchanan here defends the classical-liberal case for individualism against notions of collectivism. <https://www.independent.org/pdf/tir/tir_05_1_buchanan.pdf>

Ideas, Persons, and Events (2001) Liberty Fund. This 19th volume in Buchanan's 20-volume *Collected Works* consists mostly of short essays, recollections, and book reviews.

What Should Economists Do? (1979; edited by H. Geoffrey Brennan and Robert D. Tollison) Liberty Fund. This volume collects some of Buchanan's musings on the nature of economics, society, and humankind. The lead essay in this volume is a landmark 1964 paper by him that gives this volume its name. This volume contains also one of Buchanan's most philosophic yet accessible—and famous—papers, his 1978 "Natural and Artifactual Man."

"The Domain of Constitutional Economics" (1990) *Constitutional Political Economy*, volume 1; and "The Constitution of Economic Policy" (1986), Nobel Prize Lecture <https://www.nobelprize.org/prizes/economic-sciences/1986/buchanan/lecture/>. Together, these two pieces provide a full picture of the reasons for Buchanan's life-long insistence on the importance of constitutional rules.

The Consequences of Mr. Keynes (2nd impression, 1977; co-authored with John Burton and Richard E. Wagner), Institute of Economic Affairs. This monograph is the most accessible, to non-economists, of all of Buchanan's "technical" writings. <https://iea.org.uk/publications/research/the-consequences-of-mr-keynes>

Books and articles about James Buchanan and Public Choice

Donald J. Boudreaux (2013, January 9), "In Appreciation: James M. Buchanan," *Wall Street Journal*. <https://www.wsj.com/articles/SB10001424127887324581504578231932109403950>

David R. Henderson (2006), "James M. Buchanan," *Concise Encyclopedia of Economics*. <https://www.econlib.org/library/Enc/bios/Buchanan.html>

Richard E. Wagner (2017), *James M. Buchanan and Liberal Political Economy*, Lexington Books. This intellectual biography of Buchanan—written by a co-author, colleague, and former student—is excellent.

Donald J. Boudreaux (2014), "Why Government Fails and Why Ideas Matter," *Cato Policy Report* (November/December). <https://www.cato.org/policy-report/november/december-2014/why-government-fails-why-ideas-matter>

William F. Shughart II (2006), "Public Choice," *Concise Encyclopedia of Economics.* <https://www.econlib.org/library/Enc/PublicChoice.html>

Randy T. Simmons (2011), *Beyond Politics,* Independent Institute. This book is a superb primer on public choice.

Gordon Tullock, Arthur Seldon, and Gordon Brady (2000), *Government: Whose Obedient Servant?* Institute of Economic Affairs. This book is also an excellent primer on public choice, co-authored by one of its founders.

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