

Musgrave and Buchanan On the Role of the State

Reviewed by Wallace E. Oates

PUBLIC FINANCE AND PUBLIC CHOICE: Two Contrasting Visions of the State

By James M. Buchanan and
Richard A. Musgrave

264 pp. Cambridge, Mass.: MIT Press, 1999

WHEN I WAS A GRADUATE student at Stanford in the early 1960s, Richard Musgrave's monumental treatise *The Theory of Public Finance* was our bible for the field of public finance. Published in 1959, the tome provided the first comprehensive, systematic, and rigorous treatment of the field. Moreover, it embodied a very activist and positive perspective on the role of the public sector in the economy. Musgrave defined three major economic roles for government: the provision of public goods and other measures to correct for "market failure" in the allocation of resources; the redistribution of income to achieve an equitable distribution of societal output among households; and the use of Keynesian policies to attain high levels of employment with reasonable stability of prices.

Musgrave's vision of the public sector was thus a very activist one: a market economy is subject to serious malfunctioning in several basic respects and it is the job of the government to provide needed corrective measures to put things on the right course. From this perspective, the decade of the 1960s was a heady time to be a young public-

finance economist. The new Kennedy Administration lent a willing ear to advice from the Walter Heller-led Council of Economic Advisors. This resulted, among other things, in a large tax cut (in spite of an existing budgetary deficit) to get the economy going. Later in the decade, the federal government introduced major new programs to address poverty, the problems of the cities, and environmental concerns.

In the course of my studies at Stanford, I also came across a small volume by James Buchanan and Gordon Tullock, *The Calculus of Consent* (1962). Buchanan and Tullock suggested a rather different and much less sanguine view of the public sector. The book's theme was the potentially deleterious effects of majoritarian politics on the economy and society. Buchanan and Tullock argued that special interest groups and coalitions push government to institute programs that promote the groups' interests at the expense of society and the economy at large. The result is a powerful tendency toward public sector over-expansion, with rising tax rates accompanying the increasing levels of (sometimes implicit) transfer payments. For this reason, Buchanan and Tullock counseled government to adopt a set of "rules" or a constitution that would effectively constrain public sector expansion. Far from supporting an activist view, Buchanan and Tullock's message was one of combating government intervention in the market.

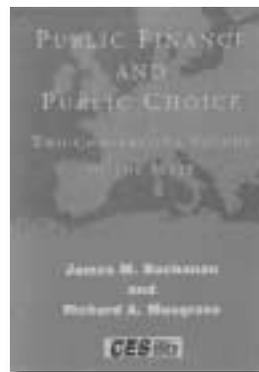
The subsequent decades have brought recognition to Musgrave and Buchanan as two of the most distinguished members of the economics profession. Musgrave has had a long and enormously productive career that reaches back to Munich and Heidelberg in the 1930s and then across the Atlantic to the United States, where he taught at Swarthmore, Michigan, Johns Hopkins, Princeton, and Harvard. Buchanan received the 1986 Nobel Prize in Economics for his founding and development of public choice. He has turned out a steady stream of important books and articles around which the public choice movement has coalesced, and

he has taught at the University of Virginia, UCLA, the Virginia Polytechnic Institute, and most recently at George Mason University.

It was thus a major event in March of 1998 when Buchanan and Musgrave squared off before a select audience of economists in Munich for a weeklong debate on their "visions of

the state." Musgrave, then 87 years old, and Buchanan, then 78, followed a carefully structured form of debate. On the first day, each presented his own fascinating intellectual history, describing the origins and evolution of his view of the state. In the subsequent days, one presented a paper on a specific topic, to which the other responded. This exchange was then followed by general discussion with the audience.

The proceedings of this debate, including the discussion from the floor, have been published in a quite remarkable and striking book, *Public Finance and Public Choice: Two Contrasting Visions of the State*, (MIT Press, 1999). Rarely are we provided such a setting in which two major scholars explore in a leisure-



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ly way their different approaches to understanding the world. As the debate continues, it evolves; by the end, readers are able to delineate with increasing clarity the points on which Musgrave and Buchanan see eye-to-eye and those where they go different ways. As Nobel Laureate Robert Solow puts it on the dust jacket, “Who could resist the chance to eavesdrop on their reflections? Certainly not anyone who cares about the role of government in modern society.”

COLLECTIVE ACTION: GOOD OR BAD?

