

# Institutions and Constitutions: The Economic World of James M. Buchanan

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James Buchanan, surely best known as one of the scholars who established the subdiscipline of public choice, was awarded the 1986 Nobel Prize in economics “for his development of the contractual and constitutional bases for the theory of economic and political decision-making.”<sup>1</sup> That statement by the Nobel committee suggests a contribution that is considerably broader than public choice, if one thinks of public choice as the use of economic methods to analyze political decision-making, but at the same time appears to leave out much of the subject matter of public choice, if one characterizes the subject matter as the type of research that appears in *Public Choice*, the journal. The broad nature of the Nobel committee’s statement is very appropriate, in that it references a particular approach that Buchanan’s work has consistently taken when analyzing private sector and public sector economic activity. Buchanan’s work has always focused on the institutional framework within which people exchange, whether that exchange is a bilateral market exchange or a more complex exchange made through collective decision-making. Within the sphere of collective decision-making, an important part of the institutional framework is the set of rules within which collective action takes place – that is, the constitutional rules. This is just as true for market exchange. Buchanan’s work has consistently recognized that whether one is analyzing market exchange or political exchange, the outcomes depend critically on institutions and constitutions.

## The Subject Matter of Economics

Buchanan (1979) notes that modern economic analysis focuses on the way that individuals choose among various alternatives, with a heavy emphasis on maximization. Individuals make choices that maximize their utilities, firms are managed to maximize profit, and economic policies are designed to maximize social welfare. Economic problems become technological problems, and even the idea of an economic problem suggests that there is some solution. Buchanan (1979: 26, emphasis in original) says that economics should "... concentrate on *exchange* rather than *choice*." Comparing an analysis of an individual choosing among alternatives to a group of individuals engaging in economic activity, Buchanan (1979: 28) says, "The fact of association requires that a wholly different, and wholly new, sort of behavior take place, that of exchange, trade, or agreement." Buchanan critiques the framework of competitive general equilibrium, where all are price-takers and no participant can influence the outcome by noting that all social content has been eliminated from the model, so every firm and every individual views the economy as a set of constraints within which they make choices, rather than seeing themselves in a situation within which they can engage in mutually beneficial exchange with others.

Buchanan criticizes Samuelson (1954) for depicting the market as a mechanism, a calculating machine, that generates aggregate outcomes. Rather, Buchanan sees it as an arena within which individuals can engage in exchange for the purpose of accomplishing their own ends. Sometimes, Buchanan notes, bilateral exchange will be insufficient for individuals to achieve their ends, and collective action will be required. Buchanan (1979: 34) says, "Economics is the study of the whole system of exchange relationships." That would include collective action taken by government. "What I should stress is the potentiality of exchange in those sociopolitical institutions that we normally regard as embodying primarily coercive or quasi-coercive elements." Economists can analyze politics as exchange. Economics, as Buchanan sees it, studies exchange, not choice.

Buchanan (1962) notes that when applying the Pareto principles in economic analysis, little insight is gained by viewing them as descriptive of exchanges of goods and services, because

individuals have an incentive to engage in mutually advantageous exchange, so with a given institutional framework, a Pareto optimum is produced almost tautologically. If people have an opportunity to engage in mutually advantageous exchange, they will, as long as transaction costs are not too high. If transaction costs are too high, then because of those costs, the exchange would not be mutually beneficial. The Pareto concepts make more sense when applied to rules and institutions. If a group of people can change the institutional constraints so that exchanges that are not mutually advantageous because of transaction costs become so, then the rules can be changed and a Pareto improvement can be made. Buchanan's vision of economics as the study of exchange, rather than choice, points directly toward the institutional environment within which exchange takes place.

