Chapter 3

The Individualistic Approach to Fiscal Policy

The state has its origin in, and depends for its continuance upon, the desires of individuals to fulfil a certain portion of their wants collectively. The state has no ends other than those of its individual members and is not a separate decision-making unit. State decisions are, in the final analysis, the collective decisions of individuals.

—James M. Buchanan, "The Pure Theory of Government Finance: Suggested Approach" (1949)

The previous chapter on Buchanan's analysis of the public debt features an example of his individualistic approach to fiscal policy. When analyzing the activities of government, the costs and benefits of government policies fall on individuals, not on aggregates or groups. The argument that domestically held public debt is no burden because "we owe it to ourselves" is revealed as fallacious once we recognize that the aggregate—ourselves—is really composed of many individuals, some of whom will pay the taxes to finance the debt repayment, and some of whom will receive the proceeds when they redeem the bonds they hold.

To appropriately analyze the process of fiscal exchange in which debt is issued to finance current expenditures, one must look at the costs and benefits borne by individuals, not collectives. This rule applies to the analysis of all types of fiscal policies, not just debt. This approach is, for the most part, how economists analyze taxation. If the tax system is made more progressive, that is, if upper-income people are taxed more to finance redistribution of resources to lower-income people, economists explicitly recognize that costs are imposed on some individuals for the benefit of others. Buchanan simply argued that the same type of explicit recognition be given to the costs and benefits imposed on others when financing is done with debt. Ultimately, individuals, not groups, pay taxes; and individuals, not groups, benefit from government expenditures.

The Wicksellian Influence

Near the start of his Nobel Prize lecture, James Buchanan told a story that, both in conversation and in print, he told often.

> One of the most exciting intellectual moments of my career was my 1948 discovery of Knut Wicksell's unknown and untranslated dissertation, *Finanztheoretische Untersuchungen*, buried in the dusty stacks of Chicago's old Harper Library. Only the immediate post-dissertation leisure of an academic novice allowed for the browsing that produced my own dramatic example of learning by serendipity. Wicksell's new principle of justice in taxation gave me a tremendous surge of self-confidence. Wicksell, who was an established figure in the history of economic ideas, challenged the orthodoxy of public finance theory along lines that were congenial with my own developing stream of critical consciousness. (Buchanan, 1986)

Although historians of Buchanan's thought debate the accuracy of this story's details, its core is indisputably true: Buchanan was very impressed with the work of the Swedish economist Wicksell (1851–1926), and especially with his approach to public finance. Buchanan believed that the explanatory power of and the normative implications drawn from Wicksell's theory of government taxing and spending were far superior to anything offered by English-language public-finance scholars of the mid-twentieth century.

When Buchanan was just beginning his professional career, Anglo-American public-finance theory was overwhelmingly devoted to exploring the effects of different systems, types, and rates of taxation upon the behaviour of citizens in private markets. How do citizens trade off leisure for labour in one tax regime compared to in other tax regimes? How much of the burden of a sales tax legally imposed on retailers is shifted onto consumers? And the biggest question of all: how can government raise $X amount of revenue while imposing the least harm on its citizens?

Yet those Anglo-American scholars were doing virtually no positive theorizing about how government officials actually go about making fiscal decisions. In the Anglo-American tradition, government was implicitly assumed to be an agent hovering above the citizenry and motivated to tax and spend independently of any preferences that citizens might have over fiscal matters.

Governments, at least those in democratic countries, were assumed to tax, or advised to tax, in ways that satisfy the independent criterion of equity. Taxation is horizontally equitable if all citizens who have the same income or wealth are taxed alike; taxation is vertically equitable if the burden of taxation rises evenly as income or wealth rises. As for spending, government officials might—and in democratic countries perhaps do—make such decisions with the intention of promoting the greater good.

The Anglo-American public-finance scholars were making no effort to develop a positive, descriptive theory of fiscal decisions. In the mid-twentieth century economists typically assumed that government decision-makers act to further the public interest, without analyzing the process by which those decisions actually are made. In contrast, Buchanan recognized that those who design public policy often take their own interests into account, which are not necessarily the same interests as those of their constituents, and, therefore, politicians' actions might *or might not* promote the public welfare.

Influenced by Wicksell, and later by his immersion in the works of Italian public-finance scholars, Buchanan worked to craft a positive theory of fiscal decision-making. This positive theory aimed at explaining observed outcomes and would, in turn, underpin Buchanan's formation of normative guidelines for government spending and taxation.