FOR THE INTELLECTUAL POINT OF DEPARTURE, both economists employ an individualistic and contractarian philosophical framework. Neither of them sees the state as an organic unit unto itself; as Musgrave puts it, “I think of the state as an association of individuals engaged in a cooperative venture, formed to resolve problems of social coexistence and to do so in a democratic and fair fashion” (p. 31). Despite this agreement, the two quickly move off on different paths. For Musgrave, the public sector has its own legitimacy alongside the market. It is not to be seen as an “aberration” from the “natural order,” but rather as “a natural means of addressing a different set of problems” (p. 31). The private and public sectors, from this perspective, are natural complements to one another that play in tandem their roles in promoting social welfare.

For Buchanan, in contrast, the public sector represents a serious threat. Making use of a simple but illuminating numerical model, Buchanan explains what he sees as the inherent tendencies in a majoritarian system for coalitions to raid “the common pool” of the tax system to their own benefit. Majoritarian politics, in Buchanan’s view, inevitably involves the emergence of majority coalitions that push through fiscal measures to redistribute resources in their favor. This leads to a destructive growth of the public sector that puts pressure on the tax base and has a wide variety of unfortunate social and economic effects.

From this perspective, the central

problem becomes one of constitutional design to constrain the overly expansive and destructive tendencies of government. Such constraints may take the form of departures from simple-majority rule that require a more inclusive majority (as Buchanan explored in *The Calculus of Consent*) or the constraints could be embodied in constitutional provisions requiring such things as a balanced budget. As a more pervasive principle, Buchanan argues for a “constraint of generality” that would effectively limit politicians to measures that are genuinely “public” in the sense of providing benefits more or less equally to all. This would eliminate specially targeted benefits and transfers that naturally emerge in a majoritarian setting. Underlying all this, Buchanan explains, is a fundamental objective: “[M]y concern and my primary motivation here in a normative sense is preventing the exploitation of man by man, or woman by woman, through the political process. That is what is driving my whole approach” (p. 152). Musgrave, although readily admitting the presence of inefficiencies and some misguided policies, does not see the essential issue as one of restraining government. For him, the role of “rules” is “not only to restrain, but to enable” (p. 51). Government, like the market, can make its own basic contribution to social well-being.

This disagreement, of course, results in quite different views about the size and scope of government. In a moment of admittedly vast oversimplification, Buchanan observes that “[Musgrave] places considerably more relative weight on the ‘good’ that collective action can do, whereas I place more relative weight on the ‘bad’ that unconstrained collective action might do” (p. 108).

In addition to the overall size of government, the divergent views lead to some important differences in preferred policy measures. In the spirit of his principle of generality, Buchanan has come to support a flat tax with “demogrants.” Under this proposal, all income would be subject to a single tax rate with transfers taking the form of equal grants per capita. Each individual would thus receive a fixed sum (the demogrant) and

then would pay taxes at a fixed rate on his or her income. Such a system could, in principle, be fairly redistributive depending on the agreed-upon level of the demogrant. Low-income individuals could receive a larger sum in the form of the grant than they pay in taxes so that they would receive a positive net transfer from the government. Musgrave vehemently opposes such a measure on the grounds that it could be extremely costly in budgetary terms. Further, it would exhibit virtually no progressivity as it reaches those with higher incomes. For Musgrave, the heart of the federal tax system should be a progressive individual income tax that results in what he sees as a more socially fair outcome.

FISCAL FEDERALISM IN EUROPE

BECAUSE THE DEBATE TOOK PLACE IN Munich, much of the associated discussion turned to issues of European Union. This was especially evident on the fourth day of the debate when the topic was “fiscal federalism.” The evolution of the New Europe is a major issue among public-finance economists there; the critical issue involves the roles to be played by the national governments of the member countries and the new “central government” in Brussels. The term “fiscal federalism” (a technical term used in the field of public finance) refers to the economics of the vertical structure of the public sector. It thus addresses issues of the division of fiscal responsibility among different levels of government, the assignment of tax bases to central, provincial (state), and local governments, and various matters of intergovernmental finance such as the design of grant systems and revenue sharing.

The Maastricht Treaty governing European Union explicitly adopts the “principle of subsidiarity” that appears to establish a presumption in favor of decentralized governance with the condition that public policy and its implementation should be assigned to the lowest level of government capable of achieving the objectives. However, the principle provides no operational criteria for making decisions about the assignment of responsibility, so the

landscape is essentially clear for the evolution of the new public sector in Europe. The basic source of contention revolves around the role of fiscal competition among governments (in this case, member countries). Some economists see such competition as healthy, providing the same sort of disciplined guidance that competition provides in the private sector. Others see it as “destructive competition” that leads to public policies designed to attract new business investment and jobs that result in excessively low tax rates and an underprovision of public services. To avert such outcomes, many Europeans support a variety of cooperative measures — forms of “harmonization” — that might, for example, set a floor under value-added tax rates in all member countries.

