Milton Friedman, James Buchanan and Constitutional Political Economy

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Abstract

This chapter argues that the ambiguous bifurcation in Frank Knight's understanding of economics would manifest itself through the divergent paths in the earlier writings of his students Milton Friedman and James Buchanan. It argues that despite Friedman's stature in the scientific elite of the profession of economics, the stronger argument for the classical liberal order is found in Buchanan's work. Moreover, we argue that in the later part of Friedman's career as a classical liberal political economist, his arguments for the free market society moved away from his earlier emphasis on efficiency claims to the broader claims about the institutional framework within which the game of life is played. In short, Friedman came to stress more the arguments of Buchanan concerning the positive analysis of the politics of economic policy, and the constitutional level of analysis for reform.

Keywords

Milton Friedman, James Buchanan, Constitutional Political Economy, Comparative Institutional Analysis, Spontaneous Order.

1 Introduction

There is a general consensus that F.A. Hayek, Milton Friedman and James M. Buchanan were the leading defenders of the classical liberalism within the economics profession in the latter half of the twentieth century. Hayek, of course, founded the Mont Pelerin Society (MPS) and long served as its president (1947-61), but Friedman and Buchanan were active members and in fact served their own terms as the MPS president – Friedman (1970-72) and Buchanan (1984-86). Furthermore, all three would be recognized with the Nobel Memorial Prize in Economic Sciences for their pioneering contributions to economics: Hayek (1974), Friedman (1976), and Buchanan (1986). However, for our purposes it is important to stress that Hayek was the senior member of this group, and arguably made his major professional contributions to economics prior to 1950. As a result, within the formative decades of the free market counter-revolution (1950-1970), it was Friedman and Buchanan who were responsible in their respective ways to mounting the challenge to the Keynesian hegemony within the economics profession. Thus, it is their ideas that we concentrate our effort on exploring in this chapter. Their respective contributions to economics spanned across methodology; price theory; monetary theory and policy; fiscal theory and policy; and political economy. Moreover, their respective research programs can be traced to a common influence in their teacher at the University of Chicago: Frank Knight.

Throughout his long career, Knight's work exhibited a tension between a narrow view of economics as a science, and economics as a necessary but not sufficient component of a broader social philosophy. For Knight, economics can be viewed as a strict science of modeling and measurement, *and* as part of a broader discipline that he conceives of the individual not so much as an atomistic utility maximizing machine but as a strategic player in the social game of life – a game full of conflicts that must be worked out, delusions that must be tamed, and creativity that must be encouraged (see Emmett 2009, chapter 7). In *The Calculus of Consent*, Buchanan comments that Knight had suggested the following: "If the purpose of a game is 'efficiency,' this could best be secured by allowing all the players to get on the same 'side'" (1962[1999]: 111).Instead, Buchanan continues, specific rules are adopted because they will "make for an 'interesting' but not an 'efficient' game." I cannot see this quote on page 111. Please clarify.[1]

We want to suggest that this ambiguous bifurcation in Knight's understanding of economics would manifest itself through the divergent paths in the earlier writings of Friedman and Buchanan. There is, in essence, a "tale of two Knights" that must be told in the history of the Chicago School of Economics.[2] To make our chapter even bolder, we argue that despite Friedman's stature in the scientific elite of the profession of economics (ranking him within the top 5 most influential economists of the 20th Century, perhaps second only behind Keynes in some rankings), his celebrity status as a public intellectual, and undoubtedly the most recognized free market thinker world-wide during his lifetime, the stronger argument for the classical liberal order is found in Buchanan's work. Moreover, we argue that in the later part

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[1] Throughout this paper we will continually attribute to Buchanan ideas reflected in his joint work with Gordon Tullock. This is for literary flow and does not reflect at all any diminution on our part of the contribution of Tullock.

