

The Collected Works of
James M. Buchanan

VOLUME 18

Federalism, Liberty, and the Law



From left: Bruno Leoni, James M. Buchanan, unknown, Sylvania Leoni, Ursula Hicks, unknown, Stresa, Italy, 1961

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*Federalism, Liberty,
and the Law*



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Foreword

The papers reprinted in this eighteenth volume of the Collected Works are less diverse than they may seem initially. All of them at least implicitly touch on two characteristic James Buchanan concerns: on the one hand, the desire that individual sovereignty be respected in society and, on the other, that monopoly power as a threat to individual sovereignty be controlled.¹

Since the state is the greatest threat to individual sovereignty, why not eliminate this threat completely and try to do away with the state altogether? Anarchism, in this sense, appeals to Buchanan, as it must to all who value liberty. But, as opposed to more extreme and more utopian libertarians, he well understands that in our world it takes a state to defend the individual against the state. Buchanan, therefore, is not an anarchist but, rather, what may be called a “reluctant anarchist” who accepts both that the state is the greatest threat to individual sovereignty and that without some statelike monopoly, individual sovereignty cannot be protected.

Obviously, for Buchanan, founding a state is not intrinsically desirable. But at least under modern conditions of population density and organizational skills, there is no way to prevent a state or a statelike monopoly organization from emerging in any given territory. Once the state is invented, there is no longer a “stateless” equilibrium in the game of life.

Maximizing liberty, or freedom from political power, would inevitably lead to the precept that one should strive to reach an anarchistic situation without any monopoly over the use of power in any territory. However, be-

1. On the concept of interindividual respect, see the introduction to volume 17 in the Collected Works, *Moral Science and Moral Order*, as well as some of the essays in part 1 of that volume, “Methods and Models.” On the theory of monopoly, see volume 17, part 3, “Moral Community and Moral Order.”

cause anarchy is not among the options of constitutional choice, the maximization of liberty must be rejected.² As is argued in “Federalism and Individual Sovereignty,” the maximand of a rational libertarian can be individual sovereignty only within the constraints of a system of law backed by the political power of a state.

But even if some degree of statelike monopoly power seems unavoidable, there are, of course, several ways to control and contain monopoly power. Besides the separation of powers in society and the assignment of offices by periodic elections, federalism, for Buchanan, is of particular importance. He imagines a federation as an organizational structure characterized by competition among several states.

Competition among states is desirable provided that such harmful forms of anarchic competition such as arms races or outright war are controlled. For Buchanan, therefore, the first function of the central authority of a federation is to prevent states from harmful ways of competing with each other. A second function of the central federal authority is to provide the basic “traffic rules” for the interaction of individuals living in the federation. More specifically, it has to lay down the basic rules of the game such that the free movement of capital, goods, and, most important, people among states is guaranteed.

If freedom of movement of capital, goods, and people is guaranteed, then the power of the collective decision-making bodies of the several states over the individual members of the states is limited. Not only freedom of exit but also freedom of entry must be guaranteed by the central structure of the federation. These twin guarantees and the related suppression of the harmful forms of competition mentioned previously create a competitive system in which individuals can freely utilize the protection of one state against exploitation by another. It is not required that everyone be potentially mobile for freedom of movement to constrain the conduct of state governments. The mere possibility of some citizens leaving and taking their taxable capacity with them can serve as a protection for all.

Because of his fundamental quasi-Kantian respect for the individual, Bu-

2. On this see, in particular, James M. Buchanan, “Federalism and Individual Sovereignty,” *Cato Journal* 15 (Fall/Winter 1995/96): 259–68, reprinted in part 2 of this volume, “Federalism and Freedom.”

chanan thinks of competitive federalism as a universal principle of social organization rather than a specific American achievement.³ Ideas such as those expressed in the preceding paragraph seem so simple and almost self-evident for Buchanan that he deems it surprising that so few social philosophers and scholars of jurisprudence and political economy seem to be adherents of true, or competitive, federalism.

