

Buchanan's increasing returns'' multiplier.

I. Most scholars , as for Buchanan's contributions, limit their attention to his typical public choice works , such as the earlier ones the Wicksellian principle of unanimity, the subsequent book on the Constitutional Calculus of Consensus with Gordon Tullock, the innumerable essays based on his original contractarian approach to the theory of public economics and to the economics of institutions and related ethical problems , the theory of federalism as theory of competitive clubs. Obviously here there are very important , often seminal, contributions. But I prefer to focus on a more recent original contribution of him , strictly connected with the current political economy issues, which, in my opinion, has not been considered with due attention, i.e. his work on the "return of increasing returns", that has revolutionary implications for fiscal policy. His interest on this typically Marshallian~Pigouvian area of economic analysis , was originated by a search for the economic foundation of the "Victorian" ethical virtues of work , enterprise and saving (for investment) , disseminated in a group of papers then collected in *Ethics and Economic Progress, 1995*. He argues that those who add work , saving- investments, entrepreneurial activities to the market economy increase the size of the market, thus providing "externalities " that give origin to increasing returns , for the benefit of the community at large. It is therefore , in the interest of the community., to entice everybody to these virtues.

2. From .the ethical issues that lead him to think about increasing returns , moved to the analytical foundations of them, with the volume of essays of essays "The Return to Increasing Returns"(hence forth RIR), edited with J. Yoon in 1995 . RIR is an extraordinary effort of reviewing the -microeconomics of growth with the critical purpose of assessing -whether the standard neo classical general equilibrium postulates still hold. Starting from their "classical origin" in Adam Smith' theory of "division of labor", and from Alfred Marshall' s economies of specialized skills and machinery, pertaining to localized industries and to productions on a large scale, Buchanan then focuses on Allyn Young's general law of "increasing returns" interrelated with economic progress, "by the extension of the market and the division of labor in its modern forms," i.e. "the economies which are to be had by using labor in roundabout or indirect way". RIR has been published at the very beginning of the uninterrupted expansion of US economy- still lasting in 1999- that more and more, has lead to search explanations in terms of " new economic laws". Increasing returns have been rescued in a variety of ways for this purpose.

3. Buchanan's own contributions, in RIR, are subsequent to the important works of Paul Krugman on increasing returns in international trade and to Paul Romer's equally important contributions on increasing returns in relation to endogenous technological changes. But they differ in fundamental ways from both of them.. Krugman, whose paper on "Increasing Returns, Monopolistic Competition and International Trade" is reproduced in RIR - considers, as leading factors of the increasing returns phenomenon,, the combination of monopolistic competition, economies of scale and technological progress, affecting particular industries and trades among different countries, specialized in some of them. Buchanan focuses on Allyn Young's more general view of division of labor, as function of the extent of the market, as the basic factor of increasing returns, *not related to particular industries, but to the economy at large*. In a sense, therefore, his theoretical position on this complex issue, it is much similar to that of Paul Romer, whose two well known papers on growth based on specialization and on endogenous technological changes, both reappear in RIR. However, again, in respect to Romer's, one may say that Buchanan's view of the theme is more general, even if both of them share the view that free international trade is beneficial to the highly industrialized countries and to the emerging economies as well. In Buchanan's own words "Romer, who quite explicitly ties his work to Allyn Young's emphasis on specialization, identifies technology as the output that emerges from a production process that exhibits increasing returns to scale. By investing in knowledge, in human capital, final output will increase more than proportionately due to the impetus given to the introduction of new technology". "Although the sector over which increasing return apply is relatively large in the endogenous growth models, it remains nonetheless the case that identification, as such, is necessary for policy inferences to be drawn from the analysis. The increasing returns to scale are not truly economy wide in scope".

