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Austrian Economics and Public Choice

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Abstract. In this introduction, we will first discuss the methodological affinities between the market process and public choice approaches to political economy, and then suggest that because of these affinities market process scholars should feel at home using public choice analysis to study politics, and public choice scholars should feel at home using market process analysis to study the economy. In a fundamental sense, public choice theory refers to the application of the economic way of thinking to study the political process.[1] The economic way of thinking deals with individual decision-making, and exchange relationships in a variety of social settings. Mises is arguably the first scholar to champion a unification of the social sciences by way of a common rational choice model.[2] And, Hayek should be recognized as one of the forerunners of the economics of politics with his *The Road to Serfdom* (1945) and constitutional political economy with his *The Constitution of Liberty* (1960).[3] Furthermore, Buchanan and Tullock's contribution to modern political economy touch on these themes: rational choice, catallactics or exchange, and constitutional construction.

The papers in this special issue of *The Review of Austrian Economics* by Buchanan and Vanberg, Levy, Foldvary, and Naka point to the strong methodological and theoretical affinities between public choice and market process economists. The papers by Holcombe, Sutter, Benson, and López move from the methodological and theoretical level to the realm of applied theory and empirical work.

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Establishing the Common Ground

In its emergence, public choice represented a departure from the "organic State" model of collective action toward an individualistic model (Buchanan and Tullock 1962:11–15.). In public choice theory, government is neither a collective entity nor an instrument of ruling classes, but a vehicle or "machine" by which individuals choose to act in concert with one another for the purpose of producing collective goods. Moreover, in choosing collectively, individuals are no less self-interested than in their private choices (Olson 1965:101). So public choice begins as the study of political agents using the conventional behavioral assumption of individual self-interest found in the study of economic agents. In this sense, the methodology of public choice is entirely consistent with the Austrian "practice of viewing social wholes (such as national economies) as the product of individual actions..." (Christainsen 1994:11). Both market process and public choice economists begin with methodological individualism, and both are in stark contrast to holistic accounts in the social sciences. The Austrians developed their methodological individualism within their debate with the German Historical School, and public choice theory developed their approach as a challenge to public interest theories of government policy-making. The similarities are highlighted also by the fact that Buchanan and Tullock use the term "praxiological" to describe their general approach (1962:16–30, especially 29) and Buchanan references Mises in a favorable manner in his original papers developing his basic model of the voting process (Buchanan 1954).

Though similar in terms of methodological individualism and the commitment to the unification of the social sciences on the foundation of a rational choice model, Austrian and public choice economics often differ regarding the role of information in the polity. A common way to express this difference is with reference to the twin assumptions of benevolence and omniscience on the part of political economy decision-makers. Mid-century public interest theories assumed both benevolence and omniscience, and thus promoted a Romantic conception of the state. Ludwig Mises pointed out that whenever intellectual and moral perfection is attributed to the state the logically inescapable conclusion is that the state should be in direct control of all decision-making (Mises 1949:692). Because of the mid-century prevailing wisdom that in the social sciences that equated questions of incentives with motivation, and because of Mises's own style of value-free science, he chose to question the assumption of intellectual perfection while leaving the assumption of moral perfection in place.[4] Even if good spirited public officials wanted to allocate resources in an effective manner, they would not have the requisite information/knowledge to make rational economic calculations about the alternative uses of scarce resources. This is the crux of Mises's famous "impossibility" thesis with regard to rational economic calculation under socialism.

Public choice economics as developed in the 1950s and 1960s, took a different analytical path. Public choice theorists adopted a hard-headed economics which challenged the benevolence assumption, but left the omniscient assumption alone. Political agents (voter, bureaucrat, politician) act in their own interest with perfect information. Hence, by ignoring the structural uncertainty of the future and the diffuseness and subjectivity of knowledge, public choice analysis, one could argue, is methodologically inconsistent with Austrian economics. On the other hand, Austrian political economy, challenges the omniscience assumption, but continues to be reluctant to relax benevolence (Kirzner 1984, Ikeda 1997) and is therefore methodologically inconsistent with public choice. In simplest terms, a combined Austrian-public choice approach to political economy would relax both assumptions, and many contributions to this volume and the broader literature fit within this category.[5] This hybrid market process and public choice paradigm for political economy analysis was, in fact, championed by Hayek, and it was argued by him that this approach was indeed a crucial aspect of the great contribution which Hume and Smith made to human knowledge in the 18th century. As Hayek put it:

> [T]he main point about which there can be little doubt is that Smith's chief concern was not so much with what man might occasionally achieve when he was at his best but that he should have as little opportunity as possible to do harm when he was at his worst. It would scarcely be too much to claim that the main merit of the individualism which he and his contemporaries advocated is that it is a system under which bad men

> can do least harm. It is a social system which does not depend for its functioning on our finding good men for running it, or on all men becoming better than they now are, but which makes use of men in all their given variety and complexity, sometimes good and sometimes bad, sometimes intelligent and more often stupid (1948:11–12).

