1. Introduction

One commonly view about Buchanan is that “The Pure Theory of Government Finance: A Suggested Approach” (1949c) is the founding article, the matrix of what he would wrote during most of his academic career not only in public finance but also in public choice or political economy (see Wagner, 2017). In particular, this article is viewed as important because it shows that Buchanan was already, barely one year after having completed and defended his dissertation, an abstract theorist interested in public finance, for whom what was crucial to any theory of the state were the philosophical foundations on which such a theory rests. Also of importance is that this article shows that Buchanan was already defending the voluntary exchange theory that had been developed by the Italian or Swedish public finance theorists, among whom Knut Wicksell figures prominently. Buchanan’s interest in pure theory, and in Wicksell, is confirmed by the publication of two other articles: “Knut Wicksell on Marginal Cost Pricing” (1951b) and “Wicksell on Fiscal Reform: Comment” (1952c).

These articles evidence Buchanan’s interest in “pure theory”, in public finance and in Wicksell. Yet, certainly because the ideas contained in these papers, and because Wicksell, became so important for Buchanan, commentators tend to focus too much on these articles
when studying Buchanan’s early works. As a corollary, they forget that these three articles—
that total less than twenty pages—represent only a part of what Buchanan wrote at that time.
While he was studying public finance, Buchanan wrote three other articles (1949b, 1950,
1952a), a book review (1952d) a reply (1952e) and an unpublished draft (undated, circa
1952). That these articles represent about forty-five pages would be irrelevant if they did not
all bear on the same theme—the role of the federal state in its interactions with states or
vertical relationships in a federation. Thus, Buchanan was seemingly more or as much
interested in the issues he discussed in these articles than in pure public finance. This is
precisely the purpose of this article, to present and discuss the “other”—published as well as
unpublished—articles Buchanan wrote between 1949 and 1952.

Focusing on the intellectual, academic and political context of the period, we show that
these writings stemmed from a concern for the South and a belief to defend the intervention
of the federal government, without abandoning his conviction that competition and a free
market were the best economic systems. We show how Buchanan’s theoretical framework
allowed him to face the dilemma without difficulty. Indeed, Buchanan did not see a free
market economy as opposed and incompatible with the intervention of the state. This allows
us to give a more precise and subtler image of Buchanan than some may have.

2. The federal government and the South

In August 1948, Buchanan defended his dissertation. On September 2, the graduation
ceremony took place at the University of Chicago. Then, immediately afterwards, Buchanan
left to the University of Tennessee, Knoxville, where he had studied less than ten years
before. He had been hired as assistant professor. Buchanan then wrote his first academic
articles, “The Pure Theory” and “Regional Implications of Marginal Cost Rate Making”. The
latter was the first of Buchanan’s academic articles to be published—in the July issue of the
Southern Economic Journal—but, Buchanan certainly wrote it after “The Pure Theory” and
before revising it.2 Thus, after having used the ideas of what he would soon call “a subsidiary

2 There is no direct evidence as to when Buchanan wrote these articles. One can assume that he started to
write “The Pure Theory of Government Finance” (1949b) after he arrived at the University of Tennessee,
Knoxville in September 1948. The paper was completed in February 1949. Buchanan received a letter from
Malcolm Hogg in which he briefly commented on the paper dated February 28. It seems that Hogg was
commenting this article.
portion of my dissertation at Chicago a few years ago.”3 To write his first academic article, Buchanan chose to devote the second one to a question that was unrelated to his dissertation.

To understand the choice of this topic, as well as the next ones, it is important to recall Buchanan’s belief that the South was at disadvantage compared to the rest of the country, above all the North, because of a lack of economic resources. He also believed that the gap with the North would not close spontaneously. Hence, the development of the South required an intervention of the federal government. This had been at the core of two of his student essays (1946, 1947b) and of his dissertation (1948). Now, it happens that Buchanan had completed the writing of his dissertation and started his academic career when Harry Truman was campaigning for the election, and then elected president of the USA. And Truman was favorable to the intervention of the state in the economy. He had hammered the same message since he had arrived at the White House in 1945, when he had been convinced by the virtues of Roosevelt’s New Deal. After the election, on November 3rd, Truman repeated again how he believed in the need for an extended welfare state in which the federal government would play an important role. And had made his point clear in the discourse on the State of the Union he gave on January 5, 1949. Then, Truman explained how his views differed from Roosevelt’s. The New Deal was no longer sufficient for the period of peace in which the world and the U.S.A. were entering. “[T]o keep the country prosperous”, the government had to cover more areas than in the past – such as health, transportation, the banking system, employment and the labor market, antitrust laws, agriculture. He was proposing a “fair” instead of a “new” deal to the American citizens – “[e]very segment of our population and every individual has a right to expect from our Government a fair deal.”4

Truman’s fair deal was not a form of new deal with more government. The role of the government would be different. Truman was envisaging to implement new form of liberalism and capitalism in the USA. The goal was indeed to have “a mixed economy that would preserve the essentials of capitalism while mitigating its abuses.” (Hamby, 1972, 657) In Saving American Capitalism. A Liberal Economic Program (1948) that came to be seen as “the major liberal economic manifesto of the Truman era” (658), Seymour Harris wrote that

3 Buchanan to Uhr, January 22, 1952.
the U.S.A. need a “hybrid system”, that would “combine the best features of the Russian system … with the attractive features of our system.” (1948, 10) He was not the only one to put forward such a claim. In the late 1940s in the USA, the idea that a new form of capitalism was necessary gained a large recognition. Paul Samuelson, for instance, defended an economic system that was a “middle way” between capitalism and communism. He even used the example of Great Britain to evidence how economic socialism could actually combine with political freedom (1948, 589). Such a system would rest on planning, indeed its backbone. Samuelson, again, argued that “the mistakes which a flock of independent competitors make … would be lessened in an economy characterized by planning” (1948, 39). Also, Dwight Waldo viewed “planning” is necessary to build a “Good Society” – “there is no natural harmony of nature, no Divine or other purpose hidden beneath the flux and chaos of present planlessness” (1948, 67). In other words, the Fair Deal was paving the way towards a new form of capitalism in the USA. A point with which Buchanan clearly disagreed. Indeed, with its opposition between two – and only two – theories of the State, “The Pure Theory” was clearly a rejection of the idea that a third system was be necessary.

This raised an interesting and challenging question: could the intervention of the federal government be defended, as Buchanan did, without adhering to the economic doctrine he disagreed with? The question was all the more challenging that this new and hybrid form of capitalism, the federal government would assume a different role in the economy. This meant that the relationships with the States would then inevitably be affected. Again, this was what Buchanan had discussed in his student essays and in dissertation (1948).

In the USA, and in particular with Truman, the question had a quite specific flavor. What was at stake was more than the vertical relationships in a federation, but above all the relationships between the North and the South. Indeed, even if Fair Deal policies were aimed at improving the situation of all the country, the South was more particularly targeted as a possible beneficiary of these policies than others. A Southerner, Truman – but also Roosevelt, another Southerner, before him – believed that it was indeed time to “enabl[e] liberalism to finally develop south of the Mason-Dixon Line” (McMahon, 2007, 115). He was convinced that allowing the South to develop economically also required to change it. Economic and social, cultural aspects were intertwined. Of course, one of the questions that was particularly important was race and discrimination. When Truman added a civil rights plank to his campaign platform, the resistance organized. The so-called “Southern Revolt” led to the
creation of a Dixiecrat movement. In the 1948 election, Strom Thurmond ran against Truman, that is another Democrat, for a States’ Rights Democrat party (Boyd, 1952; Rayback, 1954). Thurmond won four Southern states only. Southerners were more on Truman’s than on Thurmond’s side.

No evidence proves that Buchanan might have been opposed to Truman’s move to improve civil rights. But there exists evidence that proves that he was concerned by the economic dimension of Truman’s program. Indeed, the opposition of Southerners to Truman cannot be reduced to a racial matter or to the question of the so-called values of the South. Skepticism also dominated as to the positive effects that interventions of the federal government would have on the economy of the Southern states. Relevant for our discussion is the legislation over the level of wages. Southerners did not easily accept when Roosevelt tried to implement it: labor was “cheap” in the South and the measure “threatened to deprive the section in attracting cheap-labor industry.” (Leuchtenburg, 2005, 128) It was not well received when it came from Truman either, and that he he announced, in his January discourse on the State of the Union, his plans to increase in the minimum wage “to at least 75 cents an hour”. Southerners again expected that the South would suffer more from the measure than the rest of the country. Unsurprisingly, Buchanan was among them. He wrote “Unemployment, Industrial Slowdown Could Result From Minimum Wage Law”, was published in NEWSPAPER, in January 1949, a few days after Truman’s discourse.