[2] The contrast between the two strands of Knight's thought is most apparent in a comparison between George Stigler and Buchanan, but that will have to be for another paper. Also, the fact that, as we will argue, Friedman's positions shift noticeably between 1960 and 1980 suggests that he is perhaps the middle-ground figure between these two polar readings of Knight.

of Friedman's career as a classical liberal political economist, his arguments for the free market society moved away from his earlier emphasis on efficiency claims to his broader claims about the institutional framework within which the game of life is played. In short, Friedman came to stress more the arguments of Buchanan concerning the positive analysis of the politics of economic policy, and the constitutional level of analysis for reform.

A perusal of Friedman's *Capitalism and Freedom* and Buchanan's *The Calculus of Consent*, both published in 1962, reveals Friedman's understanding of the market in terms of efficiency within a given set of rules, whereas Buchanan emphasized the actual derivation of the rules of the game. "The economist," Buchanan stressed, "should not be content with postulating models and then working within such models. His task includes the derivation of the institutional order itself from the set of elementary behavioral hypotheses with which he commences" (Buchanan 1968 [1999a]:5). In addition, allocative efficiency, from this perspective, is a by-product of the competitive market process within a specific institutional setting, not a defining goal of the system. One must always keep in mind the distinction in the two levels of analysis: (i) examination of the rules of the game, and (ii) examination of the play of the game within a set of rules. In *Capitalism and Freedom*, Friedman's emphasis was on (ii), whereas in Buchanan's work as reflected in *The Calculus*, but also throughout his career, the emphasis was on (i). Political economy, obviously, needs both levels of analysis to be relevant to the broader social philosophical project of classical liberalism.

This subtle difference in Friedman's and Buchanan's respective ways of thinking about markets implied differing public policy conclusions. In their defense of the superiority of markets, Friedman took a "mainstream" approach to defend the efficiency of the competitive market model, while Buchanan adopted a "mainline", or Smithian, approach that emphasized the market as part of a larger social order based on exchange.[3] To put it somewhat crudely and simply, Friedman argued that the competitive market will exhaust all the gains from trade and exploit all the gains from innovation, whereas Buchanan argued that the market is

> the institutional embodiment of the voluntary exchange processes that are entered into by individuals in their several capacities. That is all there is to it. Individuals are observed to cooperate with one another, to reach agreements, to trade. The network of relationships that emerges or evolves out of this trading process, the institutional framework, is called "the market" (Buchanan 1964: 219).

We argue below that it was Buchanan's development of the Public Choice tradition and his role in reviving political economy that led to a later dovetailing of his and Friedman's thinking on public policy.

2 From *Capitalism and Freedom* to *Free to Choose*

In *Capitalism and Freedom*, Friedman bases his argument for the efficiency of the market on the model of perfect competition. By the time that *Free to Choose* had been published, he emphasized a more dynamic and entrepreneurial market where the gains from trade and the gains from innovation are forever being sought and adjusted by individuals participating within the market arena.[4] Related to this point, Friedman reflected in a comment in late 2001 that ten years previously he would have urged countries transitioning from socialism to "privatize, privatize, privatize" (Friedman 2002: xvii). However, he added: "But, I was wrong ... It turns out that the rule of law is probably more basic than privatization" (ibid., xvii-xviii).

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[3] See Boettke (2012) for a discussion of the distinction between 'mainstream' and 'mainline'.

[4] Similar to the case of *The Calculus of Consent* with Buchanan and Tullock, our in-text references for *Free To Choose* will be to Friedman in full knowledge and respect for the contribution made to his work by his co-author Rose Friedman.

