THEORY AND PRACTICE OF ECONOMIC POLICY

TRADITION AND CHANGE

Selected Papers from the 9th Aispe Conference

edited by
Piero Bini
Gianfranco Tusset

FrancoAngeli

Collana di studi e ricerche dell'Associazione Italiana per la Storia del Pensiero Economico - Vol. V

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The publication of this book was possible thanks to the financial contributions of:
Banca Antonveneta Foundation; Regional Government of Veneto; Provincial Administration of Padua; Municipality of Padua; AcegasAps; Research Institute Sintesi; Faculty of Political Science; Department of Economics and University of Padua.

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FOREWORD

by *Piero Bini* and *Gianfranco Tusset*

The aim of the book

Study of the relationship between economic theory and economic policy choices does not pertain to the more consolidated tradition of the history of economic thought, which instead largely comprises other academic genres, most notably scientific biographies of the great economists of the past. But as a relatively new area of research, close examination of this relationship is potentially of great interest, as regards both the knowledge that it yields and the complexity of the method employed. Among the knowledge purposes of such research, understanding the linkage (when and to the extent that it can be determined) between a theory and particular economic policy prescriptions is certainly the most conspicuous. But it is flanked by various other purposes: to test the applicative relevance of a certain scientific relation; to examine the multiple elements involved in economic policy-making; to investigate the tendency of economists to pursue strategies for their personal success within the profession; and others besides.

Accordingly, the historian of economic thought must be able to move between the categories of economics and the events of history, but also among the doctrines of political science, the insights deriving from the sociology of knowledge, and other sources as well.

It is perhaps not entirely coincidental that historiographical interest in the theory/policy relationship has grown in parallel with the questioning of the canons of positive economic science, this being the methodological approach which maintains that the objective analysis of real economic trends can and should be kept separate from normative prescription of the appropriate policies. Put briefly, now that such separation has lost part of its methodological authoritativeness, and with the current tendency towards greater theoretical pluralism, the breadth as well as complexity of the theory/policy relationship has become apparent.

It is then necessary to consider that the conception itself of economic policy changed during the last twenty years of the twentieth century. This intellectual and scientific shift caught many scholars of economics by surprise and induced them to investigate its essential significance. The outcome was greater sensitivity to the historical dimension and to the methodological specificities of research into the topic. In other words, the observation that, over time, different conceptions of economic policy have prevailed also brought awareness of the

mutable relationship between economic policy – as the stage when economic knowledge is put into practice – and economic theories. At the same time, it stimulated attempts to grasp the array of components – theoretical, social, cultural, political, sociological, etc. – which variously substantiate that relationship.

This book consequently examines the connection between theory and economic policies from a historical perspective, and seeks to show, albeit not systematically, its methodological specificities. The book first concentrates on classical economic thought, and then addresses the neoclassical approach – and the institutionalist approach in parallel with it – concluding with examination of the theory/practice relation in regard to chronologically more recent, or indeed present-day, questions.

The contents of the book

The book contains twenty papers given to the IX AISPE Conference held in June 2006 at the University of Padua's Faculty of Political Sciences. Some 140 papers were presented at the conference, and the ones included in this book were selected from them. The purpose of the conference was to stimulate research into the evolution of economic policies, from the first theories to the most recent proposals and practices. The papers dealt with individual authors, schools of thought, theories, categories of economic policies, and policies concerning sectors, regions, countries, and institutions. The criterion adopted in organizing this book and in defining its sections has been the one mentioned above: highlight the specificity, but also the plurality, of the relationships between economic theory and economic policy choices.

The volume divides into six sections. The first, "State and Market in the History of Economic Thought", deals with two classic themes: 1) the notions of 'government' and 'institutions' espoused by the main schools of thought; 2) the intertwined relations among government, market and anti-trust agencies. These two broad surveys also serve to introduce the following five thematic sections. The first of them is entitled "Economic Policy and Knowledge", given the salience which the articles in the section give to the various types of knowledge presumed by economic theories.

