

# **The Marketizers**



# The Marketizers

Public Choice and the Origins of the  
Neoliberal Order

Jacob Jensen



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First published in 2022 by Goldsmiths Press  
Text copyright © 2022 Jacob Jensen  
Goldsmiths, University of London, New Cross  
London SE14 6NW

Printed and bound by Versa Press, USA  
Distribution by the MIT Press  
Cambridge, Massachusetts, USA and London, England

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A CIP record for this book is available from the British Library

ISBN 978-1- 913380-52-6 (pbk)

ISBN 978-1- 913380-51-9 (ebk)

[www.gold.ac.uk/goldsmiths-press](http://www.gold.ac.uk/goldsmiths-press)

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## Acknowledgments

Economists may argue that individuals are self-interested, but the past seven years have provided me with ample evidence to the contrary. The Department of the History of Ideas and Philosophy at Aarhus University provided the best possible environment for writing the dissertation upon which this book builds. Thanks to Bjarke Skærlund Risager, Christoffer Basse Eriksen, Eva Krause Jørgensen, Jakob Bek-Thomsen, Lars Lodberg, Nicolaj Krejbjerg, Nicolai Mariegaard von Eggers, Louise Rognlien, Ludvig Goldschmidt, Magnus Møller Ziegler, Thomas Erslev, Thomas Palmelund Johansen, and Tobias Dias for making it such an enjoyable workplace. Special thanks to Christian Olaf Christiansen, Esben Bøgh Sørensen, and Simone Sefland Pedersen for their unfailing kindness and optimism.

Though I bear sole responsibility for the outcome, the book is the result of many people's generosity. Dieter Plehwe gave advice in the early stages of the project, and his comments shaped it in important ways. The members of my dissertation committee, Casper Andersen, Joel Isaac, and Sonja Amadae, gave vital suggestions that helped turn a narrowly framed dissertation into a book with a broader intervention. Will Davies's and Quinn Slobodian's invaluable guidance and comments made this a far better book than the one I initially had in mind. The manuscript also benefited immensely from the conversations I had with my three closest work partners over the past seven years. Mikkel Thorup's ability to see potential in even the feeblest idea made him an ideal supervisor and sparring partner. He taught me that writing is not a pouring of the soul onto paper, and that perfection is not the measure of success.

These dictums kept me sane during the years working on the manuscript and helped usher it to completion. Niklas Olsen shaped this project to the extent that I am no longer sure which ideas are his and which are mine. He tirelessly commented on drafts, shared his ideas, and allowed me, as a postdoc in his “Key Actors – Peopling the Neoliberal Economy” project, funded by the Danish Research Council, ample time to turn the dissertation into a book. Without my office partner, Jesper Vestermark Køber, the past three years would most likely have been more productive for the both of us, but also far less fun.

Friends and family reminded me that life’s most important moments lie outside academia. Alexander Sørensen, Frederic Maigaard, Fredrik Leicht, Oscar Petersen, and Rune Justesen provided much-needed time away from book writing. With wonderfully dark humor, David Hasberg Zirak-Schmidt picked me up whenever I hit a rough patch. My parents, Gitte and Carsten, encouraged me throughout my studies, which I would not have been able to finish without their help. Above all, I am grateful for my daughter Ingrid. Having spent so much time studying economists who believe that individuals pursue only their own self-interest, I thank her for reminding me daily that love is an antidote to that conception.

# Introduction

## From Compensation to Marketization

Speaking before Congress in 1996, Bill Clinton announced the end of an era. “We know big government does not have all the answers,” he declared. “We know there’s not a program for every problem. We have worked to give the American people a smaller, less bureaucratic government in Washington. And we have to give the American people one that lives within its means.”<sup>1</sup> Announcing the end of big government, Clinton accounted for the progress of the reinvention of government his administration had initiated when he took office three years before. Among its achievements, he singled out the reduction of the federal workforce, the elimination of unnecessary rules and regulations, and the devolution of responsibility from Washington to states and municipalities.<sup>2</sup>

The core components of his administration’s National Partnership for Reinventing Government were customer-orientation and employee-empowerment through the introduction of performance evaluations. The goal was to “empower” employees, decentralizing decision-making at the

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<sup>1</sup> Bill Clinton, “State of the Union Address,” January 23, 1996, <https://clintonwhitehouse4.archives.gov/WH/New/other/sotu.html>.

<sup>2</sup> Ibid.

federal level while having bureaucrats meet performance targets. One of the core challenges of the reinvention of government was thus to devolve decision-making to lower levels of government and to introduce new systems of performance targets and rewards. Rather than follow regulations and rules, the National Performance Reviews encouraged public employees to pursue results that benefited citizens as customers, a core characteristic of good government:

We had to start with the basics. Some agencies had never thought in terms of customers before, so the National Performance Review conducted workshops for agencies to figure out who their customers were. In private business it's easy—the customer is the person with the money, the person who might go to your competitor. But most agencies have no competition, and they saw Congress as their source of money. We even had complaints from taxpayers saying they were the government's owners, not its customers. They are right about being the owners, but they are customers, too, like a Ford Motor Company stockholder who buys a Ford.<sup>3</sup>

The Clinton administration thus premised the reinvention of government on a comparison of service in the public and private sectors with the aim of making the former resemble the latter. The simplest strategy government agencies had pursued to reach this goal was to ask citizens what they wanted from government and then act on that. To make bureaucrats responsive to their customers, the National Performance Reviews recommended the introduction of customer-based performance appraisals of government strategies. Another

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<sup>3</sup> Al Gore, "The Best Kept Secrets in Government: A Report to President Bill Clinton," Report of the National Performance Review, September 29, 1996.

vital component was to make government employment meaningful. This included new civil service legislation, which aimed to give government agencies more flexibility in evaluating the performance of individual bureaucrats and their bureaus.<sup>4</sup>

This book examines the origins of this marketization. It argues that the reinvention of government would have been unthinkable without postwar economists' interventions in political theory. Public choice theorists like Anthony Downs, James Buchanan, Vincent Ostrom, and William Niskanen opened a space of imagination that made it possible to remake government in the image of the firm. As a body of thought, public choice emerged when economists began using the tools of their discipline to address problems that had traditionally been the purview of political scientists. Applying rational choice assumptions to politics, public choice theorists analyzed citizens, politicians, and bureaucrats as economic agents. Working in a context of ballooning public expenditures and vastly increased revenue from the federal income tax, they felt empowered to treat the state's membership—its representatives, its civil servants, and its voters—as what they in some respects had become: managers for, contributors to, and recipients of a staggering volume of public goods and services, from education to health care to pensions and military defense. Incapable of acting in the public interest, citizens voted only for the candidate they stood to gain the most public goods and services from, politicians sought only election by providing these goods and services, and bureaucrats aimed only to advance their careers and expand their bureaus. Deploying the market as the best analogy for understanding political decision-making, the key move of these marketizers was to

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<sup>4</sup> *Ibid.*, 20.

reconceptualize politics as the demand for and the supply of public goods. This was a momentous act of transvaluation. In response to the evolution of postwar American fiscal policy, the marketizers developed a theory of politics that made the late twentieth-century reinvention of government imaginable.

This marked the beginning of a new phase in twentieth-century American state building. The period from the 1890s to the 1970s had been an age of expansion of government's administrative capacities through regulation and compensation. During these decades, the reach of American government gradually extended into ever more areas of economic and social life. Turn-of-the-century progressive reformers built a *regulatory state* that intervened in individual markets to prevent monopolies and protect citizens from harmful practices and substances. They did so by arguing for the atomization of markets to break up the large-scale corporations that had developed in the late nineteenth century.

Like the progressives, the architects of the New Deal order believed that the federal government should intervene in the market to protect the public interest.<sup>5</sup> The economic crises of the 1930s proved to these New Dealers that the market system required a strong state. Their novelty lay in the form

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<sup>5</sup> The following paragraphs, and the distinction between the regulatory and compensatory states, draw heavily on Alan Brinkley, *The End of Reform: New Deal Liberalism in Recession and War* (New York, NY: Vintage Books, 1995). For a succinct statement of the relationship between New Deal liberals and the idea of the state, see Alan Brinkley, "The New Deal and the Idea of the State," in *The Rise and Fall of the New Deal Order*, ed. Steve Fraser and Gary Gerstle (Princeton, NJ: Princeton University Press, 1989), 85–121.

of government they developed. They articulated much more expansive definitions of both the regulatory and compensatory capacities of government. Believing that large-scale organization was inevitable, in the early 1930s they dabbled with planning to protect American consumers from artificially inflated prices. This was a radicalization of the antitrust ideal, which they inherited from the progressives. The means was aggressively intrusive state involvement in the workings of the economy. Rather than simply breaking up monopolies, late-1930s New Dealers advocated a significant expansion of the number of administrators to increase control of big corporations, matching their size.

Though important aspects of this regulatory state survive to this day, the New Dealers arrived at a more moderate conception of government's role in the economy during World War II. The experiments in planning afforded by the war dispelled the New Dealers' hopes that greater control was possible, while the economic revival in response to wartime production dispelled their idea that it was necessary. Instead, they set in motion the development of a *compensatory state*. The purpose of this state was compensating for market failures rather than large-scale control of the economy.

Postwar liberals expanded the compensatory state in much the same way that early New Dealers had expanded the regulatory state which progressive reformers had built. As a result, public expenditures ballooned. This was sustainable under the relative balance between democratic and economic demands in the postwar period.<sup>6</sup> In exchange for acceptance of the market order and private property rights, labor enjoyed

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<sup>6</sup> Wolfgang Streeck, "The Crises of Democratic Capitalism," *New Left Review* 71 (2011): 5-29.

the benefits of the rapidly expanding welfare state, which lessened the anxieties and uncertainties associated with unemployment, old age, and sickness. In short, workers saw their dependence on the market reduced in this period through an extraordinary expansion of public expenditures.<sup>7</sup> An equally extraordinary level of economic growth, which raised profits, wages, and the standard of living, undergirded the development of this compensatory state.

In the 1970s, the lockstep relationship between the private and the public sector came under pressure in a perfect storm of social, cultural, and economic crises. To use a phrase popular at the time, American democracy had become ungovernable.<sup>8</sup> People's expectations exceeded what government was able to give them. The downturn threw the postwar balance between democratic demands and economic growth out of kilter. The result of this conjuncture was the advent of a *marketized state* along the lines suggested by public choice theorists.<sup>9</sup>

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<sup>7</sup> On decommodification as the core characteristic of the welfare state, see Gøsta Esping-Andersen, *The Three Worlds of Welfare Capitalism* (Cambridge: Polity Press, 1990).

<sup>8</sup> Michel Crozier et al., *The Crisis of Democracy: Report on the Governability of Democracies to the Trilateral Commission* (New York, NY: New York University Press, 1975); Grégoire Chamayou, *The Ungovernable Society: A Genealogy of Authoritarian Liberalism* (Medford, MA: Polity Press, 2021).

<sup>9</sup> Theorists have conceptualized this state formation in various ways. For the related literature on the privatized and contracting state, which focuses on the outsourcing of public services, see Chiara Cordelli, *The Privatized State* (Princeton, NJ: Princeton University Press, 2020). For scholarship on the competition state, which emphasizes international competition, see Philip G. Cerny, "Paradoxes of the Competition State: The Dynamics

Reimagining American government on the model of the market, these marketizers played a role comparable to progressive reformers, New Dealers, and postwar liberals. If their predecessors had expanded the administrative capacity of American government through regulation and compensation, public choice theorists expanded it through marketization.

From Ronald Reagan's attempts at privatization in the 1980s to Clinton's reinvention of government in the 1990s, public choice was the theoretical foundation of marketization. In March 1988, Reagan's Commission on Privatization delivered its report on "the appropriate division of responsibility between the federal government and the private sector." Unsurprisingly, the commission recommended the privatization of a wide range of government services to make government more effective. This was justified with reference to the two principles of consumer choice and cost efficiency.<sup>10</sup> To furnish its conclusions, the members of the commission had surveyed a large amount of literature, and one of the principal bodies of thought they drew on was public choice theory.<sup>11</sup>

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of Political Globalization," *Government and Opposition* 32, no. 2 (April 1997): 251–274; Joachim Hirsch, *Vom Sicherheitsstaat zum nationalen Wettbewerbsstaat* (Berlin: ID Verlag, 1998); Bob Jessop, *The Future of the Capitalist State* (Malden, MA: Polity, 2002); Philip Bobbitt, *The Shield of Achilles: War, Peace and the Course of History* (London: Allen Lane, 2002). For scholarship on governance, which stresses the emergence of performance accountability, see Mark Bevir, *Democratic Governance* (Princeton, NJ: Princeton University Press, 2010).

<sup>10</sup> President's Commission on Privatization, "Privatization: Toward More Effective Government," March 1988, unnumbered cover letter to the President.

<sup>11</sup> *Ibid.*, 233–234.

The report singled out the analyses which showed that interest-group politics resulted in inefficiencies because it pressured legislators to increase the volume of goods and services provided by government. The remedy, according to the commission, was to reduce the influence of interest groups by reducing the number of programs and services supplied by the federal government.

The Commission on Privatization's proposals were radical and mostly went unrealized. Though Reagan's privatization drive was largely unsuccessful, it pushed the boundaries of the conversation and the limits of the American political imagination. The Clinton administration proceeded along similar lines and reinvented government on the model of the market. Reviewing the origins and results of the reinvention of government in late 1996, John Kamensky, the deputy director of the National Performance Review, claimed that public choice theory was one of the most significant bodies of thought undergirding the Clinton administration's efforts to make government cost less and work better.<sup>12</sup> The marketizers had opened a new way of thinking about the relationship between government and its citizens. The marketized state thus originated in public choice theorists' reinvention of politics as the demand for and supply of public goods and services.

There is no shortage of complaints that neoliberalism defies consistency of meaning.<sup>13</sup> This book simply defines it as the

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<sup>12</sup> John M. Kamensky, "Role of the 'Reinventing Government' Movement in Federal Management Reform," *Public Administration Review* 56, no. 3 (May 1996): 247-255.

<sup>13</sup> For a widely discussed argument that the neoliberal label should be abandoned, see Daniel T. Rodgers, "The Uses and Abuses of 'Neoliberalism,'" *Dissent*, Winter 2018, [www.dissentmagazine.org/article/uses-and-abuses-neoliberalism-debate](http://www.dissentmagazine.org/article/uses-and-abuses-neoliberalism-debate).

state-enforced expansion of competition to all spheres of life. Historians and social theorists have explained the origins of the neoliberal order in several ways.<sup>14</sup> Essentially, there are two different narratives. A sizable literature emphasizes the 1970s and 1980s as a significant historical break from the post-war period. A second, emerging body of scholarship deemphasizes these changes, focusing instead on the continuities between the New Deal and neoliberal political orders.

Much of the early literature takes its point of departure in the economic changes taking place from the late 1960s onwards.<sup>15</sup> On the one hand, the entrance of West Germany,

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For counterarguments to Rodgers, see Julia Ott et al., “Debating the Uses and Abuses of ‘Neoliberalism’: Forum,” *Dissent*, January 22, 2018, [www.dissentmagazine.org/online\\_articles/debating-uses-abuses-neoliberalism-forum](http://www.dissentmagazine.org/online_articles/debating-uses-abuses-neoliberalism-forum). For earlier complaints about the neoliberal label, see Clive Barnett, “The Consolations of ‘Neoliberalism,’” *Geoforum* 36, no. 1 (2005): 7–12; Taylor C. Boas and Jordan Gans-Morse, “Neoliberalism: From New Liberal Philosophy to Anti-Liberal Slogan,” *Studies in Comparative International Development* 44, no. 2 (2009): 137–161.

<sup>14</sup> For the concept of the market turn, see Avner Offer and Gabriel Söderberg, *The Nobel Factor: The Prize in Economics, Social Democracy, and the Market Turn* (Princeton, NJ: Princeton University Press, 2016).

<sup>15</sup> Gérard Duménil and Dominique Lévy, *Capital Resurgent: Roots of the Neoliberal Revolution* (Cambridge, MA: Harvard University Press, 2004); David Harvey, *A Brief History of Neoliberalism* (Oxford: Oxford University Press, 2005); Robert Brenner, *The Economics of Global Turbulence: The Advanced Capitalist Economies from Long Boom to Long Downturn, 1945–2005* (London: Verso, 2006); Judith Stein, *Pivotal Decade: How the United States Traded*

Japan, and later China into global markets forced down the profitability of American corporations. On the other hand, the oil shocks of the 1970s had dire economic consequences in the form of rising unemployment and inflation. This combination of increased international competition and stagflation ended a period of remarkable economic growth and led to an economic policy shift. The result was the fall of the New Deal order and the rise of the neoliberal order.<sup>16</sup> Examining the effects of this transition, scholars inspired by Michel Foucault have emphasized the processes of subjectivation which have transformed all of us into economic agents.<sup>17</sup> They argue that neoliberal rationality has turned us into utility-maximizers, undermining participatory ideals and practices, to the detriment of democracy. In explaining the intellectual origins of this shift in economic policy and governmentality, many have

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*Factories for Finance in the Seventies* (New Haven, CT: Yale University Press, 2010).

<sup>16</sup> Gary Gerstle, *The Rise and Fall of the Neoliberal Order: America and the World in the Free Market Era* (New York, NY: Oxford University Press, 2022).

<sup>17</sup> For Foucaultian approaches to neoliberalism, see Michel Foucault, *The Birth of Biopolitics: Lectures at the Collège de France, 1978–79* (New York, NY: Palgrave Macmillan, 2008); Nikolas S. Rose, *Powers of Freedom: Reframing Political Thought* (Cambridge: Cambridge University Press, 1999); Pierre Dardot and Christian Laval, *The New Way of the World: On Neoliberal Society* (London: Verso, 2013); Wendy Brown, *Undoing the Demos: Neoliberalism's Stealth Revolution* (New York, NY: Zone Books, 2015); S. M. Amadae, *Prisoners of Reason: Game Theory and Neoliberal Political Economy* (New York, NY: Cambridge University Press, 2016).

focused on the ideas, logics, and networks behind it. Much of this research centers on the international Mont Pelerin Society (MPS), which was the cradle of neoliberalism.<sup>18</sup> These historians have done much to explore how economists associated with the Austrian, Ordoliberal, Geneva, Chicago, and Virginia

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<sup>18</sup> For a small selection of the vast literature that focuses on members of the MPS, see R. M. Hartwell, *A History of the Mont Pelerin Society* (Indianapolis, IN: Liberty Fund, 1995); Bernhard Walpen, *Die offenen Feinde und ihre Gesellschaft: Eine hegemonietheoretische Studie zur Mont Pèlerin Society* (Hamburg: VSA-Verlag, 2004); Serge Audier, *Le colloque Lippmann: Aux origines du néolibéralisme* (Paris: Le Bord de l'Eau, 2008); Philip Plickert, *Wandlungen des Neoliberalismus: Eine Studie zu Entwicklung und Ausstrahlung der "Mont Pèlerin Society"* (Stuttgart: Lucius & Lucius, 2008); Jamie Peck, "Remaking Laissez-Faire," *Progress in Human Geography* 32, no. 1 (2008): 3–43; Philip Mirowski and Dieter Plehwe, eds., *The Road from Mont Pèlerin: The Making of the Neoliberal Thought Collective* (Cambridge, MA: Harvard University Press, 2009); Ben Jackson, "At the Origins of Neo-Liberalism: The Free Economy and the Strong State, 1930–1947," *The Historical Journal* 53, no. 1 (2010): 129–151; Daniel Stedman Jones, *Masters of the Universe: Hayek, Friedman, and the Birth of Neoliberal Politics* (Princeton, NJ: Princeton University Press, 2012); Angus Burgin, *The Great Persuasion: Reinventing Free Markets since the Depression* (Cambridge, MA: Harvard University Press, 2012); Philip Mirowski, *Never Let a Serious Crisis Go to Waste: How Neoliberalism Survived the Financial Meltdown* (London: Verso, 2013); William Davies, *The Limits of Neoliberalism: Authority, Sovereignty and the Logic of Competition* (London: SAGE, 2014); Melinda Cooper, *Family*

Schools changed our ideas about the appropriate relationship between market, state, and individual.

The second set of explanations focuses on the continuities between the New Deal and neoliberal eras. In an early contribution, Sonja Amadae argued that the Cold War gave birth to rational choice liberalism, which economized the American conception of democracy to defeat the Soviet Union.<sup>19</sup> Amy Offner compellingly argues that postwar liberals were already experimenting with the kinds of decentralization that became ubiquitous from the 1980s onwards, making available a number of blueprints for implementation.<sup>20</sup> Dorothy Ross has similarly argued that the weakening of social concepts began in the 1950s rather than in the 1970s.<sup>21</sup> As Elizabeth Popp-Berman

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*Values: Between Neoliberalism and the New Social Conservatism* (New York, NY: Zone Books, 2017); Quinn Slobodian, *Globalists: The End of Empire and the Birth of Neoliberalism* (Cambridge, MA: Harvard University Press, 2018); Niklas Olsen, *The Sovereign Consumer: A New Intellectual History of Neoliberalism* (London: Palgrave Macmillan, 2018); Thomas Biebricher, *The Political Theory of Neoliberalism* (Stanford, CA: Stanford University Press, 2019).

<sup>19</sup> S. M. Amadae, *Rationalizing Capitalist Democracy: The Cold War Origins of Rational Choice Liberalism* (Chicago, IL: University of Chicago Press, 2003).

<sup>20</sup> Amy C. Offner, *Sorting Out the Mixed Economy: The Rise and Fall of Welfare and Developmental States in the Americas* (Princeton, NJ: Princeton University Press, 2019).

<sup>21</sup> Dorothy Ross, "Whatever Happened to the Social in American Social Thought? Part 1," *Modern Intellectual History* 18, no. 4 (December 2021): 1155–1177; Dorothy Ross, "Whatever Happened to the Social in American Social Thought? Part 2," *Modern Intellectual History* 19, no. 1 (March

shows, the turn to efficiency in American government was as much a project of the postwar left as the right, in the process replacing equality as the primary policy objective.<sup>22</sup> Whereas Offner and Popp-Berman focuses on the market elements in the New Deal order, Brent Cebul and Lily Geismer have thrown light on how the Democratic Party ended up accentuating these elements.<sup>23</sup> In the wake of the political realignment that took place in reaction to the civil rights movement, the counterculture, and the Great Society programs, the Democratic Party settled on the New Democrats' rearticulation of liberalism, which became influential during Bill Clinton's two terms in the 1990s. Very much in line with postwar liberals' goals, these neoliberals accepted key components of the market turn but repurposed them to save the American welfare state, aiming to make it more efficient and responsive.

This book attempts to strike a balance between break and continuity. On the one hand, too great a stress on continuity

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2022): 268–296. Ross's articles are directed primarily at Daniel Rodgers's influential argument. See Daniel T. Rodgers, *Age of Fracture* (Cambridge, MA: Harvard University Press, 2012).

<sup>22</sup> Elizabeth Popp Berman, *Thinking Like an Economist: How Efficiency Replaced Equality in US Public Policy* (Princeton, NJ: Princeton University Press, 2022).

<sup>23</sup> Brent Cebul, "Supply-Side Liberalism: Fiscal Crisis, Post-Industrial Policy, and the Rise of the New Democrats," *Modern American History* 2, no. 2 (July 2019): 139–164; Lily Geismer, "Agents of Change: Microenterprise, Welfare Reform, the Clintons, and Liberal Forms of Neoliberalism," *Journal of American History* 107, no. 1 (June 1, 2020): 107–131; Brian Balogh, *The Associational State: American Governance in the Twentieth Century*, Politics and Culture in Modern America (Philadelphia, PA: University of Pennsylvania Press, 2015).

risks obscuring the radicalism of marketization and the ways in which it has reduced democratic accountability and participation. Though it did not reduce the size of the state significantly, the marketization of public service provision blurred accountability and representation. Separating provision from production, for example, allowed private contractors to produce public services. But private contractors are unable to act as genuine representatives precisely because they are agents of private interests rather than the public interest.<sup>24</sup> Arguably, this disconnect is at the heart of the current crisis of the American public sector.

On the other hand, if we want to understand this crisis, we need to understand the origins of the marketized state. In line with the field of American Political Development, which originated in the theory that new state formations emerge out of the ones they replace, this book argues that the marketized state emerged to solve problems associated with the compensatory state.<sup>25</sup> Focusing on a broader cast of characters, the book shows that marketization evolved in dialogue with the compensatory state and not solely in opposition to it. Too great a stress on the notable exceptions like James Buchanan obscures that most public choice theorists aimed to restructure American government, not dismantle it. Their economic theories of politics developed in lockstep with the American compensatory state, reflecting on and attempting to solve the problems at the heart of this political architecture. As such,

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<sup>24</sup> On this, see Cordelli, *The Privatized State*.

<sup>25</sup> For the original statement, see Stephen Skowronek, *Building a New American State: The Expansion of National Administrative Capacities, 1877–1920* (New York, NY: Cambridge University Press, 1982).

there was a great deal of continuity across the traditional division of American history into the distinct political orders of the New Deal and neoliberalism. This should serve as a warning to those who romanticize the democratic capitalism of the postwar period and pine for a return to the balance that purportedly characterized that era.<sup>26</sup> To avoid repeating the mistakes of the postwar period, we need to understand the problems that helped topple the New Deal order, and the architecture of the solutions that replaced it. The location of the origins of the marketized state in a peculiar theoretical problem in public finance is the most important contribution of this book.

As Joseph A. Schumpeter once remarked, “the spirit of a people, its cultural level, its social structure, the deeds its policy may prepare—all this and more is written in its fiscal history, stripped of all phrases. He who knows how to listen to its message here discerns the thunder of world history more clearly than anywhere else.”<sup>27</sup> Schumpeter was right. Public finance is a brilliant vantage point for gauging the character and extent of political changes. Accordingly, this book uses economic theories of politics as both an indicator of and a factor

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<sup>26</sup> For an analysis that comes close to romanticizing the postwar era, see Streeck, “The Crises of Democratic Capitalism”; Brown, *Undoing the Demos*; Colin Crouch, *Post-Democracy* (Malden, MA: Polity, 2004); Peter Mair, *Ruling the Void: The Hollowing of Western Democracy* (London: Verso Books, 2013).

<sup>27</sup> Quoted in Isaac William Martin, Ajay K. Mehrotra, and Monica Prasad, *The New Fiscal Sociology Taxation in Comparative and Historical Perspective* (Cambridge: Cambridge University Press, 2010), 1.

in the evolution and dissolution of the New Deal order.<sup>28</sup> On the one hand, they are a useful barometer of a prolonged political transformation in postwar America that commodified the relationship between citizens and the state. Public choice theories reflected the fact that Americans had become customers of their government, paying through their taxes for the public provision of goods and services that the market had previously supplied haphazardly. On the other hand, they were also a factor in this story, making the market turn in the relationship between citizens and American government imaginable. Economic theorists of politics were “innovative ideologists” who offered legitimacy to a form of provision that was questionable at the time.<sup>29</sup> With the depression fresh in the mind of most Americans, the provision of public goods, services, and benefits was public exactly because markets had proved unable to supply them satisfactorily. Opening a space of imagination, public choice theorists made possible hitherto unthinkable policies like the separation of provision and production in public services, the introduction of market-like competition between bureaus and municipalities, the treatment of citizens as customers, and the use of performance incentives.

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<sup>28</sup> On concepts as both indicators and factors, see Reinhart Koselleck, “Begriffsgeschichte and Conceptual History,” in *Futures Past: On the Semantics of Historical Time* (New York, NY: Columbia University Press, 2004), 75–92.

<sup>29</sup> On innovative ideologists, see Quentin Skinner, “Moral Principles and Social Change,” in *Visions of Politics: Regarding Method* (Cambridge: Cambridge University Press, 2002), 145–157.

These examples of marketization originated in the practical and intellectual problem of identifying the optimal output of public services. Today, this problem goes by the name of free riding. Technically, it is limited to non-exclusionary and non-rivalrous goods. The prime examples are military defense and street lighting. Providers of such services cannot exclude people from enjoying the benefits of protection from foreign foes or well-lit streets. In economists' world of self-interested economic agents, people have an incentive to hide their preferences for such services by avoiding paying for them, knowing government will supply them anyway. Though technically limited to certain goods, for economists of the public sector free riding became a proxy for discussing the inherent problem associated with identifying the optimal output in the absence of a price mechanism.

This problem is as old as the provision of public services. European public finance theorists first identified it at the turn of the twentieth century. Chapter 1 shows how American economists rediscovered free riding in the aftermath of the Great Depression. Closely related to the extraordinary expansion of public services and benefits in the decades immediately before and after World War II, American public finance theorists rearticulated the purpose and function of the American state as the supply of public goods rather than the service of the common good. Paul Samuelson's formalization of the concept of public goods was the culmination of this commodification of the common good. However, Samuelson's theory of public expenditures justified only a very limited number of government activities. With government coercion redefined as legitimate only in the rare cases where the market failed to provide public goods like military defense, street lighting, and lighthouses, the problem remained of relating individual ends to government activities in a way that did not restrict it

to providing non-excludable and non-rivalrous goods. Mid-century American government did, after all, supply much more than narrowly defined public goods. Public choice theory emerged in the attempt to articulate market-like instruments that might solve the problem of optimal output. Over the course of the period from the 1950s through the 1980s, they came up with four different solutions: party competition, voluntary exchange, voting with the feet, and performance incentives.

Chapter 2 examines how economists like Anthony Downs tried to specify a political device that would register the demand for public goods and services as efficiently as the price mechanism. In response to the problem of optimal output, Downs reimagined elections as demand mechanisms, which allowed citizen-customers to reveal their preferences for publicly provided goods and services. This was a theory of the demand for public goods in which the logic of competition forced political parties to cater to the median voter's preferences. Downs's theory of democracy as a competition between vote-maximizing politicians was the culmination of an effort to reconceptualize the relationship between citizens and their representatives so that it reflected a new reality. This quest began as part of a comparative debate about the desirability and viability of capitalism versus socialism, and the role of democracy in controlling the economy. Harold Hotelling provided an early attempt to reconceptualize politicians as competitors, and citizens as their customers, in his spatial model of competition. However, Hotelling's model was not meant to legitimize democracy under capitalism. He meant it as a critique of the tendency of competitive politics to ignore the margins in favor of the median. This was an insight that other economic theorists of democracy all but forgot.

The solution of voluntary exchange, the subject of Chapter 3, was radically at odds with Downs's solution, which relied on majority rule. Comparing individual choice in the market and in politics, the 1986 Nobel laureate James M. Buchanan argued that the virtue of the market was that it avoided the necessity of constructing consensus. While politics necessarily required violation of individual preferences, the market allowed everyone to express their choice. According to Buchanan, only unanimous decision-making could make politics resemble the marketplace, and he proceeded to outline a constitutional framework that would remake democratic politics in the image of the market. The objective of Buchanan's constitutional unanimity rule was to constrain the demand and supply of public goods in the context of mounting demands on American government in the 1960s. In this context, he developed the idea of a fiscal constitution, the purpose of which was to impose fundamental, constitutional limits on government's ability to tax its citizens. Buchanan proposed several different solutions, from "tax-rate limits" and "tax-base constraints" to "procedural limits" in the form of a qualified majority rule or a balanced-budget amendment. This redescription of the social contract as a fiscal constitution aimed at limiting taxation and balancing spending and revenue, was symptomatic of the changed relationship between citizen and state, which became increasingly economic over the course of the postwar period. In Buchanan's constitutional economics, the purpose of the social contract is to introduce limits on the democratic majority's ability to spend beyond the state's means and protect the wealthier minority from undue tax burdens.

Whereas Buchanan's solution relied on the idea of a quid pro quo relationship between citizens and their government, Chapter 4 shows that the idea of "voting with the feet" relied

on competition between public service suppliers. This was a theory of the supply of public goods in which the logic of competition forced public bureaus to become more responsive, accountable, and representative of citizens' individual preferences. In the process, public choice theorists replaced the complex relationship between the state and its citizens with the simpler one between the firm and its customers, reducing political participation to the choice between leaving the public organization and its product or remaining a customer. The political scientist Vincent Ostrom thus contended that the solution to the problem of ascertaining the optimal output of public goods was the decentralization of supply to local units of government. The premise of this fragmentation of national power into a cacophony of local governments was that citizens needed to be willing and able to move according to their preferences. A greater variety in service levels between communities was the precondition for citizens' choice between these different areas. Less variety meant less mobility on the part of citizens and thus less competition between communities and public organizations in the supply of public goods. This competition between and within metropolitan communities would resolve possible conflicts between efficiency concerns and democratic concerns of representation. If citizens were willing to vote with their feet, local political units would have to compete to attract citizen-customers to their government-store. The objective of this market model of competitive municipalities was not a shrinking of the state. Its aim was to make bureaucracy more democratic as well as efficient by subjecting bureaus to decentralized, market-like competition.

The final idea public choice theorists proposed to solve the problem of optimal output was performance incentives. Chapter 5 shows how economists like William Niskanen proposed to solve the oversupply of public services by introducing

performance incentives in the public sector. Rejecting the idea that bureaucrats served the public interest, public choice theorists argued that they were self-interested economic agents. Like managers in the private sector, public administrators strove to maximize the budgets of their bureaus to the detriment of the public purse. To counter the divergence between individual bureaucrats' costs and benefits and total costs and benefits, Niskanen and other public choice theorists proposed the introduction of profit-like incentives. The intention with monetary rewards, for example, was to make competition between bureaus and municipalities work. According to public choice theorists, the premise of competition was the introduction of profit-like incentives. This was widely accepted across the political spectrum. Already in the late 1960s, center-left economists such as Charles Schultze, who would chair Jimmy Carter's Council of Economic Advisors, accepted incentives as a necessary solution to the efficiency problems that the Great Society expansion of the American public sector entailed.

As such, marketization was a bipartisan affair. From Richard Nixon to Barack Obama, American administrations have pursued decentralization of public goods and services in a market-like fashion, and performance incentives remain an important tool in public management. This book tells the story of how we ended here. It began with economists' search for the optimal output of public goods and services in the 1940s and 1950s.



# 1

## The Problem of Optimal Output

In 1977, at the cusp of the market turn, the Canadian political theorist C. B. Macpherson perceptively distinguished between three historically successive ideal-typical models of liberal democracy.<sup>1</sup> The first, “protective democracy,” prevailed in the nineteenth century. Closely linked to classical liberalism, this model sought to institutionalize measures which protected citizens and the emerging market society from undue interference by democratically elected governments. The second, “developmental democracy,” prevailed in the first half of the twentieth century. Connected to the advent of social liberalism, this model sought to develop ordinary citizens’ capacity to participate in politics. The third, “equilibrium democracy,” came to prevail in the decades following World War II.<sup>2</sup> Though Macpherson did

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<sup>1</sup> This passage borrows from Jacob Jensen, “Public Goods and the Origins of Equilibrium Democracy,” *The Tocqueville Review* 41, no. 2 (December 2020): 65–86.

<sup>2</sup> C. B. Macpherson, *The Life and Times of Liberal Democracy* (Oxford: Oxford University Press, 1977). For Macpherson’s earliest observation of political theorists’ increasing use of market concepts in political theory, see C. B. Macpherson, “Market Concepts in Political Theory,” *The Canadian Journal of Economics and Political Science / Revue Canadienne d’Économique et de Science Politique* 27, no. 4 (1961): 490–497.

not make the connection, this model's reconfiguration of democratic politics in an economic idiom was closely associated with the rise of neoliberalism. The political theorist Wendy Brown has argued that the result of this reconfiguration is a replacement of *political* man with *economic* man.<sup>3</sup> Over the course of the past fifty years, Brown argues, economic rationality has thus undone democratic imaginaries that value equality, participation, and deliberation rather than competition.

Sonja Amadae argues that this reconfiguration of democratic politics emerged in response to the Cold War.<sup>4</sup> The struggle between the United States and the Soviet Union is an important explanatory device in the history of postwar America.<sup>5</sup> Amadae argues that rational choice theories of politics were part of the twentieth century's ideological struggle between capitalism and socialism, serving as the linchpin in the capitalist West's defeat of the socialist East. In Amadae's account, the RAND Corporation was the primary incubator of economic theories of politics.<sup>6</sup> RAND, an acronym for research and development, was a think tank established in Santa Monica in 1946 and gradually geared towards studies of strategic decision-making, operations research, and systems analysis in the early 1950s.<sup>7</sup> Certainly, many of the economists examined in this book spent time at RAND. However,

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<sup>3</sup> Brown, *Undoing the Demos*.

<sup>4</sup> Amadae, *Rationalizing Capitalist Democracy; Amadae, Prisoners of Reason*.

<sup>5</sup> See, for example, the essays collected in Joel Isaac and Duncan Bell, eds., *Uncertain Empire: American History and the Idea of the Cold War* (Oxford: Oxford University Press, 2012).

<sup>6</sup> Amadae, *Rationalizing Capitalist Democracy*.

<sup>7</sup> *Ibid.*, 40–41.

affiliation with a Cold War institution did not necessarily make them Cold Warriors.<sup>8</sup> Most of them seem merely to have taken advantage of the opportunities that the Cold War provided for funding and institutional support. What, then, was the origin of economic theories of politics?

In explaining their emergence, this chapter shifts emphasis from the international politics of the Cold War to the domestic politics associated with the mid-century expansion of American public expenditures.<sup>9</sup> In response to widespread

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<sup>8</sup> On this, see Nils Gilman, "The Cold War as Intellectual Force Field," *Modern Intellectual History* 13, no. 2 (August 2016): 514.

<sup>9</sup> In this shift of emphasis, I elaborate and extend insights made in the literature on American public finance. See Michael Pickhardt, "Fifty Years after Samuelson's 'The Pure Theory of Public Expenditure': What Are We Left With?," *Journal of the History of Economic Thought* 28, no. 4 (December 1, 2006): 439–460; Richard Sturn, "'Public Goods' before Samuelson: Interwar *Finanzwissenschaft* and Musgrave's Synthesis," *The European Journal of the History of Economic Thought* 17, no. 2 (2010): 279–312; Alain Marciano, "Why Market Failures Are Not a Problem: James Buchanan on Market Imperfections, Voluntary Cooperation, and Externalities," *History of Political Economy* 45, no. 2 (2013): 223–254; Marianne Johnson, "James M. Buchanan, Chicago, and Post-War Public Finance," *Journal of the History of Economic Thought* 36, no. 4 (December 2014): 479–497; Marianne Johnson, "Public Goods, Market Failure, and Voluntary Exchange," *History of Political Economy* 47, Annual Supplement (2015): 174–198; J. Daniel Hammond, "Paul Samuelson on Public Goods: The Road to Nihilism," *History of Political Economy* 47, Annual Supplement (2015): 147–173; Maxime Desmarais-Tremblay, "Musgrave, Samuelson, and the Crystallization of the Standard Rationale

unemployment and destitution, the American state hypertrophied into a provider of goods and services that the market had hitherto supplied. In the middle decades of the twentieth century, the public sector thus became one of the most important issues on the political agenda. This chapter argues that economic theories of politics emerged in response to this fundamental transformation of American politics. The growth in government expenditures in response to welfare and warfare forced economists to justify increased public provision. From the late 1930s through the 1950s, public finance theorists grappled with the problem of identifying the optimal output of publicly provided goods and services. In contrast to goods and services provided on the market, public provision had the disadvantage that it was difficult to reach an equilibrium between citizens' demand and government supply. Self-interested citizens had an incentive to avoid paying for their provision. To solve the problem, public finance theorists like Richard Musgrave and Paul Samuelson relied on a vision of omniscient planning. Though they did not contemplate marketization of government, they nonetheless commodified the relationship between citizens and the state. Welfare services were objects of trade, sold by government and purchased by citizens through taxes. This commodification reflected the advent of the welfare state, and commodification eventually

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for Public Goods," *History of Political Economy* 49, no. 1 (2017): 59–92. I also join recent research which argues that postwar economists became interested in collective decision-making because of their increasing involvement in policy-making. See Beatrice Cherrier and Jean-Baptiste Fleury, "Economists' Interest in Collective Decision after World War II: A History," *Public Choice* 172, no. 1–2 (July 2017): 23–44.

led to marketization, as we will see in the next chapters. As such, marketization evolved to solve some fundamental problems of the welfare state.

The German émigré economist Richard Musgrave was one of the first economists to grapple with the problem of optimal output in the provision of public goods and services. Born in a small town in Saxony in 1910, Musgrave came to America in 1933 on a stipend from the Deutscher Akademischer Austauschdienst. Joining the impressive roster of German-speaking academics who left Europe for America in the 1930s, he received his PhD from Harvard University in 1937.<sup>10</sup> Musgrave's formative experience was the New Deal expansion of government during the 1930s.

The New Deal marked the beginnings of a “populist-bureaucratic” regime. It was populist in the sense that politics began revolving around how power could be used rather than how it could be constrained. It was bureaucratic in the sense that it relied on administrative bureaucracies in the use of this power.<sup>11</sup> One of the surest signs that a new political regime had arrived was that the language of public affairs changed. Labels like “nonpartisan,” “bipartisan,” “independent,” “centrist,” “moderate,” and “mainstream” became ubiquitous, perhaps to lend a sense of harmony to a political scene divided into “liberal” and “conservative,” “left” and “right.”<sup>12</sup> Likewise, the new administrative agencies gave birth to an alphabet soup of

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<sup>10</sup> Hans-Werner Sinn, “Please Bring Me the *New York Times*,” *International Tax and Public Finance* 16, no. 1 (2009): 124–135.

<sup>11</sup> Morton Keller, *America's Three Regimes: A New Political History* (New York, NY: Oxford University Press, 2007), 202.

<sup>12</sup> *Ibid.*, 203.

acronyms like the NRA, SEC, and TVA, to name but a few of the forty agencies born during the New Deal.<sup>13</sup>

The result of the reform initiatives was an extraordinary growth in the administrative capacities of the American state. Certainly, the reach of nineteenth-century federal government was not “weak” in comparison.<sup>14</sup> This was evident from the very beginning of the republic. The founders never intended it to be powerless. An elaborate postal and communications system was constructed early on, and throughout the nineteenth century, the American state played a part in the continuation of slavery, the removal of Native Americans from their lands, the restriction of immigration, and other discriminatory regulations based on race, ethnicity, religion, and gender. It was in the public provision of goods and services that the twentieth-century expansion of American state authority was unprecedented.

There were three main sources of increased government activity and spending from the 1930s onwards. The first of these was social policy. While the “welfare state” was not a part of the American political vocabulary before the 1940s, American government had not neglected social policy. Veterans of the

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<sup>13</sup> *Ibid.*, 205; Ira Katznelson, *Fear Itself: The New Deal and the Origins of Our Time* (New York, NY: Liveright Publishing Corporation, 2013), 232.

<sup>14</sup> William J. Novak, “The Myth of the ‘Weak’ American State,” *The American Historical Review* 113, no. 3 (2008): 752–772; Brian Balogh, *A Government out of Sight: The Mystery of National Authority in Nineteenth-Century America* (Cambridge: Cambridge University Press, 2009). The rest of the paragraph follows the historiographic summary in Novak, “The Myth of the ‘Weak’ American State,” 758.

