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978-1-009-43444-7 — Monitoring the State or the Market
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PART I

THE PERIOD UNTIL THE GREAT DEPRESSION

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Introduction

Much of modern economic theory deals with the short-term and, because of that, it has largely cut its connection with history. Economic history is no longer a required field in many PhD economics programs. In recent decades, economic theorizing has become increasingly technical, in an attempt to make economics more and more like physics, and less and less like sociology or psychology. Economics has become much more connected with current developments, and model building has become the norm (see Solow, 2005). This was not the case a century ago when economists such as Karl Marx, Alois Schumpeter, and Edwin Seligman, who was an important professor at Colombia University, among others, had theorized about the existence of relationships between economic and historical developments (see Marx, 1867; Seligman, 1907; Schumpeter, 1942). They had theorized that, in the long-term, economic developments often lead to important social reactions.

This change in emphasis in economic analysis has had some good and some less-good consequences. While the modern approach has many advantages and has made economics look more rigorous and more scientific, making economic relations and economic articles resemble those in physics, it has failed to recognize the ways in which economics continues to be significantly different from physics. For example, economic variables are rarely precisely measured, and, at times, there are long and undefined lags between the time when a policy is enacted or some actions are taken by individuals or by the government and when their effects are fully felt in the economy. It also fails to recognize that the short-term effects of some policies may be different from those in the long-term, as had been theorized by historical determinism in the past.

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The difficulties in measuring variables and the lags are often ignored by economists in their more technical, modern approach. This means that modern economics, to some extent, has become increasingly detached from historical developments and also, at times, from a longer run reality. Some psychologists, such as Kahneman, Tversky, and others, have also concluded that individuals often suffer from irrationality, so that the fundamental assumption of rational behavior on the part of market participants can lead to unexpected results.

The modern approach also tends to ignore the existence of relationships that do not lend themselves to easy, quantitative, or econometric estimations but that should not be ignored, even when they do not allow the building of models. Policies are generally assumed to have *immediate* and clearly *quantified* and *quantifiable* effects. However, in the real world, lags always exist, and they can be of different and unknown length.

There are also results that are not predictable at the time the policy changes are made, especially but not only when the policies generate major changes on distributional, and not just on allocational, grounds. These are the changes that will be stressed in this book. Economists should pay more attention to these possibilities and not ignore them.

This book will focus mainly on long-term developments and on relationships that are often not easy to subject to quantitative, precise estimations. It will cover three, somewhat distinct, though partly overlapping, periods. The first is the period from around the early or mid-nineteenth century until the 1920s. The second is the period from the Great Depression, in the 1930s, until the 1970s. The third is the post-1970s period, until the Great Recession in 2008–2009, with also some comments on the most recent years.

The years after the Great Recession have characteristics of their own, including, most recently, the impact of the COVID-19 pandemic on the economy, the great increases in public debt and public spending that accompanied the pandemic both in the United States and other countries, and, more recently, the advent of the war in Ukraine and the sudden return of high inflation.

The characteristics and the long-term impact of these recent phenomena are difficult to define or to forecast at this time. They may take different future forms or directions. For this reason, they will receive less direct attention in this study.

During the above three periods, the countries' governments played distinctly different roles for a variety of reasons, including because some

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important aspects of the economies and of the market were changing significantly. See Summers (2013) on some of these changes in the past four decades, and Tanzi (2011) for an early and longer perspective.

The roles that both the government and market played during the above periods were, at times, close to what was needed and, at other times, far from it. This conclusion implies that the harmony that should exist, or that can be expected or hoped to exist, between the role of the market and that of the state at times increases and at other times decreases, leading to inevitable reactions.

This book will deal with what may be, or may have become, the most important question in economics, namely the economic role that the government or, more broadly, the state should play, in countries that are both democratic and that operate with market economies. That role cannot remain unchanged over long periods of time, as some economists seem to believe. The longer some roles are sustained, the more they set in motion forces that will make it more difficult to sustain those roles in the long-term. This is true for both pro-government and libertarian roles.

The emphasis in this book will often be on the United States, but the arguments will have more general implications and the discussion will be more pragmatic and less formal than is the norm in economics books.

What role should the government play, or should have played at given times? How did that role change over time? And why did it change? How closely did it come to match what the market may have needed, in terms of corrections, and what the countries' citizens may have expected the governments to do, in terms of equity, at a particular time? And why has the government economic role become increasingly larger and more complex with the passing of time in countries that have remained largely democracies with market economies?

This book will speculate on some of the above questions, without the hope of being able to answer them in any precise or definitive manner, and with the expectation that other economists may not agree with the answers given to the questions addressed. But raising some of those questions may have its own merit, because they have not been raised in such a direct way but should have been.

The key or the guiding assumption will be that, at any one time, there should be some balance, or some harmony, between the corrections that the market requires from the government and what many citizens expect the government to do. That balance is not likely to require an unchanging government role and a government role is always required in a large community.

