



TAXATION IN FISCAL EXCHANGE

A comment

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The paper argues that Buchanan's contractual-constitutional approach to the fiscal process is extremely fruitful, as it takes explicit account of the politico-economic framework. There are, however, several weaknesses connected with this approach. Other approaches within the realm of 'public choice' should also be used.

1. The main lines of the argument

The objective of Buchanan's (1976) paper is first to show that both sides of the fiscal account, i.e. taxes and expenditures, must be analyzed simultaneously. Secondly, he shows that such an analysis must take into account that fiscal decisions are public, i.e. the decision process lies within the political framework. The 'optimal taxation' approach fails in both respects, leading to inconsistencies and to severe problems with respect to the basis of its normative propositions.

Buchanan offers an alternative to this orthodox 'excess burden' or 'optimal taxation' approach, using 'public choice' concepts. This view is illustrated by the simple exchange model going back to Wicksell and Lindahl: decisions about publicly supplied goods and their financing through taxation are interdependent and simultaneous. Under suitable conditions (especially no strategic behaviour) the political bargaining process captures the gains from trade. An equilibrium is Pareto-efficient and agreed on by unanimous consensus.

In the real world this voluntary exchange model is, according to Buchanan, only partly applicable, because the central bridge between benefits from public expenditures and taxes may often not exist due to (1) intervening political institutions (parties, pressure groups, etc.) and (2) the use of the majority rule, allowing the exploitation of the minority by the majority. On the 'constitutional' level in which there is uncertainty over who will belong to the majority or minority, complete agreement may be reached about the desirability to have norms prohibiting such exploitation. The taxation norms on which the 'optimal taxation' approach is based may be interpreted as part of such a constitutional provision, but there should be corresponding norms on the expenditure side.

Buchanan shows that pure transfers may also be interpreted to be the result of unanimous provision. Again, in contrast to the orthodox approach, no externally imposed norms are necessary. The struggle about pure transfers at the *post*-constitutional stage may lead to a huge waste of resources, possibly exceeding benefits from the public good supply.

2. The value of the public choice approach

Buchanan's view of the fiscal process is extremely fruitful. For many purposes the only adequate approach is to accept that public expenditures and taxes are in the realm of *political* economy. Fiscal decisions *are* political, and if there is any economic influence it must be analyzed within an explicit framework of politico-economic interdependence. Buchanan shows well that this applies not only to positive but also to *normative* studies of the public economy. Values (norms) in a democracy may not simply be taken from the outside, they rather must be analyzed as a result of the political process. Moreover, it must be stressed that 'optimal taxes' will only be put into practice if they are acceptable within the politico-economic process. This aspect must be analyzed explicitly for a good policy because otherwise one may end up with the 'optimal tax' proposals being completely distorted in the democratic process, or, even more likely, to remain a discussion topic among some academic economists.

The reluctance to take into account the *public* (and therefore political) aspects of economic problems may be acceptable as long as economic theory is mainly concerned with areas in which market processes were dominating. However, when (neoclassical) theory turns to public economics, it is high time to take account of politico-economic interdependence and democratic decision-processes, and to dismiss the idea of a (benevolent) dictator applying the 'optimal' propositions offered by economists.

Buchanan is, of course, one of the first and most distinguished proponents of modern political economy. Even more importantly, his paper gives an excellent example of how to apply this general approach to a particular area.

3. An alternative story

Buchanan interprets the existence of 'taxation norms' and pure transfers with the help of an individualistic contractual-constitutional model. An alternative approach, also within public choice, would be to assume 'ethical preferences' which express value judgments,¹ e.g. as suggested by Pattanaik (1971, ch. 2) and MacRae (1973). The observation (also made by Buchanan) that the majority (in many cases) does not really exploit the minority can then be interpreted as a

¹Ordinary 'subjective' preferences are answers to the question: do you prefer x to y ? 'Ethical' preferences are answers to the question: do you think that x is a better social state than y ?

result of corresponding 'ethical' preferences, and not the result of a fixed agreement at the constitutional level. The same applies to pure transfers.

Buchanan's public choice approach certainly is theoretically much more appealing since it is based on a strongly individualistic argument. 'Ethical' preferences are more or less an ad hoc (and ex post) device and should themselves be explained in some way. However, empirical experience for Switzerland lends some support to the view that the majority at the *post*-constitutional level does not exploit minorities, even though nothing can prevent it from doing so: referenda and initiatives at the federal level are not bound by written constitutional restrictions. Buchanan might argue in this case that the constitutional contract may also be unwritten; however, his approach runs the risk of being reduced to an untestable (tautological) ad hoc explanation. Written and/or unwritten constitutional contracts must be proven to exist *before* any particular taxation norm is derived.