### Buchanan's Institutional Approach

Throughout his career Buchanan has taken an institutional approach to economic analysis. Buchanan (1949) argues that rather than viewing government as a mechanism for maximizing some measure of social welfare – taking Samuelson (1947) as an example of the approach he recommends against – government should instead be viewed as an institutional setting within which individuals can agree to accomplish ends collectively that could not be undertaken individually. Buchanan references Wicksell (1967) as a proponent of this approach, as he often has in his work.<sup>2</sup> Buchanan criticizes the traditional theory of taxation, noting that taxes are treated as paid to the government with nothing given to citizens in return. Indeed, even in the twenty-first century most analyses of taxation treat taxes that way, looking at how tax revenue can be extracted from taxpayers at least cost, with no analysis of how that revenue will be spent. In keeping with Buchanan's vision of politics as exchange, Buchanan argues that any theory of optimal taxation must weigh the costs and benefits, and that because there is no independent measure of benefit, agreement among citizens must be the benchmark. Buchanan's individualistic approach to fiscal theory relies on political institutions to weigh the costs and benefits of collective action, rather than envisioning a Pareto optimal outcome as a goal and then

designing policies to get there. Only through the process of exchange are the individuals' values that are assumed to exist in the aggregate model actually revealed.

Buchanan (1954a) writes a review article of Arrow (1951) in which he argues that Arrow's "impossibility theorem" is less relevant to social choice issues than at first it appears. Buchanan begins by questioning the idea of a "socially rational" decision-making process, and notes that majority rule, a commonly-used decision-making rule, can never be viewed as resulting in some kind of optimal outcome. It is only a mechanism for making collective decisions. Buchanan also notes that when people's preferences differ, collective choices are rarely going to give any one individual outcomes that individual most prefers all the time. In this context a cyclical majority may even be a desirable outcome. Normally, votes are over candidates, not policies, and a cyclical majority would give various groups the opportunity to see their preferred candidates elected, rather than have a majority permanently dominate a minority. Even there, the election of different candidates to office does not necessarily mean that different policies will be enacted as a result. Political outcomes are driven by political institutions, and elections are only one of many political institutions at work. A cyclical majority in candidates will not necessarily produce a cyclical majority in policies. The political process is not a mechanism for revealing a social welfare function, it is an institutional structure within which people act collectively to produce outcomes they could not produce individually.

Buchanan (1954b) extends these ideas by comparing collective choice through voting with individual choice in the market. He offers a series of now-familiar arguments for why individuals are more likely to find their preferences satisfied through market exchange rather than through voting for an outcome that is imposed on everyone in the collective. This reinforces the idea that government action is beneficial when individuals want to accomplish ends that require collective action and cannot be accomplished through individual exchange.

Buchanan's (1965) theory of clubs takes an institutional approach to public goods theory. Public goods theory following Samuelson (1954) defines a public good as a good that, once produced, additional consumers can consume the full amount of the good without reducing the

consumption of any additional consumer. Buchanan takes an institutional approach by looking at the conditions under which groups would form to produce goods collectively rather than relying on individual exchange in the marketplace. Buchanan's approach has the advantage of taking into account the possibility of congestion of public goods, such as when additional traffic causes a road to become congested, and impure public goods that straddle the line between Samuelsonian public and private goods. Buchanan's article laid the foundation for a literature on what has been called club goods. Buchanan's emphasis, however, is on the "club" that produces those goods – that is, on the institutional framework that provides them – rather than on the goods themselves.

Buchanan (1969) looks at the nature of cost and choice to develop an argument that costs are opportunity costs, so the cost of any choice is the value of the foregone alternative. But because the alternative is foregone, the cost is subjective and cannot be known precisely. One cannot know what would have occurred had a different choice been made. Value is only revealed through a market process, where in the process of exchange values are attributed to goods and services. Taking this approach, one might in the abstract conjecture that there is some optimal allocation of resources based on an aggregation of individual production and utility functions into a general equilibrium, but the actual values that people place on goods and services are only revealed through the process of exchange. The data needed to compute a general equilibrium cannot be observed. One cannot observe utility functions and production functions, but only the prices and quantities that are produced when consumers and producers make choices based on the opportunities they perceive. There is no such thing as social welfare beyond the individual welfare of members of a group, and that individual welfare is only revealed as a result of the exchanges that individuals actually make.

Buchanan (1962) makes perhaps the clearest statement of his institutional approach to economics by noting that individuals will exchange for their mutual benefit whenever the opportunity exists, so with a given set of institutions, resources will tautologically be allocated Pareto optimally. Economic analysis takes place by examining alternative institutional arrangements which allow people greater opportunities for mutually advantageous exchange,

whether that means bilateral exchange or through collective action. The institutional approach Buchanan takes to economic analysis is apparent even in his earliest work.

