The Collected Works of
James M. Buchanan

VOLUME 14

Debt and Taxes

James M. Buchanan, University of Giessen, Germany, June 1982

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Foreword

Although James Buchanan's interests are wide-ranging, the core of his professional reputation as an economist and the origin of much of his broader thinking lies in public economics—in engagement with the questions of what governments should do and how governments should properly finance what they do. It has been a persistent theme in Buchanan's approach that these questions cannot be satisfactorily handled separately: specifically, that the issue of the appropriate methods of revenue-raising must be fully integrated with consideration of the general purposes to which the revenue is to be put. For much of Buchanan's career, this integration went somewhat against the practices of the economics profession. The tradition was that public finance divided itself fairly neatly between those who saw their expertise as lying in tax analysis and those who engaged the more abstract welfare economics issues of the economic theory of the state. And though there has been some change in professional attitudes on these matters, much of that change attributable to Buchanan's own influence, the division of intellectual labor still tends to fall along this fault line. For this reason, as editors, we feel somewhat uncomfortable about the division of Buchanan's public economics papers between this volume and the next along essentially equivalent lines. That is, in the current volume, we present the papers on taxation and debt; we then deal with the public expenditure papers in volume 15, *Externalities and Public Expenditure Theory.* We want, therefore, to emphasize the importance of reading the material in these two volumes in tandem. The emphasis here goes somewhat beyond more general urgings elsewhere about the overall coherence of Buchanan's thinking and the desirability of seeing his work as a whole. In an important sense, the essential *point* of Buchanan's worldview is caught up in the insistence, which he derives originally from Knut

Wicksell, that public spending and revenue-raising are inextricably linked aspects of the same politically constituted action.

In the same spirit, it is as well to draw attention to the tax and debt papers in the representative collection of papers in volume 1 of the Collected Works, *The Logical Foundations of Constitutional Democracy.* It is an obvious concomitant of the centrality of debt, taxation, and public expenditure as topics in Buchanan's thought that some of the significant papers on those topics would need to be included in the initial introductory volume. Accordingly, the reader should be alerted to the selections in part 3 of volume 1, and particularly to "Taxation in Fiscal Exchange," which is in some ways the most overtly contractarian/Wicksellian treatment of tax questions in Buchanan's work.[1]

Equally, the books *Public Principles of Public Debt, Public Finance in Democratic Process, Democracy in Deficit,* and *The Power to Tax,* appearing in the present series as volumes 2, 4, 8, and 9, respectively, are all centrally relevant to the papers collected in this volume.[2] There is much of Buchanan's thinking about taxation and debt, for example, that is only lightly represented in the papers in the current volume. There is no concentrated version of the central argument in *Public Principles of Public Debt;* there is relatively little account in the papers of the central ideas advanced in *Public Finance in Democratic Process;* and we have deliberately omitted several papers whose argument is directly replicated in the book-length treatments.[3]

The papers included here divide themselves quite naturally into two parts

1. James M. Buchanan, "Taxation in Fiscal Exchange," *Journal of Public Economics* 6 (1976): 17–29, reprinted in volume 1 in the series, *The Logical Foundations of Constitutional Liberty.*

2. James M. Buchanan, *Public Principles of Public Debt* (Homewood, Ill.: Richard D. Irwin, 1958), volume 2 in the series; *Public Finance in Democratic Process: Fiscal Institutions and Individual Choice* (Chapel Hill: University of North Carolina Press, 1966), volume 4 in the series; James M. Buchanan and Richard E. Wagner, *Democracy in Deficit: The Political Legacy of Lord Keynes* (New York: Academic Press, 1977), volume 8 in the series; Geoffrey Brennan and James M. Buchanan, *The Power to Tax: Analytical Foundations of a Fiscal Constitution* (New York: Cambridge University Press, 1980), volume 9 in the series.