Civil War and mothers were the first recipients of social benefits in the second half of the nineteenth and early decades of the twentieth century.<sup>15</sup> Such efforts expanded significantly in response to the Great Depression. Most importantly, the New Deal gave birth to the Social Security Act of 1935, which gave elderly people the right to a pension, and insured those of working age against unemployment. While these initiatives were advances, they were also limited by the racial structure of the South, whose representatives and senators were able to veto any bill that could have ended, or even modified, segregation.<sup>16</sup>

The second source was warfare. The entrance into World War II had two consequences. It resulted in an unprecedented expansion of government expenditures for the costs of war, which subsequent administrations maintained throughout the Cold War. Fears of the arms race, both before and after World War II, left a permanent mark on American politics and public expenditures.<sup>17</sup> In addition, the war precipitated government planning of parts of the economy. In 1942, the creation of the National War Labor Board gave the executive branch the power to end labor disputes in whichever way it saw fit. Likewise, the Office of Price Administration, also established in 1942, had

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<sup>15</sup> For the origins of American social policy and the nascent welfare state, see Theda Skocpol, *Protecting Soldiers and Mothers: The Political Origins of Social Policy in the United States* (Cambridge, MA: Harvard University Press, 1992); Seth Koven and Sonya Michel, eds., *Mothers of a New World: Maternalist Politics and the Origins of Welfare States* (New York, NY: Routledge, 1993).

<sup>16</sup> For this argument, see Katznelson, *Fear Itself*, 14–16.

<sup>17</sup> *Ibid.*, 12–13.

the power to adjust prices to prevent inflation, speculation, and similar activities with disruptive effects.<sup>18</sup>

Such market regulations and stabilizing interventions in the economy were the third source of increased government activity and spending. The early New Deal contained a number of radical attempts to solve the economic crisis, experimenting with statist planning to counterbalance the structural flaws of the market system. In the postwar period, however, economic policies settled on a moderate conception of government's role in the economy.<sup>19</sup> Though the late 1930s saw the birth of the economy as an object of macroeconomic intervention, as opposed to the economic sphere of individual markets invented in the early modern period, policy-makers gave up on radical attempts at planning.<sup>20</sup> Management of the economy was mostly restricted to countercyclical measures.

In response to the dual exigencies of depression and war, American tax revenues thus increased extraordinarily as a percentage of GDP.<sup>21</sup> This would have been inconceivable were it

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<sup>18</sup> *Ibid.*, 342–343.

<sup>19</sup> Brinkley, *The End of Reform*.

<sup>20</sup> Hugo Radice, “The National Economy: A Keynesian Myth?,” *Capital & Class* 8, no. 1 (1984): 111–140; Timothy Mitchell, “Fixing the Economy,” *Cultural Studies* 12, no. 1 (1998): 82–101. For an elaboration of Radice’s and Mitchell’s insights, see Timothy Shenk, “Inventing the American Economy” (PhD Diss., Columbia University, 2016). On the distinction between the economic and the economy as an object of socio-technical intervention, see Daniel A. Hirschman, “Inventing the Economy: Or, How We Learned to Stop Worrying and Love the GDP” (PhD Diss., University of Michigan, 2016).

<sup>21</sup> For an historical table of federal tax revenue as a percentage of GDP, see Council of Economic Advisors, “The Annual

not for the 1913 introduction of the federal income tax, the signal achievement of Progressive Era social reform.<sup>22</sup> From the last quarter of the nineteenth century, economic thinkers like Henry Carter Adams, Richard T. Ely, and Edwin R. Seligman championed the principle that American citizens should pay taxes not in terms of how much they benefited from government goods and services but in proportion to their ability to pay. This defense of progressive taxation provided the intellectual foundation of the modern American fiscal state.<sup>23</sup> However, the ability-to-pay approach to public finance had a significant blind spot. Its advocates focused primarily on the aspect of justice in taxation, neglecting expenditures. As public spending expanded in the 1930s, the legitimacy of expenditures became a core concern of public finance theorists.

This led to a renewed interest in the so-called voluntary exchange theory of public finance, associated primarily with late nineteenth- and early twentieth-century German,

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Report of the Council of Economic Advisors,” February 2018, 35, [www.whitehouse.gov/wp-content/uploads/2018/02/ERP\\_2018\\_Final-FINAL.pdf](http://www.whitehouse.gov/wp-content/uploads/2018/02/ERP_2018_Final-FINAL.pdf).

<sup>22</sup> James T. Kloppenberg, *Uncertain Victory: Social Democracy and Progressivism in European and American Thought 1870–1920* (Oxford: Oxford University Press, 1986), 355.

<sup>23</sup> On the importance of Adams, Ely, and Seligman in the advent of American public finance and the making of the modern American fiscal state, see Marianne Johnson, “Progressivism and Academic Public Finance, 1880 to 1930,” *History of Political Economy* 46, no. 1 (2014): 1–32; Ajay K. Mehrotra, *Making the Modern American Fiscal State: Law, Politics, and the Rise of Progressive Taxation, 1877–1929* (Cambridge: Cambridge University Press, 2013).

Swedish, and Italian economists. The most prominent of these Continental public finance theorists was the Swede Knut Wicksell. His 1896 *Finanztheoretische Untersuchungen* outlined a theory of the relationship between the state and individuals that resembled that between firms and their customers.

Wicksell was a progressive, and it was difficult to disentangle his economic theory from his advocacy of social reform, principally improved conditions for the poor in society and the widening of the franchise.<sup>24</sup> Wicksell, however, was concerned that the lower classes, once in power, would “impose the bulk of taxes upon the rich and may at the same time be so reckless and extravagant in approving public expenditures [...] that the nation’s mobile capital may soon be squandered fruitlessly.”<sup>25</sup> Wicksell feared that this might hamper the progressive course, and he therefore introduced the idea of a unanimity rule as a bulwark against the lower classes’ ability to tax the rich and increase spending recklessly.

According to Wicksell, “the only certain guarantee against [...] abuses of power lies in the principle of unanimity and voluntary consent in the approval of taxes.”<sup>26</sup> The unanimity rule would ensure that the exchange of taxation for public goods happened on a voluntary rather than coercive basis. However, Wicksell did not believe that unanimity rules would prove an obstacle to social reform. On the contrary, he was convinced people would find a great many things to agree on in charting a progressive course towards social justice.<sup>27</sup> Though Wicksell’s

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<sup>24</sup> Marianne Johnson, “Wicksell’s Social Philosophy and His Unanimity Rule,” *Review of Social Economy* 68, no. 2 (2010): 188.

<sup>25</sup> Quoted in *ibid.*, 200.

<sup>26</sup> Quoted in *ibid.*

<sup>27</sup> *Ibid.*, 187.

central concern was the improvement of the lives of the lower classes, the unanimity principle and the associated theory of voluntary exchange protected the private property rights of the wealthy.

Wicksell and the Continental tradition of public finance were largely forgotten by the late 1930s. In 1939, however, Richard Musgrave brought the tradition back to life in a critical survey in the *Quarterly Journal of Economics*. His aim was to synthesize conflicting nineteenth- and twentieth-century theories of taxation and public expenditure.<sup>28</sup> This ambition was closely related to developments within economics. During Musgrave's graduate studies and early career, the American economics discipline underwent a remarkable transformation. Before World War II, the economics discipline was characterized by a plurality of approaches, with the institutionalist school the most dominant approach in American economics departments.<sup>29</sup> While institutionalism did not constitute a coherent body of approaches, theories, and assumptions, institutionalists shared a commitment to understanding the interactions between institutions, emphasizing empirical studies, larger legal-economic and cultural frameworks, questions of social justice, and the view that the consequences of

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<sup>28</sup> Desmarais-Tremblay, "Musgrave, Samuelson, and the Crystallization of the Standard Rationale for Public Goods," 61; Sturn, "'Public Goods' before Samuelson," 279.

<sup>29</sup> Mary S. Morgan and Malcolm Rutherford, eds., *From Interwar Pluralism to Postwar Neoclassicism* (Durham, NC: Duke University Press, 1998). On institutionalism, see Malcolm Rutherford, *The Institutional Movement in American Economics, 1918–1947: Science and Social Control* (Cambridge: Cambridge University Press, 2013).

an unregulated market system could only be ameliorated by creating new institutions.<sup>30</sup> During and immediately after World War II, institutionalism was gradually replaced by the so-called neoclassical synthesis, which combined traditional microeconomics, examining the decision-making behavior of individuals and firms in individual markets, and macroeconomics, examining the economy as a whole.

This transformation was also evident within Musgrave's subfield of public finance. During the early 1940s, Keynesianism and Pigovianism replaced institutionalism.<sup>31</sup> John Maynard Keynes articulated his influential theory of the business cycle and governmental tools to prevent economic downturns in the mid-1930s. Like other British liberals of the interwar period, Keynes feared a radical overthrow of capitalism and sought to ameliorate the worst effects of the market system by increasing government intervention in the economy. The result was a macroeconomic theory that allowed governments to use their fiscal capacities to stabilize the business cycle.<sup>32</sup> In a similar vein, the British economist Arthur C. Pigou fleshed out his

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<sup>30</sup> Mary S. Morgan and Malcolm Rutherford, "The Character of the Transformation," in *From Interwar Pluralism to Postwar Neoclassicism*, ed. Mary S. Morgan and Malcolm Rutherford (Durham, NC: Duke University Press, 1999), 2-3.

<sup>31</sup> Marianne Johnson, "Harold Groves, Wisconsin Institutionalism, and Postwar Public Finance," *Journal of Economic Issues* 49, no. 3 (2015): 691.

<sup>32</sup> For some recent illuminating accounts of Keynes's political economy, see Geoff Mann, *In the Long Run We Are All Dead: Keynesianism, Political Economy, and Revolution* (London: Verso, 2017); Zachary D. Carter, *The Price of Peace: Money, Democracy, and the Life of John Maynard Keynes* (New York, NY: Random House, 2020). The classic account is

microeconomic theory of government spending in his 1928 book, *A Study in Public Finance*. Pigou, like the Americans Adams, Ely, and Seligman, based his theory of public finance on the ability-to-pay principle, that is, on the principle of progressive taxation in which people sacrifice proportionally to their income.<sup>33</sup>

Musgrave began his 1939 article on “The Voluntary Exchange Theory of Public Economy” by addressing what he saw as the main shortcoming of Pigovian public finance. He argued that Pigou and his followers ignored the expenditure aspect of public finance in favor of the revenue aspect, thus leaving the legitimate relationship between expenditures and revenue unaccounted for.<sup>34</sup> In his dissertation, Musgrave had therefore tried to reconcile the British public finance tradition with the Continental, primarily German-language, voluntary exchange theories.<sup>35</sup> In contrast to British public finance, the voluntary exchange theorists’ primary concern was to outline the revenue-expenditure process.

Musgrave had two intentions in his 1939 survey of voluntary exchange theories. The first was to provide an in-depth introduction to an English-speaking audience of an overlooked

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Robert Skidelsky, *John Maynard Keynes, 1883–1946: Economist, Philosopher, Statesman* (New York, NY: Penguin Books, 2005).

<sup>33</sup> Arthur C. Pigou, *A Study in Public Finance* (London: Macmillan & Co., 1928).

<sup>34</sup> Richard Abel Musgrave, “The Voluntary Exchange Theory of Public Economy,” *The Quarterly Journal of Economics* 53, no. 2 (1939): 213.

<sup>35</sup> Desmarais-Tremblay, “Musgrave, Samuelson, and the Crystallization of the Standard Rationale for Public Goods,” 61; Sturn, “‘Public Goods’ before Samuelson,” 279.

body of thought. The second was to outline what he called a planning approach to public finance. This planning approach was articulated against the background of his critical introduction to voluntary exchange theory and its shortcomings.

Musgrave explained that voluntary exchange theorists believed that taxation should be based on the benefit principle. This meant that taxation should be based on the benefit citizens derived from being taxed. As Musgrave explained it, voluntary exchange theory was based on the idea that the revenue-expenditure process was guided by “the same ‘laws’ that govern market price in private economy.”<sup>36</sup> This meant, Musgrave elaborated, that taxes were “voluntary payments rendered by the individual in exchange for services supplied by public economy, and in accordance with his evaluation of those services.”<sup>37</sup> By conceptualizing the relationship between the citizen and the state as a voluntary exchange of taxes for goods, the voluntary exchange theorists forced government revenue to correspond exactly to services provided to the individual taxpayer. In this sense, through an analogy with the supply of goods and services in the private economy, voluntary exchange theorists commodified the common good as those goods that government supplied to its citizens. There was no need for references to metaphysical conceptions of *the* public good when the purpose of government was to supply public *goods* in accordance with the individual preferences of its citizens.

As such, voluntary exchange theorists were the first to promote a market model of politics in which the relationship

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<sup>36</sup> Musgrave, “The Voluntary Exchange Theory of Public Economy,” 214.

<sup>37</sup> *Ibid.*

between citizens and their government was analyzed by analogy with the relationship between customers and firms in the private economy. While the origins of the economic approach to politics should thus be found in Europe in the late nineteenth and early twentieth centuries, the question of why it was revived in mid-twentieth-century America is of greater interest here.

Musgrave's critical survey was intended to bring the question of expenditures back into the theory of public finance in response to the growth of public expenditures in mid-century America. In this context, Musgrave's exposition of voluntary exchange theory served as a springboard for his preferred "planning approach" to public finance. While Musgrave rejected the voluntary exchange theory of the state, Musgrave nonetheless adopted its conception of the state as a provider of public goods. This is a crucial point. Though Musgrave rejected the feasibility of voluntary exchange, he took over the idea of the state as supplier of public goods. This theory of the state was the mainspring of public choice theory. Where he differed from the voluntary exchange theorists was on the question of how citizens' demands for public goods could be ascertained.

Musgrave presented three arguments against voluntary exchange theorists' interpretation of how government interacted with its citizens.<sup>38</sup> First, Musgrave simply pointed to the actual revenue-expenditure process, arguing that direct compulsion everywhere prevailed in the extraction of taxes.

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<sup>38</sup> The literature on Musgrave focuses almost exclusively on the third, neglecting the empirical fact of compulsion and value pluralism. See the examinations of Musgrave's rejection of voluntary exchange in Desmarais-Tremblay, "Musgrave, Samuelson, and the Crystallization of the Standard Rationale for Public Goods"; Sturn, "'Public Goods' before Samuelson."

“The very fact that such enforcement appears universally necessary,” Musgrave argued, “indicates the absence of a general willingness to comply with the obligation to contribute.”<sup>39</sup> The empirical fact that coercion was everywhere employed in the collection of taxes pointed to the unrealistic nature of the idea that the revenue necessary to cover the provision of public goods and services would be paid voluntarily.

Second, the multiplicity of opinions, tastes, values, and preferences among the citizenry made mutual agreement among citizens on which goods should be provided by the public sector highly unlikely. “The contention,” Musgrave argued, “that fiscal policy in the modern community—democratic or authoritarian—is determined as a direct resultant of the mutual agreements of a multitude of contributors, acceptable to each and all of them, at best constitutes an unacceptable simplification of the highly intricate political process through which collective decisions are arrived at.”<sup>40</sup>

The third shortcoming of voluntary exchange theory was the fact that people, under the assumption that self-interested utility-maximization is rational, would try to avoid paying for the public services from which they could not be excluded. This theory of “free riding,” as it would come to be called, was Musgrave’s most significant contribution to the theory of public goods.<sup>41</sup>

Musgrave acknowledged that voluntary exchange theorists had recognized this pathology, but, he interjected, their

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<sup>39</sup> Musgrave, “The Voluntary Exchange Theory of Public Economy,” 219–220.

<sup>40</sup> *Ibid.*, 220.

<sup>41</sup> Desmarais-Tremblay, “Musgrave, Samuelson, and the Crystallization of the Standard Rationale for Public Goods.”

conception of the relationship between citizens and government as a voluntary exchange denied it. If all people acted in this pathological manner, Musgrave argued, a problem arose for the theory of voluntary exchange. "If the total cost of public services is covered by a large number of contributors," he explained, "a reduction in the contribution of any one contributor will fail to affect notably the total supply of public services—either from the point of view of this contributor or in the eyes of other contributors who join in the consumption of the same indivisible services."<sup>42</sup> This meant that people were able to enjoy the provision of a service without paying their fair share of the costs associated with supplying it. Ultimately, Musgrave argued, this would result in a reduction in the volume of services, leading to an unstable situation.

Against the background of the standard assumption of rational economic action, Musgrave thus argued that people who could not be excluded from enjoying the benefits of goods, services, and resources would avoid paying for them. This pathology would inevitably lead to an undersupply of public goods and services. In 1964, James M. Buchanan dubbed these people "free riders," and a year later Mancur Olson generalized free riding as the logic of all collective action.<sup>43</sup> Ubiquitous in the social sciences today, the concept

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<sup>42</sup> Musgrave, "The Voluntary Exchange Theory of Public Economy," 219–220n5.

<sup>43</sup> Desmarais-Tremblay, "Musgrave, Samuelson, and the Crystallization of the Standard Rationale for Public Goods," 66; James M. Buchanan, "What Should Economists Do?," *Southern Economic Journal* 30, no. 3 (1964): 220; Mancur Olson, *The Logic of Collective Action: Public Goods and the Theory of Groups* (Cambridge, MA: Harvard University Press, 1965).

started its life as the fundamental argument against the feasibility of voluntary exchange between individuals and their government. Coercion, Musgrave argued, was a necessary feature in the provision of public goods from which people could not be excluded from benefiting. The purpose of government was to provide the non-excludable goods that the market failed to supply.

Musgrave, for his part, was more interested in analyzing the ways in which public wants could be provided for than he was in figuring out how these wants were arrived at. Voluntary exchange theorists, by contrast, were concerned with the decision-making processes that led to public rather than private production of goods and services, assuming that “the public economy itself will undertake to supply only those goods and services in the production of which it is superior to private enterprise.”<sup>44</sup> They provided a solution to the problem of demand revelation by introducing a quid pro quo requirement in the relationship between citizens and their government. It was an elegant solution because it allowed citizens the same option of exit as they had when deciding whether to purchase a good or service on the marketplace. Denying its feasibility, Musgrave rejected that exit was an option in the provision of public goods and services. There was no way in which citizens could be allowed to leave the state and its product. Musgrave turned instead to a planning approach that essentially pushed the problem aside.

The 1930s and 1940s were awash with debates about planning. The economic crisis and the socialist alternative of the Soviet

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<sup>44</sup> Musgrave, “The Voluntary Exchange Theory of Public Economy,” 215.

Union made central direction of the economy attractive for social reformers. The Roosevelt administrations of the early 1930s contemplated radical planning initiatives. Convinced that the capitalist system was seriously flawed, some New Dealers believed that centralized economic planning was needed to restrain corporate power. In fact, the first Roosevelt administration was most successful in regional planning. The New Deal investments in infrastructure projects like dams, roads, bridges, and electrification in the South and the West provided the foundation for economic growth in these regions after World War II.<sup>45</sup> It is against the background of these experiments in planning that Richard Musgrave's alternative planning approach to public economy is best understood.

Invoking the concept of planning, Musgrave inevitably embedded his approach in the contemporary debates about markets versus planning in the allocation of society's resources. Like the debate about public expenditures, these debates essentially revolved around the size of the public economy relative to the private economy. However, whereas the core issue in the debate about public expenditures was identifying the optimal output of government services, the debates about markets versus planning were principled discussions about which of the two allocative mechanisms, the price mechanism or a planning board, was the most appropriate device for guiding the entire economic system. These debates were exceptionally dichotomous, and its participants often portrayed the choice between markets and planning as a choice between liberal capitalism and socialism.

Musgrave tried to distance his planning approach to public economy from this debate by not confronting it directly.

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<sup>45</sup> Brinkley, *The End of Reform*, 6.

He pointed out that his planning approach to public economy bore no resemblance to central planning in a socialist economy. "While in the case of the latter the planning function embraces most, or all, of the economic activity, the revenue-expenditure process is assumed to operate within an economy which to a dominating extent is organized as a system of private enterprise,"<sup>46</sup> Musgrave contended, aiming for a middle-of-the-road position between the two camps.

As an architect of the mixed economy, Musgrave did not develop a theory of complete central control. Government only had a role to play in the procurement of those goods and services which the market failed to provide. Problems of planning the provision of public goods and services were easily solved, Musgrave argued, by following the prescription of least cost, meaning that public goods and services should be procured at minimum cost. Government would thus only undertake the provision of goods and services in which it had "an efficiency advantage over private enterprise."<sup>47</sup>

Musgrave dispensed with the problem of aggregation, arguing that the economist could take social wants as given. In other words, in the division of labor between the social sciences, the problem of aggregation of individual preferences into social preference scales was a public policy problem, while the problems of planning were matters for the economist. "For purposes of economic analysis," Musgrave explained, "the scale of social wants may be considered as predetermined, just as the scale of individual tastes is considered a predetermined factor in traditional value theory. Like the 'registration'

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<sup>46</sup> Musgrave, "The Voluntary Exchange Theory of Public Economy," 232.

<sup>47</sup> *Ibid.*

of individual preference scales through the medium of market behavior, social preference scales are registered through the medium of public policy.”<sup>48</sup>

By analogy with the study of the private economy, the student of the public economy could take preferences for granted. The political process, according to Musgrave, had already determined what social wants should be satisfied. All that was left for the public economist was determining the most efficient way to reach these predetermined ends.

Though Musgrave tried hard to avoid the dichotomous debates about markets versus planning, the Brown University economist Alfred C. Neal placed Musgrave’s suggested planning approach to public finance squarely in the context of the so-called socialist calculation debate that was raging at the time. Neal specifically referenced Ludwig von Mises’s 1920 article, “Economic Calculation in the Socialist Commonwealth,” and the “epidemic of articles” that it gave rise to in the following decades.<sup>49</sup>

When “Economic Calculation in the Socialist Commonwealth” appeared in 1920, Mises was chief economist at the Vienna Chamber of Commerce. Unable to secure a position at the University of Vienna, he exerted his influence through a fortnightly seminar, which included the economist Friedrich Hayek among its regular participants.<sup>50</sup> The seminar met against the background of post-World War I Vienna’s radical experiments in social democracy. In the aftermath of the

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<sup>48</sup> *Ibid.*, 233.

<sup>49</sup> Alfred C. Neal, “The ‘Planning Approach’ in Public Economy,” *The Quarterly Journal of Economics* 54, no. 2 (1940): 246.

<sup>50</sup> Ludwig von Mises, *Erinnerungen* (Stuttgart: Gustav Fischer Verlag, 1978), 66.

collapse of the Habsburg dual monarchy of Austria-Hungary, the Social Democratic Party gained an absolute majority in the city parliament elections of May 4, 1919. The newly elected city government introduced a number of unprecedented social innovations in health and social services, childcare, public housing, and taxation. Nicknamed Red Vienna, the capital of Austria quickly became the envy of social reformers across Europe. Combined with the Soviet experiments in communism, the world seemed on the verge of a post-capitalist future.<sup>51</sup>

Attacking the very possibility of economic rationality under the collective ownership of the means of production, Mises's "Economic Calculation in the Socialist Commonwealth" provoked a vigorous two-decade debate about the viability of socialist economies. While recognizing that the exchange of consumption goods under socialism would not constitute a problem, Mises argued that without the use of money prices economic planners would never be able to determine the value of production goods in a socialist state.

In the 1930s, the so-called market socialists, led by the Polish-American Oskar Lange, counterargued that a central planning board would be able to calculate the prices of the factors of production just as efficiently as a decentralized market system.<sup>52</sup> Using general equilibrium theory, Lange argued

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<sup>51</sup> On Red Vienna, see Anson Rabinbach, ed., *The Austrian Socialist Experiment: Social Democracy and Austromarxism* (Boulder, CO: Westview Press, 1985); Helmut Gruber, *Red Vienna: Experiment in Working-Class Culture, 1919–1934* (Oxford: Oxford University Press, 1991).

<sup>52</sup> Oskar Lange, "On the Economic Theory of Socialism: Part One," *The Review of Economic Studies* 4, no. 1 (1936): 53–71; Oskar Lange, "On the Economic Theory of Socialism: Part

that a central planning board could just as easily calculate demand and supply as the imaginary “Walrasian Auctioneer” who balanced demand and supply in the perfectly competitive market.<sup>53</sup>

Alfred Neal pointed out that this debate between capitalists and socialists was divided into the extremes of complete planning and free competition. As a result, both sides of the debate had neglected the intermediate category of “partial planning” which characterized most Western countries. Neal’s aim in the article was to “discover whether rational distribution of resources and free choice to consumers are possible in an ‘interventionist economy’ not completely planned.”<sup>54</sup> Neal used Musgrave’s planning approach as the point of departure for his investigation into whether price theory could be used to analyze collective wants.<sup>55</sup> Neal’s argument against Musgrave is significant because it very clearly illustrates the main problem in public goods theory, namely, that the problem of

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Two,” *The Review of Economic Studies* 4, no. 2 (1937): 123–142. For detailed expositions of Lange’s argument, see Don Lavoie, *Rivalry and Central Planning: The Socialist Calculation Debate Reconsidered* (Cambridge: Cambridge University Press, 1985), chapters 4 and 5; Joseph Persky, “Retrospectives: Lange and von Mises, Large-Scale Enterprises, and the Economic Case for Socialism,” *Journal of Economic Perspectives* 5, no. 4 (1991): 229–236.

<sup>53</sup> On this, see Philip Mirowski, *Machine Dreams: Economics Becomes a Cyborg Science* (Cambridge: Cambridge University Press, 2002), 233.

<sup>54</sup> Neal, “The ‘Planning Approach’ in Public Economy,” 246–247.

<sup>55</sup> *Ibid.*, 247–248.

determining the optimal output of public goods and services could not be set aside.

Neal denied that a voting mechanism might be used as a device for consumers to express their preferences. Because of the mathematics involved, citizens would be able neither to understand nor to make rational choices about the governmental revenue-expenditure process. In the market, where individual demands prevailed, it was comparatively easy for individuals to make decisions regarding expenditures and the revenue needed to cover them. By contrast, in the public revenue-expenditure process, “given the right to vote according to a complex preference system for kinds and amounts of expenditure and methods of raising it,” Neal argued, the individual “cannot estimate costs to himself, *unless the whole system of simultaneous equations, as in the case of the general equilibrium, can be solved.*”<sup>56</sup> A semi-competitive economy thus faced the same problem that Hayek had pointed out in his argument against the idea of economic planning: it necessarily relied on a static conception of the economy, which did not display the dynamics of the actual market process.

Concluding on a pessimistic note about the possibilities of intervention in a semi-competitive capitalist society, Neal argued that “partial planning” posed a threat to democracy because government intervention had the potential to subvert the ideals of rational judgment and agreement upon which democratic societies rested. “The road to dictatorship,” Neal concluded, in a phrase very similar to the one Friedrich Hayek would use as a title a few years later, “may well be paved with the good intentions of economic planners.”<sup>57</sup>

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<sup>56</sup> Ibid., 252, italics in original.

<sup>57</sup> Ibid., 254.

Siding with Mises and Hayek, Neal thus argued that partial planning was plagued by the same problems as full planning. It would be impossible for a central board to gather the necessary evidence to rationally allocate resources in a planned economy. This violation of the individual consumers' sovereignty, which collective demand represented, could undermine the presuppositions of democratic government. Like a completely planned economy, the partially planned economy that Musgrave suggested needed to have a device to amalgamate individual wants into coherent collective wants, which a decentralized system provided easily.

The vexing political-theoretical problem at the heart of public finance, then, was the place of the democratic electorate in defining the optimal output of public goods. Musgrave pushed the problem aside. Other economists, however, refused to leave the question to political scientists. In 1943, Howard Bowen revisited the idea of voting as a mechanism for deciding on the provision of public goods in an article published in the *Quarterly Journal of Economics*. "The Interpretation of Voting in the Allocation of Economic Resources" rehearsed many of the same themes that preoccupied Musgrave. In contrast to Musgrave, however, Bowen aimed at a theory of demand for publicly provided goods. Bowen's main contribution to the economic theory of politics was his redescription of polling as a democratic mechanism for ascertaining citizens' demands for public goods and services. This was an important step in the commodification of the political relationship between the state and its citizens.

Born in Spokane, Washington, Bowen taught at the University of Iowa from 1935 to 1942, when he took a position as chief economist at the Joint Congressional Committee on Internal Revenue. In 1947, after a few years at a Wall Street bank, he returned to higher education when he became dean

of the University of Illinois College of Commerce.<sup>58</sup> Bowen's formative political and intellectual experiences were the Great Depression and the accompanying revolution of Keynesian macroeconomics. Bowen was part of a cohort of economists who, in response to the economic crisis, rejected the dissociation of economics and ethics.<sup>59</sup> Inspired by the trend toward planning, Bowen aimed to provide planners with the tools to ascertain the demand for government goods and services as easily as free choice allowed producers in the market to ascertain consumers' desire.

The fundamental problem was estimating the marginal rates of substitution in the absence of individual consumer choice, to which social goods could not be subjected. Bowen argued that "the closest substitute for consumer choice is *voting*."<sup>60</sup> He thus redefined democracy as a market mechanism

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<sup>58</sup> Later, in the 1950s, Bowen's articulation of the concept of corporate social responsibility provoked such heavy criticism that he was forced to resign from his position at the University of Illinois, a victim of McCarthyism. On this, see Winton U. Solberg and Robert W. Tomilson, "Academic McCarthyism and Keynesian Economics: The Bowen Controversy at the University of Illinois," *History of Political Economy* 29, no. 1 (1997): 55-81.

<sup>59</sup> On the Great Depression and Keynesianism as Bowen's formative experiences, see Aurélien Acquier, Jean-Pascal Gond, and Jean Pasquero, "Rediscovering Howard R. Bowen's Legacy: The Unachieved Agenda and Continuing Relevance of Social Responsibilities of the Businessman," *Business & Society* 50, no. 4 (2011): 610.

<sup>60</sup> Howard R. Bowen, "The Interpretation of Voting in the Allocation of Economic Resources," *The Quarterly Journal of Economics* 58, no. 1 (1943): 33, italics in original.

in which voters are consumers of public goods. Where economic voting allowed producers of individual goods to ascertain the ideal output, political voting allowed producers of social goods to ascertain the ideal output. Bowen, like the voluntary exchange theorists, thus defined the common good in economic terms as *goods*. Political voting allowed citizens to express their individual demands for publicly provided goods and services in accordance with their individual cost-benefit analyses. Bowen was one of the first Americans to provide a comprehensive analogy between voting and the market. He treated voting as a direct democracy in which citizens could vote for the social goods they desired.

Nonetheless, there was a problem. The voting solution, Bowen acknowledged, was only feasible in very small local communities. "In a society which has outgrown the town-meeting stage, it is seldom practicable to decide on the output of specific social goods by means of popular voting."<sup>61</sup> More specifically, legislators and bureaucrats who were tasked with providing and producing social goods needed to find "methods of finding out what the people want, i.e. how much of each social good should be produced."<sup>62</sup> Bowen did not believe that elected representatives would be able to discern the demand for social goods. He argued that "the result of an election can seldom be regarded as an unequivocal indication of public desires."<sup>63</sup>

With voting out of the question as a barometer for public wants, planners needed different devices for ascertaining what social goods people wanted, and how much they wanted

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<sup>61</sup> *Ibid.*, 42.

<sup>62</sup> *Ibid.*, 42-43.

<sup>63</sup> *Ibid.*, 43.

of them. As alternatives, Bowen suggested using polls, questionnaires, and similar devices "to study the desires of the individuals who compose the public."<sup>64</sup> Bowen argued that the increasing use of planning in the allocation of public resources necessitated the employment of techniques such as these in aggregating individual tastes.<sup>65</sup>

Of the alternatives, polls provided the best way forward, if certain conditions were met. "First, it would be necessary that the issue had been discussed sufficiently to enable the pollees to become informed. Second, in order to be sure that the individual pollees would use thought and discretion in reaching their decisions, it would be necessary for them to have a sense of responsibility, i.e. to feel that their choices would actually influence policy."<sup>66</sup> In short, for polling to work, citizens would have to overcome their ignorance, and policy-makers would have to be representatives of and responsive to citizens' wishes. Inspired by the contemporary experiments in different kinds of planning, Bowen remained optimistic about the possibilities of devices such as polling for ascertaining the collective demands of citizens. Paul Samuelson demolished what was left of that optimism.

1948 was the last year of the politics of the 1930s.<sup>67</sup> Whereas Franklin D. Roosevelt's administration had contemplated and attempted some radical solutions to the economic crisis of the 1930s, experimenting with statist planning to counterbalance

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<sup>64</sup> Ibid.

<sup>65</sup> Ibid.

<sup>66</sup> Ibid.

<sup>67</sup> Michael Harrington, "Mystical Militants," *New Republic*, February 18, 1966.

the structural flaws of the market system, postwar economic policies settled on a moderate conception of government's role in the economy.<sup>68</sup> Tellingly, Paul Samuelson's influential undergraduate *Economics* textbook was first published in 1948.<sup>69</sup> A professor at MIT, Samuelson was the foremost representative of the increasing use of mathematics in American economics.<sup>70</sup>

The signal contribution of Samuelson's textbook was its synthesis of orthodox microeconomics and the macroeconomics of Keynes. This "neoclassical synthesis," as it came to be called, was a consensus about two tenets. The first was the belief that firms and individuals make rational decisions, aiming to maximize their utility. The standard methods of microeconomics were thus applicable to the study of the behavior of firms and individuals. The second tenet was the belief that prices and wages do not adjust quickly to clear markets. Accordingly, most postwar economists agreed that government intervention was needed to adjust markets to avoid prolonged disequilibrium. While macroeconomic modeling was used to justify countercyclical fiscal policies at an economy-wide level, interventions in individual markets were guided by

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<sup>68</sup> Brinkley, *The End of Reform*.

<sup>69</sup> Paul A. Samuelson, *Economics: An Introductory Analysis* (Boston, MA: McGraw-Hill Book Company, 1948).

<sup>70</sup> For an intellectual biography of Paul A. Samuelson, see Roger E. Backhouse, *Founder of Modern Economics: Paul A. Samuelson* (New York, NY: Oxford University Press, 2017). On the genealogy of Samuelson's "Pure Theory of Public Expenditure," see Pickhardt, "Fifty Years After Samuelson's 'the Pure Theory of Public Expenditure'"; Hammond, "Paul Samuelson on Public Goods."

the so-called New Welfare Economics, which was developed in the aftermath of Lionel Robbins's 1932 *Essay on the Nature and Significance of Economic Science*.

Robbins rejected the prevailing definition of economics as the study of welfare, which had been dominant since the turn of the century. Robbins gave two reasons for the inadequacy of the welfare definition. First, he argued that interpersonal comparisons of utility were impossible because individuals' preferences are incommensurable. Second, he argued that the ethical considerations required by such interpersonal comparisons of utility were outside the purview of economists if they were to remain neutral about values.<sup>71</sup> Instead, Robbins defined economics as "the science which studies human behavior as a relationship between ends and scarce means which have alternative uses."<sup>72</sup> This definition of economics as the study of behavior under scarcity, which became dominant during the decades that followed, significantly expanded the scope and reach of economic generalizations to include areas of life not usually considered economic.<sup>73</sup>

Arthur Cecil Pigou, who succeeded Alfred Marshall as professor of political economy at the University of Cambridge in 1908, had articulated the foundational principles of British welfare economics in his 1914 *Wealth and Welfare* and his 1920

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<sup>71</sup> Lionel C. Robbins, *An Essay on the Nature and Significance of Economic Science* (London: Macmillan & Co., 1932), 120–126.

<sup>72</sup> *Ibid.*, 15.

<sup>73</sup> For a history of how Robbins's definition of economics became the most widely accepted, see Roger E. Backhouse and Steve G. Medema, "Defining Economics: The Long Road to Acceptance of the Robbins Definition," *Economica* 76, no. 1 (2009): 805–820.

*The Economics of Welfare*. Like Marshall, Pigou contended that economics was the study of the causes of material welfare. Their approach to the economics of welfare was very much a response to the consequences of industrial capitalism and the demands of the British working class for improved standards of living and greater political influence.<sup>74</sup>

Facing the crisis of liberalism, believed to be brought on by the inability of nineteenth-century laissez-faire to respond appropriately to the pressing social questions of the time, the welfare economists joined other British liberals in a redefinition of the liberal tradition. They stressed that individuals could only unfold their potential within a community directed towards collective moral ends and in consideration of the common good.<sup>75</sup> Welfare economists saw their role as one of devising economic policy tools to ameliorate market failures and improve social conditions through government intervention in the economy.<sup>76</sup>

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<sup>74</sup> Roger E. Backhouse and Tamotsu Nishizawa, "Introduction: Towards a New Interpretation of the History of Welfare Economics," in *No Wealth But Life: Welfare Economics and the Welfare State in Britain, 1880–1945*, ed. Roger E. Backhouse and Tamotsu Nishizawa (Cambridge: Cambridge University Press, 2010), 1–21.

<sup>75</sup> On the new British liberalism as an ideology of social reform, see Michael Freeden, *The New Liberalism: An Ideology of Social Reform* (Oxford: Oxford University Press, 1986).

<sup>76</sup> Backhouse and Nishizawa, "Towards a New Interpretation of the History of Welfare Economics," 8–9; Norikazu Takami, "The Sanguine Science: The Historical Contexts of A. C. Pigou's Welfare Economics," *History of Political Economy* 46, no. 3 (2014): 383.

Defining individual welfare in terms of satisfactions, or utilities, and social welfare as the summation of individual welfares, Pigou established his theory on classical utilitarian foundations. This presupposed a ranking of individual satisfactions, defined as interpersonal comparisons of utility. In *The Economics of Welfare*, Pigou stressed that economists should only concern themselves with welfare that could be measured in monetary terms as an equitable increase in national income.<sup>77</sup> Pigou also introduced the concept of what was later termed externalities, that is, the costs or benefits that affect an individual standing outside the economic transaction.<sup>78</sup> Welfare economists have since then defined an externality as negative if it lowers the welfare of an individual who did not choose to incur the cost. The purpose of government intervention in economic activity becomes legitimate in so far as it reduces the social costs of transactions through taxes and regulation.

While Pigou's theory of welfare was not the intended target of Robbins's *Essay*, it was its primary victim.<sup>79</sup> Rejecting

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<sup>77</sup> Arthur C. Pigou, *The Economics of Welfare* (London: Macmillan & Co., 1920), 11.

<sup>78</sup> *Ibid.*, 159. On the history of externalities and the concepts' absence from economic analysis after Pigou's initial articulation, see Steven G. Medema, "'Exceptional and Unimportant'? The Rise, Fall, and Rebirth of Externalities in Economic Analysis" (Working Paper, 2017), <https://ssrn.com/abstract=3057411>.

<sup>79</sup> For the argument that John A. Hobson and Ralph Hawtrey were the intended targets of the *Essay*, see Roger E. Backhouse, "Robbins and Welfare Economics: A Reappraisal," *Journal of the History of Economic Thought* 31, no. 4 (2009): 475–477.

interpersonal comparisons of utility, Robbins based his definition on the premise that it is impossible to reach common agreement on a definition of welfare, the common good, the public interest, or any such related conceptions of collective ends. Besides the methodological difficulties in discerning a common good on the basis of incommensurable individual preferences, values, tastes, and opinions, his reasons for restricting economics to the study of means as they relate to given ends were practical. "In the rough-and-tumble of political struggle," Robbins explained, "differences of opinion may arise either as a result of differences about ends or as a result of differences about the means of attaining ends [...] If we disagree about ends it is a case of thy blood or mine—or live and let live, according to the importance of the difference, or the relative strength of our opponents. But, if we disagree about means, then scientific analysis can often help us to resolve our differences."<sup>80</sup> While the question of means was amenable to economic analysis, questions of morality left no room for argument, according to Robbins.

By the late 1930s, Robbins's rejection of interpersonal comparisons of utility was widely accepted, and a new generation of welfare economists scrambled to find a way to construct a viable economics of welfare, leaving behind the classical utilitarianism of Alfred Marshall and Arthur Pigou. Reviving the Italian economist and sociologist Vilfredo Pareto's 1896 *Cours d'Économie Politique*, the new welfare economists defined an optimum situation as one in which it was not possible to make anyone better off without making someone else worse off.<sup>81</sup>

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<sup>80</sup> Robbins, *An Essay on the Nature and Significance of Economic Science*, 134.

<sup>81</sup> See Vilfredo Pareto, *Cours d'Économie Politique Professé a l'université de Lausanne* (Lausanne: F. Rouge, 1896).

In 1938, in “A Reformulation of Certain Aspects of Welfare Economics,” the American economist Abram Bergson (born Burk) was the first to articulate “exactly what it was that was optimal in such an optimum” by introducing the concept of the social welfare function.<sup>82</sup> A social welfare function ranks social states as either better, worse, or indifferent for every possible pair of social states. Significantly, Bergson argued that interpersonal comparisons of utility were unavoidable—but they needed to be made explicit. In line with this, he put forward a social welfare function based on explicit value judgments or interpersonal comparisons of utility that made it possible to rank pairs of alternative social states. This individualistic social welfare function enabled the necessary conditions for the calculation of a social optimum without resorting to cardinal utility.

Developing the ideas set out in Abram Bergson’s 1938 paper, Paul Samuelson’s 1947 *Foundations of Economic Analysis* refined the concept of the social welfare function, which became dominant in the American economics discipline in the 1950s. Like Bergson, Samuelson concluded that it was impossible to escape interpersonal comparisons of utility.<sup>83</sup> Value judgments were an inescapable feature. However, Samuelson’s important point was that these value judgments were extraneously given. It was not the purview of economists to make normative decisions. Economists simply studied the

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<sup>82</sup> Roger E. Backhouse, *A History of Modern Economic Analysis* (Oxford: Basil Blackwell, 1985), 305; Abram Bergson, “A Reformulation of Certain Aspects of Welfare Economics,” *The Quarterly Journal of Economics* 52, no. 2 (1938): 310–334.

<sup>83</sup> Paul A. Samuelson, *Foundations of Economic Analysis* (Cambridge, MA: Harvard University Press, 1947), 243–244.

impact of various normative economic arrangements, comparing pairs of social states.

Samuelson thus pushed the problem of preference aggregation aside and referred to an unspecified consensus in American society. He explained that the starting point of economic analysis was the assumption that some ethical belief had been arrived at. "Without inquiring into its origins," Samuelson explained, "we take as a starting point for our discussion a function of all the economic magnitudes of a system, which is supposed to characterize some ethical belief—that of a benevolent despot, or a complete egoist, or 'all men of good will', a misanthrope, a state, race, or group mind, God, etc."<sup>84</sup> The specifics of the ethical belief did not matter. Any possible ethics was admissible. Samuelson thus assumed that an agreement on political ends had been reached. The question of how individual preferences could be aggregated into a coherent social welfare function was shunted aside and explained as the outcome of an unexplained social consensus. This was a typical move. All postwar economists engaged with problems of collective decision-making resorted to an extraneously given social consensus on ends to make their analyses add up.<sup>85</sup> The theory of welfare economics nonetheless had inescapable political implications in so far as Pareto optimality provided a principle for the expansion of governmental authority. Deviations from Pareto optimality thus pointed to the necessity of government intervention to correct market failures.

What were the goods and services that government could unquestionably be expected to provide? This

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<sup>84</sup> *Ibid.*, 221.

<sup>85</sup> Cherrier and Fleury, "Economists' Interest in Collective Decision after World War II."

question animated Samuelson's 1954 "Pure Theory of Public Expenditure," the article generally regarded as the first formalization of the idea of public goods. Samuelson had three theoretical intentions in writing the article. First, he wanted to prove the usefulness of mathematics in the economics discipline. Second, he aimed to prove the impossibility of a decentralized market solution to the problem of public goods. Third, and most significantly, he wanted to complete his theory of the social welfare function.<sup>86</sup> However, his theory relied on an implicit redefinition of the purpose and function of the state.<sup>87</sup> As the reception of Samuelson's paper demonstrates, his contemporaries believed that this public goods theory of the state justified only a limited number of the goods and services that mid-century governments actually provided.