Examination then moves to the 'great themes' of economic policy. The third section, entitled "Distribution and Poverty", reprises an issue addressed traditionally by public policies, from antiquity until the present day, and which concerns both redistribution within individual countries and the dynamics among groups of countries at different stages of development. The articles in the section also investigate why the distributive issue has gradually lost importance in contemporary economic debate. The fourth section, "Monetary Policy and Banking", concentrates on another canonical theme in economic

policies. It briefly reconstructs some features of the American and Italian banking systems, and then dwells on the monetary policy theory which gave rise to the 'monetary circuit approach'. The fifth section, entitled "Wage Policy", treats aspects concerning the reception in Italy of Walras' mathematical applications to economics and the wage laws in the late nineteenth century, and considers the recent debate on wages, policy and full employment. Finally, the sixth section – "Current Issues" – deals with topics central to the current theoretical and political debate: from the interweaving between 'new' economic theory and 'new' economic policies, through polices for technological innovation, current 'third-way' schemes, fiscal and budgetary policies in the United States during the Clinton administration, to reflection on the international coordination of economic policies.

Of course, not all the great issues of economic policies have been thoroughly addressed by the book, given the space available: some are mentioned only in passing. However, we believe that the analyses will be sufficient to fulfil the interest of economists and historians of economics.

The publication of this book would not have been possible without the suggestions and advice of all the participants at the IX Conference and, especially, the components of the AISPE Board.

We wish to express our gratitude to all those bodies and institutions whose financial support has made the Conference and publication of this book possible: Banca Antonveneta Foundation; Regional Government of Veneto; Provincial Administration of Padua; Municipality of Padua; AcegasAps; Research Institute Sintesi; Faculty of Political Science; Department of Economics and University of Padua.

I. State and Market in the History of Economic Thought

HARNESSING SELF-INTEREST: MARKET AND STATE IN THE HISTORY OF ECONOMIC THOUGHT

by *Steven G. Medema*[*]

1. Introduction

The question as to the appropriate role for government within the economic system is as old as economic thought itself.[1] For much of the history of economic ideas, the economy was seen as but one piece of a larger social system and the study of economics, or political economy, as simply one facet of a larger social theory. It was only with the advent of commercial society and the organization of economic activity more overtly within the context of the market that the perception of the economy as a quasi-independent part of the social system began to gain currency. This has a number of implications, but for our purposes one of these stands out: the earlier economic literature envisions a system wherein government and the economy are integrally linked as aspects of the social system, whereas in later literature government and economy – or government and the market – are often viewed as independent spheres of action with corresponding questions as to how much the one should 'intrude' upon the other.

The perspectives that motivate or underlie the discussion of the appropriate economic role for government are many and diverse, and the resulting analysis thus reflects diverse and often contradictory accounts of the appropriate tasks for government within the legal-economic sphere. The vastness of this topic requires the selective adoption of an organizing principle, and that adopted here is «the economic role of government as a response to the forces of self-interest.» While this necessarily excludes a variety of contributions and per-

[*] Department of Economics, University of Colorado at Denver, Campus Box 181, P.O. Box 173364, Denver, CO, USA. This essay served as the basis for my opening address at the annual conference of L'Associazione italiana per la storia del pensiero economico (AISPE) in Padova in June 2006. I am grateful to Piero Bini and Gianfranco Tusset for their invitation to address the conference, and to publish this paper. An abridged version of this paper appeared as "The Economic Role of Government" in Jeff Biddle, John B. Davis, and Warren J. Samuels, eds., *The Blackwell Companion to the History of Economic Thought* (Oxford: Blackwell, 2003), whose permission to reproduce portions of that essay here is gratefully acknowledged. The present paper form the basis for part of my forthcoming book, *The Hesitant Hand: Market and State in Modern Economic Thought* (Princeton: Princeton University Press).

[1] Interestingly, in spite of the centrality of this issue throughout the stream of economic analysis, no comprehensive examination of the subject has been made. The present essay is part of a larger project that seeks to remedy this deficiency in the literature.

spectives, I hope that it provides the vehicle for a useful analysis of how the economic role of government has been viewed throughout the history of economic thought and analysis and the forces that have motivated these views.

2. Preclassical economics

One of the defining characteristics of much of preclassical economic thought is its naturalistic, or natural law, orientation – an orientation that is reflected in the roles ascribed to government by the preclassical scholars. This a priori approach to the subject made the role of government something given rather than something that is to be worked out. We find here no theory of governmental behavior to speak of, no serious analysis of the ability of government to carry out the tasks ascribed to it by these authors. What we have, rather, is – in many cases, at least – an assumed natural order of things and consequent statements of how government should act so as to facilitate the operation of a social-economic system that comports with the dictates of natural law.

