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Why the Virginia School of Political Economy Matters

We have, I think, the makings of what could be a rather interesting little group in Buchanan, Vining, and myself – all solid Chicago products who did our lessons in Knight well. We have in mind trying to build a rather distinctive little “school,” since we cannot hope – nor do we much care – to diversify in the grand manner of the giants of our profession. With studied diversification, we could be at best a third-rate faculty. Following the other track we may be able to do a useful job and to collect an interesting faculty and student body.

G. Warren Nutter to Ronald Coase (4 December 1956)

1.1 Introduction

Taken separately, the contributions of the best-known principals of the early Virginia School of Political Economy – James Buchanan, Gordon Tullock, and Ronald Coase – are monuments of twentieth-century economics. Yet despite their longstanding collaborations, significant differences characterize the research programs of Buchanan, Tullock, and Coase. Other prominent members of the early Virginia School, especially Rutledge Vining and Warren Nutter, add even more variation to the so-called School, so much so that one wonders if they are properly characterized as a “School.”¹ The first question for a work on the Virginia School, then, is what beyond geographical proximity unites the works of Virginia political economists?² Second, supposing a satisfactory answer to this question, how does the Virginia School relate

¹ We emphasize Vining’s prominent role, notwithstanding that his name is found only in insider accounts of the Virginia School, e.g., Goetz 1991, pp. 7–8; Kliemt 1994, p. 9; and Buchanan 2004.

² Warren Nutter’s vision of the “school” in the making is detailed in his 4 December 1956 letter to Ronald Coase, reproduced as Appendix 1.1. This is the earliest reference to a “school” of which we know. Buchanan’s 8 November 1971 letter to Mancur Olson

to orthodox economics? As this study unfolds, it will become clear that, notwithstanding significant differences of approach and research questions, unifying threads run through the works of the Virginia School economists. These features separate the Virginia School from mainstream economics and from the Chicago School with which it is often identified. We begin by specifying the orthodoxy in order to sketch how Buchanan and his colleagues departed from it.

In the decades leading up to the early years of the Virginia School, orthodox economics unified around an approach to the economic problem described in Lionel Robbins's famous work, *The Nature and Significance of Economic Science* (1932), how to best attain exogenously determined goals in the face of scarcity. While Robbins was satisfied with economic models of individual choice, he denied that a large part of economics was scientific.³ Most famously, while it was proper to suppose the marginal utility of a good fell as the quantity consumed increased – accounting for ordinary experience (Wicksteed 1910) – no such scientific procedure existed for the evaluation of economic policies that inevitably involved utility comparisons across persons. Some people win from a policy change, while others lose, and Robbins held there was no scientific way to calculate a net gain or loss. Instead, such judgments were matters of ethics or convention. Robbins himself was comfortable with a “political economy” in which such a social convention that everyone has equal weight is employed to provide the calculus.

Against Robbins's view, the orthodoxy that became known as New Welfare Economics postulated fixed preferences. Assuming that people were concerned only with physical things and their goals were fixed, New Welfare Economists focused on policies that would increase physical output. If there were more *things* to go around after the policy change, and people's goals remained unchanged, then it was possible at least in principle to redistribute and ensure that no one suffered a reduction in *things*. Whether the redistribution actually occurred became a matter of debate. For Kenneth J. Arrow, who represented the minority position, an unrealized compensation was irrelevant, a position he held in common with Buchanan.

about the “Virginia School” (Appendix 1.2), sharpens the distinction between Virginia and Chicago.

³ Even this was, for Robbins, something of a reach as there was no reason to believe economists possess complete understanding of religious views, customs, or other factors that influence demand.

The fixed preference response to Robbins assumed that physical units were all that mattered. To use Nicholas Kaldor's example (Kaldor 1939), suppose that removing a tariff on corn imports increases the real income of the community by allowing more corn into the market. If the case for free trade depends upon only the quantity of corn, the assumption is that no one in the community cares about how the policy is implemented, for example, whether the tariff is removed by vote or at the point of a gun. The implicit underlying assumption is that people have no preferences for process but they care only about product.

Importantly, if people have no preferences over process, economists are warranted to focus exclusively on product. Thus, the orthodox approach enabled economists plausibly to "discover" instances in which individuals "fail" to pursue their goals – cases in which output is not maximized – and to propose some mechanism to correct this failure. This approach to economics emerged following the Marginal Revolution of the 1870s and attained high status in the 1940s through the research of the Cowles Commission, then housed at the University of Chicago. Its famous proponents were Tjalling C. Koopmans and Arrow, both of Cowles, whose work provided the technical framework required by the claims of fixed preferences. The issue of a complete understanding of the goals of people was critical in the technical exchanges.