Samuelson began the paper with a demarcation between private consumption goods, "which can be parceled out among different individuals," and collective consumption goods, "which all enjoy in common in the sense that each individual's consumption of such a good leads to no subtraction from any other individual's consumption of that good."<sup>88</sup> As he had done in *Foundations of Economic Analysis*, Samuelson argued that it was not the economist's task to define the ethical preferences

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<sup>86</sup> For this argument, see Hammond, "Paul Samuelson on Public Goods."

<sup>87</sup> For an earlier, similar argument that Samuelson's theory of public goods represented a theory of the state, see Russell Hardin, "Economic Theories of the State," in *Perspectives on Public Choice: A Handbook*, ed. Dennis C. Mueller (New York, NY: Cambridge University Press, 1997), 21–34.

<sup>88</sup> Paul A. Samuelson, "The Pure Theory of Public Expenditure," *The Review of Economics and Statistics* 36, no. 4 (1954): 387.

that constituted the social welfare function.<sup>89</sup> Samuelson's equations restated his version of the new welfare economics given in *Foundations of Economic Analysis* but added an equation that stated a theory of public goods which was meant to complete his version of a social welfare function.<sup>90</sup>

Samuelson acknowledged, however, that the Continental voluntary exchange theorists, Richard Musgrave, and Howard Bowen had already explained the basic logic of his argument.<sup>91</sup> Samuelson's contribution to the findings of these theorists was the formalization of public goods as part of a social welfare function.<sup>92</sup> Following them, Samuelson argued that the problem with collective consumption goods was that they could not be subjected to market exchange: "*No decentralized pricing system can serve to determine optimally these levels of collective consumption.*" Government officials would have to try different routes to obtain information on the optimal level of provision of public goods and services. Several avenues could be explored to find a solution, including indoctrination of consumers of public goods to reveal their preferences, or the use of polling as Bowen had suggested in his 1943 article. "But [...] now it is in the selfish interest of each person to give *false* signals, to pretend to have less interest in a given collective consumption activity than he really has, etc."<sup>93</sup> Taxing according to

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<sup>89</sup> Ibid.

<sup>90</sup> Ibid. On this, see Hammond, "Paul Samuelson on Public Goods."

<sup>91</sup> Samuelson, "The Pure Theory of Public Expenditure," 388.

<sup>92</sup> For this point, see Hammond, "Paul Samuelson on Public Goods."

<sup>93</sup> Samuelson, "The Pure Theory of Public Expenditure," 388–389, italics in original.

a benefit theory of taxation would not solve the problem in a decentralized manner.

The political implication of Samuelson's logic was that coercion was required in the provision of public goods. The rational self-interest of citizens meant that collectively consumed goods would not be provided by the market, and that their optimal output would be almost impossible to ascertain. Samuelson's conclusion was thus that government would not be able to ascertain the optimal levels of output that firms were able to obtain through the price mechanism. In contrast to public suppliers, private firms were able to adjust their levels of supply because the price mechanism provided the necessary information about demand.

Samuelson's theory of public goods spawned a great deal of debate in the late 1950s. The economists Stephen Enke, Julius Margolis, and Gerhard Colm offered the most significant contributions to the debate about public goods in the immediate aftermath of Samuelson's "Pure Theory of Public Expenditure." There was a clear pattern in the reception of Samuelson's theory. Enke, Margolis, and Colm all sensed that it entailed a revision of the theory of the state. They all observed that Samuelson's theory of public expenditures allowed for the supply of only a very small proportion of the goods and services that the mid-century American state actually provided. The reception of Samuelson's article is significant because it illuminates the problem public choice theorists tried to solve: finding a mechanism for demand revelation that did not reduce government to supplying only non-exclusionary and non-rivalrous goods.

Enke was the first to respond, and he placed Samuelson as part of a tendency within economics to misuse mathematics. He complained that complicated mathematical notation was

displacing simple prose as the primary form of expression.<sup>94</sup> Enke was especially displeased with the unrealistic assumptions of mathematical abstraction, which lacked the nuanced complexity of prose. This, according to Enke, was evident in Samuelson's distinction between purely private and purely public goods. The problem was that many goods and services provided by the American government were neither pure private nor pure public goods. Enke provided the examples of "highways, public hospitals and libraries, police and fire protection, and defense against air attack" as examples of goods and services that were not covered by the strict definition of public goods but were nonetheless provided by government.<sup>95</sup> The unrealistic nature of Samuelson's stark demarcation between public and private goods made his theory useless to policy-makers.<sup>96</sup> The unrealistic assumptions of mathematical expression thus reduced the functions of the state to a minimum.

Julius Margolis, in his "Comment on the Pure Theory of Public Expenditure," likewise pointed out that Samuelson's sharp distinction between private and collective consumption goods was unrealistic and entailed an unrealistic vision of government. Moreover, Margolis argued that "Samuelson's formulation of the domain of public services stems from an economic liberal's image of the state."<sup>97</sup> In this image, a private market

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<sup>94</sup> Stephen Enke, "More on the Misuse of Mathematics in Economics: A Rejoinder," *The Review of Economics and Statistics* 37, no. 2 (1955): 131.

<sup>95</sup> *Ibid.*, 132.

<sup>96</sup> *Ibid.*, 133.

<sup>97</sup> Julius Margolis, "A Comment on the Pure Theory of Public Expenditure," *The Review of Economics and Statistics* 37, no. 4 (1955): 348.

economy was “the natural condition of society,” and the function of government was merely to undertake the production of goods to which property laws only applied imperfectly. In this sense, Samuelson’s articulation of the concept of public goods was merely a rearticulation, in formal mathematical notation, of classical liberals’ idea of the state. Margolis objected that, in the real world, government did not only supply Samuelson’s narrowly defined public goods. It also supplied impure goods like education. Samuelson’s individualistic approach was thus inadequate if government provision of these impure goods was to be understood. That, according to Margolis, required political sociology.

Similarly, Gerhard Colm criticized Samuelson for distorting the character of politics into a stark dichotomy between public and private goods. To Colm, Samuelson’s approach appeared to be “a marriage between the ghost of the long-time buried *homo economicus* with an equally sterile *mulier politica*.”<sup>98</sup> This is a revealing comment, making explicit what Samuelson, and before him the voluntary exchange theorists, Musgrave, and Bowen, had left implicit, namely, that the theory of public goods conflated economics and politics, commodifying the state and the relationship between individuals and their government.

Rather than assume, as Samuelson seemed to do, that citizens merely voted to get as many public goods as possible while avoiding paying for them, Colm found it more useful to assume that citizens had their own ideas about how their country ought to be ruled. He assumed instead “that each voter

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<sup>98</sup> Gerhard Colm, “Comments on Samuelson’s Theory of Public Finance,” *The Review of Economics and Statistics* 38, no. 4 (1956): 409.

has on his mind, though vaguely, some concept of the requirements of national interests and general welfare.”<sup>99</sup> Assuming as Samuelson did that voters only had their own interests in mind overlooked that even the most egoistic individual “argue[s] that what is best for him is also best for the country, thereby transforming a personal preference into a general welfare choice.”<sup>100</sup> Colm’s remarks thus revealed an entirely different conception of politics as deliberation by public-interested citizens. Samuelson’s conception, by contrast, was a vision of politics as economics, assuming that the purpose of the state was to provide the goods consumed by self-interested citizens.

Critics of neoliberalism tend to portray the very act of thinking about democracy through economic categories as an unholy act of desecration. Rather than reproduce this unidirectional story, this chapter has shown how mainstream economists, even those with sympathies that leaned leftward like Knut Wicksell, Richard Musgrave, Howard Bowen, and Paul Samuelson, worked to commodify the state at some level and reframe the relationship of citizens to their representative government in the idiom of their discipline. This is inexplicable without reference to the problems associated with the postwar expansion of the American public sector. Whereas previous research has emphasized the importance of the Cold War, this chapter has argued that the foundation of public choice theory was public finance theorists’ commodified vision of the relationship between Americans and their state. The problem of optimal output that they articulated implied a material conception of the common good. They thus replaced the metaphysics

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<sup>99</sup> Ibid.

<sup>100</sup> Ibid.

of the public good with the physics of public goods. Services like military defense, street lighting, health care, pensions, and education were objects of trade that citizens paid for through their taxes.

In this sense, at least, there was no sharp break between the New Deal order and the neoliberal order. The welfare state entailed a vision of citizens as consumers. Marketization thus evolved to solve the problem of optimal output associated with the provision of public goods. If citizens were rational economic actors, they could not be trusted to pay for the supply of services like military protection or street lighting, because they would be able to enjoy the benefits of their provision either way. Non-excludability meant that the market would fail to provide such goods. However, the absence of a price mechanism also meant that it would be near impossible to estimate the optimal supply of these services, leading to either over- or under-spending. Without going into detail, Musgrave and Samuelson suggested that the only feasible solution to the problem of optimal output was planning.

Dissatisfied with Musgrave and Samuelson's answers, as we will see, public choice theorists argued for a restructuring of the relationship between the state and its citizens so that it resembled the relationship between the firm and its customers. Public choice theorists envisioned four modes of reinventing government along market lines: party competition, voluntary exchange, foot voting, and performance incentives. All of these solutions promised to solve the problem of optimal output, marketizing the demand and supply of public goods and services.

# 2

## Stability in Party Competition

The advent of universal suffrage in the early 1900s was accompanied by the rise of mass politics with political parties at the center. These parties played a crucial role in mediating between the large classes of people that constituted civil society, on the one hand, and state institutions, on the other. Over the course of the last three decades, this party system has come apart. Political parties are no longer institutions to which people feel a sense of belonging. Party membership has declined. Electoral turnouts have decreased. Party elites have retreated to the institutions of the state. In the words of the late Peter Mair, “the age of party democracy has passed. Although the parties themselves remain, they have become so disconnected from the wider society, and pursue a form of competition that is so lacking in meaning, that they no longer seem capable of sustaining democracy in its current form.”<sup>1</sup> Parties have become firm-like organizations, responding to voters’ demands rather than pursuing ideological visions of a better society.

Mair was careful to avoid a unidirectional explanation for this hollowing of Western democracy, stressing the complexity

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<sup>1</sup> Mair, *Ruling the Void: The Hollowing of Western Democracy*, 1.

of the historical background.<sup>2</sup> He offered two explanations, globalization and individualization. Globalization undermined party democracy by constraining national governments' independence, making them subservient to international organizations and markets. Individualization undermined party democracy by fragmenting the collective identities that undergirded mass parties; chief among these was the decline in class-consciousness. The result was the decline in party membership, decreasing electoral turnout, and the retreat of political elites.

This chapter tells a different story about the deconstruction of this crucial pillar of postwar democracy.<sup>3</sup> It examines how Anthony Downs articulated an economic theory of democracy as an electoral competition between politicians for votes. This was a theory of the demand for public goods in which the logic of competition forced politicians to cater to voters' preferences. Downs explicitly developed his economic model of democracy to solve the problem of optimal output in the public goods theory of the state. Competition between politicians mimicked the market mechanism, allowing voters to shop between political parties, leaving their product, that is, policy package, if it did not suit their preferences for public goods and services. In other words, Downs's theory redefined the relationship between parties and their voters to make it resemble that between firms and

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<sup>2</sup> This interpretation of Mair follows Wolfgang Streeck, "The Politics of Exit," *New Left Review* 88 (August 1, 2014): 121–129.

<sup>3</sup> Parts of this chapter first appeared in Jacob Jensen, "Anthony Downs and the Equilibrium Theory of Democracy," *Æconomia. History, Methodology, Philosophy* 11, no. 1 (March 1, 2021): 29–47.

their customers. The chapter thus shows that the transformation of political parties into firm-like organizations was not a response to developments in the 1970s. It emerged in response to the advent of the compensatory state. The conception of political parties as firms was a response to the very welfare state that political parties, especially on the left, fought hard to build.

The central problem in American political theory after World War I was the accommodation of political authority to a modern, industrialized society beset by social conflicts and increasingly governed by professionals.<sup>4</sup> The idea of an organically unified people embodied in the concept of the state had come to seem quaint in the face of the diversity and plurality of interests produced by the new industrial society.<sup>5</sup> As the sense of a unified public faded, social scientists struggled to find new ways to legitimize growing government intervention in citizens' lives. In this context, American social scientists began

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<sup>4</sup> Jessica Wang, "Scientists and the Problem of the Public in Cold War America, 1945–1960," *Osiris* 17 (2002): 323–347; Edward Aloysius Purcell, *The Crisis of Democratic Theory: Scientific Naturalism and the Problem of Value* (Lexington, KY: University of Kentucky Press, 1973); Daniel T. Rodgers, *Contested Truths: Keywords in American Politics since Independence* (Cambridge, MA: Harvard University Press, 1987); John G. Gunnell, *The Descent of Political Theory: The Genealogy of an American Vocation* (Chicago, IL: University of Chicago Press, 1993); John G. Gunnell, *Imagining the American Polity: Political Science and the Discourse of Democracy* (University Park, PA: Pennsylvania State University Press, 2004).

<sup>5</sup> Gunnell, *Imagining the American Polity*, 15–18, 145.

analyzing politics as a competition between interest groups, elites, and individuals.

Though diverse and difficult to generalize about, the first and second generations of American political scientists, in the nineteenth century, had articulated a version of popular sovereignty embodied in the concept of the state. Government, on the other hand, was a separate concept, describing the administration of the state. The initial construction of the American concept of the state was largely the work of the German émigré Francis Lieber.<sup>6</sup> Born in Berlin in 1798 and educated at Jena and Dresden, he came to America in 1827, bringing a distinctly German conception of the state with him.<sup>7</sup> Prior to Lieber's arrival in America, in *The Federalist Papers*, for example, American political commentators had usually used the word "state" simply to refer to the separate political entities of the American states. Lieber facilitated its transformation into a democratic concept, defining a state as an organically unified people.<sup>8</sup> Adapting German historicist and idealist philosophy to American conditions, Lieber's conception lay the foundations of the emerging political science discipline, describing and justifying the political workings of the American republic.<sup>9</sup> Lieber's concept of the state remained dominant well into the twentieth century.<sup>10</sup> The image of the relationship between government and state was even affirmed by the US Supreme Court in the cases *Texas v. White* and *Poindexter v. Greenlaw*,

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<sup>6</sup> This follows the argument in Gunnell, *Imagining the American Polity*.

<sup>7</sup> *Ibid.*, 16.

<sup>8</sup> *Ibid.*, 53.

<sup>9</sup> *Ibid.*, 58.

<sup>10</sup> *Ibid.*, 16.

in 1869 and 1887, respectively. The Court defined a state as a “political community” of people, whereas government was defined as the organizing unit of this community. This “distinction between a government of a state and the state itself” separated free government from despotism.<sup>11</sup>

By the 1920s, however, this distinction was beginning to blur as social theorists lost confidence in the existence of a unified and organic people. Holding that “knowledge was empirical, particular, and experimentally verifiable” and that there were no a priori truths, during the interwar period so-called “scientific naturalists” underscored the weaknesses of traditional democratic theory.<sup>12</sup> As David Ricci has argued, in the interwar period, social scientists and political commentators thus undermined “the very object which the discipline was professionally committed to support, namely, the democratic polity.”<sup>13</sup> In response to the social fracture brought on by industrial capitalism, American political scientists began analyzing politics as dominated by conflicting pressure groups. Formal interest groups were among the most analyzed group formations.

The first American to advance a modern theory of politics as a play between interest groups was Arthur Bentley. In *The Process of Government*, from 1908, Bentley not only rejected organic society as the elemental unit of social scientific analysis but also came to reject the individual as the methodological starting point. Instead, he took group

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<sup>11</sup> *Ibid.*, 71.

<sup>12</sup> Purcell, *The Crisis of Democratic Theory*, 3, 6, 11.

<sup>13</sup> David M. Ricci, *The Tragedy of Political Science: Politics, Scholarship, and Democracy* (New Haven, CT: Yale University Press, 1984), 78.

activity as his fundamental unit of investigation.<sup>14</sup> America, he argued, was composed of “groups of men, each group cutting across many others, each individual man a component part of very many groups.”<sup>15</sup>

Bentley argued that “society itself is nothing other than the complex of the groups that compose it.”<sup>16</sup> Normative aspects such as the common good disappeared in Bentley’s analysis. There was only the competition of interests. Individuals in government, whether politicians or administrators, represented certain interests rather than the public good. However, Bentley believed that the activities of competing interests were “all knit together in a system.”<sup>17</sup> In politics, Bentley argued, “government is the process of the adjustment of a set of interest groups in a particular distinguishable group or system.”<sup>18</sup> Government’s capacity to adjust and balance interests brought social order to the otherwise chaotic competition of interests. Bentley described this equilibrium of interest groups in the idiom of economic theory. This was no coincidence. Bentley’s interest in politics derived from his interest in economics. He was inspired by the Austrian economist Carl Menger’s theory of marginal utility in his quest to find a basic unit that could be applied to the analysis of all social

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<sup>14</sup> Dorothy Ross, *The Origins of American Social Science* (Cambridge: Cambridge University Press, 2004), 332.

<sup>15</sup> Arthur F. Bentley, *The Process of Government: A Study of Social Pressures* (Chicago, IL: The University of Chicago Press, 1908), 204.

<sup>16</sup> *Ibid.*, 222.

<sup>17</sup> *Ibid.*, 260.

<sup>18</sup> *Ibid.*, 218.

behavior.<sup>19</sup> Menger was one of the architects of the so-called marginal revolution, which transformed economics from the study of production and labor to the study of consumption and the individual behavior of firms and individuals.

In Germany, similarly inspired by economic theory, the social theorist Max Weber also defined politics as a competition.<sup>20</sup> However, whereas a pluralist like Bentley stressed the competition between interest groups, Weber stressed the competition between leaders. This was an elite conception of politics. In his lecture on "Politics as a Vocation," given in late January 1919, Weber, for example, argued that the American party "boss has no firm 'principles'; he is completely without convictions and is interested only in how to attract votes."<sup>21</sup> Weber connected American politicians' self-interestedness to the capitalist system:

Needless to say, the bosses will resist any outsider who represents a threat to their own sources of money and power. But in the competition for the goodwill of the voters, it is not unusual for them to have found themselves obliged to stoop to endorse candidates who are thought to be the enemies of corruption.

In America, then, we have party machines built on strikingly capitalist lines.<sup>22</sup>

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<sup>19</sup> Ross, *The Origins of American Social Science*, 332, 336.

<sup>20</sup> Though dated, the unsurpassed intellectual biography of Max Weber remains Wolfgang J. Mommsen, *Max Weber and German Politics, 1890–1920* (Chicago, IL: University of Chicago Press, 1990).

<sup>21</sup> Max Weber, *The Vocation Lectures* (Indianapolis, IN: Hackett Publishing Company, 2004), 70.

<sup>22</sup> *Ibid.*, 71, my italics.

Weber thus explicitly analyzed the competition for votes in analogy with the way capitalism operated. Such conceptions of politics as a competition between groups and politicians were ubiquitous in the first half of the twentieth century. Pluralists and elite theorists simply neutralized the struggle for power in the language of competition.

In the mid-1930s, Frank Knight outlined a theory of “*democracy as competitive politics*,” which bore a striking resemblance to Weber’s definition of democracy.<sup>23</sup> It appeared in “Economic Theory and Nationalism,” an essay he had first presented at the 1934 meeting of the American Economic Association and then published in *The Ethics of Competition and Other Essays*.<sup>24</sup> The political context of the essay was the division of the world into three modes of economic governance, capitalism, socialism, and fascism. Europe, Knight remarked at the outset, was transitioning from capitalism to fascism, abandoning the short-lived attempts to create economic democracy.<sup>25</sup> Once again, then, we see the importance of the division of the world into the opposing allocation mechanisms of markets and planning for the theorists writing before the 1950s.

Knight thus proceeded to outline the three major modes of economic organization. His main purpose was to provide a historical narrative of the rise and decline of what he called “the dualistic institutional system of liberalism.”<sup>26</sup> By this, Knight meant that “[a]n economic system of ‘free’ market relations, even in its maximum development, must operate in a

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<sup>23</sup> Frank H. Knight, *The Ethics of Competition and Other Essays* (Freeport, NY: Books for Libraries Press, 1969), 295, italics in original.

<sup>24</sup> *Ibid.*, 277(\*).

<sup>25</sup> *Ibid.*, 277.

<sup>26</sup> *Ibid.*, 288.

framework of political order, to protect property and enforce the rules of the market.”<sup>27</sup> This emphasis on the necessity of a strong state to create and uphold the rules structuring the market system is a key characteristic of neoliberalism, as opposed to classical liberalism. Knight, like many early neoliberals, emphasized that “extreme individual laissez-faire is impossible.”<sup>28</sup> The political order that grew up in tandem with economic individualism, Knight explained, was democracy in its representative form. However, at its origins, the character of this political order was merely protective.<sup>29</sup>

When laissez-faire became “intolerable,” the masses, according to Knight’s truncated historical narrative, turned to democratic politics, in the form of the new liberalism, social democracy, and socialism in Europe, and Progressive Era politics and the New Deal in America.<sup>30</sup> Knight defined the purpose of these movements as the use “of the political machinery of the democratic state to effect the organization of economic life, in place of the system of private property and free enterprise.”<sup>31</sup> Whereas economic individualists conceptualized the state as an “order-maintaining agency,” socialists conceptualized the state as a productive instrument.<sup>32</sup>

Returning to the character of democracy, Knight took a somewhat idiosyncratic turn to explain the shortcomings of democratic politics:

In principle, democracy is political individualism. The pure or direct democracy of the town meeting or small city-state, governed by an

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<sup>27</sup> *Ibid.*

<sup>28</sup> *Ibid.*, 291.

<sup>29</sup> *Ibid.*, 288.

<sup>30</sup> *Ibid.*, 293.

<sup>31</sup> *Ibid.*, 294.

<sup>32</sup> *Ibid.*

assembly, governed by an assembly of its entire citizenship, is the nearest approach to pure political individualism short of anarchy, and democracy in the sense of representative institutions is an adaptation necessary for larger communities. The essential point is that, as it has worked out in practice in the modern world, *democracy is competitive politics*, somewhat as free enterprise is competitive economics (though inherently a competition for a monopolistic position), and shows the same weaknesses as the latter. In ideal theory, neither is competitive in the psychological sense.<sup>33</sup>

Knight thus defined democracy as an individualistic concept. This is surprising. Throughout most of its history, democracy has been seen as mob rule, that is, as quintessentially collectivistic.<sup>34</sup> However, Knight's juxtaposition of economic individualism and political individualism served a point. He argued that politics was as prone to undermine competition as "free" markets.

The context for this indictment of politics was the rapid expansion of the sphere of political management in the early 1930s. As the world sank into an historically unprecedented economic depression, America drifted towards more expertise management of society and economy. This forced American social scientists to address the problem of reconciling popular rule and planning, in either its complete or its partial variant. Joseph A. Schumpeter, an Austrian émigré economist, provided one of the most influential responses to this problem.

Taking up a position at Harvard University in the beginning of the 1930s, Schumpeter's formative experience was

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<sup>33</sup> *Ibid.*, 295, italics in original.

<sup>34</sup> For this point, see Ellen Meiksins Wood, *Democracy against Capitalism* (London: Verso Books, 1995), 205–237.

the end of the Habsburg Empire in the aftermath of World War I. In this context, as John Medearis has demonstrated, Schumpeter developed two theories of democracy which would structure his political thinking throughout his career.<sup>35</sup> The first was a transformative conception of democracy. In this theory, the extension of the franchise to the masses had the potential to undermine established hierarchies. The second was the aristocratic model of democracy, which Schumpeter conceptualized most clearly in *Capitalism, Socialism and Democracy*, published in 1942, and which remains the better known of the two. However, as Medearis points out, the elite model of democracy as method was born out of the transformative conception. With elites threatened by social-democratic initiatives, representing an extension of democracy into the economy, Schumpeter formulated an aristocratic vision of democracy in which elites secured social order.<sup>36</sup>

Arriving in America in the midst of the Great Depression, Schumpeter developed his vision of aristocratic democracy in response to the New Deal, which he considered an example of the transformative power of democracy, extending as it did democracy into the economic sphere.<sup>37</sup> While Medearis is certainly right in contextualizing Schumpeter's theory of democracy as a conservative and reactionary response to democratic upheavals in interwar Austria and America, *Capitalism,*

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<sup>35</sup> John Medearis, *Joseph Schumpeter's Two Theories of Democracy* (Cambridge, MA: Harvard University Press, 2001).

<sup>36</sup> *Ibid.*, 20.

<sup>37</sup> On Schumpeter and the New Deal, see John Medearis, "Schumpeter, the New Deal, and Democracy," *The American Political Science Review* 91, no. 4 (1997): 819–832.

*Socialism and Democracy* was also a response to the socialist calculation debate.<sup>38</sup>

In *Capitalism, Socialism and Democracy*, Schumpeter sided with Oskar Lange and the market socialists against the Austrians. Singling Ludwig von Mises out “as the only authority standing for denial that we need to mention,” Schumpeter argued that a centrally planned economy was in fact possible.<sup>39</sup> Mises’s argument was meaningless because a socialist society, according to Schumpeter, would separate production from distribution:

Since *prima facie* there are no market values of means of production and, what is still more important, since the principles of market society would not admit of making them the criterion of distribution even if they did exist, the distributive automatism of commercial society is lacking in a socialist one. The void has to be filled by a political act, let us say by the constitution of the commonwealth. Distribution thus becomes a distinct operation and, in logic at least, is completely severed from production.<sup>40</sup>

Though Schumpeter’s democratic theory was thoroughly embedded in a long conservative lineage of fears about democracy, his counterarguments against Mises served the important purpose of proving that socialism could in fact work, but that its feasibility relied on the quality of political leadership. Engagement with the socialist calculation debate thus helped Schumpeter bridge the gap from the question of

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<sup>38</sup> On Schumpeter’s role in the calculation debate, see Lavoie, *Rivalry and Central Planning*.

<sup>39</sup> Joseph A. Schumpeter, *Capitalism, Socialism and Democracy* (Abingdon: Routledge, 2010), 154.

<sup>40</sup> *Ibid.*, 155.

whether socialism was workable to the question about the relationship between socialism and democracy.

Schumpeter's chief target in the analysis of this question was a chimeric eighteenth-century philosophy of democracy, which he defined as "that institutional arrangement for arriving at political decisions which realizes the common good by making the people itself decide issues through the election of individuals who are to assemble in order to carry out its will."<sup>41</sup> The foundation of this classical doctrine of democracy was that there existed a discernible common good. However, Schumpeter argued that there was "no such thing as a uniquely determined common good that all people could agree on or be made to agree on by the force of rational argument."<sup>42</sup>

To evade the challenges of identifying the public interest, Schumpeter simply reduced democracy to the bare minimum of electing or evicting representatives. Whereas in the classical theory of democracy "the selection of representatives is made secondary to the primary purpose of democracy which is to vest the power of deciding political issues in the electorate," Schumpeter defined democracy as "that institutional arrangement for deriving at political decisions in which individuals acquire the power to decide by means of a competitive struggle for the people's vote."<sup>43</sup> In Schumpeter's model, democracy is a method, not an ideal. The primary function of electoral voting was to produce government. This definition of democracy as procedure legitimized and necessitated the rule of professional elites.

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<sup>41</sup> *Ibid.*, 225.

<sup>42</sup> *Ibid.*, 226.

<sup>43</sup> *Ibid.*, 241.

Schumpeter's theory of democracy was closely connected to his theory of entrepreneurial competition. Juxtaposing competition for leadership in the economic sphere to competition for leadership in the political sphere, Schumpeter conceded that competition was hardly ever perfect, though "never completely lacking either," but it was the best approximation of fairness one could hope for.<sup>44</sup> Just as competition on the market ensured that only the most entrepreneurial businesses survived, political competition for votes would ensure that the most competent leaders would be elected. Schumpeter's model of democracy is often seen as a precursor to postwar economic theories of democracy. As C. B. Macpherson has pointed out, in Schumpeter's model, "democracy is simply a market mechanism: the voters are the consumers; the politicians are the entrepreneurs."<sup>45</sup>

Schumpeter stressed the aristocratic aspect of markets, arguing that political competition would bring forth the most eligible leaders, just as economic competition ensured that markets were dominated by the most innovative entrepreneurs. However, if socialism and democracy were to be compatible, Schumpeter argued that the sphere of politics could not be extended to cover all economic affairs. Efficient management required a separation between administration and politics. The greatest problem facing a socialist society was the restriction of the sphere of politics. "After all," Schumpeter argued, "effective management of the socialist economy means dictatorship not *of* but *over* the proletariat in the factory."<sup>46</sup>

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<sup>44</sup> *Ibid.*, 243.

<sup>45</sup> Macpherson, *The Life and Times of Liberal Democracy*, 79.

<sup>46</sup> Schumpeter, *Capitalism, Socialism and Democracy*, 269, italics in original.

While these workers were subjugated in the factory, they were sovereign at election time. Nevertheless, Schumpeter argued, socialist governments could just as easily restrict their sovereignty. "As a matter of practical necessity, socialist democracy may eventually turn out to be more of a sham than capitalist democracy ever was," he concluded.<sup>47</sup>

Schumpeter's elite theory of democracy was exceptionally influential. In the 1950s, social scientists like Robert Dahl, Gary Becker, and Anthony Downs all relied on his competition theory of democracy in their interpretations of American politics. Becker and Downs were economists, Dahl a political scientist. In 1956, Dahl published *A Preface to Democratic Theory*, in which he developed the theory of polyarchy that he would become famous for. Dahl had first deployed the term in the 1953 *Politics, Economics, and Welfare*, which he co-authored with Charles Lindblom.<sup>48</sup> This book contrasted the price system and planning, the main modes of control in the socio-economic debates of the early 1950s, with their preferred alternative of polyarchy. Polyarchy referred to the process through which non-leaders controlled their leaders, and an essential part of this process was the competition between the latter. Along with elections, political competition between leaders ensured their responsiveness to non-leaders, which made the distinction between democracy and dictatorship meaningful.<sup>49</sup>

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<sup>47</sup> Ibid., 269.

<sup>48</sup> Robert A. Dahl and Charles Lindblom, *Politics, Economics, and Welfare* (New York, NY: Harpers and Brothers, 1953).

<sup>49</sup> Robert A. Dahl, *A Preface to Democratic Theory* (Chicago, IL: University of Chicago Press, 2006), 132.

A year after the publication of Dahl's *A Preface to Democratic Theory*, Gary Becker, an economist at the University of Chicago, published "Competition and Democracy," which also treated democracy as competition—but with a different purpose. It was part of a trend at the University of Chicago to expand the scope of economic analysis and tools. Becker's vision of the scope of economics was idiosyncratic at the time, to say the least. In 1951, he began doctoral work on an economic approach to discrimination. Milton Friedman's graduate course on price theory was particularly important in his intellectual formation, and the main theme of his career became the extension of the application of price theory to areas of social life not usually considered economic.<sup>50</sup> Economics imperialism, as several of its practitioners called it, was a hallmark of Chicago School neoliberalism. Economic thinkers like Becker, George Stigler, and Richard Posner extended economic analysis to non-economic topics such as the family, regulation, and law.<sup>51</sup> Becker's article on "Competition and Democracy" was an early example of this trend.

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<sup>50</sup> On economics imperialism, see Jean-Baptiste Fleury, "Wandering through the Borderlands of the Social Sciences: Gary Becker's Economics of Discrimination," *History of Political Economy* 44, no. 1 (March 1, 2012): 11.

<sup>51</sup> Steven G. Medema, "The Trial of Homo Economicus: What Law and Economics Tells Us about the Development of Economic Imperialism," *History of Political Economy* 29, Supplement 1 (1997): 122–142; Edward P. Lazear, "Economic Imperialism," *The Quarterly Journal of Economics* 115, no. 1 (2000): 99–146; Ben Fine and Dimitris Milonakis, *From Economics Imperialism to Freakonomics: The Shifting Boundaries between Economics and Other Social Sciences* (London: Routledge, 2009); Edward Nik-Khah and Robert

Becker framed the article within ongoing discussions about monopolies and government intervention to break them up. His core argument was that “the recommendation of government intervention does not follow from the demonstration that government could improve matters.”<sup>52</sup> In other words, the theoretical demonstration that government interventions could improve things was not the same as demonstrating that they did so in the real world. Becker’s point was that the democratic ideal could not provide the basis for government intervention, decisions on which should, according to Becker, rely on the actual workings of government intervention.

Becker developed a democratic ideal which was very similar to Knight’s and Schumpeter’s. Citing the latter,<sup>53</sup> Becker defined democracy as “*an institutional arrangement for arriving at political decisions in which individuals endeavor to acquire political office through perfectly free competition for the votes of a broadly based electorate.*”<sup>54</sup> He emphasized that political parties’ main aim was to get elected for office, “just as the immediate aim of any firm is to be chosen by consumers.”<sup>55</sup> By analogy, Becker thus redescribed parties as firms and voters as consumers. But this was merely the democratic ideal.

The real world, Becker argued, fell woefully short of this ideal. He provided two reasons for diminished competition

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Van Horn, “Inland Empire: Economics Imperialism as an Imperative of Chicago Neoliberalism,” *Journal of Economic Methodology* 19, no. 3 (2012): 259–282.

<sup>52</sup> Gary S. Becker, “Competition and Democracy,” *The Journal of Law & Economics* 1 (1958): 105.

<sup>53</sup> *Ibid.*, 106n2.

<sup>54</sup> *Ibid.*, 106, italics in original.

<sup>55</sup> *Ibid.*, 106.

in the public sphere. First, large-scale centralization of public organizations reduced competition in actual democracies. Candidacy for high offices, such as the presidency, required vast sums of money to reach widespread voters. The money involved in such an enterprise was not available to every citizen. On the contrary, only few people and organizations were able to provide the necessary money, thus excluding many from running for the most important offices.<sup>56</sup>

Second, the accumulation of many different activities in the same government agencies reduced political competition. Becker suggested that this tendency to make relatively few people responsible for a wide variety of public goods and services was born of citizens' ignorance in political matters. Centralizing power in the hands of relatively few people gave citizens a clearer picture of who was accountable for what.<sup>57</sup>

Centralization and ignorance were thus "the two most potent forces producing monopoly and other imperfections in democracies."<sup>58</sup> In extension of this, Becker's concluding point was that monopoly was just as important a factor in politics as it was in markets. Returning to the article's opening question about the legitimacy of political intervention in markets, Becker argued that market imperfections did not justify intervention "if the imperfections in government behavior were greater than those in the market."<sup>59</sup>

This conclusion was perfectly in line with the developments in the Chicago School at the time. Whereas Knight's generation had emphasized government intervention to

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<sup>56</sup> *Ibid.*, 108.

<sup>57</sup> *Ibid.*

<sup>58</sup> *Ibid.*, 109.

<sup>59</sup> *Ibid.*

enforce market competition, the second Chicago School was moving towards a different conception of monopoly.<sup>60</sup> Postwar Chicago School economists concluded that market concentration was not a problem. They believed the state was the problem, and that markets should be deregulated to prevent powerful interest groups and corporations from lobbying regulatory agencies for antitrust measures that would shield them from competition. Becker's article was part of this development, and it was no coincidence that it was published in the *Journal of Law and Economics*, the house journal of the peculiar conception of the intersection between law and economics at Chicago. As Rob Van Horn has demonstrated, the creation of the Chicago School's law and economics approach was embedded in the reinvention of antitrust regulation.<sup>61</sup> Becker's article underscored the anti-political undertone of the law and economics approach, providing further arguments for reducing the scope of politics and regulation.

Though Anthony Downs shared Becker's Schumpeterian conceptualization of democracy as competition, he came to radically different conclusions about its efficacy and extent. Whereas Becker aimed to reduce the size of American government, Downs aimed to lend legitimacy to government expenditures and activities. His 1957 book *An Economic Theory*

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<sup>60</sup> On this shift, see Robert Van Horn, "Reinventing Monopoly and the Role of Corporations: The Roots of Chicago Law and Economics," in *The Road from Mont Pèlerin: The Making of the Neoliberal Thought Collective*, ed. Philip Mirowski and Dieter Plehwe (Cambridge, MA: Harvard University Press, 2009), 204–237.

<sup>61</sup> *Ibid.*

*of Democracy* started as a dissertation written under the supervision of Kenneth Arrow at Stanford University. Downs's doctoral work was conducted in an institutional setting dictated by American Cold War concerns. The Office of Naval Research supported Downs's dissertation on the request of Arrow, who did some consulting for the Office. Downs had initially wanted to work on the economics of expressways but switched topics when he was introduced to Joseph Schumpeter's *Capitalism, Socialism and Democracy*. Against the background of Schumpeter's elite theory of democracy, Downs set out to formalize how government officials in a democracy were made to fulfill their social function of formulating and carrying out policies, while pursuing their personal ambition of being elected and staying in power.<sup>62</sup>

The opening paragraphs of Downs's book pointed to increased government activity in the economy as the main impetus for engaging with the question of political decision-making. "Throughout the world," Downs explained, "governments dominate the economic scene. Their spending determines whether full employment prevails; their taxes influence countless decisions; their policies control international trade; and their domestic regulations extend into almost every economic act."<sup>63</sup> Economic theory had not yet taken the large role of government sufficiently into account.

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<sup>62</sup> Anthony Downs, "The Origins of an Economic Theory of Democracy," in *Information, Participation, and Choice: An Economic Theory of Democracy in Perspective*, ed. Bernard Grofman (Ann Arbor, MI: University of Michigan Press, 1993), 198.

<sup>63</sup> Anthony Downs, *An Economic Theory of Democracy* (New York, NY: Harper, 1957), 3.

Increased government spending, taxation, and regulation thus drove Downs's theoretical explorations of political behavior. His ambition was to construct "a generalized yet realistic behavior rule for a rational government similar to the rules traditionally used for rational consumers and producers."<sup>64</sup> That is, his aim was to produce a theory of government behavior that would match the theory of market behavior. In his search for the microfoundations of government activity, Downs engaged two strands of thought within the economics discipline.

The first was public finance. In relating his model to this body of literature, Downs's point of departure was Samuelson's theory of public goods. Downs considered the theory completely unsatisfying because it reduced government activities to an absolute minimum, making it unable to explain, let alone justify, government provision of divisible goods and services.<sup>65</sup> The challenge was finding a mechanism that would create a correspondence between citizens' individual ends and those of the ruling elite. The task, in other words, was to find a mechanism of representation that did not restrict government to providing only goods that were non-exclusionary and non-rivalrous.

To that end, Downs turned to a second body of literature concerned with the economics of welfare. Within this literature, his supervisor's work on the impossibility of constructing a social welfare function loomed large. A recipient of the 1972 Nobel Memorial Prize in Economic Sciences, Arrow was one of the most significant economists of the latter half of the twentieth century, famous not only for his general possibility

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<sup>64</sup> *Ibid.*

<sup>65</sup> *Ibid.*, 16–17.

theorem but also for his work on general equilibrium.<sup>66</sup> Born in New York in 1921, Arrow's formative experience was the Great Depression, which forced his family into ten years of poverty. As a result, he had to go to City College, which at the time provided college education free of charge. For his graduate studies, he entered Columbia University and studied with Harold Hotelling, whose strong reputation in statistics attracted the mathematically gifted Arrow. During his graduate studies in the late 1940s, he divided his time between Columbia University in New York and the Cowles Commission at the University of Chicago.<sup>67</sup>

It was during a 1949 stint as a consultant for the RAND Corporation, the quintessential Cold War research institution, that Arrow first defined the general possibility theorem. The general possibility theorem should therefore be understood partly against the background of the Cold War.<sup>68</sup> As Odd Arne Westad has argued, the origin of the Cold War was

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<sup>66</sup> For the original statement of the theory of general equilibrium, see Kenneth J. Arrow and Gerard Debreu, "Existence of an Equilibrium for a Competitive Economy," *Econometrica* 22, no. 3 (1954): 265–290. For a history of modern equilibrium theory, see Till D uppe and E. Roy Weintraub, *Finding Equilibrium: Arrow, Debreu, McKenzie and the Problem of Scientific Credit* (Princeton, NJ: Princeton University Press, 2014).

<sup>67</sup> Kenneth J. Arrow, "Kenneth J. Arrow," in *Lives of the Laureates: Twenty-Three Nobel Economists*, ed. Roger W. Spencer and David A. Macpherson (Cambridge, MA: MIT Press, 2014), 18–19.

<sup>68</sup> Amadae, *Rationalizing Capitalist Democracy*, chapter 2; Mirowski, *Machine Dreams*, 305.

an ideological struggle between two diametrically opposed responses to modernity, which first took shape not in the 1940s or 1950s but in the 1890s and then accelerated after the Russian Revolution. Liberal capitalism and socialism promoted two radically different modes of governance. While the capitalist countries led by the United States based their social systems on the price mechanism (duly assisted by the state, of course), the socialist countries led by the Soviet Union based their social systems on planning. It was this ideological struggle that defined the Cold War years from the late 1940s through the early 1990s.<sup>69</sup>

Arrow's dissertation topic was suggested to him by the philosopher Olaf Helmer, a researcher at RAND. Helmer, in Arrow's own account, articulated the puzzle that would form the basis of his dissertation: "The meaning of utility or preference for an individual was clear enough, but what was meant by that for a collectivity?"<sup>70</sup> In answer to this question, he constructed a general possibility theorem, which was published in 1951 in *Social Choice and Individual Values*.

Arrow opened the book by asserting that "in a capitalist democracy there are essentially two methods by which social choices can be made: voting, typically used to make 'political'

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<sup>69</sup> See Odd Arne Westad, *The Global Cold War: Third World Interventions and the Making of Our Times* (Cambridge: Cambridge University Press, 2005); Odd Arne Westad, *The Cold War: A World History* (New York, NY: Basic Books, 2017).

<sup>70</sup> Kenneth J. Arrow, "The Origins of the Impossibility Theorem," in *The Arrow Impossibility Theorem*, ed. Eric Maskin and Amartya Sen (New York, NY: Columbia University Press, 2014), 147.

decisions, and the market mechanism, typically used to make 'economic decisions.'<sup>71</sup> Whereas dictatorship and social convention, the two remaining methods of social choice, relied on either one will or divine will in making social decisions, voting and the market system were "methods of amalgamating the tastes of many individuals in the making of social choices."<sup>72</sup> The question Arrow attempted to answer was whether collective choices, where the wills of many people are involved, can be rational in the sense that the many individual preference orderings constituting society can be ranked into a single societal preference ordering.

The outcome of the investigation was his now famous possibility theorem, which holds that collectively rational group decisions are impossible. Using the mathematical language of set theory rather than calculus or algebra, Arrow formulated his proof against the background of the rule of well-ordered, transitive preferences. This means that if A is preferred to B, and B is preferred to C, consistency requires that A is preferred to C. Arrow's work was essentially an exercise in mathematics, not economics, revisiting a mathematical problem that had been discovered in the eighteenth century.<sup>73</sup> The story of the general possibility theorem, then, is as much about the expansion of mathematics into economics as it is about the expansion of economics into political theory.

An interesting political-theoretical aspect of Arrow's theorem was his definition of the object of choice. While the

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<sup>71</sup> Kenneth J. Arrow, *Social Choice and Individual Values* (New York, NY: John Wiley and Sons, 1951), 1.

<sup>72</sup> *Ibid.*, 2.