### *The Calculus of Consent*

In hindsight it is easy to say that Buchanan and Tullock's (1962) *The Calculus of Consent* was the book that started the public choice revolution. Earlier work, such as Black (1958) and Downs (1957), are foundational books in public choice, but public choice became an identifiable subdiscipline when Buchanan and Tullock not only added their book, but also held a conference on the subject in 1963 that became an annual event and evolved into the Public Choice Society. *The Calculus of Consent* clearly fits the theme of "institutions and constitutions" that characterizes Buchanan's work. Buchanan and Tullock took an institutional approach to their analysis of collective decision-making. In keeping with themes in Buchanan's earlier work, they examine logrolling and vote trading, depicting politics as exchange. They look at the effect of institutions such as a bicameral legislature, and they discuss the effects of special interests on political outcomes.

*The Calculus of Consent* also lays the foundation for constitutional economics, because Buchanan and Tullock explicitly develop a framework for analysis within which decisions on the rules within which people interact are distinguished from the decisions people reach within the constraints of those rules. This idea also comes across in Buchanan (1962), published the same year as *The Calculus of Consent*. Buchanan's work, which has always focused primarily on the public sector, and has always taken an institutional approach, focuses on constitutional rules as the embodiment of institutions in *The Calculus of Consent*. The book explicitly focuses on collective action, and explicitly develops a framework for analyzing the constitutional framework within which collective decision-making takes place, separately from the decisions that are made within the constitutional rules.

Buchanan's work has been remarkably consistent throughout his long career, as Meadowcroft (2011) notes, so it would be difficult to say that any point in his career was a "turning point." But

the publication of *The Calculus of Consent* might come as close to a turning point as one could find in Buchanan's career, because of the book's publication, because the book was immediately well-received, and because its publication represented the beginning of public choice as a distinct subdiscipline.

## Buchanan's Constitutional Economics

Buchanan's work after the publication of *The Calculus of Consent* has taken a consistently constitutional approach to public choice. Buchanan (1975) develops a social contractarian model for identifying optimal constitutional rules. Buchanan's benchmark for evaluating constitutional rules is unanimity, and one might view Buchanan (1975) as providing a more complete foundation for the constitutional framework developed in Buchanan and Tullock (1962). Brennan and Buchanan (1980) apply this constitutional framework to taxation by examining the constitutional rules that have the potential to constrain a government with the power to tax from using that power to exploit the citizens it taxes. Brennan and Buchanan (1985) further develop their ideas on constitutional economics in this book sub-titled "constitutional political economy," where they lay out the notion that the constitutional framework lays the foundation for individual interaction, and those constitutional rules create a framework that channels individual actions toward their fellows away from predatory zero-sum and negative-sum action to action that is positive-sum and mutually advantageous.

This is the same constitutional framework that Buchanan had been developing throughout his career, but now explicitly developed using the constitutional economics, or constitutional political economy, name. The terminology is interesting in light of the fact that public choice, going by that name, was only a few decades old at the time. But, by attracting a following of established academics, a substantial amount of public choice literature fit within the "science of choice" framework, even as Buchanan (1979) argued that economics should focus on the process of exchange, rather than choice. Sandmo (1990: 63) notes that Buchanan's work has no empirical orientation. Not only has Buchanan not done any empirical work, he rarely references the

empirical work of others, even though a substantial share of the articles in the journal *Public Choice* have substantial empirical content. One reaction to the methodological orientation of much of public choice was the creation of a new journal, *Constitutional Political Economy*, in 1990, that would focus more exclusively on the institutional and constitutional framework within which Buchanan worked.