3. This consideration explains, for example, the omission from the representative papers of the Leviathan account of earmarking, "Tax Instruments as Constraints on the Disposition of Public Revenues"; the argument appears without serious modification as chapter 7 of *The Power to Tax.* Geoffrey Brennan and James M. Buchanan, "Tax Instruments as Constraints on the Disposition of Public Revenues," *Journal of Public Economics* 9 (June 1978): 301–18.

and correspond with the two elements of the title. It seems logical, however, to present the two elements in the opposite order from that in which the title announces them. Euphony dictates titles; logic dictates arrangement. The first four parts of the book, therefore, deal with tax analysis. Part 1 offers six general papers concerning the characteristic features of the Buchanan approach. Two of these examine explicitly the connection between public choice theory and public finance—"Public Finance and Public Choice" and the subsequent "Public Choice and Public Finance." The former treats the influence of emergent public choice theory on developments in public finance scholarship, while the latter traces the public finance origins of public choice theory. The next two papers, "Democratic Values in Taxation" and "Tax Reform as Political Choice," focus on other general aspects of Buchanan's method of tax analysis: as the titles imply, both papers emphasize the central *political* character of tax policy.[4] The final two papers in this section are included to highlight the difference between Buchanan's approach and the conventional "public economics" approach, as represented by the work of Richard Musgrave.[5] It was Musgrave's work during the 1950s that synthesized and refined orthodox public finance—most notably in his treatise *The Theory of Public Finance*.[6] In that sense, Musgrave's contribution and Buchanan's reactions to it form the perfect backdrop against which to assess the distinctiveness of Buchanan's conceptual framework.

Part 2 includes five papers on specific issues in tax analysis—earmarking, indirect versus direct taxation, and tax incidence—all within the context of an essentially democratic model of political process.[7] Part 3 treats tax questions in

4. James M. Buchanan, "Public Finance and Public Choice," *National Tax Journal* 28 (December 1975): 383–94; "Public Choice and Public Finance," in *What Should Economists Do?* (Indianapolis: Liberty Fund, 1979), 183–97; "Democratic Values in Taxation," in *Freedom in Constitutional Contract: Perspectives of a Political Economist* (College Station: Texas A&M University Press, 1977), 243–53; "Tax Reform as Political Choice," *Journal of Economic Perspectives* 1 (Summer 1987): 29–35.

5. James M. Buchanan, "The Theory of Public Finance," *Southern Economic Journal* 26 (January 1960): 234–38; "Richard Musgrave, Public Finance, and Public Choice," *Public Choice* 61 (June 1989) 289–91.

6. Richard A. Musgrave, *The Theory of Public Finance: A Study in Public Economy* (New York: McGraw-Hill, 1959).

7. James M. Buchanan, "The Economics of Earmarked Taxes," *Journal of Political Economy* 71 (October 1963): 457–69; "The Constitutional Economics of Earmarking," in

what has come to be known as the Leviathan model of political process in which ordinary electoral constraints are ineffective and where government discretion is interpreted in terms of access to economic rents. There are six papers in this section, including the original statement of Leviathan tax theory and several that deal with the normative and political logic of tax limits.[8]

The papers included in part 4 are a more diverse set. "The Tax System as Social Overhead Capital" offers a constitutionalist perspective on the tax system. "Tax Reform without Tears" is a piece of more or less conventional efficiency-oriented tax analysis, though with a characteristically contractarian edge. In "The Political Efficiency of General Taxation," Buchanan lays out a justification for more or less conventional tax norms as a means of avoiding essentially *political* distortions. And in "Rational Majoritarian Taxation of the Rich," we see the application to tax analysis of Buchanan's development of Smithian ideas relating to increasing returns.[9]

Charging for Government: User Charges and Earmarked Taxes in Principle and Practice, ed. Richard E. Wagner (London and New York: Routledge, 1991), 152–62; James M. Buchanan and Francesco Forte, "Fiscal Choice through Time: A Case for Indirect Taxation?" *National Tax Journal* 17 (June 1964): 144–57; James M. Buchanan, "Externality in Tax Response," *Southern Economic Journal* 33 (July 1966): 35–42; James M. Buchanan and Mark V. Pauly, "On the Incidence of Tax Deductibility," *National Tax Journal* 23 (June 1970): 157–67.