2.1. The Greeks and Scholastics

The Greek contribution to economic thought has come down to us primarily through the works of Plato and Aristotle,[2] and their analysis centered around the *polis*, or city-state. As Joseph Schumpeter (1954: 54) has described the Greek philosopher, «it was from the *polis* that he looked into the universe, and it was the universe – of thought as well as of all other human concerns – that he found reflected in the *polis.*» The economic turmoil of their time led both Plato and Aristotle to contemplate the issue of life in the ideal state, and their analysis was built around the question of what, in such a state, would constitute «the good life.» An important aspect of this was justice, including the role to be played by the governing authority within such a context.

The economic upheaval that created the shadow under which Plato and Aristotle discussed economic issues was seen as a consequence of the surge in economic growth following the liberalization of commercial activity, including the expansion of international trading activity. Given what they saw as the undesirable effects of economic growth, their analysis was centered around the establishment of a relatively stationary state of economic activity, but one wherein the citizen of the state had a reasonable standard of economic well being. And, given their administrative bent, Plato and Aristotle were concerned with the determination of the most efficient means of accomplishing this.

Both Plato and Aristotle were deeply suspicious of the ability of the forces of material self-interest to generate a harmonious and just social order, given

[2] See Plato's *Republic* and *Laws*, and Aristotle's *Politics* and *Ethics*.

what they observed going on around them. Moreover, Plato saw no room for participatory governance and did not believe that the citizens could understand how to achieve the efficient outcomes of the ideal state unless they submitted themselves to the guidance of a ruler possessing superior intelligence. The ideal state could not, for Plato, evolve; it must be imposed. The law-giver expert would have the flexibility – as contrasted with a fixed body of law – to adapt the laws of the state to meet situational needs. Moreover, this ruler could be trusted to govern in the interests of society as a whole because to act unjustly would not be in the ruler's self-interest. And, given that the ruler ruled justly, obedience on the part of the subjects would be in their self-interest. Plato's ideal state, then, was to be «rationally organized … an efficient, static, changeless society administered by experts» (Lowry 1987: 93). Aristotle shared Plato's aristocratic bent, but without advocating the same degree of regulatory control over individuals' lives.

For Plato and Aristotle, the most straightforward means of attaining their objectives for the ideal state was through relatively strict limits on commercial activity, and this is where the state was to play a central role within the Greek system. They favored a system of laws structured so that there obtained a stationary state with a reasonable level of economic well-being for all citizens. Aristotle saw the market as a «creature of the state» (*Ibid.*: 237), and with this came prescriptions for the regulation of commercial dealings. For example, both Plato and Aristotle recognized that the creation of an economic system that could generate a satisfactory level of material well-being required the harnessing of the division of labor, but they believed that this should be carried out in such a way that natural roles were enforced (in the case of Plato) or at least given effect to (e.g., condoning slavery in the case of Aristotle) by government. But both Plato and Aristotle objected to the internationalization of the division of labor owing to the base influences they believed this would introduce (and had already introduced) into society, and various government actions – such as separate domestic and international trading currencies – were recommended to mitigate incentives to seek private gain through foreign trade. Commercial activity in general was frowned upon, and at best was seen as a necessary evil to equalize needs and possessions. Reflecting this, policies including prohibitions against lending at interest, the elimination of profits, and statutory fixation of prices were recommended to keep commercial activity in check.

That there were certain significant parallels between the respective analyses of the Greeks and the scholastics should come as no surprise, given that St. Thomas Aquinas (1225-74), the foremost of the schoolmen, set about in the larger body of his analysis to reconcile church teachings with the work of Aristotle. The scholastic analysis of the relationship between man and his creator, an aspect of which is the relation between individuals in a social context, led them to consider the commodity exchanges and monetary issues from a Chris-

tian moral perspective, and the basic question motivating scholastic inquiry here was, «What ought a Christian man to do.»