1.2 Virginia Political Economy

In contrast to the orthodoxy's claims of fixed preferences and completeness, the Virginia School economists united around a theme of potential learning, and especially learning via discussion.⁴ This view, which linked to Buchanan's and Nutter's teacher, Frank Knight, added a complexity to the maximization problems posited by Arrow and Koopmans. It implied, for instance, that it was untenable to make cross-country comparisons of growth rates when institutions varied, as had become fashionable among orthodox economists seeking to predict when the Soviet economy would overtake that of the United States. More than this, it was no longer straightforward to conclude that observed choices represented failures of optimization. This latter was particularly important because, in the view of

⁴ Buchanan disagreed with the fixed preference assertion in Olson and Clague's preliminary version (1971): "In one sense, we are not defiant as taking tastes as given. We are defiant in saying that tastes are outside our purview, a slightly different thing." The full letter to Olson is reproduced as Appendix 1.2.

the early Virginia School economists, there was consequently much less warrant to devise policy recommendations for interventions to “fix” choices. Instead, it fell to the political economist to study, and try to make sense of, people’s choices. The Virginia economists focused on institutional reforms that, in Buchanan and Tullock’s formulation, would allow gains from trade to create a politics as exchange.

The contrast between the orthodoxy and Virginia became clear in the exchange between Koopmans, at the Cowles Commission, and Vining at Virginia. The debate concerned the desirability of imposing a theoretical economic model on data for estimation. While the question of whether markets ought to be imposed on people is widely interesting, the question of whether to impose a theoretical economic model on data is obviously much narrower. The two problems, however, are related; and many controversies begin with technical differences. The connection is evident in the exchange that occurred in the late 1940s.

Koopmans opened the debate between econometricians and statisticians over the completeness of the econometrician’s model in an article titled “Measurement without Theory.”⁵ He attacked the statistical procedures of the National Bureau of Economic Research [NBER] for being atheoretical and thus inefficient.⁶ In his view, without theory-directed estimation the NBER economists were leaving information on the table. In a much later study published by the Cowles Commission, Edmund Malinvaud (1988) suggested that Vining’s contribution foretold exploratory data analysis and specification search, the now-standard responses to incomplete specification.⁷ Malinvaud read the Koopmans–Vining exchange with

⁵ Hendry and Ericsson (2004, p. 780): “Koopmans (1947) assumed that economic theory was complete, correct, and unchanging, and hence formed an optimal basis for econometrics. However, as Rutledge Vining (1949) noted, economic theory is actually incomplete, abstract, and evolving, so the opposite inference can be deduced.” Compare David Hendry’s comments on professional literacy noted in Section 1.3.

⁶ Nutter’s work on Soviet growth (Nutter 1962) was produced under the auspices of the NBER. In Chapter 5, we discuss its funding source (the Rockefeller Foundation).

⁷ This passage, in which Vining (1949, p. 78) uses “discovery” and “search,” may have prompted Malinvaud’s reading: “The work of Burns and Mitchell that is being criticized purports to be a work of discovery and hypothesis-seeking, and it is not clear at all what meaning should be given to ‘efficiency’ in this context. Statistical efficiency is an attribute of an estimation and testing procedure rather than of a procedure of ‘search,’ . . . Discovery has never been a field of activity in which elegance of conception and equipment is of prime consideration.” Koopmans responded (1949, p. 90): “I come now to the distinction between problems of ‘hypothesis-seeking’ and problems discussed in the theory of estimation or in the Neyman–Pearson theory of ‘hypothesis-testing.’ This touches on unsolved problems at the very foundations of statistical theory, and I must confess that I do not see clearly through the issues involved.”

care and called attention to how their discussion concerned the question of aggregating individual goals.⁸ While this latter issue has been neglected, it represented the heart of the matter.

In his reply to Koopmans, Vining suggested that there is more to the study of economics than the sum of individual optimizations.⁹ Koopmans in turn responded with an appeal to methodological individualism:

If a theory formulates precisely (although possibly in probability terms) the determination of the choices and actions of each individual in a group or population, in response choices and actions of other individuals or the consequences thereof (such as prices, quantities, states of expectation), then the set of these individual behavior characteristics is *logically* equivalent to the behavior characteristics of the group. Such a theory does not have an opening wedge for essentially new group characteristics. Any deus ex machina who should wish to influence the outcome can only do so by affecting the behavior of individuals (1949, pp. 86–87).

