

## CENTRAL BANKING AND THE FED: A PUBLIC CHOICE PERSPECTIVE

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This paper examines central banking in general and the Federal Reserve system in particular from the perspective of the theory of public choice. It is common to rationalize central banking as being necessary to offset the market failures that would otherwise plague a competitive regime of free banking. By overcoming problems of public goods and externalities, central banking would raise the aggregate level of wealth in a society, in much the same manner as the effective governmental provision of security of property and contract would raise it.

The theory of public choice, however, explains that the mere development of a rationalization or justification for a regulation or institution is not the same thing as an explanation of what that regulation or institution actually accomplishes. What is actually accomplished, in economic regulation generally, as well as in banking regulation in particular, depends upon the incentives that characterize a particular institutional or constitutional framework. For instance, the development of central banking could represent an outcome of a rent-seeking political process. In this case the average level of wealth might be lower than it could be under some alternative institutional regime, but there would be a controlling subset of the population that would be better off under the present regime.

This paper first explores possible disparities between the apologetics of central banking and its actual accomplishments. It then examines the Federal Reserve system in particular, arguing that the support for central banking seems more likely to be explained by the economic theory of rent-seeking than by the theories of market failure and public goods.

## Rationalization, Explanation, and Central Banking

It is often claimed that a competitive system of free banking will be plagued by problems of public goods and externalities. The resulting market failure is then used to rationalize or justify government control over the money and banking industry. A rationalization for governmental involvement in the supply of money is not, of course, an explanation of the actual conduct of government with respect to the supply of money. Moreover, the efficiency basis for governmental involvement in the supply of money has some problematical aspects. These can be seen by considering four major elements in the rationalization of central banking, namely: the natural monopoly character of money; the social saving through the development of fiat money; the promotion of economic stability through an activist monetary policy; and the external diseconomies that would otherwise plague a competitive system of free banking.

### *The Natural Monopoly Rationalization*

The assertion that communication becomes less costly as the number of languages in use declines seems to be intuitively obvious, much like the assertion that the sun rises in the east and sets in the west was long regarded as intuitively obvious. And the cognitive basis of the assertion about a common language may be no firmer than that of the movement of the sun. Nonetheless, it is something that is generally believed, and this same principle is commonly extended to money by asserting that exchange becomes less costly as the number of media of exchange in a society decreases. The argument that there is a saving in transaction costs through the adoption of a common medium of exchange is not, of course, a rationalization for governmental provision of that medium. As Carl Menger (1892) explains, money arose through ordinary economic processes and not through some collective act. While both money and lighthouses have often served as archetypical illustrations of public goods, the historical record shows clearly that both have been supplied through ordinary market institutions.<sup>1</sup>

There are numerous cases in which we are all better off by some degree of standardization, but for the most part that standardization arises naturally through competitive market processes. However, in some cases it might be possible to imagine improvements upon the standardization that results from competition. Typewriter keyboards might provide one such illustration. In the early days of typewriters

<sup>1</sup>See Coase (1974) for a discussion of the lighthouse example.

there were numerous arrangements of the keyboard. Gradually the present keyboard came to dominate. It was selected primarily for mechanical reasons of avoiding the jamming of keys; it is not the arrangement that would maximize typing speed if the jamming of keys were no concern, as it no longer is. However, such an act of imagination does not translate automatically into an explanation of reality. With respect to the typewriter, for instance, if the present value of the gain from the introduction of a new keyboard were substantial, there would surely exist profit opportunities for developing ways of marketing that superior product to beginning typists, even if not to experienced typists. And with the passage of time, the new keyboards would become increasingly dominant.

With respect to money, a claim that government is improving upon the money that has arisen through usage, while possibly correct, should likewise be examined carefully, for the introduction of that new money might serve quite different purposes. During the French Revolution, for example, the government offered what it called a monetary improvement, the *assignat*, but it encountered public resistance. As Andrew Dickson White (1912, pp. 78–79) observed:

It [the Convention] decreed that any person selling gold or silver coin, or making any difference in any transaction between paper and specie, should be imprisoned in irons for six years; that anyone who refused to accept a payment in *assignats*, or accepted *assignats* at a discount, should pay a fine of three thousand francs; and that anyone committing this crime a second time should pay a fine of six thousand francs and suffer imprisonment twenty years in irons. . . . [T]he Convention decreed, in May 1794, that the death penalty should be inflicted on any person convicted of "having asked, before a bargain was concluded, in what money payment was to be made.

Finally, Roland Vaubel (1986, p. 933) argues that if money production were a natural monopoly, there would be no need to restrict entry by giving government a monopoly on high-powered money. The fact is, says Vaubel, that "we do not even know whether money is a natural monopoly good," and entry barriers "prevent us from finding out." This has certainly been the case in modern democratic states.