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There are and previously have been conservative economists, such as the late James Buchanan and others from the School of Public Choice – the School that Buchanan created in the 1960s – who have argued that, at least in the United States, the broad role of the government, including that of local or subnational governments, was established a long time ago by those who wrote the US Constitution. Therefore, the government should continue to be guided faithfully by those constitutional principles, unless they have been formally modified by constitutional amendments, which are very difficult to make given the institutional set up that was also created a long time ago. In their views, the role of the state should not change in any significant way, even to reflect major structural, economic, technological, and social changes that inevitably take place in the real world and will continue to take place.

The above conservative fundamentalism has continued to have many followers who have viewed any new governmental intervention with suspicion, even when such intervention would save many lives – as would, for example, restrictions on buying guns, a right protected by the US constitution. In the case of guns, the Pew Research Center has reported that, in 2020, 45,222 persons were killed by guns in the United States, and the related costs are $557 billion dollars a year. Clearly this individual freedom has a high social cost.

There are others economists and plain citizens who believe that a market and a society require more, and possibly frequent, changes to better reflect the preferences and the needs of the current generations, not of the generations when the constitutions were drafted, at times centuries ago. For example, the need for individuals to have guns was obviously different two or more centuries ago when most US citizens lived in largely rural settings.

Other economists and informed citizens believe that the government should adjust its role whenever necessary, to correct for changing "market failures" and for developmental changes, which in their view might include the failure of not generating full employment with stable prices, of not creating a reasonable and a broadly or socially-acceptable income distribution, and sustaining an environmental balance that will allow a continuation of life on earth in the future. New scientific evidence may also suggest changes in regulations, as in the impacts of smoking on health and the use of dirty fuels on the environment.

Many economists have continued to pay more attention to the technical concept of allocation of resources and short-term *efficiency*, as defined in traditional "price theory" textbooks, than to the more

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ambiguous and less precisely defined concepts of *equity and sustainability*, which some economists continue to consider based on *value judgment* and not on *scientific* principles.

The change toward a more "scientific-based" economics, to distinguish it from sociology, came especially after 1870, in part as a consequence of the "Marginalist Revolution in Economics," a revolution that tried to establish boundaries on what should be "economic science" (see Winch, 1972). The marginalist revolution made interpersonal comparisons "unscientific." As a consequence it prevented the comparison of incomes between individuals. These comparisons could not be addressed given the rules of the "science" of economics. This view remained popular until the Great Depression in the 1930s, when it started to be challenged by some. It is still popular today among conservative groups.

However, equity was and has continued to be important to most people. It is especially important for people who live in urban communities where different standards of living are easily observable and where they can and do influence social relations. Equity has become more important with the passing of time, as societies have become more urbanized and as the media have spread more information on the standards of living of different classes. The goods consumed by the upper classes are now advertised for everyone to see. When inequality exceeds certain limits and becomes significant in a society, history teaches us that violence often follows, and it can become the "great leveler" (see Scheidel, 2017).

Attention to equity cannot be ignored by relying on the argument used by some economists that such attention requires a value judgment, while the pursuit of efficiency requires only scientifically based analyses. This misses the point that, in a fundamental way, the concept of efficiency is also based on a value judgment. This is surely the case with the Pareto optimum, a criterium that was broadly accepted and used in welfare economics; or with the definition of *absolute* poverty, that is still widely used today in comparing countries' standards of living. Both dismiss the importance of *relative* incomes and focus on *absolute* incomes, as they are defined, or as they are measured, by current prices, which, in turn, are partly influenced by the existing income distributions. Different income distributions would often lead to different relative prices.

In a rich society, some individuals or families can feel poor even when they have more to eat and a better place to live than people centuries ago. Relative income matters, and the existence of super rich individuals in a society, individuals who today travel in private jets or private yachts,

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accentuates the differences that exist in the income distributions. This is especially the case in modern societies where the media report on and advertise the habits of the superrich, making the rest of the population feel poorer.

In 1949, James Duesenberry, then an important and highly regarded professor of economics at Harvard University, published a book that gave importance to the relative income position of individuals, in determining their marginal propensity to consume. He theorized that, the lower was the *relative* income position of individuals or families, as opposed to their *absolute* income, the higher would be the marginal propensity to consume out of their incomes. Vice versa, the higher was the relative income of individuals, the higher would be their rate of saving. These behaviors would tend to make the income distribution less even over time and to perpetuate inequality. Available recent statistics, such as the World Inequality Report, 2022 (p. 95) still strongly support Duesenberry's theory.

Poverty cannot be considered just an absolute concept but must be considered a relative one, and the distribution of income, through a "demonstration effect," determines the behavior of consumers, and thus the growth of the economy. Because of its impact on accumulated saving, it also determines the future income distribution.

Equity and efficiency cannot be sharply compartmentalized, as they, often, have been by economists. The position of an individual, or of a family, in the distribution of income is an important factor in determining the saving rates (and the opportunity) faced by different individuals and society. Saving rates are important in determining social mobility.