Buchanan’s objective was to discuss some of “the possible effects of the imposition of a higher legal minimum wage” (1949a, 5). “Minimum wage” was a question that Buchanan had already discussed, in his 1946 essay on “‘Federalism’: one Barrier to Labor Mobility” (1946) as well as in a notebook filled for the exam in ECON 300B (taught by Milton Friedman) on February 14, 1947 (1947a). Buchanan had then in particular detailed the negative consequences that would result from a reduction of “the wage differential between northern and southern labor”. First, it would reduce employment in the South, because firms would be oblige to “hire workers to the point where marginal productivity equalled the higher wage” (1947a, 300B) – which meant that workers would not be able to increase their productivity: “their productivity could not equal that required if they were to be hired at the national wage”. Second, and complementarily, an increase in the wages in the South would reduce the incentive firms could have to invest in the South – “[t]he incentive for capital to flow into the south … since returns could be lessened” now that labor was as expansive as in
the North. The income in the South would remain low. Workers would then have an “incentive … to migrate to the north to find whatever employment it could at any usage” (1947a, 300B) – which was not necessarily bad news: one may anticipate that that would reduce unemployment but also meant that labor productivity in the South would remain low. To Buchanan, on the contrary, wage differential should be enforced. Then, “capital would … flow into the South”, workers would find jobs and, “in the long run the productivity of the southern workers would have a chance to equate that of the northern worker”.

In his 1949 newspaper article, Buchanan made the same claims again. To him, a higher minimum wage would benefit to some workers only – in contradiction to what was suggested at that time – but would also create unemployment. Those problems would probably be more severe in the South than in the other states of the Union. That policy threatened to disadvantage the Southern states – more than the rest of the country. The explanation was that “on the average, Southern workers receive less wages than non-Southern workers”. Thus, any increase in the wage rate would reduce the supply of jobs and the workers paid below the minimum wage “will be thrown out of work”. Unemployment would increase. That could be expected since, as Buchanan noted, the “industries which are most prevalent in the South are those which employ a large amount of labor relative to the capital equipment, and a large supply of unskilled labor relative to the more skilled group” (1949a, 5).

In his 1946 and 1947 term papers, Buchanan had claimed that unskilled labor was a consequence of the low financial capacities of a state. He had then claimed that, as a consequence, interarea transfers from the rich to the poor states were necessary to improve the situation of the latter, and should be implemented before any other measure. It would have then been Buchanan’s logical next step to write that equalizing transfers should – at best – precede minimum wages. The policy would have allowed poor (Southern) states to improve their supply of public goods and services, and then to reduce unskilled labor, which would then have prevented the negative impact of an increase in minimum wages. In other words, Buchanan could have easily used his previous works to write about a topical policy question related to the role of the federal government in the economic development of the South. That was not what he chose to do. There were other more pressing issues to discuss than a policy that would be implemented at the end of the year. Thus, Buchanan postponed writing about fiscal equity, interarea transfers and federalism and wrote on one of the major reasons Southerners had in the recent past for quarreling with the federal government: the differences
in freight rates between the South and the North. The “long and bitter” (Lockin, 1946, 466) controversy over interterritorial freight rates – some even talked of a battle\(^5\) – that lasted for decades had ended in the second half of the 1940s.

3. Transportation policies and the role of the federal government

In those years, the country was divided in five major geographical rate territories: the Eastern or Official, the Southern, the Western trunk-line, the Southwestern and the Mountain-Pacific territories. Railroad companies could not charge the price they wanted to ship goods from one territory to another one. Those rates were then fixed by the Interstate Commerce Commission (ICC). And, since the nineteenth century (Potter, 1947, 438), Southern and Western states have complained that those rates were discriminatory against the South and the West and favorable to the East.

A regionalized or sectionalized rate-structure was in itself sufficiently problematic. Established “in the pioneer days of the railroads” (Barton, 1940b, 198), when the needs and the structure of the economy was entirely different, it was now completely obsolete and had become a constraint to economic development. That was known but had been documented by a report supervised by J. Haden Alldredge, transportation economist at the Tennessee Valley Authority, the conclusions of which had been that “[t]he division of the nation into autonomous rate-making territories … creates the first source of inherent discrimination.” (UCLR, 178)\(^6\) That was all the more problematic that the rate structure was difficult to change and had become “[a] muddle of compromise” (Lively, 1948, 358; Barton, 1940b, 198). And that, as the Alldredge report also evidenced, the rates paid by producers in the Southern and in the Western territories to ship goods in other territories were higher than those paid by producers in the Eastern or Official territory. The same year – on May 16 – a case was filed by the Southern Governors’ Conference “asking for an adjustment of

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\(^{5}\) The so-called “freight rate battle” (Tally, 1947; Fortune October 4, 1944, p. 149).

\(^{6}\) “This survey shows that the present territorial freight-rate boundaries, which are the outgrowth of tradition, constitute barriers against the free flow of commerce which are hampering and restricting the normal development of the Nation as a whole by preventing a full utilization of the varied natural resources that exist in the different regions of the country. It reveals that the existence of these barriers tends to retard substantially the commercial and economic development of the Tennessee River drainage basin and ad-joining areas in the South. The report suggests that the establishment of a uniform principle of making interterritorial freight rates will aid the commercial development of such regions as the Tennessee Valley and redound to the benefit of the Nation as a whole.” (Currie, 1947 392)
interterritorial rates applying from Southern Territory to Official Territory on a number of manufactured products” (Barton, 1940b, 199).

Although it was admitted there were millions of possible rates and that the lack of precise date made difficult the evaluation of the economic consequences of these differences in freight rates (Nelson 1947); that, most of the time, the official class rate structure was not used, and “that transportation costs were lower in the South than in the North” (Locklin 1947, 497), it nonetheless became a common belief that freight rates were higher in the South and in the West than in the North East – “[w]hile his conception might not have been technically perfect, the man on the street became aware that the South was unfairly burdened with a freight-rate handicap” (Barton, 1947, 518). Class differentials were judged “unreasonable and prejudicial” (Heath, 1946, 214). It was alleged that they had “inhibited economic growth and development in those areas” (Barton, 1947, 507) and “hindered … industrial development” (ibid.; see also Barton, 1940a), affecting the location of industries and the mobility of labor (Nelson 1947, 532). The problem was “as important as any with which the South has had to struggle in the past few decades” (Barton, 1940a), “one of the major issues in the adjustment of the South to the national economy.” (Potter, 1947, 416) It affect the economic and the social structure of the Southern states, as well as other regions and the entire national economy. As a commentator tellingly put it,

“[t]he existing freight-rate matter in so far as it concerns the South is not the fundamental problem of the South in that it is the crux of all the region’s troubles. It is rather a barrier in the path that leads to the solution of the South’s ultimate problem which is that of finding ways and means to permit the people of the region to achieve a higher standard of living through a better use of their energies and faculties in utilizing the physical resources which are at hand.” (Goff 1940, 454)

“[F]reight rate differentials” were presented as “[t]he major problem which faces almost all

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8 Indeed, there were a lot of exceptions – “[m]ore than 95 per cent of all the nation’s freight traffic moves on such exceptions to the class rate structure, designated loosely as commodity rate” (Lively 1948 360).

9 Goff noted: “[t]he transportation situation operates to influence their way earning a living whether they like it or not. The majority of people must stick to farming, mining, and forestry, or closely allied activities, with little choice, unless they emigrate to other sections” (1940, 455) Hence, “some of the South’s finest technically trained young people too frequently leave the region find a better field for their talents in the industrial developments of other areas.” (ibid.)
industry in the South” in the report on “The Economic Conditions of the South” written in 1938 for Roosevelt by the National Emergency Council. It was noted that “[t]he present interterritorial freight rates ... handicap the development of industry in the South.” (1938, 58)

A few months later, in 1939, the president of ICC found “that a major reason” that explained that situation was “an unfair adjustment of freight rates which has favored the producers of the North and burdened those of the South.” (Eastman, quoted in Currie, 1947, 391)

It was all the more “discouraging” (Goff 1940, 455) that the “freight-rate barrier” was “man-made” an expression used in the report to Roosevelt (1938, 59; see also (Barton, 1947, 518; Currie, 1947, 392), “artificial” (Goff, 1940 457; Berge, 1947 361; Currie, 1947, 392). It did not rest on economic or technical differences. It must be understood that transportation rates were primarily fixed by rate associations or rate bureaus that were associations of railroad companies that existed in all regions, including the South and West, and that controlled, in violation of the antitrust requirement of the Sherman Act, the level of rates as well as the behaviors of the different members and the settlement of conflicts.10 These associations that were viewed as “cartels” (Wiprud 1945) or monopolies (Potter 1947; Berge, 1947). The private arrangements that existed among these private firms were not ignored by the government or by the ICC. But it was suggested that they accepted them. It was even argued that an alliance existed that united railroad companies, bankers – most railroad companies were owned by banks – and the government (Wiprud, 1945; see also Young 1947). Thus, two problems combined: the regulation of freight rates by an administrative agency and anti-trust cases due to an alliance between bankers, railroad companies and the government.

