PROLEGOMENA FOR A STRATEGY OF CONSTITUTIONAL REVOLUTION

by

James M. Buchanan

I. Introduction

When I was invited to present this lecture, it was suggested that I use the occasion to follow up and to develop my comments and discussion of the paper presented by Professor Peter Bernholz at a Washington, D.C. conference in 1986. Bernholz's paper was on prospects for reform in monetary constitutions, and my comments were entitled, "The Relevance of Constitutional Strategy."[1] I shall try to respond positively to the suggestion by examining prospects for genuine constitutional reform in the late 1980's and early 1990's. Is the time at hand when genuine constitutional revolution in Western countries may be possible? How could we recognize the elements of the socio-economic-political interaction process, including the attitudes of the participants, that might bring constitutional reform within the realm of the feasible? Can we identify steps that the political economist might take to direct or to channel discussion toward mutually beneficial changes in the rules of the political game?

In the paper mentioned, Bernholz limited his attention to prospects for change in monetary regimes, and he introduced a discussion of how separate interest groups might converge in support of regime change during specifically identifiable phases or stages of cycle described by differential rates of inflation. That is to say, the Bernholz argument suggested that the prospects for constitutional reform may vary with the situational setting and that an examination of the convergence and/or divergence among the separate interest groups may generate, for the observing political economist, a basis for a constitutional strategy. I propose here to go even further back in analysis, so to speak, and to examine the basic features of the "dilemma" that exists, pre-reform, in each of three "constitutions," the regulatory, the fiscal, and the monetary. Once these elemental features or characteristics have been identified, the problems faced in any reform strategy are more readily subject to analysis.

It will first be necessary to define, very briefly, what I mean by constitutional change, reform, or revolution. I shall, of course, be covering material here that I have discussed in many earlier books and

[1] Peter Bernholz "The Implementation and Maintenance of a Monetary Constitution," *Cato Journal*, 6 (Fall, 1986), 477-512; James Buchanan, "The Relevance of Constitutional Strategy," *Cato Journal*, 6 (Summer, 1986), 513-518.

articles. But a short summary, presented in Section II, seems essential in order to insure that my subsequent argument is understood.

After the summary statement of the constitutional perspective, I shall, in Sections III, IV, and V, examine the distinct features in the separate diagnoses of the regulatory, the fiscal, and the monetary constitutions.

II. The Economy as a Constitutional Order

Those who conceptualize national economies as networks of macroaggregates that can be managed or manipulated for the purpose of promoting the achievement of macroeconomic objectives cannot understand what the terms "constitutional reform" or "constitutional revolution" mean. In this conceptualization, economic policy is straightforwardly teleological; there exist objectives worthy of achievement that are recognized by the authorities, and the economy must be guided towards such ends.

The constitutionalist perspective differs dramatically in its fundamental conceptualization of what the "economy" is. Here the political economy is conceived as a *constitutional order* that, in itself, and, as such, embodies no independently defined objective or goal, and has no function. The order is best described as a set of rules, or constraints, within which individuals, and organizations of individuals, interact, one with another, in promoting their own, individually initiated, purposes. Patterns of outcomes or results (allocations, distributions, utilization and growth rates) depend critically on the rules that constrain both private and public choices. And persons, generally, may judge some patterns of outcomes to be less desirable than others that might be generated under alternative rules. In such circumstances, there may be general agreement on a change in the rules, or constitutional reform.

It is essential to recognize that the choice of a rule (or a set of rules) within which a pattern of outcomes may emerge over a sequence of interactions, is categorically distinct from the choice of an outcome or result that has well-defined characteristics. Policy is misdirected to the extent that it is motivated by the notion that specific outcome targets can be achieved. Even an ideally omniscient and benevolent authority could not choose an allocation of resources, a distribution of income, a rate of resource utilization, or a rate of economic growth. This proposition holds even if we totally ignore issues relating to the definition of what the ideals would look like in each case.

The social interaction process necessarily involves choices made by the many separate individuals and organizations in the economy-polity, each one of whom chooses subject to the constraints that are separately confronted. The many choices generate one outcome from among a whole set of outcomes that might emerge within the same set of constraining rules. To model policy as if the alternatives for "social choice" are outcomes amounts to a denial that participants retain independent powers of choice. Those who choose rules for games do not, in doing so, choose solutions; rather, solutions *emerge* from choices of players made within the rules that constrain them.