In the years that followed the publication of Duesenberry's book, the relative income hypothesis was considered important and highly plausible, and it was endorsed and used in some studies (for example, in Tanzi, 1965). (Disclosure: Duesenberry had been one of my professors at Harvard, in the early 1960s). However, in spite of its high plausibility, that hypothesis disappeared in later years, displaced by the less plausible "permanent income hypothesis," advanced by Milton Friedman (see Frank, 2005).

This result was probably due to the rising popularity of Milton Friedman in the 1970s, or perhaps because the relative income hypothesis had relied on sociological or psychological concepts, rather than on purely economic ones such as permanent income. Economists have always struggled in making interpersonal comparisons, so many have refrained from making them (see, also, Palley, 2008).

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The views of economists (more than those of normal citizens, who have less precise information but more spontaneous reactions) have oscillated, over the years, between the tendency to see the government as an enemy of a market considered broadly efficient, as economists define efficiency, to that of seeing the government as a possible close replacement for the market, or even as a possible solution for most of the social and economic problems that citizens face. See on this the early debate between Seligman and Nearing in 1922.

The first view was dominant among classical, laissez faire economists, especially during the nineteenth century, when the alternative to laissez faire was mercantilism, that is *excessive* and *arbitrary* government intervention, as it had been in France and other places. Many economists made a dogma of the laissez faire philosophy, which in their view would reduce the governments' arbitrary interventions (see, for example, Bastiat, 1864). Some broadly laissez faire views continue to influence many economists and politicians today.

The alternative view, as especially promoted by Karl Marx and his followers, played a role in experiments with central planning in the twentieth century, in Russia and the Soviet Union countries, and later in China and other countries. The experiments with socialism did not prove particularly successful, and central planning is now much less popular than it used to be. However, some of the thinking that had accompanied it, in milder socialist versions, has continued to attract many people, and even some economists. Many economists now believe that wise and limited government actions can and must be a useful complement to the work of the free market.

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Early Views on the Economic Role of the State

Over the centuries, various philosophers, political scientists, and, later, economists have theorized about what the role of governments, or more generally the state, should be in an economy. Their theorizing was inevitably influenced by the experiences that they had with the actual roles that governments had been playing, or had played, at times when governments had rarely been democratic.

The government roles, of course, depended on both the *intentions* of the policymakers, their views of the world, and the economic and political *reality* that the policymakers faced. That reality could prevent governments from pursuing some roles that they might have wished to pursue, but that may have been unrealistic, at those times. In those early years, the economic status of families was still largely based on traditional and largely inherited rights, and not on democratic principles or market performance.

Two centuries ago, Edmund Burke had written that: "one of the finest problems in legislature [is] to determine what the state ought to take upon itself to direct by the public wisdom and what it had to leave with as little influence as possible to individual exertion." A century later, in a lecture that he gave in Berlin, in 1926, Keynes would write that "perhaps the chief task of economists … is to distinguish … the Agenda of Government from Non-agenda, and the companion task of Politics is to devise forms of Government within" (Keynes, 1926, p. 40). The role of the state had been a long-term topic of debates, starting at least from the time of the Greek philosophers.

In the distant past, and until Adam Smith's time, *mercantilism* had been the most common policy that governments had adopted.

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The concept of mercantilism may be a bit vague to current economists, but a good description of it and of its functions can be found in Max Weber's (1923) *General Economic History*. Some detailed and broader description of the specific features of how mercantilism was applied in France in the seventeenth century can also be found in Solomon (1972). In France, in the seventeenth and much of the eighteenth century, mercantilism was promoted through government regulations. The French government imposed many and some rather unusual and extreme forms of regulations. For example, it regulated the height of buildings in Paris, the size of handkerchiefs that could be sold, and even assigned permits to beggars, permits that specified the street corner where a particular beggar could beg. Some other governments, as for example that of the Kingdom of Sardinia, specified the color in which doors of houses could be painted.

Governments regulated trade and other economic activities of individuals and enterprises. Britain followed some forms of mercantilism, as was indicated by Adam Smith, but it did it in a less rigid form than France. This difference can be seen by comparing Paris, with its architectural regularity, and London, with its lack of it.

In 1613, an economist from the then Kingdom of Naples, named Antonio Serra, published a book that provided a rather precise and detailed description of mercantilist policies related to trading activities. In his monumental *History of Economic Analysis*, Schumpeter (1954) would describe Serra's book as the very first book ever written that could claim to be an authentic *economics* book, in a modern sense, rather than just a philosophical treatise.

In Serra's time the wealth of a country was measured mainly by the quantity of gold and silver that the sovereign had available. This was the wealth that could be used for fighting wars, for supporting sovereigns, and for other national purposes. It was the kind of wealth that had made Spain rich and powerful at that time, due to the gold and silver coming from its American colonies.

In the absence of gold and silver mines in a country, or in conquered territories, such wealth could be accumulated mainly through trade, by limiting imports, through import duties and other government-imposed restrictions, while giving incentives and support to exporters. At that time payments for imports and receipts for exports were settled in gold and silver, which were the means of exchange. Therefore, the balance of payment largely determined the wealth, in gold and silver, that a country had available.

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