Buchanan and Musgrave predictably take different sides on this issue. Buchanan’s approach is based on his political philosophy while Musgrave comes at this matter as a fiscal economist. For Buchanan, fiscal decentralization is a mechanism for disarming a huge central government with monopolistic powers. In a system of decentralized public finance, state or local governments must compete with one another for residents, firms, and tax base. Musgrave takes a more measured position: “I am not arguing for centralization but against destructive competition, and this requires some coordination among jurisdictions” (p. 202).

The ongoing debate among economists in Europe on this matter is in flux. A huge theoretical literature has emerged in the public-finance journals that explores various facets of competition among governments. But this literature is inconclusive. It is not difficult, for example, to envision settings (or to construct “models,” as economists like to call them) in which competition among governments is quite healthy and leads to outcomes that promote social welfare. But at the same time, some realistic modifications to such models bring to light potential distortions in public-sector choices that can result from such competition.

It is unclear at this juncture where

all this is headed. Buchanan, for his part, would like to see a “competitive federalism” in Europe. In fact, he thinks that, in light of the differences in languages and traditions, such a system “is almost going to necessarily emerge” (p. 182).

From a more traditional perspective, many of us are uneasy with the ongoing evolution of the public sector in Europe. On the one hand, the member countries are effectively giving up many of their fiscal powers. Having lost their monetary and exchange-rate prerogatives with monetary union, they have also seriously curtailed their fiscal capacities with restrictions on debt finance. Member countries thus have a much diminished capacity to carry out traditional macrostabilization policy.

Likewise, with the high degree of capital mobility and a growing mobility of labor (notably skilled labor), national governments will find themselves much more constrained in their ability to provide various social programs, especially those that support low-income households. In a competitive federalism, decentralized governments find it difficult to adopt such policies, inasmuch as generous support tends to attract poor households while the higher taxes needed to fund the programs provide an inducement for exit to those bearing the taxes.

Most countries address this problem by having the central government take on a primary role for these two functions. But in the emerging European setting, the central government will be too small. Its projected budget, perhaps on the order of 2 percent of GDP, will not be large enough to provide the built-in or discretionary stabilization measures needed to address cyclical movements in aggregate income. Member countries that find themselves subject to localized shocks to output and employment will (like states in the U.S.) have little scope for corrective policies. Likewise, no one sees the central government taking over the general function of income transfers and social services for the poor.

The fear is that the emerging structure of the public sector in Europe may be ill-suited to performing two of the traditional tasks of public finance. Musgrave shares these concerns: “It thus remains

to be seen whether the combination of unitary and decentralized features, now posited in the E.U. structure, will prove tenable — a fascinating experiment in federalism of importance not only to Europe but also elsewhere” (p. 175).

EVALUATING THE PUBLIC SECTOR IN THE TWENTIETH CENTURY

ON THE FINAL DAY OF THE DEBATE, THE protagonists expanded the scope of the discussion well beyond strictly economic concerns to address explicitly “Morals, Politics, and Institutional Reform: Diagnosis and Prescription.” This provided a valuable opportunity to pull together much of the earlier argument in terms of its broader implications for social structure and reform.

For Buchanan, the twentieth century has been a “terrible century” that ushered in “the bloated welfare-transfer state” with serious moral consequences. “Trust in markets seems everywhere replaced by threat of litigation, and trust in politics can scarcely be sustained in the face of near-total corruption” (p. 216). Much of the “moral rot” is attributable to “the exaggerated size of the public sector relative to the total economy” (p. 217). There has been a serious depreciation of our stock of “social capital” that “was represented in personal attitudes of independence, obeying laws, self-reliance, hard work, self-confidence, a sense of permanence, trust, mutual respect, and tolerance” (p. 220).

Drawing on some idealized concepts of social moral structure, Buchanan proposes a number of reforms aimed at reducing the size of government and limiting, through his principle of generality, the capacity for majoritarian politics to exploit the common pool. But he is not optimistic. With the decline in the capacity of the modern nation-state to engender any sense of community or commitment, there seems “to be no discernible spark of moral-ethical renewal.”

