JAMES BUCHANAN'S FEDERALIST PAPERS

Jonathan Pincus

Working Paper 94-2

The University of Adelaide,
Department of Economics,
ADELAIDE, S.A. 5005

ISBN 0 86396 251 3
JAMES BUCHANAN'S FEDERALIST PAPERS

Jonathan Pincus

Economics Department
University of Adelaide

ABSTRACT

A small but important part of Buchanan's work is focussed on issues relating to federalism. This includes the early equalisation grants paper (from his doctoral dissertation), the mid-career papers on Tiebout processes and the later paper on fiscal cartels in The Power to Tax (1980). The aim of the current paper is to assess the importance of these contributions both to the federalism literature and as pieces of Buchanan's own intellectual agenda. One important question is whether, together, these Buchanan contributions represent a proper 'public choice' theory of federalism - and if not, where the major gaps lie.

* This paper derives from joint work with Geoff Brennan for an edited book on The Intellectual Legacy of James M. Buchanan, for Edward Elgar.
Introduction

When Walter Oi was in Australia recently, he remarked he believed that Jim Buchanan had attended every Southern Economics meeting for forty three years, come what might. Buchanan's first paper, "Regional implications of marginal cost rate recovery," was published in the *Southern Economic Journal*. Now, although it is presumptuous to infer motivations for Buchanan's work from biographical details, especially since Buchanan has written his own memoirs, it is tempting to suggest that Jim's southernness is connected to his interest in federalism. Certainly included in Buchanan's affection for the constitutional arguments of the American founding fathers is a fondness for Madison's views on the advantages of the 'compound republic', as well as for other means of achieving a separation of powers. Buchanan's constitution for a good society includes some federal arrangements.

We will outline Buchanan's contributions to the economics of federalism in Section 2. In his initial contributions, Buchanan's criterion was the equity, not the efficiency of federal arrangements. In a dispute with A.D. Scott in the early 1950s, Buchanan again defended federal grants on grounds of equity. Scott, however, had attacked them on the efficiency ground that population would be retained, inefficiently, in resource poor regions by a system of federal equalising grants. Buchanan's initial response on the question of efficiency was weak. Subsequently, Tiebout's famous 1956 article on the effects of competition among jurisdictions rekindled the debate, when it was taken as evidence against the proposition Buchanan had asserted but not proved in 1950, about the efficiency of migration in the face of a suitable system of equalising grants. Surprising is a continuation into the early 1970s, well after the start of Buchanan's methodological attack on the conventional use of the Pareto

1July 1949, 53-61
2"Personal history, in one sense, explains everything, yet it predicts nothing because the same life histories can be claimed to predict the monthly subscriptions lists of both the *Monthly Review* and *Commentary*," R.C. Lewontin, New York Review of Books, 7 April 1994, p. 35
criterion, of a continued emphasis on the correction of inefficiencies arising in some federal arrangements\(^3\) (Section 3). What was lacking, until the later book with Brennan, *The Power to Tax*, was a strong defence of federal arrangements themselves (Section 4). The final section discusses what would help to complete the research agenda on federalism in Buchanan's work.

2: The early papers on federalism

'Federalism and fiscal equity'

Buchanan's 1948 University of Chicago PhD, concerning federalism, resulted in 1950 in one of his earliest main papers\(^4\). It contains many of the elements of Buchanan's contributions to federalist theory, particularly the notion of the fiscal residuum\(^5\); the existence of differential incomes, with the implication that these were due to locational rents; and a process of migration in response to the income available in various locations. This paper seems to have framed Buchanan's federalism work for some decades.

The title reveals the thrust of the paper. Accepting the classical tax desideratum, the equal treatment of equals, Buchanan argues that this form of 'fiscal justice' can be achieved within a federation by appropriate intergovernmental fiscal arrangements. The placing of citizens in positions of fiscal equity with their equals in other states is an 'ethically acceptable' form of redistribution, and requires state-specific federal tax rates or, as an inferior alternative, unconditional grants to the states (p. 179-89). Referring to the 1940 Canadian Royal Commission on Dominion-Provincial Relations, Buchanan stated that "The explicit objective of such a system would be the placing of all state units in a position which would allow them to provide a national average level of public services at average tax rates" (p. 174), an objective familiar to students of the Australian Commonwealth Grants Commission.

