



Institut économique de Montréal



with

Professor James M. Buchanan, Nobel Prize Laureate in Economics (1986)



James Buchanan is the cofounder of public choice theory a branch of economics that developed from the study of taxation and public spending. It holds that people acting in the political marketplace, voters, politicians, lobbyists and bureaucrats are motivated mainly by self-interest and that the incentives for good management in the public interest are weak since political decision-makers are susceptible to capture by interest groups. For this work he was awarded the 1986 Nobel Prize in economics. Among his best-known works are *The Calculus of Consent* (1962 co-authored with Gordon Tullock) and *The Limits of Liberty* (1975 coauthored with Robert Tollison). He was born in Tennessee and has spent most of his academic life in Virginia, most recently at George Mason University. He was founding director of the Center for the Study of Public Choice. James Buchanan was interviewed after a conference on equalization co-sponsored by the Montreal Economic Institute, the Atlantic Institute for Market Studies, and the Frontier Centre for Public Policy in Montreal on October 25th, 2001.

Frontier Centre: Can you provide a brief definition of "public choice" economics, a field of study for which you received the Nobel Prize for Economics in 1986?

James Buchanan: I usually have a three-word description -- it is "politics without romance". Politics is a romantic search for the good and the true and the beautiful. "Public choice" came along and said, "Why don't we model people more or less like everyday persons? Politicians and bureaucrats are no different from the rest of us. They will maximize their incentives just like everybody else." By taking that very simple starting point, you get a completely different view of politics and its analysis.

FC: Can you define "rent seeking"?

JB: People share a universal behavioural trait: if there are profits to be made, the effort to get that money will attract investment. This is true in the private sector, the market sector, as well as the public sector. If you create an artificial scarcity through public policy, artificial rent so to speak -- setting up a new import quota or giving out a particular office that is very beneficial -- people are going to invest money, time and resources in trying to secure that opportunity. If the value is created independently of the search for it, the search for it is wasted. It is a subtle concept, yet a simple one, too. For example, imagine that Queen Elizabeth I, in her time, had the opportunity to give out a monopoly for playing cards within the kingdom. She knew she was going to give it to one of her courtiers. These courtiers would then all try to curry her favour. Meanwhile, they would not contribute anything to the product of the kingdom, in fact, they were wasting resources trying to secure a single prize. That, more or less, is rent seeking.

FC: How do we prevent or minimize rent-seeking behaviour in the design of public policy?

JB: We try to prevent the creation of artificial rents. Rather than setting up quotas to stop imports we levy a tariff, that would be better. Or we pay wages in the public sector which are roughly equivalent to the productivity in the private sector and we don't therefore make it a special benefit to get a bureaucratic position.

FC: Most U.S. states have legislative mechanisms to restrict unrestrained spending like balanced budget laws. Several Canadian provinces have introduced balanced budget legislation to discourage deficit financing. What is your view of such devices?

JB: Well, I have long been in favor of a balanced budget restriction at the level of the federal government of the United States. Because the federal government has money-creating powers it can, in fact, be very damaging if it runs a series of budget deficits. With the state government in the United States, they don't have money-creating powers. The automatic discipline imposed by the fact that they are in a common monetary unit and don't have control over the money power means that the balanced budget restriction is less needed.

FC: You originally saw merit in the policy of equalization that redistributes income from wealthier to poor regions – today you seemed to qualify your view on that. Why?

JB: Well, I am more qualified than I was. The main reason is that I now recognize it is much more difficult to get implemented politically what might be desirable economically. Even if you came out with an economic argument in favor of equalization -- and I think there are arguments on both sides -- I would still come down in favour of some sort of a scheme on strict economic grounds. That's on the presumption that you could get politically implemented precisely what it was you recommended. But the way politics works, it is very unlikely that you would get what you would desire.