4. Discussion of some specific aspects

4.1. *The simple Wicksellian exchange model*

Buchanan builds a model with (two) individuals equal in all respects (income, wealth, etc.), except for their preferences for public goods. He shows convincingly that in this case an equal tax burden is inefficient (as well as inequitable). As the neoclassical 'optimal taxation' approach disregards the expenditure side completely, it would in this case suggest equal taxation. (As a referee pointed out, the 'optimal tax' approach might take into account that the individual utility functions may also depend on the supply of public goods. In this case the equal-tax proposition is true only if the individuals are weighted equally and the utility functions are separable.) This optimality proposition thus *implicitly* assumes that equal income and wealth entail equal preferences for public goods. It is rather nice to observe that the very abstract neoclassical theory in this particular instance relies on *sociological* theory, saying that income and wealth largely determine one's role, i.e. shapes one's preferences! It is, of course, commendable to take account of well-founded knowledge of other social sciences, but if neoclassical theory were prepared to go in this direction, it would certainly not be optimal to do so in one particular case only; there are many similar propositions and theories which would have to be introduced into neoclassical theory.

Buchanan notes that the Lindahl solution for public goods constitutes the 'closest possible equivalence to private-goods exchange' (1976, p. 20). One might argue that this is not a virtue as Buchanan suggests. It might be questioned whether the search for such equivalences² really captures the characteristic

²These are also very strong in the models of party competition. See e.g. Riker and Ordeshook (1973).

features of nonmarket processes. One might establish a case for the opposite procedure, namely to study exactly those aspects of nonmarket decision-making mechanisms which are *distinct* from the price mechanism. Following such a view, the Wicksellian exchange model would not be considered an appropriate picture of the basic relationships. 'Reality' would then be evaluated quite differently from Buchanan, e.g. the possibility of exploitation through the majority rule compared to unanimity would not be defined in these terms and would not be considered a problem at all.

Buchanan's approach is certainly able to throw light onto many aspects of political economy – and onto problems shared by many political scientists – but one should be aware that there exist other approaches within public choice.

4.2. *The exchange model and reality: Does the exchange paradigm function?*

Buchanan expresses the view that the exchange model only partially works in reality, especially because majority rule is incompatible with a general contractual agreement among all citizens. Pressure groups are mentioned only once (1976, p. 23). It may well be argued that in modern industrial societies there is indeed a lot of exchange, i.e. log-rolling, between pressure groups and with the government going on. This bargaining, for many reasons, does *not* fulfill the requirements of Wicksellian exchange. Majority rule is in many instances only formally or not at all applied, e.g. because many problems never come up for formal decision in parliament or by referendum.

If this view is accepted, the Wicksellian exchange model would not be (partly) inapplicable because of majority rule but because the *actual* exchanges happening are of quite a different nature. Buchanan's constitutional norms would then have the function of protecting the weak or forgotten groups against exploitation through bargaining. It may well be that such norms would look quite different from those necessary to prevent exploitation by the majority.

4.3. *Constitutional agreement*

Buchanan interprets 'taxation norms' to represent unanimous constitutional agreements in the state of uncertainty to safeguard exploitation of the minority by the majority. It would have been interesting to know more precisely what forces exist to prevent the majority from using its power once it knows about its position and interests in the postconstitutional stage. In another paper [Buchanan and Bush (1973, p. 154)] he himself stresses the importance of a 'viable constitution' in which 'a majority of the individuals in the post-constitutional stage benefit.' As the majority benefits by exploiting the minority through taxation, a constitutional contract would not seem to be viable.

5. Pure transfers

5.1. *Transfers and exchange*

Buchanan offers an interesting explanation of pure transfers by a constitutional contract. To some extent, at least, transfers serve an allocative function, namely to secure agreement for structural changes and growth (e.g. agriculture, unemployment benefits). For such cases, the exchange paradigm is well suited: the concept of utility interdependence is not the only way to put transfers into an exchange framework.

5.2. *The transfer struggle*

Buchanan is very concerned about the possible huge resource wastage when the post-constitutional political process is used to effect pure transfers. The proper distinction made between this struggle and the strategic problems involved in the Wicksellian bargaining process is not fully convincing, and it is not clear why the resource costs of the latter are much smaller, as Buchanan seems to assume. As noted above, the struggle concerning transfers may make it possible to attain a higher efficiency frontier, i.e. it may result in a *net* resource gain.

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