In the first article of that new journal, Buchanan (1990) notes that economic analysis often examines people's choice within constraints. Constitutional political economy focuses on the choice of constraints. The idea that Buchanan puts forward as the foundation for a new journal and a new sub-discipline in social science is the same one Buchanan (1962) had put forward decades earlier. In keeping with his emphasis on politics as exchange, Buchanan (1990: 1) argues that constitutional political economy emphasizes "cooperative rather than conflictual" interaction among individuals.<sup>3</sup>

A short and clear summary of the primary constitutional issue that Buchanan's work deals with is found in the sub-title of his book, *The Limits of Liberty: Between Anarchy and Leviathan*. Buchanan takes a Hobbesian view of anarchy, in that without a government to create and enforce rules life would be a war of all against all where people would find themselves constantly at risk from the violence of others. However, the government powerful enough to protect people's rights also has the potential to be the worst violator of those rights, an idea that goes back to Thomas Jefferson. No government; no liberty. But at the other extreme, Leviathan government; no liberty. Buchanan's work is probing the limits of liberty, that lie between anarchy and Leviathan. The challenge is to develop a constitutional framework that allows people to interact productively and cooperatively with each other, but that constrains the enforcer of the rules sufficiently to prevent the enforcer from becoming an exploiter.

## Conclusion

James Buchanan is perhaps best known for the pioneering work he has done to establish the sub-discipline of public choice as a part of mainstream economic and political thought. While this

characterization of Buchanan's work is not inaccurate, it does not convey the institutional and constitutional orientation that Buchanan's work has had from the beginning of his career. Sandmo (1990) and Meadowcroft (2011) both note the remarkable consistency in Buchanan's work. In hundreds of published articles and dozens of books, Buchanan has consistently focused on the importance of the institutional framework within which people interact. If one looks at economics as studying exchange, the exchanges that people are able to make depend on the institutional structure within which they operate. That institutional structure is a product of collective choice.

Consider as an example a developer who wants to build a shopping center. This development would rely on institutions such as a clear system for recognizing title to the land on which the shopping center would be built, financing institutions, regulatory institutions that could facilitate or stand in the way of such a development, taxing institutions that might determine whether the development would be profitable, institutions that would provide roads and other infrastructure, and even more broadly, institutions that determine the limits of the corporate form of economic organization, and legal institutions that can facilitate or inhibit complex transactions like this one. The institutional structure sets the rules under which individuals interact with each other, and determines what exchanges are feasible and what exchanges are not. In keeping with Buchanan's (1962) institutional approach, given the rules, people will make all exchanges that are mutually advantageous. Some institutional structures will facilitate more mutually advantageous exchanges than others, so economic analysis should focus on the way societies choose their institutions.

The institutional structure is a product of social interaction, perhaps the result of the strong imposing their preferences on the weak, perhaps as a result of a general agreement among everyone in a society, or more likely some combination of the two. Public choice, while heavily focused on analyzing politics as exchange, and therefore emphasizing institutions as a product of agreement, also recognizes the disproportionate influence of interest groups and the rent-seeking activity of some that can impose costs on others. Rent-seeking and interest group politics are examples of some using their (political) power to impose their preferences on others. The point is

that the rules under which individuals interact – the institutional structure – is a product of choices that individuals make. Individuals do not choose one entire institutional structure over another; rather, individual decisions and collective decisions work together to produce a system of social rules within which individuals operate.

Constitutional economics analyzes the way these rules are chosen and looks at the consequences of choosing one set of rules over another. It is the institutional approach to public choice. When one looks at Buchanan's contributions to public choice, they fall into the constitutional category. While Buchanan is rightfully credited as one of the founders of public choice, not only has his work been constitutional in nature from the beginning, it has also been what he has argued economists should do. While Buchanan is typically characterized as a public choice economist, he might be more accurately characterized as an institutional economist who has focused on constitutional issues.<sup>4</sup> Institutions and constitutions. That is the economic world of James M. Buchanan.

## Notes

<sup>1</sup> This statement is taken from [www.nobelprize.org/nobel\\_prizes/economics/laureates/1986](http://www.nobelprize.org/nobel_prizes/economics/laureates/1986), "The Official Web Site of the Nobel Prize."

<sup>2</sup> The reference to Wicksell (1967) is Buchanan's translation of Wicksell's 1896 essay that originally appeared in German.

<sup>3</sup> For a critique of this emphasis, see Yeager (1985, 2001).

<sup>4</sup> Along these lines, See Williamson (1990) who places public choice as one of the branches of institutional economics.

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