Regardless of the ultimate location of political authority, whether this be concentrated in a single person, party, or class or dispersed among many persons who act through some collective decision making institutions, any imposed politically directed action, and law, must modify the constraints for all those who choose in any of the many capacities or roles. In this narrowly defined sense, any political action must be "constitutional." It seems preferable, however, to restrict the usage of the term "constitutional" to those actions that have rules changes as their primary purpose.[2] The "economy as a constitutional order" is described by the set of rules within which individuals and organizations (including government) make choices and implement them in subsequent actions.

An existing constitution is evaluated through reference to the relative desirability of the pattern of outcomes that it allows the choices of participants to generate stochastically over a temporal sequence. The problems that arise in diagnosing "constitutional failure" are difficult and not well understood, even if we restrict attention to evaluation by a single person, whether this person be an active participant or an outside observer. My concern here is not, however, with such problems, as difficult as these may be.[3] My concern is with the comparative evaluation of an existing set of rules made by the many separate persons in a constitutional democracy, where basic changes in structure are made, ideally, only upon consensual agreement.

It is, first of all, self-evident that any agreement on diagnosis of a constitutional order is enormously more difficult to achieve than the making of a diagnosis itself by a single person, or even by a group of persons who share evaluative norms. In particular, if the *status quo* set of rules, or some part thereof, is consensually diagnosed as needing reform or change, players must not only agree that the "game" played out within

[2] Taxation offers an example. Any tax will modify the constraints faced by individuals in the polity, even the lumpsum tax that is often used for bench-mark comparisons by public finance theorists. But a tax levied for the purpose of financing public outlay, which will change constraints for individual choice, is not exclusively aimed at accomplishing the behavioral change induced by the modification of constraints. In the terminology suggested here, only the latter tax is to be considered "constitutional."

[3] See, Rutledge Vining, *On Appraising the Performance of an Economic System* (Cambridge: Cambridge University Press, 1984), for a concentrated treatment of some of the issues in constitutional diagnoses at the level of the individual evaluator.

the existing rules is negative sum, in some appropriately defined opportunity cost sense, but, also, there must be agreement upon the alternative set of rules that is predicted to yield higher utility levels. The monetary regime offers a good example. There may be general agreement that an existing regime "fails" in comparison with some alternative regime, but agreement may break down on identification of the alternative with which the existing regime is compared. The discretionary authority of national central banks may be judged to be nonpreferred, by all parties, but the preferred alternative may be a gold standard by some and a rule-directed fiat system by another.

Is it not absurd to think that the required consensus could ever be attained? Will not there be at least some major groups in a polity that will consider any existing rules preferred over any alternative? I do not underestimate the magnitude of the challenge here. But, by way of precaution, we must keep in mind that, if there is no agreement possible on any change, then the existing set of rules is, in this sense, to be considered optimal. The simple logic of Pareto criteria tells us that if an existing state of affairs is to be evaluated as Pareto-inferior, there must exist at least one alternative that is Pareto-superior. The challenge to the political economist is to locate the set of changes that will command general agreement.[4]

III. Features of the Regulatory Dilemma

I propose to examine, in turn, three areas where constitutional failure seems to be present in Western democratic nations, three "constitutions." I shall try to outline, in each case, elementary features of the pre-reform setting. This step is required *before* any discussion-analysis of possible change in rules.

In this Section, I consider the general area of "regulation," by which I refer to the direct intrusion of politicized controls over market interaction. The familiar examples are political controls over (or interferences with) terms of potential voluntary exchanges of goods and services: controls over wages, prices, interest rates, rents, entry into and exit from occupations, industries, and locations. In each case, the political controls are motivated by producer group interests, which seek to secure benefits (monopoly rents) at the expense of the citizenry generally. Any change in rules that prohibits such political control is clearly not to the particularized interest of any such potentially favored group if the policy issue affecting that group is taken one at a time and in isolation. The potential or actual beneficiary group or class will never freely assent to piecemeal constitutional change. The particular interest of the group will be damaged in the process.

By contrast, each group that finds itself damaged by regulations that serve to generate particularized benefits to other groups and interests would, in its *constitutional* interest, prefer that all of the other regulations be removed and that exchanges be allowed unrestricted domain over these sectors of economic life. If this generalized conflict between the individual's particular interest and his constitutional interest is acknowledged, then the way seems open for a general agreement that will prohibit, constitutionally, any political interference with the freedom of voluntary exchange. If the number of producer groups that secures political protection becomes sufficiently large, the losses suffered, even by a protected producer group, may outweigh any gains from the protection. In this setting, the members of all protected producing groups, along with nonproducers in the economy, will agree on a change in rules that eliminates protection over *all* groups.