This shift in argument on the superiority of free markets moved from one in terms of resource allocation to one based on the institutional framework of the market economy that enables individuals to realize the gains from social cooperation. Moreover, this transition in thinking can be traced from two of Freidman's most popular books: *Capitalism and Freedom*, published in 1962, and *Free to Choose*, published in 1980. Though Friedman was certainly not blind in *Capitalism and Freedom* to the focus on exchange and the institutions within which exchange takes place (see, in particular, Friedman (2002): 22-36), his point is on the efficiency of the competitive market and the perverse consequences of government intervention into the competitive order. As Friedman writes in the preface of *Free to Choose*, in contrast to *Capitalism and Freedom*, that book "is influenced by a fresh approach to political science that has come mainly from economists" (Friedman and Friedman (1980) [1990]: ix).

i. Efficiency and public interest

Capitalism and Freedom, although regarded today as quite conventional free market thinking, was considered controversial when it appeared for its defense of free markets and its indictments about the depredations of government intervention. Friedman's main thesis in that book is that economic freedom is a necessary, though not a sufficient condition for political freedom. A market economy based on private property rights, the enforcement of contracts, and the rule of law is necessary to check political coercion rather than to reinforce its encroachment, but it cannot guarantee the latter. It is important to stress that Friedman did not provide a wholesale criticism of the role of government in the market. Like his predecessors in classical economics, as well as his classical liberal contemporaries, he recognized that government had a role in three categories: (1) the provision of public goods, such as national defense, law, and roads; (2) the correction of negative externalities, which he calls "neighborhood effects" (Friedman 1962 [2002]:14); and (3) preventing the formation of monopolies through "the effective enforcement of rules such as those embodied in our anti-trust laws"(ibid., 28). The basis with which Friedman makes this conclusion is in terms of "market failure," or inefficiencies stemming from voluntary exchange creating third-party effects. But as Randy Simmons puts it quite succinctly, "market failure means real-world markets failing to achieve the standards of an imaginary, perfect market" (Simmons 2011: 12).

Friedman states that "a major source of objection to a free [market] economy is precisely that it does [its] task[s] so well. It gives people what they want instead of what a particular group thinks they ought to want" (Friedman ibid., 15). When the conditions of freedom of choice are absent, though, there remains an essential role for government to play in society: "What the market does is to reduce greatly the range of issues that must be decided through political means, and thereby to minimize the extent to which government need participate directly in the game" (ibid.). Politically, this approach assumes an idealized notion of government that can correct such "market failures" efficiently. This form of argument about the role of government tends to understate that market processes are discovery procedures (see Hayek 1976 and 1978), and the role in which private property rights, prices, and profit and loss incentivize the coordination of dispersed and sometimes even, tacit knowledge. On the other hand, this public interest logic understates the costs of finding and implementing government solutions. While Friedman characterizes the market in terms of efficiency, his assessment of the state in resolving "market failures" is based on an optimistic public interest rendering of the proper role of government "to do something that the market cannot do for itself"

(Friedman ibid., 27). The argument postulates that political actors will "know how" to internalize any negative externalities.

We should be clear that the argument put forth is one of emphasis in analysis, and not an absolute rendering of Friedman's position. In making our case, we are pushing the assumptions of a tight argument in terms of efficiency to its logical conclusion; as Frank Knight often remarked, "To call a situation hopeless is equivalent to calling it ideal" (Knight quoted in Buchanan 1962: 204). *Free to Choose* is not only a more concrete book than *Capitalism and Freedom*, as Friedman suggests (1980 [1990]: ix), but, despite this claim, it has *more,* not less, theoretical framework, and a novel one at that which is more grounded in the ideas of Hayek and the work of contemporary economists, such as Buchanan, Coase, Alchian, and Demsetz. That is, *Free to Choose* is grounded on the idea that institutional problems demand institutional solutions. The exclusive focus on the efficiency of competitive markets and the government's ability, even if limited, to fix inefficiencies results in a logical trap. The market economy idealized in terms of efficiency is cut off from institutional reform. Friedman's close friend and colleague George Stigler best articulates this assumption and its implications for public policy:

> When a society wishes, for example, to give more income to a group than the market provides, we may surely analyze the efficiency with which this is done… [E]very durable social institution or practice is efficient, or it would not persist over time. New and experimental institutions or practices will rise to challenge the existing systems. Often the new challenges will prove to be inefficient or even counterproductive, but occasionally they will succeed in replacing the older system. Tested institutions and practices found wanting will not survive in a world of rational people. To believe the opposite is to assume that the goals are not desirable (Stigler 1992: 459).