### *The Social Saving Rationalization*

Even though money might arise through competitive market processes, there is a potential social saving from replacing specie with fiat. A system of free banking might well have developed in which bank notes represented claims on gold or some other commodity. Part of the stock of gold would have been held as reserves or base

money, with the remainder being used for nonmonetary purposes. The average wealth of the members of this society could be increased if the gold that was used for monetary purposes were replaced by what Luigi Einaudi (1953) characterized as imaginary or political money—so long as that replacement operated “perfectly.” Under a perfectly working system of imaginary money, the society will experience a positive wealth effect as the stock of monetary gold is replaced by political fiat, thereby releasing that monetary gold for nonmonetary uses. The possibility of such a saving, however, does not imply the realization of that saving. Consider Einaudi’s characterization of the replacement of real money with imaginary money: “Instead of a crude but certain monetary unit like the grain or gram or pure gold, it [imaginary money] established an abstract unit which the public fancied to be stable. Princes could manipulate this monetary device for their own advantage, although they acted as if it were for the benefit of the public” (p. 260).

Roger Garrison (1983) is correct in his observation that a perfectly working system of fiat money will be superior to a system based on commodity money. But what are the institutional requisites for such perfection (or even near-perfection)? The problem, of course, is one of trust and reliance. Suppose someone were to say that there would be a social saving from replacing our present system of personal security, in which resources are tied up in locks, guns, dogs, police, and the like, with a system of trust and love. This might be thought of as buffoonery, and it might provide material for political speeches or churchly sermons, but it would not be thought of as being grounded in reality. Merely pointing out the potential social saving that would result if people did not feel a need for investing in various forms of personal security does not imply that there is any way of realizing that saving.

Why is it any different in the case of money? Why is the claim that fiat money offers a potential social saving vis-à-vis a commodity standard not greeted in the same manner as the aforementioned claim about achieving a social saving by replacing locks and dogs with love and trust? Both propositions are certainly true, but do we know any more about how to achieve the social saving from replacing a commodity money with a fiat money than we know about achieving the social saving from replacing locks and dogs with love and trust?

In the case of commodity standards, there are various constraints grounded in self-interest that limit note issue and thereby make it reasonable for people to trust their banks. But this trust is purchased at a price: audits, financial reports, investigations, occasional bank failures, and the like are part of the process of the production of trust

and reliability. The process for producing trust and reliability under a fiat standard encounters the problem of counterfeiting. If government fiat substitutes for a money commodity, what, if anything, is there to restrain the increase in monetary claims? Private counterfeiting is limited, though hardly eliminated, by a system of punishment for detection. But the interests that would lead to counterfeiting privately are exactly the same as those that would lead to counterfeiting publicly: counterfeiting will take place so long as the value of the claims to resources exceeds the cost of counterfeiting, which in turn includes both the punishment costs and the opportunity costs of the resources invested in counterfeiting.

#### *The Economic Stability Rationalization*

A further advantage often claimed for a regulated system of central banking over a competitive system is that a central bank's control over base money makes it possible to achieve economic stability. If people were suddenly to increase their demand for money, the real balance effect would operate as a corrective market process, of course, but in a system of competitive free banking there is no supplementary action that individual banks could take to speed the corrective process. It is often claimed, however, that a policy of monetary expansion by the central bank would speed that process of correction. Hence, an economic order characterized by a central bank would have a higher level of average wealth than one characterized by free banking, because there would be less wastage through economic disruption and discoordination.

Once again, however, merely to state a hypothetical case is not equivalent to making a real case. While the rational expectations analysis of anticipated policy measures raises serious questions about the scope for promoting stability through an activist policy, that line of analysis does not seem to go far enough in its critique of activist monetary policy, due perhaps to the highly aggregated nature of those models. To speak of "output" or "employment" and their stabilization neglects important questions of economic coordination within a complex, time-dependent structure of production. It is not sufficient to describe stability in terms of some aggregate output or employment; rather, it is necessary to describe the *pattern* of production and employment—and hence, the allocation of resources among competing uses. In other words, a policy that promotes stability is not a program that smooths out fluctuations in some single, homogeneous item called output, but rather is a program that promotes more fully the coordination of economic activities by millions of people scattered throughout the nation and even the world, in a

setting in which it is impossible for any person or committee actually to orchestrate that coordination.

As Don Lavoie (1985) explains, the theory of economic calculation shows that a truly hierarchically organized economy is impossible. Although it is possible to understand the general processes by which we can feel assured about our ability to eat our morning's breakfast, it would be impossible for anyone even to describe the detailed, coordinated actions of everyone involved in making breakfast possible, let alone those involved in organizing more complicated activities. But if an activist policy of economic coordination, that is, central planning, is impossible, how is an activist monetary policy any more possible? At the very least, for an activist monetary policy to be possible, it would seem necessary to be able to describe in detail how the entire structure of economic activity is affected by various monetary changes.

*The External Diseconomy Rationalization*

It is commonly claimed that in a system of free banking one bank will be able to impose costs on other banks and depositors, with the result that people in general will be poorer under a system of free banking than they would under a central bank. This claim posits an individual bank that has issued an excessive amount of notes, and suggests that the inability of depositors of one or a few banks to redeem their deposits for specie will spread fear to other depositors. If individual depositors are relatively uninformed about the solvency of any particular bank, they might use the observation that one bank is insolvent as evidence that their own bank is insolvent, or at least is less solvent than they had previously believed. This is not to say that individual banks have any inherent tendency toward excessive note issue; the clearing of notes against bank reserves can be recognized as constraining the issue of notes by individual banks. Rather it is only to say that the issue of excessive notes by one or a few banks can threaten the stability of those banks that did not overissue bank notes, but which cannot convince their depositors that this is so.