At least two factors may explain why competitive federalism is not more popular. First, there are those social theorists and ordinary citizens who imagine themselves as sitting in the driver's seat when forming their political opinions. They imagine that they decide for the collective as a whole and, therefore, quite naturally tend to conceive of decision making for the collective in terms of a benevolent despot. But if the decision maker is imagined as a benevolent despot, why divert his powers by competitive federal structures? It seems quite plausible indeed that a benevolent decision maker should be endowed with monopoly power. For then he certainly can do most good. Then there are those who are totally disillusioned with the state in general. They are immune to falling into the benevolent despot trap. Rather they feel that the state is so dangerous that no good can be expected from federal state structures as well. For them, the devolution of a unitary state into a federal one is not worth the effort. Adding another layer of state organization to an existing structure of independent states is, at best, futile but can make things worse.

As far as the first view is concerned, nothing needs to be added to Buchanan's thorough rejection of the model of the benevolent despot in all its forms. With respect to the latter view, it may be helpful to recall the original American dispute about reforming the first American constitution. In this dispute between the so-called Federalists, who in fact were favoring quite strong central structures, and the so-called Anti-Federalists, who, arguably, were the true adherents of competitive federalism, the Federalists won the day. But the Anti-Federalists' prediction that the constitution envisioned by the Federalists and later adopted by the American people would eventually

3. On this see, in particular, some of the papers reprinted in part 1, "Methods and Models," of volume 17 of the *Collected Works, Moral Science and Moral Order*, and, for additional remarks, see also the introduction to that volume.

lead to a unitary or quasi-unitary state was proved right in the course of history.⁴ Studying American constitutional history might, therefore, teach Europeans some lessons about the risks of European integration. But Buchanan thinks that American history can teach the Europeans some lessons about their federative opportunities as well.

Those Europeans who, like the British, have been living under free institutions for an extended period of time may feel that giving up parts of their sovereignty in a European federation might not be a price worth paying. Evidently, the danger of creating a super-Leviathan must be taken seriously whenever we merge several states into a federation. And Buchanan himself is well aware of the omnipresent threat of Leviathan.⁵ Yet, in view of Buchanan's arguments, even the British might want to give federal structures some second thought. In the Buchanan framework, giving up national sovereignty is desirable if this can help to protect individual sovereignty. In particular, if such constitutional options as a well-specified secession clause and a well-specified fiscal constitution for the European Union are taken into account, Buchanan would insist that there is such a thing as Europe's constitutional opportunity which to seize might, in fact, be favorable for European citizens.⁶

In a characteristically Buchanan-like move, Buchanan insists on comparative institutional analysis in which likely developments under a European competitive federal structure should be compared with realistic predictions of the likely future if present structures remain in place. As far as the likely

4. The Federalist Papers are so well-known and so easily available that any specific reference seems to be superfluous; but attention might be drawn to the work of the Anti-Federalists as, for instance, selected by Murray Dry from *The Complete Anti-Federalist*, ed. Herbert J. Storing (Chicago and London: University of Chicago Press, 1981).

5. The title of one of the papers reprinted in volume 1, "Socialism Is Dead, but Leviathan Lives On," says it all (the John Bonython Lecture, CIS Occasional Paper 30 [Sydney: Centre for Independent Studies, 1990], 1–9). For more on postsocialist political economy, see part 3, "Economics in the Post-Socialist Century," of volume 19 of the series, *Ideas, Persons, and Events*.