As we saw in Chapter 1, Buchanan rejected the assumption that the state is a benevolent overlord of the individuals who comprise the governed. In his theory of fiscal choice, Buchanan sought to explain government spending and taxing decisions as arising from the same individualistic motives that economists assume guide spending and consumption decisions in private markets. The difference between the two settings, of course, is that governments make collective decisions—decisions that all members of the political community must live with. Buchanan showed, however, that the same analysis of the decision-making logic at work in private markets can be fruitfully used to analyze the way that citizens in democratic polities make collective choices.

Two features of Wicksell's approach to public finance are especially relevant to Buchanan's work. The first is Wicksell's insistence that, at least in democratic societies, government budgeting should be analyzed as what Buchanan called "fiscal exchange." Government spends money to produce various goods and services for citizens, and it obtains this money, mostly through taxation, from citizens. Therefore, whether the government's whole budget or any of its individual components are worthwhile depends upon citizens getting their money's worth. It follows that public-finance theorists should assess the merits of budgetary outcomes and budgetary proposals from the perspective of the citizens who are taxed to pay for government expenditures and who then receive government-supplied goods and services in exchange.

Wicksell's second foundational contribution to Buchanan's thought is his rejection of the benevolent-despot model of government. If the government's budget appropriately emerges from fiscal *exchange*, budgets are not imposed on the populace. They are agreed to through a collective decision-making process that begins with the citizens who are to live under those budgets. Government has no interest of its own; it is merely an organizational tool that citizens use to achieve their collective goals.

Fiscal decisions and democratic politics

In our democratic age this conception of government perhaps sounds obvious. But from it follows the conclusion that the state is not an agency existing independently of citizens. The state has no greater knowledge than is possessed by its citizens. Nor is the state—or the officials chosen to execute this process of fiscal exchange—driven by motives more benevolent than are the motives that drive the self-interested citizens who, in Buchanan's ideal world, would bargain with each other to create the state.

Economists often depict government as an omniscient organization that implements policies to maximize social welfare. But this depiction falls short in at least two ways. First, there is no such thing as "social welfare" beyond the welfare of each of the individuals who make up the society. Second, recognizing that government is not omniscient, there is no way for policy makers to know what policies would benefit those who are affected by them beyond discovering the preferences of its citizens as revealed by those citizens themselves. The provisions of such a revelation is an important role of the democratic process; democratic debate, compromise, and decision-making reveal the preferences of citizens who should realistically expect to be net beneficiaries of government actions.

Herein lies the great challenge of collective decision-making. Because there is no such thing as the general will or social welfare beyond the welfare of each of the individuals in the group, the challenge is to design democratic institutions so that they reflect the preferences of the citizens as closely as possible. Simple majority-rule voting on all issues has the obvious shortcoming that it allows a majority to impose costs on the minority, thus requiring institutions to be designed to safeguard against this outcome. Here again, Buchanan took inspiration from Wicksell, who noted that if unanimous approval is required for government to act, the approval of everyone means that everyone's welfare is improved and the decision is in the public interest because it is in the interest of everyone who makes up that public.

Later chapters will consider nuances around this idea of requiring unanimous agreement. The subject was one that occupied a great deal of Buchanan's attention throughout his career. Meanwhile, note that for taxes to be generally agreed to in an informed way, citizens must know beforehand how those tax revenues will be spent.

Buchanan emphasized that the desirability of taxes cannot be evaluated independently of how that tax revenue is to be spent. The common sense behind this insight is that if individuals are asked if they want to pay a particular tax, they usually say no, because a tax imposes a cost on them. On the other hand, if they are asked whether they favour paying a tax on gasoline to finance road construction, they are more likely to agree to it, weighing the costs to them of the proposed tax against the benefits that they anticipate the road would provide. The merits of any particular tax cannot be evaluated independently of how the tax revenues will be spent.

This seemingly straightforward insight is rarely recognized by public-finance economists even in the twenty-first century. The economics of taxation commonly depicts taxes as revenue that goes to the state, with the idea that the state should extract this revenue in a manner that is least painful to taxpayers. Rarely does the economics of taxation recognize that revenues will be used to pay for collective goods that benefit taxpayers. Too often, taxes are analyzed as if they are a penalty levied on people for earning income or having wealth. Buchanan's approach views taxes as the price people pay for government-supplied goods and services.

Ricardian equivalence

Ricardian equivalence, a concept based on the work of David Ricardo (1772-1823), is the idea that there is effectively no difference between financing government expenditures through taxation or through debt. This argument differs from the one addressed in the previous chapter, which insists that, because future resources cannot be used for current projects, the burden of projects today funded with government debt cannot be passed on to future generations. Ricardian equivalence also differs from the "we owe it to ourselves" argument.