The problem, at base, is one of uninformed depositors and banks with no means of convincing depositors to the contrary. Hence, a central bank is rationalized as being necessary to assure the solvency of the entire system by acting as a lender of last resort, as well as by regulating the individual banks to prevent excessive note issue. For such informational problems to arise, it must be impossible for banks readily to transmit knowledge about their solvency. The theoretical possibility of such inherent instability in free banking is one more conceptual illustration of the "lemon" problem described by George

Akerlof (1970). In the lemon model, the sellers of used cars know the quality of their cars but the buyers of cars know only the average quality of used cars and know nothing about the quality of any particular car. The persistence of such a state of asymmetric information is, of course, inconsistent with the existence of a market for used cars, for only "lemons" will be offered for sale. What is noteworthy about the *lemon problem* is its counterfactual character, for the market for used cars has developed—through the organization of dealerships and the development of diagnostic services, among other things—in such a way that the lemon problem is suppressed.

It is the same with competitive banking. If depositors have no knowledge about the solvency of different banks, and so assume that all banks are equally (in)solvent, they would interpret a failure of one bank to pay its depositors as evidence that most or all banks are in a similar state. In such a setting panics will surely erupt, assuming that a banking system already exists. More generally, of course, it is hard to reconcile the assumption of conditions that lead to such inherent instability in free banking with the emergence and development of free banking in the first place. And even if it were costly for depositors to investigate the solvency of banks, it would be in the banks' interest to provide such information reliably.

On this point, Richard Timberlake (1984a) shows that clearing-house associations arose during the latter half of the 19th century as a market response to the problems of providing reliable information and coping with uncertainties in the timing of payments. Ross Watts and Jerold Zimmerman (1983) have shown that the development of independent auditing had nothing to do with governmental regulation or taxation, but rather arose out of the interest of corporations in demonstrating to potential investors the reliability of their financial reports. And with respect to free banking, Arthur Rolnick and Warren Weber (1984, 1985) have shown that knowledge about bank solvency was readily available in easily understandable form. For instance, bank notes in Indiana, New York, and Wisconsin were strongly backed and they exchanged at par, whereas in Minnesota bank notes that were backed by weak railroad bonds exchanged well below par. The presumption of insufficient knowledge about the solvency of different banks is distinctly counterfactual.

### The Fed and the Theory of Bureaucracy

The cognitive basis of the common justifications for central banking seems even weaker now than it did at the time of Vera Smith's (1936) critique of those justifications. To some extent this is due to our

improved knowledge of how free banking systems actually operated, as well as to the effort of economists to develop explanatory theories of public choice processes. In particular, public choice theory has revealed the systematic incongruities between normative justifications for particular policy measures and the positive explanation of the actual choice of particular policy measures. The remainder of this paper explores the process of central banking and the Fed's behavior from a public choice perspective. This section and the next rely, in turn, upon the economic theories of bureaucracy and legislation to examine Fed policymaking.

While the literature on bureaucracy that has examined central banks is still comparatively sparse, the popularity of central banks as a subject of examination seems to be growing. Consistent with the central thrust of the literature on bureaucracy, Mark Toma (1982) and William Shughart and Robert Tollison (1983) ask whether there is any direct relation between the well-being of Fed officials and the type of policies the Fed pursues. They both select the Fed's method of financing as being of pivotal importance. The Fed is not financed directly by budgetary appropriations, but rather through its interest earnings on the Treasury debt it holds, although the Fed returns the bulk of those earnings to the Treasury. As compared with the case where the central bank was financed by budgetary appropriations, the effect of the present form of financing might seem to impart an inflationary bias to the Fed, because increases in its holdings of government debt would increase the size of its budget, unless it returned all of the additional interest earnings to the Treasury.

In a similar presumption about the dependence of central bank conduct upon the incentives it faces, though with somewhat different empirical results, Michael Parkin and Robin Bade (1978) attempt to relate the inflationary tendencies of central banks to the degree to which they are controlled by the government. They find significantly lower inflation in West Germany and Switzerland, which in their judgment have the greatest degree of central bank independence among the nations examined. Furthermore, what Parkin and Bade found to be important was not the method by which the central bank was financed, but the degree of independence the bank had in appointing its board and making policy.<sup>2</sup> Moreover, Parkin (forthcom-

<sup>2</sup>Evidence on how the conduct of a central bank depends on the type of incentives it faces is also presented in Santoni's (1984) examination of the Bank of England from 1694 to 1913. Between 1694 and 1793 the Bank of England's profit-maximizing conduct occurred with a zero rate of inflation, as it did also from 1822 to 1913. But between 1793 and 1821 the Parliament created accommodating, inflationary incentives by suspending specie payments and taking over control of the money supply. This occurred during the Napoleonic Wars, and while inflationary finance has been popular during wars, the British did fight the Seven Years' War (1755-63) without inflationary finance.



ing) suggests that a *truly* independent central bank, which means a central bank that unwaveringly pursues a policy of stable money growth, will both achieve monetary stability and constrain the government's creation of deficits. If the central bank sticks with a rule of constant money growth despite the government's creation of budget deficits, the government's ability to sell bonds will eventually be constrained by the willingness of the public to hold those bonds.