6. In this volume, see James M. Buchanan and Roger L. Faith, "Secession and the Limits of Taxation: Toward a Theory of Internal Exit," *American Economic Review* 77 (December 1987): 1023–31; James M. Buchanan and Dwight R. Lee, "On a Fiscal Constitution for the European Union," *Journal des Economistes et des Etudes Humaines* 5 (June/September 1994): 219–32; and James M. Buchanan, "Europe's Constitutional Opportunity," in *Europe's Constitutional Future* (London: Institute of Economic Affairs, 1990): 1–20.

course of events under present political efforts of European integration is concerned, Buchanan would certainly be as skeptical as the British critics of Europe. He would insist only that a better federal future for Europe can be imagined. If the right constitutional measures were adopted, this would have overall beneficial effects and would, predictably, lead to a constitutional future superior to the likely course of events without such federal structures. In fact, the observable effects of the freedom of movement of capital, goods, and people realized in present-day Europe make it hard to deny that the sovereignty of the individual citizen as opposed to his national (Leviathan) government has been enlarged by federal structures. So, why not try to move in this direction?

The first part of this volume, "The Analytics of Federalism," contains highly influential papers of a more technical nature. They provide important analytical insights into the workings of federal structures. Certainly Buchanan's views on more practical policy issues, in particular with regard to European federalism, are much more contested. But regardless of this, the papers reprinted in the second part, "Federalism and Freedom," should make fascinating reading for anyone who is interested in the subject of securing individual sovereignty by means of federal safeguards. The same holds true for the papers reprinted in the third part, "Liberty, Man, and the State." These papers basically speak for themselves. It might be noted in passing, though, that the concern with the monopoly power of the state, if often implicit, is always distinct. This holds good also for the essay "Property as a Guarantor of Liberty," even though here the concern is with society rather than the state as exerting power over the individual.⁷ In the form of a conjectural history, this extended essay provides a theory of economic cooperation which brings together many of Buchanan's basic ideas and ideals.

Creating and protecting the sovereignty of the individual is central also to the papers reprinted in the next part, "The Constitution of Markets." Somewhat more extended comments on the fifth part, "Economists, Efficiency, and the Law," may be in order, however. At first glance, the relationship to individual sovereignty, on the one hand, and the state monopoly to the legitimate use of power, on the other, seems quite weak. But Buchanan is still

7. James M. Buchanan, "Property as a Guarantor of Liberty," *The Shaftesbury Papers*, vol. 1 (Hants, England: Edward Elgar, 1993), 1–64.

dealing with potential abuses of the monopoly power of the state. For instance, Buchanan criticizes those who suggest that judges rather than seeking for the right answer to a problem within the limits of the law should act as law makers and solve the problem according to some extralegal standard. He feels that acting that way amounts to an abuse of the discretionary power that is granted to those who are involved in the enforcement of law.

Now Buchanan acknowledges that all law is in need of interpretation, but for him, it makes a huge difference whether we approach the law from the point of view of someone who, to the best of his knowledge, intends to interpret the law as is or as someone who feels entitled to make it what it should be. Even if the law *per se* leaves quite a bit of scope for maneuvering, it makes a difference to a judge's behavior whether he feels entitled to decide things according to extralegal standards of right and wrong or whether he imagines himself as being bound by the law as he sees it. Adopting the attitude of someone who perceives himself as bound by the law, a judge will try to find out what the law of the land is, while a judge who feels entitled to take resort to extralegal standards will search for the "right answer" somewhere outside the "constitutional contract."⁸ And, what the judge is looking for will at least, in part, influence what he finds—and how he "finds."

Obviously Buchanan rejects the view of many jurists who believe that law is so open to interpretation that virtually "anything goes." In support of Buchanan's position, it might be added here that the lawyers' view of the law tends to be distorted precisely because it is the view of lawyers. Their perception of the law is, to a large extent, determined by cases that go to court. Yet, forming a theory of the workings of the law on the basis of such cases is as if a management scientist would form a theory of the firm based on a sample of firms that have gone bankrupt. For our understanding of how the law, in fact, works in social reality, it is at least as important to look at those dealings that do not go to court as at those that do. Taking this into account, speaking of "the law as is" becomes much more plausible, and consequently, Buchanan's insistence on the distinction between within-law choices and the choice of law becomes more plausible too.