The idea behind Ricardian equivalence is that rational individuals recognize that when government finances today's spending with debt, the tax obligations of people in the future will rise. This debt, of course, must be serviced and repaid. If today's taxpayers care about their future selves and about their children and grandchildren, they will—if they are fully rational—increase their savings today so they or their heirs will have on hand enough money to pay the higher taxes that are destined to be imposed tomorrow. Or so goes the argument of economists who believe in the reality of Ricardian equivalence.

David Ricardo discussed this idea in his *On the Principles of Political Economy and Taxation*, first published in 1817; thus the name "Ricardian equivalence." But while Ricardo explored the argument, he ultimately rejected it. Buchanan also rejected it. His reasoning again shows the merits of taking an individualistic approach to fiscal policy.

The *non*-equivalence argument, which Buchanan defended, is that if people's taxes are reduced and government spending is instead financed by debt, people will spend at least some of the additional disposable income they receive from lower taxes on consumption goods today. Therefore, financing through debt rather than through taxes shifts resources toward more consumption spending. Taxation and debt are *not* equivalent methods of public finance, because debt financing, unlike tax financing, shifts expenditures toward current consumption.

Buchanan's rejection of Ricardian equivalence does not rest on any assertion that individuals irrationally fail to recognize that increased government indebtedness entails higher future tax burdens. Rather, his individualistic approach to public finance takes account of the fact that the lower taxes that individuals enjoy today (as a result of debt financing of today's expenditures) are a sure source of additional disposable income today. But these same individuals do not know if they or their heirs will be the particular taxpayers in the future who will have to service the debt.

If they or their heirs have low incomes in the future, they will not pay much in taxes and the burden of the debt will therefore be borne by others. Because no one knows when he or she will die or can predict exactly what his or her taxable income will be when the debt must be repaid, the value of a dollar that with certainty is not taxed away today is higher than is the value of a dollar that only *might* be taxed away tomorrow. Each of today's citizen-taxpayers is thus made to feel wealthier with debt financing than with tax financing. Each person, in turn, is prompted by debt financing to spend more today on consumption items.

In contrast to Buchanan's individualistic focus, the Ricardian equivalence argument effectively aggregates everyone into a single taxpayer. This aggregate individual would get from debt financing a tax cut today in exchange for higher taxes tomorrow. If such an infinitely lived aggregate individual were real, he or she would rationally save the funds from today's tax cut in order to pay those future taxes. But the individualistic approach recognizes that there are many distinct taxpayers today and there will be many distinct taxpayers in the future. It is reasonable to expect rational individuals to devote at least some of the money they reap from a tax cut to consumption.

Buchanan's critique of Ricardian equivalence is noteworthy because it shows the insights that can be gained by taking an individualistic approach to fiscal policy. Buchanan shows that there is good reason to question economic analysis that treats aggregate groups as though they are individuals.

The fiscal-exchange model of government

Buchanan's fiscal-exchange model of government depicts government as an organization through which individuals come together collectively to produce goods and services they cannot easily acquire through market exchange. Just as individuals trade in markets for their mutual benefit, government facilitates the ability of individuals to engage in collective exchange for the benefit of everyone. This fiscal-exchange model is an ideal, of course; Buchanan was well aware of the possibility that those who exercise government power can and often do abuse it for their own benefit at the expense of others. Much of his work was devoted to understanding how government can be constrained in order to keep this abuse to a minimum. When those constraints are effective, collective action through government can further everyone's well-being.

The fiscal-exchange model is based on the idea that taxes are the price citizens pay for government goods and services. And just like prices in the marketplace, the value of the goods and services government supplies should exceed the prices citizens pay, in the form of taxes, for these goods and services. As a public-finance economist, Buchanan's work is founded on this idea, but this idea also naturally raises the question of how institutions can be designed to assure that government output is worth its cost. Buchanan here drew on Wicksell's insight that if individuals are required to agree unanimously to the taxation and expenditures, everyone will benefit.

In the fiscal-exchange model, government's purpose is to enable citizens to organize in order to take collective action, and to bargain with each other to determine which particular activities will be undertaken by government and at what and whose expense. If everyone agrees, government action is in the public interest, because it is in the interest of all of the individuals who make up the public. Trite as Wicksell's point might sound, it ran—and still runs—counter to the prevalent Anglo-American view of government budgeting.