The Collected Works of
James M. Buchanan

VOLUME 4

Public Finance in Democratic Process

James M. Buchanan with portrait of Knut Wicksell,
Stockholm, Sweden, 1986

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Public Finance in Democratic Process

Fiscal Institutions and Individual Choice

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Foreword

James M. Buchanan is a self-declared Knut Wicksell disciple—or, at least, a disciple of the Wicksell 1896 habilitation thesis.[1] The later Wicksell work on monetary theory has certainly had its influence, but in other quarters. There are three aspects of Wicksell's 1896 analysis in particular that Buchanan has picked up and developed. These are the analysis of market failure in the provision of public goods; the insistence on conceiving policy decisions (government expenditure decisions specifically) as the outcome of a political process (and one, moreover, not inhabited exclusively by moral heroes); and the necessity of treating the tax and expenditure sides of the budget as interconnected. Of these, the first passed into public economics orthodoxy fairly painlessly. True, there was a lapse of a half century between Wicksell's work and the development of public expenditure theory at the hands of Howard Bowen, Paul Samuelson, Richard Musgrave, and Buchanan in the midcentury decades, but this development was one that mainstream public finance welcomed readily—and in some quarters, enthusiastically.

Buchanan's role specifically in the development of public goods theory is reflected in the book *The Demand and Supply of Public Goods.*[2] Although Buchanan's work in this area of scholarship has a distinctive orientation (reflecting its more self-conscious Wicksellian approach), it could hardly be claimed that it is unique in the way that his work has been in the public choice field. Put another way, public economics orthodoxy has taken up the second and third strands of the Wicksellian legacy only patchily and reluc-

1. Knut Wicksell, *Finanztheoretische Untersuchungen* (Jena: Fischer, 1896).

2. James M. Buchanan, *The Demand and Supply of Public Goods: A Defense and Restatement* (Chicago: Rand-McNally, 1968), volume 5 in the series. Also see volume 15 in the series, *Externalities and Public Expenditure Theory.*

tantly. It is clear, for example, that the antipathy to the "benevolent despot" model of government evident in the Wicksell discussion is the starting point for much modern public choice analysis, and no less clear that this antipathy is a direct assault on the orthodox public finance approach. Moreover, although public choice theory bears on questions of budgetary policy, it is by no means exhausted by them. It is therefore proper that public choice theory has taken on a life of its own in political science departments, alongside political theory of other kinds, as well as in economics departments.

To see public choice theory merely as an offshoot of and servant of public finance–public economics would be entirely too narrow a view and, arguably, too broad a view also. It would, for example, be entirely possible for a public finance economist to accept the necessity of an explicit political component in policy analysis and seek to supply that element by appeal to a theory of political process other than the public choice one. Nevertheless, the practice in public economics is generally to ignore the political element as either of second order concern or as appropriately handled independently by other scholars. Whether such independent treatment is appropriate is an issue that is central to the third strand of the Wicksellian legacy. This third strand involves the insistence that taxation should be seen as connected to the expenditure side of the budget and, indeed, that both taxation and expenditure be seen as inextricable parts of a single overarching political determination. To appeal to the title of the previously referenced Buchanan book, *The Demand and Supply of Public Goods,* tax arrangements are a critical element in the *supply* side and cannot be divorced from the *demand* side.

Or at least, so Buchanan (and earlier Wicksell) argued. In fact, standard practice in public economics pretty routinely involves *separate* treatment of the tax and expenditure sides of the budget. In tax analysis, the usual approach is to take the level of revenue required as fixed and to explore the most "efficient" and "equitable" way to raise that fixed revenue, deliberately suppressing any feedback effects of the method of financing on the revenue level itself. This procedure indeed achieves the status of a methodological requirement via the "equirevenue comparison" principle and the "differential tax incidence" analytics. These methodological strictures may serve a useful conceptual purpose in separating different aspects of the effects of tax changes—in particular in distinguishing effects on expenditure levels from other effects. However, all too often the consequence of this procedure is that effects on expenditure levels are entirely overlooked.