In this atmosphere, it is no surprise that the ICC initiated a process to revise and standardize freight rates. It began in 1939. It was then viewed “as one of the most difficult problems the Commission has ever had to face” (Bigham 1947 207), a particularly “severe test” (UCLR, 1947, 177).11 After six years of work, on May 15, 1945, the ICC issued its

10 The situation was already difficult by the end of the 1920s. It worsened in the 1930s because of “the virtual suspension of the antitrust laws during the first years of the New Deal.” (Potter, 1947 445) It was, as one understands, impossible to file complaints against such practices.

11 The importance of the document was such that a commentator wrote: “[t]he Commission’s decision is generally regarded as its most important and far-reaching action in sixty years, and it is no exaggeration to say that it affects virtually every person in the United States.” (Miller, 1947 549)
“Consolidated Freight Classification”, a document that “ordered that [freight rates] be made uniform throughout the country.” (Tally 1947 174) The ICC had found plenty of evidence “of the higher charges paid by shippers in the South and West using class rates.” (Barton, 1947 531) And suits were brought in violation of the Sherman Act. The most famous case was the suit for conspiracy brought by the State of Georgia in 1945 in the Supreme Court of the United States against railroad companies for having fixed “unfair and non-competitive rates, all tending to penalize … and damage her economy” (Tally, 1947 173).

While the judgement was pending, there were discussions regarding the legitimacy of Georgia’s complaint. After all, if rates were regulated by the ICC antitrust issues could not be involved too. Railroad companies, unsurprisingly, opposed “to antitrust enforcement in the transportation field.” (Wiprud, 1947, 571) They “turned to the Congress for relief from the antitrust laws for all their collective activities.” (576) The problem was no longer simply an economic or even a legal one. It was now “political” (578). But the U.S. Supreme Court upheld the ICC and the state of Georgia’s contention and granted her motion. That was not the end of “our war for economic equality in the Southwest” (Gossett, 1945 366). A battle had nonetheless been won.

Very “popular” (Nelson, 1947 532), the controversy attracted a lot of attention, including among legal scholars and economists, before and after the creation of uniform rates. Articles were frequently published in the 1940s about the discriminatory dimension of those rates and about possible economic justifications. The ICC decision to revise the rates gave a new impetus to the discussions. A session at the 1945 American Economic Association annual meetings was devoted to this theme (Stevens at al., 1946). In 1947, a symposium was

12 It was said that “the Commission’s sweeping decision in the Class Rate case appeared to crown the efforts of southern and western interests with complete success.” (Currie, 1947 393) Or: “[t]he South’s substantial achievements in its war on rate discriminations are the result of political pressure.” (Lively, 1948 383)
13 The complaints went beyond the question of discriminatory freight rates. “Among the offenses charged are the … suppressing improvements in railroad service, limiting improvement in rail equipment and facilities, and hindering the development of forms of transportation that compete with railroads.” (Berge, 1947, 468)
14 In 1947, the so-called Reed-Bulwinkle Bill passed. It was “designed to provide the means of exempting from the Sherman Act all agreements between carriers to fix collectively rates, classifications, divisions, allowances, time schedules, routes, the interchange of facilities, the settlement of claims, the promotion of safety, and "the promotion of adequacy, economy or efficiency of operation or service."” (Wiprud 1947, 576)
15 Sydney Alderman viewed it as “a political football”: “[w]henever a southern politician has been unable to find a real political issue to present to the public, he has only to pick up this particular football and run with it, to the loud applause of his self-supplied rooting section, to gain wide acclaim and support.” (1947, 579)
published in *Law and Contemporary Problems*. Then, in 1949, Buchanan contributed to the debate with his second academic article, “Regional Implications of Marginal Cost Rate Making” (1949c). Buchanan was not a “pure theoretician”, unconcerned by practical issues. He had chosen to discuss one of the most typical instances of discrimination from the North and East against the South. A question that bore, more broadly, on, whether or not, it was really possible to devise a policy implying the intervention of the federal government that would be favorable to the South. Hence, it indirectly bore also on the possibility to devise a new form of capitalism in the USA.

Thus Buchanan became involved in discussions about the federal government and the South by dealing, in an exercise of applied economics, with railroad rates. It is not so surprising. As one would recall, the level of railroad rates had been crucial for farmers in Tennessee – they were one of the reasons that had led his grandfather to politics. He had also studied issues pertaining to transportation and mobility, focusing in particular on the institutional barriers and obstacles to mobility, that were also barriers and obstacles to economic development and an optimal allocation of resources. He was undoubtedly alert to any new about transportation. Beyond personal memories, the question was topical from the perspective of the role of the federal government in the development of the South.

Actually, the question Buchanan was discussing was not so much whether or not the intervention of the federal government was legitimate. Railroads were among those domains in which it does not seem that there was no doubt about it. Even free-market economists – like Simons – agreed on that. Very few defended the idea that the industry should be left to free market and free competition (see Wiprud, 1945, 1947, as one exception). The question was rather how much should firms be charged for using railroads.

Buchanan had already said a few words about that in the draft of “The Pure Theory”. He had insisted that the “goods and services made available by the government … are always offered at the average cost of provision … The supply curve of public services thus becomes the average cost curve … the public economy operates on average cost and not marginal cost principles.” (1949a, 13) But he had also added that “[t]his type of analysis … in no way requires that each particular service must be "sold" to individuals at the average cost of provision. This is patently not the case. In the social-service state many are offered free. In other areas, where government activity is in the nature of a private enterprise, the optimum
condition is represented by offers at the marginal costs of provision.” (1949a, 14)

Pricing goods at their marginal cost of production was under discussion in those years. This is what Buchanan apparently discovered after having written the first version of “The Pure Theory”, when he heard about marginal cost pricing for firms operating under decreasing costs – such as railroad companies.16 Rooted in the works of Alfred Marshall (1890) and enriched with the contributions of, to mention but a few, Pigou (1920) or Knight (1924), what was already known as the marginal cost controversy had been revived by the works of Abba Lerner (1937, 1944), Harold Hotelling (1948) and Coase (1946, 1947). Hotelling and Lerner suggested that marginal cost pricing could be used even for firms with decreasing costs but that implied that firms were subsidized for the difference between the marginal and average costs. Vickrey had named that solution the “Lerner rule” (1948, 218).

Yet, Buchanan was not interested in the controversy or in marginal cost pricing per se. He had no intention “to elaborate or to discuss either the theoretical validity or the practical applicability of this principle” (1949c, 53) – he added in a footnote that “[t]he particular difficulties which arise in the administration of a system in accordance with this rule need not be discussed here.” (53). It is not even clear that he was aware that a controversy existed since, beyond Lerner and Vickrey, he referred to none of the other economists who had been involved in it – not even Knight or Hotelling, although his 1938 contribution bore on railway rates. Buchanan did not refer to or mentioned Wicksell on marginal cost pricing – to which he will devote an article two years later. He was explicitly trying to contribute to the debate about the freight rates that, did he note, “have traditionally been significantly lower in the Official or Eastern territory … than in the Southern and Western territories.” (54) With a precise objective: to justify the intervention of the federal government in favor of the South.

Buchanan thus took Lerner’s idea for granted, not even paying attention that Lerner had used marginal cost pricing to defend socialism17, and agreed that subsidies should paid to

16 The reference to the “private enterprise” disappeared in the final version of “The Pure Theory”. He wrote: “in no way does it imply that each particular service is "sold"to individuals at the average cost of provision. In the social-service state many are offered free; others at marginal-cost prices.” (1949c. 498)

17 Lerner’s argument was that the principle was easier to apply in a socialist than in a capitalist economy because there is no need to implement a complex system of tax and bounties to help firms to fill the gap between marginal and average costs. Indeed, “[i]n the socialist State… there is no need for any particular firm or industry to cover its costs.” (1937, 269)
allow firms “to cover the full costs of production” (53). He started from there “to predict or to project the results of the application of the marginal cost principle in one aspect of road rate making problem. The particular aspect to be considered is that concerning the geographic or regional pattern of freight rates.” (53) From this perspective, was the 1947 decision of the Interstate Commerce Commission to adopt and implement a “policy of rate uniformity between the two regions” (56) a correct policy?