Exploring the Common Ground

Exactly where and how sharply the methodological lines can be drawn is subsumed by the efforts to put these methodological principles to work and by the results obtained when doing so. The paper in this volume by James Buchanan and Viktor Vanberg is exemplary. They argue that a constitutional structure founded upon the assumptions of benevolence and omniscience is predicted to fail when the structural uncertainty associated with radical subjectivism is introduced into the analysis: "The best of intent will not allow the future to be brought within the present, no matter how perfect the knowledge of the present may be. And if the institutional structure embodies the presupposition that such a feat is possible, stagnation and failure must emerge." In application to the events culminating in the late 1980's, this is in one sense why socialism failed. In application to the lines of methodological demarcation, this expands the relevance to political economy of one of the hallmarks of Austrian economics, radical subjectivism.

In an analogy to robust statistics, the paper by David Levy presents a related line of argument regarding the would-be ideal constitution. Under ideal circumstances in which the data are distributed in accord with the assumptions of a given estimator—say, normally distributed for least squares estimation—then the given estimator is also ideal. But when the data do not cooperate, when they deviate from normality, the given estimator may become inferior to another and perhaps even catastrophic in its estimates. Buchanan's worst-case scenario approach to constitutional political economy can be put into analogous terms. *If* the political actor is benevolent and omniscient, the socialist ideal is possible. But a socialistic constitution without benevolence may be inferior to a market system and even catastrophic, as became the case.

Where Buchanan and Vanberg have shown that a socialist constitution makes possible the worst-case scenario when viewed in a combined Austrian-public choice approach, the article by Fred Foldvary shows that a market process, potentially best-case scenario constitution is implied by the same approach. Modern democracies are large scale, in which voter-constituents face an exacerbated knowledge problem in making collective choices. This increases the base on which to disperse the costs of rent seeking, and creates voter apathy. Inefficient policies arise, and they persist due to specific forms of large-scale democratic mechanisms that exacerbate knowledge problems. In the alternative, Foldvary considers small-group voting, or "cellular democracy," a highly decentralized constitution in which representatives are elected first in very small groups, then representatives of the representatives are elected to the next higher level, and this continues consecutively until the entire polity is commonly represented. Revenues originate from the bottom up, and constitutional rules—such as secession and recall rights—minimize the incentives for voters to seek transfers and for the elected to provide them. Merely installing such institutions to mass democracy would bely the knowledge problem. Only the combined decentralization and incentive-alignment creates the desired effect: through decentralized representation, political outcomes are able to tap into local knowledge and thus better reflect constituents' policy preferences. As Foldvary writes, "cellular democracry provides for a more market-like, more decentralized process which is thus a more efficient process with respect to what individuals desire."

Both Austrian and public choice economics emphasize not only choice under institutional constraints, but choice of specific institutions over others, as well. The paper in this volume by Naka demonstrates this well. In the political reform of post-war Japan, why were certain constitutional provisions selected and not others? And what were the long-term consequences of this institutional design? The initial post-war institutional arrangement guaranteed a rural parliamentary majority. Naka approaches this as having facilitated exchange between the economically productive political minority (urban constituents) and the relatively unproductive rural majority: the majority enacted growth-inducing public investment (rather than simple transfer programs) in exchange for rural subsidies commensurate with economic growth. Such a social contract unravels itself, though, when sustained economic growth and urbanization add complexities and factions to the nexuses of political exchange. To regulate these complexities, additional institutions would emerge. But conservative bias to the old social contract resisted, enabling excessive rent-seeking, a gradual breakdown of the old contract, and subsequent sustained economic recession. The contractarian, comparative institutional analysis helps to understand, in very general terms, the earlier growth and subsequent slowdown of the Japanese economy.

One of the challenges to Austrian economics in general is to establish more and broader empirical relevance, to show that its analytical principles are applicable to standard questions and can provide answers that standard economics cannot. Such accomplishments are necessary to, as Sherwin Rosen has notoriously put it, "pass the market test" (Rosen 1997). While Rosen's critique upholds a narrow view of intellectual progress, scientific revolution, and even the publication market, we too emphasize the need for applied-theoretic and empirical work to come from Austrian economists. The remaining papers in this symposium support the conclusion that an abundance of opportunities for such contributions sits on the common ground between Austrian and public choice economics. For instance, Rosen posited that the theory of the entrepreneur is one of the biggest strengths of Austrian economics. Modeling political agents—whether voters, bureaucrats, or politicians—as entrepreneurs is a significant arena in which Austrian applications to political economy can establish empirical relevance. We have two such general areas in mind, though there are no doubt many more.