Musgrave, in contrast, finds Buchanan’s perception of “moral collapse” to be “overly pessimistic.” From his perspective, “The taming of unbridled capitalism and the injection of social responsibility that began with

the New Deal was a step forward” (p. 228). For Musgrave, the emergence of the public sector over the past century has been primarily a response to changing needs and preferences in a democratic society for protection against the vagaries of economic ups and downs, the provision of a social safety net, and a more equitable distribution of the fruits of economic progress.

An evaluation of the twentieth century is a complicated matter. Any toting up of the good and bad produces a lengthy list with many items in both columns. Among the “goods,” for example, we find enormous increases in wealth, major improvements in health including extended longevity and greatly reduced rates of infant mortality, the fall of Communism, major advances in democratic institutions around the globe, improved conditions for minorities, and so on. But there are surely matters for concern emerging from the past century; these “bads” include not only Buchanan’s concerns with a growing public sector, but increased pressures on the planet’s environmental and natural resource capacities, threats from nuclear proliferation, continuing ethnic conflicts, the frightening prospects associated with the AIDS epidemic and other diseases, and on and on.

What is most striking is the remarkable divergence in how different observers read these tendencies. Some (one thinks, for example, of the late Julian Simon and his *The State of Humanity*) are exuberant over the advances of the twentieth century and the course of continuing progress. Others, like Buchanan, see a preponderant dark side. How do we assess the half-full glass?

GOVERNMENT OUT, MARKETS IN?

AS I REFLECT ON THE DEBATE, I AM struck with the way in which the intellectual stage for such an exercise has shifted over recent decades. As I mentioned at the outset, the 1960s and 1970s were times of an activist public sector. The widespread acceptance of Keyne-

sian macroeconomic measures, the War on Poverty, and federal programs directing huge inputs of resources directly into the center cities indicate the intellectual tone, largely supported by academia, for policy-making in that era.

At that time, Buchanan found only a small audience to give him a sympathetic hearing. But things have changed dramatically. Our sense of the capacity of the government sector to address issues such as macroeconomic stabilization policy and the eradication of poverty has been seriously shaken. In fact, Buchanan and many of his public-

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choice colleagues have been part of a larger movement that challenges the underlying assumptions of the welfare state. We hear much less about “market failure”; indeed, a recent article in *Regulation* is entitled “The End of Market Failure” (Vol. 23, No. 2). Exemplifying a large body of recent literature, this article reconsiders an overly enthusiastic and not always securely founded view of public policy.

As John Kay has argued, with the advent of Ronald Reagan in the U.S. and Margaret Thatcher in the U.K. (among others), we have entered an era of “faith in market forces.” The key ideas driving public policy have become ones of deregulation, privatization, and devolution with a focus on “government failure” rather than on the limitations of the market. Indeed, a major theme of current policy design is the search for ways to integrate market incentives into public programs. One creative and quite successful measure of this kind is the market for sulfur-emissions allowances created under the 1990 amendments to the Clean Air Act to address the problem of acid rain.

The new century faces the challenge of finding the right balance between the private and public sectors. The decade of the 1990s was a good one for the overall U.S. economy. Since the recession in

March 1991, we have experienced one of the longest periods of uninterrupted economic growth on record. The decade has also been a time of low rates both of unemployment and price inflation and, equally impressive, a time when most government budgets moved from a condition of persistent deficit into surplus. And yet, all is not well.

While the continuing expansion has generated enormous increases in aggregate output and wealth, this growth has not spread evenly across the spectrum of households. Based on standard measures, there is general agreement that the degree of inequality in the distribution of income has widened over recent decades. In fact, the share of aggregate income going to the top five percent of households in the U.S. has risen fairly steadily since 1950 and now stands at

over 20 percent, its highest level over this period. In contrast, the share of the lowest five percent of families has fallen to its lowest level in this fifty-year span. And the poverty rate stood at a higher level in the late 1990s than in the early 1970s.

This, of course, is one of the problems of a free-market system: while it promotes growth and efficiency, it can at the same time increase risk and insecurity. The task facing us is one of finding effective ways to lift incomes at the bottom and to open up opportunity. This most certainly does not mean turning back from the efforts at welfare reform in the 1990s, but finding new ways to provide a social safety net through measures that encourage and subsidize work and that promote good schools.