<sup>73</sup> Eerik Lagerspetz, "Plurality, Approval, or Borda? A Nineteenth Century Dispute on Voting Rules," *Public Choice* 168, no. 3 (2016): 265–277.

theory of consumers' choice operated with commodity bundles as the alternatives of choice, in Arrow's theory of elections "the alternatives are candidates."<sup>74</sup> Arrow further stated that the "selection of candidates is presumably a device for achieving selection among policies."<sup>75</sup> These candidates represented the social states which were the underlying objects of choice. Arrow provided a comprehensive definition of a social state, which not only included the activities in the private economy but also public goods like military defense, management of international relations, and goods and services provided by local governments.<sup>76</sup> As such, Arrow based his theorem on the commodification of the relationship between politicians and citizens, refuting the very idea of a common good. There were only public goods, the material services provided by government.

Accordingly, Arrow proceeded to criticize a motley crew of eighteenth- and nineteenth-century philosophers and social theorists like Jean-Jacques Rousseau, Immanuel Kant, Karl Marx, and the classical utilitarians. Denying the possibility of making interpersonal comparisons of utility in calculating the public interest, Arrow explicitly targeted their conceptions of the common good.<sup>77</sup> He argued that "if we exclude the possibility of interpersonal comparisons of utility, then the only methods of passing from individual tastes to social preferences which will be satisfactory [...] are either imposed or dictatorial."<sup>78</sup> Arrow thus left the theory of democracy in

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<sup>74</sup> Arrow, *Social Choice and Individual Values*, 12.

<sup>75</sup> *Ibid.*, 6.

<sup>76</sup> *Ibid.*, 17.

<sup>77</sup> *Ibid.*, 81–86.

<sup>78</sup> *Ibid.*, 59.

shambles, arguing that “the doctrine of voters’ sovereignty is incompatible with that of collective rationality.”<sup>79</sup>

While the political context of Arrow’s theorem was undoubtedly the Cold War, he intervened in two different intellectual contexts, the new welfare economics and the socialist calculation debate. However, in so far as Arrow’s theorem was a contribution to debates about the social welfare function in the new welfare economics, the reception of *Social Choice and Individual Values* shows that it was based on a misinterpretation on Arrow’s part. Abram Bergson and Paul A. Samuelson, as well as other contemporary critics, pointed out that Arrow misconstrued the welfare function as a social aggregation of individual preferences.<sup>80</sup> In Samuelson’s and Bergson’s view, the welfare function was individualistic in the sense that it ranked individuals’ preference rankings of social states. Thus, few welfare economists accepted that the possibility theorem refuted their work.

In fact, Arrow’s work was perfectly in line with the tenets of the new welfare economics.<sup>81</sup> As such, it caused little surprise, and welfare economists reviewed *Social Choice and Individual Values* negatively. The welfare economists believed that Arrow primarily addressed questions concerning collective decision-making processes and how to construct them.<sup>82</sup> Though it was

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<sup>79</sup> Ibid., 60.

<sup>80</sup> On this misinterpretation, see Herrade Igersheim, “The Death of Welfare Economics: History of a Controversy,” *History of Political Economy* 51, no. 5 (October 1, 2019): 827–865.

<sup>81</sup> Amadae, *Rationalizing Capitalist Democracy*, 105.

<sup>82</sup> This paragraph builds on Herrade Igersheim, “The Death of Welfare Economics: History of a Controversy” (Working Paper, 2017), <https://papers.ssrn.com/abstract=2901574>.

clearly related to their work, they did not believe the theorem had significant implications for their theories of the social welfare function. Whereas the welfare economists had focused on evaluations of individual welfare, Arrow shifted focus to a conception of the social welfare function as a constitution-like instrument, determining the framework for aggregating individual preferences into social ends. This interpretation allowed Arrow to conflate the debate about the social welfare function with the similar debate about socialist calculation, which *was* about the problem of aggregating individual preferences into social ends.

The Cowles Commission, which Arrow was affiliated with, included several prominent market socialists like Oskar Lange, Jacob Marschak, and Tjalling Koopmans. These economists worked to refute the arguments put forth by Ludwig von Mises and Friedrich Hayek about the difficulties of calculating demand and supply in a socialist planned economy.<sup>83</sup> Arrow did not refer to Hayek, but the possibility theorem was essentially a response to Hayek's theory of the market as a superior information processor.<sup>84</sup> In his most widely celebrated article, the 1945 "Use of Knowledge in Society," which won him the 1974 Nobel Memorial Prize in Economic Sciences, Hayek argued that Lange was completely mistaken in his contention that consumers in evaluating goods through their demand simultaneously evaluate the means of production. The practical problem remained that no single entity, such as a planning board, would be able to ascertain all the relevant information to direct an economy rationally.<sup>85</sup>

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<sup>83</sup> Mirowski, *Machine Dreams*, 302.

<sup>84</sup> *Ibid.*, 302–308.

<sup>85</sup> F. A. Hayek, "The Use of Knowledge in Society," *The American Economic Review* 35, no. 4 (1945): 529–530.

Where Mises had argued that it would be completely impossible to rationally calculate the means of production in a collectivized economy, Hayek conceded that it might be *theoretically* possible for a planning board to manage the information required to coordinate the economy. *In practice*, however, it would not be able to do so.<sup>86</sup> His main contribution to the socialist calculation debate was the assertion that the superiority of the price mechanism rested on its ability to coordinate dispersed knowledge into a coherent social order. Hayek's work on knowledge in the 1940s reiterated that information is decentralized and unevenly dispersed among members of society. Decisions should therefore not be made by a central administration, but rather by those with particular knowledge about the problem at hand. According to Hayek, the beauty of the price mechanism is its efficiency in coordinating these locally made decisions. Competition was "essentially a process of the formation of opinion: by spreading information, it creates that unity and coherence of the economic system which we presuppose when we think of it as one market."<sup>87</sup> In its

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<sup>86</sup> Here I follow the standard account first expounded in Abram Bergson, "Socialist Economics," in *A Survey of Contemporary Economics*, ed. Howard Ellis (Homewood, IL: Richard D. Irwin, Inc., 1948), 412–448. This account is repeated in most literature on the debate. See, for example, Philip Mirowski and Edward Nik-Khah, *The Knowledge We Have Lost in Information: The History of Information in Modern Economics* (Oxford: Oxford University Press, 2017), 62. For a strong argument that Hayek's position did not differ substantially from Mises's, see Lavoie, *Rivalry and Central Planning*, 21.

<sup>87</sup> F. A. Hayek, "The Meaning of Competition," in *Individualism and Economic Order*, by F. A. Hayek (Chicago, IL: University of Chicago Press, 1948), 106.

spontaneous coordination of these millions of preferences, the market escapes the violation of consumers' sovereignty, which was inherent in planning. Hayek's argument that the market is able to compute the millions of tastes composing a society does not survive Arrow's general possibility theorem. In the general possibility theorem, neither the market nor voting is able to produce coherence without violating the sovereignty of the individual. In other words, Arrow's work had devastating consequences for any theory of preference aggregation.

According to Anthony Downs, Arrow's work had "demolished what was left of [Abram] Bergson's social welfare function and dissolved the relationship between individual and social ends which it had tried to establish."<sup>88</sup> However, Downs's model suggested that collective decision-making was not as doomed as Arrow had concluded. In fact, Downs's analysis aimed to prove that Arrow's theorem was not always relevant, and even when it was relevant, it was applicable only to a rather limited range of areas of choice.<sup>89</sup>

The starting point of his analysis was the formalization of voters and politicians as self-interested actors. On the one hand, politicians acted to get reelected by maximizing their share of the vote. "Thus politicians in our model," Downs explained, "never seek office as a means of carrying out particular policies; their only goal is to reap the rewards of holding office *per se*. They treat policies purely as a means to the attainment of their private ends, which they can reach only by being elected."<sup>90</sup> On the other hand, the citizen, according to Downs, "casts his vote for the party he believes will provide him with

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<sup>88</sup> Downs, *An Economic Theory of Democracy*, 18.

<sup>89</sup> *Ibid.*, 18–19.

<sup>90</sup> *Ibid.*, 28.

more benefits than any other.”<sup>91</sup> Citizens were nothing but consumers of public goods and services seeking to maximize their piece of the public pie.

Tellingly, Downs conflated the distinctions between the political and the economic. “Corresponding to the infamous *homo economicus*,” Downs explained, “our *homo politicus* is the ‘average man’ in the electorate, the ‘rational citizen’ of our model democracy.”<sup>92</sup> In his analysis, political man was transformed into economic man. The public and the private remained separate, but any notion of behavioral asymmetry was dissolved. Citizens were treated as consumers in both realms, of public goods in the public economy and of private goods in the private economy. Downs thus transposed the political into an economic key. His model rested on an analogy between economics and politics in which parties behave like firms, politicians like entrepreneurial managers, and voters like customers, choosing the party that best serves their individual demands for public goods and services.

If politicians were merely self-interested economic agents with little concern for the public interest, what was the purpose of ideology? Downs argued that the purpose of ideologies was to reduce uncertainty. Rather than having to acquaint themselves with every issue on the ever-shifting political agenda, voters could merely consult the political parties’ ideological platform and more or less foresee each party’s stance on specific matters of policy.<sup>93</sup>

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<sup>91</sup> *Ibid.*, 36.

<sup>92</sup> *Ibid.*, 7.

<sup>93</sup> *Ibid.*, chapter 7.

In the effort to explain the predictive capacity of this theory of political ideologies, Downs relied on Harold Hotelling's spatial model of competition. Hotelling had articulated a market theory of representative democracy in a side-remark in his 1929 article on "Stability in Competition." Born in 1895, Hotelling was hired by Stanford University's mathematics department in 1927, a position he held until he moved to Columbia University in 1931 and then on to the University of North Carolina at Chapel Hill in 1946. Hotelling's economics was organized around three themes.<sup>94</sup> First, as a mathematician and statistician he was committed to providing economics with a more rigorous theoretical foundation. Second, he was mainly interested in the policy implications of economics. Third, his work was guided by socialist convictions. Hotelling's key concern was improving public policy through mathematical analysis of the market mechanism's ability to maximize the public good. All of these features are apparent in his 1929 article on "Stability in Competition," the only one he produced on the particular issue of competition.

The main context of "Stability of Competition" was the interwar debates about capitalism versus socialism. Hotelling's main point in the article was that market competition tended to produce socially undesirable outcomes, arguing that "our example has also an application to the question of capitalism *v.* socialism, and contributes an argument to the socialist

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<sup>94</sup> Adrian C. Darnell, "The Life and Economic Thought of Harold Hotelling," in *The Collected Economics Articles of Harold Hotelling*, ed. Adrian C. Darnell (New York, NY: Springer New York, 1990), 15, 22.

side.”<sup>95</sup> The wastefulness of competition provided an argument in favor of socialism because the market did not result in a socially optimal society.

To be more specific, “Stability in Competition” examined the conditions of competitive stability in markets, advancing a spatial model of competition. Rather than assume that only one price can be obtained in the market, Hotelling imagined the market as an “extended region.” As illustration he supposed that consumers were uniformly distributed along a line of fixed length—for example, the main street in a town. Now imagine two stores selling exactly the same product at exactly the same price but located at different ends of the street. Given that the model’s consumers differ only in terms of geographical location along the street, they will choose the store which is closest because it provides the lowest cost of transportation. Only consumers who live exactly halfway between the two stores will be indifferent as to which store to buy the product at. The implication of Hotelling’s spatial model is that stores and firms will tend to move geographically closer to each other in order to win customers from the competing firm. As a result, firms tend to “cluster unduly,” in discordance with the public interest, as “more and more sellers of the same commodity arise.”<sup>96</sup>

Hotelling pointed out that his spatial model could be used in several areas not usually considered within the purview of economics. He argued that the tendency for competing units to cluster around a median was so general that it was not confined to economic life:

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<sup>95</sup> Harold Hotelling, “Stability in Competition,” *The Economic Journal* 39, no. 153 (1929): 52.

<sup>96</sup> *Ibid.*, 45, 14.

In politics it is strikingly exemplified. The competition for votes between the Republican and the Democratic parties does not lead to a clear drawing of issues, an adoption of two strongly contrasting positions between which the voter may choose. Instead, each party strives to make its platform as much like the other's as possible. Any radical departure would lose many votes, even though it might lead to stronger commendation of the party by some who would vote for it anyhow. Each candidate 'pussyfoots,' replies ambiguously to questions, refuses to take a definite stand in any controversy for fear of losing votes. Real differences, if they ever exist, fade gradually over time though the issues may be as important as ever.<sup>97</sup>

In Hotelling's model of competition, political differences between the parties, just as the location of the stores on main street, would gradually disappear and cluster around a median. The implication of Hotelling's spatial model was that the center, whether geographical, economic, social, or political, would always be served better than the periphery. The result was that the public interest ceased to be the object of policy. Winning by catering to the majority, at the expense of the minority, was the only goal in politics. Competition for votes, rather than responsiveness to the public interest, was the essence of politics under democratic capitalism, according to Hotelling.

We see, then, in Hotelling's 1929 article the first signs of an economic theory of democratic representation. Much like the public finance theorists engaging with increasing government expenditures, Hotelling's model redescribed voters as customers being served by politicians competing for their vote. However, crucially, his analysis was a critical complaint about the spread of market-like patterns of competition to politics. To

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<sup>97</sup> Ibid., 54–55.

Hotelling, the resulting lack of responsiveness to the broader interests of communities was deplorable. This insight was lost in subsequent developments of the theory of democracy as a competition between politicians.

It was certainly overlooked, or ignored, by Downs. He nonetheless used Hotelling's model according to which the parties in a two-party system tended to converge on the median voter. "Whereas parties in a multi-party system try to remain as ideologically distinct from each other as possible," Downs explained, "parties in a two-party system deliberately change their platforms so that they resemble one another."<sup>98</sup> However, Downs completely missed the fact that Hotelling's model was meant as a critique of the way in which competition results in neglect of the public interest in favor of the coveted median. He instead legitimized the result as a proof of representative democracy's ability to reach a state of equilibrium. He thus purported to explain the prevalence of centrist politics by reference to the self-interest of voters and politicians. This has become the dominant conception of party politics in America and Western Europe, accepted by political scientists and commentators as the explanation for what they consider the empirical fact of ideological convergence between political parties.

While Downs's spatial model of political competition relied on the assumption that citizens vote according to their preferences for public goods and services, against the background of his theory of information costs he also argued that citizens' role in politics was very limited. The problem was not so much whether or not citizens were able to acquire the

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<sup>98</sup> Downs, *An Economic Theory of Democracy*, 115.

relevant and necessary information, but whether the costs of acquiring it would prevent them from doing so. Downs thus played on the theme of the ignorance of the masses but shifted the vocabulary to the cost-benefit analytical terms of economics. The result was strikingly different from what previous theorists of democracy had argued. In Downs's model it was no longer a question of the ability of the masses to acquire information but a question of costs. Citizens, in Downs's theory, were not irrational. Their lack of information was instead considered rational.

Downs thus argued that the "information-seeker continues to invest resources in procuring data until the marginal return from information equals its marginal cost."<sup>99</sup> Such was the cost-benefit analysis of the voter. When marginal return met marginal cost in the equilibrium equation, voters had acquired enough information to make their decision. In other words, the degree of ignorance in political matters was rooted in individual analyses of the costs and benefits of obtaining the relevant information. In most cases, benefits were negligible and costs high.

Three factors determined the size of voters' investments in information. "The first is the value to him of making a correct decision as opposed to an incorrect one."<sup>100</sup> If voters derived no value from investing in making the best decision, they would not vote. The second factor was the "relevance of the information to whatever decision is being made."<sup>101</sup> That is, voters engaged in an estimation of the probability of the chances the acquired knowledge had of making them change

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<sup>99</sup> *Ibid.*, 215.

<sup>100</sup> *Ibid.*

<sup>101</sup> *Ibid.*

their decision. The third factor was the cost of obtaining information. According to Downs, the “comparison of the estimated marginal cost and estimated marginal return of any bit determines whether this particular bit should be acquired.”<sup>102</sup> Though these were highly innovative shifts to the register of economics, his conclusions about voters’ willingness and ability to acquire the necessary knowledge to participate in elections were perfectly in line with Walter Lippmann’s arguments in *Public Opinion* from 1922 and *The Phantom Public* from 1925.

Born in 1889, Walter Lippmann became one of the nation’s most prominent public intellectuals, famous for his combination of journalism and political philosophy.<sup>103</sup> In his 1922 *Public Opinion*, Lippmann argued that citizens could simply not have a competent opinion about the increasingly complex issues facing a modern society. The traditional democratic ideals of the nineteenth century had become outdated. People, divided in the pursuit of their own purposes, were both unable and unwilling to participate in the complex public affairs of the nation.

The problem was that the world that had to be dealt with politically was out of sight. It had to be “explored, reported, and imagined.” Perceptions of reality were always mediated, and in order to create the illusion of a “Public Opinion,” a “National Will,” a “Group Mind,” or a “Social Purpose” experts were required. “[R]epresentative government, either in what is ordinarily called politics, or in industry,” he explained, “cannot

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<sup>102</sup> Ibid., 216.

<sup>103</sup> For a brilliant intellectual biography of Walter Lippmann, see Ronald Steel, *Walter Lippmann and the American Century* (New Brunswick, NJ: Transaction, 1999).

be worked successfully, no matter what the basis of election, unless there is an independent, expert organization for making the unseen facts intelligible to those who have to make the decisions."<sup>104</sup> According to Lippmann traditional democratic theory never confronted the problem that arose from the discrepancy between ideals and reality.

Instead, traditional democratic theorists, Lippmann claimed, assumed that society was in harmony. Democratic idealists knew that citizens' political knowledge was limited, that the area of self-government was not boundless, and that communities were not as self-contained as their theory required.<sup>105</sup> Democratic idealists, in Lippmann's account of their views, recognized that "[c]onditions must approximate those of the rural township if the supply of information is to be left to casual experience."<sup>106</sup> However, this circumscribed version of the democratic community was wholly unfit for the complexities of the modern experience.

"In the absence of institutions and education by which the environment is so successfully reported that the realities of public life stand out sharply against self-centered opinion," Lippmann argued, "the common interests very largely elude public opinion entirely, and can be managed only by a specialized class whose personal interest reach beyond the locality."<sup>107</sup> He thus explained that the public interest would have to be produced by a superior class of experts who were able to see beyond their own parochial interests. Lippmann

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<sup>104</sup> Walter Lippmann, *Public Opinion* (Brunswick, NJ: Transaction Publishers, 1992), 30-31.

<sup>105</sup> *Ibid.*, 264-267.

<sup>106</sup> *Ibid.*, 270.

<sup>107</sup> *Ibid.*, 310.

claimed that this professional class's superior ability to manage the complex supply of information would be sufficient to make the common good intelligible to the public.

Nonetheless, in the space of just a few years, Lippmann's concerns about the limitations of democracy grew darker. Not only did the average citizen not possess adequate competences to participate in the public affairs of the nation, Lippmann now argued that the public was but a phantom. In the 1925 *The Phantom Public*, Lippmann asserted of the citizen that "[i]n the cold light of reason he knows that his sovereignty is a fiction. He reigns in theory, but in fact he does not govern."<sup>108</sup> The omniscient citizen of traditional democratic theory was an unattainable ideal, a myth. The general public's participation in political affairs should be confined to an absolute minimum and limited to procedural concerns: "To support the Ins when things are going well; to support the Outs when they seem to be going badly, this, in spite of all that has been said about tweedledum and tweedledee, is the essence of popular government."<sup>109</sup> This procedural definition of democracy, very similar to Schumpeter's, underscored the need for a professional class.

Anthony Downs admitted that his conclusions tended to "prove logically contentions that Lippmann and others have reached by observing politics empirically";<sup>110</sup> but whereas Lippmann asserted that it was impossible, or at least difficult, for people to reach an informed decision about public issues because of socio-psychological limitations, Downs shifted the

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<sup>108</sup> Walter Lippmann, *The Phantom Public* (New Brunswick, NJ: Transaction Publishers, 1993), 4.

<sup>109</sup> *Ibid.*, 117.

<sup>110</sup> Downs, *An Economic Theory of Democracy*, 14n12.

register to that of economics. This allowed him to produce a novel theory of abstention from voting.

He started from the simple, but very real observation that “[c]itizens in a democracy who are eligible to vote in democratic elections often fail to do so.”<sup>111</sup> Downs argued that if there were zero costs to voting, those who were indifferent to the outcome of the election would not vote, while those who had any kind of preferences would go to the voting booth. As such, in this simple model, the degree of indifference was the key to explaining abstention from voting in zero-cost elections. The problem arose when the returns of voting were introduced into the model. According to Downs, “the returns from voting are usually so low that many voters abstain; hence tiny variations in the cost can sharply redistribute political power.”<sup>112</sup> This was especially to the disadvantage of low-income groups for whom the costs of obtaining the required information was often greater than the benefits they received. They simply required higher returns from voting to bear the costs of obtaining the necessary information, which high-income groups were better able to pay. This resulted in low-income groups being less informed and thus more uncertain, which again led them to discount the returns of voting.

From his novel theory of the logic of abstention, Downs reached the same conclusion as Lippmann about the consequences of uncertainty and the costs for citizens of obtaining the necessary information to participate in politics. “In any society which contains uncertainty and a division of labor,” Downs explained, “men will not be equally well-informed

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<sup>111</sup> *Ibid.*, 260.

<sup>112</sup> *Ibid.*, 274.

politically, no matter how equal they are in all other respects.”<sup>113</sup> In other words, an expert elite necessarily emerges who, because it is better informed, has greater influence over government policy formation. “This conclusion emphasizes once more,” Downs pointed out, “the inherent inequality of political power in democratic societies.”<sup>114</sup> To Downs, democratic politics was thus not necessarily at odds with domination. Instead, he concluded that “the cost of information prevents our model government from ever functioning by consent of the governed in a pure sense.”<sup>115</sup> In Downs’s model of democracy, then, informational asymmetries justify, or at the very least explain, the emergence of political and administrative elites. These elites have little sense of the public interest. Aiming only to be reelected, they cluster around the median voter.

Downs, elaborating on other theories of political competition, offered a comprehensive explanation of democratic decision-making in economic terms, which answered the problem of optimal output in the provision of public goods and services. Treating parties like firms, politicians as entrepreneurs, and voters as customers shopping for policy packages had the advantage that it made the political process similar to the market mechanism. The model allowed voters, in an individual rather than collective capacity, to leave a party and its package of political goods and services if it did not suit their wants.

This was symptomatic of a reduction of politics to self-interested consumption, leaving no room for public-interestedness. This has become a dominant conception of the

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<sup>113</sup> *Ibid.*, 221.

<sup>114</sup> *Ibid.*, 247–257.

<sup>115</sup> *Ibid.*, 257.

purpose of political parties. They no longer seem to be organizations in which people find a sense of purpose and belonging. They merely exist to satisfy voters' wants for public goods and services, not necessarily to make society a better place. In explaining this transformation of mass political parties into firm-like organizations, previous research has emphasized the processes of globalization and individualization. By contrast, this chapter has shown that the conception of parties as firms competing for voters is inexplicable without reference to the advent of the compensatory state. The change began not in the 1970s but early in the postwar period. It reflected the fact that politicians had come to resemble businesspeople in charge of firms offering goods and services in exchange for citizen-customers' votes.

Public choice theorists all sought market-like solutions to this commodification of the common good. Downs's theory confirmed the ability of party competition to produce a stable political system, meeting the demands of voters efficiently. Other public choice theorists strongly opposed this argument, however. The next chapter shows how James M. Buchanan articulated a radically different conception of democracy. Believing that majority voting, which Downs favored, resulted in transgressions of the rights of minorities, Buchanan argued for a revival of voluntary exchange. Only unanimity, he claimed, would make politics resemble the direct-democratic exchange which he believed characterized the market.



# 3

## The Revival of Voluntary Exchange

Late 1970s America saw the advent of a strong tax resistance movement, which resulted in legislative measures to restrict the taxing and spending capacity of state and local governments. This was not the first instance of successful tax resistance in American history. Balanced-budget requirements, for example, had long constrained American states' fiscal flexibility. Introduced as either constitutional or statutory provisions from the late nineteenth to the mid-twentieth century, these requirements stipulate that government revenue must correspond with government spending.<sup>1</sup> This sounds like good home economics, but when applied to the public household it seriously risks undermining the states' ability to react to crises, which typically necessitate budgetary deficits. What set the 1970s and 1980s tax revolt apart was the effort to introduce supermajority votes for the approval of tax increases. For example, the infamous Proposition 13, introduced in California in 1978, required a two-thirds majority approval of future tax increases in both houses of the state legislature. By the early 2000s, sixteen states required legislative

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<sup>1</sup> Daniel L. Smith and Yilin Hou, "Balanced Budget Requirements and State Spending: A Long-Panel Study," *Public Budgeting & Finance* 33, no. 2 (2013): 6.

or electoral supermajority to approve tax increases.<sup>2</sup> In combination with balanced-budget requirements and taxing and spending limits, American state and local governments have trouble providing the essential public goods and services that American citizens need and demand, affecting the level of welfare negatively.

Though the background of the tax revolt was multifaceted, and causes differed from place to place, there is no doubt that Nobel laureate James Buchanan played an important role in the intellectual history of supermajority rules. Buchanan has become a controversial figure. Arguing that he was the mastermind of the radical right, Nancy MacLean has argued that Buchanan's constitutionalism evolved in response to Southern desegregation imposed by the federal government.<sup>3</sup> Though the account generated enormous controversy, recent research has followed

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<sup>2</sup> Melinda Cooper, "Infinite Regress: Virginia School Neoliberalism and the Tax Revolt," *Capitalism: A Journal of History and Economics* 2, no. 1 (2021): 70.

<sup>3</sup> Nancy MacLean, *Democracy in Chains: The Deep History of the Radical Right's Stealth Plan for America* (New York, NY: Viking, 2017). On the context of racism, see especially Phillip W. Magness, Art Carden, and Vincent Geloso, "James M. Buchanan and the Political Economy of Desegregation," *Southern Economic Journal* 85, no. 3 (2019): 715–741; Jean-Baptiste Fleury and Alain Marciano, "The Sound of Silence: A Review Essay of Nancy MacLean's *Democracy in Chains: The Deep History of the Radical Right's Stealth Plan for America*," *Journal of Economic Literature* 56, no. 4 (2018): 1492–1537. On the mastermind claim, see Ross B. Emmett, "Reading the Hermeneutics of Suspicion with Suspicion: A Review Essay on Nancy MacLean's *Democracy in Chains: The Deep History of the Radical Right's Plan for America*" (Working Paper, 2018),

MacLean's example. Embedding Buchanan in Southern tax resistance, Melinda Cooper has argued that he influenced the deconstruction of American states' fiscal capacity.<sup>4</sup>

This chapter downplays Buchanan's influence, arguing that his work was mostly a political failure. Placing Buchanan's political thought in the context of public goods theory, it shows that the foundation of his political thought was the revival of the direct-democratic theory of voluntary exchange, which he intended as a solution to the problem of optimal output.<sup>5</sup> The basis of this fiscal principle is the idea that the relationship

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[https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3187542](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3187542).

<sup>4</sup> Cooper, "Infinite Regress."

<sup>5</sup> In making this argument, I rely on the many accounts of Buchanan's career. See Jürgen G. Backhaus and Richard E. Wagner, "From Continental Public Finance to Public Choice: Mapping Continuity," *History of Political Economy* 37, Annual Supplement (2005): 314–332; Marianne Johnson, "Wicksell's Unanimity Rule: Buchanan's Dominance Considered," *American Journal of Economics and Sociology* 64, no. 4 (2005): 1049–1071; Marianne Johnson, "The Wicksellian Unanimity Rule: The Competing Interpretations of Buchanan and Musgrave," *Journal of the History of Economic Thought* 28, no. 1 (2006): 57–79; John Meadowcroft, *James M. Buchanan* (New York, NY: Continuum International Publishing Group, 2011); Marciano, "Why Market Failures Are Not a Problem"; Johnson, "James M. Buchanan, Chicago, and Post-War Public Finance"; Johnson, "Public Goods, Market Failure, and Voluntary Exchange"; Alain Marciano, "Buchanan and Pro-Social Behaviors: Why Ethics Is Necessary," *Economia. History, Methodology, Philosophy* 5, no. 3 (2015): 295–311; Alain Marciano, "Buchanan's Non-Coercive Economics for

between citizens and the state should be *quid pro quo*, meaning that taxpayers only receive the goods, services, and benefits for which they have opted to pay. Buchanan's principal contribution to public choice theory, and the marketization of government, was his argument that the best way to secure voluntary exchange in the political marketplace was a constitutionally embedded unanimity criterion. This would prevent majority tyranny by making politics more akin to the voluntary exchange he believed characterized the relationship between customers and firms in the private economy. Aware that the introduction of a unanimity rule was unfeasible, however, he began advocating a combination of qualified majority rules and balanced-budget requirements in the late 1970s. Though such rules were important at the local and state levels, Buchanan's concern was with introducing limits at the

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Self-Interested Individuals: Ethics, Small Groups, and the Social Contract," *Journal of the History of Economic Thought* 38, no. 1 (2016): 1–20; Peter J. Boettke and Alain Marciano, "The Distance between Buchanan's 'An Economic Theory of Clubs' and Tiebout's 'A Pure Theory of Local Public Expenditures.' New Insights Based on an Unpublished Manuscript," *The European Journal of the History of Economic Thought* 24, no. 2 (2017): 205–237; Richard E. Wagner, *James M. Buchanan and Liberal Political Economy: A Rational Reconstruction* (Lanham, MD: Lexington Books, 2017); Alain Marciano, "Buchanan and Public Finance: The Tennessee Years," *The Review of Austrian Economics* 32 (2019): 21–46; Jean-Baptiste Fleury and Alain Marciano, "The Making of a Constitutionalist: James Buchanan on Education," *History of Political Economy* 50, no. 3 (2018): 511–448; Marianne Johnson, "Rules versus Authorities," *Public Choice* 175, no. 3 (2018): 219–228.

federal level, an ambition that never materialized. This concern emerged in response to the challenges associated with making the supply of public goods and services meet citizens' demands in a market-like fashion.

The American South was a special target of both New Deal and Fair Deal policies, which aimed to revive economic growth in the region. The Tennessee Valley Authority, established in 1933, was emblematic of these efforts. The Valley was a particularly destitute area of the United States in the 1930s, with one of the lowest average incomes in the country. The purpose of the Tennessee Valley Authority was to modernize the region by constructing dams to provide electricity, improving farming practices, and employing a large number of people. The public-utility company was one of Roosevelt's greatest successes, which helped prove that government intervention was a key factor in creating economic growth.

The concern for the Southern United States was a driving force in James M. Buchanan's effort to make politics resemble the market.<sup>6</sup> In opposition to New Deal efforts to improve the region, he worked to reduce the scope and reach of the federal state. Born in 1919, Buchanan grew up in rural poverty in Tennessee. Over the years, he repeatedly stressed his destitute agricultural origins as an important part of his intellectual development. Buchanan's origins narrative served political purposes. Firstly, it subtly conveyed that he knew poverty intimately, in effect shielding him from charges of disregard for the poor. Secondly, it nurtured his sense of being an outsider, in terms of both his political views and his economics. His origins were quite usual, however. It was a common characteristic

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<sup>6</sup> On this, see Marciano, "Buchanan and Public Finance."

among men and women of his generation to shift from childhood poverty to well-off adulthood in academia. To a large extent, this shift was a result of the very welfare state that he spent his career trying to limit.

Though poor, Buchanan's family was important in the local community. Emblematic of the family's position in the county, the local public school Buchanan attended was named the Buchanan School after his paternal grandfather, John P. Buchanan, who had been a one-term governor of the state of Tennessee. In his own telling, from his early years, Buchanan "was assigned the role as family successor to my grandfather. I was to be the lawyer-politician, and Vanderbilt University (prelaw, then law) was understood as the final rung on my educational ladder."<sup>7</sup> Despite worries that he did not have the extrovert disposition to become a politician, he was trained in public speaking. But the Great Depression destroyed his dream of earning a law degree. Economic realities made a degree from Vanderbilt University impossible. Instead, Buchanan attended the local "Middle Tennessee State Teachers College in Murfreesboro, which allowed me to live at home and to earn enough for fees and books by milking dairy cows morning and night for four years."<sup>8</sup> Graduating from Middle Tennessee in 1940, he was drafted into the United States Navy in 1941 before he could take up a fellowship in statistics at Columbia University in New York City. In 1945, he joined the vast number of veterans who took advantage of the GI Bill's opportunities for further schooling. Having spent

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<sup>7</sup> James M. Buchanan, *Economics from the Outside In: "Better than Plowing" and Beyond* (College Station, TX: Texas A & M University Press, 2007), 2.

<sup>8</sup> *Ibid.*

some time during the war in New York, he decided not to take Columbia up on its prewar offer. Instead, on the recommendation of a former teacher from Middle Tennessee, he enrolled in the University of Chicago's graduate program in economics.<sup>9</sup>

What were Buchanan's formative intellectual influences during these years? Roy Blough supervised Buchanan's dissertation.<sup>10</sup> The two did not get along, however, and Buchanan soon gravitated towards Frank Knight, a preeminent economist in the 1930s and an important figure in the early development of the so-called Chicago School of Economics.<sup>11</sup> His dissertation, "Fiscal Policy in a Federal State," completed in 1948,

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<sup>9</sup> On Buchanan's formative experiences, see Johnson, "The Wicksellian Unanimity Rule"; Johnson, "Wicksell's Unanimity Rule"; Marciano, "Why Market Failures Are Not a Problem"; Johnson, "James M. Buchanan, Chicago, and Post-War Public Finance"; Johnson, "Public Goods, Market Failure, and Voluntary Exchange"; Marciano, "Buchanan and Public Finance"; Johnson, "Rules versus Authorities"; Fleury and Marciano, "The Making of a Constitutionalist: James Buchanan on Education."

<sup>10</sup> Johnson, "James M. Buchanan, Chicago, and Post-War Public Finance," 482.

<sup>11</sup> On Frank Knight and the Chicago School, see Ross B. Emmett, *Frank Knight and the Chicago School in American Economics* (London: Routledge, 2009). On the Chicago School, see Robert Van Horn, Philip Mirowski, and Thomas A. Stapleford, eds., *Building Chicago Economics: New Perspectives on the History of America's Most Powerful Economics Program* (Cambridge: Cambridge University Press, 2011); Robert Van Horn and Philip Mirowski, "The Rise of the Chicago School of Economics and the Birth of Neoliberalism," in *The Road from Mont Pèlerin: The Making of the Neoliberal Thought*

was strongly influenced by the free-market atmosphere in the Economics Department at the University of Chicago. During his first year at Chicago, among other courses, Buchanan took Knight's course on price theory and Henry Simons's on the "Economics of Fiscal Policy."<sup>12</sup>

However, it was the discovery of the Swedish economist Knut Wicksell's 1896 *Finanztheoretische Untersuchungen* that had the greatest impact on Buchanan's theory of the state. In the late 1940s, Buchanan revived and defended the theory of voluntary exchange and the principle of unanimity, which Richard Musgrave and Paul Samuelson had rejected as unfeasible. Following Wicksell, Buchanan aimed to develop an individualistic theory of democratic government. The rule of unanimity was a vital component of Buchanan's model of the state because it allowed citizens to exit public goods and services they did not want.

In 1949, Buchanan's article "The Pure Theory of Government Finance" appeared in the *Journal of Political Economy*. In it, Buchanan distinguished between two opposing political theories of the state which could provide the foundations for a pure theory of government finance:

In the first, or what might be called the "organismic," theory, the state, including all individuals within it, is conceived as a single organic entity. In the second, the state is represented as the sum of its individual members acting in a collective capacity. The individual and the state are fundamentally opposing forces in the latter concept, while in the organic view the state, or general interest, subsumes all individual

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*Collective*, ed. Philip Mirowski and Dieter Plehwe (Cambridge, MA: Harvard University Press, 2009), 139–178.

<sup>12</sup> Johnson, "James M. Buchanan, Chicago, and Post-War Public Finance," 483–484.

interests. The theory of government finance based upon the second concept of the state may be called the “individualistic” one.<sup>13</sup>

To Buchanan, concepts like “social welfare,” “social utility,” “public interest,” “common good,” and “general will” had little meaning. Instead, he emphasized that the state did not have any ends as a separate entity apart from its individual members. Importantly, to Buchanan “[t]he income of the state represents payment made by individuals out of their economic resources in exchange for services provided.”<sup>14</sup> What public goods and services were to be provided could not be determined with reference to a common good; that depended only on “the collective willingness of individuals to purchase them.”<sup>15</sup> To Buchanan, the relationship between citizens and governments ought to be based on voluntary exchange. Politics was no different than the market in so far as both were concerned with the exchange of goods and services. Like Richard Musgrave, Howard Bowen, Paul Samuelson, and Anthony Downs, then, he relied on a commodified vision of the state as a provider of public goods rather than the servant of the public good. Buchanan’s economic conceptualization of politics was much stronger, however, because he believed that the relationship between citizens and their government should be voluntary and modeled on market exchange.

Buchanan argued that the rejection of *quid pro quo* amounted to a violation of the individual citizen. “The procedure of leaving out the benefit side amounts to concluding that

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<sup>13</sup> James M. Buchanan, “The Pure Theory of Government Finance: A Suggested Approach,” *Journal of Political Economy* 57, no. 6 (1949): 496.

<sup>14</sup> *Ibid.*, 498.

<sup>15</sup> *Ibid.*, 499.

each individual actually gets no benefit whatsoever from the government services provided him," Buchanan argued.<sup>16</sup> This was obviously unacceptable to someone trying to construct a theory of the state on individual foundations. If individuals did not know how they benefited from public goods and services, government would not exist. No one, according to Buchanan, would be willing to pay the necessary taxes.

Citizens, Buchanan believed, should know what their taxes were being used for and how they benefited from these expenditures individually. The organismic theory of the state therefore amounted to a violation of individual rights. Buchanan's ethical ideal was a government that provided only the goods and services that citizens in their individual capacity approved of. Ideally, this required unanimity among citizens. This would solve the practical difficulty of imputing individual shares of the aggregate benefit of government-provided goods and services. Buchanan believed that public goods would be provided for if the benefits of their provision exceeded the costs of providing them.<sup>17</sup> This was a much more radically marketized conception of the relationship between citizens and their government than that advanced by Musgrave, Bowen, Samuelson, and Downs. While they all relied on a commodified conception of the state, Buchanan's theory of politics as exchange was based on a more complete analogy between the market and politics.

In the early 1950s, Buchanan continued to apply the principles of unanimity and voluntary exchange to problems associated with publicly provided goods and services.<sup>18</sup> In "Federalism

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<sup>16</sup> *Ibid.*, 500.

<sup>17</sup> *Ibid.*, 499.

<sup>18</sup> Johnson, "Public Goods, Market Failure, and Voluntary Exchange," 183.

and Fiscal Equity,” for example, he addressed the problem of fiscal inequalities between the American states, which had acquired urgency because of some fundamental changes in the structure of the American public economy. He listed three developments:

First, the continual industrialization, specialization, and integration of the economy on a national scale has tended to concentrate high income receivers in specific geographical areas. Second, there has been an extension of the range of governmental activity at all levels in the political hierarchy [...] Third, this extension of governmental activity at the lower levels of government (and in peacetime at the top level) has taken place largely through the increase in the provision of social services.<sup>19</sup>

In other words, the federal political system’s most acute problem was the discrepancy between an increasingly integrated national economic system and a political structure that continued to be decentralized in state units. The appearance of the social state had made these disparities between the states apparent. Though Buchanan agreed that political centralization would solve the fiscal problem of federalism, he contended that “political centralization as a proposal for solution is precluded if we accept the desirability of maintaining the federal form.”<sup>20</sup> Buchanan clearly favored federalism.<sup>21</sup> Once again, his solution was to advance the benefit principle, arguing that “interstate differences in fiscal capacity should be traced to their ultimate impact upon individuals.” This would result in stronger support for

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<sup>19</sup> James M. Buchanan, “Federalism and Fiscal Equity,” *The American Economic Review* 40, no. 4 (1950): 584.

<sup>20</sup> *Ibid.*, 585.

<sup>21</sup> *Ibid.*, 584.

equalization between the states.<sup>22</sup> This, in turn, required a robust concept of fiscal justice. The concept of fiscal justice that Buchanan developed was the principle of “equal treatment of equals.” This, Buchanan explained, required that “the object of comparison should be the aggregate fiscal pressure upon the individual or family, not tax treatment alone. The balance between the contributions made and the value of public services returned to the individual should be the relevant figure.”<sup>23</sup> Buchanan thus argued that the problem of fiscal disparities between the states should be solved against the background of the benefit principle.

However, Buchanan conceded that central government intervention through discriminatory personal income taxation would be necessary to redistribute from high-income areas to low-income areas. This would be necessary, Buchanan argued, if the decentralized political power structure were to survive in an era of national economic integration.<sup>24</sup> Very clearly, then, Buchanan was responding to the tension between an unprecedented expansion of the national economy and the decentralized political structure that divided power among the states. Buchanan’s solution, as always, was the application of the unanimity principle as the best expression of individual consent to being governed.

In 1951, Buchanan applied this principle to the problem of decreasing-cost industries in the article “Knut Wicksell on Marginal Cost Pricing,” published in the *Southern Economic Journal*. It was in this paper that he first made the connection between the Pareto criterion, which defines the optimal state

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<sup>22</sup> Ibid., 586.

<sup>23</sup> Ibid., 587 and 588.

<sup>24</sup> Ibid., 595 and 599.

of allocation as one in which no individuals can be made better off without making at least one individual worse off, and Wicksell's unanimity principle.<sup>25</sup> The brief paper mostly paraphrased and summarized Wicksell's theories of public finance, but at the end of the paper, Buchanan suddenly argued that Wicksell's "special theory of taxation in accordance with the principle of unanimity can be interpreted in terms of the Paretian conditions of optimum welfare. Obviously," he interjected, "no one is worse off if some allocation of the required tax can be found which is acceptable to everyone."<sup>26</sup> According to Buchanan himself, this equation between Wicksell's unanimity rule and Pareto optimality was an important development in his thinking.<sup>27</sup>

Buchanan developed this equation as part of a debate on marginal cost pricing. Once again, the market analogy intersected with a debate about publicly provided goods and services and the associated questions of revenue and expenditure. When Buchanan intervened in the early 1950s, however, the debate about marginal cost pricing was ebbing. Just a decade before, it had raged in the aftermath of Harold Hotelling's 1939 "The General Welfare in Relation to Problems of Taxation and of Railway and Utility Rates."<sup>28</sup> The marginal

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<sup>25</sup> For this point, see Johnson, "Public Goods, Market Failure, and Voluntary Exchange," 184.

<sup>26</sup> James M. Buchanan, "Knut Wicksell on Marginal Cost Pricing," *Southern Economic Journal* 18, no. 2 (1951): 177.

<sup>27</sup> Johnson, "Public Goods, Market Failure, and Voluntary Exchange," 183.

<sup>28</sup> Harold Hotelling, "The General Welfare in Relation to Problems of Taxation and of Railway and Utility Rates," *Econometrica* 6, no. 3 (1938): 242-269.

cost controversy was the third of the three major debates of the 1930s and 1940s that intersected with the debate about public expenditures. The other two were the debates about planning versus markets and the economics of welfare. The common theme of these debates was that they entailed consequences for the relationship between individuals and their government in the context of an expanding public sector.

The debate over marginal costs in decreasing-cost industries was about how prices in a decreasing average cost enterprise, like railways and public utilities, should be determined.<sup>29</sup> Hotelling suggested that they should be set at marginal cost with subsidies covering the fixed costs.<sup>30</sup> In 1946, Ronald Coase, an economist at the London School of Economics who received the 1991 Nobel Memorial Prize in Economic Sciences, argued in favor of multipart pricing to preserve a market-based signaling of demand.<sup>31</sup> Buchanan's solution was to apply the benefit principle, meaning that every individual paid for the goods they consumed and the services they used.