First, we consider the well-known democratic efficiency debate. The debate exists because the logical extension of neoclassical analysis makes it impossible to discriminate between efficient and inefficient policies. In the first place, neoclassical economics is capable of identifying inefficient policies: this embodies the value of having an efficiency standard. But the same neoclassical theory, when applied to political markets (i.e. neoclassical public choice) advances the argument that the perception of inefficient policies is merely an illusion (Stigler 1982, Becker 1983, Wittman 1995). Rational individuals are no more likely to leave \$500 bills on the sidewalks of Pennsylvania Avenue than Wall Street, so democratic markets must be efficient.[6]

How can a combined Austrian-public choice economics address this paradox? Consider Hayek's "Economics and Knowledge" (1937) in which individual rationality only results in market equilibrium if the analyst can explain the acquisition and dissemination of knowledge, particularly through the use of prices and the exploitation of profit opportunities. The Walrasian auctioneer—which embodies the big bills on the sidewalk metaphor—is an insufficient assumption that creates nothing but a tautology: an equilibrium condition results in itself. Extending Hayek's analysis to the democratic efficiency quagmire, the pure logic of neoclassical public choice has resulted in the tautology "The policy that exists is efficient, otherwise it would not exist." Becker's interest groups have perfect information about political profit opportunities; therefore, all profit opportunities are exhausted. If a politician saw that he could make an efficiency improvement, he would have the incentive to form the coalition to make the policy change. And the pure logic of choice, according to Hayek, implies that he *will* see that opportunity if it were to exist. In short, a political-economic theory must incorporate the process of acquiring and disseminating knowledge (of policies' costs and benefits and of political profit opportunities) in order to avert the tautology that "what exists is efficient." Then public choice theory reacquires its critical edge.

To be sure, Virginia scholars have been critical of the institutionless analysis embodied in Becker and Wittman (Rowley 1997, Lott 1997). But these criticisms have been either unduly ignored or discarded as imprecise. It is possible, too, that these criticisms are viewed with the "negative heuristic" problem with which Austrian economists are self-critical (Vaughn 1998). The papers in this volume by Randall Holcome and Daniel Sutter address the democratic efficiency debate by introducing political entrepreneurship atop a Virginia-style institutional analysis, such that a "positive heuristic" is advanced to achieve valuable applied-theoretic results. Holcombe characterizes political markets as generating political profit opportunities when political instability and inefficient policies exist. Political entrepreneurs act to seize such opportunities; however, unlike economic entrepreneurship, doing so requires coalition building and coercive action. Because coalition building features the logic of concentrated benefits and dispersed costs, and exchange is not necessarily voluntary or mutually beneficial, a political profit opportunity may emerge from the enactment of an economically inefficient policy. Thus political entrepreneurs, because of the institutions provided by majority rule politics, often are given the incentive to create inefficiencies in the economy, a result that is necessarily absent from the neoclassical public choice approaches. In parallel reasoning, Sutter notes the emphasis of the market process view on the disequilibrium effects of political entrepreneurship, and argues that the debate can be at least partly attributed to the methodologically different emphasis of neoclassical public choice on equilibrium. Sutter, in fact, argues that Virginia scholars not only share the institution-based approach of Austrian scholars, but also implicitly adopt a market process disequilibrium approach, and only because of this do Virginia scholars conclude with democratic inefficiency. Sutter, in effect, claims that the common ground is there even if it is unacknowledged.

The underlying salient feature of Holcombe and Sutter is the application of Hayek's knowledge problem to critique the Stigler/Becker/Wittman pure logic of choice, and thus to contend that in politics, like in the market, a pure logic of choice does not necessarily result in the pure logic of equilibrium, unless we can in fact demonstrate the process by which they acquire the knowledge necessary to perfectly dovetail their plans with those of others. In the equilibrium framework, economists too often assume what it is that they must prove, and this has been true for political economists as much as it was for theorists of perfect competition. The disequilibrium market process model, obtained by introducing the political entrepreneur, offers the beginnings of a theory of error that is necessary to avoid that paradoxical compulsion we mentioned above and to develop a theory of learning by agents within the political process. Obviously more work is needed in this area, but Holcombe and Sutter provide a good start.