While viewing common property as the ideal (as evidenced in communal monastic institutions), the scholastics were very much of the mind that private property was optimal for society as a whole owing to the negative incentive effects common property provides for sinful, worldly people – a religious take on the Aristotelian position. Unlike Plato and Aristotle, the scholastics were more favorably disposed to commercial activity, and were generally of the mind that market outcomes would satisfy the dictates of justice in the absence of monopoly or fraud. Following Aquinas, the early scholastics supported prohibitions on lending at interest, although this view slowly eroded over time as later scholars came to understand the opportunity cost associated with lending. Concern over the harmful effects that could come with macroeconomic fluctuations led many scholastics to support some degree of price control – the regulation of prices within certain upper and lower limits – so as to mitigate the extent of the fluctuation in the value of money over time.

For both the Greeks and the scholastics, relatively extensive government activity was a necessary tool for bringing about a harmonious social-economic order. There was not so much an over-arching theory of the state here as there was a set of supposedly naturally-ordained ends that government could (and indeed necessarily should) assist society in attaining. In particular, the forces of self-interest were thought to promote outcomes inconsistent with those prescribed by nature or by God, and government action was considered necessary to prevent, or at least minimize, the more base impacts of self-interested behavior.

2.2. Mercantilism

Mercantilist political economy differed from Greek and scholastic thought in the relative lack of emphasis given to questions of value and distribution but, like this earlier work, embodied the view that broad-based government intervention in economic activity was very much in the national interest. The mercantilist goal of nation-state building, combined with their notion that the measure of a nation's wealth consisted in its stock of precious metals, engendered a view of government policy consisting of extensive regulation of economic affairs. There was continuity with Greek and scholastic thought in the view that individual self-interest, if given free reign, would run against the national interest, although the moral qualms of the Greeks and Scholastics on this score were replaced by more worldly concerns in the hands of the mercantilists.[3] Self-interest, in the mercantilist view, was bound to lead to excessive con-

[3] It should be noted here that the continuity was hardly intentional. The mercantilist literature is noticeably devoid of references to previous economic thinking.

sumption of both domestic and foreign goods (and especially luxuries), thereby diminishing the quantity and raising the price of goods for export (reducing their competitiveness on world markets) and increasing imports – thus harming the trade balance and the nation's stock of precious metals.

Mercantilism saw the melding of political and economic policy under the nationalistic banner. While embodying no unified, coherent, systematic body of economic analysis, mercantilist doctrine was squarely aimed at the promotion of bullion accumulation through policies of export promotion and import restriction – the result being the maximization of the trade surplus payable in bullion. Indeed, the rod against which policy proposals should be measured was, for the mercantilists, the effect on the nation's stock of precious metals. That political and economic objectives here were mutually reinforcing can be seen when one notes that bullion accumulation went hand-in-hand with the development of military (including naval) power, which at once protected both nation and trade shipments; the acquisition of colonies, which brought empire, sources of raw materials for manufacturing, and markets for exports; and the slave trade, which offered up low-cost labor.

All of this was to be accomplished by means of a wide-ranging scheme of economic policy, of which import restriction and export promotion were only the most obvious components. Even here, however, a number of writers recognized that outright prohibitions on imports and excessively high tariffs would serve only to encourage smuggling and even destroy markets for one's exports, and exceptions were allowed for consumer necessities and raw materials that could not be produced at home in the necessary quantities. Beneficial export policies, meanwhile, were thought to include the removal of customs duties and other export impediments, subsidies for the export of manufactured products, and restrictions on the export of raw materials (which could be used by other nations to produce manufactured goods that would compete with home products). These policies would result in the export of products with the highest value added. Other proposals were also offered up, such as the regulation of precious metals exchanges – including prohibitions on bullion exports, exchange control, and protecting the quality of coinage – as well as regulations restricting the hoarding of bullion and its conversion into plate, jewelry, etc., in order to ensure sufficient currency in circulation to fuel the nation's economic activity. Strategic policies that would favor certain important national industries and protect infant industries were much in vogue, as were labor-related policies – including loose immigration and tight emigration rules, and subsidies to encourage workers to relocate to manufacturing centers – that would serve to keep labor supply up and wages low, thus facilitating the price-competitiveness of exports.

While appearing to be centered around the pragmatic idea of nation-state building, the mercantilist doctrine was not without its own natural law aspect. As Jacob Viner (1937: 100-101) pointed out, the mercantilists

> managed ingeniously to adapt the doctrine of [divine] providence to their own particular views … [using] the doctrine either to justify the restriction of certain products to Englishmen, on the ground that Providence had assigned them to this country, or appealed to the doctrine in support of that branch or type of trade which they wished to have fostered, while completely forgetting the doctrine when attaching other branches or types of trade.