8. Geoffrey Brennan and James M. Buchanan, "Towards a Tax Constitution for Leviathan," *Journal of Public Economics* 8 (December 1977): 255–73; "The Logic of Tax Limits: Alternative Constitutional Constraints on the Power to Tax," *National Tax Journal* 32 (June 1979): 11–22; James M. Buchanan and Roger Congleton, "Proportional and Progressive Income Taxation with Utility-Maximizing Governments," *Public Choice* 34 (1979): 217–30; James M. Buchanan, "The Ethical Limits of Taxation," *Scandinavian Journal of Economics* 86 (April 1984): 102–14; "Coercive Taxation in Constitutional Contract," in *Explorations in Constitutional Economics,* comp. Robert D. Tollison and Viktor J. Vanberg (College Station: Texas A&M University Press, 1989), 309–28; "Constitutional Constraints on Governmental Taxing Power," *ORDO* Band 30 (Stuttgart: Gustav Fischer Verlag, 1979): 349–59.

9. Geoffrey Brennan and James Buchanan, "The Tax System as Social Overhead Capital: A Constitutional Perspective on Fiscal Norms," in *Public Finance and Economic Growth,* ed. Karl Roskamp (Detroit: Wayne State University Press, 1983), 46–56; James Buchanan and Geoffrey Brennan, "Tax Reform without Tears," in *The Economics of Taxation,* ed. Henry Aaron and Michael Boskin (Washington: The Brookings Institution, 1980), 33–54; James M. Buchanan, "The Political Efficiency of General Taxation," *National Tax Journal* 46 (1994): 401–10; James M. Buchanan and Yong J. Yoon, "Rational

The papers in the remaining parts of this volume are concerned with public debt but, as already emphasized, constitute only a small part of Buchanan's writing on this topic: the more extensive and systematic treatments are in the book-length discussions.[10] However, we can detect in the debt papers the same prevailing themes and anxieties—in particular, the need to see debt-financing in terms of its effects on political processes and a general Wicksellian concern about the justice and political efficiency of current generations of citizens voting for themselves expenditures for which future generations will have to pay. Because these anxieties depend for their coherence on the idea that debt does indeed transfer tax burdens intertemporally in a relevant sense, sustaining this prior analytical claim has been a central part of the Buchanan agenda in the area. Buchanan's early argument for this claim is contained in *Public Principles of Public Debt,* and in part 5 of this volume we include several supporting statements from that earlier period.

Questions about debt-incidence enjoyed a resurgence of attention following the appearance of Robert Barro's paper "Are Government Bonds Net Wealth?" Although Barro's paper was developed out of a concern broadly with the micro foundations of macroeconomics, and although his argument makes no reference to either the original Ricardian version or the public finance literature on debt-incidence, the debate on the effects of social security entitlements on private savings that surrounded his paper involved claims about public debt incidence rather at odds with Buchanan's. The three papers that make up part 6 are all concerned, one way or another, to address Barro's "neo-Ricardian" position. (The quotation marks in this context are used to signify that though Ricardo originally exposited the logic of the position he explicitly rejected its real-world relevance.)[11]

Part 7 contains seven papers oriented in various ways to the constitu-

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Majoritarian Taxation of the Rich: With Increasing Returns and Capital Accumulation," *Southern Economic Journal* 61 (April 1995): 923–35.

10. See, in particular, volumes 2 and 8 in the Collected Works, *Public Principles of Public Debt* and *Democracy in Deficit.*

11. James M. Buchanan, "Barro on the Ricardian Equivalence Theorem," *Journal of Political Economy* 83 (April 1976): 337–42; Geoffrey Brennan and James M. Buchanan, "The Logic of the Ricardian Equivalence Theorem," *Finanzarchiv* 38 (1980): 4–16; James M. Buchanan and Jennifer Roback, "The Incidence and Effects of Public Debt in the Absence of Fiscal Illusion," *Public Finance Quarterly* 15 (January 1987): 5–25.

tional politics of debt-financing.[12] What implications does access to public debt have for the conduct of democratic politics? asks Buchanan. And with those implications in mind how might we rationally constrain the operation of in-period politics? The final paper in this section involves a particularly astounding possible solution to excessive use of the debt option: Buchanan has not lost his capacity to be controversial![13]