Likewise, the much-cited “Graying of America” is forcing us to rethink and restructure programs to support the aged. The source of the problem is not hard to understand. In 1960, there were over five payroll-tax paying workers per Social Security beneficiary. By 1999, this ratio had fallen to 3.4. And by 2030, it is estimated that the ratio will be down to 2.1! This will force upon us what Rudolph Penner, Isabel Sawhill, and Timothy Taylor call “The Unavoidable Necessity of Renegotiating the Intergenerational Contract.” Society will have

to do more than just “fix” Social Security and Medicare; it will have to forge a complicated package of public and private efforts to provide retirement income and medical support for the aged. This package is likely to involve increased incentives for private saving and, perhaps, encouragement to stay on the job longer.

These are just two of the challenging issues that will require an appropriate blend of private and public activity over the coming decades. The market system is a powerful engine for generating economic growth, but it cannot do everything. There are, in fact, obvious cases where markets break down in their role of allocating society’s scarce resources efficiently.

To take one important example, market systems cause excessive air pollution for a straightforward reason: individual profit-seeking firms simply do not have any incentive to economize on their use of clean air (in contrast to their use of other scarce resources like labor and materials for which they must pay the social cost). Public policies to promote cleaner air are essential for societal welfare, but such policies must themselves be effective in correcting the problem.

Too often we have seen regulatory measures that either fail to achieve their objective or do so in an excessively costly way. We have come a long way in recent years, both in learning about sensible procedures for setting standards for environmental quality and in designing cost-effective ways to induce compliance from the sources of pollution. As with the environment, the solution to many of our economic and societal problems depends on our understanding of the strengths and limitations of both markets and government and on our capacity to design institutions that allow them to work together to produce welfare-enhancing outcomes.

The Musgrave-Buchanan exchange provides a valuable backdrop for thinking about these matters. Their views, sharply contrasting as they are, cover the gamut from the basic philosophy of government on the one hand, to specific policy measures on the other. It is rich fare for the reader. **R**

Redirecting the Environmental Movement

Reviewed by Peter VanDoren

HARD GREEN: Saving the Environment From the Environmentalists: A Conservative Manifesto

By Peter Huber

224 pp. New York: Basic Books, 1999.

SHOULD WE CURB COAL-FIRED electricity production? Do we need to regulate farmers’ use of fertilizer in the Midwest? What benefits could we obtain from restricting diesel emissions? Peter Huber would recommend that scientific inquiry be used to ascertain the relationship between each of the three activities and adverse environmental effects. His implicit premise is that if the negative effects of coal and diesel emissions or fertilizer use are “real” then scientifically informed government intervention can “fix” the problem. And if the best science suggests that the causal links are problematic or non-existent, the implication is that environmental regulation is an example of illegitimate and unwarranted state action.

But what if citizens want clean air just because they want clean air, not because dirty air actually has any scientifically demonstrable effects? Why should government be environmental at all? Should government not just create and defend property rights and, thus, be neutral with respect to the life plans of citizens? Are preferences for clean air not just like preferences for pizza or cars? Put differently, is there anything about a simple libertarian view of government as creator and defender of property rights that does not allow those with environmental preferences to pursue their vision of the good life?

Such questions require an economic framework. Within an economic

framework, environmental policy disputes, like all policy disputes, are about the distribution of wealth and property rights, or about the ability of current market institutions to achieve efficiency. Thus, useful environmental policy books are those that explain the nature and possible resolution of wealth and efficiency disputes about the provision of environmental goods and the ability of markets to implement solutions.

Peter Huber’s new book, *Hard Green*

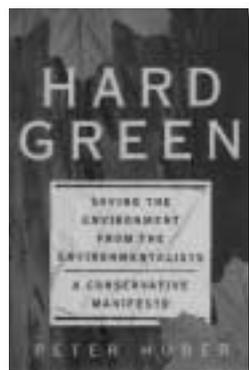
(New York: Basic Books), is a successful attack on the scientific basis for environmentalists’ policy preferences. His implicit premise is that sound scientific knowledge resolves policy disputes. But Huber himself abandons scientific analysis when it comes to his favorite environmental amenity — the wilderness

— and he undermines his own analysis by conceding that people have a right to their environmental preferences regardless of the preferences’ scientific validity. Huber does not follow the logical implications of his analysis and he avoids developing an economic analysis of environmental issues.

THE HARDS AND THE SOFTS

Huber describes two archetypal groups of participants in the environmental policy morality play. The first group, whom he describes as Hard Green, emulates Theodore Roosevelt. Hard Greens want the government to own the most precious natural assets, like the Grand Canyon, Yosemite, and Yellowstone. They also want government to develop markets for the most obvious externalities to the air and water. But besides these actions, Hard Greens do not want government to become involved in environmental affairs.

The second group, whom he describes as Soft Green, has a more



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