By contrast, Buchanan's approach to tax analysis has focused directly on such feedback effects. The particular model of politics chosen has varied. In some contexts, he has followed Wicksell in assuming a bargaining model in which the tax liabilities of particular citizens emerge as an endogenous part of the bargains struck.[3] In *The Power to Tax* and papers in that tradition, the model of government chosen is a monopoly one, and, in this case, different taxes are distinguished by the fiscal power (as reflected in maximum revenue potential) they represent. In the current volume, *Public Finance in Democratic Process,* the political model is a more conventional democratic one in which voters choose among alternative levels of public goods supply under relatively fixed tax arrangements and in which something like the standard median-voter model prevails.[4] The title of the volume is, in this sense, totally descriptive. The argument concerns those aspects of taxation that become relevant when the financing of public activities ("public finance") is conceived through an explicitly democratic-political lens. In particular, two related questions arise: First, how do different tax arrangements translate into different (marginal) cost shares or "marginal tax prices" for public goods to different voters? and, second, how do such changes in such tax arrangements influence voters' net demands for public activity and the emergent majoritarian equilibrium? Since what is relevant in this connection is the set of the voters' *perceived* tax prices, then fiscal illusion becomes extremely significant. Unlike orthodox tax theory, which focuses on the effects of taxes on choices between taxed and nontaxed private goods (notably including leisure) and the efficiency and equity implications of such choices, the core of attention in *Public Finance in Democratic Process* is the public-private choice—the effects, that is, of tax choice on the nature and size of the expenditure side of the budget.

3. See, for example, James M. Buchanan, "Taxation in Fiscal Exchange," *Journal of Public Economics* 6 (1976): 17–29, in volume 14 in the series, *Debt and Taxes.*

4. 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. Also see volume 14 in the series, *Debt and Taxes;* James M. Buchanan, *Public Finance in Democratic Process: Fiscal Institutions and Individual Choice* (Chapel Hill: University of North Carolina Press, 1966).

As Buchanan emphasizes, this approach involves seeing tax phenomena through a different lens—through a different "window" to use the Nietzschean metaphor to which Buchanan appeals in the preface. (Indeed, the preface and the epilogue to the book provide an interesting incidental view of Buchanan's method as he himself interprets it.) However, this "alternative perspective" line should not allow the orthodox tax theorist to shrug off the implications of *Public Finance in Democratic Process.* Even at the most minimal level, once the possibility of feedback effects of tax arrangements on expenditure levels is allowed for, the efficiency and equity effects of alternative tax systems must take those feedback effects into account. "Democratic process" remains relevant even within the orthodox normative framework. For this reason, it is somewhat surprising that the central messages of *Public Finance in Democratic Process* have not been more readily accepted into public finance orthodoxy. Unlike *The Power to Tax,* for example, the conclusions of which might be seen as a wholesale attack on orthodox tax theory, *Public Finance in Democratic Process* is a work more hospitable to public finance orthodoxy and could be treated as an extension (albeit an important one) of the conventional approach.

Geoffrey Brennan
Australian National University
1998

Preface

Fiscal theory is normally discussed in a frame of reference wholly different from that adopted in this book. This dramatic shift of emphasis plays havoc with disciplinary orthodoxy, and few guideposts remain to indicate whether or not the bounds of reasoned argument have been overextended. By necessity the approach taken here requires that I consider the processes through which individual choices are transmitted, combined, and transformed into collective outcomes. Careful research and scholarship in this area is in its infancy, and the necessary reliance on crude, unsophisticated models underscores the exploratory nature of the work.

My best critics have been my graduate students, and the theme most recurrent in their comments concerns the unreality of the individualist-democracy models of political order on which the analysis is based. In the real world, individuals, as such, do not seem to make fiscal choices. They seem limited to choosing "leaders," who will, in turn, make fiscal decisions. This idea, that, in modern political structures, individuals are satisfied when they "choose the choosers," is sufficiently pervasive to justify some discussion, even at this early stage. In certain aspects of life, it is, of course, meaningful and efficient for the individual to choose "experts" who will, in turn, be empowered to make the necessary ultimate decisions. The case of medical care is perhaps the most familiar. In selecting a doctor, the individual is choosing someone that he considers more qualified than he to make decisions on his behalf. The individual does so, however, only because the ultimate criterion, good health, is understood by both parties and is capable of reasonably definite objective measurement.