The relationship between the central bank and the Treasury or government has been portrayed in stark relief by the "Unpleasant Monetarist Arithmetic" of Thomas Sargent and Neil Wallace (1981), which draws out the implications of the dominance-subordination relationship between the central bank and the government for the course of budget deficits and money creation. Their model is fully consistent with Parkin's analysis of the ability of a *truly independent* central bank—that is, one that had both the will and the means to promote stable monetary growth—to constrain both the inflation rate and the ability of the government to engage in deficit finance.

But suppose the government is dominant. Sargent and Wallace model this possibility by assuming that the size of the budget deficit is exogenous to the monetary authority. Even if the monetary authority initially follows a stable money growth rule, it will eventually have to shift to a policy of deficit accommodation, because the public will be unwilling to buy the government bonds the deficit requires. Although money might be tight now, it will have to be looser in the future, under the presumption that the deficit is exogenous. Their use of the term "unpleasant arithmetic" expresses the possibility that if individuals generally expect an increase in future money growth due to the deficit, a current policy of tight money could actually be accompanied by an increase in current prices. But even if prices do not rise now, they will fall by less than what they should have fallen, as judged by *monetary models* that fail to take into account the present value consequences of the future behavior that is implicit in present policy actions.

A truly independent central bank that was dedicated to the promotion of monetary stability would constrain both government deficits and inflation. On the other hand, a central bank that was ultimately controlled by the government would accommodate the government's fiscal policies.<sup>3</sup> In the latter case, monetary policy (inflation) falls in line with politics (deficits). Since central banking institutions are chosen as part of the regulatory apparatus of government, it would seem doubtful that a government in which the pursuit of political

<sup>3</sup>On this point, see Brunner (1986) and Jordan (1986).

interest led it in expansionary directions would choose banking regulations that both made monetary policy truly independent of politics and created incentives and constraints that led the monetary authority to promote monetary stability. An independent Fed is, within our present political regime, surely a wholly imaginary construction. After all, Congress established the Fed, and it could always change the Fed whenever and however it wanted. It is surely more reasonable to say that Congress chooses and sustains one form of organization over another because the form it chooses advances more fully the interests of a dominant set of its members.

Although it is surely reasonable to seek to explain Fed conduct in terms of the costs and gains of different courses of conduct, it is also ultimately unsatisfactory to consider the conduct of bureaus without considering the conduct of their legislative sponsors. Congress created and oversees the Fed, and Congress chooses the method by which the central bank is financed and its governors chosen. If the Fed were acting contrary to the interests of its sponsors, those sponsors, principally the House and Senate banking committees, would have an incentive to modify the Fed's incentive structure. If the congressional sponsor did not want an inflationary bias, for example, it would change the method by which the Fed is financed. Alternatively, if Congress approved of the inflationary bias but did not want the Fed to capture the gains from inflation, it would require the Fed to return its inflationary gain to the Treasury. Congress could then decide who would receive the gains from inflation through the appropriations process. Since it is clearly costly for a sponsor to monitor agencies, monitoring will tend to focus on relatively visible activities (Lindsay 1976). In the case of the Fed, such things as the number of employees are relatively visible, so it seems unlikely that the Fed would be able to pursue an inflationary expansion of the monetary base beyond what Congress would desire as a way of increasing its own staff.

### Legislation, Rent Seeking, and the Fed

With few exceptions governments have been involved in the regulation if not the direct production of money. Of course, the same thing could be said about economic activity in general. The thesis that in undertaking such regulation governments are offsetting externalities or providing public goods does not seem to have much support. This leaves for consideration the other main type of government activity, rent seeking, in which government serves as a means of transferring wealth. The theory of rent seeking recognizes that

people can seek wealth not only by producing services that other people value, but also by transferring wealth to themselves from others, either directly as in tax and subsidy programs or indirectly as through securing favorable legislation that restricts competition.<sup>4</sup>

What holds for economic activity in general also should hold for the production of monetary services as one particular type of economic activity. It has, of course, long been recognized that inflation can serve as a form of taxation. In a commodity money system, however, this form of taxation would be relatively costly. If the government simply issued more notes through its own bank, and if that bank were simply one bank among many in a competitive banking industry, the government's bank would run the same risk of failure as would any private bank that engaged in excessive note issue. While the government's bank could probably suspend payment in specie without failing in the same sense that a private bank would fail, it would still bear a cost because customers would shift their patronage to more reliable banks.

Alternatively, the government could engage in such activities as the clipping and shaving of coins, and then re-issue debased coins. While governments have often debased commodity monies in this fashion, and for reasons that are perfectly understandable from the perspective of a theory of counterfeiting, it is surely more costly for government to engage in inflation or counterfeiting under a commodity money system than it would be under a fiat money system. Even in a fiat money system, government's ability to inflate will be limited by its need to maintain some *credibility and acceptability*, as evidenced by the lengths to which the French government went to secure acceptance for its assignats.

