Comments on Buchanan

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by Allan H. Meltzer

James Buchanan has taken up an interesting but difficult subject: the role of culture and norms in making the market system, or other system, work. When reading this paper, I thought about previous attempts by economists to model differences in countries or social systems. Two in particular come to mind. In *Capitalism, Socialism and Democracy*, Joseph Schumpeter discussed the institutional and cultural structure of capitalism. He decided that the cultural foundation was breaking down, and concluded that much of the structure of capitalism could be used, without the profit motive, to achieve progress and increase utility in the new culture to be achieved under socialism. Like Lange, but unlike von Mises and Hayek, Schumpeter claimed that the behavior that produced capitalist development could be made to work tolerably under a different system of social organization. Schumpeter was wrong. Buchanan is clearly on the side of von Mises and Hayek, but his argument differs from theirs.

In his book, *The Rise and Decline of Nations: Economic Growth, Stabilization and Social Rigidities*, Mancur Olson advances the thesis that radical transformation generates growth and social utility by breaking the rules or norms that are the source of rents. I have been intrigued by the issue but skeptical of Olson's answer. It does not explain the stagnation or even retrogression in much of Africa after independence. China, Eastern Europe, and the Soviet Union had a radical transformation to communism without the result predicted by Olson's argument. There was a radical transformation but it did not release productive energies. Italy retained many of the institutions built under fascism, often with many of the same people doing the daily work. Yet Italy's postwar progress in increasing output, income and standards of living has been impressive by the standards of Italian history or world averages. Thus, Olson's thesis provides neither a necessary nor a sufficient condition for explaining the relative progress of nations. It fails to account either for countries where rents were destroyed or countries where they were not much affected by transformation. Nor does it explain why the United States has maintained relatively constant growth of per
capita income for more than 100 years. Why have accumulated rents not slowed the growth rate?

The more standard tradition in economics neglects cultural differences. The model of man used is what Brunner and Mechling call REMM -- resourceful, evaluating, maximizing man. This person exists everywhere, but the constraints differ in different social systems.

Current work on economic growth is an example relevant for these cross-cultural comparisons. These theories try to explain differences in growth rates or relative positions of countries as a consequence of initial position and the rate of investment in human and non-human capital. Cultural differences are not mentioned.

The convergence of living standards suggested by recent growth theory has occurred for some countries but not for others. Initial position does not explain why Hong Kong, Taiwan, Singapore and Korea have raised living standards much more in the past forty years than the Philippines, Argentina, or much of Africa. Putting in dummy variables for Africa and Latin America, as many of the empirical studies do, gives appropriate recognition to the state of our knowledge. I conjecture that if reliable data were available, so that Eastern Europe could be included in the tests of recent growth theories, another set of dummy variables would be needed.

I read Jim Buchanan's paper as an attempt to fill part of this gap in our knowledge about cross-cultural differences. Buchanan argues that we should not try to explain the behavior of Eastern Europe and the Soviet Union, and by inference countries such as the Islamic or African nations, without reference to their cultural or institutional norms. In contrast to Olson, radical transformation may destroy rents without generating much progress in living standards. There could be retrogression. Unlike current growth theory, Buchanan does not expect one model to explain development everywhere. His claim is that culture and institutional differences are more important than we recognize.

Let me agree with one of Buchanan's main conclusions. The success or failure
of the market system depends on the institutional structure. Without laws, rules, educational accounting systems, judicial systems, competition, enforcement systems, and political stability, private property and a market system generally will not be sufficient to provide growth in standards of living. Privatization of socialist enterprises, by itself, is not a guarantee of efficiency or economic development.

Jim argues that to analyze the Soviet and Eastern economies, we have to replace the "exchange model" with the "collective model." The reason is that the exchange model depends on norms or cultural features that are not present in a collectivist society.

What are these norms? He cites two in particular. In the exchange model exchanges between parties are accepted as mutually beneficial, and entrepreneurial behavior is accepted and rewarded. People view themselves and others as buyers and sellers, consumers and producers.

In the collectivist economy, the idea of gains from trade is at least suspect and generally is rejected. People are suspicious, envious or intolerant of entrepreneurs who break established norms to gain from exchange. The link between individual effort and individual reward is broken.

Jim is careful not to make the contrast too sharp. There are collectivist and market elements in both types of economies. He finds it simpler to avoid repeating the qualifying phrases, and I will do the same. Yet, I have to point out that seventy years of cultural conditioning does not seem to have affected the black marketeers, the taxi drivers, the currency changers, and a host of others that are now very visible in Soviet cities. Should this be dismissed as aberrant behavior? Should it be compared to the behavior of bureaucrats working in the command economy system of regulatory agencies like SEC, FTC, EPA, FDA, and others? I will return to this issue.

1I'll not comment on the importance of what he calls understanding, since I am not clear on what role that plays in his argument. People do not have to understand how airplanes, autos, or computers operate to use them productively. Businessmen and consumers in the west do not understand how a market system operates or why it achieves efficient allocation. Why do Russians or other Soviet citizens need this understanding?
Jim uses Samuelson’s analysis of pure public goods as a model for Eastern Europe. In the Samuelson model, people allocate goods and services that cannot be partitioned. My use excludes yours. The most common examples depend on technologies such as seats in a theater or at a football game. In place of physical technology, Jim uses organizational behavior. The idea is that in a collectivist, command economy, where prices, profits, and individual gains from trade do not direct resource allocation, progress depends on a willingness to internalize norms of behavior. Individuals must believe in the social benefits achieved through cooperative behavior. Otherwise, cooperative behavior does not produce much social gain.