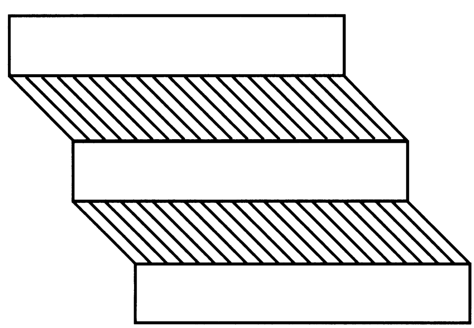
Is politics like medicine? Are we willing to choose "experts" who will decide for us? Are we prepared to allow government "for the people" but not "by the people"? It is apparent that there is a fundamental difference here, and that it is summarized by the absence of agreed-on and objective criteria. We are not normally willing to allow chosen political "leaders" to decide for us, save within very restricted limits, because we disagree sharply among ourselves concerning what should be chosen. In one sense, the departure from standard democratic procedures during periods of war emergency confirms the basic hypothesis of democracy. For only in such periods are collective goals or objectives shared sufficiently by the populace to make genuine delegation of decision-making to experts acceptable. In the absence of such emergency, the delegation of ultimate decision power to experts, or presumed experts, is inconsistent with our notions of a free society. Individuals do not agree on criteria, and the range for collective action is wide. Why should the individual be willing to delegate to a presumed expert his power of public choice when he is unwilling to so delegate his power of private choice?

The delegation of choice discussed here is not the same thing as *representative* government. To an extent, of course, elected representatives choose for their constituents in any large democracy. So long as their choices are, however, constrained and guided by the ultimate wishes of their constituents, the democratic models retain relevance.

The central criticism of the individualist-democracy models is in part introspective, and it stems from each person's feeling that he is alienated from "the State." The primary psychological relation of the single individual to government is one of coercion, and, recognizing this, the individual is reluctant to discuss, or even to think about, voluntaristic aspects of the process. This reaction mechanism need not be damaging, so long as the alienation is kept within appropriate limits. Effective democratic process, and useful theorizing, does not require that each and every citizen feels himself to be a participant in a continuous referendum. The individual may, and does, recognize that many of the complex political-governmental institutions are beyond his own range of control or influence. He must, nonetheless, recognize that some power of ultimate choice rests with him and his fellows. To the extent that personal alienation from the State extends beyond this point, to the extent that the individual loses all sense of influence in determining the limits on political action, effective democratic process is eliminated, and the models developed in this book are admittedly inapplicable.

In this case, the analysis should properly shift from the behavior of the voter-citizen-taxpayer-beneficiary to that of the decision-maker, who secures benefits without suffering costs, and of the decision-taker, who suffers costs and secures benefits only at the suffrage of his rulers. The political-fiscal process factors down into a two-class model, and the behavior of two groups must be examined. Developments in American democracy may suggest to some observers a shifting toward such a model. Descriptive realism is often deceptive, however, and, hopefully, the individualist-democracy models retain predictive relevance. If they do not, we should at least be willing to examine the alternative.

Is it not possible, indeed probable, that our conceptual analysis of social-political institutions is basically analogous to our visual reaction to the familiar staircase figure below? We can view the figure in either one of two ways, but it is impossible to view it in both ways simultaneously. One must, somehow, shift his vision, itself an interesting mental process, in order to change the steps into risers and vice versa.



Our conception of fiscal process seems much the same. It may be consistently interpreted and analyzed in a ruling-class, "establishment," or force model of political order. And, as I hope this book suggests, the process can also be consistently interpreted through an individualist-democracy framework. In any relevant modern setting that is broadly described as "democratic" in the Western sense, each of the two conceptions possesses some explanatory potential. The relative efficacy of the two models need not be discussed, and the normative implications can also be left out of account. Orthodox discussion in public finance reflects an uncertain mixture of the two approaches, along with a liberal dosage of idealist-democracy norms. The resulting inconsistencies are not surprising. If this book does little else than call attention to the importance of the political decision process in public finance theory, its lesser purpose will have been achieved.