The essential feature of this pre-reform regulatory setting is described in the classical prisoners' dilemma. Given the constitutional rules of the game, as they exist, producer groups maximize utility by seeking protection under the state's regulatory umbrella. As more and more groups succeed in this effort, a point is reached where members, even of those groups that are protected by regulation, are worse off than they would have been or would be in the absence of political regulation generally. But the generalization feature is worthy of emphasis here; it would not be in the utility-maximizing interest of any protected group to seek removal from the protective umbrella of regulation in isolation from the other protected groups. Constitutional reform can only be successful if it is sufficiently *general* to bring in large numbers of separate producer interests and remove all of these, simultaneously, from the regulatory umbrella.

IV. The Potential for Reform in the Fiscal Constitution

The central flaw in existing fiscal constitutions lies in the absence of any constraint on the debt financing of current public consumption. The effect of the Keynesian revolution in economic policy was to repeal effectively the balanced budget norm for fiscal prudence. Post-Keynes, political decision makers have felt free to exercise their natural proclivities to spend without taxing currently, proclivities that are based on the desires to meet demands of constituents. As I have argued on numerous occasions and in many forums for three decades, the suggested constitutional reform is simple and straightforward and represents the implemen-

[4] For a statement of this general methodological position, see, my "Positive Economics, Welfare Economics and Political Economy," in my *Fiscal Theory and Political Economy* (Chapel Hill: University of North Carolina Press, 1960), pp. 105-124. Also, see, W. H. Hutt, *A Plan for Reconstruction* (London: Kegan Paul, Trench, Trubner, 1943).

tation of a central principle of classical public debt theory. The constitution should be changed to include a prohibition of debt financing of outlay on currently consumed publicly provided goods, services, and transfers.

Note, however, that the basic features of the pre-reform *status quo* here, with the observed regime of continuous deficit financing, are quite different from those that are present under the protectionist regulatory regime discussed in the previous section. The fiscal *status quo* cannot be modeled in terms of the classical prisoners' dilemma, where individuals' particular or operational interests may conflict with their more generalized constitutional interests. Any argument for constitutional reform must incorporate recognition of the distinct structural features. In the ongoing deficit regime persons living now, in their capacities as current recipients of publicly financed benefits or in their capacities as current taxpayers, secure net utility gains at the direct expense of persons who will occupy beneficiary-taxpayer roles in future periods (there will, of course, be some overlap between these groups). Deficit financing of current consumption is a pure intertemporal transfer. And, like all transfers, no efficiency gains are available that, even conceptually, would allow the potential gainers from a change (future-period taxpayer-beneficiaries) to compensate the potential losers (current-period taxpayer-beneficiaries). The argument for constitutional change must, therefore, be grounded differently from the interest-based logic of regulatory reform.

There are two separable features of the argument here, each of which is derived from a feature that is familiar in nonfiscal application. In the first, we ignore the collective decision aspects of fiscal choice and concentrate exclusively on the individual. Here any change in the rules that will restrict debt financing of current consumption must call upon some argument from the "economics of temptation." The individual who recognizes his own possible "weakness of will" in future periods may choose to impose upon himself binding constraints that will effectively prevent his situational responses as might be dictated by in-period utility maximization. This precommitment logic has been discussed by Elster, Schelling, Thaler and others in such examples as forebearance from tobacco, alcohol, food, and sex. Somewhat more generally, the argument may be extended to personally derived norms against pure consumption borrowing.

A second part of an argument for change in fiscal rules requires the introduction of the collective aspects of choice. Even in settings where an individual might not, upon reflection, choose to bind himself against consumption borrowing, he may well agree to bond or precommit the collective of which he is a member. He may do so because he does not "trust" his fellow members to refrain from "temptation," and because he recognizes that in majoritarian settings, he cannot effectively forestall *undesired political* choices.[5] One or both of these elements may generate a consensus that a balanced budget rule should be adopted, despite the recognized current-period loss.

There is, however, an implication of the constitutional reform logic here that is not present in the regulatory example. Because rule changes here do, indeed, impose acknowledged current-period utility losses, relative to utility levels enjoyed in the absence of the change, consensus building may require that implementation be lagged over several periods. This time lag requirement is not central to reform in the regulatory constitution, as previously discussed.

Also, as the discussion suggests, the moral or ethical dimension of the comparative evaluation of the *status quo* and the alternative regime becomes important in the fiscal constitution whereas such dimension may remain relatively insignificant in the thrust for regulatory depoliticization. Deficit financing of current public consumption involves a more blatantly unjust transfer from future-period to current-period taxpayer-beneficiaries than the more diffuse transfer from consumers to producers in the regulatory setting. Quite apart from this difference in generality, there are also "excess burdens" produced by politicized interference with voluntary exchanges, the elimination of which offers a "cushion" for working out agreed-on compromises on rules changes. No such "excess burden" exists in the pure intertemporal transfers reflected in deficit financing. Only some introduction of a moral argument can oppose the play of self-interest here.