If economic and political exchange are *efficiently inefficient*, then it must be regarded so as a rational outcome of individuals seeking to further their interests given the particular institutional context. To understand this point, let us assume the standard neoclassical postulates of individual utility maximization, market equilibrium, and stable preferences (see Becker 1976: 5). If maximizing utility means preferring greater amounts of pecuniary *and* non-pecuniary wealth, then given the institutional setting, individuals will substitute between these forms of income based on their relative costs.

Given that institutional constraints, such as private property rights and money prices, or lack thereof, shape the relative costs of pursuing these forms of income, then both a competitive market and a centrally planned economy can both be said to be "efficient," if inefficiency here means that a situation is capable of being changed so that an individual could earn more pecuniary income with no loss in non-pecuniary income, and vice versa (see Alchian and Kessel 1962: 160-61). That is, individuals within any institutional context face tradeoffs and opportunity costs, both economically and politically. Within a centrally planned economy, in which private property rights are absent, the opportunity cost of earning greater non-pecuniary income, such as relaxed monitoring of workers by managers, is lower than the opportunity cost of earning greater profits. Moreover, given the absence of rational calculation of relative scarcity, managers will lack both the incentive and the knowledge of increasing profits without sacrificing non-pecuniary income, so they are said to be behaving "efficiently." Individual employees will then earn lower real money wages in a centrally planned economy, but within the institutional context this practice is said to be "efficient" if individuals maximize utility by substituting non-pecuniary income, such as greater shirking, shorter hours, increased job security, etc., for higher real money wages. Political actors face the same tradeoffs as well. Although central planners may have a smaller tax base from which to extract revenue, they will also maximize utility by substituting other rents for taxes, such as exercising discretion over economic resources. Since political actors cannot substitute economic freedom and maximize wealth without eroding their own political power, their behavior is said to be “efficient”.

If so-called “inefficiencies” persist, it “stems from the fact that more than narrow efficiency has been involved in almost every case – that inexplicit or incomprehensible goals were served by these policies and served tolerably efficiently” (Stigler 1982: 10). A market viewed in terms of efficiency will place both political and economic actors on the “same side” in that they each maximize their respective utility *within the given set of rules*, however contradictory and conflicting their particular objectives may be. That is, once the rules of the game are established, little can be done to reform the behavior of the economic and political actors playing the game. Therefore, so-called “market failures” cannot be explained in terms of efficiency within the rules of the game, but can only be evaluated in terms of exchange of the rules themselves.

In contrast to the understanding of markets in terms of ubiquitous efficiency, Buchanan argued that such an “overly restricted conception of market behaviour” (Buchanan 1964: 219) neglects the propensity of individuals to discover voluntarily more inclusive institutional arrangements within which efficiency emerges. Efficiency considerations are not eliminated from Buchanan’s conception, since “The motivation for individuals to engage in trade, the source of the propensity, is surely that of “efficiency”” (ibid.). Rather, efficiency, or moving from a less preferred to a more preferred position, is a constant propensity of human behavior within the rules of the game, but the manner in which efficiency manifests itself is dependent on the truck, barter, and exchange of the institutions themselves.

The proposition that exchange must be extended to constitutional-level rules is not inconsistent with the tendency towards efficiency within a given institutional context, but once we acknowledge that entrepreneurship on a higher tier of discovering the rules of the game, then entrepreneurship on a lower tier of the game itself must substitute mechanistic, lighting rod calculators of pleasure and pain (see Boettke and Leeson: 2009 [2012]). It is this clarification of the alleged paradox in Knight's thinking that Buchanan was best able to illustrate through his recognition of exchange behavior of the rules of the game themselves and how the tendency towards utility maximization is being constantly adjusted and readjusted by the entrepreneur within a dynamic institutional setting. It is this conception of the market that Friedman employs in his defense of a free society in *Free to Choose*.

ii. Knowledge, discovery, and institutions

The impact of Buchanan's research reveals itself significantly by the time Friedman wrote *Free to Chose*. In the preface, Friedman specifically credits Buchanan and other economists within the Public Choice tradition as influencing the assumptions implicit throughout the book:

> *Free to Choose* treats the political system symmetrically with the economic system. Both are regarded as markets in which the outcome is determined by the interaction among persons pursuing their own self-interests (broadly interpreted) rather than by the social goals the participants find it advantageous to enunciate (Friedman 1980 [1990]: xiv).