To answer the question, Buchanan made a graphical analysis, drawing long run and short run average and marginal cost curves, as well as demand curves for the “plant”, that is the railroad network, in the East and in the South. He did not derive the curves from a model but from available traffic data. It indeed seemed possible to infer that the average costs of operation were “approximately equivalent in the Eastern and the Southern regions” (57) and hence that the cost curves could “be assumed roughly identical for the two regions” (57). Then, if rates were based on average costs, Buchanan’s graph shows that they should be identical in both regions. At this rate, the average costs would be covered. That was consistent with his analysis in “The Pure Theory”, as well as with the policy decided by the Interstate Commerce Commission.

He also noted that the plant in the East “had been expanded beyond the range of increasing returns to scale while the “plant” in the Southern region [it] is still in this range of increasing returns to scale.” (57) Hence, the railroad system “in the Southern region is not being utilized to its optimal capacity” (58) and “is being utilized more fully … in the Official territory” (58).

Then, in contradiction to his claim that “the public economy operates on average cost and not marginal cost principles”, Buchanan investigated what would happen if marginal cost curves were used to determine those freight rates. His graph – that is, in all likelihood traffic data – showed that “the marginal costs of proving rail freight service are higher in the Eastern or Official territory” (58). The implication was straightforward: rates should be different and, more precisely, rates should be lower in the Southern region than in the Eastern/Official area (58) That was “the reverse of the traditional disparity” (58) and also in contradiction with the

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18 He thus wrote: “[i]n the case of such decreasing cost industries [such as natural monopolies], it has been shown optimum allocation of resources is secured by the use of the marginal cost principle even if subsidization is found to be necessary to enable an o unit to cover the full costs of production.” (1949c, 53)
policy that consisted in setting uniform rates. Indeed, by using marginal cost pricing, Buchanan could not only show that policies had so far been unfavorable to the South and also legitimize a policy that could be favorable to the South.

Buchanan went one step further. On the graph he drew, the intersection between the marginal cost and the demand curves leads to a lower rate in the South and higher in the East than the one based on average the cost. Such rates would logically decrease the activity (the use of the network) in the East and increase it in the South. As a counterpart, they would also generate losses for the firms in the South – the marginal cost being lower than the average cost. The loss could be covered by the gain made in the East, where the marginal cost was higher than the average cost (Buchanan, 1949c, 58)

Thus, to deal with the main cause – the level of freight rates – of “the nation’s No. 1 economic problem”, Buchanan proposes a solution that involved the intervention of the federal government – via a federal agency –, indeed suggesting “that the national government takes over control of the system of the country” (53). That this meant a certain form of centralization did not seem to be a problem. After all, railways were a natural monopoly. That remained consistent with Simons’s arguments. In addition, and he departed here from what Lerner had written (see fn 34), the solution had the merit of avoiding a complex system of tax and hence no need to switch from capitalism to socialism or to invent a new political-economic system. Using the profits made in the Official territory to subsidize the “plant” in the South could easily be implemented in a free market economy.

4. A central and limited role for the federal government

Writing “Regional Implications” had thus given Buchanan the possibility to repeat his (student’s) claim and that was becoming a leitmotiv – the federal government should redistribute income to poor states – without however using any of the arguments he had previously used. Those, in particular, contained in “A theory of financial balance in a federal state” (1947b), an essay Buchanan had written for ECON 362, “State and Local Finance” taught by Roy Blough. At that time, Buchanan had been suggested to publish his essay.19 This is what he finally did in 1949 – the article was submitted on January 31, 1950 –, with his

19 A handwritten – undoubtedly from Blough – mention made on the first page of the essay reads “A + – you should prepare a paper on this for publication”.
third academic article, “Federalism and Fiscal Equity” (1950b). The article strictly follows the 1947 term paper (1947b) and the parts of the dissertation based on the paper, except from the title that is close to his dissertation’s – “Fiscal Equity in a Federal State” – and very different from the essay’s. Obviously, Buchanan was convinced that his dissertation treated more of fiscal equity and equalizing grants than it dealt with Wicksell and voluntary exchange theories. And indeed, besides a reference to the “benefit of *quid pro quo* principle” (1950b, 585), the paper bears no trace of these theories.

Theoretical discussions around equalizing grants were no more vivid when Buchanan wrote his article than they were one year earlier when he had started to write his first articles – this is confirmed by the literature Buchanan referred to in his paper. With the exception of his article on government finance, the most recent references dates back to 1947. Thus, what may have led Buchanan to write his article was precisely that the relationships between the North and the South, between the federal government and local ones, and the need to help the South via federal aids remained topical. Truman’s fair deal was being implemented, as for instance evidenced by the amendment of the Federal Fair Labor Standards Act of 1938, voted on October 26, 1949, that increased the minimum wage as Truman had promised it would be the case. That might or would affect the economy of the Southern states and increase the gap with the Northern States, at least if Buchanan’s predictions were correct. In that case, now that the measure was implemented, the question of helping the South needed to be raised even more strongly than earlier. It was now time to insist on the importance of equalizing grants and federal policies to correct resources and income inequalities between states that Buchanan had pleaded for. In other words, it was time for Buchanan to make his ideas on these points visible. This is what he did with this article.

The starting point was the dilemma – Buchanan did not use the word though – that federal regimes have to face: “each government unit is limited in its operation by [its] geographical boundaries; it can withdraw resources for the financing of public services only from those available within this area” (1950b, 583-584). Now, because fiscal capacities vary from one unit to the other, “the over-all fiscal problem of the federal polity” (584) was that could emerge possible “fiscal inequalities among these units” (584). And, again as he had written previously, he insisted on the fact that the problem was inexistens in 1789 but had “grown progressively more acute” (1950b, 584) as the economy developed. Indeed, not only wealth progressively had concentrated in certain geographical areas – accentuating the
differences in terms of fiscal capacities of each state – but also each level of government produced more and more public goods and services and, in particular, “social services”. Now, the latter are provided “equally to all citizens or upon some basis of personal need” (585) rather than on a benefit or quid pro quo basis; social services are thus provided independently from individual’s capacity to pay. This meant that units of governments with different fiscal capacities were nonetheless obliged to provide equal services. This could not but lead to unequal tax rates and, accordingly, mean an unequal treatment of equals.

Buchanan thus repeated and summarized his claims about the fiscal dilemma of federalism (1946, 1947b), the importance to maintain a form of fiscal justice and the need to use the “basic” but “widely recognized” (1950b, 587) principle of “equal treatment for equals” or equal treatment for persons dissimilar in no relevant respect.” (587) This principle, did he insist, “is essential as a guide to the operations of a liberal democratic state, stemming from the same base as the principle of the equality of individuals before the law” (586). It means that “[a]n individual should have the assurance that wherever he should desire to reside in the nation, the over-all fiscal treatment which he receives will be approximately the same.” (589) The reference he used was Pigou (1929), as in his dissertation, rather than Sigdwick – who was surprisingly not longer cited or quoted. And, again, he proposed to verify whether or not the principle was satisfied by using the fiscal residuum.

Then, Buchanan came back to a dimension that he had discussed in the 1946 term paper, mobility. That allowed him to stress the negative dynamic consequences fiscal injustice would have in terms of efficiency and not in terms of justice only. The reasoning was straightforward: if “the fiscal balance for equals is not made equivalent for all areas of the economy” (589), individuals will migrate from the poorest to the richest states, from the low to the high fiscal capacity states or, more precisely to, to the areas that would allow them to get a higher fiscal residuum – “[i]f 'equals' are thus pressed more in one area than in another, there will be provided an incentive for migration of both human and non-human resources into the areas of least fiscal pressures” (589). This would obviously end up in a reallocation of economic resources, a process that Buchanan did not view as beneficial. He did not envisage that this might mean that resources would move to places were more productive and hence where they would receive higher rewards. At least, he did not mention this aspect. He focused on the negative consequences that these moves would have for the poor or low-income states. Wealth and resources would progressively concentrate in already rich and
resourceful states or areas. Their already high fiscal capacity would therefore increase even more. Complementarily, poor states would become poorer and their fiscal capacity would be further decreased. Thus, Buchanan was warning his readers that mobility in a situation in which fiscal capacities vary so much from one place to the other would create more problems, increasing fiscal divergencies between poor and rich states and generating “a considerable distortion of resources” (589).