In fact, these appeals to providence, often couched in nationalistic garb, regularly served to mask what was really self-interested advocacy on the part of the author: the attempt to use governmental policy to support private interests. But there was more to the natural law aspect than just this. Lars Magnusson (1993: 6-8) has argued that mercantilism departed from previous thinking by viewing the economic system as «an independent territory with its own distinctive laws.» Here, economic welfare «more than anything else depended upon the statesman's ability to rule according to the laws dictated by an independent economic realm,» this being necessary owing to the inability of self-interested private action, as translated through the market mechanism, to maximize national wealth defined in terms of precious metals stocks.

While virtually all of the analysis of the economic role of government during the mercantilist era was trade-related, a prominent exception can be found in the work of William Petty, whose *Treatise of Taxes and Contributions* (1662) can rightly be called the first study in public finance. While his positions on trade issues had a mercantilist flavor (albeit much more reasonable than the garden-variety mercantilist positions), Petty's focus was more internal, or domestic, in nature. Petty was compelled to lay out what he considered to be the appropriate role for government to provide a basis for discussing how the public finances might better be managed and the necessary revenues secured to support the proper governance of the nation. For Petty, this role consisted of six basic elements: (i) the provision of national defense; (ii) providing law and order on the home front; (iii) providing for the established church; (iv) the provision of education; (v) the provision of public works, such as roads, bridges, and harbors; and (vi) assisting the poor and the unemployed. This last included not only transfer payments, but also make-work jobs for the unemployed that would keep their minds and bodies disciplined until more gainful and productive employment became available. Petty also recommended limits on certain types of occupations, including clergy and lawyers, on the grounds that there existed far more of these than were necessary for the nation, and, by reducing their numbers, the state could reduce the expenses necessary for the support of the church and the legal system. As we shall see, Petty's perspective on the appropriate functions for government was carried through in classical analysis.

2.3. Physiocracy

The backlash against mercantilist thinking first came to the fore among the 18th-century French physiocratic thinkers. Physiocratic doctrine was very much a reaction against Colbert's mercantilist policies that had for many decades promoted French manufacturing at the expense of agriculture. These policies, combined with wars and high tax burdens, served to impoverish the agricultural peasant proprietors and thus retarded productivity advances in the agricultural sector.

The physiocratic reaction against mercantilist policies was best evidenced in their belief that agricultural production is the cornerstone of economic activity. They argued that agriculture alone generates a net product – a surplus of output over input. Whereas the mercantilist goal was the maximization of the nation's stock of precious metals, for the physiocrats the goal was to maximize the net product, and it was against this rod that the efficacy of all policy proposals was to be judged. This net product was the sole source of funds for investments in increased productivity, and François Quesnay and his followers saw the maximization of this surplus as providing the means to advance the technology of agricultural production to match that of other nations. Obviously, since agriculture was thought to be the only sector that generated a net product, and the maximization of the net product was the appropriate goal for society, the physiocrats were steadfastly against policies that restricted agricultural production for the benefit of the manufacturing sector – such as the prohibitions on agricultural exports that served to keep food prices, and thus manufacturing wages, low.

The physiocrats said that the world consists of a set of self-evident truths arising from natural law, and they believed that these truths could be discovered by means of human reason. These natural laws extended to the economic system and, according to the physiocrats, the state that governs best will govern in accordance with these laws. Against the mercantilist policy scheme, Quesnay argued that the sole function of the state is the provision of security – national defense and the appropriate system of laws (those that harmonize with natural law). That the physiocrats were against government interference with commerce is evident from Quesnay's essay on 'Corn,' where he argued that «all trade ought to be free … It is enough for the government to watch over the expansion of the revenue of the kingdom's property; not to put any obstacles in the way of industry; and to give the people the opportunity to spend as they choose …» (Meek 1962: 79). Likewise, in his "General Maxims for the Economic Government of an Agricultural Kingdom," Quesnay said that «complete freedom of trade should be maintained; for the policy for internal and external trade which is the most secure, the most correct and the most profitable for the nation and the state, consists in full freedom of competition» (*Ibid.*: 237). This freedom of trade or competition entailed freedom in the production and circula-