While a government that wanted to increase its command over resources through inflation would understandably want to replace a competitive system of free banking with some form of regulation or direct provision of banking, the existing Federal Reserve system does not seem consistent with the proposition that the Fed is part of a program for maximizing government's tax collections. Even setting aside questions about whether the actual inflation tax is one that maximizes government's tax take, the fractional reserve system of banking requires the government to share the seigniorage from monetary expansion with commercial banks. And the lower the required reserve ratio, the greater is the share captured by commercial banks.

<sup>4</sup>The seminal work is Tullock (1967). Many papers on rent seeking are collected in Buchanan, Tollison, and Tullock (1980). A thorough survey of the theory of rent seeking is provided by Tollison (1982).

Recognition of this sharing of seigniorage raises the possibility that the Fed represents not just a means of increasing taxes but also a method of cartelizing what would otherwise be a competitive banking industry.

Although, as Lawrence H. White (1984) explains in his study of free banking in Scotland in the 18th and 19th centuries, individual banks would be constrained in issuing notes by the demand for redemption by other banks and by individual note holders, all banks could engage in overissue if they could agree to reduce their demands for redemption. One method for doing this would be to replace individual bank notes with a common note, and to develop rules and procedures that would lead each bank to issue the amount of notes that would conform to the systemwide profit-maximizing supply of notes and loans. Reserve requirements can serve as a source of the necessary rules and procedures. This arrangement would seem to accomplish the same thing as an agreement not to redeem each other's notes, only perhaps in a less costly fashion.

An important part of the theory of regulation and rent seeking has developed around the demand by producers for cartels and the supply by legislatures of those cartels. The demand side of such legislation is relatively straightforward and is represented by the present value of the rents that could be captured by a cartel. Complications arise with respect to such things as promoting the durability of the cartel, restricting the development of substitute products, and constraining chiseling among the members, but the latent demand for cartels is straightforward and is no different for banks than it is for eggs, milk, clothing, and the like. The legislature is in the business of supplying legislation, and it will seek to produce a value-maximizing mix of legislation. Essentially this means that legislation will be sold to the highest bidders, although the production of one piece of legislation may raise or lower the value of other pieces. For example, the value of legislation that strengthens the monopoly position of dairy farmers would be diminished by legislation that reduces restrictions on the marketing of reconstituted milk.

As with any cartel there is a problem with the durability of rents, because what is individually rational for members of the cartel conflicts with what maximizes the aggregate wealth of the entire membership. And even if there is no chiseling among the members of the cartel, there is a problem of restraining entry. Moreover, the problem of chiseling is not easily resolved, because of the numerous margins along which it can occur.

A rent-seeking approach to the Fed does perhaps put the questions of the Fed's "independence" in somewhat different light. It is Con-

gress that chooses whether the Fed will be "independent" or "dependent," and Congress presumably will make that choice on the basis of the organizational form that will maximize the value of legislation to buyers. To the extent control over the Fed is a matter of control over the initial receipt of new money, an independent Fed might raise the price that people will pay for such control. In any event, it is the *distributional consequences* of alternative monetary institutions and their processes of monetary expansion that will be the *primary element* in explaining the choice and persistence of particular institutions. Consider, for instance, a distributionally neutral increase in the stock of fiat money. Such an increase would be one in which each person's nominal money balance increased by the same percentage. In these days of computerization it would be relatively easy to implement this approach to monetary expansion. Each depositor's commercial bank account simply would be credited by the desired percentage growth rate. If the desired growth rate were .01 percent per day, as Richard Timberlake (1984b) suggests in a different context, this rate of credit would be applied to the average monthly balances of each depositor. Consistency with the reserve requirements of the Federal Reserve could be maintained by crediting each bank's reserve account with the Fed by the appropriate amount; the Fed could then increase its *holdings of government debt* as required. Monetary expansion, therefore, would take place in such a way that *distributes the new money in proportion* to existing money balances.

But monetary expansion does not take place in this manner. If it did it would correspond to a model of counterfeiting in which everyone counterfeited at the same rate and, hence, there would be no gain to counterfeiting. The gain to counterfeiting depends on its distributional effect. In this neutral expansionary process, the taxes that people pay through inflation are equal to the gains they experience as inflators. But there is no point to such a process of inflation; there would be no demand for such an institutional format, for it essentially would be no different from a competitive system of free banking, at least with respect to its distributional properties.

Central banking, as such, must contain distributional changes vis-à-vis a competitive system of free banking. The Fed would seem to be principally involved in the supply of counterfeiting, and to do so by virtue of a license from Congress. More particularly, it would seem fruitful to model the Fed as the agent of the House and Senate Banking committees, as Kevin Grier (1985) has done. Accordingly, the Fed's survival depends on whether alternative legislation becomes

more valuable to some set of people than the value of maintaining the Fed is to those who would lose by its demise.

Any existing mode of operation that generates a particular level of rents will through time come to generate less rent for a variety of reasons. Chiseling might take place. Input monopolies could form to capture a share of the rents. Quality competition could arise. Substitute lines of business would be likely to develop. To the extent these things happen, the value of alternative legislation will rise relative to the present value of the present Fed legislation. The Civil Aeronautics Board (AB), which initially created rents for the domestic airline industry, is perhaps instructive on this point. Even though the CAB prevented entry, it could not prevent quality competition among carriers, as well as the participation of labor unions in the sharing of those cartel rents. As those rents eroded, the value of the cartel fell, thereby increasing the likelihood of its demise or replacement.