FC: There is evidence that government-to-government equalization systems in Canada have meant transfers tending to expand the size of the public sector in receiving provinces, for example, by propping up inefficient and ineffective policy delivery models. Would it not be wiser to transfer resources directly to the individuals in these regions instead of governments?

JB: Yes. In my original analysis of this, back in 1948, I made that point quite specifically. From an ideal economic point-of-view, you would definitely have to give it to individuals. My scheme at that time applied to differential rates of income tax in different provinces. Once you transfer from government to government, you have another source of major inefficiency.

FC: What are the obstacles that you might see in shifting from government-to-government to an individual transfer system?

JB: That gets back into rent-seeking. Once you have an equalization instrument in place, as you have in Canada, there arise tremendous bureaucratic values -- bureaucratic rent so to speak -- in maintaining the system that you have. To shift to a system that paid the transfers directly to individuals, by having differential rates of federal income tax levied to adjust to provincial fiscal capacities, which would be my preference, you would have huge bureaucratic opposition. People would try to protect the rents they have in the current system of institutions.

FC: You talked today of fiscal capacity as a commons. Could you briefly describe or explain that?

JB: If you have an area where high-income receivers concentrate, you have a higher fiscal capacity. That fiscal capacity is a valuable resource and will create rent-seeking. People will try to get that resource one way or the other, including immigration. It is very much like the medieval peasants putting their sheep on the commons pasture. It is better than the open range, and if you let them have open access they will, in fact, put too many sheep on the pasture and waste the value that the pasture has. We want to limit the exploitation of the fiscal capacity of the richer regions by keeping

down the rate of immigration to a level that would be meaningful and efficient. One way to do that is to have a scheme of equalization which essential bribes people to stay in the poorer regions.

FC: Does the absence of equalization in the United States create a more dynamic economy by keeping spending down, hence taxes lower? Canada has a lower living standard than the United States – can we draw a connection between equalization and this gap?

JB: I wouldn't necessarily say that. You've got a more dynamic economy in the sense that the U.S. has more mobility, and that has plusses and minuses. You have real value in having stability in communities, a fact economists sometimes don't recognize. America is perhaps excessively mobile in the sense that there is sometimes not enough stability in communities. Dynamism in the economy is not necessarily the "be all and end all".

FC: You mentioned today some of the challenges around equalization. For example, in the Province of Manitoba we are seeing a changing demographic where the older consuming population is expanding and receiving services paid for by equalization while the younger population, the entrepreneurs and job-creators, are moving to places like Alberta which have lower taxes. We are creating a more dependent population as our ability to pay for it shrinks. It is a difficult situation, how would you handle that?

JB: This is happening in many situations but I don't know quite what the solution is. Certainly an equalization scheme won't handle that. You are getting distortion in the way people are spacing themselves out or locating and it has economic consequences that may not be desirable. I don't know of a policy scheme that would handle that very well.

FC: There was a comment today suggesting that a major problem with equalization was that it allows politicians to provide services without being accountable for the taxes involved. It seems like a classic public choice issue, where spending can only go up. Could you comment on that?

JB: That's a classic objection to any scheme of grants from one level of government to another. If politicians get money to spend and don't have to be responsible for taxation, then of course that will bias their attitude toward more spending as opposed to cutting back on spending. If you follow that objection, you can never justify any sort of inter-governmental grants. Yet you may feel it necessary, and you may be willing to put up with that as a cost in order to get more effective power decentralized out of your central government. If you don't have that, and you have no grants, then the pressure is to put everything up to the level of the central government. You have to trade these things off one against the other.

FC: Part of your work was the whole idea of concentrated benefits versus diffused costs and the tendency for interest groups to drive up government spending. Could you briefly explain what that is?