The theme of *Free to Choose* is one that is markedly "mainline" over its "mainstream" forerunner: "Mainline is defined by a set of positive propositions that held in common from Adam Smith onward, but mainstream economics is a sociological concept related to what is currently fashionable among the scientific elite of the profession" (Boettke 2012: xvii). From a mainline perspective, economics is fundamentally about exchange and the institutions within which exchange takes place. From Adam Smith to F.A. Hayek to Vernon Smith, mainline economists derived the invisible hand theorem of the market from the self-interested postulate of human behavior by way of institutional analysis. It is this pronounced shift to a focus on institutional factors that we are arguing is what we see in Friedman's argumentative transition. The fundamental difference between *Capitalism and Freedom* and *Free to Choose* is the former's emphasis on economic policy while the latter incorporates the politics of economic policy-making itself. *Free to Choose* recognizes the constitutional analysis of rules and procedures that guide implementation of those policies and the policy-making procedure itself.

Even before his publication of *Free to Choose* in 1980, Friedman began to incorporate broader claims about the power of the invisible hand and the role of institutions in filtering through invisible hand processes conducive to good or bad market outcomes. He argues that "[t]he failure to understand this profound observation has produced an invisible hand in politics that is the precise reverse of the invisible hand in the market" (Friedman 1977: 12). Interestingly enough, Friedman claims that appeals to the invisible hand yields

> [A] highly sophisticated and subtle insight. The market, with each individual going his own way, with no central authority setting social priorities, avoiding duplication, and coordinating activities, looks like chaos to untutored eyes. But through Smith's eyes we see that it is a finely ordered and effectively tuned system, one which arises out of men's individually motivated actions, yet is not deliberately created by men. It is a system which enables the dispersed knowledge and skill of millions of people to be coordinated for a common purpose. Men in Malaya who produce rubber, in Mexico who produce graphite, in the state of Washington who produce timber, and countless others, cooperate in the production of an ordinary rubber-tipped lead pencil - to use Leonard Read's vivid image... (ibid., 11).

Although Friedman argues that *Free to Choose* is a more concrete book over its predecessor *Capitalism and Freedom*, and indeed it is, despite his own claim that it is a "less theoretical book," *Free to Choose* is a *more* theoretical book precisely because it embraces the highly sophisticated and subtle insight of the invisible hand and how the spontaneous order of market processes manifests itself through the constitutional level of rules. In short, recognizing the distinction between two levels of analysis, which is (i) that of examination of the rules of the game and (ii) examination of the playing of the game within a set of rules, lends itself to greater theoretical sophistication in understanding a free society that is usually not credited to *Free to Choose*.

The Friedman defense of the market order in *Free to Choose* lends itself to the coordinating power of the "invisible hand", and the solutions offered to externalities created and exacerbated by public policy itself are based on institutional explanations that were not prominent in *Capitalism and Freedom*. Friedman's discussion of how the market economy functions through the incentives and information of property, prices and profit/loss is the prime example of a spontaneous order. This "broader view" of the invisible hand, as he calls it, extends also to the emergence of money, language and informal institutions, such as customs and social conventions (Friedman 1980 [1990]: 25-27).