By contrast, Koopmans held that individuals act “as members of a group”:

This does not deny the existence of essentially social phenomena, based on imitation, such as fads and fashions, waves of optimism and pessimism, panics and runs; or based on power struggles, such as price wars, trust formation, lobbying; or based on a social code or sense of responsibility, such as the acceptance of personal sacrifice for a common objective. It is maintained only that such social phenomena are necessarily acted out by individuals³ as members of a group (1949, p. 87).

Koopmans’s footnote 3 foretells what would preoccupy the Virginia School economists in the decades that followed:

³ It is true that the choices of individuals are restrained by a framework of institutional rules enforced or adhered to by the government, the banking system and other institutions. These rules (tax schedules, reserve requirements, etc.) can to some extent be taken as given for the analysis of economic fluctuations. In a deeper analysis, these rules and the changes in them would need to be explained further from choices by individuals interacting, in various degrees of association with each other, through political processes (1949, p. 87).

⁸ Malinvaud (1988, p. 308): “In this interchange, a substantial part is taken by a discussion about the potentialities of a structural system built by aggregation of individual demand and supply equations derived from maximizing behavior.” Buchanan’s letter to Olson (reproduced in Appendix 1.2) echoes Vining.

⁹ Vining (1949, p. 79): “I think that we need not take for granted that the behavior and functioning of this entity can be exhaustively explained in terms of the motivated behavior of individuals who are particles within the whole. It is conceivable – and it would hardly be doubted in other fields of study – that the aggregate has an existence apart from its constituent particles and behavior characteristics of its own not deducible from the behavior characteristics of the particles. We should work toward an explicit delineation of the entity itself – its structure and functioning – and the role that hypothesis and formal theory play in the stages of this growth of understanding is subtle and irregular.”

This response essentially conceded lack of completeness, at least in the long run, to Vining. Indeed, it is fully in line with Robbins's argument noted in Section 1.1.

1.3 Against Efficiency: James Buchanan versus Kenneth Arrow

Arrow addressed the question of the political process almost immediately thereafter in his 1951 *Social Choice and Individual Values*. There he demonstrated that a democratic political process composed of individuals who possess well-ordered preferences, something traditionally required for optimization models, exhibited reversals of social ordering. Even though Arrow's example of reversals was by no means new (Duncan Black 1958 discussed precursors), his result shocked the profession because it suggested that there was something wrong with democracy itself. Arrow's contribution was profound: he demonstrated that instability prevails under eminently reasonable conditions of democracy.

Buchanan seems to have been the only contemporary commentator who suggested that Arrow's demonstration of unstable social ordering was actually a good feature of democracy, since there was no consensus in Arrow's society from which the reversals followed. Without consensus, an enduring decision would be premature, an imposition (Buchanan 1954). Here, Buchanan put his finger on the critical step between individuals and the group: Arrow's assumption that in the process of collective decision-making individual preference orderings do not change. For Buchanan, such an assumption was contrary to the liberal characterization of a democracy as "government by discussion." Although Knight used the phrase often, crediting Lord Bryce, the inspiration came from Mill's statement in *On Liberty* that until a people can improve themselves by discussion, they are not ready for democracy.¹⁰ The profession largely neglected Buchanan's argument; some forty years later, Amartya Sen recognized its significance (A. K. Sen 1995).¹¹ We return to "government by discussion" often throughout the book because it has a remarkable, and controversial,

¹⁰ A characteristic statement is found in Knight's lecture series: "Lord Bryce defined democracy as 'government by discussion,' and genuine discussion is the ideal type of free association, its defining exemplification" (Knight 1960, p. 163).

¹¹ Sen (2012, p. 16–18): "Public reasoning is not only crucial for democratic legitimacy, it is essential for a better public epistemology that would allow the consideration of divergent perspectives. It is also required for more effective practical reasoning. It can bring out what particular demands and protests can be restrained in interactive public reasoning, in line with scrutinized priorities between a cluster of quite distinct demands. This involves a process of 'give and take' which many political analysts, from Adam Smith and the

implication. In Section 1.5, we briefly foreshadow the more detailed analysis that follows by considering Buchanan's most controversial pieces as well in Nutter's neglected argument about foreign policy.