4. Buchanan's approach, as said, goes beyond. Increasing returns are the *general law of market economy operating in competition*, replacing that of increasing costs, of classical and neo classical economic competitive equilibrium. Sraffian and Chamberlinian monopolistic competition assumptions are not only unnecessary to ground this general law, rather appear to obstacle its full display. And Marshall-Pigou's dicotomy between increasing and decreasing returns, based on externalities in a competitive setting, from Buchanan's point of view is reductive because based on a sort of classification of different industries or areas. Decreasing returns, for Buchanan, are simply an exception, mostly connected with barriers to the functioning of the market forces. And here comes his *seminal* theoretical contribution consisting in:

a) identifying "sectors (defined in terms of "valued goods") where returns to scale *do not*, and *cannot* be present, rather than sectors where increasing returns are present, these basically being "non market sectors";

b) i connecting the additional income obtained from additional input with the market expenditure side as *demand for market-produced* tradeable output, thus allowing for increasing returns, by the increased market size

5. The starting point of the virtuous circle is the input supplied to the market. By supplying more inputs to the market in exchange for an additional income that will be expended on the goods and services generated in the market, under increasing returns, the individual who so acts benefits others indirectly through the extension of the market and, through this, by the degree of specialization (*in the broad Allyn Young sense*) to be potentially exploited. "The effect emerges as, a pure price change, in real terms, made possible by the increase in aggregate supply of valued productive capacity in the economic nexus. Here the analyst must resist the temptation to disregard the externality because it enters the utility function through price. In the traditional terminology, the externality is "technological" and hence Pareto relevant, because it expands the choice set of some person in the nexus, without fully offsetting restrictions in the choice sets of others". Notice that Buchanan's crucial passage is on the *demand side*. "The additional income secured from the sale of additional inputs returns to the market as additional demand for market-produced tradeable output. This extension of demand which it is matched by the initiating increase in supply that made it possible, will create the potential for the exploitation of further specialization, *in some production*, that remained just below the margin of economic viability in the pre change equilibrium". If one then considers the expenditure on the market of the income obtained by this increased output, there shall be another round of external effects of the increase of the size of the market, allowing for further specialization affecting some productions, that was formerly below the margin of "economic viability".

6. This construct of Buchanan appears similar to a Keynesian multiplier: but differs from it in nature, because the starting point is a market's full employment, where and additional demand creates the possibility of producing additional output with the given amount of inputs, by adding specialization.

It seems to me that the implications of this fascinating "Buchanan's multiplier" go well beyond the "work ethics" on which he was focusing, in his paper "the supply of labor and the extent of the market, condemning the "anti work ethic of the 1960, summarized in the admonition "take the time to smell the flowers".

Clearly, the increase of the size of the market, by promoting free trade areas, increases the scope for Buchanan's multiplier. More over, the same shall be true for deregulations and privatizations, in particular as for labor markets deregulations. They not only shall benefit the unemployed who, in this way, shall be able to find a new job and shall render more competitive productions of goods and services which were below the level of profitability. By this increase of inputs and outputs they shall

create external economies by the increased size of the market, allowing for further specialization and "increased returns". These effects shall be pronounced the least the economy is constrained by regulations reducing its capacity of reorganizations along the lines of increasing returns.

7. Above all, it appears to me that this Buchanan's theoretical contributions explains why a fiscal policy of tax reductions is beneficial to growth beyond the conventional Laffer's curve approach. Indeed reducing the amount of income subtracted by taxes to those who supply inputs broadens the contribution of their expenditures to the size of the market, thus allowing the full display of the positive externalities of their economic behaviors. One might object that if taxes are given back to the market economy by public expenditure, these externalities shall be restored. But this is not the case if the public expenditure consists in production of *non market goods ad services*. Additional expenditures, as pure transfers provided that they do not exert a negative effect on work supply, shall be comparable, to some extent, to tax reductions, from the point of view of Buchanan's multiplier. But reduction of taxes, if entices *to work more* shall be, in any case, better. Thus, while to get by public expenditure some effect of the Buchanan increasing returns multiplier, one shall adopt transfers financed by budgetary deficit without any restriction in monetary policy, tax reduction, even with balanced budgets, shall have real economy expansionary effects, via the Buchanan's "increasing returns multiplier".

Buchanan's contribution consists, then, in showing that tax reductions, i.e. the reduction of the size of the public sector, *with balanced budget*, has an expansionary effect, *via the demand side*.