Central to this understanding of the competitive market is the role of the entrepreneur. Through his pursuit of profit opportunities, the knowledge that is dispersed through the price system is discovered, utilized, and communicated to others, driving the market toward coordination. In this way, the most willing suppliers and the most willing demanders of any particular good or service are guided to realize the mutual gains from exchange in the least costly way. It is often cited that the source of "market failure" is in the difficulty of identifying external costs and benefits. However, it is from these so-called "inefficiencies" that the entrepreneur emerges in the pursuit of pure profit to mitigate these third-party effects.

Rather than assuming that the government is merely a correction for imperfections in economic modeling, following the influence of Buchanan, Friedman notes that "government measures also have third-party effects. And if such effects are important for a market transaction, they are likely also important for government measures intended to correct the 'market failure" (Friedman 1962 [2002]: 31). However, the perverted incentives of government's dead hand serve to "reward" the political entrepreneur by exacerbating the alleged negative externalities and the creation of new ones, such as rent-seeking and perpetual budget deficits. In the next section, we discuss this last point with reference to Buchanan's development of Public Choice theory, which he called "politics without romance," and the influence it had on the public policy conclusions that he and Friedman would later share.

3 The rebirth of political economy

Buchanan, also a student of Frank Knight, approached his understanding of market behavior through the paradigm of "good sports," or a conception of the market as a game to be played. (Emmett 2009: chapter 7). Whereas Friedman approached his understanding of markets in terms of allocative efficiency of resources by economic actors, Buchanan "dared to be different" within the profession by conceptualizing political economy as the study of exchange and the institutions in which exchange takes place. He saw efficient outcomes of individual choice in the market in terms of *post-constitutional* arrangements, whereas efficiency in politics could be achieved only under a rule of unanimity for collective choice, or *pre-constitutional* arrangements that lead efficient market outcomes.

The philosophical sophistication of Buchanan allowed him to carve out a research program that bucked the trend against scientism and logical positivism precisely when they dominated methodological propositions in economic theory (see Friedman 1953). Under the "as if" assumption of perfect knowledge, many economists active during the period 1950 to1970 asserted that the theory of general equilibrium holds for both a central planner as well as for a competitive market process (see Hayek 1948 [1980]). Not only does this theory result in the conclusion that efficient planning occurs irrespective of institutional context, but it also implied that political processes were efficient and could costlessly correct any market failures that the analyst identified. Buchanan de-romanticized this vision of the public sector by his pioneering of Public Choice (see Buchanan 1979).

Buchanan made a point to relax the assumptions of *homo economicus* and efficiency to understand a wider range of purposive human action based not only on the exchange of goods and services, but also of the rules of the game:

> If human interaction is limited to voluntary exchange conceived in its broadest sense, a theory of institutional structure can be derived, yielding something closely akin to the standard model of competitive order as the end or equilibrium product … Using nothing more than his standard tools, the economist can predict, first, the emergence of this structure, and, secondly, the characteristics of the outcomes that such a structure will tend to produce. Only after this stage is reached can the economist begin to talk about the relationship between competition as an organizational structure, and efficiency (Buchanan 1968 [1999a]: 5).

This emphasis on endogeniety of collective action in economic policy is precisely where Buchanan differed from Friedman on modeling economic policy.

Before *The Calculus of Consent*, economic theory frequently postulated an objective welfare function which "society" sought to maximize and assumed that political actors were motivated to pursue that objective welfare function (see Buchanan 1954). Buchanan's critique of this approach was based on emphasizing elementary principles of economics, which had become lost in mathematical formalism and excessive aggregation. The main pillars of his research pointed out: (1) that no objective welfare function exists, (2) that even if one existed, societies do not choose (only individuals do), and (3) that individuals within the markets, just as in the politics, base their choices on their private assessment of costs and benefits.

The brilliance of Buchanan's exchange paradigm was to show that "society" does not face costs in allocating public expenditures, but only political actors face opportunity costs in choosing how to distribute public resources (Buchanan 1969 [1999b]). By anchoring political choices in price theory and methodological individualism, Buchanan was able to revive political economy and reveal that logic of choice in politics ran in the opposite direction of the logic of choice in economics. From his central tenets of analysis flow four elementary propositions: the vote motive; the logic of dispersed costs and concentrated benefits; the short-sighted bias in policy; and the constitutional perspective in policy evaluation.