The basic draft of this book was written during the summers of 1962, 1963, and 1964. The manuscript was thoroughly revised during the period, February–August, 1965, and final changes were made in early 1966. I am indebted to the National Committee on Government Finance, Brookings Institution, for research support and assistance. Helpful clerical assistance has also been provided by the Thomas Jefferson Center for Political Economy, University of Virginia, and especially through the services of Mrs. Betty Tillman. Emilio Giardina, Charles Goetz, W. C. Stubblebine, and Gordon Tullock provided helpful comments on early drafts. Among editorial readers who were identified James S. Coleman, Anthony Downs, Roland N. McKean, and William N. Riker contributed useful advice for revision. Mark Pauly deserves especial thanks for his assistance with the index.

Charlottesville
March, 1966

PART ONE

The Effects of Institutions on Fiscal Choice

I am ready to admit that much of my discussion may be classified as arm-chair speculation. I accept the title gladly, for this is, in fact, the manner in which everything may be taken into account, and an inclusive, internally consistent system constructed. For this reason, I never worry about the external consequences of carrying out my theory. How much of it—or whether any at all—may be practically applied in the near future, practical men may decide. I become the same as they if I try to take into account every conceivable practical criticism.

—Knut Wicksell, in the Preface to *Finanztheoretische Untersuchungen* (Jena: Gustav Fischer, 1896).

1. Introduction

Individuals, separately and in groups, make decisions concerning the use of economic resources. They do so in at least two capacities: first, as purchasers (sellers) of goods and services in organized markets, and, secondly, as "purchasers" ("sellers") of goods and services through organized political processes. Economic theory has been developed largely to explain the workings of organized markets, and the trained economist understands how decentralized decisions are mutually co-ordinated so as to produce allocative results that are internally consistent. Economists, especially English and American, have devoted little time and effort to an explanation of individual behavior in the second decision process.[1] Individual participation in collective decision-making has not been thoroughly analyzed, and the means through which the separate private choices are combined to produce "social" or "collective" outcomes have not been subject to careful and critical research. This relative emphasis on the interaction process in private markets was, to some degree, justifiable so long as organized markets retained overwhelming allocative importance. But when more than one-fourth of all products, even in those economies that are presumably noncollectivist, is destined to be used for collective rather than for private purposes, some modification in the emphasis seems in order.

There exists no "theory of collective choice," no "theory of demand for collective goods," that is analogous to the familiar theorems and propositions

1. "The application of income to the payment of taxes is a particular case of the general law of the division of income." The recognition of this point was characterized as a major Italian contribution to the theory of public finance by Gino Borgatta in his summary preface to a volume of translations. (Gino Borgatta, "Prefazione," *Nuova Collana di Economisti,* Vol. IX, *Finanza* [Torino: Unione Tipografico Editrice Torinese, 1934], p. xxxi.)

in neoclassical economics. We know little about how individuals behave as they participate in collective choice. In societies that are organized democratically, even in the broadest sense of this highly ambiguous term, individuals must be assumed to participate in the formation of "public" decisions. They may, of course, do so indirectly and at several stages removed from specific allocative choices. They may be motivated by group rather than individual interest, and they may remain indifferent over wide margins of public choices. The complexities of modern politics and bureaucracy should not, however, conceal the underlying realities, and gross misunderstanding can result if individual participation in, and reaction to, public decisions is either neglected or assumed away. The omniscient and benevolent despot does not exist, despite the genuine love for him sometimes espoused, and, scientifically, he is not a noble construction. To assume that he does exist, for the purpose of making analysis agreeable, serves to confound the issues and to guarantee frustration for the scientist who seeks to understand and to explain.