To deal with the problem, and close the gap, one could try to centralize political functions. That was the solution Buchanan had envisaged in his earlier writings and to which he came back, to repeat that “[i]t is true that complete political centralization would resolve the peculiar fiscal problem of federalism” (585). Fiscal injustice would disappear, equals being treated equally – all individuals would benefit from the same services and pay the same tax rates. Incentives to migrate to wealthier states would disappear too. But, as in his previous works, Buchanan rejected this solution. Even if he no longer claimed that federalism has a value in itself, he stuck to his belief that one should preserve “the federated political structure” (1948, 4). This meant accepting the fiscal dilemma and “take some action in support of proposals aimed at adjusting these interstate fiscal differences.” (1950a, 599)

To Buchanan, the best solution to achieve this result was to use “geographically discriminatory central government personal income taxation.” (595) Taxes would be differentiated according to the level of wealth of the state in which individuals live and, to be more precise, individuals would then pay higher (resp. lower) taxes in rich (resp. poor) states. That would have one major advantage: there was no need to effectively divert or transfer resources from rich to poor states. However, discriminatory tax rates would be difficult to implement. There were two problems. First, the constitution prohibited the geographical differentiation of taxes and, second, the fiscal illusion that affects individuals leads them to focus on tax rates without taking into account benefits. Individuals would thus miss that higher taxes would go with higher benefits and would certainly migrate where tax rates were lower – that is to poorer states. That would be a cause for additional inefficiency.

That the best policy measure could not be applied did not mean that one should abandon the objective. Buchanan admitted that “a precise application of the equity principle in the real world [is] extremely difficult”. (595) Yet, the difficulties “should not serve to prevent its use as a proximate standard for intergovernmental fiscal policy.” (595) Hence, one should adopt a
second best solution. To Buchanan, it was to proceed to transfers of income from rich to poor states to “place [Sates] in a position to treat citizens in the same manner fiscal wise as their equals in all other states.” (596) After these transfers, “the individual’s place of residence will no longer have a significant effect upon his fiscal position.” (591) Or, using the same example as in his previous essays: “[p]ersons earning the same income and possessing the same amount of property will no longer be subjected to a much greater fiscal pressure in Mississippi than in New York, solely because of residence in Mississippi.” (591)

More precisely, to guarantee that individuals would be treated equally, Buchanan insisted again that grants should be given “unconditionally” and that states should be financially responsible – he cited Simons against Hansen on the fact “that legislatures can be trusted to spend if required to tax accordingly” (Simons, 1942, 178; in Buchanan, 1950b, 598). The main reason was ethical. As he had explained in his 1947 paper, Buchanan repeated that the transfers made in the frame of the equalization policy he was advocating for were “are ethically due the citizens of the low income state unit” (598). Indeed, “States are made claimant through no fault of their own or of their respective citizens.” (598) These transfers were made to restore justice, not to fulfill objectives decided by the federal government. Hence, one could not tell states how to spend that money.

It was necessary to respect the sovereignty of each state even though, as Buchanan admitted, “states would not necessarily, or probably, choose to” (596) treat equals equally. Public policies were also shaped by “state political decisions” (596). That point had been emphasized in the literature (Corry, 1941; Maxwell, 1946). He had himself insisted, in his M.A. thesis (1941) and in his 1947 term paper, that political biases were effective and important – when he had explained that small counties benefitted from favorable fiscal policies because they were more represented in the state parliament. He made a similar claim in a review of James Thorogood’s A Financial History of Tennessee Since 1870 (Buchanan, 1951a), criticizing the author for having ignored the “[u]nderlying political conflicts and stresses which have certainly been of major importance in shaping the financial history of the state” (369). Hence, fiscal policies could not be reviewed and evaluated without taking those the political forces at play into account. Thus, although he insisted on the importance of constitutional rules, Buchanan also argued that political behaviors within the constitutional frame also mattered and should not be neglected.
But, Buchanan immediately downplayed the importance of these political misbehaviors. The unequal treatment of equals that might or would result from unadapted local policies was “reduced to insignificance in comparison to those now present” (596), that is those due to the place of residence. Thus, these behaviors were not sufficiently problematic to legitimate conditional grants or to constrain these states to adopt specific measures, even in areas in which there were national common objectives. There was no reason to expect that states would misuse these resources or use them differently from other states. To Buchanan, equalization policies, equalizing grants – that amount to transfer income from rich to poor states – would necessarily lead states to adopt policies that would also fulfill these objectives. He found “highly probable that, if an equalization policy of the sort proposed here were carried out, national interests would be adequately served without any national government direction of state expenditure.” (597)

That was the case with education. Buchanan believed that poor states would adopt specific standards in education as soon as they were no longer limited by a too tight budget constraint: “[t]he low income states provide deficient educational standards largely because of their fiscal plight; remove this, and it seems likely that their service standards would approach those of other states without any restraints upon state budgetary freedom.” (597) Therefore, a federal aid to education was necessary. To Buchanan, this was “the most important of specific policy measures” that should be adopted.

5. Planning, free markets and an optimal fiscal policy for the South

Buchanan also tried to promote the same ideas in non academic circles. When he was invited to a workshop in Economic Education that took place in July 1950 at the Ward-Belmont College, Nashville (TN), Buchanan made the same points as in “Federalism and Fiscal Equity”. This is what can be read in a piece written as a set of articles aimed at presenting the different contributors to the workshop and published in the Nashville’s Tennessean, on May 7, 1950 – what Buchanan said during this workshop is lost.

Buchanan is first quoted for defending the idea that taxes in low income areas must be heavier than in high income areas to provide the same amount of services and that the federal government should help poor states “to eliminate this situation”. The journalist put it in the most direct terms: the “federal government is obligated to provide funds to low income states”. For his part, Buchanan described the South is a “low income area” that, as a
consequence, “must take its people more heavily that higher income areas in order to provide adequate public services”. Buchanan had taken the opportunity of talking to the local press, to state that the South was poor and should benefit from transfers made by the federal government. Even if this is not surprising, it was the first time that Buchanan was so explicit. References to the South had so far remained implicit or discrete in his academic articles. It meant a lot in a period in which that question was the object of particularly hot debates.

That Buchanan accepted that the federal government should play a central – but limited – role in the economy and more specifically should help the South, as Roosevelt and Truman had also proposed, did not imply that he agreed about the need to change the system and move towards the new form of capitalism they were advocating for. Much to the contrary. This is what he said in a talk given at the Knoxville Exchange Club on March 2, 1950. The text of the talk is not available but the account given by journalist John Peck, published in the Knoxville Journal on March 3, based on long quotations from Buchanan, is sufficiently detailed and clear to understand Buchanan’s views.

We thus learn that Buchanan’s ’s talk bore on “The Future of the Free Enterprise System”, and, from the title Peck gave his account – “Free System Endangered, Club Warned” –, we understand that Buchanan’s tone was not positive. This is confirmed by Peck who wrote that Buchanan “term[ed] himself a pessimist” (Peck). Yet, in a manner typical of his talks over the next decades, he also believed that there remained room for action. He said: “[n]othing is inevitable”, and added

“we must swim upstream instead of taking the easy way and swimming downstream as is too often the case. As thinking people we must retain implicit faith in the ability of men to come to their senses and reorient the social organization toward the reestablishment of the ideal of freedom."

What made Buchanan pessimistic were the “[u]nmistakable trends … which are sweeping this nation toward more and more collectivism and centralization” (Peck, 1950). There was too much planning and control in the economy. He thus condemned “regulated capitalism, price controls and other New Deal experiments” (Peck) that were invented after the great depression. Buchanan illustrated his purpose, criticizing the laws adopted in the 1930s, that had created monopolies – including on the labor market with free collective bargaining. He also targeted the National Recovery Agency codes – but thanked the judges of the Supreme Courts for having ruled them unconstitutional – and all the “controls” that had
been introduced by the Roosevelt administration during the war that had not been abandoned now that it was over: “[w]e still have rent controls. And the administration still asks for standby powers of rationing and controls, agriculture support programs, fair trade laws and minimum wage laws” (Buchanan).

Which did not mean that Buchanan believed in the total absence of regulation and state intervention. Too much planning was actually the second and most recent of the two threats that endangered what Buchanan called the free market system. The other and oldest one – the source of all problems – was precisely the absence of planning. That was the view adopted by those who defended the free market or free enterprise system in the nineteenth century. They gave the false impression that free enterprise should be equated with unlimited freedom and the complete absence of government intervention – “those who forwarded this concept in the last century went too far with their distrust of government” (Buchanan) and “construed [it] too much too imply 'freedom to do as I please' regardless of the equal freedom of others.” (Buchanan) Thus, Buchanan also condemned this form of capitalism, that rests on an “unbounded faith in freedom of markets” (Peck).