V. Potential Change in Monetary Rules

In the paper referred to earlier, Bernholz suggested that the dynamics of the inflationary process offer opportunities for implementing change in the monetary structure. In his analysis, nonconstrained discretionary authorities exhibit consistent inflationary bias due to the pervasive political pressures. As the authority responds by reducing the value of the monetary unit, the interests of government and of debtors, both existing and potential, are promoted at the expense of creditors. As potential creditors (lenders) recognize the inflationary patterns and make predictions concerning their continuance, they will demand and be able to secure protection of value through modified terms of intertemporal exchange. As this adjustment takes place, the earlier gains from inflation to the government on the one hand and to debtors on the other may be squeezed out, and, in some cases, converted into net losses. At some appropriate point in the dynamic sequence, there can be a genuine

[5] For elaboration of the argument here, see Chapter 21, in my *Liberty, Market and State* (New York: New York University Press, 1986), pp. 229-239.

convergence of debtor and creditor interests on a shift in structure toward a regime that embodies predictability in the value of the monetary unit.

Predictability, in and of itself, implies pure efficiency gains to all potential transactors who use money as a medium of exchange or store of value. There is an "excess burden" in nonpredictability that is analogous to that involved in politicized interferences with market exchanges, and this "excess burden" can provide a cushion for securing agreement among different interests. Note here that the efficiency-based argument for predictability is not the same as the argument for *stability* in the value of the standard, at least in any direct sense. On the other hand, if a change in regime insures predictability in the value of the monetary unit, there should arise no conflict among interests (*e.g.*, debtors and creditors) as to the direction or rate of change in this value through time. If all transactors make the same prediction as to the temporal path of change in the standard's value, and if the regime insures that these expectations are fulfilled, there is no difference in first-level efficiency between inflationary, stable, and deflationary patterns. Efficiency differences here, which may be minimal, arise only from differences in the resource costs of using money relative to other standards for storing value.

VI. The Welfare Politics of Constitutional Change

I have entitled this paper "prolegomena" for a strategy of constitutional revolution. My central point has been that we must understand the characteristic features in the diagnosis of regime failure in each of the three cases examined before proceeding to suggest specific reforms. This approach suggests, in turn, that the prospects for securing constitutional change need not be so dismal as pessimistic political economists sometimes seem to accept. With reference to both the regulatory and the monetary constitutions, there can arise some convergence of special interests in support of change; the thrust need not come from some effective representation of the generalized and diffuse interests of nonorganized and nonorganizable consumers. In regulatory reform, the very multiplicity of special interests who seek, and get, regulatory protection from the state may, at some point, insure that these interests, in their roles as consumers, will recognize the negative-sum aspects of the rent-seeking game in which they are all involved. In monetary reform, the dynamics of the inflationary sequence will possibly generate a convergence of interests on basic structural change at the appropriate point in the sequence.

In the fiscal constitution, the reform in the rules that will replace the regime of permanent deficit financing with one of balanced budgets is not so amenable to any convergence of interests as is the case with the

other constitutional sectors examined here. The overt conflict of interests here is not between groups within the existing population (between producers and consumers in the regulatory case, between debtors and creditors in the monetary case), but between "generations," or between temporally defined sets of taxpayers-beneficiaries. Some motivation other than the current interests of persons, whether organized in special interests or diffused and generalized, must describe any thrust toward the introduction of constitutional checks.

It may seem, in some respects, surprising that the agitation for constitutional change seems to be greatest precisely in this area where the interest-based thrust for change would seem weakest. On the other hand, the observed agitation seems to have produced relatively little effective change. Perhaps we can explain the differences in the three regimes, along with the prospects for dramatic constitutional change, by the characteristic features of the diagnosis after all. Because both the regulatory and the monetary rules are ultimately vulnerable to pressures from interest-driven coalitions in support of change, the excesses of departures from the dictates of efficiency-defined ideals may have been more limited. The protectionist intrusion of the modern state may be limited by the recognition that, if it extends beyond certain limits, it becomes self-destructive in the interest-driven polity. The monetary authorities, seeking always to protect their own bureaucratic interest, may reckon on the interest group feedback from too extensive an exercise of the inflationary engine. There is no such limitation internal to the fiscal profligacy that describes the financing of modern states; the relatively greater agitation for a change in fiscal rules arises precisely because there are less constraining internal checks.