Buchanan conceded that such voluntary exchanges were subject to the criticisms mounted by Musgrave.<sup>32</sup> However,

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<sup>29</sup> For an outline history of the marginal cost controversy, see Brett M. Frischmann and Christiaan Hogendorn, "Retrospectives: The Marginal Cost Controversy," *The Journal of Economic Perspectives* 29, no. 1 (2015): 193–205.

<sup>30</sup> Hotelling, "The General Welfare in Relation to Problems of Taxation and of Railway and Utility Rates."

<sup>31</sup> R. H. Coase, "The Marginal Cost Controversy," *Economica* 13, no. 51 (1946): 169–182.

<sup>32</sup> Buchanan, "Knut Wicksell on Marginal Cost Pricing," 178n13.

Buchanan argued that the funding for decreasing-cost industries “through voluntary contributions by beneficiaries seems more plausible than such financing of the more general governmental functions.”<sup>33</sup> Contrary to Musgrave’s assertion, Buchanan believed that voluntary exchange was feasible, arguing that “Wicksell’s proposal scarcely seems more impractical and unrealistic than many of the more sophisticated modern proposals for the application of the marginal cost pricing rule.”<sup>34</sup> Buchanan’s defense of the application of voluntary exchange to decreasing-cost industries was the simple one that the benefits of railways, public utilities, and other services provided by decreasing-cost enterprises were more tangible than other publicly provided goods and that people would therefore wish to contribute to their funding.

In the mid-1950s, Buchanan turned from public finance theory to constitutional theory. The outcome was a conception of unanimous voting as a Pareto-optimal situation. Only unanimity, according to Buchanan, could make politics resemble the marketplace. He proceeded to outline a constitutional framework that would remake democratic politics in the image of the market, at least at the constitutional stage.

Constitutionalism holds a prominent place in the history of American political thought. At the turn of the twentieth century, American lawyers and legal scholars turned their attention to economic matters. While a stress on private property rights informed legal thinking in the nineteenth century, the twentieth century saw an increasing emphasis on the need to curtail economic power. Stressing empirical evidence, legal

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<sup>33</sup> *Ibid.*, 178.

<sup>34</sup> *Ibid.*

realists of the 1920s and 1930s criticized the tendency of traditional constitutionalism to restrain the power of government. The civil rights movement and the growing demand for economic and social change in the 1960s further emphasized that government needed to be allowed to play a greater role in American life.<sup>35</sup> Buchanan's early constitutional theory was at once at odds with and in congruence with these developments. On the one hand, his constitutional theory sought to provide the productive state with a legitimate foundation. On the other hand, his unanimity solution inevitably pointed toward a smaller government.

The story of Buchanan's constitutional turn begins with Arrow's general impossibility theorem. In two articles published in the *Journal of Political Economy* in 1954, Buchanan engaged Arrow's work. In these two articles, his concerns about the state of democracy in the face of expanding public expenditures intersected with the calculation debate. The intellectual origins of Buchanan's view of the market were Knut Wicksell's work on public finance, Frank Knight's teachings, and the free-market attitude at Chicago. His discovery of the works of Mises and Hayek in the mid-1950s seems to have provided the last push in the development of his view of the market and how its choice process differed from that of politics. In making his distinctions between decision-making in the market and in politics, Buchanan essentially followed the outlines of Hayek's conceptualization of the market as a

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<sup>35</sup> On postwar constitutionalism, see Herman Belz, "Changing Conceptions of Constitutionalism in the Era of World War II and the Cold War," *The Journal of American History* 59, no. 3 (December 1972): 640.

mechanism for the coordination of individual preferences, which central planners and traditional voting procedures would never be able to replicate.

In "Social Choice, Democracy, and Free Markets," published in April 1954, Buchanan took issue with Arrow's assertion that the market, like voting, is unable to produce stable collective outcomes. "By the very nature of free markets," Buchanan counterargued, "the only entity required to compare two social alternatives when a choice is actually made is the individual."<sup>36</sup> The market, in contrast to politics, had no need for collective entities. "And, since individual orderings are assumed to be connected and transitive," he explained, "the market mechanism does provide a means of *making consistent choices*, as long as individual values remain unchanged."<sup>37</sup> In contrast to the political process of voting, then, markets were as consistent and rational as the individuals making the choices. According to Buchanan, the virtue of the market, compared to voting, is that it avoids the necessity of constructing consensus in a social welfare function.

In extension of this point, Buchanan argued that "the consistency of market choice is achieved without the overruling of minority values, as would be the case if ordinary political voting were made consistent."<sup>38</sup> While politics necessarily requires violation of individual preferences, the market allows everyone to express their choice. Buchanan pointed out that the only way to make political decisions resemble those made

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<sup>36</sup> James M. Buchanan, "Social Choice, Democracy, and Free Markets," *Journal of Political Economy* 62, no. 2 (1954): 122.

<sup>37</sup> *Ibid.*, 122, italics in original.

<sup>38</sup> *Ibid.*, 122.

on the market was to introduce a unanimity rule.<sup>39</sup> A central concern in Buchanan's career became the outline of a program for introducing such a rule at the constitutional level.

This was an attempt to make politics resemble markets. Therein lies the originality of Buchanan's economic approach to constitutional consent. By contrast, Hayek aimed to rein in the powers of the state by demarcating the borders between politics and the market.<sup>40</sup> In response to the crisis of democracy in the 1960s and 1970s, as we will see, Buchanan reverted to a similar tactic of separating the two spheres. However, Buchanan's early work in the 1950s and early 1960s hinted at a far more original vision of political decision-making rules that would make politics approximate the market's private decision-making procedure. In this endeavor, he relied on Ludwig von Mises's work.

In Buchanan's own telling, no one even mentioned Mises during his graduate studies, and he only became acquainted with Mises when researching his 1954 article on "Individual Choice in Voting and the Market." After Buchanan had finished the first draft, he read Mises's 1949 magnum opus *Human Action*, and, in Buchanan's own words, "found out, amazingly, that he had come closer to saying what I was trying to say than anybody else."<sup>41</sup> The tenets of Austrian economics helped Buchanan sharpen his case for unanimity voting in deciding the supply of public goods that he developed in the second half of the 1950s. The result was an outline of how direct

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<sup>39</sup> *Ibid.*, 123.

<sup>40</sup> F. A. Hayek, *The Constitution of Liberty* (Chicago, IL: University of Chicago Press, 1960).

<sup>41</sup> "An Interview with Nobel Laureate James M. Buchanan," *Austrian Economics Newsletter*, Fall 1978, 4, 10.

democracy could be made to resemble the marketplace via a rule of unanimity.

In “Individual Choice in Voting and the Market,” published in August 1954, Buchanan analyzed the differences between voting and the market as choice processes. Explicitly relying on the Austrian conception of the market, he made five distinctions between the market and politics.<sup>42</sup> First, whereas the individual was the acting party in the market choice, in political choice, the collectivity was the “entity for which decisions are made.”<sup>43</sup> As a result, individuals in the market can predict the consequences of their choice, while the individual voter will never be able to predict which of the alternatives on offer will be chosen. Second, whereas individuals in the market were able to distance themselves from the social organization, individual choice in voting is inherently social.<sup>44</sup> This meant that individuals’ preferences necessarily had to be adjusted to account for the preferences of other citizens, thus violating the sanctity of the individual.

Third, there was the question of free riding. Because decisions in the voting process will be made in any case, the individual may abstain from voting, knowing that others will choose. By contrast, “responsibility for market decisions is uniquely concentrated on the chooser; there can be no abstention.”<sup>45</sup> The price mechanism, in other words, forced individuals to choose, whereas the political process invited them to abstain.

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<sup>42</sup> James M. Buchanan, “Individual Choice in Voting and the Market,” *Journal of Political Economy* 62, no. 4 (1954): 335n2, 336n10, 337, 339n20.

<sup>43</sup> *Ibid.*, 335.

<sup>44</sup> *Ibid.*, 336.

<sup>45</sup> *Ibid.*, 337.

Fourth, Buchanan argued that voting choices are more mutually exclusive than market choices, which allowed for a larger number of combinations of goods and services. “As a result of this difference, individual choice in the market can be more articulate than in the voting booth,” Buchanan explained.<sup>46</sup> The choice of the word “articulate” is significant. It was a powerful redescription of the market as better able to let citizens voice their concerns. In Buchanan’s argument, the market was the most effective method for registering citizens’ preferences through their consumption choices.

Fifth, “in voting, the individual does not choose among *existing* but rather among *potential* alternatives.”<sup>47</sup> By contrast, “each dollar vote in the market becomes positively effective to the individual.”<sup>48</sup> Mises was the most prominent exponent of this analogy between voting and shopping. In the 1922 *Die Gemeinwirtschaft*, Mises argued that the market process is just as democratic as the political process because it allows consumers to act independently without having to subordinate their individual preferences to a common good. In Mises’s account, the essence of democracy was not to be found in the technical tools of democracy such as the electoral system. Its real function was to make peace. Democratic institutions such as elections “make the will of the people effective in political matters, by ensuring that its rulers and legislators are elected by the people’s vote. Thus are eliminated those dangers to peaceful social development which might result from any clash between the will of the rulers and public opinion.”<sup>49</sup>

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<sup>46</sup> Ibid., 338.

<sup>47</sup> Ibid., 339, italics in original.

<sup>48</sup> Ibid., 339.

<sup>49</sup> Ludwig von Mises, *Socialism: An Economic and Sociological Analysis* (Indianapolis, IN: LibertyClassics, 1981), 442–443.

By contrast, an economic order based on private ownership of the means of production needed no special institutions to prevent a clash between rulers (in the guise of producers) and ruled (in the guise of consumers). Free competition did the trick, bending production to the consumer's will and compelling the obedience of the producer to consumers.

Mises concluded, "the lord of production is the consumer. From this point of view the capitalist society is a democracy in which every penny represents a ballot paper. It is a democracy with an imperative and immediately revocable mandate to its deputies. It is a consumers' democracy."<sup>50</sup> This way, Mises explicitly contested more conventional democratic visions of the ideal political process, arguing that the market provided the solution to the problem of discerning the public interest. Not denying the efficacy of the political process, he simply claimed that the market mechanism provided the same but without intermediate institutions, implicitly portraying the market as far more representative of individual citizens than the political process. In a socialist economic democracy, the consumer was denied the sovereignty afforded by the market in a capitalist society.

Like Mises, Buchanan used the trope of the monetary vote as an attack on the lack of democracy in majority voting. Insofar as rationality in individual behavior was deemed

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<sup>50</sup> Ibid., 443. On the history of consumer sovereignty, see Olsen, *The Sovereign Consumer: A New Intellectual History of Neoliberalism*. On the political-theological implications of consumer sovereignty, see Stefan Schwarzkopf, "The Political Theology of Consumer Sovereignty: Towards an Ontology of Consumer Society," *Theory, Culture & Society* 28, no. 3 (2011): 106–129.

desirable, these differences pointed to the superiority of the market process. "The market should also be preferred as a choice process," Buchanan argued, "when individual freedom is considered in isolation."<sup>51</sup> Individual freedom meant free choice. "The absence of negative results of individual choices and, therefore," Buchanan explained, "of the direct coercion which requires that the individual accept unchosen alternatives makes for a greater degree of freedom in market choice."<sup>52</sup> Buchanan thus put *choice* at the very center of his moral philosophy. What mattered was the improvement of the range of choices available to individuals.

In connection to this, Buchanan circumvented the intricate relationship between economic power and freedom of choice: "The essential point to be emphasized in this connection is that the inequalities present in market choice are inequalities in individual power and not in individual freedom."<sup>53</sup> In effect, his theory first and foremost protected the economic rights of the wealthy minority by unlinking economic power from freedom. Like many other liberals, he refused to acknowledge the left wing's argument that inequalities of economic power resulted in inequalities of individual freedom. For him, the market remained a sphere of voluntary exchange. By contrast, politics was a sphere of coercion. His quest was to make political exchange resemble the voluntary exchange of the marketplace through marketization. He would spend the 1960s trying to find realistic ways to implement direct-democratic unanimity requirements in collective decision-making.

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<sup>51</sup> Buchanan, "Individual Choice in Voting and the Market," 341.

<sup>52</sup> *Ibid.*

<sup>53</sup> *Ibid.*, 340.

In the late 1950s, Buchanan began collaborating with Gordon Tullock, who spent the 1958/59 academic year at the Thomas Jefferson Center for Studies in Political Economy and Social Philosophy. Buchanan and Warren Nutter had established the Center at the University of Virginia in 1957. Its first brochure described it “as a community of scholars who wish to preserve a social order based on individual liberty.”<sup>54</sup> Over the years, institutionalized at different universities in Virginia, the Center became the central hub for the development of public choice theory and the advocacy of constitutional changes that would turn politics into a marketplace.

Buchanan’s collaboration with Tullock culminated in *The Calculus of Consent*, published in 1962.<sup>55</sup> As Sonja Amadae has pointed out, Buchanan and Tullock reinvented “the logical foundations of constitutional democracy so that it resembles the logic of the marketplace.”<sup>56</sup> Comparing traditional majority voting with a system based on unanimity, they argued that both have costs. While traditional majority voting incurs external costs, the unanimity principle incurs decision-making costs. Acknowledging its imperfections, Buchanan and Tullock advocated a constitutional design requiring near-unanimity in collective decision-making.

Buchanan’s and Tullock’s historical justification of the economic analysis of politics illuminates the intimate connection between the growth of the administrative capacities of the postwar American state and the economic analysis of politics.

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<sup>54</sup> Quoted in Steven G. Medema, “Related Disciplines’: The Professionalization of Public Choice Analysis,” *History of Political Economy* 32, Annual Supplement (2000): 303.

<sup>55</sup> Amadae, *Rationalizing Capitalist Democracy*, 136.

<sup>56</sup> *Ibid.*, 139.

“When governmental machinery directly uses almost one-third of the national product, when special interest groups clearly recognize the ‘profits’ to be made through political action, and when a substantial proportion of all legislation exerts measurably differential effects on the separate groups of the population,” they explained, “an economic theory can be of great help in pointing toward some means through which these conflicting interests may be ultimately reconciled.”<sup>57</sup> Before the birth of the producing state, there was little need for an economic theory of politics, according to Buchanan and Tullock. Their logic was simple. In a world where politics is increasingly dominated by economic matters, an economic theory of politics is a necessity. In this sense, Buchanan and Tullock, like most of the other actors in this narrative, were responding to the extraordinary postwar expansion of public expenditures, which reflected growing government activity. Market models of politics were thus important indicators of a fundamental transformation of American politics as well as factors in its evolution.

The methodological starting point of Buchanan and Tullock’s economic analysis of politics was the axiom of self-interest. They charged that the logic of consistency required the same individual to act in politics as in the marketplace, meaning that people were no more public-interested in politics than when they made decisions in the market. Buchanan and Tullock simply removed this asymmetry by analyzing political actors as economic agents.<sup>58</sup>

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<sup>57</sup> James Buchanan and Gordon Tullock, *The Calculus of Consent: Logical Foundations of Constitutional Democracy* (Ann Arbor, MI: University of Michigan Press, 1962), 22.

<sup>58</sup> *Ibid.*, 20.

Self-interest is not an unusual assumption in the history of political thought. What makes public choice theory stand out is the homology between markets and politics: the double-sided assumption that politics can best be explained using the vocabulary of economics and that collective-decision-making should therefore resemble private decision-making in the marketplace. This was the problem that Buchanan and Tullock tried to provide an answer to. Introducing an unanimity rule amounted to introducing voluntary exchange in the public economy. If unanimity was required, everyone had the option to opt out if a particular proposal did not suit their preferences.

Following the lead of modern welfare economics, Buchanan and Tullock refused to make interpersonal comparisons of utility, stressing instead that “a change must be demonstrated to make at least one person in the group ‘better off’ without making any other person ‘worse off.’”<sup>59</sup> According to this Paretian efficiency criterion, total welfare can increase only if there is unanimous consent among the members of the group. Buchanan and Tullock thus reiterated that unanimity was equivalent to Pareto optimality. “Falling back on the Pareto criterion for assessing changes,” they argued, “we admit as ‘better’ only those changes that are observed to be approved unanimously by all members of the group.”<sup>60</sup> This Paretian conception of consent fulfilled the requirements of both efficiency and democracy, eliding any differences between the two. “Any change that secures unanimous support is ‘clearly desirable,’ and we can say that such a change is ‘in the public interest,’” they explained.<sup>61</sup> This valorization of the principle of unanimity was at the very heart of Buchanan’s approach to

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<sup>59</sup> *Ibid.*, 285.

<sup>60</sup> *Ibid.*

<sup>61</sup> *Ibid.*

politics. He rejected the social welfare function as a useful tool for aggregating preferences. There was nothing to aggregate. Social consent needed to be unanimous if it were to uphold the principle of methodological individualism.

In line with this, Buchanan and Tullock asserted that the introduction of unanimity at the constitutional level provided “a criterion against which individual person’s decisions on constitutional issues may be analyzed.”<sup>62</sup> Unanimity provided a meaningful way of analyzing which decisions improved societal welfare on an individual basis. The unanimity principle was the political equivalent of the Pareto criterion, because “it provides us with an extremely weak ethical criterion for ‘betterness,’ a criterion that is implicit in the individualist conception of the State itself.”<sup>63</sup> Despite their argument that the Pareto criterion was an “extremely weak” ethics, it was nonetheless a moral criterion. Public choice theorists had to introduce ethical criteria to ground their analysis, however weak or disguised their assumptions. In that sense, they advanced a politics of anti-politics. The homology of form between the Pareto criterion and collective decision-making reduced politics to the administration of the status quo, allowing only changes that leave no one worse off.

In connection to this, Buchanan and Tullock’s distinction between an ordinary level of politics, which referred to decisions made in legislative assemblies, and a constitutional level, which referred to decisions made on the framework rules within which ordinary politics in legislative assemblies operated, is important.<sup>64</sup> The rule of unanimity was simply too impractical in day-to-day political decision-making. In ordinary politics, then, less-than-unanimity rules, even majority

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<sup>62</sup> *Ibid.*, 6.

<sup>63</sup> *Ibid.*, 14.

<sup>64</sup> *Ibid.*, especially chapter 9.

voting, were permissible to ease the costs of decision-making. At the foundational level of constitution-making, however, the rule of unanimity was a requirement. Only at the constitutional level could politics be made to resemble decision-making in the market and acquire democratic credibility in the Paretian sense.

Implicit in this distinction was the assumption that only direct democracy at the constitutional level was comparable to the market process. This way, Buchanan and Tullock legitimated the market process as a more democratic mechanism than representative democracy. Ordinary politics, on the other hand, was a necessary evil that could not be made to resemble the market process. This accounted for the persistence of government failure. In this sense, Buchanan and Tullock legitimated the market process as a form of direct democracy, simultaneously delegitimizing ordinary politics by stressing its inability to live up to the unanimity requirement. By arguing that ordinary politics was democratically inferior to markets, they seriously undermined the very possibility of a legitimate political order.

From the mid-1960s, America experienced a series of social, political, and economic crises from which it has arguably never recovered. Though the first half of the postwar period had been far from quiet, marked as it was by McCarthyism and the injustices of racial and gender discrimination, it was a tranquil period compared to what came later. As James Patterson has argued, postwar Americans “developed ever-greater expectations about the capacity of the United States to create a better world abroad and a happier society at home.”<sup>65</sup> From the mid-1960s onwards, disillusionment set in.

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<sup>65</sup> James T. Patterson, *Grand Expectations: The United States, 1945–1974* (New York, NY: Oxford University Press, 1998), vii.

The social crisis was threefold. First, there was the civil rights movement's demand for an end to segregation. The unjust and brutal treatment of African Americans was a powerful reminder that reconstruction was an unfinished process. Second, there was the generational divide between the generation that had come of age during the 1930s and 1940s and the boomers who were born during these years of turmoil but grew up in relative affluence. When they started college in the 1960s, they proved eager to break the cultural ties to their parents' generation. Third, the Vietnam War turned into a political crisis, which quickly fused with student unrest on campuses across the country and the civil rights movement's protests. Despite a number of legislative achievements on civil rights and welfare, the Vietnam War gradually consumed Lyndon B. Johnson's presidency, preventing him from seeking a second term in 1969. To make matters worse, his successor, Richard Nixon, was forced to resign the presidency in 1974 because of his involvement in the Watergate scandal. The economic crisis erupted in 1974 when oil prices shot through the roof. The deeper origin of the crisis was the combination of increased international competition and the inflationary pressure from wage demands and energy prices. Whatever its causes, the American economy never returned to the remarkable growth figures that had characterized the postwar period.<sup>66</sup>

In providing a single framework for understanding these crises and their meaning for the American state, two parallel literatures from the 1970s stand out, one from the right and one from the left. The one from the left emphasized Western

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<sup>66</sup> On the postwar period as an exceptional era in economic history, see Thomas Piketty, *Capital in the Twenty-First Century*, trans. Arthur Goldhammer (Cambridge, MA: The Belknap Press of Harvard University Press, 2017).

governments' "crisis of legitimation." Originating in the writings of the West German social theorists Claus Offe and Jürgen Habermas,<sup>67</sup> the notion of a legitimation crisis found a receptive audience in America, where it overlapped with an emerging literature on the fiscal crisis of the state, the emblematic title of James O'Connor's 1973 book. In the acknowledgments, O'Connor thanked Claus Offe for his criticisms of the entire manuscript during his stay at the Max-Planck-Institut in Starnberg in the fall of 1972.<sup>68</sup> O'Connor, a Marxist-inspired political economist, argued that the American capitalist state suffered from having to serve two contradictory needs, accumulation and legitimation. On the one hand, it had to serve the capitalist class's need for accumulation. On the other hand, in order to be legitimate, it had to serve the people's need for a comprehensive welfare state. These two contradictory demands led to the fiscal crisis of the state.<sup>69</sup>

The discourse from the right articulated a "crisis of discipline."<sup>70</sup> Samuel P. Huntington's contribution to the

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<sup>67</sup> Jürgen Habermas, *Legitimationsprobleme im Spätkapitalismus* (Frankfurt am Main: Suhrkamp, 1973); Claus Offe, *Struktur-Probleme des Kapitalistischen Staates: Aufsätze zur Politischen Soziologie* (Frankfurt am Main: Suhrkamp, 1972).

<sup>68</sup> James O'Connor, *The Fiscal Crisis of the State* (New Brunswick, NJ: Transaction Publishers, 2002), iv.

<sup>69</sup> O'Connor, *The Fiscal Crisis of the State*. For an update of this theory of the tension between markets and democratic politics in response to the prolonged 2008 global financial crisis, see Streeck, "The Crises of Democratic Capitalism."

<sup>70</sup> For an analysis of the crisis of discipline as the third of four successive crises of American democracy since the early twentieth century, see Alasdair Roberts, *Four Crises of American Democracy: Representation, Mastery, Discipline, Anticipation*

Trilateral Commission's 1975 report on the governability of democracies was characteristic of this perspective. Huntington argued that the surge of democratic activity in the 1960s produced a crisis of governability in the 1970s. The vitality of democracy manifested itself in the rights-conscious movements of African Americans, women, and students, to name just a few of the groups that took to the streets, marching and protesting, demanding to be heard. The effects of this democratic surge were contradictory, according to Huntington. On the one hand, Americans demanded and received more benefits from government than ever before. On the other hand, their confidence in government decreased. As governmental activity increased, governmental authority declined. Huntington associated this paradox with a shift in balance from the political and interest-aggregating institutions of government to its bureaucratic and regulating institutions.<sup>71</sup>

The crisis of democracy was the background against which Buchanan articulated his attack on majoritarian democracy in the 1970s. His worries about the expansion of the American fiscal state, combined with the social and political crisis of the 1960s, led him to articulate a theory of a protective state to prevent both governmental overreach and anarchy. In retrospect, Buchanan claimed that *The Calculus of Consent* was an attempt to provide what he called the "productive state" with constitutional legitimacy.<sup>72</sup> The productive state, according to

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(New York, NY: Oxford University Press, 2017), 97–132. Roberts interprets the crisis of democracy as one of discipline.

<sup>71</sup> Crozier et al., *The Crisis of Democracy*, 64.

<sup>72</sup> James M. Buchanan, *The Limits of Liberty: Between Anarchy and Leviathan* (Chicago, IL: University of Chicago Press, 1975), 7.

Buchanan, described the function of the state as the supplier of public goods. By contrast, the rest of his career was in large part devoted to circumscribing this productive aspect of the state by articulating a constitutional theory of “the protective state.” The protective state described the function of the state as the supplier of public order, protecting the rights of individuals, especially property rights. The intellectual context of this protective theory of the state was the resurgence of anarchist thought, on the one hand, and Mancur Olson’s argument about the logic of collective action, on the other.

Born in 1932, Olson earned a PhD in economics in 1963 on a dissertation about “The Generalized Theory of Public Goods.”<sup>73</sup> In 1967, after a stint at Princeton University, he was appointed deputy assistant secretary of the US Department of Health. After two years in Lyndon B. Johnson’s cabinet, Olson left public service for a position as professor of economics at the University of Maryland, where he remained until his death in 1998.<sup>74</sup>

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<sup>73</sup> On Mancur Olson and the concept of free riding, see Philip Pettit, “Free Riding and Foul Dealing,” *The Journal of Philosophy* 83, no. 7 (1986): 361–379; Richard Tuck, *Free Riding* (Cambridge, MA: Harvard University Press, 2008); Philippe Fontaine, “Free Riding,” *Journal of the History of Economic Thought* 36, no. 3 (2014): 359–376; Roger Congleton, “The Logic of Collective Action and Beyond,” *Public Choice* 164, no. 3/4 (2015): 217–234.

<sup>74</sup> On Mancur Olson’s life and contributions to the economics of politics, see Melvin J. Hinich and Michael C. Munger, “Mancur Lloyd Olson (1932–1998),” in *Readings in Public Choice and Constitutional Political Economy* (New York, NY: Springer, 2008), 131–134.

Reviewing Buchanan and Tullock's *The Calculus of Consent*, Olson noticed the "somewhat eccentric ideological quality" that characterized their approach to politics. While Olson conceded that their right-wing vantage point was the source of their theory's originality, he argued that their view of voluntary cooperation was "a serious logical error."<sup>75</sup> Olson contended that where large numbers of people were involved, people had an incentive to free ride on others' contributions; that is, they had an incentive to avoid paying for public goods whose benefits they enjoyed just as much as those who paid for them. Contrary to Buchanan and Tullock, Olson therefore argued that social costs could not be alleviated through voluntary private organization. Coercion was necessary to ensure that the collective interest of the group was taken care of.

Three years later, in the 1965 *Logic of Collective Action*, Olson expanded on these arguments. He argued that some of the problems associated with Buchanan's and Tullock's unanimity requirement could be solved with the help of some of the ideas developed in the book.<sup>76</sup> Olson's core argument about collective action was simply that "unless the number of individuals in a group is quite small, or unless there is coercion or some other special device to make individuals act in their common interest, *rational, self-interested individuals will not act to achieve their common or group interests.*"<sup>77</sup> The implication of Olson's argument was that voluntariness was

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<sup>75</sup> Mancur Olson, review of *The Calculus of Consent: Logical Foundations of Constitutional Democracy*, by James M. Buchanan and Gordon Tullock, *The American Economic Review* 52, no. 5 (1962): 1217–1218.

<sup>76</sup> Olson, *The Logic of Collective Action*, 41n63.

<sup>77</sup> *Ibid.*, 2, italics in the original.

only possible in very small groups, though he suggested no numeric limit to the size of the group. *The Logic of Collective Action*, in other words, suggested that small groups, such as big-business lobbies, would dominate larger groups, such as consumer interest organizations and labor unions, in the competitive political play between interest groups.

In the 1965 article "Ethical Rules, Expected Values, and Large Numbers," Buchanan acknowledged Olson's argument that the size of the group determined the degree to which coercion was necessary.<sup>78</sup> In small groups, organizations, and communities, no coercion was necessary. Ethical rules were sufficient when small numbers of people were involved. The larger the group, the more free-rider situations arose. In other words, voluntary association through unanimity was possible in small-number settings, whereas larger groups and communities required coercion to ensure the provision of public goods like defense. The larger the number, the larger the limit on liberty. The core of Buchanan's argument was that with an increase in group size the likelihood of individuals becoming private maximizers increased correspondingly. Ethical rules were only obeyed in small-group settings.

In extension of this, the events of the late 1960s proved to Buchanan that a strong protective state was a necessity in protecting the social order.<sup>79</sup> In the second half of the 1960s and the

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<sup>78</sup> On Buchanan's theory of the relationship between group size and ethics, see Marciano, "Buchanan's Non-Coercive Economics for Self-Interested Individuals"; Johnson, "Rules versus Authorities." These paragraphs largely follow these accounts.

<sup>79</sup> On this context, see Amadae, *Prisoners of Reason*, 177-178.

first half of the 1970s, Buchanan developed a more pessimistic vision about the feasibility of voluntary exchange. Buchanan had believed that anarchy was possible in small groups, which made government coercion unnecessary because they induced people to follow “an ethical rule of action” rather than the brute force of authority.<sup>80</sup> However, the upheavals on college campuses across the nation made it evident to Buchanan that anarchy based on small groups had the potential to result in disorder. The student uprisings at the end of the 1960s are thus a crucial background for understanding the development of Buchanan’s thought in the 1970s.

Buchanan experienced the interrelated social and political crises of the 1960s firsthand at the University of California at Los Angeles, where he took a position in the middle of the decade. Buchanan relocated to UCLA after his and Tullock’s relationship with the University of Virginia’s administration soured, but he was never comfortable on the West coast, and he returned to Virginia in 1969 to direct the newly established Center for Study of Public Choice at Virginia Polytechnic Institute. VPI had brought in Tullock the year before, and the two developed a vibrant intellectual community there in the 1970s.<sup>81</sup>

In this institutional context, Buchanan tried to outline the economics of the initial settlement of rights and rules and the role of the state in protecting this initial settlement.

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<sup>80</sup> Marciano, “Buchanan’s Non-Coercive Economics for Self-Interested Individuals,” 18.

<sup>81</sup> On the Center for Study of Public Choice at VPI, see Wagner, *James M. Buchanan and Liberal Political Economy*, 16; Medema, “‘Related Disciplines,’” 305–306.

His 1975 book *The Limits of Liberty* envisioned a state that avoided the Scylla of anarchy and the Charybdis of Leviathan. *The Limits of Liberty* emerged out of discussions of anarchy at the Center for Study of Public Choice at VPI,<sup>82</sup> which resulted in two edited volumes, *Explorations in the Theory of Anarchy* and *Further Explorations in the Theory of Anarchy*.<sup>83</sup> It would be difficult to comprehend this interest had anarchy not become a keyword in American politics as a result of political movements on both the right and the left reacting against the growth of the American state. On the left, parts of the student movement had strong libertarian leanings.<sup>84</sup> On the right, the anarcho-capitalists were a force to be reckoned with.<sup>85</sup>

Led by the economist Murray Rothbard, the anarcho-capitalists produced a split on the American right, first with the splitting of the Young Americans for Freedom in 1969, and a

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<sup>82</sup> Buchanan, *The Limits of Liberty*, x-xi.

<sup>83</sup> See Gordon Tullock, *Explorations in the Theory of Anarchy* (Blacksburg, VA: University Publications, 1972); Gordon Tullock, ed., *Further Explorations in the Theory of Anarchy* (Blacksburg, VA: University Publications, 1974).

<sup>84</sup> For a succinct overview of the relationship between the New Left, counter-culture, and anarchism, see Peter Marshall, *Demanding the Impossible: A History of Anarchism* (Oakland, CA: PM Press, 2010), 539-558. See also David DeLeon, "The American as Anarchist: Social Criticism in the 1960s," *American Quarterly* 25, no. 5 (1973): 516-537.

<sup>85</sup> On anarcho-capitalism and its relationship to the rest of the libertarian movement, see Brian Doherty, *Radicals for Capitalism: A Freewheeling History of the Modern American Libertarian Movement* (New York, NY: PublicAffairs, 2007).

few years later with the establishment of the Libertarian Party.<sup>86</sup> What set anarcho-capitalists apart was their redefinition of anarchism as the absence of the state in favor of completely free markets. They belonged to a liberal tradition which emerged in the early 1950s to describe the classical liberal emphasis on individualism, unregulated markets, and limited government.<sup>87</sup>

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<sup>86</sup> On Murray Rothbard, see Justin Raimondo, *An Enemy of the State: The Life of Murray N. Rothbard* (Amherst, NY: Prometheus Books, 2000). On the relationship between Rothbard and the Libertarian Party, see Daniel Bessner, "Murray Rothbard, Political Strategy, and the Making of Modern Libertarianism," *Intellectual History Review* 24, no. 4 (October 2, 2014): 441–456. On the division of Young Americans for Freedom, see Gregory L. Schneider, *Cadres for Conservatism: Young Americans for Freedom and the Rise of the Contemporary Right* (New York, NY: New York University Press, 1999). On the relationship between the New Left and the New Right, see Rebecca E. Klatch, *A Generation Divided: The New Left, the New Right, and the 1960s* (Berkeley, CA: University of California Press, 1999). On the student libertarian movement, see Jonathan Schoenwald, "No War, No Welfare, and No Damn Taxation: The Student Libertarian Movement, 1968–1972," in *The Vietnam War on Campus: Other Voices, More Distant Drums*, ed. Marc J. Gilbert (Westport, CT: Praeger Publishers, 2001), 20–53.

<sup>87</sup> The literature on libertarianism is small, but growing. For an indispensable account of libertarianism's place on the modern American right, see George H. Nash, *The Conservative Intellectual Movement in America since 1945*, 30th Anniversary Edition (Wilmington, DE: ISI Books, 2006). For snapshots of five significant libertarian thinkers, see Doherty, *Radicals for Capitalism*. For a brilliant collective biography of three libertarian women, see Jennifer Burns, "The Three 'Furies' of

Among libertarian intellectuals, which included the journalists Garret Garrett, John T. Flynn, and Frank Chodorov, Albert Jay Nock, an Episcopalian priest turned journalist, stood out for his clarity of ideological vision. In *Our Enemy, the State*, published in 1935, Nock argued that the expansion of governmental power reduced societal power. Inspired by the German sociologist Franz Oppenheimer's 1908 *Der Staat*, Nock distinguished between two different modes of directing social relations.<sup>88</sup> "There are two methods, or means, and only two, whereby man's needs and desires can be satisfied," Nock confidently established. "One is the production and exchange of wealth; this is the economic means. The other is the uncompensated appropriation of wealth produced by others; this is the political means."<sup>89</sup> In Nock's dichotomy, the economic method led to individual freedom, whereas the political method led to repression and exploitation of the individual. This dethronement of politics was the essence of the libertarian reconfiguration of the liberal tradition. Radical libertarians left no room for politics. Anarcho-capitalists like Rothbard argued for the abolition of government in favor of a completely free market. What was the core characteristic of their ideology?<sup>90</sup>

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Libertarianism: Rose Wilder Lane, Isabel Paterson, and Ayn Rand," *Journal of American History* 102, no. 3 (2015): 746–774. For a biography of Rand, see Jennifer Burns, *Goddess of the Market: Ayn Rand and the American Right* (New York, NY: Oxford University Press, 2009).

<sup>88</sup> Franz Oppenheimer, *Der Staat* (Frankfurt am Main: Literarische Anstalt Rütten & Loening, 1908).

<sup>89</sup> Albert Jay Nock, *Our Enemy, the State* (Caldwell, ID: Caxton Printers, 1950), 51.

<sup>90</sup> For some recent accounts of Murray Rothbard's career and ideological origins and legacies, see Bessner, "Murray Rothbard, Political Strategy, and the Making of Modern

Anarcho-capitalism revolved around the isolation of individuals in their domestic sphere, both at the level of the nation and at level of the household.<sup>91</sup> These emphases on the private sphere explain Rothbard's peculiarly shifting alliances, from the New Left in the 1960s to the paleo-conservative right in the 1990s. Rather than strictly strategic political moves, they were rooted in a consistent ideological outlook. Rothbard found common ground with the New Leftists on the question of American imperialism, abroad and at home. Abroad he wished to reduce American militarism in Vietnam, romanticizing the isolationist right of the 1930s. It was not, however, a retreat to the United States of America. His isolationism was segregationist. He therefore supported Black Nationalists' efforts to create self-governing African American communities, just as he supported those communities calling for white power. The solution, according to Rothbard, was to divide Americans into communities based on race.

In the beginning of the 1970s, Rothbard broke with the New Left. While he applauded the anti-war achievements of the movement, he lamented the egalitarian turn it took in the late

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Libertarianism"; Quinn Slobodian, "Anti-'68ers and the Racist-Libertarian Alliance: How a Schism among Austrian School Neoliberals Helped Spawn the Alt Right," *Cultural Politics* 15, no. 3 (November 1, 2019): 372–386; Melinda Cooper, "The Alt-Right: Neoliberalism, Libertarianism and the Fascist Temptation," *Theory, Culture & Society*, April 7, 2021; Jacob Jensen, "Repurposing Mises: Murray Rothbard and the Birth of Anarchocapitalism," *Journal of the History of Ideas* 83, no. 2 (2022): 315–332.

<sup>91</sup> This and the next two sections build on Jensen, "Repurposing Mises: Murray Rothbard and the Birth of Anarchocapitalism."

1960s. He was particularly condescending of feminism. What worried him about the women's liberation movement was its attack on the patriarchal household and its insistence that the personal was political. This was an intrusion into the domestic private sphere worse than conscription and police violence. Rothbard embodied his conception of self-ownership in the idea of homesteading. Whereas neoliberal economists centered on the entrepreneur, Rothbard's anarchism focused on the smallholder. Based on the myth of the American frontier, this was essentially an agricultural vision of the isolated settler and his family tilling their sixteen acres out west against all odds. Rothbard thus confined interpersonal relations to individuals' familial households and their ethnically defined national community.

Public choice theorists found anarchy, as defined by Rothbard, to be an important normative ideal but ultimately unfeasible because of the problem of public goods. Nearly all the contributions to *Explorations in the Theory of Anarchy* and *Further Explorations in the Theory of Anarchy* rejected Rothbard's idea that markets could exist without an enforcing centralized agent. Buchanan's *The Limits of Liberty* was based on this insight. Its purpose was to find the principles through which people voluntarily subjected themselves to coercion. The outcome was an unconventional constitutional theory of "ordered anarchy."<sup>92</sup>

In 1976, the economist Scott Gordon placed Buchanan's *Limits of Liberty* as part of a revival of the contractarian tradition alongside John Rawls's *Theory of Justice* and Robert Nozick's *Anarchy, State, and Utopia*.<sup>93</sup> While Buchanan was

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<sup>92</sup> Buchanan, *The Limits of Liberty*, x.

<sup>93</sup> Scott Gordon, "The New Contractarians," *Journal of Political Economy* 84, no. 3 (1976): 573-590; John Rawls, *A Theory of*

the only one of the three with formal economic training, Gordon pointed out that all three drew extensively on modern economic theory.<sup>94</sup> Oddly, Gordon left out Hayek's *Law, Legislation and Liberty*, the first volume of which had been published in 1973.<sup>95</sup> Nonetheless, in so far as Buchanan tried to outline a system of the rule of law that would demarcate the boundaries of the political to protect the market, his position most closely resembled Hayek's. The end result was a definition of the constitution as the fundamental document of law that regulates the economic relationship between citizens and the state, protecting property rights and public order.

Buchanan reconceived the problem of political order in terms of the so-called Prisoner's Dilemma,<sup>96</sup> a game-theoretical example that demonstrates the conditions under which rational individuals will not cooperate, even if cooperation would serve their interests better. The Prisoner's Dilemma is thus a rather nefarious foundation to construct a theory of politics on. Contradicting Buchanan's earlier theories of cooperation in small groups, it suggests that coercion is unavoidable, and that disorder is a potential concern even in small-number settings. As such, state force was a necessary component in the construction of a free society. If the threat of anarchy legitimized state monopoly on violence, it did not

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*Justice* (Cambridge, MA: Belknap Press, 1971); Robert Nozick, *Anarchy, State, and Utopia* (New York, NY: Basic Books, 1974).

<sup>94</sup> Gordon, "The New Contractarians," 574.

<sup>95</sup> F. A. Hayek, *Law, Legislation and Liberty: A New Statement of the Liberal Principles of Justice and Political Economy* (London: Routledge, 2012).

<sup>96</sup> Amadae, *Prisoners of Reason*, 180.

restrain the productive state and the ever-expanding expenditures associated with it. That was a problem Buchanan found a solution to in the late 1970s.

By the end of the 1970s, political and economic circumstances had changed significantly. While anti-tax sentiments had always run deep in America, calls for tax reform grew louder as the 1970s were ending. Most prominent of these “anti-tax crusades” was the amendment of Proposition 13 to the constitution of the state of California in 1978.<sup>97</sup> Proposition 13 imposed limits on the state of California’s ability to impose taxes on property and introduced a supermajority requirement for the approval of future tax increases. Among the advocates of the proposition was Milton Friedman, who appeared in TV commercials pushing the Proposition.<sup>98</sup>

Friedman was not the only neoliberal economist to react to the developments in California. In *The Power to Tax*, from 1980, Buchanan and his co-author Geoffrey Brennan connected their theory of a fiscal constitution directly to Proposition 13. “At times we felt as if we were being swept away by political developments that threatened to reduce our efforts to little other than academic exercises,” they wrote.<sup>99</sup> After swimming against the current for more than a quarter

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<sup>97</sup> On American tax resistance and “anti-tax crusades,” see Romain Huret, *American Tax Resisters* (Cambridge, MA: Harvard University Press, 2014).

<sup>98</sup> *Ibid.*, 231.

<sup>99</sup> Geoffrey Brennan and James M. Buchanan, *The Power to Tax: Analytical Foundations of a Fiscal Constitution* (Cambridge: Cambridge University Press, 1980), xi.

of a century, Buchanan's ideas were suddenly and unexpectedly mainstream.

Buchanan and Brennan's idea of a fiscal constitution developed in response to increasing public deficits in the late 1970s as well as increasing anti-tax sentiments among Americans. In *The Power to Tax*, they thus outlined the "analytical foundations of a fiscal constitution" as part of an attempt to constrain taxation. This vision of the fiscal constitution built on work Buchanan had done in the late 1970s with the economist Richard Wagner. One of the most significant aspects of Buchanan's work in this period was the idea of the balanced-budget amendment coupled with supermajority rules for tax increases.<sup>100</sup>

One of the first texts in which Buchanan outlined his version of a balanced-budget amendment was in the 1977 book *Democracy in Deficit* and the 1978 article "The Political Biases of Keynesian Economics," both co-authored with Wagner. *Democracy in Deficit* was part of a broader movement, spearheaded by economists associated with the University of Chicago, that was delegitimizing the Keynesian approach to macroeconomic management.<sup>101</sup> Whereas Keynesians focused their energies on government's ability to counteract the ups and

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<sup>100</sup> Thomas Biebricher, "Neoliberalism and Law: The Case of the Constitutional Balanced-Budget Amendment," in *Democracy and Financial Order: Legal Perspectives*, ed. Matthias Goldmann and Silvia Steininger (Berlin, Heidelberg: Springer Berlin Heidelberg, 2018), 155–175.