Buchanan found this extreme form of free market capitalism problematic. Having led to government “inaction” (Buchanan), no measure was taken to prevent or correct the disastrous consequences of the great depression – Buchanan claimed that the government should have played an active regulatory role in particular in monetary area. Thus, convinced, on the one hand, that a free market system meant no government intervention and observing, on the other hand, how it had failed, people “lo[se] .. faith” in, “mistrust[ed]”, free markets. Hence, unsurprisingly, “this nation began to seek another system” (Peck). As understandable as it was, this was a mistake. Rather than a new system, what was needed was to go back to what a genuine free market system, what it should have always been, namely a hybrid system, combining freedom – rather modestly defined as “the freedom to enter any occupation of to set up any business that he wishes” (Buchanan) – with government intervention. Or, as as he said in the conclusion of his talk, a free market system involved a form of planning – “[w]e must … sharply separate 'planning for competition' from 'planning against competition'.” He then added: “[w]hat we fail so miserably to see is that the free market system is the only plan yet devised which will produce what the most people want in the most efficient manner”. Planning is necessary for competition to take place and a free market economy to develop.
Simons’ insistence on the importance of rules to organize the economic game comes to mind when one reads this account of Buchanan’s talk. One must not forget that Buchanan also defended the intervention of the state to help poor states. What mattered to him was planning for competition and planning for the South. This leads us to another reference that seems to be important to understand Buchanan’s views on planning. It is a book entitled, *Planning for the South. An Inquiry into the Economics of Regionalism* (1943) and written by a professor of economics at Vanderbilt University, John V. van Sickle. The book had attracted Buchanan’s interest when he wrote his dissertation – it is included in the list references. One may note a certain closeness between their Buchanan and van Sickle: their concern for the “persistence … of regional inequalities … over generations” (1943, viii), and the “difficulties confronting the South” (ix), their belief in individual freedom as well as in the need to combine free markets and democracy. And, even if the impact van Sickle’s book on Buchanan is difficult to measure – Buchanan did not cite nor quote it in his work –, the talk he gave gave in Knoxville seems to be built on van Sickle’s ideas.

In his book, as Buchanan in his talk, van Sickle distinguished “Liberalism” or, to use a “more modern term Liberal Planning” (ix) from laissez-faire – “[l]iberalism … is not laissez-faire” (20) or “to repeat is definitely not a synonym for laissez-faire.” (22) Both were based on the defense of freedom, that he had defined as Buchanan in his talk as the freedom for consumers to “guid[e] production” (11) and “occupational freedom” (11) for producers. But, to van Sickle, again a point Buchanan made, laissez-faire was unrestricted – a regime of “untrammelled (sic) private enterprise” (20). This system had produced “undeniable gains in material well-being” (6) that van Sickle, a pro-market economist, could not but mention, but also generated terrible situations that he did not ignored – “abject poverty … slums, brutal colonial exploitation of primitive peoples, and periodically a breakdown of the productive processes”, (6), crises “which threw tens of thousands of hungry workers on the streets and left farmers bankrupt amidst their surpluses.” (6) Unrestricted competition was “harsh” (11). It was also “slow” (11), “exceeding slow” (44) to correct itself. So slow that it could do “irreparable harm… to the natural and human resources in low income areas.” (44) So slow, that it might not even correct itself, as proved by the situation in the South. As “a practical method of reform” (ix), laissez-faire was thus “futile” and “cruel” (ix).

Hence, planning was necessary. Not the authoritarian and totalitarian “total planning” that was aimed at controlling the economy and society, and was therefore opposed to markets
or, as Buchanan had put it, against competition. What was needed, the “liberal planning” Van Sickle advocated for, was a form of planning that would preserve competition – “Competition is a control force that the Liberal State must rely on.” (25) It was a form of planning meant to avoid the harshness of laissez-faire and to accelerate adjustments on markets. In other words, to improve the functioning of markets: “Liberalism sees its great task, therefore, as that of "perfecting the market."” (20) or “the Liberal State … may properly interfere to reinforce the "market's" efforts at adjustment.” (44) Indeed, planning for the market or for competition. Which, to van Sickle, meant – the proximity with Buchanan’s “rules of the game” is striking – that “law makers and officials [had] to provide the legal and social institutions which will enable us to make the necessary adjustments for ourselves.” (32)

After the theoretical foundations, van Sickle praised the “resources base” of the region that “rivals, if it does not surpass, those of some of the Great Powers” (45) and then identified the goals that should be aimed at. Here, he took care to distinguish his views from those of the Agrarians – including the Southern ones. The goal the South should aim was “diversification” – that is, agricultural diversification and industrialization. Crucial to this process was factor mobility – “the transfer of the factors from areas of lower to areas of higher productivity” (168) – and more precisely the mobility of capital, that van Sickle found more important than that of labor – “we should not rely too heavily on population mobility to equalize regional differences … Capital should be more mobile than labor.” (100)

To reach that goal, one should start by removing the “artificial barriers to factor mobility” (204) and to the diversification of the Southern economy. Van Sickle listed the protective tariff on the Southern region (169-172), the freight rate structure (172-181), the Fair Labor Standards Act (181-191), collective bargaining (191-195) and Federal housing subsidies (195-203) that he proposed to transform in one way or the other. But that was not enough. Measures of “positive assistance” (204) should also be taken by the Federal government to aid the Southern region. The “a differential Federal aid” (204) the South should benefit from should take the form of unconditional grants-in-aid – “[t]he states should be left reasonably free to devise ways and means of making Federal grants do as much work as possible.” (211) These grants were a prerequisite for would promote regional equalization and a correct functioning of the economy – “For grants to be effective, however, a reallocation of revenue measures between the Federal and the state governments is a prerequisite.” (217) Then, he gave some details as to how the Federal and state fiscal systems
should be reformed and suggested some administrative and institutional reforms. He also insisted that his program would benefit the South and the entire nation: “a constructive program of equalization will enhance the national income” (208) or “[a]ll the programs advocated in this study tend to increase and regularize the flow of the national income” (234).

Whether Buchanan was influenced by van Sickle can be debated. He nonetheless shared some of his views. In particular, the need to industrialize the South, to increase investment in capital in the area. The lack of investment, the excessive supply of labor compared capital was indeed the main cause that explained the underdevelopment of the South and the related earnings differential with the North.

Buchanan made the point after Jesse W. Markham hard argued in a 1950 article that “[t]he North-South annual wage differential is not so much a result of the smaller size of capital investment in southern labor markets as it is a result of the kinds of industries in which investment has taken.” (283) To counter Markham’s argument, Buchanan wrote a short “Note on the Differential Controversy” (1950a), published in July 1950. He claimed that to think of the kinds of investment as independent from the size of the investments, as Markham did, was a mistake. The two variables were related. Actually, the kinds or types of investment that could and would be made in a region depended from the size of investments already made. In the South, precisely, the size of investment was low. Or, in terms of ratios, the economy of the South was characterized by “an excessive supply of labor relative to its capital investment” (1950a, 59) – a major different with “the non-South” (59). Hence, the firms that “were attracted to the South” were those “using little capital relative to labor” (59) or more labor than capital, and even a labor “heavily weighted with the low ranks” (59). These industries, wrote Buchanan, “will be, and have been, attracted to the South more readily than other types.” (59) Thus, what we observe, in particular Markham, was the consequence of a pattern, “the pattern that exists in the South today.” (59) To change the situation, the solution was not to select one type of investment or another, but to attract any kind of capital – “The South seems in no position to discourage any type of industrialization at the present time.” (60) That was the goal public policies should aim at – without, however, ceasing “to exploit rather than overlook the inherent economic advantages which the region possesses” (60), by which he obviously meant low wages.

Then, at about the same time as he wrote the Note and gave the Knoxville talk,
Buchanan wrote “The Optimal Fiscal Policy for a Southern State” – an unpublished and undated manuscript that is probably from 1950, the most recent reference being from 1947. With this essay, Buchanan pushed the analysis from his “Note” further and seemed to be trying to use arguments similar to van Sickle’s. The reference to the latter’s a book is even the first in the paper. Also, Buchanan referred to “the optimal allocation of resources in th[e] national economy” (4), which had been important for van Sickle. What kind of fiscal policy could be used to industrialize the South?

He explained that poor states were obliged to tax more heavily economic resources than rich states and also, because their resources depend on the taxable wealth that is created by economic activities within its borders, may chose to do so to “increas[e] the share of national economic resources contained within its borders.” (2) This would be done without any consideration for economic efficiency and may prevent the maximization of the national income. To solve the problem, one could use interarea transfers or “a carefully chosen state policy” (5), that may achieve desired economic results both from both the viewpoint of the individual state and the national economy.” (5)

This policy would have to take into account that the South “is characterized by an unfavorable labor-capital ratio in relation to the economy of the United States as a whole. Relative to the amount of capital investment in the area there is an excessive supply of labor.” (5) Thus, taxes and expenditures – an optimal fiscal policy meant using both complementarily – should aim at equilibrating the ratio in a way that would be more favorable to the South and, accordingly, to the national economy. This meant increasing the amount of capital to promote industrialization and decreasing the quantity of labor – “along with industrialization, the continued out-migration of labor should be encouraged” (6) or, to me more precise, the out-migration of unskilled workers should be encouraged, while the educated and most productive workers should be prevented to move of the region.