---

\(^3\)The relevance of Pareto Optimality,* JConflictRes 6 (December 1962), pp. 341-354

\(^4\)Federalism and fiscal equity,* AER 40 (Sept 1950), 583-99

\(^5\)Fiscal residuum' was introduced in Buchanan 'The pure theory of government finance: a suggested approach', *JPE LVII* (Dec 1949)
3: Attacks on the Tiebout mechanism

Although in his 1950 paper Buchanan adopted the viewpoint that the "equal treatment of equals" is desirable for reasons of equity, in a brief paragraph he argued that without appropriate grants, there would be a fiscal incentive for migration from states offering low or negative fiscal residua to those offering high residua, causing a considerable divergence from the resource allocation dictated by 'economic criteria' alone (p. 178). It was to the underlying issue of the efficiency of migration that Buchanan turned in two co-authored publications in the early 1970s.

A transition was provided through a dispute with A.D. Scott, in 1952\(^6\). Buchanan again emphasised "commonly accepted ethical standards" concerning distribution, when criticising Scott's argument against federal grants to resource poor states, as well as Scott's exclusive focus on "securing optimum resource adjustments"\(^7\). However, he did attempt to dispute Scott on efficiency grounds, but unconvincingly. Having introduced the useful distinction between equalisation of factor prices and the equalisation of incomes, Buchanan's argument then turned on an empirical question of the excess of the 'social productivity' of capital in poor regions of the United States over that in the rich.

It should come as no surprise to those who expect that Buchanan's work will prove to be internally consistent (and he professes not so to expect), that he should have been sceptical of any claims about the efficiency of the 'Tiebout process' involving mobile citizens, each having regard to the best fiscal bargain. In his 1950 paper, Buchanan had made the claim that in the absence of a suitable fiscal instrument, migration would not allocate resources efficiently. No such instrument figured in Tiebout's 1965 paper, yet its model was widely interpreted to show that migration would produce something like Pareto optimality. Like all those who have thought deeply about the issues, Buchanan is fully aware that an appropriate institutional or

\(^6\)Federal grants and resource allocation,' JPE LX.3 (June 1952), and replies and counter-replies.

\(^7\)His 1971 paper with Wagner (see below) acknowledges that concern in 1952 was with horizontal equity norms.
constitutional framework is needed before we can safely rely upon decentralised or competitive processes to secure beneficent outcomes. The framework he had supported in 1950 was an system of regionally differentiated national tax rates or suitable federal grants. In a pair of joint papers published in 1970 (Buchanan and Wagner) and 1972 (Buchanan and Goetz), he set out to prove this framework\textsuperscript{8}.

Buchanan and Wager pose the problem of inefficient migration in the context of a common property model, in order to provide an efficiency basis for equalising elements in unconditional grants. For the private good, the presence of an immobile factor, land, assures declining marginal product of labour (= population). Beginning with the case of a pure public good, supplied optimally, Buchanan and Wagner argue that migration will equalise the sum of the values of the marginal private product and the average public product, whereas efficient allocation of the mobile factor requires equalisation of the sum of the two marginals\textsuperscript{9}. A system of fiscal grants in favour of the richer state could induce a more efficient allocation of population\textsuperscript{10}. However, the case for equalising grants emerges when the tax-side externalities are outweighed by the uncompensated congestion costs that migrants impose on other users of impure, local public goods\textsuperscript{11}. "At current margins of decision, there is likely to be a greater return per dollar invested in keeping a family in Arkansas than in helping Chicago finance part


\textsuperscript{9}For the public good, Buchanan and Wagner use the term 'public-product value' to denote the net effect on the tax-price and benefit sides, or the fiscal residuum.