Unlike Friedman, who challenged Keynesianism on its own methodological terms, Buchanan grounded his analysis of microeconomics as well as macroeconomics in terms of individual choice within a particular institutional context. Moreover, it led him to rethink how cost is defined in economics and its implications for public policy. Following the subjectivism of the Austrian economists, including Menger, Mises, and Hayek, Buchanan saw the notion of cost as inherently tied to the act of individual choice and understood a subjective assessment of trade-offs by individuals if it would have any meaning in a theory of decision making.

Costs understood correctly would lead us to rethink neoclassical welfare economics. For example, the Pigovian remedy to negative externalities, such as pollution, was to charge a tax such that it would bring marginal benefits of the polluter into line with marginal social costs. However, as we mentioned earlier, only under the assumption of perfect knowledge in general competitive equilibrium can a planner ascertain objectively measurable costs, since all the data is given. But in such equilibrium there are also no deviations between marginal private costs and marginal social costs. Not only is such a construct ideal, but it is also cut off from institutional analysis. In other words, Buchanan pointed out that Pigovian taxes are either possible and redundant, or impossible to set because the institutional conditions presupposed for their establishment either eliminate their necessity or preclude their enactment.

Buchanan's application of a consistently subjectivist notion of cost would also yield different public policy conclusions in macroeconomics as well. Keynesian economists presupposed that political actors maximize an objective social welfare function in which they would incur budget deficits during recessions and run budget surpluses during booms. Moreover, they inferred that the debt burden was "owed to ourselves."

Buchanan challenged the Keynesian orthodoxy by questioning the incentives of political actors in the model and demonstrating the intergenerational transfer of the debt burden. By disregarding the notion of a social welfare function, let alone its maximization, political actors would assess costs as subjective trade-offs in the maximization of their own welfare functions. Understood this way, what incentives do politicians have to decrease expenditures during economic booms if their goal is to maximize votes? If pursued as designed, such a model would reverse the logic of politics by concentrating costs and dispersing benefits during times of economic prosperity. However, this is incompatible with the institutional incentives of electoral politics. Moreover, the intergenerational transfer of the debt burden is consistent and reinforces the logic of politics. If voters are rationally ignorant, why would politicians pay attention to an interest group that is yet to be born? Thus, it is in the interests of political actors to shift the debt burden to future generations.

For Buchanan, an appreciation for subjectivism was the cornerstone of a research program based on choice and the institutional context in which choices are made. It had tremendous ramifications for his conception of social order and how it ought to be organized.

4 Freedom in constitutional contract

Both Buchanan and Friedman shared the frustration among classical liberals with the growth of the state in the twentieth century. Much of that growth could be attributed to the intellectual climate of opinion, which romanticized the political process and failed to grasp the basic principles of spontaneous order analysis. However, to understand the political process itself, Friedman adopted many arguments from Public Choice to explain the growth of government.

Under the influence of Buchanan's constitutional political economy, Friedman would come to argue that the best hope for constraining leviathan was on the constitutional level of rules. Like Buchanan, the arguments put forth by Friedman in the last chapter of *Free to Choose* for constitutional limits to government acknowledge the inability to constrain democratic majority rule on the *post-constitutional* level from special interests and logrolling. On this point Friedman wrote:

> [T]hose of us who want to halt and reverse the recent trend should oppose additional specific measures to expand further the power and the scope of government, urge repeal and reform of existing measures, and try to elect legislators and executives who share that view. But that is not an effective way to reverse the growth of government. It is doomed to failure. Each of us would defend our own special interests and try to limit government at someone else's expense (Friedman 1980 [1990]: 298-99).

Reform, therefore, would not come from steering individuals and their strategies in the right direction, but only from changes in the rules of the game.