On the tax-side, Buchanan noted that regressive taxation would be the best way “to attract capital investment and to encourage continued out-migration of unskilled agricultural labor while at the same time discouraging out-migration of the more productive components of the labor force” (8). But, it would also probably not be accepted – it is a “conceivable but does not present a realistic alternative in our society.” (10) A system that was, according to him, “at all feasible in light of modern standards of social justice seems a uniform poll tax”
That would not be sufficient to raise enough money. Hence, what he viewed as was “general sales tax present itself as the practicable alternative.” (10) Then, in terms of expenditures – about which Buchanan gave very few details –, he insisted again on measures that would attract capital – “expenditures on informational and promotional campaigns designed to acquaint potential investors with a state [a]s appropriate” (12). Also, he stressed how important were “expenditures such as those on education, highways, public health, sanitation, general control, and care of the indigent.” (12-13) Indeed, did he conclude, “[t]hese services are inflexible.” (13)

**Equalizing grants: efficiency or ethics**

In a letter to Earl Hamilton, the then editor of the *Journal of Political Economy*, dated from October 29, Buchanan wrote that he “hope[d] to have, in the not too distant future, a manuscript of my own to submit for your consideration.” He was probably referring to “Federal Grant and Resource Allocation” (1952a) – the only paper published in the *Journal of Political Economy* in (June) 1952 – on which Buchanan might have been working at that time. Thus, in the fall of 1951, while he was starting to work again on the philosophical foundations of public finance, he was also and still working on the same old topics, that had interested him since his dissertation – the federal dilemma, labor and capital mobility, transfers to poor regions, the ethics of equalizing grants, the need for grants to prepare the South to compete with the North. Buchanan was coming back to old themes.

Nothing in the economic or political situation in the South and in the US had changed to the point that he had to repeat his arguments. These topics had not even received much attention recently. Very few articles were published in 1951. Two articles must nonetheless be singled out – “A Note on Grants in Federal Countries” (1950), by Anthony D. Scott and “Government Expenditures and Economic Welfare (with special reference to grants-in-aid)” (1951), by Harold M. Somers – for having attracted Buchanan’s attention. Which is easily understandable: both authors opposed to transfers from rich to poor states, that they view as an obstacle to mobility and hence to an efficient allocation of resources. Indeed, to them, efficiency “requires mobility of resources from less productive to more productive uses” (Somers, 1951, 22) or “transferred from places where [their] marginal product is low to places where it is high” (Scott, 1950, 419).

Somers and Scott differed in their analyses. The former had written a paper on the limits
of old and new welfare economics, in which he came to cite, to criticize it, what he called Buchanan’s “plan” (1951, 22) to treat equals equally. To him, such a plan would preclude mobility, prevent the “maximization of economic welfare” (22) and hence “freeze the economy into a sort of stationary state.” (22) He concluded without ambiguity that, “[a]lthough this plan may appear to be consistent with fiscal equity, it is subversive to economic welfare.” (22) Thus, it “cannot be used for the allocation of government expenditures with a view toward the maximization of economic welfare.” (24)

Scott pushed the analysis and criticism further. He started his article with the book by Maxwell that Buchanan had used in his essays on the federal dilemma and, without nonetheless naming it, acknowledged the problem exactly as Buchanan had done: “in federal countries, [e]ach province … levies its own taxes and sets it own standards of services” (1950, 417) which meant that, because “”poorer” provinces … cannot levy the same tax per capita as the rich provinces … the bundle of services distributed to the citizens must be correspondingly small.” (417) Then, rather than putting the problem in the abstract terms of welfare maximization, he reasoned in the more concrete and more appealing to Buchanan ones of national income. To him, the goal was to maximize the “income for the whole country” and “national production” (419).

From this perspective, however, these transfers were “undesirable in the long run” (419, italics added). Undesirable indeed but for economic reasons only, that is in terms of efficiency – “[t]here is a valid objection, on the grounds of inefficiency, to making such transfers … of government income from place to place” (418). They “prevent the maximisation of national income” (418-419) by “impeding the automatic tendency for an economy to allocate labour where it is most productive” (421). Indeed, by increasing the social services provided to the people living in poor areas, would encourage them to remain there, or would reduce the incentive to migrate to wealthier areas – “the higher the proportion government amenities are of total family income, and the less the attractiveness of higher real wages is elsewhere.” (421) In addition, these transfers would be a waste also because they would never change the wealth of an area. That was central in Scott’s analysis: poverty came from a “lack [of] resources or natural advantages sufficient to give [individuals] a standard of living equal to that in other parts of the nation” (421). He compared living in such places as trying “to scratch a living in a wilderness or in a desert.” (421) That could not be changed, even by transferring income to poor areas. Thus, labor or of capital would always be more
productive in a rich than in a poor area. Which meant that the South was and would remain poor as its inhabitants, whatever amount of income was transferred to them by rich states. The only solution was to incite people to leave the area and move to a “better land”. To facilitate out-migration to areas offering employment opportunities.

Such arguments and the meaning for the South could and did not leave Buchanan indifferent. He reacted by writing a comment “Federal Grant and Resource Allocation” (1952a). Interestingly, it was not Somer’s criticism of the “equal treatment for equals” principle that bothered Buchanan but Scott’s rejection of the idea that a federal government should help poor regions. The latter were really what was important to Buchanan – by contrast with Scott, for whom what mattered was the maximization of the national income. Thus, to Buchanan, the problem was the existence of differentials among regional units, and the need to reduce or eliminate them. To do that, one should start by understanding where do these differentials come from. Buchanan supposed, in the first part of his article, that differences in income come from inefficiencies in the allocation of resources – that is, labor and capital – among regions. More precisely, Buchanan viewed the market as a process. Thus, when the “adjustment of resources to market criteria” (209), as he put it, is “improper” (215) or not “perfect” (215) or, much more interesting, “incomplete” (209), there would exist “resource disequilibria” (208) that cause these differences in income. A proper, perfect adjustment should be complete. But it cannot be because – as he had claimed in “Optimal Fiscal Policy for the South” – of the “comparative abundance of unskilled labor in relation to capital, skilled labor, and entrepreneurship.” (209) This explained “the low-income levels of the "poor" sections” (209). Resources had then to be shifted from rich to poor regions.

Scott, as seen above, had claimed that this would be inefficient. Buchanan disagreed. Analyzing and comparing the effects of differential tax rates – his preferred way of proceeding (1950) –, unconditional grants combined with reduced taxes and conditional grants, he concluded that one could not conclude, that it could not be said with certainty “that income transfers from the high-income to the low-income areas will tend to retard the movement of resources toward their most productive employments.” (214) Most of the transfers would shift resources “in the direction indicated to be desirable by market criteria” (214) but sometimes resources might shift in the wrong direction. Hence, “[t]he net result cannot be determined without empirical investigations into actual situations” (210)
There were nonetheless exceptions. There were at least two areas in which one could say with certainty that grants would shift resources in the desirable way and therefore tend to reduce income differences: transportation and education. The effects are easy to understand. First, “[t]he provision of a relatively better highway system in a low-income state will tend to attract capital investment which perhaps could not otherwise be attracted, including investment in transportation itself.” (1952a, 212) Second, equalizing educational grants would not only improve the skills of unskilled workers, reduce migration from skilled workers to other states and would also affect the inflow of capital – “[a] better educated labor force will prove more attractive to potential investors, other things remaining the same.” (213) Both types of grants would allow low-income states to meet “their primary need, industrialization” (213), reduce the resources disequilibria and then differences in income.

Thus, in the first part of his analysis, Buchanan had demonstrated that grants would reduce or eliminate income differentials when the latter were supposed to be caused by an incomplete adjustment of resources. It was a first criticism of Scott’s analysis.

Then, Buchanan asked, let us admit that the process of adjustment be complete. Would the differences in income disappear? Would the problem of the poverty of poor regions be solved? No, did he answer: “even should the marginal conditions of optimum resource adjustment be satisfied” (216) and the “rewards for a resource unit in a high-income and in a low-income state” (216) were “identical” (216), differences in income between regions “would be present” (216). Indeed, “the free play of economic forces” (215) may eliminate the “[g]eographical differences in rewards to like units of resource” (215), but not the “differences in climate, topography, soil, mineral resources, proximity to sea, invested capital resources, etc.” (216) The marginal productivity of labor and capital would be equal across the country but the income each of these unit would create would remain lower in poor regions. A “full equalization of incomes” (215) was out of reach.