The comparison of the two models yields an interesting proposition about differences in the two systems. The proposition states that: as the market system expands, the gains from trade increase; as the collective system expands, the gains from free ridership increase. Thus, progress and social welfare increase in one case and diminish in the other.

Buchanan uses as an example the behavior of hotel clerks. In a western hotel, the idea of gains from exchange is part of the culture. The clerk knows that he or she gains directly or indirectly if guests are pleased, so the clerk behaves in a way that is helpful and pleasing. In a Soviet hotel, the norms are collective. Service is poor or non-existent. The clerk does not internalize the culture or incentives that induce good service.

So far, so good. Restated in terms of the relative frequency of helpful service, the proposition seems correct. My issue with Jim’s paper is the extent to which the difference in behavior depends on differences in behavioral norms and the extent to which it reflects differences in other constraints. What prediction do we make about behavior when the constraints change? Do we expect people in the Soviet Union and Eastern Europe to behave like capitalist REMM’s if the institutions change? Or, do we expect a long period of adaptation while they forget collectivist behavior and learn to act like REMMs.

Buchanan’s view is that it is naive to believe that the market order can emerge full blown in the Communist countries. Much depends on the meaning of “full blown.” How long will the transition take? How much will depend on learning?
I take a different view than Buchanan's. I have no quarrel with his claim that the exchange economy and the gains from trade are basic features of our system. I would start at a different point, specifically with the REMM model. Individual's maximize subject to constraints. The (non-cultural) constraints differ in public and private enterprises and in capitalist and socialist economies. Under capitalism, exchange and gains from trade emerge as a result of maximizing behavior. Individuals seek out opportunities for profitable exchange. Under communism, such behavior was not only despised culturally, it was often punished as anti-social. People maximize under communism, subject to very different constraints. In particular, the soft budget constraint meant that losses were paid by the rest of society.

Once the constraints are changed or removed, I expect former Communist REMMs to find a new optimum involving markets, trade and exchange. The extent that this will occur will depend on the new constraints, including institutional structure, particularly degree of privatization, legal protection of property rights, a hardening of budget constraints, etc.

What evidence can I bring to bear? Two or three examples may suffice. First is the behavior of Chinese farmers. Even without fully vesting private property rights, a change in Chinese government policy to permit free market pricing succeeded in raising agricultural output dramatically, improving product quality and broadening the product mix. Farmers responded to the market system promptly and decisively. The political crackdown in 1989 was not followed by reversion to the Communist system of agriculture management. Output continued to expand rapidly.

Second is the experience of Poland, Hungary, East Germany and even the Soviet Union. Once the political constraints are relaxed or removed, markets appear and people engage in mutually beneficial trades. East Germans had no problem learning about the gains from trade in goods and labor services once they found a way around or through the wall. Hedrick Smith's *The Russians*, written before the reforms, details the important role played by trade and markets in Brezhnev's Soviet Union.

Third, we now have the postwar experience of sustained growth under a market system. Growth has not been limited to Western Europe and North America where culture is European. Japan, many Asian countries, parts of Latin America and even
some isolated places in Africa have achieved economic progress and higher standards of living by shifting to a market economy or expanding its sphere.

Japan is a useful example. Before 1868, Japan was more closed to the outside world than most of the countries of Eastern Europe. For centuries, the cultural tradition put the warriors or samurai at the top, the merchants at the bottom. That tradition did not prevent Japan from becoming a trading nation quickly once the constraints on trade were relaxed. Nor did it prevent the merchants from becoming powerful as individuals and as a group.

One of the many things I learned from Jim Buchanan is that the attainable social optimum depends on the institutions in place. Comparisons between countries or societies may be a comparison of different points on the dynamic production frontier as in the usual analyses. But Jim insisted that they may also be comparisons between interior and exterior positions of equilibrium. The equilibrium at an interior point is the best that a country can do under the political or social system. Communism constrained the available opportunities to an interior point. Relaxing the constraints outlawing private property and markets, changing the legal and monetary systems, etc. should be followed by the development of markets and an increase in mutually beneficial trade.

I do not fully reject Buchanan’s point, but I think the paper overstates its importance. Learning about how to operate in a new system takes time. Some learn more slowly, but REMM's learn. Putting in place the institutions under which capitalism works best is important. Argentina, Japan, and Western Europe have different institutions and very different experiences. Differences in institutional arrangements may help to explain the differences in outcome. Theories of growth or development might do better if they treated structure more carefully.

Adam Smith taught us that the propensity to barter and exchange is universal. The REMM model makes the same claim for learning, evaluating and maximizing behavior. I am inclined to see differences in societies as dependent more on the degree of openness (in Karl Popper's sense) than on inherent cultural differences. The evidence from Eastern Europe, to date, seems to favor the proposition that once institutional constraints are removed and the political economy opened, markets, trade
and exchange appear promptly.

I recognize that the Soviet Union has a reputation for envy and dislike of markets that might fit Buchanan's view. We often hear that traders are regarded as thieves and that many people regard trade as little better than criminal activity. Let me close by accepting these claims and offering an alternative interpretation. Private traders are common, but private producers in the Soviet Union are rare. Those that exist are hindered, so they produce very little. Much of what is sold in private markets is alleged to be stolen from state enterprises or warehouses. Hence purchasers see the so called free market as a place where the same shoddy goods produced in the Soviet Union are available at higher prices. This is disliked and even despised.

McDonald's is respected and admired. Service is better. Quality is better. And waiting lines are long. This is an example of mutually beneficial exchange. It seems to have produced not envy, but a keen desire for more of the same.