The Limits of Liberty (1975) [2000] articulates Buchanan's political philosophy and his argument for governance through the state that would both empower and constrain it. In that book, Buchanan distinguishes between the "protective" state and the "productive state." The protective state "emerges as the enforcing agency or institution, conceptually external to the contracting parties" (Buchanan 1975 [2000]: 88). In this capacity, the state is external to contracting parties and does not "produce" anything other than contract enforcement. The productive state, on the other hand, produces collective goods. These two roles of the state are conceptually distinct, and the failure to distinguish these roles leads to confusion. For example, the law is a form of "public capital" that emerges from an initial anarchistic equilibrium as part of "an all-inclusive legal contract for the whole community" (ibid., 140).

In the post-constitutional moment, players of the political/economic game treat the rules as constraints and devise optimal strategies in response to them. The supply and demand of public goods is subject to a process of collective choice in this moment. However, rules that were intended to have good market outcomes but generate incentives to patterns of behavior can be regarded as rules in need of change. This led Buchanan to further distinguish the productive state from the redistributive state. Unlike the productive state, which adds value by coordinating the plans of actors who are unable to do this through individual action, the redistributive state simply transfers value from one party to another through collective action. Unfortunately, the logic of politics concentrates benefits to rent-seeking parties and disperses costs to “rationally ignorant” taxpayers, biasing the process of collective action in a manner which often transforms productive states into redistributive states, even if this is against the best intentions of economic and political actors.

This tendency to transition from a productive state to a redistributive state led Friedman to follow Buchanan in his policy conclusions. In the last chapter of *Free to Choose*, he elaborates on the logic of politics as operating “in precisely the opposite direction to Adam’s Smith’s invisible hand. Individuals who intend only to promote the *general interest* are led by a political hand to promote a *special interest* that they had no intention to provide” (Friedman 1980 [1990]: 292). Agricultural subsidies, import tariffs, and the growth in bureaucracy have expanded the role of government and substituted the rule of men for the rule of law, all in the name of the general interest. Rather than try to elect “good” legislators to counter this trend, the establishment of amendments to the U.S. Constitution is a more direct and fundamental way to change current policy. Among these would include a balanced budget amendment to prevent deficit spending and the shifting of the debt burden to posterity that Buchanan recognized in his research on public finance.

Indeed, it is the case that we are free to choose, albeit not of the outcomes of political and economic process, but of the rules that govern individual exchange in politics and economics. Buchanan’s discourse in political philosophy and comparative institutional analysis reopened the conversation in economics to once again deal with questions about public policy which Friedman recognized and so forcefully applied in his analysis of spontaneous order.

5 Conclusion

We have attempted to demonstrate here the methodological roots of Milton Friedman's and James Buchanan's economic way of thinking and political philosophy. We believe it is important to stress that Friedman was dedicated to the proposition that ideas matter. But for him to avoid the intellectual trap that efficiency arguments present to upholding that proposition, he had to adjust the relative weight he placed on the allocative efficiency of the market and the institutional framework within which economic relationships are established.

By *Free to Choose*, the argument about the power of the market is focused on information processing and complex coordination, and the examination of politics is about the tyranny of interest group manipulation. The reform effort of *Free to Choose* is decidedly argued on constitutional rather than policy grounds, and this, we contend, is a shift from *Capitalism and Freedom*. Friedman's move, we have argued, was motivated both by the intellectual trap of "efficiency always" explanations revealed in the work of Stigler and the budding research program in constitutional political economy as developed by his former "student" James Buchanan, which provided a suggested path to avoid the trap. Yes, indeed, you can be both a reformer and a positive economist. You do not have to choose between being an economist or a preacher.[5] Both Friedman and Buchanan – Nobel Laureates in their own right – were avid defenders of a free society, but the manner in which they did so can be traced to their mutual influence in Frank Knight and the ambiguity with which Knight understood economic science, the market economy, and the politics of reform.

[5] Contrast Buchanan (1959) with Stigler (1982). Also see Rodrik (2013) for the power of ideas to defeat special interest groups in the politics of reform.

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