We must be content to let the discussion of law rest with that, since this is certainly not the appropriate occasion to enter into a debate about some of

8. For the related discussion of the separation of law and morals, see Herbert Hart, *The Concept of Law* (Oxford: Oxford University Press, 1961).

the deeper issues of the philosophy of law and the methodology of jurisprudence. Suffice it to note that in a somewhat less philosophical vein, two contributions in part 5 are intriguing too. The piece “In Defense of *Caveat Emptor*” is a strikingly clear and relevant contractarian contribution to the ongoing debate on “risk management” in society, while “Notes on Irrelevant Externalities, Enforcement Costs and the Atrophy of Property Rights” takes us, at least in a way, to “the edge of the jungle.”⁹ The former paper concerns the defense of individual sovereignty in the domain of decisions about risk taking. The second connects the idea of individual sovereignty to the issue of state monopoly. This issue of state monopoly is a central one in the two papers that make up part 6 of this volume, “Law, Money, and Crime.” The problem of controlling the discretionary powers of those who are themselves in charge of controlling money in society is obvious.¹⁰ That nonstate monopoly is perhaps not always a bad thing and may even be deemed desirable in a comparative institutions approach as a second-best solution is made clear in the very last paper, “A Defense of Organized Crime?”¹¹

Although monopoly and its control are central topics in all the pieces reprinted here, “monopoly” does not appear in the title of this volume. This fact reflects our view that titles should have a positive cast. We have judged it better to direct attention to those mechanisms that protect individual sovereignty than to those that assault it. On this basis, *Federalism, Liberty, and the Law* seemed an appropriate title for this volume.

Harmut Kliemt
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 1998

9. “In Defense of *Caveat Emptor*,” *University of Chicago Law Review* 38 (Fall 1970): 64–73, and “Notes on Irrelevant Externalities, Enforcement Costs and the Atrophy of Property Rights,” in *Explorations in the Theory of Anarchy*, ed. Gordon Tullock (Blacksburg, Va.: Center for Study of Public Choice, 1972), 77–86. The term is, of course, borrowed from Gordon Tullock, “The Edge of the Jungle,” in *Explorations in the Theory of Anarchy*, 65–75.

10. It may useful also to consult the paper “Predictability: The Criterion for a Monetary Constitution” (James M. Buchanan, in *In Search of a Monetary Constitution*, ed. Leland B. Yeager (Cambridge: Harvard University Press, 1962), 155–83 in volume 1 of the series, *The Logical Foundations of Constitutional Liberty*).

11. James M. Buchanan, “A Defense of Organized Crime?” in *The Economics of Crime and Punishment*, ed. Simon Rottenberg (Washington, D.C.: American Enterprise Institute, 1973), 119–32.

PART ONE

The Analytics of Federalism

Federalism and Fiscal Equity

Fiscal relations between central and subordinate units of government have become an important problem area in the United States during the last two decades.¹ Increasing attention has been, and is being, given to the more practical policy proposals aimed at accomplishing specific short-run objectives. While this may have been necessary, perhaps too little attention has been placed upon the study and the formulation of the long-run objectives of an inter-governmental fiscal structure.² This paper seeks to formulate a specific long-run goal for policy and will discuss the advantages which might be expected to arise from its general acceptance.

I

A distinct group of problems inherently arises when a single political unit possessing financial authority in its own right contains within its geographical limits smaller political units also possessing financial authority.³ These

From *American Economic Review* 40 (September 1950): 583–99. Reprinted by permission of the publisher.

1. The most general survey of the whole field published to date is: U.S. Congress, Senate, *Federal, State and Local Government Fiscal Relations*, Sen. Doc. 69, 78th Cong., 1st Sess. (Washington, Government Printing Office, 1943). Other competent works include: J. A. Maxwell, *The Fiscal Impact of Federalism in the United States* (Cambridge, Harvard University Press, 1946); Jane P. Clark, *The Rise of a New Federalism* (New York, Columbia University Press, 1938); G. C. S. Benson, *The New Centralization* (New York, Farrar and Rinehart, 1941).