<sup>101</sup> On this movement, see especially Robert Leeson, *The Eclipse of Keynesianism: The Political Economy of the Chicago Counter-Revolution* (New York, NY: Palgrave, 2000).

downs of the entire economic system,<sup>102</sup> Friedman, for example, argued that what truly mattered was the supply of money.<sup>103</sup> Buchanan and Wagner's book stands out in this crowded field because of its relentless focus on the impact of Keynesianism on the budgetary deficit of the American state. Buchanan and Wagner argued that Keynesianism was a break with what they called "old-time fiscal religion," which they favored.<sup>104</sup>

Whereas this old-time fiscal religion had emphasized balanced budgets, Keynesianism, according to Buchanan and Wagner, resulted in public indebtedness. To remedy this situation of a democracy in deficit, Buchanan and Wagner proposed not to abandon democracy but to return to the old-time fiscal religion.<sup>105</sup> Their concern was the results of Keynesianism in the hands of democratically elected officials:

Our central thesis is that the results we see can be traced directly to the conversion of political decision makers, and the public at large, to the Keynesian theory of economic policy. At a preliminary and

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<sup>102</sup> The literature on Keynes and Keynesianism is voluminous. For a recent, powerful examination of Keynesianism, see Mann, *In the Long Run We Are All Dead*.

<sup>103</sup> For Friedman's most influential academic exposition of monetarism, see Milton Friedman and Anna Jacobson Schwartz, *A Monetary History of the United States: 1867-1960* (Princeton, NJ: Princeton University Press, 1963).

<sup>104</sup> James M. Buchanan and Richard E. Wagner, *Democracy in Deficit: The Political Legacy of Lord Keynes*, The Collected Works of James M. Buchanan, Vol. 8 (Indianapolis, IN: Liberty Fund, 2000), 10.

<sup>105</sup> *Ibid.*, 5.

common-sense level of discussion, the effects of Keynesian economics on *democratic* politics of budgetary choice seem simple and straightforward, whether treated in terms of plausible behavioral hypotheses or of observable political reality. Elected politicians enjoy spending money on projects that yield some demonstrable benefits to their constituents. They do not enjoy imposing taxes on these same constituents.<sup>106</sup>

Before Keynesianism became the norm of budgetary policy, old-time fiscal religion had imposed the criterion of balanced budgets on economic policy-makers. In Buchanan and Wagner's narrative, Keynesianism had broken this balance, removing the limits imposed by the older norm of fiscal responsibility. The predictable result was an increase in public spending that was not matched by a corresponding increase in public revenues. Buchanan and Wagner's deployment of the language of discipline, like Huntington's crisis of democracy narrative, was essentially a charge against democracy's tendency to overspend. The most efficient way of preventing this was to impose constitutional limits on government spending.

A year later, Buchanan and Wagner reiterated their critique of "The Political Biases of Keynesian Economics." In language very similar to Downs's, Buchanan and Wagner argued that "political competition is not unlike market competition. Politicians compete among themselves for the support of the electorate, and they do so by offering policies and programs they feel will get them elected or reelected."<sup>107</sup> On Buchanan

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<sup>106</sup> *Ibid.*, 95, italics in original.

<sup>107</sup> James M. Buchanan and Richard E. Wagner, "The Political Biases of Keynesian Economics," in *Fiscal Responsibility in Constitutional Democracy*, ed. James M. Buchanan and Richard E. Wagner (Boston, MA: Springer US, 1978), 87–88.

and Wagner's interpretation, politicians attempted to balance expenditures and revenues in ways that would get them elected. This was an economic conception of democratic politics as a spending-and-revenue process centered on the size and composition of the public budget.

The crucial difference between them and Downs was that they included the constitutional framework in their considerations of the decision-making process in a democracy. "The size and composition of public budgets in such a competitive democracy," Buchanan and Wagner explained, "can be viewed as a product of the preferences of a politician's constituents and the constitutional-institutional rules that constrain the political system."<sup>108</sup> Like Downs, Buchanan and Wagner deployed a conception of democracy as a competition between politicians for votes. Unlike Downs, they pointed to the inflationary effect of this competition on the public budget.

In line with their commitment to fiscal conservatism, they therefore introduced the idea of a balanced-budget amendment to the constitution. "With a balanced-budget rule," they explained, "any proposal for expenditure must be coupled with a proposal for taxation."<sup>109</sup> This would constrain the democratic majority's ability to produce budgetary deficits. In this sense, Nancy MacLean is certainly right in claiming that Buchanan's political philosophy was about chaining democracy.<sup>110</sup> Buchanan worried that democratic majorities, if unrestrained by constitutional restrictions, would continue to increase the budget, leading to ever-increasing public expenditures.

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<sup>108</sup> *Ibid.*, 89.

<sup>109</sup> *Ibid.*

<sup>110</sup> MacLean, *Democracy in Chains*.

This formed the background against which Buchanan and Brennan, in *The Power to Tax*, advanced an interpretation of the social contract as a fiscal constitution. As suggested by its title, the book was “about government’s power to tax, how this power may be used, and how it may be and should be constrained.”<sup>111</sup> Buchanan and Brennan wished to delineate the legitimate activities of government by analogy with the rules of a game.

Deploying John Rawls’s conception of the “veil of ignorance,”<sup>112</sup> Buchanan and Wagner argued that “[t]he logic of constitutional restrictions is embodied in the implicit prediction that any power assigned to government may, over some ranges and on some occasions, be exercised in ways that are at variance with the desired usage of such power, as defined by citizens behind the veil of ignorance.”<sup>113</sup> Rawls, however, had deployed the veil of ignorance in the 1971 *A Theory of Justice* to argue that citizens would agree, constitutionally, to a wide range of policies.<sup>114</sup> Rawls, writing at the tail-end of the New Deal period, has typically been interpreted as attempting to lend constitutional legitimacy to the welfare state.<sup>115</sup> Buchanan’s constitutionalism aimed at protecting minorities from the majority, which required a strong state to enforce the rule of law. Here Buchanan and Brennan explicitly pointed

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<sup>111</sup> Brennan and Buchanan, *The Power to Tax*, 1.

<sup>112</sup> Rawls, *A Theory of Justice*.

<sup>113</sup> Brennan and Buchanan, *The Power to Tax*, 5.

<sup>114</sup> Rawls, *A Theory of Justice*.

<sup>115</sup> For this historiographical interpretation, see Katrina Forrester, “Citizenship, War, and the Origins of International Ethics in American Political Philosophy, 1960–1975,” *The Historical Journal* 57, no. 3 (September 2014): 774.

out that their constitutionalism was in line with Hayek's strong emphasis on the rule of law.<sup>116</sup>

Buchanan and Brennan deployed the veil of ignorance to indicate the limited nature of citizens' constitutional consent to being coerced. The background against which they made this argument was the standard assumption of public choice theory: that politicians and bureaucrats were motivated by self-interest rather than the public interest, thus going against what citizens had agreed to at the constitutional stage. Buchanan and Brennan therefore introduced the concept of the fiscal constitution. The purpose of this conception was to suggest the imposition of fundamental, constitutional limits on government's ability to tax its citizens. Buchanan and Brennan proposed a number of different solutions, from "tax-rate limits" like that of Proposition 13 to "tax-base constraints" to "procedural limits" in the form of a qualified majority rule or a balanced-budget amendment.<sup>117</sup> In the end, what mattered most to Buchanan and Brennan was not so much the specificity of the limit but that limits be imposed. What they hoped to have demonstrated was that, behind the veil of ignorance in the original position, "the individual, as potential taxpayer, placed in a hypothetical where he is allowed to select among alternative sets of constraints on the taxing power of government, will rationally choose to exercise his option and impose some such constraints."<sup>118</sup> This redefinition of the constitution as a fiscal device for limiting taxation and balancing spending and revenue was symptomatic of the changed relationship between citizen and state, which became increasingly economic over the course of the postwar period.

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<sup>116</sup> Brennan and Buchanan, *The Power to Tax*, 191–192.

<sup>117</sup> *Ibid.*, 192–203.

<sup>118</sup> *Ibid.*, 204.

Contrary to recent research, which has highlighted the importance of Southern racial structures and associated tax revolts, this chapter has argued that Buchanan's constitutionalism evolved in response to what he called the productive state. He designed counter-majoritarian decision-making rules that would turn politics into a marketplace. His earliest idea, adopted from the Swedish economist Knut Wicksell, was that the only way to marketize political decision-making was through the introduction of a unanimity rule. Only unanimous voting would make political exchange voluntary rather than coercive. Over the course of the postwar period, however, he gradually acknowledged that unanimity was an unrealistic decision-making rule. Instead, in lockstep with the tax revolt of the 1970s, he began advocating a combination of qualified majority rules and balanced-budget requirements. He argued that such procedural constraints would not necessarily limit government spending.

Buchanan was right. Procedural rules have not reduced government spending. Despite strong campaigns for their introduction at the federal level, Congress has never passed legislation requiring balanced budgets or qualified majorities for passing tax increases. In that sense, and contrary to Nancy MacLean's assertion that he was a mastermind of the American right, Buchanan's work was a failure. At the local level, however, balanced-budget requirements and qualified majority rules have forced municipalities to search for alternative sources of revenue. As Melinda Cooper has argued, these are typically regressive in nature, hurting low-income groups the most. However, Buchanan's primary concern was not with the local level; it was with the national. It was the productive state he aimed, but failed, to marketize. That explains the evolution of his constitutional thought from unanimity to qualified majority rules to balanced-budget amendments. He intended

each of these solutions to make political exchange more akin to market exchange, watering them down as he went along.

As such, Buchanan's work mostly stands out because of its failure to make much of a difference at the level that most concerned him. By contrast, party competition, foot voting, and performance incentives were far more important, changing the nature of government supply of public goods and services. Foot voting, which the next chapter turns to, was an especially influential market model of government supply. Citizen mobility, public choice theorists held, would force state and local governments to compete for voter-consumers.



# 4

## Voting with the Feet

“The built-in guarantee of freedom is [what] makes us so unique, and that it is the right of the citizen to vote with his feet,” President Ronald Reagan explained to a reporter in 1981. “If a state is badly managed,” he elaborated, “the people will either do one of two things: They will either use their power at the polls to redress that, or they’ll go someplace else.” If people were unsatisfied with the way government officials ran things, they could simply leave the place behind. Reagan based his philosophy of foot voting on American citizens’ willingness and ability to move: “We’ve been and still are a very migrant people. I think Americans move more than anyone else.”<sup>1</sup> This philosophy was the premise of his administration’s efforts to reinvent federalism and decentralize American government.

In the terminology of the German-American political economist Albert Hirschman, this represented a shift from voice to exit as the dominant logic of politics. Voice and exit are the two means by which managers of an organization—be it a firm or a state—find out about its failings. In the voice

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<sup>1</sup> Ronald Reagan, Interview With Reporters on Federalism, November 19, 1981, [www.presidency.ucsb.edu/documents/interview-with-reporters-federalism](http://www.presidency.ucsb.edu/documents/interview-with-reporters-federalism).

option, people express their dissatisfaction to management in the hope of changing things for the better. This, according to Hirschman, corresponds to the way politics ideally works. In the exit option, people simply stop buying the firm's products or leave the organization. This corresponds to the way customers ideally hold firms accountable on the market.<sup>2</sup> Scholars have only just begun uncovering the origins of the shift from voice to exit as the basis of political legitimacy, but the literature has mostly focused on radical libertarians' secessionist fantasies.<sup>3</sup> It has not yet considered the role played by the economists at the heart of this chapter.<sup>4</sup> The origins of the

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<sup>2</sup> Albert O. Hirschman, *Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States* (Cambridge, MA: Harvard University Press, 1970), 4.

<sup>3</sup> Casey R. Lynch, "'Vote with Your Feet': Neoliberalism, the Democratic Nation-State, and Utopian Enclave Libertarianism," *Political Geography* 59 (July 2017): 82–91; Harrison Smith and Roger Burrows, "Software, Sovereignty and the Post-Neoliberal Politics of Exit," *Theory, Culture & Society* 38, no. 6 (November 1, 2021): 143–166; Raymond Craib, *Adventure Capitalism: A History of Libertarian Exit, from the Era of Decolonization to the Digital Age* (Oakland, CA: PM Press, 2022). For an exception that covers James Buchanan's theory of secession, see Quinn Slobodian, "Demos Veto and Demos Exit: The Neoliberals Who Embraced Referenda and Secession," *Australian Journal of Political Economy* 86 (2020): 19–36. For another exception, which argues that Friedrich Hayek best expressed the logic of exit, see Thomas Biebricher, "Neoliberalism and Democracy," *Constellations* 22, no. 2 (2015): 255–266.

<sup>4</sup> Parts of this chapter first appeared in Jensen, "Public Goods and the Origins of Equilibrium Democracy."

politics of exit, I argue, were in public choice theorists' reinvention of federalism.<sup>5</sup>

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<sup>5</sup> Examining these economists, the chapter draws on the literature on the Bloomington School. See Daniel Stedman Jones, "The Neoliberal Origins of the Third Way: How Chicago, Virginia and Bloomington Shaped Clinton and Blair," in *The SAGE Handbook of Neoliberalism*, ed. Damien Cahill et al. (Los Angeles, CA: SAGE, 2018), 167–178; Stephen J. Collier, "Neoliberalism and Rule by Experts," in *Assembling Neoliberalism: Expertise, Practices, Subjects*, ed. Vaughan Higgins and Wendy Lerner (New York, NY: Palgrave Macmillan US, 2017), 23–43; Peter J. Boettke and Christopher J. Coyne, "Methodological Individualism, Spontaneous Order and the Research Program of the Workshop in Political Theory and Policy Analysis," *Journal of Economic Behavior & Organization*, Polycentric Political Economy, 57, no. 2 (2005): 145–158; Vlad Tarko, *Elinor Ostrom: An Intellectual Biography* (London: Rowman & Littlefield International, 2017); James M. Walker, "The Bloomington Workshop: Multiple Methods, Interdisciplinary Research, and Collective Action," *Public Choice* 163, no. 1–2 (2015): 85–93; Paul Dragos Aligica, "Public Administration, Public Choice and the Ostroms: The Achievements, the Failure, the Promise," *Public Choice* 163, no. 1–2 (2015): 111–127; Roberta Q. Herzberg, "Governing Their Commons: Elinor and Vincent Ostrom and the Bloomington School," *Public Choice* 163, no. 1–2 (2015): 95–109; Michael A. Fotos, "Vincent Ostrom's Revolutionary Science of Association," *Public Choice* 163, no. 1–2 (2015): 67–83; Tim Forsyth and Craig Johnson, "Elinor Ostrom's Legacy: Governing the Commons and the Rational Choice Controversy," *Development and Change* 45, no. 5 (2014): 1093–1110; Robert L. Bish, "Vincent Ostrom's

Working in a context of fiscal crisis at all levels of American government, thinkers like Charles Tiebout, Vincent Ostrom, and Wallace Oates argued for devolution of responsibilities from the federal level to state and local levels. The chapter shows how Tiebout, Ostrom, and Oates developed a theory of “voting with the feet,” which they argued would solve the problem of estimating the optimal output of public goods and services. Their idea was that, at the local level, municipalities would be able to discern their supply of welfare services by using citizen mobility as a demand signal. Assuming that citizens were willing and able to leave their political unit if they were unsatisfied with its level of public services, Tiebout, Ostrom, and Wallace argued that competition for citizens would force local governments to become responsive. This, however, entailed a fragmentation of political authority and devolution of responsibility to the local level. They argued that

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Contributions to Political Economy,” *Publius: The Journal of Federalism* 44, no. 2 (2014): 227–248; Michael D. McGinnis and Elinor Ostrom, “Reflections on Vincent Ostrom, Public Administration, and Polycentricity,” *Public Administration Review* 72, no. 1 (2012): 15–25; Paul Dragos Aligica and Vlad Tarko, “Polycentricity: From Polanyi to Ostrom, and Beyond,” *Governance* 25, no. 2 (2012): 237–262; Barbara Allen, Ada M. Harrison, and Roberta Q. Herzberg, “Vincent Ostrom,” *PS: Political Science and Politics* 45, no. 4 (2012): 792–795; Michael D. McGinnis and James M. Walker, “Foundations of the Ostrom Workshop: Institutional Analysis, Polycentricity, and Self-Governance of the Commons,” *Public Choice* 143, no. 3/4 (2010): 293–301; Paul Dragos Aligica and Peter J. Boettke, *Challenging Institutional Analysis and Development: The Bloomington School* (London: Routledge, 2009).

the polity should be polycentric, having multiple centers of authority, rather than monocentric. Their theory of foot voting was not a vision of radically reduced public expenditures or tax burdens. That was the main concern of James Buchanan. Worried about the mounting federal deficit in the late 1980s, he took the exit option to its logical conclusion. In place of the individual exit theory of Tiebout, Ostrom, and Oates, he developed a theory of coalitional exit, involving the threat of secession of a group of citizens. A constitutionally guaranteed right of secession, Buchanan had come to believe, was the only provision that could prevent American government from imposing ever more taxes on its citizens.

Speaking at the National Governor's conference in 1969, Richard Nixon addressed the problems of governability at the turn of the 1970s. "The central race is neither an arms race nor a space race," he declared. "It is the race between man and change." Putting Cold War concerns to the side, Nixon rearticulated the challenges at the end of the 1960s in extension of modernity's perennial problem of change. "The central question is whether we are to be the master of events, or the pawn of events. If we are to win this race, our first need is to make government governable." The root cause of this governability crisis, according to Nixon, was the mounting federal deficit. State and local governments were under pressure from citizens' rising demands for services on the one hand and rising costs of provision on the other. The Lyndon B. Johnson administration had spent more than 250 billion dollars on social programs as part of his Great Society platform. "Yet far from solving our problem," Nixon explained, "these expenditures had reaped a harvest of dissatisfaction, frustration, and bitter division." Worse, it was proving very difficult generating sufficient revenue to cover these enormous spending increases.

“Overcentralized, over-bureaucratized, the federal government became unresponsive as well as inefficient,” he continued. Nixon’s answer to these problems was government reforms centered on his vision for a “New Federalism.” This philosophy of devolved government was a direct response to the centralization associated with the New Deal, Fair Deal, and Great Society social programs. The core of the New Federalism was “to help regain control of our national destiny by returning a greater share of control to state and local governments and the people.”<sup>6</sup> By the 1970s, then, the idea of federalism saw a revival in response to the problems of the New Deal order.

Among the political theorists who engaged with the concept of federalism in postwar America, the most prominent was the émigré political scientist Carl J. Friedrich. Concerned about the postwar political developments in Europe and particularly his native Germany, Friedrich developed a theory of federalism as process in the 1950s and 1960s.<sup>7</sup> Friedrich’s interest in federalism derived from his interest in constitutional theory. He considered the two inseparable. “The rise of modern constitutional government has been accompanied by the establishment of an increasing number of federal schemes,” Friedrich explained in *Constitutional Government and Democracy*, first published in 1950. “The parallel is so

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<sup>6</sup> Richard Nixon, “Address at the National Governors’ Conference,” September 1, 1969, [www.presidency.ucsb.edu/documents/address-the-national-governors-conference](http://www.presidency.ucsb.edu/documents/address-the-national-governors-conference).

<sup>7</sup> Carl J. Friedrich, *Trends of Federalism in Theory and Practice* (New York, NY: Frederick A. Praeger Publishers, 1968).

striking that federalism must be considered one of the most important aspects of constitutionalism.”<sup>8</sup>

Friedrich was involved in the establishment of the European Political Community in the 1950s, and in extension of these efforts to construct a new Continental political unit he developed his theory of federalism. Federalizing was a continuously evolving process:

Federalism should not be considered as a static pattern, as a fixed and precise term of division of powers between central and component authorities. Instead, federalism should be seen as *the process of federalizing a political community*, as the process by which a number of separate political organizations, be they states or any other kinds of associations, enter into arrangements for making joint decisions on joint problems, or conversely the process through which a hitherto unitary political organization becomes decentralized to the point where separate and distinct political communities arise and become politically organized and capable of making separate decisions on distinct problems.<sup>9</sup>

Friedrich’s work on federalism was concerned with the first instance of the federalizing process. The construction of a European political community required arrangements that allowed the countries to make joint decisions about joint problems. The first efforts at establishing such a European

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<sup>8</sup> Carl J. Friedrich, *Constitutional Government and Democracy: Theory and Practice in Europe and America*, Third Edition (New York, NY: Ginn and Company, 1950), 189.

<sup>9</sup> Carl J. Friedrich, “Federal Constitutional Theory and Emergent Proposals,” in *Federalism: Mature and Emergent*, ed. Arthur W. Macmahon (New York, NY: Russell and Russell Inc., 1962), 514–515.

community failed, but later a European Economic Community developed and evolved into a fragile union of European states.

Another significant political scientist who participated in the postwar debate about federalism was William Riker. He preceded his foray into federalist theory with a significant contribution to public choice theory. *The Theory of Political Coalitions*, published in 1962, was the first book in the tradition of positive political theory, which helped pioneer rational choice and game theories in political science departments, where they later became mainstream. The same year *The Theory of Political Coalitions* was published, Riker accepted a position as chair of the University of Rochester's Department of Political Science, a position he held until 1977. The expectation was that Riker would build a political science program that would rival the best in the country. It was a success. Before Riker's arrival the department had been unranked. Ten years later it ranked fourteenth, and twenty years later it was among the top ten political science departments in the United States. In building a program focused on so-called "positive political theory," Riker stressed quantitative methods and formal methods of analysis.<sup>10</sup>

*The Theory of Political Coalitions* was, in part, a reaction to Anthony Downs's economic theory of democracy. Contrary to Downs, Riker introduced the so-called size principle, which holds that politicians form minimal winning coalitions, that is, coalitions that are only as large as they need to be. The difference between Riker and Downs stemmed in large part from their different conceptions of politicians' aims. In Downs's

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<sup>10</sup> Bruce Bueno de Mesquita and Kenneth Shepsle, "William Harrison Riker, 1920–1993," *Biographical Memoirs* 79 (2001): 11.

*An Economic Theory of Democracy*, politicians were first and foremost office seekers, and therefore the maximization of votes made sense in his theory. By contrast, in Riker's theory of political coalitions, politicians were first and foremost allocators of society's scarce resources, and therefore it made sense for them to form the smallest coalitions possible.<sup>11</sup>

Riker's work was striking in its use of game-theoretical tools to explain political phenomena. Riker's *Theory of Political Coalitions* was preceded by the recent publications of R. Duncan Luce and Howard Raiffa's 1957 *Games and Decisions*, as well as Thomas Schelling's 1960 book *The Strategy of Conflict*, which won him the 2005 Nobel Memorial Prize in Economic Sciences. In particular, Schelling's work was a product of the Cold War tensions between the Soviet Union and the United States, analyzing as it did strategic behavior in international conflict situations. Relying on the same theoretical apparatus, but unrelated to contemporary problems of international relations, Riker's book was an attempt to explain legislative processes in Congress through game theory. His conclusion was that legislative processes, contrary to the conclusions of Downs, often resulted in disequilibrium, rendering the system unstable.

Riker's theory of federalism was similarly negative. He "interpreted federalism as a bargain between prospective national leaders and officials of constituent governments for the purpose of aggregating territory, the better to lay taxes and raise armies."<sup>12</sup> Politicians struck this bargain to meet threats,

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<sup>11</sup> *Ibid.*, 8.

<sup>12</sup> William H. Riker, *Federalism: Origin, Operation, Significance* (Boston, MA and Toronto: Little, Brown and Company, 1964), 11.

diplomatic or military. Riker positioned this theory against Beard's interpretation of the constitution. Whereas Beard had offered an economic theory of the shift from a peripheralized federalism under the Articles of Confederation to a centralized form of federalism under the new constitution, Riker offered what he called a military interpretation of the constitution. In other words, he argued that federalism emerged out of military concerns. Resting his case on the fact *The Federalist Papers* dealt heavily with defense issues, he claimed that the founders meant the federalist structure to provide security for the United States.<sup>13</sup> This claim had important implications. Because the purpose of centralized federalism was to provide military security, Riker did not believe that it had any practical importance in the way people were governed.

Riker's theory of federalism was universally acknowledged as a significant contribution to the debate about federalism, but it was not universally accepted. Vincent Ostrom was among the theorists who took issue with Riker's account.<sup>14</sup> Whereas Riker did not believe that federalism made any difference in the way people were governed, Ostrom's work revolved around arguments for a devolved system of government.

The starting point of Ostrom's theory of federalism was Charles M. Tiebout's 1956 "A Pure Theory of Local Public Expenditures." This article developed a theory of foot voting, which came to form the basis of Ostrom's vision of federalism. Responding to Paul Samuelson's 1954 article "The Pure Theory of Public Expenditure," Tiebout reconceptualized local public

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<sup>13</sup> *Ibid.*, 17–20.

<sup>14</sup> Vincent Ostrom, "Can Federalism Make a Difference?," *Publius* 3, no. 2 (1973): 197–237, doi:10.2307/3329443.

organizations as firms competing for citizen-customers who revealed their preferences by moving if the local supply of public goods and services did not satisfy their wants. As customers of public organizations, citizens were shoppers, choosing between different communities according to their preferences for public goods and services.

Tiebout's article demonstrated that government could be efficient, but only if it was decentralized and government provision of goods and services subjected to market-like competition for citizens. The result of Tiebout's model was a disenchantment of centralized public power, on the one hand, and a reenchantment of decentralized private power, on the other hand. The starting point of his analysis was the argument that citizens were better able to express their demands for public goods and services at the local level than at the national level.<sup>15</sup> Tiebout offered an alternative definition of a public good as "one which should be produced, but for which there is no feasible method of charging the consumers."<sup>16</sup> Compared to Samuelson's definition, this conceptualization had the advantage that it allowed for the objections of Enke and Margolis. In other words, Tiebout believed that his definition had the advantage that it did not reduce government to providing goods that were non-rivalrous and non-exclusionary. It allowed government to produce whatever goods the market mechanism was unable to put a price on but which needed to be provided anyway.

The problem was finding a mechanism for preference revelation that would do the work that the price system failed to

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<sup>15</sup> Charles M. Tiebout, "A Pure Theory of Local Expenditures," *Journal of Political Economy* 64, no. 5 (1956): 416.

<sup>16</sup> *Ibid.*, 417.

do. According to Tiebout, “[t]he core problem with which both Musgrave and Samuelson deal concerns the mechanism by which consumer-voters register their preferences for public goods.”<sup>17</sup> In extension of this, Tiebout envisioned government as a firm-like organization “whose objective it is to ascertain [the consumer’s] wants for public goods and tax him accordingly.”<sup>18</sup> To Tiebout, then, the purpose of government was the supply of public goods and services. The trouble was finding a decentralized solution that would work just as efficiently as the market.

The solution that Tiebout provided was local rather than centralized provision of public goods and services. This would allow citizens to pick the community that offered the goods and services which corresponded most closely to their preferences. This assumption rested on two preconditions. First, differences between communities were an essential component in this vision of decentralized public goods provision. Variance in the provision of local public goods meant that the particular demands of citizens were more likely to be met. Second, there needed to be a large number of communities for citizens to choose between. The larger the number of communities, the greater the competition.<sup>19</sup> Just as on the market, the logic of competition between communities would ensure adequate choices for consumers to choose between:

Just as the consumer may be visualized as walking to a private market place to buy his goods, the prices of which are set, we place in the position of walking to a community where the prices (taxes) of

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<sup>17</sup> Ibid.

<sup>18</sup> Ibid.

<sup>19</sup> Ibid., 418.

community services are set. Both trips take the consumer to market. There is no way in which the consumer can avoid revealing his preferences in a spatial economy. Spatial mobility provides the local public-goods counterpart to the private market's shopping trip.<sup>20</sup>

Tiebout thus contended that there was a solution to Samuelson's problem of preference revelation. The mobility of citizen-customers would ensure that they picked the local communities that best suited their pattern of preferences,<sup>21</sup> but it required a fragmentation of national power into a cacophony of local governments. This feudalistic vision of communities competing for customers of public goods and services could easily be mistaken for yet another example of a mid-century American vision of small-scale community development.<sup>22</sup> It was not. It was a vision of communities forced to compete by the market-like mobility of citizens. It was a vision of communities under constant pressure to improve or perish.

This was also evident in Samuelson's uneasy comments on Tiebout's article. Samuelson conceded that Tiebout's model went some way to providing a solution to the problem of preference revelation. However, he raised a number of objections to Tiebout's theory. His principal concern was based on a far more communitarian vision of local government than Tiebout's. "People want to 'improve' their community, not abdicate from it," he argued.<sup>23</sup> According to

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<sup>20</sup> Ibid., 422.

<sup>21</sup> Ibid., 424.

<sup>22</sup> Daniel Immerwahr, *Thinking Small: The United States and the Lure of Community Development* (Cambridge, MA: Harvard University Press, 2015).

<sup>23</sup> Paul A. Samuelson, "Aspects of Public Expenditure Theories," *The Review of Economics and Statistics* 40, no. 4 (1958): 337.

Samuelson, citizens were not likely to abandon their communities in favor of others. They were more likely to stay and try to improve them through political means rather than force them to improve through the economics of leaving. Citizens, though individually sovereign, as indicated by Samuelson's use of the word "abdicate," had social responsibilities to their communities from which they should not be allowed to flee. However, even if people were likely to simply leave their communities, Samuelson questioned "whether groups or like-minded individuals shall be 'free' to 'run out' on their social responsibilities and go off by themselves."<sup>24</sup>

In postwar America, several municipalities were experimenting with market-like competition between suppliers of public goods and services. One of the forerunners of this development was Los Angeles. California's sprawling largest city thus provided plenty of opportunities to study marketization, and in 1958 Tiebout took an assistant professorship at the University of California at Los Angeles.<sup>25</sup> In this connection, Tiebout came into contact with Vincent Ostrom, a political scientist who had earned his PhD from UCLA in 1950. The same year that Tiebout accepted a position in Los Angeles, Ostrom was hired by UCLA's political science department. Part of Ostrom's position was at UCLA's Bureau of Governmental Research, where he participated in the Lakewood Project. Lakewood

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<sup>24</sup> Ibid.

<sup>25</sup> This paragraph builds on John D. Singleton, "Sorting Charles Tiebout," *History of Political Economy* 47, Annual Supplement (2015): 218–221.

was a planned suburban community completed in 1953.<sup>26</sup> Lakewood's residents voted to incorporate as a city under Los Angeles County in 1954. In a pioneering move, Lakewood chose to contract the City of Los Angeles to provide most of its municipal goods and services. Contracting out was thus not a product of the 1970s but envisioned and implemented much earlier. The purpose of the Bureau of Governmental Research's project was to study the contract system in Los Angeles.

Upon settling at UCLA, Tiebout began attending the project seminars that also included Robert Warren and Elinor Awan, who would later marry Ostrom and take his last name. The minutes of a 1959 seminar makes the intent of the Lakewood Project very clear. "The Lakewood Project—the study of the contract system in Los Angeles—will be approached in light of the model furnished by economics," the minutes explained. "Rather than as a limited examination of relations between political units, this study will evaluate the performance of the county government as a seller of goods and services, and of particular local units as the buyers of these services, as unions organized to meet the demand of consumers (the citizens)."<sup>27</sup> This was a commercialization of citizenship. The reconceptualization of the citizen as a consumer was thus at the very heart of the Lakewood Project, which analyzed "the interaction within the area as the operation of a market system."<sup>28</sup> Like an industrial organization, the object of government, whether local, state, or federal, was the provision of goods and services,

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<sup>26</sup> This paragraph builds on Mike Davis, *City of Quartz: Excavating the Future in Los Angeles* (London: Verso, 2006), 165–169.

<sup>27</sup> Quoted in Singleton, "Sorting Charles Tiebout," 219.

<sup>28</sup> Quoted in *ibid.*

and government needed to be analyzed as such. This entailed a different view of the citizen, as a consumer rather than a political being. This application of economics to matters of politics provoked disagreement from a number of political scientists at the Bureau of Governmental Research, and eventually the Bureau's report on Lakewood bore neither Tiebout's, Warren's, nor Ostrom's names.

The three pursued their economic analysis of metropolitan government elsewhere. In a 1961 article on "The Organization of Government in Metropolitan Areas," the three introduced the concept of polycentricity, which they defined as "many centers of decision-making which are formally independent of each other."<sup>29</sup> This was a reinvention of federalism. Whereas the traditional conception implied a separation of jurisdictions into local, state, and national levels, polycentricity implied crosscutting these jurisdictions on specific matters of policy.<sup>30</sup> Polycentricity conceived of politics in economic terms, arriving at the conclusion that both collective decision-making and the supply of public goods and services should be decentralized.

The Hungarian-British philosopher Michael Polanyi first coined the concept of polycentricity in his 1951 book *The Logic of Liberty*.<sup>31</sup> Polanyi initially developed the concept to explain

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<sup>29</sup> Vincent Ostrom, Charles M. Tiebout, and Robert Warren, "The Organization of Government in Metropolitan Areas: A Theoretical Inquiry," *American Political Science Review* 55, no. 4 (December 1961): 831.

<sup>30</sup> McGinnis and Ostrom, "Reflections on Vincent Ostrom, Public Administration, and Polycentricity," 15.

<sup>31</sup> Michael Polanyi, *The Logic of Liberty: Reflections and Rejoinders* (London: Routledge and Kegan Paul, 1951).

scientific success as the outcome of a multiplicity of decision centers, but he quickly expanded the concept to address the problem of socialist calculation that Ludwig von Mises had articulated in the interwar period. Polanyi argued that the market was a polycentric system in which decisions were made by many different agents who spontaneously adjusted their behavior according to other agents' decisions.<sup>32</sup> This mimicked Friedrich Hayek's argument about the wide dispersal of knowledge in society, which purportedly explained why socialist planning boards would fail in coordinating a complex economy. Planners would simply be unable to gather and compute the information needed to plan the supply of goods.<sup>33</sup> In a similar vein, Ostrom, Tiebout, and Warren picked up the concept to explain why decentralized decision-making would not only be far more efficient in improving the relationship between ends and means but also far more democratic.

Ostrom, Tiebout, and Warren explained that their article was "an initial effort to explore some of the potentialities of a polycentric political system in providing for the government of metropolitan areas."<sup>34</sup> Anchored in local governance problems in Los Angeles, their article was an attempt to provide a decentralized theory of municipal government. In connection to this, they redescribed "the 'business' of governments in metropolitan areas as providing 'public goods and services.'"<sup>35</sup> This commodified vision of local government's purpose was one of the clearest examples of the transposition of politics

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<sup>32</sup> Aligica and Tarko, "Polycentricity," 237–238.

<sup>33</sup> Hayek, "The Use of Knowledge in Society."

<sup>34</sup> Ostrom, Tiebout, and Warren, "The Organization of Government in Metropolitan Areas," 832.

<sup>35</sup> *Ibid.*

into an economic idiom. Polycentricity was meant to provide the conceptual basis for the argument that bureaucracy could be handled on a decentralized basis and made to operate like a firm under market-like competitive conditions.

Ostrom, Tiebout, and Warren appealed to the philosopher John Dewey's conception of the public in the development of their conception of polycentricity.<sup>36</sup> "For each public good there corresponds some 'public,'" they argued.<sup>37</sup> Dewey's conception of democracy derived from his observations of industrial capitalism and the social effects of economic transactions. Explaining how the public came into being, Dewey's point of departure was the fact that human acts have consequences upon others:

Following this clew, we are led to remark that the consequences are of two kinds, those which affect the persons directly engaged in a transaction, and those which affect others beyond those immediately concerned. In this distinction we find the germ of the distinction between the private and the public. When indirect consequences are recognized and there is effort to regulate them, something having the traits of a state comes into existence. When the consequences of an action are confined, or are thought to be confined, mainly to the persons directly engaged in it, the transaction is a private one.<sup>38</sup>

This definition of the public essentially revolved around externalities. The problem was transforming society's manifold

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<sup>36</sup> For Dewey's most famous elaboration of the public and its problems, see John Dewey, *The Public and Its Problems* (Chicago, IL: The Shallow Press, 1954).

<sup>37</sup> Ostrom, Tiebout, and Warren, "The Organization of Government in Metropolitan Areas," 833.

<sup>38</sup> Dewey, *The Public and Its Problems*, 12.

private opinions into a coherent public opinion, which could serve as government's basis of legitimacy. Dewey insisted that government needed to be underpinned by democratic participation and deliberation, but Americans were stuck with "local town-meeting practices and ideas" wholly inadequate in "a continental national state."<sup>39</sup> Only slowly and incompletely did political structures adjust to the social transformations brought on by industrialization. Until the Great Society of steam and engine was transformed into a "Great Community," Dewey contended, the public would "remain in eclipse."<sup>40</sup>

Rather than affirm and legitimize the division of American society into disparate publics, Dewey believed that "the essential need, in other words, is the improvement of methods and conditions for debate, discussion and persuasion. That is *the* problem of the public."<sup>41</sup> Dewey's participatory and deliberative conception of democracy was not a realistic description of the way politics worked. His democratic vision was an ideal against which the actual workings of the American polity should be measured, an ideal against which the actual workings of the American polity fell woefully short.

Citing Dewey, Ostrom, Tiebout, and Warren explained that "the public consists of all those who are affected by the indirect consequences of transactions to such an extent that it is deemed necessary to have those consequences systematically provided for."<sup>42</sup> They thus argued that the public, a metaphysical principle, could be understood in less abstract terms

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<sup>39</sup> Ibid., 113.

<sup>40</sup> Ibid., 142.

<sup>41</sup> Ibid., 208.

<sup>42</sup> Ostrom, Tiebout, and Warren, "The Organization of Government in Metropolitan Areas," 833.

as arising when the market produced undesirable effects on third parties. In economic parlance, this was called negative externalities, that is, the social costs of market transactions. Importantly, however, every externality applied only to the delimited community whose members were affected by the social cost. This had important implications for the scale of public goods and services production: some had to be provided at the national level, others at the regional level, and others again at the local level.

Regardless of level, however, the public organizations which provided public goods and services were plagued by the problem of calculating the optimal output of goods and services, prone as it was to free riding on the part of citizens.<sup>43</sup> Ostrom, Tiebout, and Warren provided an innovative solution to this problem:

The *production* of goods and services needs to be distinguished from their *provision* at public expense. Government provision need not involve public production—indeed, at some stage in the sequence from raw materials to finished products virtually every public good, not already a natural resource, is of private origin. So, a public agency by contractual arrangements with private firms—or with other public agencies—can provide the local community with public services without going into the business of producing them itself.<sup>44</sup>

The primary benefit of outsourcing the production of public goods and services was that it allowed the political community, responsible only for their provision, to put more pressure on the producers through the performance measures that competition induced. This was a vision of local public

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<sup>43</sup> Ibid.

<sup>44</sup> Ibid., 834, italics in original.

economies operating under market-like conditions. As a substitute for the pricing of public goods, which was impossible to ascertain, competition between providers, whether public or private, would keep government spending in line and in accordance with citizens' preferences for public goods and services. Measurement and quantification allowed public service providers to rank producers and thereby enforce competition.<sup>45</sup> Market-like competition, according to Ostrom, Tiebout, and Warren, had the advantage that it improved control, efficiency, political representation, and self-determination, the four criteria they outlined for the optimal production and provision of public services.<sup>46</sup>

In this context, the most important aspect of public organization was making sure that the size of the bureau corresponded with the affected public and the decision-making political community. Citing Dewey once again, they argued that problems of scale arise when the political community did not coincide with the affected public. This suggested that the existing boundaries between local, state, and federal levels should be replaced with crosscutting jurisdictions. This would make the size of the relevant governmental organization coterminous with the relevant public and the relevant political community.<sup>47</sup>

By contrast, in the traditional centralized structure of governmental organization, which had grown increasingly hierarchical since the turn of the century, the scale of the organization was out of touch with the relevant public, which in turn did not necessarily correspond with those who made

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<sup>45</sup> *Ibid.*, 834.

<sup>46</sup> *Ibid.*, 835.

<sup>47</sup> *Ibid.*, 836.

the decisions. Ostrom, Tiebout, and Warren called this modern state form “Gargantua,” which “with its single dominant center of decision-making, is apt to become a victim of the complexity of its own hierarchical or bureaucratic structure.”<sup>48</sup> The major problem with the Gargantua of public organization was that it was all too often “unresponsive to many of the more localized public interests in the community.”<sup>49</sup> This was a classic critique of the disconnect between centralized organization and peripheral interests. Their original contribution was to introduce market-like mechanisms as a solution to the tension between administrative efficiency and democratic legitimacy.

The problem of a centralized state, according to Ostrom, Tiebout, and Warren, was fragmenting it into the “smaller sets of publics that may exist within its boundaries.”<sup>50</sup> Once these local publics had been recognized, the provision of the relevant public goods and services could be selected and produced by separate entities, either public or private. What mattered was the introduction of competition among these producers. “Patterns of competition among producers of public services in a metropolitan area, just as among firms in the market,” Ostrom, Tiebout, and Warren reasoned, “may produce substantial benefits by inducing self-regulating tendencies with pressure for the efficient solution in the operation of the whole system.”<sup>51</sup> By introducing an invisible hand into the production of public goods and services, competition would solve the tension between efficiency and representation that was one of the core problems of modern government.

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<sup>48</sup> *Ibid.*, 837.

<sup>49</sup> *Ibid.*

<sup>50</sup> *Ibid.*

<sup>51</sup> *Ibid.*, 838.

Explicitly redescribing public service providers as “vendors,” Ostrom, Tiebout, and Warren argued that competition would increase both responsiveness and efficiency. The separation of provision from production would not only improve the computation of the optimal level of public goods; it would also ensure that bureaucratic suppliers of public goods varied their products according to each citizen’s individual preferences.<sup>52</sup> This was a reinterpretation of the relationship between citizens and local governments as one between customers and firms. The premise of this theory was the same that Tiebout had outlined in his 1956 article offering a “Pure Theory of Local Expenditures.” Citizens needed to be willing and able to move to another community if it suited their order of preferences better. A greater variety in service levels between communities was the precondition for citizens’ choice between these different areas. Less variety meant less mobility on the part of citizens and thus less competition between communities and public organizations in the supply of public goods.<sup>53</sup> This competition between and within metropolitan communities would resolve possible conflicts between efficiency concerns and democratic concerns of representation. As long as citizens were willing to vote with their feet, local governments would be forced to respond to attract customers to their store.

The market model of local government was a thoroughly economic vision of politics. Yet its objective was not to shrink the state or the scope and reach of politics. The aim was to make bureaucracy more democratic as well as efficient by decentralizing bureaus and subjecting them to market-like competition. The aim was not the limitation of bureaucracy but

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<sup>52</sup> *Ibid.*, 839.

<sup>53</sup> *Ibid.*, 838.

the fulfillment of its promises by introducing the exit option in the provision of publicly provided goods and services. Ostrom's vision of politics, in other words, was thoroughly democratic. However, it was very different from Dewey's participatory and deliberative vision of democracy. Guided by the invisible hand of polycentric competition, governments in Ostrom's vision would be forced to serve their communities or perish in the face of citizens' exit to other jurisdictions.

In the early 1970s, Ostrom explicitly tied the theory of polycentricity and foot voting to the principle of federalism. His *Political Theory of the Compound Republic*, published in 1971, excavated the logic of federalism in James Madison and Alexander Hamilton's essays in *The Federalist Papers*. Written as contributions to the constitutional debates in 1787 and 1788, *The Federalist Papers* defended and explained the new constitution that was under consideration in the states after its drafting at the Federal Convention. The new constitution was under heavy attack from anti-federalists who believed that it spelled centralization and violations of the individual rights of citizens. Generally, the anti-federalists were in favor of small communities and feared the effects of the powerful central government proposed by the new constitution. In the process of articulating supporting arguments for the new constitution, the federalists redefined the meaning of a republic. Before *The Federalist Papers*, republics were generally associated with small states in which the people were greatly involved in the political process. Madison, however, redefined it by associating it with large states in which representatives ruled on behalf of the people, corresponding to the political structure that would result from the new constitution. One motive behind the effort to turn the thirteen states into a union was to consolidate America fiscally, enabling the young republic to pay

back its creditors for the loans that had paid for the war. From the very beginning, then, the American federal structure was closely connected to fiscal policy.