### Monetary Reform Without Political Reform?

Both the academic division of labor and the sources of financing that sustain it lead naturally to a piecemeal approach to public policy issues. Thus monetary policy is approached separately from tax policy which is approached separately from housing policy, and so on. Although such a division of labor and knowledge is inescapable, this piecemeal approach to public policy issues has some serious limitations. Recognition that monetary instability originates ultimately in political processes must, I think, lead one to ponder the utility of discussing monetary reform in isolation from political reform. If the present pattern of monetary institutions and the economic characteristics they tend to promote are a product of individual self-interest operating within the existing political order, what is the survival value of sensible monetary reform without political reform?

It is possible for accidental forces to generate conditions under which some deregulation of money might take place. This happened with airlines and perhaps with trucking. But what I consider to be reasonable models of our present political regime suggest that free enterprise in air transportation as well as in trucking has low survival value. It is abjectly inconsistent to use an economic model of the market for legislation to explain the development of public regulation, and then to look upon deregulation as the sudden dominance of consumer interests over narrower interests, whether such interests are those of producers only or of some conjunction of producers and subsets of consumers.

Rather than being characterized as representing the sudden dominance of common-interest politics over special-interest politics, *deregulation would seem better represented as a temporary confluence of dominant special interests*. For instance, if the firms in an industry want regulations that raise prices while consumers want regulations that lower them, and if the value of this regulation is independent of the value of other pieces of legislation, the resulting outcome will depend on the relative valuations to the contending factions. If those valuations are equal, which admittedly is an assumption that clashes with the general presumption that concentration defeats diffusion, it is possible for the zero regulation, competitive output to result.

However, such an outcome would not be described as representing the transformation of a rent-seeking political process into some aggregate wealth-maximizing process; the same rent-seeking process remains in place, except that in this particular legislative market the value-maximizing outcome is, for now, zero legislation. This condition is fragile, however, for there is no reason to expect the roughly equal valuations to persist. For example, instead of producers being opposed by a unified group of consumers, there may be opportunities for transfers among consumers, as through cross-subsidization, in which the cartel gain is shared between producers and a subset of consumers, as well as by the politicians who establish and maintain the cartel. The sustainability of deregulation of money or anything else, as against the possible emergence of instances of deregulation as one possible outcome of rent-seeking politics, would seem to depend on some underlying political reform that diminishes the ability of legislatures to interfere with property rights and requires them instead to operate more consistently within the framework of those rights.

Recent scholarship in public choice, which is surveyed in William Mitchell (1983), has shown that there are systematic reasons for the substantial divergences between the rationalizations advanced for governmental activities and the actual consequences of those activities. While the rationalizations envision government as protecting rights and providing beneficial activities that cannot be provided efficiently through markets, much government activity seems to involve the injection of insecurity into ownership and the replacement of relatively efficient markets with less efficient government provision. Moreover, these outcomes are an understandable attribute of the incentive features of contemporary democratic institutions.

That democracies possess a latent tendency to degenerate into rent seeking has, of course, long been commonplace among students of

political theory and history. That possibility was central to James Madison's *Federalist* No. 10, and its control was a central concern in some of Madison's other essays in the *Federalist*. In the same vein, Alexander Tytler, an 18th century Scot historian, generalized from his study of democracy in ancient Greece:<sup>5</sup>

A democracy cannot exist as a permanent form of government. It can only exist until a majority of voters discover that they can vote themselves largesse out of the public treasury. From that moment on, the majority always votes for the candidate who promises them the most benefits from the public treasury, with the result that democracy always collapses over a loose fiscal policy. . . .

Recent scholarship in public choice has extended and deepened our knowledge of the properties of majoritarian democracy, reaffirming in the process such insights as those of Madison and Tytler. Indeed, one of the major contributions of the recent literature on public choice has been a better recognition of how minority factions can dominate a system based on majority rule.<sup>6</sup>

It has been recognized for millenia that constitutional government faces strong and perhaps ultimately irresistible tendencies to confound *jurisdictio* and *gubernaculum*.<sup>7</sup> The central principle of constitutionally limited government is that a constitution is at base an antecedent agreement among a set of people to constitute a government, and it most clearly is *not* an act of government itself. Individual rights are not created by a constitution but rather are the basis upon which a constitution is established. Government governs (*gubernaculum*), but it governs subject to the same rules of law (*jurisdictio*) that apply to all other persons and institutions in society. For instance, a strict interpretation of and adherence to the Fifth Amendment strictures on taking property without just compensation, perhaps as illustrated by *Pennsylvania Coal Co. v. Mahon*,<sup>8</sup> has the effect of forcing government to act by the same rules of law as all other participants in society: resources can be shifted from one use to another only with the consent of the owners of those resources.

The issue of what types of constitutional reform might be required to reestablish a more thoroughly constitutional democracy is well beyond the scope of this paper. My intention even in raising these questions of political reform, as against sticking more narrowly to a

<sup>5</sup>As quoted in Niskanen (1978, p. 159).