Our second area of focus in which a combined Austrian-public choice approach to political economy can gain empirical relevance is with legislator/regulator behavior. The papers by Bruce Benson and Edward López do so, again by introducing entrepreneurship into models of political behavior. Arguing from a new institutional perspective, Benson notes that regulation of an industry amounts to specifying an assignment of property rights to the wealth generated by that industry. Entry restrictions, for example, increase incumbent firm profits while decreasing potential firm profits and consumer surplus; deregulation of the same entry restriction re-assigns the rights the opposite way. From a public choice perspective, the regulator assigns these rights according to the relative political strengths of the respective interest groups in demand. And from an Austrian perspective, the regulator is an entrepreneur rather than a budget- or surplus-maximizer as in conventional public choice models (Niskanen 1994). Amid shifting interest group demands, the regulator-entrepreneur seeks out political profit opportunities from re-assigning property rights within the industry. Thus regulation is seen as a process, rather than an end state, of equilibrating and disequilibrating entrepreneurial moves. Benson details a case study of the trucking industry to demonstrate his argument. In this combined Austrian-public choice view, deregulation is a rational outcome of shifting demands and the discovery of new profit opportunities—even with the protection of capitalized rents—rather than the conundrum it presented to conventional public choice (Peltzman 1989, McCormick, Shughart, and Tollison 1984).

Finally, the paper by López shows why the legislator, as well as the regulator, may deviate from the predictions of conventional public choice models. In public choice models, the legislator is a vote- or majority-maximizing agent in static time, and therefore is predicted to serve (vote) fairly strictly in accord with constituent preferences. López emphasizes the view in public choice that the legislator, in pursuing her objective, sometimes invests in political capital goods that move her in the future toward that objective, even if it moves her at present away from it. In a market process adaptation of this investment model, the legislator confronts these investment possibilities with some degree of structural uncertainty. Applying the structure of production model of capital goods to legislator voting, López is able to distinguish votes on which the legislator is more likely to represent constituents from votes on which she is likely to invest in political capital. Empirical implications follow directly, and depart from the conventional public choice model implications.

Conclusion

Pursuing the common ground between market process and public choice analysis we contend is a worthy pursuit. In some ways it is a declarative statement, while in others it is still an interrogative that provides scope for a vibrant research agenda to unfold. As laid out in Boettke (1999b), research along these lines represents a niche for Austrian economists within the modern literature of political economists.

We hope this symposium encourages others to harvest the fertile common ground between Austrian and public choice analysis by relaxing benevolence and omniscience in studies of political economy. It is our hope that work in this vein will result in research of an applied variety, answering questions that mainstream economics cannot, and thus passing the market test. We believe that the articles gathered in this symposium represent a significant step in this direction.

Notes

1. Before proceeding, we feel compelled to clarify our meaning of "public choice." Following Mueller (1989:1) we define public choice as "the economic study of nonmarket decision making, or simply the application of economics to political science." We acknowledge that not all scholars would share our view of what this project would entail. In short, our meaning of public choice can be likened to what many have come to call "Virginia Political Economy," and we find it important to note that public choice economics is no longer synonymous with Virginia Political Economy. In some sense, this has been the case since the late 1970's when economists of the Chicago school began turning their attention to the economics of politics. It is true even more so today. The majority of modern political economy research is done outside the Virginia school tradition (e.g., political economy research done in the traditions of Chicago, Rochester and Cal Tech), and the basic teachings of public choice have been so fully integrated into mainline of economics such that in some places the tradition is referred to in the past tense (e.g. Person and Tabellini 2000:3). We emphasize the Virginia tradition in this symposium because of its deep affinities with Austrian economics. See Boettke (1998) for an overview of Buchanan's contribution to modern political economy and the relationship of this contribution to the modern development of Austrian economics.
2. See Boettke (2002) for an elaboration of this claim with regard to Mises's development of praxeology.
3. For an examination of Hayek as a public choice theorist see Boettke (1995), and for an examination of his broader contributions to political economy see Boettke (1999).
4. During the socialist calculation debate, Oskar Lange had claimed that questions of bureaucratic incentives were not appropriate for economic analysis, but belonged instead within a sociological analysis, and thus he could dispense with them in his *economic theory* of socialism (see Lange 1936, 1937:127). On the intellectual history of the socialist calculation debate see Boettke (2000).
5. Two exemplary texts in this regard are Wagner (1989:207–212) and Mitchell and Simmons (1994). Boettke's work on the history, collapse and transition from socialism is explicit in trying to develop a hybrid Austrian-Virginia Political Economy model (see Boettke 1990, 1993, 2001).
6. The logic of this argument is straightforward. First, economic theory tells us that *persistent* errors do not exist, agents may make errors, but they learn quickly and work to eliminate error in their decision-making. Second, economic theory establishes that there are efficient and inefficient states in the world, and that these states are identified through an examination of alternative states of affairs in light of economics. Third, we know through observation that certain policies that we consider inefficient (e.g., trade protectionism and subsidies) persist. The dilemma then is how do we square the first two economic arguments with this observation? One way is to argue that the persistence of a policy is evidence that its inefficiency is actually an illusion. If a lower cost alternative was available, it would have been chosen by political-economic actors. The other way that one could address the issue is to admit that error can occur and that within some institutional settings error can persist.

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