\textsuperscript{10}This result is driven by the assumptions that the public good is local (bringing benefits only to the residents of the state providing the good), and that the good is nontrivial (no congestion). The analysis is not without its difficulties concerning the tax system. On p. 239, "Each citizen pays a marginal tax price equal to his own marginal evaluation of the good", yet it is also the case that "The higher income states are able to provide the same quantity of the [pure] public good at lower tax rates"; later, "...the simplest case of equal per capita sharing in costs of the [pure] public good" is assumed. See also M. Feldstein's "Comment" on Buchanan and Wagner in the 1970 NBER volume.

\textsuperscript{11}Alternatively, an efficient allocation would ensue if property rights could be assigned in access to the public good: states would tax or subsidise migrants. However, within a federation, at least for Western civilisations, the implied right for a state of exclude immigrants, is "inimical to the functional values" (p. 246). Buchanan and Wagner were picking up the analysis of property rights in Frank Knight, "Some fallacies on the interpretation of social cost," (1924), pp. 582-606.
of the external costs that this family's migration might impose on current Illinios residents (p. 249).

In the 1972 *JPE* paper with Goetz, the focus is on the inefficiency of the Tiebout process itself. Tiebout's model is characterised as describing the adjustment process in an essentially nonspatial world of voluntary clubs, a world not appropriately descriptive if private productivity varies with location and if nonexcludable commodities have locational dimensions. Absent a system of private cities, migration causes fiscal externalities on the tax as well as on the benefit side. An ideal tax system, which would discriminate according to each individual's locational rent, is infeasible for two reasons: the majority of the electors is unlikely to stop at a redistribution designed only to offset fiscal externalities; secondly, the information required for optimal discrimination is the individual subjective valuations of locational advantages, and these are not observable (p. 84-5)\(^\text{12}\). Without empirical estimates of the various components of the externalities, however, it is impossible to say whether or not there will be excessive migration to the more populated and richer communities and so there is no clear theoretical case that grants made to improve economic efficiency will be of the equalising kind\(^\text{13}\).

4: Federalism in *The Power to Tax*

In the papers discussed above, Buchanan takes the existence federalism as a fact of economic life in the United States. Can federalism be justified? In particular, if interstate migration cannot be guaranteed to locate labour efficiently within a federal system, can the difficulty be resolved by abolishing federalism, rather than by adding a system of grants to the federal

---

\(^{12}\)Local property taxes based on arrangements designed to elicit reservation prices, rather than upon the typical rateable valuations, go some way toward the ideal discriminatory tax system. They require an owner to sell on demand (to another resident?) at the rateable valuation.

\(^{13}\)The model in Buchanan and Goetz is a modified version of that in Buchanan and Wagner. For a recent discussion, see R. Boadway and P. Hobson, *Intergovernmental fiscal relations in Canada*, Canadian Tax Paper 96, Canadian Tax Foundation, Toronto, 1993.
arrangements? In the following section, I outline how Buchanan and Brennan defend federalism on a type of efficiency ground.

Before the late 1970s, the Pareto criterion had come to play a central role in Buchanan's research program, but at the 'constitutional' stage, rather than in the context of particular policy decisions made under the constitution. Buchanan in the earlier contributions used equity as a criterion against which to judge the case for grants within a federal system; and he used efficiency, in the later discussion of Tiebout. A form of efficiency not equity is at the basis of the case in *The Power to Tax* for federalism itself. At the idealised constitutional convention, behind the veil of ignorance of one's own eventual economic and social position, surely both equity and efficiency are relevant. The assumptions required to establish the relevance of efficiency are that voters have expectations about how the world will work and, in particular, that rulers will be expected to act so as to maximise their own take from tax revenues. The argument probably implies that voters are not risk-lovers. As to equity: if it were true, as Buchanan claimed in the earlier papers, that some degree of fiscal equalisation, so as to treat "equals as equals", accords with widely accepted ethical precepts, then would it not appeal to the 'constitutional convention'? The assumption required here is that voters expect that they will be risk averse.