JB: We have a system of taxation that is fairly general, so the cost of something is borne by everybody. On the other side of the budget account, concentrated spending benefits go to particularized groups. Through trading among these groups, coalitions are built up to benefit from that spending but the costs are spread out through taxation. That spending is very concentrated and brings pressure to bear on your political leaders, who are pressured to pass special interest, sometime called "pork barrel" legislation. You can get a coalition of senators from particular states in my country, for example, who want to construct highways or dams or ports which may well be very inefficient. The taxes would be paid by the people over the whole country, but the benefits would go to the few people in those particular locations. This type of spending is a rather gross waste of resources that worsened over the years as the government has been allowed to do more particularized things.

The solution to it is to have the same principle on both sides. If you are going to spend for one group, you have to spend the same for every group, just like if you tax one group you have to tax everybody. You have to go back to having more general laws, more general taxes and more general spending programs.

FC: Does that bring us back to the theory behind the balanced budget law which also is a constraint?

JB: To some extent that's true.

FC: Your insight into the diffused cost/concentrated benefits problem would seem to explain the relentless expansion of government in Canada during the last 30 years. In your opinion what is the optimum size of government?

JB: It's not zero. Clearly, I am not an anarchist. Philosophically, I might be, but I think in practical terms. You have to have a government to provide you with legal order, with stability, enforcement of property rights, enforcement of contracts, definition of rules and regulations -- the rules of the game, so to speak -- and to provide certain shared goods and services, public services. Several people have tried to estimate this and they come out with figures like government spending at 15% of GDP. In the modern world it has gone to 40% or above. So we are way beyond the optimal, and that is easier to say than what the optimum is.

FC: So you would go with government spending at 15% of the total economy?

JB: It's not bad, but it is a ballpark estimate.

FC: The stock of apartments in my city Winnipeg is literally rotting around the edges due to rent control, yet the entire political class is hopelessly paralyzed in stopping the decay. Can we slot that in as a public choice issue where politics has overwhelmed good economics?

JB: Rent control is one policy that economists universally would oppose. It is a grossly inefficient way of allocating housing space and, of course, it inhibits construction and creates the very thing it is supposed to alleviate. It is one of those things where people simply don't understand simple economics and, therefore, put in for political reasons what will damage the very people that it is designed to help. Minimum wage levels are another classic example. But politically, sometimes you get situations where rent control will go through. It is especially true in an emergency, where there is a sudden, sharp increase in demand for housing or a cut back in supply. People will simply not allow the marketplace to allocate housing resources and so you get pressures for rent control. Once you have it, it is hard to eliminate.

FC: How do you eliminate it?

JB: Well, eventually, people have to learn the economic argument the hard way.

FC: In the battle of ideas many now acknowledge that the principles of the market economy and the more realistic analysis of politics through the window of public choice theory have won. Most people see that markets can deliver the goods better than central planning. Scholar Francis Fukuyama wrote that famous essay concluding that global acceptance of market thinking meant the "end of history"? What is your view?

JB: Francis Fukuyama is very sharp. He was a colleague of mine. But obviously we have failed. We fought socialism and won. We figured that was a big victory and in a sense it was Hayek's big victory. But, on the other hand, we have failed to build in support for a free system in a positive way. I gave a paper last year which I called the "Soul of Classical Liberalism". We have lost the soul. We haven't recognized the necessity of defending our own system at the level of ideas. We have to get people to treat the idea of a free society as a civic religion or a faith. We need to fight for that faith. I am not sure we are there. And I think this test that is being forced on us is very, very important.

FC: So, you are in favor of an aggressive military response to the events of September 11th?

JB: Well, a very thorough military response, not necessarily aggressive in the sense of being gung-ho immediately. We do it carefully, we do it systematically and we don't back-off half way. I think the

world has changed dramatically since September 11th. It should force us to recognize that we are going to have to defend the free institutions of our society against those who are simply not willing to belong to a civil order. The assumption that we can keep societies open and free to everybody is going to have to stop. We are going to have to recognize that some people simply are not qualified and do not want to belong a civil order. Until we begin to make discrimination along those lines, then I think we are going to be extremely vulnerable.