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1998

12. Viktor Vanberg and James M. Buchanan, "Organization Theory and Fiscal Economics: Society, State, and Public Debt," *Journal of Law, Economics, and Organization* 2 (Fall 1986): 215–27; James M. Buchanan, "The Moral Dimension of Debt Financing," *Economic Inquiry* 23 (January 1985): 1–6; "The Economic Consequences of the Deficit," *Symposium on Budget Balance,* ed. Carol Cox (Washington, D.C.: Committee for a Responsible Federal Budget, 1986), 11–18; "Budgetary Bias in Post-Keynesian Politics," in *Deficits,* ed. James M. Buchanan, Charles Rowley, and Robert Tollison (New York: Blackwell, 1987), 180–98; "The Balanced Budget Amendment: Clarifying the Arguments," *Public Choice* 90 (1997): 117–38; James M. Buchanan and Richard E. Wagner, "Dialogues Concerning Fiscal Religion," *Journal of Monetary Economics* 4 (July 1978): 627–36.

13. James M. Buchanan, "The Ethics of Debt Default," in *Deficits,* ed. James M. Buchanan, Charles Rowley, and Robert D. Tollison (New York: Blackwell, 1987), 361–73.

PART ONE

Taxation, Politics, and Public Choice

Public Finance and Public Choice

Abstract: Public finance has undergone major transformation since World War II. This paper surveys this transformation, particularly from a public choice perspective. Post-Marshallian public finance had two major gaps: the expenditure side of the fiscal account, and the public decision-making process. Both of these gaps have been partially filled, although much discussion of policy continues to take place in a now-outmoded setting. Social security financing is used as an illustration of the separate methodologies.

"Public finance," as a quasi-independent subdiscipline in the American academic setting, has been substantially transformed in the thirty years after the ending of World War II, although heritages of the earlier tradition remain, and notably as these affect practical political discussion. From its relatively minor role as one among many fields of applied microeconomic theory—akin to industrial organization, agricultural economics, or labor economics—public finance emerged to become "public economics," which, at least conceptually, is on all fours with "private economics," or, more familiarly, the economics of the private sector. If relative weights are assigned in accordance with relative shares in GNP, public economics promises, for better or for worse, to grow still more important in decades ahead.

My purpose in this survey paper is to discuss this transformation of public finance from a public choice perspective, one that reflects my own meth-

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I am indebted to my colleague Gordon Tullock for helpful comments.

odological presuppositions. I shall not include reference to the "theory of fiscal policy," which bloomed brightly in the early post-Keynesian environment only to fade somewhat in the face of political realities. The macroeconomic policy emphasis derived from Keynes is a causal element in the relative growth of the governmental sector and, as such, one source for the increasing attention to public economics. But there is no direct relationship between this emphasis and the fundamental paradigm shift that is the primary subject of my treatment in this paper.

Post-Marshallian Public Finance

I can commence by describing the content of public finance in post-Marshallian economics, as limited to English-language discourse. Positive analysis was restricted almost exclusively to theories of tax shifting and incidence. And, indeed, as Marshall himself explicitly recognized,[1] the theory of tax shifting becomes almost the ideal instrument for applying the principles of competitive price theory. Comparative statics offered a plausible predictive framework for analyzing tax alternatives. Within limits, and for certain simple forms, the economist could confidently predict the effects of a tax on the behavior of persons and firms in the private economy, and, through this, on the aggregate effects on such variables as relative prices, outputs, profits, and industry structure in particular sectors. For this strictly positive analysis, which could also yield empirically refutable propositions, the economist had no reason to inquire about the political purpose of taxation, no reason to introduce external evaluation of alternative tax instruments.[2] This subarea of public finance, which is essentially applied price theory, has continued to be developed through more sophisticated technical analysis which has now moved beyond the Marshallian partial-equilibrium framework to general-

1. ". . . there is scarcely any economic principle which cannot be aptly illustrated by a discussion of the shifting of the effects of some tax. . . ." Alfred Marshall, *Principles of Economics,* 8th ed. (London: Macmillan, 1930), 413.

2. Beginning attempts were made to extend an analogous positive analysis to the expenditure side of the fiscal ledger (see, for example, Earl Rolph, "A Theory of Excise Subsidies," *American Economic Review,* 42 [September 1952], 515–27). But, as noted, the predominant emphasis was, and remains, on taxation.