<sup>6</sup>See, for instance, the development of this theme in Aranson and Ordeshook (1977).

<sup>7</sup>For a careful historical survey of thought and practice on constitutional government, see McIlwain (1947) and, with respect to Great Britain, Dicey (1927).

<sup>8</sup>260 U.S. 393 (1921).



consideration of monetary reform, is not to advocate one constitutional order over another, but only to point out that the problems of monetary (dis)order we face are but one piece of a larger pattern of increasingly lawless democracy. There are myriad reflections of the same central phenomena. Monetary disorder is not independent of the growth of government spending and regulation. It is not independent of capital-eroding programs and policies. It is not even independent of such things as shifts in judicial rulings that reduce liability for the value consequences of one's actions, as, for instance, by the awarding of damages in tort actions to "victims" who clearly could have avoided the accident, but who confronted a wealthier defendant—as in the apparently not atypical case of someone who strapped a refrigerator to his back before entering a race and was awarded nearly \$1 million when he injured himself.<sup>9</sup> All of these, and many more, are manifestations of a leveling, tax-and-transfer process that reflects the problematical aspect of democracy.

In noting these problems of political order, I would affirm, only in even more general fashion, the judgment reached by James Buchanan (1983, pp. 145—46):

Unless we can get an effective change in regimes, we cannot expect our politicians or our central bankers to resolve the stagflation dilemma. *Until and unless we begin to take the long-term perspective in our private and in our public capacities, including the adoption of new and binding constitutional constraints on the fiscal and monetary powers of government, we are doomed to remain mired in the muck of modern politics.*

## Conclusion

*My purpose has been to examine some of the insights that the theory of public choice can bring to bear upon the persistence of central banking in general and the Federal Reserve system in particular; it has not been to advance or to discuss particular suggestions for reform. As for such reforms, it should be clear that I think both reason and historical evidence support the case for free banking. At the same time, I also acknowledge the arguments by such people as Michael Bordo and Anna Schwartz (1983), that nature does not make leaps and so, barring total monetary collapse, any reform we get is likely to retain considerable state regulation over the supply of money. But, to repeat, neither my purpose nor my main interest nor my competence lies in the practicalities of reform. What is raised most pertinently by the public choice perspective are some questions*

<sup>9</sup>Several such cases are discussed in Andresky, Kuntz, and Kallen (1985).

about possibilities for reform that go beyond the technical merits of various proposals. The central message of this perspective is that the actual operation of any monetary institution will depend upon the pattern of costs and gains that exist for different courses of conduct. What gets produced is what rewards producers the most—in politics, in monetary institutions, and in economic life generally.

At the ultimate, constitutional level, monetary institutions are chosen as just one subset of outcomes of a political process, and it is unlikely that the particular institutions that are chosen with regard to money will diverge greatly from the essential characteristics of political outcomes in general. As political institutions increasingly reward rent-seeking activities over genuinely productive activities, as Terry Anderson and Peter Hill (1980) have shown to be the case for the United States, the prospects that those same political processes will generate monetary institutions that operate in contrary fashion surely weakens. Those who are interested in monetary reform should recognize that the circumstances they are concerned about reflect the outcome of people's pursuit of their interests within our existing constitutional order. Monetary reform without political reform to redress the rent-seeking excesses of prevailing political institutions seems likely to be a short-lived aberration.

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# MONETARY POLICY AS A POLITICAL EQUILIBRIUM

*Kevin B. Grier*

## Introduction

In his wide-ranging and provocative paper, Richard Wagner (1986) has surely hit a raw nerve in current monetary economics by simply asking the question: Is there an economic model that can consistently explain observed Fed behavior?

Keynesian macro models imply that the Fed should follow a counter-cyclical policy often caricatured as "leaning against the wind," yet actual policies are often pro-cyclical (see Grossman 1980). Market-clearing rational expectations models imply that minimizing the variance of money growth is the desirable Fed policy (e.g., Barro 1976). Clearly no one can seriously accuse the Fed of following this policy. Robert Barro and David Gordon (1983) make an heroic effort to build a model that predicts a high inflation equilibrium with a social welfare maximizing Fed and a rational public. They succeed only by making the socially optimal unemployment rate lower than the natural rate, and even then their model is ill-suited for explaining changes in equilibrium inflation rates without relying on changes in the preferences of society.

Wagner argues that the fatal flaw in these and other popular explanations of the existence or actions of the Fed is the assumption that the Fed is an independent agency following policies that maximize the welfare of society. While some economists, notably Milton Friedman (1982), have recently taken the position that social welfare functions are not a useful way to model the Fed, they still hold to the idea of Fed independence (see also Toma 1982 and Shughart and Tollison 1983). In contrast, Wagner takes a further step and argues

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that the Fed should be modeled as the bureaucratic agent of self-interested politicians. In this view, observed monetary policy represents political, rather than economic, equilibrium. Thus understanding and predicting Fed behavior hinges more on knowledge of the incentives and institutions of its political sponsors than on skill with macroeconomic models or social welfare functions.