As Hendry pointed out in the interview quoted at Footnote 5, the Vining–Koopmans exchange is one of those classics that many cite but no one actually reads (Hendry and Ericsson 2004, p. 780). Vining's 1956 pamphlet for UNESCO, *Economics in the United States of America*, enjoyed the more common fate of being little noticed and now forgotten. This is unfortunate because the UNESCO pamphlet connects the initial exchange between Vining and Koopmans and the later work of the Virginia School. Buchanan recognized the pamphlet as one of the ten most influential pieces for his work; he wrote that it stood for hundreds of hours of discussion between himself and Vining (Buchanan 2004, p. 59).

1.4 Katallactics: The Science of Natural Equals

One helpful way to characterize the difference between the orthodoxy and the Virginia School is to consider the role of an isolated Robinson Crusoe in each tradition. For the orthodox tradition, it is appropriate to model the economy using Robinson Crusoe. In the Vining-influenced Virginia School, such a model would be nonsensical. The issue is very old. Richard Whately first mentioned Robinson Crusoe in the economics literature in his 1831 Oxford lectures, where he suggested that Crusoe fell outside the scope of the political economy of Adam Smith.¹² For Whately, political economy is concerned only with exchange. He thus proposed a different name for economics, katallactics, his coinage for the science of exchange.¹³ Whately shortly noticed an ambiguity in his proposal: exchange need not be voluntary but might also encompass an exchange of taxation for protection by government.¹⁴

Marquis de Condorcet in the eighteenth century to Frank Knight and James Buchanan in our time, have made us appreciate better."

¹² Whately (1831, p. 7): "A man, for instance, in a desert island, like Alex. Selkirke, or the personage his adventures are supposed to have suggested, Robinson Crusoe, is in a situation of which Political-Economy takes no cognizance."

¹³ Whately (1831, p. 6): "I have stated my objections to the name of Political-Economy. It is now, I conceive, too late to think of changing it. A. Smith, indeed, has designated his work a treatise on the 'Wealth of Nations'; but this supplies a name only for the subject-matter, not for the science itself. The name I should have preferred as the most descriptive, and on the whole least objectionable, is that of CATALLECTICS, or the 'Science of Exchanges'." The κ that Whately wrote as a "c" would now be written as a "k."

¹⁴ We will return to Buchanan and katallactics in Chapter 2 when we point out Whately's elaboration in later editions to encompass involuntary exchange.

Katallactics figured in the Virginia School when Buchanan struggled to rethink economics on the foundation of natural equals, the subject of Chapter 2. For now, it is sufficient to note that a Robinson Crusoe model of an economy is nothing but an individual writ large. With one individual, social conflict does not arise in any obvious fashion. By contrast, a katallactic model of an economy requires at least two traders and the interactions and discussions that follow.

In the context of a large market economy, the supposition that an individual's desires are stable and our understanding of them is complete seems relatively harmless. Other-regarding preferences may be considered as part-and-parcel of human desires and as a reasonable way to explain charitable gifts of one sort or another. However, when we suppose a Robinson Crusoe model there are no others in the model. When Friday comes to the island, the orthodoxy would assume that Robinson's preferences are unchanged, that no new goods are created, assuming away the possibility that Friday's consumption goods might be valued by Robinson. That seems a very strong, albeit implicit, specification of reclusive agency.

The most straightforward requirement of the katallactic model is that the modeler must specify the relationship between traders. Whately would soon become an Archbishop of Dublin in the Church of England and, as such, he was committed to the universal idea of natural equals. He was a force in the anti-slavery movement that asked the question on behalf of the enslaved Africans: "Am I not a man and a brother?" Indeed, the Greek word that Whately selected for "exchange" carries the context of reciprocity.

In perhaps the most remarkable example of how models constrain, consider how F. Y. Edgeworth modeled his Robinson and Friday as natural equals in *Mathematical Psychics* (1881), despite his objections to such egalitarianism enumerated only a few pages later. Unlike the textbook version of *Mathematical Psychics*, in which colorless #1 and #2 swap apples and nuts, Edgeworth himself took traders to be of different races who trade goods and labor. Moreover, if Robinson is not sufficiently sympathetic to Friday, Friday simply leaves to find land on which to work for himself. Edgeworth's account of Friday is truly remarkable in the context of the racial debates of the nineteenth century. At that time, some political economists were perhaps still influenced by Thomas Carlyle's doctrine that a desire expressed by freed slaves to work for themselves, giving up

material output for self-direction, justified their re-enslavement.¹⁵ An appreciation of how Vining's free society requires individuals with a commitment to reciprocity, helps explain Buchanan's (1964) explicit endorsement of katallactics.