Political decision-making is a complex and intricate process, much more complicated than is the nonpolitical decision-making in market institutions. The rules constraining individual choice are necessarily different in the two cases, and because of the nature, both of these rules and the underlying objectives, simple correspondence between private cost and benefit, a basic feature of market choice, cannot exist in politics. Nevertheless, at some ultimate stage or level, the individual must, somehow, "choose" how his resources are to be used collectively as well as privately. In the final analysis, the individual must "decide" on the appropriate size of the government budget, and on the breakdown of this budget among component items. Despite his acknowledged ignorance, the individual citizen must, ultimately, choose the size of outlay on public education as well as number of veterans' hospitals.

This is not to suggest that the individual makes collective choices only, or even primarily, in his role as a voter in elective processes. He exerts influences on public choices through professional organizations to which he belongs, through the publications that he supports, through the public and private bureaucracies that employ his talents. Collective outcomes emerge out of the utility-maximizing behavior of many persons acting in many separate capacities. These outcomes are not independent of or divorced from the activities of individuals even if there is little consciousness on the part of any particular person that he is choosing *for* the community, save in specific and isolated cases. Even here, he is perhaps conscious of opting for or against a highly uncertain package; rarely is he given the opportunity to make specific indications of preference for or against tax or expenditure proposals. Nonetheless, analysis that cuts through the maze and examines the cost and benefit calculus of the individual *as if* he makes specific choices seems necessary as a starting point.

How can the private "costs" that the individual takes into account in such decisions be isolated and identified? How can the private "benefits" that are expected to balance off these costs be determined? Even to raise such questions as these suggests that research objectives here must be modest. Common sense indicates that the institutions through which costs and benefits are presented to the private citizen may influence his decision. The direct costs of governmental services appear to the citizen as *taxes,* and the manner in which these are levied may significantly affect his attitudes toward the extension or the contraction of such services. This study has as its purpose the development of some rudimentary predictions concerning the effects of the various fiscal institutions on the decision calculus of the individual, as citizen-voter-taxpayer-beneficiary. The limitations of this purpose should be stressed. When the study is completed, we shall remain a long way from an integrated "theory of fiscal choice." But some of the essential elements will, hopefully, have been provided, some crude hypotheses will have been tested, and some normative implications for reform in the existing fiscal structure may have emerged in the process.

The Traditional Approach to Public Finance

Public finance, as a subdiscipline of classical, neoclassical, and even Keynesian political economy, has consisted primarily in the analysis of the effects of alternative fiscal institutions on individual and group behavior in the private economy. Taxes and expenditures, separately or in the aggregate, have been studied, both analytically and empirically, with a view toward determining their effects on the activities of persons, families, firms, and other voluntary organizations. The influence of income taxation on the individual's choice between work and leisure, the effects of business taxation on managerial efficiency, the effects of agricultural subsidies on output, the impact of highway spending programs on transportation development, the effects of budget deficits or surpluses on income, employment, and prices: all these, and many more similar topics, are familiar chapters in the treatise written in the traditional framework.

These subjects are important, and past research has yielded fruitful results. Current and future research promises to add still more to our analytical capital stock. The absence of an important aspect of public finance must be noted nonetheless. The individual does choose how to allocate his income-earning power between earning and not-earning, and he is surely influenced in this choice by fiscal institutions. But he also chooses, as a citizen in a democratically organized political community, how to allocate his potential income between private uses and public or collective uses. The structure of fiscal institutions must also affect this choice, and in important ways, even if participation in such choice by the individual seems remote and indirect. Public finance, as traditionally developed, studies individual behavior in the *private* sphere of his activity. It has not, sufficiently, examined behavior in the *public* sphere of activity, although here, too, the choices must remain *individual* in the final analysis, regardless of the decision-making rules.

Specific Purpose

This study is not aimed at developing a comprehensive "theory of fiscal choice," even at the level of individual participation. Its primary purpose is that of analyzing the effects of designated fiscal institutions on individual behavior in collective choice situations. Attempts will be made to predict the effects of such institutions as the income tax on the individual's behavior as he confronts decisions on the public usage of economic resources.

There are two parts to the study. In the first, Part I, we shall assume that the various fiscal institutions are exogenously imposed on the individual. That is to say, he is assumed to adjust his behavior under a set of institutions that he considers to be beyond his power to alter or to modify. In this initial