Given that Madison and Hamilton were actually centralizers, the enthusiasm of Ostrom and other decentralizers for *The Federalist Papers* appears odd, but they saw in their federalism an unfulfilled promise of devolved power. Ostrom pleaded for a polycentric system, decentralized in quasi-market fashion. Democratic societies, now in thrall to centralization, depended for their survival on a polycentric structure of government. This, according to Ostrom, was the strength of federalism. As fragmentation was an inherent component in a federalist system, it was an ideal form of government.<sup>54</sup> Federalism, in other words, was an optimal form of political polycentricity.

Ostrom's interest in federalism coincided with the emergence of fiscal federalism as a subfield of public economics. The increasing interest in the local and state levels among economists of the public sector was the result of several circumstances. In a survey of the burgeoning subfield, published in 1971, Richard Musgrave pointed to three reasons. First, the general thrust of public finance theory pointed in the direction of the local level. After all, states and local governments provided most social goods and services, which made it natural to take a closer look at lower levels of government. Second, there was an increasing interest in "decentralization as a way of life." As evident in the Port Huron Statement, baby boomers rejected the centralization associated with the New Deal order. Instead, they favored smaller, local communities in which political

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<sup>54</sup> Vincent Ostrom, "Polycentricity" (Annual Meeting of the American Political Science Association, Washington Hilton Hotel, 1972), 5.

participation was easier to achieve. Third, the renewed interest in fiscal federalism was the result of the increasing fiscal pressures on many local and state governments. In particular, urban centers were in fiscal distress. Accordingly, one of the most important issues in the subfield of fiscal federalism was the question of redistribution from rich states to poorer states.<sup>55</sup>

Building on Charles Tiebout and Vincent Ostrom's work, Wallace E. Oates provided an important early contribution to the field with his book *Fiscal Federalism*, published in 1972. Oates's book was a response to "the ever-mounting budgetary difficulties of state and local governments in the United States and, more generally, of decentralized governments in a great number of countries."<sup>56</sup> This fiscal crisis, according to Oates, pointed to the fact that the public sector's structure needed revision. Nixon's New Federalism was an example of this, and Oates's book was an attempt to put meat on the bones of this rethinking of the structure of intergovernmental fiscal relations.<sup>57</sup>

*Fiscal Federalism* developed the so-called decentralization theorem, which held that a central government was best able to solve the problems of economic stabilization and distribution. By contrast, local governments were best able to solve the problems associated with the provision of public goods and services. If a central government supplied these services,

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<sup>55</sup> Richard A. Musgrave, "Economics of Fiscal Federalism," *Nebraska Journal of Economics and Business* 10, no. 4 (1971): 3-4.

<sup>56</sup> Wallace E. Oates, *Fiscal Federalism* (New York, NY: Harcourt Brace Jovanovic, Inc., 1972), v.

<sup>57</sup> *Ibid.*

they would likely result in welfare losses associated with uniformity in consumption and technical waste in their production. "From an economic standpoint," Oates concluded, "the obvious attraction of the federal form of government is that it combines the strengths of unitary government with those of decentralization."<sup>58</sup> As such, only federalism was able to solve the problems of the public sector.

Oates advanced an economic definition of federalism as "a public sector with both centralized and decentralized levels of decision-making in which choices made at each level concerning the provision of public services are determined largely by the demands for these services of the residents of (and perhaps others who carry on activities in) the respective jurisdiction."<sup>59</sup> What mattered in the provision of public goods and services was that local governments decided on their appropriate level of output.

Following Tiebout, Oates argued that centralized government failed to take the variation of preferences among citizens of different geographical areas into account. The smaller the area, the greater the likelihood that individual preferences were more similar. Decentralized government, in other words, offered "the promise of increasing economic efficiency by providing a range of outputs of certain public goods that corresponds more closely to the differing tastes of groups of consumers."<sup>60</sup> Citizen mobility, as first observed by Tiebout, further strengthened this pattern, because citizens as consumers voted with their feet by selecting the community whose level of public output best satisfied their preferences. In turn,

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<sup>58</sup> *Ibid.*, 14.

<sup>59</sup> *Ibid.*, 17.

<sup>60</sup> *Ibid.*, 12.

the availability of the market-like exit option put competitive pressure on local governments to experiment and be innovative in the production of public goods and services. Finally, decentralized production had the further advantage that it tied expenditure decisions closer to the real costs associated with public production.<sup>61</sup>

Public finance theorists like Oates helped keep the conversation about New Federalism going. This initiative was part of a broad-based effort to reduce both the scale and the size of the federal level of government. Among the chief advocates of devolved fiscal responsibilities was Ronald Reagan. When he entered office in 1981, Reagan took up Nixon's New Federalism. Like Nixon, he deployed the idea of federalism as part of an attempt to break down the barriers of the New Deal state.

In his State of the Union address before Congress in early 1982, President Reagan launched a major initiative to renew the federalist creed. Having spelled out his program of spending cuts, he laid out "a program—just as bold, just as innovative—to make government again accountable to the people, to make our system of federalism work again."<sup>62</sup> Reagan meant this renewal of federalism to address the dissatisfaction with government performance that had only grown since it exploded at the turn of the 1970s. Like Nixon, he wanted to give control of public services and government spending back to the American people:

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<sup>61</sup> *Ibid.*, 12–13.

<sup>62</sup> Ronald Reagan, "Address Before a Joint Session of the Congress Reporting on the State of the Union," January 26, 1982, [www.presidency.ucsb.edu/documents/address-before-joint-session-the-congress-reporting-the-state-the-union-2](http://www.presidency.ucsb.edu/documents/address-before-joint-session-the-congress-reporting-the-state-the-union-2).

Our citizens feel they've lost control of even the most basic decisions made about the essential services of government, such as schools, welfare, roads, and even garbage collection. And they're right. A maze of interlocking jurisdictions and levels of government confronts average citizens in trying to solve even the simplest of problems. They don't know where to turn for answers, who to hold accountable, who to praise, who to blame, who to vote for or against. The main reason for this is the overpowering growth of federal grants-in-aid programs during the past few decades.<sup>63</sup>

In other words, the crisis of democracy, in Reagan's telling, was mainly the result of federally sponsored programs. The federal government allocates grant-in-aid funds to lower levels of government, sponsoring public goods and services under certain conditions and requirements, which entails an encroachment on the lower level of government and an accompanying centralization of power. According to Reagan, these grants, which cost nearly 100 billion dollars, had made federal government more intrusive, ineffective, costly, unmanageable, and unaccountable. The solution was to decentralize and cut spending. The Reagan administration proceeded to consult representatives at all levels of government about a realignment of government responsibilities. These negotiations became known as the "New Federalism negotiations."<sup>64</sup> The consultations did not result in the promised legislation, but they played an important part in Reagan's ideological efforts to deconstruct the administrative state.

Reagan had campaigned on a populist message to cut taxes, promising to lower Americans' income taxes. This was

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<sup>63</sup> Ibid.

<sup>64</sup> Richard S. Williamson, "The 1982 New Federalism Negotiations," *Publius: The Journal of Federalism* 13 (1983): 11.

a popular message after a decade of focus on tax expenditures, which strengthened long-running American tax resistance attitudes. The rise of tax-cut populism in 1970s and 1980s America was partly a consequence of the greater reliance, compared to Europe, on income, profit, and capital gains as revenue sources rather than excise taxes. The result was widespread dissatisfaction with the American system of taxation.<sup>65</sup>

The effort to lower income taxes was also part of the attempt to roll back the scope of the American welfare state as it had developed since the 1930s. Reagan suggested as much during a national address in 1981. “We can lecture our children about extravagance until we run out of voice and breath. Or we can cure their extravagance simply by reducing their allowance.”<sup>66</sup> Like spoiled children, representatives—and by extension their voters—needed to have their tax revenues reduced. His and other conservatives’ logic was that a reduction in revenues would lead to a reduction in spending for goods and services offered by the state. The assassination attempt on Reagan greatly aided the Republicans’ legislative efforts, and in August 1981 Congress passed the Economic Recovery Tax Act. It reduced the top individual income tax rate from 70% to 50%, a massive reduction that marked the beginning of a new tax regime, ending the era of easy finance that preceded it.<sup>67</sup> This was the context of Reagan’s embrace of New

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<sup>65</sup> Monica Prasad, *Starving the Beast: Ronald Reagan and the Tax Cut Revolution* (New York, NY: Russell Sage Foundation, 2018), 11.

<sup>66</sup> Quoted in W. Elliot Brownlee, *Federal Taxation in America: A History*, Third Edition (New York, NY: Cambridge University Press, 2016), 185.

<sup>67</sup> Brownlee, *Federal Taxation in America*.

Federalism. Reducing grants-in-aid and devolving responsibility for government goods and services would give states greater control over their fiscal policies. Under threat of citizen mobility, states and local governments would be compelled to keep revenues low.

Commenting on the resurgence of the New Federalism under Reagan, Wallace E. Oates took issue with the administration's proposal to shift the responsibility for Aid to Families with Dependent Children (AFDC) and the Food Stamp Program from the federal to the local level.<sup>68</sup> Established as part of the Social Security Act of 1935, AFDC was an important component in the construction of the American welfare state. The program provided cash payments to children whose parents were deceased, unemployed, unable to work, or absent from home. It was funded by the federal government but administered by the states, who were fully reimbursed for the costs of providing the benefits. Like the Food Stamp Program, it was a vital component of New Deal liberals' efforts to alleviate poverty and want through redistribution. The Roosevelt administration established the first Food Stamp Program in 1939 to curb the effects of widespread unemployment. The program ceased to exist in 1943 when wartime production had increased employment, effectively ending the economic downturns that had plagued the 1930s. Lyndon B. Johnson's administration reestablished the program as part of his War on Poverty platform, which also included significant achievements such as Medicaid, Medicare, and Head Start. In 1974, under Nixon, the program was made available nationwide so that all Americans were eligible for supplemental nutrition assistance.

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<sup>68</sup> Wallace E. Oates, "The New Federalism: An Economist's View," *Cato Journal* 2, no. 2 (1982): 478–479.

Against the background of Richard Musgrave's tripartite division of public finance, Oates opposed the shift in responsibility for these programs from the federal to the local level.<sup>69</sup> In 1959, Musgrave had divided government into three branches, a distribution branch, a stabilization branch, and an allocation branch. The function of the distribution branch was to improve social equity by curbing the unequal outcomes in income and wealth determined by the market. The function of the stabilization branch was to stabilize the market system through macroeconomic instruments like targeted public spending and taxation to achieve a high employment rate along with price stability. The function of the allocation branch was to provide the goods and services that the market system could not supply, or only provided inefficiently.<sup>70</sup>

Along with most public finance theorists at the time, Oates believed that the federal level of government should be responsible for stabilization and distribution. Economic downturns were generally national in scope, and countercyclical measures required a central authority of sufficient size to deploy the fiscal tools of monetary control and spending and taxation.<sup>71</sup> The scope of decentralized redistributive programs was likewise circumscribed. Local politicians would restrain their taxation for fear of driving high-income residents from their jurisdictions. Oates thus believed that mobility worked against social equity. Citizen mobility would hinder local

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<sup>69</sup> *Ibid.*, 474.

<sup>70</sup> Richard Abel Musgrave, *The Theory of Public Finance: A Study in Public Economy* (Tokyo: McGraw-Hill Kogakusha, 1959).

<sup>71</sup> Oates, "The New Federalism: An Economist's View," 475.

governments in collecting sufficient revenues to redistribute resources. This reflected Oates's social liberal starting point. He argued that poverty was fundamentally a national problem. The poor were unevenly divided across the United States, and central funding was necessary to redistribute resources from well-off to less well-off areas.<sup>72</sup>

Oates opposed the shift in responsibility for programs like Food Stamps and AFDC against this background. Like most public sector economists, he believed that funding for anti-poverty, redistributive programs was a responsibility for the federal level of government—out of both efficiency and equity concerns. By contrast, “the *raison d’être* for decentralized government is found in the allocation function,” Oates explained. “For various services of primarily local interest, there is a compelling case for local provision in accordance with the tastes or preferences of local residents.”<sup>73</sup> Accordingly, Oates favored the New Federalism proposals for turning over control of some federal programs of education, social services, transportation, and community development.<sup>74</sup> Whereas states and municipalities might as well supply these goods and services, federal support for assistance to the poor was essential for its provision. “In short,” Oates explained, “this is one facet of the New Federalism that involves a fundamental misunderstanding of the appropriate role of different levels of governments—a misunderstanding that may well undermine efforts to provide adequately for the poor.”<sup>75</sup>

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<sup>72</sup> *Ibid.*, 475–476.

<sup>73</sup> *Ibid.*, 477.

<sup>74</sup> *Ibid.*, 480.

<sup>75</sup> *Ibid.*, 479.

Reagan proceeded to cut both the Food Stamp Program and AFDC. Ideally, he believed that the federal government should primarily be in charge of foreign policy and defense spending. Accordingly, he pushed to increase defense spending significantly. The result was a ballooning deficit, which became a concern in public debates and within the White House.<sup>76</sup> The logic that a reduction in revenues would lead to a reduction in spending was not borne out. Inadvertently or not, Reagan ended up increasing the federal deficit enormously.

The growing deficit worried James Buchanan. He acknowledged that citizen mobility had the potential to make government more responsive and representative, but he was skeptical about its ability to curb spending and tax increases. "Free trade and migration parallel in effect some of the Wicksell-like procedural rules," Buchanan and his co-author explained in *The Power to Tax* from 1980. "By contrast with the latter, however, the indirect controls over leviathan exercised by free international economic exchange seem closer to the realm of the institutionally feasible, at least in western nations, than do the required procedural departures from majoritarian electoral processes."<sup>77</sup> Buchanan thus acknowledged that competitive federalism was a more feasible solution for the introduction of fiscal constraints than supra-majority rules and unanimity criteria. In contrast to these constitutional amendments, citizen mobility between competing political units would "render any overt fiscal constraints unnecessary."<sup>78</sup>

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<sup>76</sup> Brownlee, *Federal Taxation in America*, 187.

<sup>77</sup> Brennan and Buchanan, *The Power to Tax*, 201 in Liberty Fund Version.

<sup>78</sup> *Ibid.*

However, Buchanan considered Tiebout's model, which was the paradigm example of a world of free trade and migration, an extremely restrictive theory. While intergovernmental competition would serve to constrain governments at the lowest, local level, it would not deter government at the federal level or even the intermediate state level from imposing taxes on their citizens. Constitutional changes ought to reflect this, Buchanan and Brennan inferred, arguing that fiscal constraints were necessary to reduce taxing and spending power at the federal level. The trick, in a sense, was to redistribute power to the lowest levels of government, enabling the threat of migration to do its magic.

In the 1980s, Buchanan increasingly focused on the moral dimension of deficit spending. "The political decision makers did not 'discover' a new technology of debt financing midway through this century," he explained, speaking in Las Vegas in 1984. "What happened in this century was that debt financing ceased to be immoral."<sup>79</sup> Balanced budgets had never been a constitutional requirement. Instead, policy-makers and electorates took it upon themselves to make sure that the state did not spend beyond its means. That moral responsibility had eroded in the middle decades of the twentieth century, and Buchanan's career revolved around the introduction of binding constitutional rules to create order in the ruins of this moral erosion.<sup>80</sup>

In 1986, two years after his speech in Las Vegas, Buchanan received the Nobel Memorial Prize in Economic Sciences for his work on constitutional economics. Though his theories had

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<sup>79</sup> James M. Buchanan, "The Moral Dimension of Debt Financing," *Economic Inquiry* 23, no. 1 (January 1985): 1.

<sup>80</sup> *Ibid.*, 1-2.

become widely accepted within the profession, they did not lower expenditures. In the face of the mounting public deficit, he devised new ways to slow the tendency of democratic government to increase expenditures without increasing revenues. In 1987, the year America celebrated the bicentennial of the convention that drafted the constitution of the United States, Buchanan and his co-author Roger L. Faith published an article, which developed a theory of "internal exit."<sup>81</sup> Whereas Charles Tiebout had articulated a theory of external exit, in which individual citizens migrate from one political unit to another (be it a municipality, state, or country), Buchanan and Faith focused on the secession of a coalition of citizens.<sup>82</sup> Dissatisfied with the provision of public goods, this coalition formed their own political unit and set up a new system of provision that better suited their preferences for public goods.

At the basis of Buchanan and Faith's theory was the assumption that their model constitution granted the right of secession. "It is immediately evident," they argued, "that any such liberty imposes constraints on the potentially exploitative behavior of those in the dominating or ruling political coalition."<sup>83</sup> Buchanan and his co-author thus claimed that the inferior groups would be able to reduce redistribution by threatening the ruling coalition with secession. The sharing

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<sup>81</sup> For a different account of neoliberal ideas about secession, see Slobodian, "Demos Veto and Demos Exit: The Neoliberals Who Embraced Referenda and Secession."

<sup>82</sup> James M. Buchanan and Roger L. Faith, "Secession and the Limits of Taxation: Toward a Theory of Internal Exit," *The American Economic Review* 77, no. 5 (1987): 1023.

<sup>83</sup> *Ibid.*, 1024.

coalition, which they defined as the groups that obtained net transfers from the state, would be restricted from exploiting the inferior groups or people because they feared they would secede and thus reduce revenues:

The people or groups remaining outside the sharing coalition might represent the politically ineffective, unrepresented, or rationally nonparticipating segment of the population. But such a group also presents a potential for secession—literally or figuratively, such as evading taxes or withholding moral support for the institutions of government.<sup>84</sup>

Secession, or rather the threat thereof, placed effective limits on the majority's exploitation of the minority through taxation. Buchanan and Faith's definition of secession was broad. It not only included the extreme case of an area's declaration of independence from national government; it also included citizens who seceded from their local counties by providing and financing public goods and services which the county already supplied.<sup>85</sup> Apparently, tax evasion and the withholding of moral support for government were figurative examples of secession. In either case, the authors argued, "the critical assumption that places limits on the amount of surplus is the liberty of secession."<sup>86</sup>

Buchanan's counter-majoritarian constitutionalism had evolved from advocating a unanimity criterion to a balanced-budget amendment to liberty of secession. Every single one of these was a suggestion to curb the majority's ability to tax a minority that had not consented to it in any meaningful sense.

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<sup>84</sup> *Ibid.*

<sup>85</sup> *Ibid.*, 1023.

<sup>86</sup> *Ibid.*, 1024.

The sharing coalition, who ruled in Buchanan and Faith's model, were those who received more from the state than they paid. This coalition consisted mostly of the least well-off members of society who had most to gain from the redistributions of the welfare state. The rich, by contrast, if they were not part of the ruling coalition, "can, under our assumptions, more readily set up seceding policies," Buchanan and Faith explained. "Hence, the threat that they will do so must reduce the maximal tax that may be imposed."<sup>87</sup> In other words, the rich were the ones who had the most to gain from the liberty to secede. An amendment that allowed secession would protect the wealthiest members of society from what Buchanan considered the exploitation through the "transfer state" of those who had the least.<sup>88</sup>

Even without the liberty of secession, however, the American state was taxing the richest Americans far less heavily by the end of the 1980s. Whereas the effective tax rate of the top 1% of taxpayers was 35% in 1979, it declined to under 30% in 1989. The top 0.1% of taxpayers were even better off by the decade's end. Their effective tax rate declined from 50% in 1980 to 30% in 1990. The wealthiest were doing just fine without the threat of secession.

Voice was traditionally the only option available in organizations that have a pure monopoly on the manufacturing of specific goods or the delivery of services. With the exit option unavailable in the provision of many goods and services where government had a monopoly, citizens had to voice their dissatisfaction with governmental goods and services, relying

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<sup>87</sup> *Ibid.*, 1030–1031.

<sup>88</sup> *Ibid.*, 1031.

on rhetorical abilities, joining forces in social movements to counterbalance the power of the state and corporate interest groups. The introduction of the exit option in public goods and services provision thus eliminated the ambiguity of political processes in favor of the far less confrontational medium of price-like signals.<sup>89</sup> In Hirschman's terms, the result of the market turn was arguably the effective elimination of deliberative forms of political participation.

In contrast to recent research, which has highlighted the role of radical libertarians, this chapter has argued that the politics of exit originated in public choice theorists' attempts to solve the problem of optimal public goods output. Responding to Paul Samuelson's argument that no decentralized, market-like device existed for ascertaining voters' demand for public goods, Charles Tiebout claimed that local production would solve the problem. Voting with their feet, citizens would signal their preferences to municipalities and states. Like firms, state and local governments would have to compete for mobile citizens willing and able to leave their political unit if it did not suit their preferences. Whereas most American political theorists of the nineteenth century held that an informed, articulate, and active public was a requirement of a democratic polity, public choice theorists thus reduced citizen involvement in politics to market-like signaling of their preferences for public goods and services. This was a vision of competitive federalism developed in response to the mounting fiscal pressures at the local level. Competition, public choice theorists argued, would make local and state governments efficient and responsive.

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<sup>89</sup> On the disenchantment of politics by economics, see Davies, *The Limits of Neoliberalism*.

The fault in this vision was that it left out the incentives of the individuals in charge of production. Downs had developed a theory of politicians' and political parties' incentives to cater to the median voter. Tiebout, Ostrom, and Oates had articulated a theory of institutional competition between local governments which left out the key actor in these institutions: the bureaucrat. The next chapter turns to public choice theorists' engagement with bureaucratic incentive structures. They argued that for competitive bureaucracy to work, all levels of government needed to induce public managers, the people in charge of the bureaus, to compete through the introduction of performance targets and reward systems. Only a transformation of incentive structures would force bureaucrats to produce the optimal output discerned through localized competition. This theory completed public choice theorists' vision of the marketized state.

# 5

## The Power of Performance Incentives

A core element in the reinvention of government was the introduction of performance incentives. When explaining how the Clinton administration's reinvention of government differed from previous reforms of the American public sector, the deputy project director of the National Performance Review, John Kamensky, pointed out that "the focus is on changing the internal culture of government agencies by changing the incentives employees face in doing their work."<sup>1</sup> Whereas the Nixon and Reagan administrations' new federalism, undergirded by the public choice theoretical emphasis on foot voting, had focused on changing the structure of American government, the Clinton administration's reinvention of government focused on changing bureaucratic incentives to improve performance. Mirroring the profit motive in the private sector, the purpose of performance rewards was to incentivize bureaucrats to act in the public interest. Kamensky pointed to "the pioneering intellectual work" of public choice theorists like William Niskanen as the basis of the reinvention.<sup>2</sup>

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<sup>1</sup> Kamensky, "Role of the 'Reinventing Government' Movement in Federal Management Reform," 248.

<sup>2</sup> Ibid.

Despite the assertions of key people involved in the reinvention of government, recent interventions have argued that public choice theory was not the intellectual origin of new public management. According to Samuel Knafo and his co-authors, the emulation of private business practices was far from new. American governments have been implementing business methods to increase efficiency in the public sector since the turn of the twentieth century. During the Cold War, the Defense Department, and the institutions affiliated with it, innovated several performance indicators to improve administrative efficiency and reduce waste. According to Knafo and his co-authors, this proves that the emphasis on performance management originated in the postwar emphasis on planning. The result was “managed competition,” which empowered managers through competitive performance targets.<sup>3</sup>

This chapter argues that public choice theorists shared this emphasis on empowering managers. They intended profit-like incentives to work within a competitive framework that separated provision and production. The chapter shows that two groups were the principal architects of this form of marketization. On the one hand, the economists Gordon Tullock, Anthony Downs, and William Niskanen focused on budget-maximizing bureaucrats who expanded the size of

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<sup>3</sup> Sahil Jai Dutta, Samuel Knafo, and Ian Alexander Lovering, “Neoliberal Failures and the Managerial Takeover of Governance,” *Review of International Studies*, November 18, 2021, 14; Samuel Knafo et al., “The Managerial Lineages of Neoliberalism,” *New Political Economy* 24, no. 2 (2019): 235–251; Samuel Knafo, “Neoliberalism and the Origins of Public Management,” *Review of International Political Economy*, 2019, 2.

their bureaus' budgets at the expense of the public interest. The other group of economists, which included Armen Alchian, Harold Demsetz, and Roland McKean, examined how appropriability within government differed from property rights on the market. Aiming to reconstruct the American administrative state and improve governmental efficiency, both groups suggested correcting bureaucratic incentive structures by introducing monetary remuneration to make the public sector resemble the private. This portended and precipitated the turn to performance management in the New Public Management of the 1990s, which remains a dominant approach in public administration. The broader circumstances out of which this marketization emerged were mid-century dissatisfactions with bureaucrats' ability to serve the public interest rather than their own.

The middle decades of the twentieth century were awash with worries about the detrimental effects of governmental bureaucracy on democracy.<sup>4</sup> From the 1930s through the 1960s, American social scientists and political commentators depicted bureaucracy in stark contrast to democracy. How could the rapidly expanding administrative capacities of the American state in the wake of the Great Depression and World War II be controlled? How could bureaucrats be made representative of the citizens they were supposed to serve? As the scope and reach of the American welfare state expanded over the course of the postwar period, social

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<sup>4</sup> On this, see Anne Mira Kornhauser, *Debating the American State: Liberal Anxieties and the New Leviathan, 1930–1970* (Philadelphia, PA: University of Pennsylvania Press, 2015); Martin Albrow, *Bureaucracy* (London: Macmillan, 1970).

scientists, political commentators, and activists sought answers to these questions.

In the postwar decades, social scientists turned their attention to the advent of large-scale organizations. The historian Louis Galambos, for example, identified “a shift from small-scale, informal, locally or regionally oriented groups to large-scale, national, formal organizations” in the progressive era.<sup>5</sup> This shift in organizational mode from a structure of dispersed authority to a bureaucratic, hierarchical structure of authority occurred across the spheres of politics, economics, and society.<sup>6</sup> Galambos singled out Robert H. Wiebe’s *The Search for Order*, published in 1967, as one of the most significant contributions to this emerging organizational synthesis in the historiography of twentieth-century American polity, economy, and society.<sup>7</sup> Wiebe’s central argument was that

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<sup>5</sup> Louis Galambos, “The Emerging Organizational Synthesis in Modern American History,” *The Business History Review* 44, no. 3 (1970): 279–290. For revisions of the synthesis, see Louis Galambos, “Technology, Political Economy, and Professionalization: Central Themes of the Organizational Synthesis,” *The Business History Review* 57, no. 4 (1983): 471–493; Louis Galambos, “Recasting the Organizational Synthesis: Structure and Process in the Twentieth and Twenty-First Centuries,” *The Business History Review* 79, no. 1 (2005): 1–38.

<sup>6</sup> Galambos, “The Emerging Organizational Synthesis in Modern American History.” For revisions of the synthesis, see Galambos, “Technology, Political Economy, and Professionalization”; Galambos, “Recasting the Organizational Synthesis.”

<sup>7</sup> Galambos, “The Emerging Organizational Synthesis in Modern American History,” 287.

professional, middle-class Americans, in facing the challenges of turn-of-the-century industrialization, urbanization, and immigration, came to favor executive power and professional management at all levels of government, local, state, and federal, by the end of the Progressive Era.<sup>8</sup> Galambos was but one example of the 1960s preoccupation with the advent of centralized organization, against the background of which public choice theories of bureaucracy should be seen.

The emphasis on the significance of large-scale organizations for understanding twentieth-century American society was far from new.<sup>9</sup> Already in the early 1940s, James Burnham's book *The Managerial Revolution* had identified a similar trajectory in the development of modern American society. Burnham, a disenchanted Trotskyist, argued that the world was "in a period of rapid transformation from one type or structure of society to another type."<sup>10</sup> Comparing the similar trajectories of national socialist Germany, communist Russia, and Roosevelt's New Deal America towards large-scale control of the means of production, Burnham concluded that a new kind of managerial society was replacing capitalism. The New Deal differed very little from national socialism and communism in this regard. "Its most distinctive features," Burnham explained, "help to prepare the minds of the masses for the acceptance of the managerial social structure."<sup>11</sup> Burnham agreed with the

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<sup>8</sup> Robert H. Wiebe, *The Search for Order: 1877-1920* (New York, NY: Hill and Wang, 1967).

<sup>9</sup> Galambos, "The Emerging Organizational Synthesis in Modern American History," 281.

<sup>10</sup> James Burnham, *The Managerial Revolution: What Is Happening in the World* (New York, NY: The John Day Company, 1941), 9.

<sup>11</sup> *Ibid.*, 202.

critics on the American right who claimed that the New Deal undermined institutions and ideas undergirding capitalism.<sup>12</sup> However, socialism would not replace capitalism. “What is occurring in this transition,” Burnham argued, “is a drive for social dominance, for power and privilege, for the position of ruling class, by the social group or class of the *managers*.”<sup>13</sup>

This managerial class, striving to become dominant, cut across the classical divide between public and private, according to Burnham. Whether the means of production were privately or publicly owned, the separation of management from ownership during the interwar period had resulted in a new class configuration, that of the managers. From this perspective, the older Marxist demarcation between owners of property and the property-less mattered very little. The new demarcation was between the managers of large-scale organizations and the rest of society.

Burnham’s thesis relied on Adolf A. Berle and Gardiner C. Means’s book *The Modern Corporation and Private Property*, first published in 1932. Berle, a professor of corporate law at Columbia Law School, and Means, an institutionalist economist at Harvard University, argued that the separation of management from ownership had resulted in a loss of transparency. Shareholders, the owners of corporations, had become unable to hold managers accountable for their actions in the daily operation of corporations. In surrendering control of corporations, shareholders had accepted that corporations would not be run solely in their interest.<sup>14</sup> This, on the other

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<sup>12</sup> *Ibid.*, 201–202.

<sup>13</sup> *Ibid.*, 71, italics in original.

<sup>14</sup> Adolf A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property* (New York, NY: The Macmillan Company, 1932), 355.

hand, created an opportunity for a wholly new conception of corporate activity, according to Berle and Means. Given that owners had relinquished the control of corporations, and that the controlling groups had no legitimate claim to possess the authority that the role of managers accorded them, “[t]hey have placed the community in a position to demand that the modern corporation serve not alone the owners or control but all society.”<sup>15</sup> Burnham, for his part, shared none of the optimism embedded in this new communitarian concept of the corporation in service of society as a whole. Though he agreed that a new kind of centrally planned post-capitalist society was emerging, it would not be democratic but dominated by an elite of managers, whether the means of production were publicly or privately owned.<sup>16</sup>

In the 1950s, worries about the detrimental effects of bureaucratization on American society and democracy deepened among social scientists and political commentators.<sup>17</sup> James K. Galbraith’s *American Capitalism*, published in 1952 was premised on the argument that the advent of large-scale organizations during the late nineteenth and first half of the twentieth century had changed American capitalism irreversibly. Galbraith, an institutionalist economist at Harvard

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<sup>15</sup> *Ibid.*, 356.

<sup>16</sup> Burnham proceeded to articulate an elite theory of politics that simultaneously acknowledged and accepted the managerial class’s dominance and allowed the greater interest of the whole to be represented. See James Burnham, *The Machiavellians: Defenders of Freedom* (New York, NY: John Day Company, 1943).

<sup>17</sup> Galambos, “The Emerging Organizational Synthesis in Modern American History,” 281.

University and one of the nation's premier public intellectuals, argued that American capitalism had become characterized by oligopoly rather than perfect competition. It was in this connection that Galbraith introduced the concept of "countervailing power," which stipulated that large-scale business corporations needed to be, and to a large degree were, balanced by large-scale trade unions, citizens' organizations, and consumer advocacy groups. If such organizations failed to achieve parity with large business firms, government intervention was necessary to offset the power of big business in favor of the public interest.<sup>18</sup>

In the 1960s, these attacks on the effects of bureaucracy on democratic values became part of the core program of the New Left. Distancing themselves from the Soviet Union's false equation of true socialism with centralized political authority, the Students for a Democratic Society shifted the emphasis from bureaucratic, hierarchical planning to decentralized modes of planning society and economy as the new ideal for the Left. The Port Huron Statement, drafted in 1962, argued that the public sector should be made truly public, rather than the domain of the ruling managerial class, through "experiments in decentralization, based on the vision of man as master of his machines and his society."<sup>19</sup> This process would start at the universities, where power would have to be wrested from the administrative bureaucracies and substituted for democratic

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<sup>18</sup> John Kenneth Galbraith, *American Capitalism: The Concept of Countervailing Power* (Boston, MA: Houghton Milton Company, 1952).

<sup>19</sup> Students for a Democratic Society, "The Port Huron Statement of the Students for a Democratic Society," 1962, [www.vlib.us/amdocs/texts/porthuron.html](http://www.vlib.us/amdocs/texts/porthuron.html).

processes that would allow students to control their own lives on campuses across the country. Then the movement, in alliance with the forces of labor, civil rights, and other progressive causes outside of campus, would go on to challenge the political, economic, and military elites.

By the early 1960s, then, the legitimacy of American administrative elites was under heavy fire, and the pressure for decentralization would grow throughout the late postwar period as both sides of the political spectrum centered on the individual and its capacities for self-government. It was in this general atmosphere that public choice theorists developed their models of democratic administration. These models differed markedly from the more positive visions of bureaucracy within the field of public administration.

The tension between large-scale, bureaucratic, and hierarchical organization and democratic accountability, responsiveness, and representation was also among the paramount issues in the new science of public administration that emerged from the progressive era through World War II. From the beginning, two different approaches to public administration dominated the field, the political and the managerial. The managerial approach stressed that government should be administered in a “business-like” manner. The aim of the managerial approach was to increase administrative efficiency. The political approach stressed accountability, responsiveness, and representativeness. The aim of the political approach was to increase pluralism within public administration to make it more inclusive of the manifold values modern society consisted of.<sup>20</sup>

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<sup>20</sup> See David H. Rosenbloom, “Public Administrative Theory and the Separation of Powers,” *Public Administration Review*

The traditional public administration theories of Woodrow Wilson, Frank Goodnow, William F. Willoughby, Leonard D. White, and Luther H. Gulick unquestionably had positive conceptions of bureaucracy. However, public administration theorists did not believe that bureaucrats necessarily acted in the public interest. Born at a moment in American history when the very concept of the public interest was heavily disputed, if not rejected outright, public administration theory was largely a search for solutions to this very problem. Its practitioners provided a wide range of answers to the challenge of connecting public administrators to the interests of the public they were supposed to serve. In fact, many of them sought to remake government in the image of the corporation with the aim of increasing the efficiency of public bureaus.

Nowhere was this more evident than in Woodrow Wilson's landmark "Study of Administration," published in 1887. The first American to articulate a coherent theory of public administration, Wilson, president of the United States from 1913 to 1921, argued that popular sovereignty was the principal hindrance to efficient public administration. "An individual sovereign will adopt a simple plan and carry it out directly," Wilson argued. "But this other sovereign, the

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43, no. 3 (May 1983): 219-227. Following the tripartite separation of powers, Rosenbloom includes a legal approach, reflecting the judiciary, which stresses due process, the maximization of individual rights, and equity. However, this approach has been less influential in American public administration than the managerial and political approaches.

people, will have a score of differing opinions. They can agree upon nothing simple.”<sup>21</sup> Wilson’s core focus, which would come to resonate with Progressive Era efforts to reform all levels of government, was efficiency. Skeptical of the ability of the system to discern a coherent public interest, he separated politics and administration in that he relegated questions of representation to the political branches of government and reserved questions of efficiency for the administrative part of government. In doing so, Wilson argued that public bureaucracy could and should be a source of efficiency. This vision became a bedrock within the nascent field of public administration. However, whereas many public administration theorists favored planning as the best solution for efficiency, public choice theorists of bureaucratic supply favored market-like competition as the best solution for improving efficiency as well as responsiveness. This emphasis on competition emerged from a comparison of profit management and bureaucratic management.

With the implementation of the New Deal and the enormous increase in government intervention in the economy, critics began to worry about the effect of bureaucratization on the free enterprise system, denying that government could be anything but a source of inefficiency. American conservatism was partly born of this reaction against the New Deal and the bureaucratization that it represented. Equating the New Deal with communism and fascism, they insisted that Franklin D. Roosevelt’s policies were undermining the free enterprise

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<sup>21</sup> Woodrow Wilson, “The Study of Administration,” *Political Science Quarterly* 2, no. 2 (June 1887): 207.

system that according to them was the bedrock of American freedom. They constructed a binary in which free enterprise was up against the totalitarianism of the incipient American welfare state.<sup>22</sup>

Ludwig von Mises's theory of bureaucracy was a perfect fit for this context. In 1944, he published a short book on the problems of bureaucratic management. Simply titled *Bureaucracy*, the book translated Mises's concerns about economic planning into an attack on the growth of government power in the United States and other non-socialist countries.<sup>23</sup> Comparing profit management and bureaucratic management, Mises argued that in profit management capitalists, enterprisers, and farmers "are at the helm and steer the ship. But they are not free to shape its course. They are not supreme, they are steersmen only, bound to obey unconditionally the captain's orders. The captain is the consumer."<sup>24</sup> By contrast, neither citizens nor their elected representatives were able to control government bureaucrats to the same degree. As a result, bureaucratic administrations were both inefficient and unrepresentative. The remarkable thing about Mises's account of profit management was that, in his telling, the firm dissolved the tension between efficiency and representation. Market competition forced firms both to be more efficient and to differentiate their products and services according to consumers' individual preferences.

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<sup>22</sup> Lawrence B. Glickman, *Free Enterprise: An American Story* (New Haven, CT: Yale University Press, 2019).

<sup>23</sup> Ludwig von Mises, *Bureaucracy* (Indianapolis, IN: Liberty Fund, 2007).

<sup>24</sup> *Ibid.*, 17.

On the market, in contrast to the administrative state, efficiency and representation went hand in hand.

Mises's writings left a deep impact on Gordon Tullock.<sup>25</sup> Born in 1922, Tullock went into public service after graduating with a law degree from the University of Chicago. From 1947 to 1956, he worked as a foreign service officer in the US Department of State, serving as vice-consul in China and as a political officer at the American embassy in South Korea.<sup>26</sup> These experiences in the federal bureaucracy formed the personal background of his reflections on politics.

In *The Politics of Bureaucracy*, Tullock probed what, if not the public interest, people in public functions served. Unsurprisingly, he argued that they mostly serve their own self-interest. Like Mises, Tullock based his analysis on a stark contrast between economics and politics. "Generally speaking," Tullock wrote, "'politics' describes social situations in which the dominant or primary relations are those between superior and subordinate."<sup>27</sup> According to Tullock, this was how the term politics was used in the everyday language of ordinary Americans. Tullock went on to juxtapose "politics" with "economics," arguing that "[t]he latter, as a discipline, describes social situations in which persons deal with one another as freely contracting equals."<sup>28</sup> Tullock's definition

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<sup>25</sup> David M. Levy and Sandra J. Peart, "Gordon Tullock's Ill-Fated Appendix: 'Flatland Revisited,'" *Constitutional Political Economy* 28, no. 1 (2017): 22–23.

<sup>26</sup> For this, see the biographic sketch in front matter in Gordon Tullock, *The Politics of Bureaucracy* (Washington, DC: Public Affairs Press, 1965).

<sup>27</sup> *Ibid.*, 11.

<sup>28</sup> *Ibid.*, 10–11.

of politics was thus part of an attempt to rehabilitate the market as the sphere of freedom. While he maintained the behavioral assumption of individual self-interest, he argued that economists' assumption about freely contracting individuals did not apply in the study of governmental bureaucracy, which relied instead on the politics of subordination.<sup>29</sup> With politics defined as the relationship between superior and subordinate, Tullock included politicians as well as lower-level public administrators in his expansive definition of politics.

Drawing on the British naval historian Cyril N. Parkinson's idea of law-like ever-expanding bureaucracies, Tullock argued that there was a tendency toward "bureaucratic imperialism."<sup>30</sup> In a 1955 article in *The Economist*, Parkinson had stated his now infamous law "that work expands so as to fill the time available for its completion."<sup>31</sup> Parkinson's Law, as it came to be known, put a name on the easily recognizable tendency of administrative bureaus to expand, seemingly without limit. In extension of Parkinson, Tullock argued that "in the United States Government, the higher officials will actually encourage their inferiors to build up the size of the whole hierarchy since their own position, as well as that of their inferiors, will depend on the number of subordinates."<sup>32</sup> The incentive structure of public managers rewarded them for increasing the size of their bureaus instead of rewarding them for their accomplishments. "Efficient management," Tullock

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<sup>29</sup> Ibid., 14.

<sup>30</sup> Ibid., 134.

<sup>31</sup> Cyril Northcote Parkinson, "Parkinson's Law," *The Economist*, November 19, 1955, [www.economist.com/node/14116121](http://www.economist.com/node/14116121).

<sup>32</sup> Tullock, *The Politics of Bureaucracy*, 135.

explained, “becomes a problem about which he need not be concerned.”<sup>33</sup> This was the basis of bureaucratic imperialism, which involved expanding either by hiring new people or by raiding other bureaus’ employees.

Tullock argued that public managers favored expansion by hiring new people to avoid unnecessary internal competition. This form of bureaucratic imperialism led to an increase in the tax burden on citizens. The remedy, according to Tullock, was simple but difficult to implement:

It is only necessary that the bureaucrat’s superiors concern themselves with his performance and that of his whole division, and reward him accordingly. The bureaucratic supervisor even can be offered additional rewards for accomplishing given tasks. Measuring performance may be extremely difficult, but it should be possible, at least, for superiors to abandon the nonsensical method of rating inferiors by the number of followers that each is able to accumulate.<sup>34</sup>

Tullock thus offered one of the first public choice theoretical arguments for introducing performance rewards in the public sector. William Niskanen would later both elaborate the theory that government bureaus tended to expand and provide a more detailed blueprint for introducing performance incentives in the public sector. A crucial element in Niskanen’s reconstruction of bureaucratic incentives was the subjection of bureaus to competition. Tullock suggested something similar, though much less elaborated.

Tullock thus pointed to two further measures that would make governmental bureaucracy accountable and responsive to the electorate it was supposed to serve, decentralization

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<sup>33</sup> *Ibid.*

<sup>34</sup> *Ibid.*, 136.

and privatization. To counter the dominant trend of centralizing government at the federal level, Tullock suggested making wider use of local government. The wider use of local and state governments had the simple but important advantage of reducing the number of issues that voters would have to be informed about, and they would therefore be able to become more engaged in the political process.<sup>35</sup> However, “only the most obvious catch the eye,” Tullock explained. “We, as the sovereign people, have established a gigantic system of bureaucratic free enterprise and, as a rule with such a system, we have little control over the bulk of its activities.”<sup>36</sup> The majority of government activities, withdrawn from the market within the last half century, would thus have to be subjected to the price mechanism again. Drawing on the vision of the market as a democratic mechanism, bending the producer to the will of the consumer, allowed Tullock to argue that the subjection of public goods and services to competition would give individuals power over their provision.

While decentralization would undoubtedly “improve the functioning of our bureaucracy, [...] it still would not work well,” Tullock concluded.<sup>37</sup> “If we, as voters, are to control adequately the activities of our servants in the government a sizeable reduction in the total amount of activities attempted by the governmental apparatus is necessary.”<sup>38</sup> Enabling the people to control their public servants required privatization of public activities. Like Charles Tiebout, Vincent Ostrom, and Wallace Oates, Tullock believed devolution to local governments would

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<sup>35</sup> *Ibid.*, 221.