Indeed, as will become clear in Chapter 2, the idea of natural equals plays an important role throughout Buchanan's work. In Chapter 4 we explore how, in the context of school desegregation mandated by the Supreme Court in the 1950s, Nutter and Buchanan offered a plan to reform school financing pioneered by Milton Friedman, replacing public schools with public financing of a wider range of schools. We detail how they approached the issue on Knightian grounds. We explore how, in correspondence with Vining, Buchanan compared his approach to that of John Rawls. When Buchanan returned to racial issues, he defended an affirmative action that offers market participants a "fair chance." In later correspondence Buchanan renounced the voucher systems as inconsistent with the fairness that comes by way of integration.¹⁶ Chapter 2 examines Buchanan's obituary for Rawls in which Buchanan emphasized that Rawls demonstrated how to work with the supposition that people are natural equals along the lines of Smith (Buchanan 2003). The connection with Smith is even deeper because, as Buchanan explained, Rawls's controversial difference principle, maximizing the well-being of the worst off, is fundamentally the same as Smith's norm of the well-being of the lowest order of society (landless workers).

1.5 Where Is the Economist?

By removing the supposition of fixed goals, the Virginia School fundamentally altered the role of the economist. No longer was the economist to offer policy advice to attain the known goals of society. Instead, the role of the economist was a more modest one of offering suggestions for public consideration. In perhaps the least known of his important contributions, discussed in Chapter 9, Coase helped guide the discussions of the Fabian

¹⁵ Economic agents, as Carlyle understands them, want to produce *things* and if they fail to do so, they may justifiably be enslaved ([Carlyle] 1849). Mill's immediate response in opposition to Carlyle, ([Mill] 1850), was that material output is not the issue; at issue, instead, was the free pursuit of happiness. Levy (2001), Peart and Levy (2005), and Levy and Peart (2005) study these issues in detail.

¹⁶ In Chapter 2 we reproduce the initial exchange of letters between Rawls and Buchanan just after Rawls discovered *Calculus of Consent*. Rawls saw the implicit egalitarian presumption that would unfold over Buchanan's life's work.

Society's committee established to offer advice to the Beveridge Committee on British Broadcasting. At the time when Coase was at the London School of Economics, many economists were favorably inclined toward market socialism and the Coase–Fabian proposal to create competitive branches of British Broadcasting was in line with such proposals. The deep problem for liberals across policy preferences was the monopoly control of political discussion.¹⁷ Coase stressed that the most important role of the Beveridge Committee was to provide British people the information about what was technically feasible and then let them discuss matters (Levy and Peart 2014).

Far better known is Buchanan's 1959 proposal to make welfare economics falsifiable. This variation on the theme of Knut Wicksell (1958) has roots in the economics of Mill. Buchanan proposed that Pareto improvement would serve as the efficiency criterion. The observing economist would propose a Pareto-improving social change. If the change is adopted, the economist's suggestion is a good one; if not, the suggestion is not. It is important to notice that Buchanan's proposal does not require that the economist possesses a complete understanding of people's desires. There are many reasons why the proposal might be rejected; lack of understanding is but one.

Buchanan's 1959 paper also contained a critical step in the development of the position that politics is exchange. In this context, he addressed the question of whether real compensation is possible. The context was how to respond to Robbins's point, noted in Section 1.1, that interpersonal comparisons of well-being are not matters of science but of ethics. One popular answer to Robbins, indeed the basis of New Welfare Economics, is that the *possibility* of making no one worse off in the course of a reform is sufficient to avoid his challenge. In contrast, Pareto's criterion requires realized compensation so that someone is *actually* better off and no one is the worse. Here, as noted above, the orthodox tradition divided. Buchanan's position was in line with Arrow's, with both claiming that possible compensation was not a solution to the challenge. Only actual compensation counted. To this, Buchanan added that if people are sympathetic, the range of acceptable trades widens. Buchanan worried that an economist might be tempted to propose a policy only a majority might support. To answer this

¹⁷ Knight's argument (1951) that economic monopoly drives political monopoly was lost for many years. Attention has returned to the point with concerns about the concentration of social media.