Be that as it maybe, in *The Power to Tax* the citizens are imagined attempting to maximise their collective 'fiscal residual' in the face of the certain belief that a fraction of the tax revenues collected will be diverted to purposes of no value to the taxpayers. A federal system is advocated as a partial or incomplete bulwark against the Leviathan: it can reduce that diverted fraction. Brennan and Buchanan argue that there would be no fiscal exploitation if all

---

14 In view of the facts that someone will be the government, and that some citizens will benefit from the Leviathan's own tax take, for there to be a *unanimous*, contractarian approval of stratagems to restrain government tax revenue collections, the constitutional assembly must not contain any risk-lovers. Note that the commentary, in *The Economics of Federalism*, B.S. Grewal, G. Brennan and R.L. Mathews, eds (ANU, 1980), p. 175-177, criticises Buchanan's 1950 paper for forfeiting the federalist game by his assumption that the national government's criterion for equity should rule over those of the states. However, if one adopts a thorough-going individualistic viewpoint of the kind Buchanan typically takes, then any equity criterion is hard to justify except in contractarian terms.
public goods are Samuelsonian (technically nonexcludable, and nonrivalrous for the whole of the national population); and migration costless; and if there were no locational rents. Unfortunately, they note, there would be no public sector at all unless the central government had the constitutional power to tax and spend on the public good. If the constitution assigned exclusively to the states the task of funding the provision of public goods of this extreme type, Tiebout-type competition would be a disaster.¹⁵

To build the case for federal arrangements, Brennan and Buchanan then progressively relax the assumptions. Their initial arguments recapitulate analyses made earlier in Buchanan and Wagner, Buchanan and Goetz and, surprisingly, Tiebout: costless migration would force local suppliers of locally-excludable public goods into efficiency without fiscal exploitation, so long as there are no locational preferences or rents. A federal system of many competing government would be a more desirable bulwark against exploitive Leviathans when the costs of mobility are high and the potential great for collusion among governments; and less desirable when the public goods tend to the pure Samuelsonian kind. Brennan and Buchanan predict equalising federal grants as a consequence of the existence of a fiscal cartel, evidence for which is provided, *inter alia*, by typical assignment to central governments of the broad tax bases.

The parallels and contrasts with the 1952 Buchanan piece, and with Buchanan and Wagner, are striking. A sequence of models, similar to those educed in the earlier work in support of a system of equalising federal grants, were later employed to support the case for a federalism which is to be denied the use of federal grants.

¹⁵Brennan and Buchanan (p. 177) do assert that "There is no way of determining a priori whether these efficiency losses will be greater than, or equal to, or less than those that are to be expected under centralised assignment". Surely they jest about the Hobbesian state of nature.
5: Incomplete Thoughts about an Uncompleted Agenda?

The case for federalism presented in The Power to Tax, like that for equalising grants in Buchanan and Wagner, turns ultimately empirics: there are factors or forces that weigh on one side or the other, with no presumption about which is heavier. In view of the upsurge of interest in federalism, especially the former Soviet Union, is there not a stronger presumption?

Constitutions change, even in the most democratic of arrangements, like that of the Australian, where the 1901 Constitution was approved by majority vote in each of the constituent colonies, and can be changed with difficulty by the majority of voters in a majority of states. What attracts voters to a continuation of federal arrangements? Although it can be derided making a self-serving argument, the Commonwealth Grants Commission has repeatedly suggested that citizens will lose affection for a federation if they live in states that, due to disabilities on the revenue side or on the cost-of-service side, cannot supply the average level of services with the average tax effort. Can this argument be fitted into Public Choice or Constitutional Political Economy?

Especially in B&B, the model of political behaviour is (deliberately) very simplified. Does a strong case for a federalist structure, with or without equalising grants, emerge in models with more realistic 'in-period' political behaviour? Is electoral competition so weak (eg, because of fiscal illusion) that it can be ignored? B&B rely solely on the inter jurisdictional competition; is the "death of death duties" in Australia adequately interpreted as an example of the effects of a fiscal cartel?

16With Brennan, the present author has analysed within a Public Choice model of the median voter type, the alleged 'flypaper effect' arising in models of federal grants.