<sup>36</sup> *Ibid.*, 223.

<sup>37</sup> *Ibid.*, 222.

<sup>38</sup> *Ibid.*

go some way towards making public goods provision similar to private goods provision. The use of more local government thus reconciled the demand for more responsive government with the demand for greater efficiency. Decentralization would foster competition among local governments, which in turn would foster greater sensitivity to citizens' wishes as well as greater efficiency. What decentralization promised, in other words, was to make the citizen the captain of politics in much the same way that the consumer was captain of the economy. In the end, though, Tullock preferred privatization where possible.

Tullock's work was an important source of inspiration for Anthony Downs's theory of bureaucracy. Now an economist at the Real Estate Research Corporation in Chicago, Downs was still affiliated with the RAND Corporation. The first indication that Downs was working on a theory of bureaucracy was given in his 1960 article "Why the Government Budget Is Too Small in a Democracy." Expanding on an argument he had made in *An Economic Theory of Democracy*, Downs contended that voters' rational ignorance of the costs and benefits of policies meant that government budgets were smaller than they would have been if voters had complete information.<sup>39</sup> He acknowledged, however, that his theory ignored the effect of governmental bureaus on the size of the budget in a democracy. "If self-aggrandizing bureaus were included in the model," he argued, "each would try to maximize its own income, power, and prestige within the government. Hence it would submit a maximum estimate of its needs to the central budgeting agency (i.e., the directors of the governing party)."<sup>40</sup> Though Downs

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<sup>39</sup> Anthony Downs, "Why the Government Budget Is Too Small in a Democracy," *World Politics* 12, no. 4 (1960): 541.

<sup>40</sup> *Ibid.*, 542n4.

recognized the tendency for bureaus to expand, he asserted that bureaucrats' self-interested behavior did not contradict his argument that the government budget was too small in a bureaucracy. "The central budgeting agency would be aware of the bureau's inflationary tendencies and would develop outside checks against each bureau's vote-gain estimates," he theorized.<sup>41</sup> In other words, he argued that the self-interest of politicians would tend to offset the self-aggrandizing behavior of bureaucrats.

Downs refined this bureaucratic model over the course of the 1960s, culminating in his 1967 book *Inside Bureaucracy*. His intention with the book was to provide political science and economics with a theory of bureaucratic decision-making "to enable analysts to predict at least some aspects of bureau behavior accurately, and to incorporate bureaus into a more generalized theory of social decisionmaking—particularly one relevant to democracies."<sup>42</sup> *Inside Bureaucracy* was thus a complement to his 1957 *An Economic Theory of Bureaucracy*. Where the latter had developed a theory of the demand side of the political process, the former developed a theory of the supply side of the political process.

Downs acknowledged Tullock as his greatest inspiration.<sup>43</sup> However, he did not use the concept of bureaucracy as scornfully as Tullock had. On the contrary, he considered bureaucracies to be among the most important organizations in the complex societies of the modern world.<sup>44</sup> Methodologically,

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<sup>41</sup> *Ibid.*, 543n4.

<sup>42</sup> Anthony Downs, *Inside Bureaucracy* (Glenview, IL: Scott, Foresman and Company, 1967), 1.

<sup>43</sup> *Ibid.*, vii.

<sup>44</sup> *Ibid.*, 1.

Downs's theory of bureaucracy was more strictly economic than Tullock's, especially with regard to the assumption of rationality. The premise of Downs's theory of bureaucracy was that public administrators were self-interested economic agents, just like firm managers.<sup>45</sup> This assumption of self-interest generated three hypotheses. First, bureaucrats tried to attain their aims rationally. Secondly, bureaucrats' ends were complex, aimed at a variety of goals, including "power, income, prestige, security, convenience, loyalty (to an idea, an institution, or the nation), pride and excellent work, and desire to serve the public interest."<sup>46</sup> Third, the social functions of bureaus helped determine their internal structure and the behavior of their bureaucrats.

Analyzing how and why bureaus came into existence, Downs distinguished between four modes. First, there was the Weberian "routinization of charisma," in which a group of people forms a bureaucratic organization to realize a charismatic leader's ideas. Second, a bureau may be created to carry out a specific function. Third, a bureau may come into existence by being separated into an independent institution from an existing bureau. Fourth, an "entrepreneurial" group of people, pursuing a specific policy, may start an organization to promote this policy.<sup>47</sup> While this life cycle helped explain why bureaus came into existence, Downs, like Tullock, pointed to Parkinson's Law to explain why bureaus seek to expand their size.

All bureaucracies, public as well as private, tended to expand, according to Downs. There were several reasons for

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<sup>45</sup> *Ibid.*, 2.

<sup>46</sup> *Ibid.*

<sup>47</sup> *Ibid.*, 5.

this tendency. Expansion tended to enable bureaus to attract better personnel, to reduce internal conflicts, and to improve the quality of performance and chances of survival. On the whole, then, Downs saw bureaucratic growth through a more positive lens. What set public bureaucracies apart was that they did “not have as many restraints on their expansion.”<sup>48</sup> He argued that the primary reason for this was that the incentive structure of public managers induced them to increase spending. Building on Ludwig von Mises’s contrast between profit management and bureaucratic management, Downs explained that this misalignment between bureaucratic rewards and the objectives of their organization originated in the divorce of bureaus and bureaucrats from output markets:

Unlike most other large organizations, bureaus are economically one-faced rather than two-faced. They face input markets where they buy the scarce resources they need to produce their outputs. But they face no economic markets whatever on the output side. Therefore, they have no direct way of evaluating their outputs in relation to the costs of the inputs used to make them.<sup>49</sup>

In other words, the misaligned incentive structure resulted from the fact that there was no direct relationship between a bureau’s provision of a good or service and the income it received for providing them. Unlike the market, which relied on voluntary exchange of money for goods and services, the public sector had no mechanism for differentiating the taxes citizens paid.<sup>50</sup> By extension, the public sector was also unable to differentiate the products citizens bought with their taxes.

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<sup>48</sup> *Ibid.*, 17.

<sup>49</sup> *Ibid.*, 29–30.

<sup>50</sup> *Ibid.*, 30.

*Inside Bureaucracy* did not offer prescriptions for remedying this twofold problem. Far more significant in this regard was his 1971 article “Public Goods and Private Status,” co-authored with R. Joseph Mosen and published in *Public Interest*. “Consumer behavior is motivated by the desire for emulation and differentiation,” Mosen and Downs argued in the article, and “consumers want to create visible distinctions between large social groups or classes, and, within such groups more subtle distinctions of individuality.”<sup>51</sup> The problem with public goods, when viewed in this light, was that they did not allow their citizens to express their need for differentiation as consumers. Publicly provided goods had the disadvantage, compared to privately provided goods, that they were “ineffective in satisfying consumers’ desire to distinguish themselves through consumption.”<sup>52</sup>

Mosen and Downs drew a number of policy implications from the “law of consumer differentiation.” These included that government goods should be redesigned to allow consumers to express their individuality; that goods which could just as easily be distributed by the private sector should be removed from the public sector; that metropolitan areas should be allowed to vary the quality of public services among neighborhoods; that competition should be increased through the use of honorary and monetary rewards; that competition among communities

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<sup>51</sup> Joseph R. Mosen and Anthony Downs, “Public Goods and Private Status,” *The Public Interest*, Spring 1971, 64. For an argument that Mosen and Downs’s article was an indicator of a broader shift in the provision of public services, see Wolfgang Streeck, “Citizens as Customers,” *New Left Review* 76 (2012): 27–47.

<sup>52</sup> Mosen and Downs, “Public Goods and Private Status,” 68.

should be emphasized to a much greater degree; that private providers of goods and services should be employed to a much greater degree to facilitate greater product diversity; and, finally, that international competition should be related to domestic welfare rather than military power.<sup>53</sup> Perfectly in line with Tiebout, Ostrom, and Oates's ideas, Monsen and Downs's article thus provided a normative account of how the supply of public goods could be adjusted to serve citizens' individual preferences in the same way that firms served consumers' preferences on the market.

Public choice theorists' analyses and alternatives appeared within a broader context of calls for deregulation and privatization. At the University of Chicago, the economist George J. Stigler developed an influential theory of regulation, arguing that regulatory agencies did not act in the interest of consumers, let alone the public, but in the interest of big-business lobbies. Stigler's article "The Theory of Economic Regulation," also published in 1971, stipulated that regulatory bureaus were captured by the special interest groups they were supposed to regulate.<sup>54</sup> In other words, big business successfully lobbied the agencies to strangle competitors, resulting in monopolies. Stigler's work was part of a much broader movement that criticized the dominance of special interest groups in the 1960s. New Left historians such as Martin J. Sklar, Gabriel Kolko, and James Weinstein analyzed the progressive era regulatory regime as the result of big-business lobbying. On their view,

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<sup>53</sup> Ibid., 72–76.

<sup>54</sup> George J. Stigler, "The Theory of Economic Regulation," *The Bell Journal of Economics and Management Science* 2, no. 1 (1971): 3–21.

big business, not consumer interests, was the main beneficiary of these efforts to curb competition.<sup>55</sup> In a similar vein, the political scientist Theodore J. Lowi complained that interest-group liberalism had replaced classical liberalism, which had resulted in unsustainable budgetary growth.<sup>56</sup> In this context, Stigler argued in favor of deregulation to decrease regulatory capture along with a wide range of voices from the left.<sup>57</sup>

Likewise, in the late 1960s, Gordon Tullock developed a theory of rent seeking that resembled Stigler's theory of regulatory capture in implicitly challenging prevailing ideas about a democratic equilibrium between competing interest groups.<sup>58</sup>

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<sup>55</sup> Martin J. Sklar, "Woodrow Wilson and the Political Economy of Modern United States Liberalism," *Studies on the Left* 1, no. 3 (1960); Gabriel Kolko, *The Triumph of Conservatism: A Reinterpretation of American History, 1900–1916* (New York, NY: Free Press, 1963); James Weinstein, *The Corporate Ideal in the Liberal State: 1900–1918* (Boston, MA: Beacon Press, 1968)..

<sup>56</sup> Theodore J. Lowi, *The End of Liberalism: Ideology, Policy and the Crisis of Public Authority* (New York, NY: W. W. Norton & Co, 1969).

<sup>57</sup> On the deregulation movement, see Eduardo F. Canedo, "The Rise of the Deregulation Movement in Modern America, 1957–1980" (PhD Diss., Columbia University, 2008); Reuel Schiller, "The Curious Origins of Airline Deregulation: Economic Deregulation and the American Left," *Business History Review* 93, no. 4 (2019): 729–753. See also Paul Sabin, *Public Citizens: The Attack on Big Government and the Remaking of American Liberalism* (New York, NY: W. W. Norton & Company, 2021).

<sup>58</sup> For a sketch of the history of the rent seeking concept, see Roger D. Congleton, Arye Hillman, and Kai A. Konrad, "Forty

The article “The Welfare Costs of Tariffs, Monopolies, and Theft,” published in 1967, is Tullock’s most influential contribution to economics.<sup>59</sup> Anne Krueger, who was chief economist at the World Bank from 1982 to 1986, coined the concept of rent seeking in the 1974 article “The Political Economy of the Rent-Seeking Society.”<sup>60</sup> Rent seeking refers to interest groups’ pursuit of legal privileges and efforts to reduce competitive pressures in their respective industries. Consequently, consumers must pay higher prices for fewer goods of lower quality because of reduced competition. The result, in other words, of interest groups’ rent seeking is a distortion of public decisions that leads to a loss of social welfare.<sup>61</sup> The theory of rent seeking implied that deregulation was necessary to reduce capture of governmental agencies and politicians.

It was in this general concern with government intervention within the economics discipline that public choice theories of bureaucracy emerged. They were also consistent with the economic theory of property rights. In the late 1950s, Ronald Coase, then at the University of Virginia with James Buchanan, developed a theory of transaction costs as they pertained to the provision of public utilities like radio frequencies.

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Years of Research on Rent Seeking: An Overview” (Working Paper, 2008), [www.tax.mpg.de/fileadmin/TAX/pdf1/2008-introduction\\_rent\\_seeking\\_june\\_16\\_2008.pdf](http://www.tax.mpg.de/fileadmin/TAX/pdf1/2008-introduction_rent_seeking_june_16_2008.pdf).

<sup>59</sup> Gordon Tullock, “The Welfare Costs of Tariffs, Monopolies, and Theft,” *Economic Inquiry* 5, no. 3 (1967): 224–232.

<sup>60</sup> Anne O. Krueger, “The Political Economy of the Rent-Seeking Society,” *The American Economic Review* 64, no. 3 (1974): 291–303.

<sup>61</sup> Eamonn Butler, *Public Choice: A Primer* (London: Institute of Economic Affairs, 2012), 76–77.

The so-called Coase Theorem stipulates that in the absence of transaction costs, and with clearly defined property rights, bargaining will lead to a Pareto-optimal outcome.<sup>62</sup> The implication of the Coase Theorem is that the initial distribution of property rights is a necessary condition of market transactions. Coase's theorem gave rise to a voluminous literature on the economics of property rights in the 1960s. Among the most prominent early contributors to this body of thought were Armen Alchian, Harold Demsetz, and Roland McKean. They developed an economic theory of property rights, the common characteristic of which was suggestions for the privatization of public utilities and other publicly provided goods and services, on the one hand, and the introduction of property rights to improve governmental efficiency on the other.<sup>63</sup>

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<sup>62</sup> R. H. Coase, "The Federal Communications Commission," *The Journal of Law & Economics* 2 (1959): 1-40; R. H. Coase, "The Problem of Social Cost," *The Journal of Law & Economics* 3 (1960): 1-44.

<sup>63</sup> There is no intellectual history of this group's distinct approach to property rights. Such a history would begin with the modern rationale for public utility provision outlined in Hotelling, "The General Welfare in Relation to Problems of Taxation and of Railway and Utility Rates"; Abba P. Lerner, *The Economics of Control: Principles of Welfare Economics* (New York, NY: The Macmillan Company, 1944). It would then continue with the counterargument provided by free-market economists, beginning with Coase, "The Marginal Cost Controversy"; Coase, "The Federal Communications Commission"; Coase, "The Problem of Social Cost"; Armen A. Alchian, "Some Economics of Property Rights," *Il Politico* 30, no. 4 (1965): 816-829; Roland N. McKean, "Divergences between Individual and Total Costs within Government,"

One of the major conclusions of the economics of property rights, as explained by Armen Alchian, was that “*under public ownership the costs of any decision or choice are less fully thrust upon the selector than under private property.*”<sup>64</sup> The problem with public ownership was that it altered the incentive structure in a negative direction. Whereas managers in a private company were measured on their ability to improve the bottom line, with decisions either increasing or decreasing that single indicator, public managers did not bear the costs of their decisions to the same extent. In extension of this conclusion, members of the Mont Pelerin Society like Armen Alchian and Harold Demsetz simply advocated privatization. Roland McKean, on the other hand, offered property rights as a device to improve efficiency within government. As was nearly always the case with economic theories of politics, the moderate suggestion was the more influential.

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*The American Economic Review* 54, no. 3 (1964): 243-249; Harold Demsetz, “The Exchange and Enforcement of Property Rights,” *The Journal of Law & Economics* 7 (1964): 11-26; Roland N. McKean, “The Unseen Hand in Government,” *The American Economic Review* 55, no. 3 (1965): 496-506; Harold Demsetz, “Toward a Theory of Property Rights,” *The American Economic Review* 57, no. 2 (1967): 347-359; Roland N. McKean, “Property Rights within Government, and Devices to Increase Governmental Efficiency,” *Southern Economic Journal* 39, no. 2 (1972): 177-186; Armen A. Alchian and Harold Demsetz, “The Property Right Paradigm,” *The Journal of Economic History* 33, no. 1 (1973): 16-27.

<sup>64</sup> Alchian, “Some Economics of Property Rights,” 827, italics in original.

McKean, a Chicago alumnus, was affiliated with the RAND Corporation. Throughout his career, his core interest was the improvement of governmental efficiency. As several historians have demonstrated, RAND was at the forefront of developing devices for improving efficiency.<sup>65</sup> It is no coincidence that RAND, which offered research and analysis to the United States Airforce, was in a lead role in the effort to increase efficiency. The American military expanded enormously and rapidly in response to the Cold War, and measures were needed to make sure that decisions were cost-efficient. As the public sector expanded in response to Great Society programs in the 1960s, these devices were implemented across US government agencies.

McKean was instrumental in this development. Along with Charles J. Hitch, he authored *The Economics of Defense in the Nuclear Age*, published as a RAND report in 1960. The report advocated a relentless focus on cost efficiency in military decision-making. In other words, those in charge of defense spending needed to focus on minimizing the costs involved in reaching national security objectives. This focus on cost effectiveness was institutionalized with the implementation of the Planning, Programming and Budgeting System in the mid-1960s. Initially a defense department budgeting system, it was integrated throughout US government bureaus in the late 1960s. Though it proved unsuccessful, the program nonetheless helped instill an economic focus on efficiency at the expense of political concerns about equality.<sup>66</sup>

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<sup>65</sup> Amadae, *Rationalizing Capitalist Democracy*; Berman, *Thinking Like an Economist*.

<sup>66</sup> Berman, *Thinking Like an Economist*, chapter 5.

The failed attempt at introducing output budgeting led economists like Roland McKean to search for different devices to increase governmental efficiency. Inspired by Ronald Coase, Armen Alchian, and Harold Demsetz, McKean suggested marketizing the incentive structure of bureaucrats by implementing property rights to reduce the difference between individual and total costs within government. “The greater the divergence between individual and total costs and gains,” McKean explained, “the less likely one is to be guided by total costs and gains.”<sup>67</sup> This was a common problem in any economic activity, and as a result companies implemented devices to align managers’ and employees’ costs and gains with the company’s. “In the public sector, however, our attitude has usually differed from the above,” McKean pointed out. “Many of us in our work have tended to assume, unconsciously for the most part, that public officials are public-interest maximizers.”<sup>68</sup> Inspired by the public choice theories of Anthony Downs and James Buchanan, among others, McKean went on to imply that public employees’ individual costs and rewards needed to be rigged “to make them more nearly consistent with total costs and rewards.”<sup>69</sup> The most important obstacle to achieving such alignment was the fact that bureaucrats spent other people’s money. From politicians to top-level officials to public employees, everyone’s individual costs were misaligned with the total costs borne by taxpayers. As a result, McKean concluded, “the deck appears to be stacked in favor of gradual budgetary growth.”<sup>70</sup>

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<sup>67</sup> McKean, “Divergences between Individual and Total Costs within Government,” 244.

<sup>68</sup> *Ibid.*

<sup>69</sup> *Ibid.*, 245.

<sup>70</sup> *Ibid.*, 247.

Like Downs, Tullock, and later Niskanen, McKean thus pointed to the law-like expansion of bureaucracy. Among the many devices deployed to solve this problem were cost-benefit analysis, output budgeting, and outsourcing. McKean argued that regardless of the device, their efficacy “depends crucially on the issue: What do these devices do to the property rights or appropriability of rewards—and therefore to the ‘incentives’—of individual officials in government.”<sup>71</sup> In other words, if a device did not reward bureaucrats, it would not have a significant effect on behavior and decision-making in the public sector. McKean used “the term ‘property rights’ in a broad sense that includes one’s effective claims to rewards (positive or negative) as a result of his actions.”<sup>72</sup> In other words, it was a matter of improving government bureaucrats’ appropriability. “If each individual had ‘full’ appropriability, it would mean that he could capture the full marginal gains resulting from his actions.”<sup>73</sup> Vice versa, individuals would suffer the full marginal costs, if they had full appropriability. The problem in government was that bureaucrats, in the absence of a profit motive, had no incentive to improve efficiency, because it would be costly to themselves.

The political and fiscal pressures on American government forced Democratic Party operatives to address this problem. Charles Schultze, director of the Bureau of the Budget under Lyndon B. Johnson and chairman of the Council of Economic Advisors under Jimmy Carter, was a perfect illustration of this. As part of an administration that oversaw an enormous

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<sup>71</sup> McKean, “Property Rights within Government, and Devices to Increase Governmental Efficiency,” 177.

<sup>72</sup> *Ibid.*

<sup>73</sup> *Ibid.*, 178.

increase in the federal budget and the administrative capacities of American government, Schultze believed that performance incentives were necessary to improve public sector efficiency. In the 1969 article "Using Incentives to Improve the Effectiveness of Government," he argued that bureaucratic hierarchies were a handicap but practically unavoidable because of the tasks that the public sector carried out. "Given the lack of any measurable performance criteria for subordinate officials," he pointed out, "the top level public executive is often forced to specify in detail the set of permissible and non-permissible actions of his subordinates."<sup>74</sup> This led to rigid uniformity in public management, which thus lacked the flexibility of corporate governance.

Schultze suggested two ways of solving this problem. First, public programs could be subjected to market-like competition. A recent example of such a competitive solution was Milton Friedman's radical proposal arguing for the replacement of the public school system with a voucher model in which school grants were made to individual parents rather than the schools. According to Friedman, this would bring about competition between schools, which in turn would improve their performance.<sup>75</sup>

The second solution was to imitate market conditions in public programs. "Imitating market conditions in public programs primarily deals with changes in organizational and budgetary structure designed to provide incentives for public officials to see efficiency in the administration of governmental

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<sup>74</sup> Charles Schultze, "Using Incentives to Improve the Effectiveness of Government," *Monthly Labor Review* (1969), 34.

<sup>75</sup> *Ibid.*

programs,” Schultze explained.<sup>76</sup> The problem with this marketization was that there was no mechanism for measuring the output. Compared with the provision of a private good, which was evaluated in the single measure of price, Schultze contended that the output of public programs was “extremely complex.”<sup>77</sup> This was the problem of optimal output initially identified by public goods theorists like Richard Musgrave and Paul Samuelson. Schultze advocated the introduction of incentives:

Incentives for more effective and efficient performance of public programs cannot be considered apart from the structure of motivations, rewards, and penalties which determine attitudes and actions of the bureaucracy. To the extent that public employees are themselves judged and “rewarded” by criteria which relate to the effectiveness and efficiency rather than to the mere size of the programs under their control, individual and institutional incentives can be made consistent.<sup>78</sup>

Instead of functional budgeting, which resulted in an inferior incentive structure, Schultze suggested relying more on regional budgeting, that is, decentralizing budgetary decisions to lower levels of government, along the lines suggested by fiscal federalism. In other words, performance management and decentralization went hand in hand. More specifically, competitive performance management was a precondition for competitive decentralization, and vice versa. All public choice theorists provided blueprints for decentralizing government services along market lines. Policy-makers picked up these

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<sup>76</sup> Ibid.

<sup>77</sup> Ibid., 35.

<sup>78</sup> Ibid., 36.

blueprints to varying degrees, but all reflected the widespread belief that American government had become ungovernable and that decentralization was necessary. Given the commodification of the relationship between citizens and government that the welfare state reflected, market-like decentralization seemed the obvious alternative to hierarchical bureaucracy to many economists, political commentators, and political operatives.

Building on Tullock's, Downs's, and McKean's work, William Niskanen developed a more comprehensive theory of bureaucratic incentive structures, and the most elaborate suggestions for their transformation yet. Analyzing the ways in which the self-interested behavior of bureaucrats resulted in oversized bureaucracies, he suggested two remedies, both of which became prominent features in the reinvention of government in the 1980s and 1990s. His first, and most important, suggestion was to break the monopoly of public service suppliers by introducing competition and separating provision from production. His second suggestion was to introduce performance incentives, which was inseparable from his first proposal.

Niskanen's study challenged the idea that public administrators act in the service of the common good. "If not the public interest," Niskanen asked, "then, to what do public officials respond? What is the best model for interpreting their behavior? How can the institutions be changed to make their behavior more nearly consistent with the public interest?"<sup>79</sup> In

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<sup>79</sup> William A. Niskanen, *Bureaucracy & Representative Government* (New Brunswick, NJ: Aldine Transaction, 2007), vi.

response to these questions, Niskanen claimed that markets would solve the problems that were haunting American government in the early 1970s. On the one hand, markets allowed the representation of individual preferences far better than traditional hierarchical bureaucracy did. On the other hand, competition would keep bureaus disciplined and efficient. Niskanen thus believed that the crisis of American representative government could be solved by privatizing public services, by increasing competition among government bureaus, and, if that failed, by introducing supermajority rules that would limit the expansion of government. Niskanen's economic theory of bureaucracy was not merely a solution to efficiency problems but meant to increase government representativeness and responsiveness on the model of the market.

Niskanen defined the bureaucrat "as the senior official of any bureau with a separate identifiable budget."<sup>80</sup> Analyzing the personal preferences of these senior officials against the background of methodological individualism, Niskanen explained that "the individual consumer, entrepreneur, or, in this case, bureaucrat is the central figure of the characteristic method of economics."<sup>81</sup> *Homo economicus* was thus not confined to the market. Like the entrepreneur, the bureaucrat was "a 'chooser' and a 'maximizer.'"<sup>82</sup> In extension, by analogy with the theory of the firm, Niskanen's main descriptive argument was the budget-maximization theory, which claimed that bureaucrats aimed to maximize the budget of their bureaus. Like a businessperson maximizing the profits of his firm, the bureaucrat sought to enlarge his bureau budget, enabling an expansion

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<sup>80</sup> *Ibid.*, 22.

<sup>81</sup> *Ibid.*, 5.

<sup>82</sup> *Ibid.*

of his agency. "A bureaucrat's life," Niskanen explained, "is not a happy one (tra la) unless he can provide increasing budgets for his subordinate bureaucrats, in turn, to disburse in salaries and contracts."<sup>83</sup> Niskanen thus characterized bureaucrats as ceaseless expanders of their agencies.

This budget-maximization theory allegedly explained why governments continued to expand well beyond what the citizenry preferred and was willing to pay for. Along the lines of Charles Schultze's suggestions, Niskanen's solution to this problem involved changes at two levels of the institutional structure of bureaucracies. First, bureaucrats' incentive structures needed to be improved. Second, he argued for increased use of competition in the supply of publicly provided goods and services, between public bureaus and between public and private suppliers. Changing bureaucrats' incentive structure, he explained, would make the supply of government services efficient:

The general feature of this change would be some form of reward to senior bureaucrats to induce them to maximize, not the total budget, but the difference between the obtainable budget and the minimum total costs of the service. A change with this general feature would create, in effect, a modified profit system within the bureaucracy. The primary value of changing the incentives of senior bureaucrats in this way is that it reduces both the problem of inefficiency and the problem of oversupply that are characteristic of the conventional monopoly bureau.<sup>84</sup>

This way Niskanen envisioned bureaucrats as entrepreneurs, optimizing the difference between their bureau's budgetary

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<sup>83</sup> *Ibid.*, 40.

<sup>84</sup> *Ibid.*, 201.

input and the costs of delivering public services. Niskanen believed that the bureaucrat as optimizer would be brought into being by introducing reward systems. One way of rewarding senior bureaucrats was to allow them to “retain a previously agreed proportion of the difference between the approved budget and actual costs and return the rest to the general fund.”<sup>85</sup> Bureaucrats in senior positions would thus be allowed to keep a certain amount of their bureau budget as personal income.

Bureaucrats at lower levels could also be incentivized to become optimizers. At this level, it was more relevant to change the process of promotion, making career advances dependent on budgetary savings: “The promotion process for any lower-level bureaucrat responsible for a separately identifiable budget could be structured in the following way: A savings of 10 percent of the approved budget, for example, would make the bureaucrat eligible for a one-step promotion, a savings of 20 percent would make him eligible for a two-step promotion, etc.”<sup>86</sup> These types of performance-focused initiatives would force bureaucrats to optimize their bureau budgets in relation to the costs of the services they supplied. Other similar monetary reward systems included monetary prizes awarded after bureaucrats left office.

However, Niskanen argued that these reward systems would be worthless if they were not supplemented by the introduction of competition between bureaus. Like the businessperson operating on the market, the bureaucrat did not have an incentive to be efficient. Most businesspersons, however, were induced to be efficient in the competitive pursuit of

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<sup>85</sup> Ibid.

<sup>86</sup> Ibid., 202.

profit. A change in incentive structure to turn bureaucrats into optimizers would therefore be meaningless if it did not include increased competition between suppliers. With regard to public service delivery, Niskanen thus argued that “the most important change in the present structure of bureaucracy would be to increase the competition among bureaus in the supply of the same or similar services.”<sup>87</sup> This would force bureaus to provide public services responsively as well as efficiently.

Niskanen argued that the most essential condition for the realization of a competitive bureaucracy was “the absence of an explicit, consistent, and enforced executive policy against competition among bureaus for the supply of the same or substitute public services.”<sup>88</sup> In the absence of such a policy, existing bureaus would be encouraged to begin the supply of services currently provided solely by other bureaus. In extension, it would be necessary to introduce something like an antitrust policy to ensure competition by dividing public output between different bureaus. “At present,” Niskanen argued, “some national bureaus dwarf the largest firms in the private economy and there is strong reason to believe that the large size of national bureaus is primarily due to their protected monopoly power rather than any inherent economies of scale in producing public services.”<sup>89</sup> As such, Niskanen redeployed the antitrust critique but directed it at government bureaus. Just as in the private marketplace, the solution in the marketplace of politics was regulations that prevented monopolies on public service supply.

The introduction of market-like competition between bureaus inevitably raised a fundamental question, however.

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<sup>87</sup> *Ibid.*, 195.

<sup>88</sup> *Ibid.*, 199.

<sup>89</sup> *Ibid.*, 200.

"If the structure and incentives in a bureaucracy have to be changed so much to improve its performance," Niskanen asked, "why not rely more on private markets, where this structure and incentive exists, for the supply of public services?" He had no other answer than to encourage the increased contracting out of marketable public services. This was identical to the separation of provision and production advocated by Tiebout, Ostrom, and Warren. This meant that government would continue financing the services but not necessarily continue producing them. Instead, service delivery could be contracted out to private producers. "The primary value of a private source of supply for a public service," Niskanen explained, "is to reduce the monopoly power of the bureaucracy and the review committees."<sup>90</sup> Making the production of a service administratively independent, he believed, would increase citizens' satisfaction with public services. As an example, Niskanen pointed to the success of the manned lunar program, which involved thousands of profit-seeking private firms. "The increasing dissatisfaction with the performance of the bureaucracy in supplying some public services and the demonstrated success of private institutions in supplying some," he argued, "should be a sufficient basis for a greater number of experiments with the supply of public services by private profit-seeking firms and nonprofit institutions."<sup>91</sup> Unlike Armen Alchian and Harold Demsetz, however, Niskanen did not suggest total privatization. Instead, he called for the restructuring of public services to increase competition. His intention was not to abolish public services, but rather to redesign their supply to increase citizen satisfaction.

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<sup>90</sup> *Ibid.*, 213.

<sup>91</sup> *Ibid.*, 217.

When Bill Clinton announced the reinvention of government, it was less a reinvention than the culmination of a long-running, bipartisan effort to increase governmental efficiency along market lines. The goal of making government work better and cost less emerged and evolved in lockstep with the expansion of government services. What this chapter has shown, then, is that there was greater continuity from the 1960s through the 1990s. Marketization was an important outcome of the effort to improve governmental efficiency. The emphasis on performance rewards was a response to the fundamental problem of ascertaining the optimal output of public services. Whereas Charles Tiebout and Vincent Ostrom emphasized competition between local and state governments, William Niskanen, Roland McKean, and Charles Schultze argued that competition in the absence of performance incentives was meaningless. Individual costs and gains needed to be brought in line with total costs and gains.

The introduction of property rights within government was a marketization that reinvented bureaucratic incentive structures on the model of the profit motive. The purpose was to force bureaucrats to serve the public interest by serving their own. Niskanen's emphasis on monetary rewards was a crucial step in this direction, which upended and undermined traditional conceptions of public service. As McKean explained, in a rephrasing of Adam Smith's famous dictum, "it is not from the benevolence of the balloter, bureaucrat, or branch chief that we should expect our public goods but from their regard to their own interest."<sup>92</sup> Performance rewards, in other words, promised to bring the private interests of bureaucrats in line with the public interest.

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<sup>92</sup> McKean, "Property Rights within Government, and Devices to Increase Governmental Efficiency," 186.

# Conclusion

## Reinventing Government

In his prescient 1984 book *The Neoliberals*, the business reporter Randall Rothenberg identified the trends that were remaking American politics and especially the Democratic Party. He identified neoliberalism as a shift from New Deal liberalism's focus on centralization, macroeconomics, and interest-group politics to investment, appropriate political technologies, and cooperation. Whereas New Deal liberals had focused on redistribution, neoliberals focused their energy on investment to enlarge the economic pie. Whereas New Deal liberals based their ideology on the antagonism between different interest groups, neoliberals stressed that labor, management, and government should cooperate to achieve economic growth. Lastly, according to Rothenberg, whereas New Deal liberals focused on centralization and macroeconomic management, neoliberals favored decentralization and the use of market forces as the most appropriate political technologies.<sup>1</sup>

When Bill Clinton assumed office nine years after *The Neoliberals* appeared, his administration proceeded to make marketization a core policy objective with the implementation

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<sup>1</sup> Randall Rothenberg, *The Neoliberals: Creating the New American Politics* (New York, NY: Simon and Schuster, 1984), 46.

of the National Performance Review, later renamed the National Partnership for Reinventing Government. The Clinton administration's efforts at marketization marked the culmination rather than a significant break with the ambitions of previous administrations. The National Partnership for Reinventing Government largely continued the efforts to decentralize American public service provision along the lines of Richard Nixon and Ronald Reagan's New Federalism.

What my narrative shows is that marketization began far earlier than often assumed and that it was designed to improve the functioning of the American welfare state rather than to dismantle it. Translating turgid texts into clear ideas, this book has demonstrated that the marketization of American government emerged, in part, in response to the fiscal problem of identifying the optimal output of public services.

European public finance theorists first identified this problem of optimal output at the end of the nineteenth century, but in America it acquired urgency only in the aftermath of the Great Depression and World War II, both of which expanded government spending to unprecedented levels. Working in this context, public finance theorists like Richard Musgrave, Howard Bowen, and Paul Samuelson theorized about the legitimate level of public service supply. Though none of them advocated marketization, they nonetheless operated with a notion of government as a supplier of public goods and services, which mirrored the firm. In this sense, they commodified the relationship between government and citizen, making it resemble the relationship between the firm and the customer. This commodification developed into marketization. Whereas Musgrave, Bowen, and Samuelson favored comprehensive planning to solve the problem, public choice theorists suggested that market-like solutions in the form of party competition, voluntary exchange, foot voting,

and performance incentivization would make government more efficient and responsive. These suggestions provided the blueprints for the transformation of the compensatory state into a marketized state.

The redefinition of political parties as customer-oriented firms was closely associated with the understanding of politics as a competition between parties, which was widely shared by interwar elite theorists like Joseph Schumpeter and postwar pluralist political scientists like Robert Dahl. One of the first to treat political parties like firms was the economist Harold Hotelling, who developed a spatial model of competition that provided an explanation for market concentration and which remains highly influential in the economics profession. In the 1950s, the public choice theorist Anthony Downs provided flesh to Hotelling's side-remark about the similarity between market competition and political competition. Modeling politicians as vote-maximizers, Downs argued that political parties concentrated on the median voter to get as many votes as possible. The result was that political parties clustered around the median, differing very little from each other. Whereas Hotelling considered this an indictment of competition as a mechanism of demand satisfaction, Downs believed that it proved the responsiveness of the party-political system. The redefinition of political parties as customer-oriented firms was well suited to the gradual demise of party affiliation and participation and the shift to single-issue politics in the final quarter of the twentieth century.

Not all public choice theorists were as optimistic as Downs, however. The Nobel laureate James Buchanan spent his career fighting the expansion of the American fiscal state. His earliest suggestion was the revival of the principle of voluntary exchange, meaning that citizens received only the public goods, services, and benefits that they agreed to pay

for. Buchanan thus sought to make the public sector mimic the private sector by introducing a unanimity criterion. By the end of the 1960s, he concluded that this was unrealistic. Instead, he suggested the introduction of balanced-budget amendments at all levels of government. This idea reflected and influenced the tax resistance movement in the late 1970s, which sought to restrict the American government's tax and spending power. While this movement was successful at the local level, federal spending remains unrestrained. The national level of government was the one Buchanan was most concerned about, and as such his work was a political failure, which his changing prescriptions reflected. By contrast, other public choice theories, though the subject of far less attention, were more successful.

While Buchanan articulated and legitimized balanced-budget amendments, in the 1970s public choice theorists like Vincent Ostrom redefined federalism as a competition between political units for voter-consumers. This was both an indicator and a factor in the efforts at decentralization in response to the crisis of governability in the 1970s. Whereas Downs had focused on the political competition between parties, competitive federalism redefined public bureaus and municipalities as firms competing for customers willing and able to vote with their feet. This effort at decentralization reflected the fiscal and administrative pressures on the American federal state that had expanded rapidly over the course of the postwar period. Competitive federalism has helped foster an impoverished sense of community, according to which citizens should vote with their feet and simply leave their place of residence if they are unhappy with their government. Rather than stay and try to change it, out of a traditional sense of political obligation, public choice theorists

have argued that the only way to force governments to become responsive is the threat of leaving.

If foot voting reduced citizen participation to market-like signaling of preferences, the stress on performance incentives imagined public employees as self-interested economic agents rather than servants of the public interest. This conception of bureaucrats emerged in response to the centralizing expansion of the American state in the postwar period, culminating in Lyndon B. Johnson's Great Society programs in the 1960s. Public choice theorists like William Niskanen argued that monetary rewards would help solve the problem of optimal output by inducing bureaucrats not to oversupply the good or service that their bureau provided. Focusing on the primary actors on the supply side of the public economy, these theorists argued that competition between bureaus had little meaning if public managers' incentives were not aligned with those of their bureau. Performance incentives mirrored the profit motive, which guided managers in the private sector. Rewarding public employees for meeting specified performance targets, incentives thus marketized public management, promising to bring total costs and benefits in line with the individual costs and benefits of bureaucrats. This was taken up by leading Democratic Party operatives like Charles Schultze, chairperson of Jimmy Carter's Council of Economic Advisors. In the late 1960s, Schultze began advocating the imitation of market conditions in public programs to improve the effectiveness of a greatly expanded American welfare state.

The emphasis on the introduction of performance incentives in the public sector was the final step in public choice theorists' marketized vision of the state. In the aftermath of the expansion of American government in the 1960s, performance incentives were adopted across the political spectrum.

This was, in part, because of the spread of an economic style of reasoning,<sup>2</sup> but it was also because of cross-ideological agreement that the welfare state had reached the limits of its expansion. From the late 1960s onwards, then, different administrations tried to marketize government services and administration.

In an influential 1991 article, Christopher Hood called this movement New Public Management, emphasizing the international shifts to greater competition and performance targets in the public sector.<sup>3</sup> In the United States, these shifts were conceptualized as a reinvention of government after Ted Gaebler and David Osborne's 1992 book *Reinventing Government*. The book's overlaps with public choice theories were striking. The economic language of politics suffused Gaebler and Osborne's account, which described a new model of government that was already emerging in towns and cities across America. In their analyses of these developments at the local level, they advanced a marketized vision of bureaucrats, citizens, and politicians. They argued that the pressure of market-like competition would make government employees more responsive, while performance criteria would incentivize them to keep government spending in line.<sup>4</sup> It was no coincidence that the Clinton administration's National Performance Review was renamed the National Partnership for Reinventing Government. It signaled the congruence of the

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<sup>2</sup> Berman, *Thinking Like an Economist*.

<sup>3</sup> Christopher Hood, "A Public Management for All Seasons?," *Public Administration* 69, no. 1 (1991): 3–19.

<sup>4</sup> David Osborne and Ted Gaebler, *Reinventing Government: How the Entrepreneurial Spirit Is Transforming the Public Sector* (New York, NY: Plume, 1992).

administration's efforts at reform with prevailing international trends in public administration and service provision.

As Christopher Hood pointed out in 1991, there is a paradox at the heart of the marketized state. There is, he argued, a difference between the slogans "free to choose" and "free to manage," the twin principles that animate the new public management.<sup>5</sup> Whereas party competition, voluntary exchange, and foot voting were all meant to make citizens free to choose, performance incentives were meant to make public administrators free to manage. The conflict between the two arises because freedom of choice does not necessarily entail lower expenditures, while performance targets nearly always incentivize public employees to stay within budgetary limits. Mimicking the profit motive, performance incentives are supposed to align responsiveness and cost efficiency. In the real world, they do not align easily because government services are subject to so-called "cost disease." First articulated by William Baumol and William Bowen in an article on the performing arts in the mid-1960s, cost disease applies to jobs that have seen rising wages but no corresponding rise in labor productivity.<sup>6</sup> A classical musical orchestra, for example, uses the same number of musicians to play a Beethoven symphony today as it did in the eighteenth century, but musicians' wages have nonetheless increased significantly in that same time frame. Government services like health care and education are particularly prone to this problem. As Baumol later pointed out, this means that welfare states are caught between Scylla

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<sup>5</sup> Hood, "A Public Management for All Seasons?," 6.

<sup>6</sup> William J. Baumol and William G. Bowen, "On the Performing Arts: The Anatomy of Their Economic Problem," *The American Economic Review* 55, nos. 1-2 (1965): 495-502.

and Charybdis. Either the public sector will have to occupy an ever-greater share of the national product, or many of these services will have to be privatized.<sup>7</sup>

This is arguably the core of the current crisis of public sectors across the world. Unable to satisfactorily provide essential public services, lessen the strains of inequality, and stabilize the economic system, the marketized state is struggling to catch up with its citizens' demand. Nonetheless, it seems certain that we will not see a return to the expansion of public services that characterized the postwar period. This is evident in total tax revenues as a percentage of national income. After an explosive period of expansion, around 1970 they stagnated at approximately 30% in the American case, 40% in the British, and 50% in the Nordic countries.<sup>8</sup>

To meet citizens' demand for public services would require an expansion of state capacities akin to that which took place in the postwar period. That is an unlikely prospect. As the French economist Thomas Piketty argued in his path-breaking *Capital in the Twenty-First Century*, "the state's great leap forward has already taken place: there will be no second leap—not like the first one, in any event."<sup>9</sup> The remarkable expansion of fiscal capacities in the twentieth century reflected the construction of the compensatory state with its essential public services of health, education, and retirement, which take up

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<sup>7</sup> William J. Baumol, "Health Care, Education and the Cost Disease: A Looming Crisis for Public Choice," in *The Next Twenty-Five Years of Public Choice*, ed. Charles K. Rowley, Friedrich Schneider, and Robert D. Tollison (Dordrecht: Springer Netherlands, 1993), 17–28.

<sup>8</sup> Piketty, *Capital in the Twenty-First Century*, 475.

<sup>9</sup> *Ibid.*, 477.

the bulk of most government budgets. An expansion of government spending and taxation along the lines of the postwar period is unrealistic.

The history of the public sector in the past fifty years has largely been a quest to provide public goods and services more efficiently within the stagnated level of tax revenues as a percentage of national income. Marketization has been the primary tool different administrations have deployed in the attempt to stay within this limit. The beauty of marketization was that it promised to make government cost-efficient as well as democratically responsive to citizens' individual demand for public services. Thirty years on, however, the result appears to be a government that works worse and costs more.<sup>10</sup>

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<sup>10</sup> For a comprehensive evaluation of three decades of public sector reforms that make this argument, see Christopher Hood and Ruth Dixon, *A Government That Worked Better and Cost Less? Evaluating Three Decades of Reform and Change in UK Central Government* (Oxford: Oxford University Press, 2015).



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