2. One important work in the field is concerned with this aspect: B. P. Adarkar, *The Principles and Problems of Federal Finance* (London, P. S. King and Sons, 1933).

3. Financial authority may be defined as the power of a governmental unit to collect revenues from contained fiscal resources and to expend such revenues in the performance of governmental functions. See Adarkar, op. cit., 31.

problems become especially important in a federal polity since the financial authority of the subordinate units is constitutionally independent of that of the central government. In a federalism, two constitutionally independent fiscal systems operate upon the fiscal resources of individual citizens.⁴

The fiscal system of each unit of government is limited in its operation by the geographical boundaries of that unit; it can withdraw resources for the financing of public services only from those available within this area. If the subordinate units are required independently to finance certain traditionally assigned functions, fiscal inequalities among these units will be present unless the fiscal capacities are equivalent. There will be differences in the number and/or the standard of the public services performed for, and/or the burden of taxes levied upon, the owners of economic resources within the separate units. The nature and the extent of these differences, and the difficulties involved in their elimination, constitute the elements of the over-all fiscal problem of the federal polity.

The situation has grown progressively more acute in the United States. This can be attributed largely to the three following parallel historical trends: First, the continual industrialization, specialization, and integration of the economy on a national scale have tended to concentrate high income receivers in specific geographical areas. Second, there has been an extension of the range of governmental activity at all levels in the political hierarchy. This has required the diversion of greater and greater shares of the total of economic resources through the fiscal mechanism. Third, this extension of governmental activity at the lower levels of government (and in peacetime at the top level) has taken place largely through the increase in the provision of the social services. This when coupled with the type of tax structure prevailing has increased the amount of real income redistribution accomplished by the operation of the fiscal system.

In 1789, a significant share of economic activity was limited to local markets; there was relatively little areal specialization of production. Govern-

4. The individual must deal with three or more fiscal systems, federal, state, and one or more local units. Local financial authority is, however, derivative from that of the state, and for present purposes, the combined state-local fiscal system will be considered as one unit.

mental services were performed predominantly by the local units which were drawn up roughly to correspond in area to the extent of the local markets. Rapid developments in transportation and communication led to an ever-increasing specialization of resources. The economy grew more productive, but the inequalities in personal incomes and wealth increased. This emerging inequality was both inter-personal and inter-regional; expanding individual differences were accompanied by closer concentration of the higher-income recipients in the more favored areas. This created disparities among the states in their capacities to support public services.

These fiscal divergencies were not conspicuous, however, until the extension of governmental activity caused the traditional sources of revenue to become inadequate. As greater amounts of revenue were required at all levels, conflicts over revenue sources among state units, and between states and the central government, arose.

The form which the extension of governmental activity took was an important determining factor in making the problem more difficult. Even with the increasing costs of government, inter-regional disparities in fiscal capacity would not have been accentuated had not the extension taken place largely through the expanded provision of the social services. Had the rôle of government remained "protective," and thus the fiscal system conformed more closely to the benefit or *quid pro quo* principle, richer units would have needed greater governmental expenditures. Only when the "social" state appeared did the divergency between need and capacity become clear. As more government services were provided equally to all citizens, or upon some basis of personal need, the discrepancies between the capacities and needs of the subordinate units arose.

The emerging fiscal problem has been only one of many created by the progressive national integration of the economic system within a decentralized political structure. This development has caused many students to view the political structure as outmoded, and the federal spirit as a thing of the past.⁵ The federal polity has outlived its usefulness, and the conditions which made it necessary as a stage in the process of political development no longer

5. See Roy F. Nichols, "Federalism vs. Democracy," *Federalism as a Democratic Process* (New Brunswick, Rutgers University Press, 1942), 50.