In addition, Buchanan repeated, the fiscal pressure would always be higher in poor than in rich areas. Owners would then always be incited to move their resources to the latter. Thus, individual rational choices would not produce a socially optimal allocation of resources. That was a sort of problem of social cost. Thus, echoing what he had written in “Federalism and Fiscal Equity” and what van Sickle has argued, income differences would never be removed or reduced by competition: “[d]ifferences among states in average-real-income levels would
likely be present therefore even should the marginal conditions of optimum resource adjustment be satisfied.” (216) And, also as he had written earlier, mobility could solve the problem of income differences only if it was preceded by equalizing transfers aimed at removing fiscal differences and guarantee an equal treatment of equals (216). Transfers were thus a necessary condition to satisfy before allowing competition to take place – “[i]ncome transfers are required before the optimum can be attained.” (216-217) Even if it was not “planning for competition”, it was not so far. The claim was still that competition would work only if competitors were ready for it.

Then, Buchanan concluded his comment by examining the ethical desirability of such transfers. To him, economists could not reason in terms of efficiency only. Even if Scott was right about efficiency, there remained to discuss the “distributional” or “ethical” consequences of a policy that would consist in abandoning interarea transfers. Because economists could not neglect that reasoning in terms of efficiency would create more poverty in already poor states – “the failure to carry out the transfer on the basis of this efficiency argument obviously leaves the poor worse off, relative to the rich, than they would have been had the transfer been carried through as proposed.” (217) A fiscal policy had other and more important objectives: “equity, national interest, and the preservation of minimum standards of the public services.” (217) These objectives came before efficiency. They were fundamental in evaluations of public policies. And, from this perspective, Buchanan did not doubt that grants were justified to improve the situation of poor regions. Let us stress that Buchanan mentioned the South in footnotes only, and spoke only once of the South as “the low-income region of the United States” (1952a, 215; emphasis added).

In addition, refusing transfers to poor states on allocative grounds was “similar to harsh and oppressive measures” (217) such as taxing people living in those states more heavily than those living in rich states, or forcing them to move to rich areas. Such measures would not be accepted in a liberal society – “It is evident that the positive-policy equivalent of this efficiency objection would not be generally acceptable in a liberal society.” (217) The political workability or feasibility of policies – a point on which Buchanan will come back soon – had to be taken into account. “Thus,” Buchanan concluded,

“even if the economic analysis behind the resource-allocation argument against central-government grants to low-income states were completely acceptable, which it has been shown not to be, the use of this objection in forming policy
would carry with it many implications concerning the proper use of the "fisc."” (217)

And the proper use of the fisc and of the transfer policy was not to promote efficiency but "alternative objectives: equity, national interest, and the preservation of minimum standards of the public services.” (217)

Scott replied that he did not oppose to ethics but economists were primarily concerned with efficiency. He thus separated economics from ethics, while Buchanan was trying to reconcile them. And, as an economist, strictly speaking one may say, he had put efficiency claims before all other claims. From this perspective, he could not but maintain his views. Certainly, transferring resources to the South would improve the economic situation of the region but what mattered was to know if transferring resources to a poor region was more beneficial to the nation than transferring them to a rich one

“it is not a question of whether the provision of capital, enterprise, and training will pay dividends in the poor province. It is a question of whether the same resources will pay greater dividends in poor provinces than they would if transferred to rich provinces.” (1952, 535)

Thus, “[t]he whole argument, in fact, resolves itself into whether or not the provinces receiving the federal grants are the best fields for such aid” (535). Now, from this perspective, the quantity and quality of resources in a poor region were given and lower than in a rich one. The fate of poor regions was sealed. Investing in those regions would inevitably bring fewer rewards than investing in riche ones. A point that Buchanan rejected. He believed that, Scott noted, “(for any fixed local endowment of natural advantages) the more that capital can be induced to immigrate, the higher the demand curve will be.” (535) Or “Buchanan’s implicit assumptions is that natural resources are adequate, awaiting only development, and that labor in poor areas requires only training and experience for its efficient utilization.” (536)

That was exactly Buchanan’s assumption, as he wrote in a reply to Scott’s reply – which lead him to re-introduce arguments in terms of efficiency. To him, Scott was using the “the traditional trichotomony-land (natural resources), labor, and capital” (1952e, 538) and seemed to believe in “the Ricardian idea that natural resources are somehow "original and indestructible."” (538) A point with which Buchanan disagreed. To him, following “the Knightian classification of resources” (538), “natural resources [could be] included as a subdivision of the … capital” (538). Thus, they could be increased by the use of capital:
“There are few resources which cannot be produced and destroyed in an economic sense; investment can produce soil and even climate to a degree. For example, the Florida Everglades are now scarcely able to support the tribes of Seminole Indians, but, with substantial investment in drainage, this region might be transformed into a highly productive agricultural area. With the advent of scientific rain-making and the possible peacetime utilization of atomic energy, the importance of natural advantages in determining the efficient location of production will be further reduced.” (538)

Again, following van Sickle on that point and against the agrarians, Buchanan stressed the importance of industrialization and the need to attract capital to develop poor regions. That could be done by educating the labor force or by allowing capital to flow in poor regions. Hence, investing in transportation infrastructure – a recurrent object of interest for Buchanan since the early 1940s – was crucial. He would soon wrote on highways, roads and transportation issues (1952b). At the same time, he went on writing on grants. One opportunity was given – again by Hamilton – to review *Federal Grants and the Business Cycle* (1952), from James A. Maxwell, an author who had been important for Buchanan when he was a student. The review was published in the October 1952 issue of the *Journal of Political Economy*. The same journal published, in December, another reply to Scott Buchanan had written. Both pieces had the same objective: to stress, as he had repeatedly done, that transfers to poor states were necessary and they should be made for ethical reasons, even if they do not promote efficiency. This was one of the conclusions he put forward in his second reply to Scott was: “I did not state, and I did not intend to imply, that income-transferring grants will tend in all cases to promote a more efficient allocation of economic resources.” (1952e, 536) And also a point he made in his review of Maxwell’s book: grants are aimed at “fiscal equalization” (1952d, 458); they are made to correct an imbalance – “[t]he fiscal goal of a grant program, that of transferring income to the "poor" states because the people in those states are poor” (458).

The form such transfers could take could be discussed. A “decentralist” (458), he Buchanan believed that states should decide how to use any transfer or grant. This means that grants-in-aid or conditional grants should be abandoned because they rest on the assumption “that the central government is somehow equipped with a knowledge of a state’s own fiscal needs superior to that possessed by the state government itself.” (458) It was not Maxwell’s opinion. Buchanan regretted it, finding “unfortunate that Maxwell has seen fit to include a discussion of his favorite grant-in-aid scheme in this otherwise excellent work.” (458)
Buchanan also repeated that natural resources should be viewed as a part of capital, and could then be increased and improved by investing as with any form of capital – “[t]here are few resources which cannot be produced and destroyed in an economic sense; investment can produce soil and even climate to a degree.” (1952e, 538) There was indeed no reason to think that the South could not develop.

Conclusion

The main argument, and starting point, of our paper was that Buchanan was really concerned about the economic disadvantage of the South compared to the rest of the country and, especially, compared to the North. He believed that the gap would not be closed spontaneously and required an intervention from the federal government. Now, it happens that, at the same period – in the late 1940s – the recently elected Harry Truman launched its “Fair Deal”. Now, not only some of the policies envisaged in this frame involved the intervention of the federal government to improve the economic situation in the South, but the Fair Deal was also viewed as a paving the way towards a new form of capitalism in the USA. This raised an interesting and challenging question: could the intervention of the federal government be defended without adhering to an economic doctrine he disagreed with? Answering the question can be said to have guided Buchanan in his writing during the first years in his academic career – between 1949 and 1952. This is what we tried to show in this paper. By analyzing published articles and unpublished material, and by putting what Buchanan wrote in the intellectual, academic and political context of the period, we put forward many points that we think important to understand Buchanan’s ideas. First, Buchanan believed that the industrialization of the South was necessary to change its economic situation. Second, Buchanan defended the intervention of the federal government to redistribute – under the form of equalizing grants – income from rich to poor regions. Third, as a consequence, such redistribution was an ethical necessity, that should predate any consideration of efficiency. Even more important, fiscal justice was a pre-condition without which a competitive or free market system could not function properly. Fourth, Buchanan appears to have been primarily interested in practical, concrete problems – rather in pure and abstract questions.
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