While this method of studying regulatory policy is well-known to economists in other fields (see, for example, Peltzman 1976, Fiorina 1981, Faith, Leavens and Tollison 1982, and Weingast and Moran 1983), it is not taken very seriously by monetary economists. In this comment I expand on Wagner's theme by considering Congress and the President as the political sponsors of the Fed.

## Congress and the Fed

Wagner takes as self-evident the notion that congressional preferences will influence Fed policy:

An independent Fed is, within our present political regime, surely a wholly imaginary construction. After all, the Congress established the Fed and it could always change the Fed whenever and however it wanted (p. 528).

Of course, taking Congress as the source of Fed policy would not affect models of the Fed if the goal of Congress is maximizing social welfare. Wagner clearly rejects this view, but is vague about what the actual goals of Congress for monetary policy are. At one point he suggests that the legislature values the Fed mainly for its supply of implicit tax revenues, or seigniorage. Later he argues that it is the distributional effect of monetary policy that legislators value. He is specific in identifying who the Fed's congressional principals are: the banking committees of the House and Senate. These committees have oversight responsibility for the Fed, have fairly exclusive control of marking up and sending (or not sending) Fed related legislation to the floor of their respective chambers, and the Senate Banking Committee holds the confirmation hearing for Fed Governors.

The existing evidence for congressional influence on monetary policy is largely anecdotal and mainly negative. Research in this area tends to confuse inputs with outputs. That is, since congressmen are not economic experts, since there is no specific legislative mandate for the Fed, and since direct monitoring is infrequent, Congress must not have any control over the Fed (see Woolley 1984 as a good example of this approach). Also most researchers still assume social welfare is the congressional objective and take pro-cyclical or variable policy as *prima facie* evidence that the Fed ignores Congress.

Friedman (1982) makes exactly this argument and advocates that the Fed be placed under political control.

Wagner cites a paper of mine (Grier 1985) that provides systematic econometric evidence that the composition of the Senate Banking Committee has an influence on Fed *output*. Specifically, I show that when the committee leadership is liberal, money growth is higher than when conservative legislators hold leadership positions.<sup>1</sup> This relationship holds up even when other macroeconomic variables (GNP gap, federal deficits) are included in the regression equation. Along with Wagner, I argue that Congress, as the creator and sustainer of the Federal Reserve, has created powerful incentives to insure bureaucratic compliance with congressional goals and that self-interested politicians will use those bureaucratic incentives to obtain policies most beneficial to his particular constituency.

### The President and the Fed

While Wagner has much to say about congressional influence on Fed behavior, he is silent on presidential political influence on monetary policy. This is surprising because there is far more research about, and professional acceptance of, the idea of executive influence on Fed policy.

The most familiar link between the executive branch and monetary policy occurs via the desire of presidents to be reelected; that is, *through the political business cycle*. While there is little evidence that there is an election cycle in macro aggregates like unemployment (see McCallum 1978), Edward Tufte (1978), Kevin Maloney and Michael Smirlock (1981), and Grier (1987a, forthcoming) all present evidence that there is a systematic pattern of pre-election monetary ease followed by post-election restriction, at least over the period 1961–80.

In addition, Leroy Laney and Thomas Willett (1983) and Stuart Allen (1986) present evidence for what could be called the electoral monetization cycle. These authors show that the monetary response to a deficit is larger, *ceteris paribus*, the closer is a presidential election. Laney and Willett only test for extra accommodation of deficits in presidential election years, while Allen finds the effect in each congressional election year. Allen (1986, p. 92) summarizes his results as follows:

<sup>1</sup>I assume that liberal legislators represent activist, pro-spending, pro-inflation constituencies, while conservatives represent anti-inflation constituencies. In the paper, liberalism is measured by the Americans for Democratic Action ratings of legislators' voting.

The results provide evidence that is consistent with the observation that the Federal Reserve accommodates a portion of the change in the total public debt outstanding quarterly and provides extra accommodation of the debt prior to each Congressional election . . . and prior to the Presidential election.

Finally, Howard Neiman and I use regression equations explaining money and monetary base growth to show that while a portion of the structural deficit is consistently monetized, the component of the deficit that is correlated with the business cycle only significantly affects money growth under Democratic presidential administrations (Grier and Neiman 1987b, forthcoming). Thus the effect of the deficit on monetary expansion varies systematically according to the party affiliation of the incumbent President.

## Conclusion

Given Wagner's paper and the additional arguments and empirical evidence presented here, two concluding observations seem appropriate. The first, addressed to monetary economists seeking to model the Fed, is that the growing body of literature on political control of the Fed means that a satisfactory explanation of monetary policy will not be discovered by building more accurate models of the economy and maximizing a traditional social welfare function subject only to these economic constraints. Political incentives have predictive power for explaining monetary policy.

The second observation is addressed to advocates of monetary reform. If Fed policy is based on political incentives, then demonstrating the adverse economic consequences of the current policy regime will probably not cause any policy change. Even those who support the current monetary policy should not feel secure. Changed political incentives can change Fed policy, regardless of the overall economic properties of the current policy.

Wagner makes this point quite well by simply saying that any monetary reform must be preceded by political reform. Yet clearly binding political constraints on monetary policy will be the most difficult to get through the executive and legislative branches that benefit from the current arrangement.

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