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Introduction

1.1 The Core of Economic Policy and Its Two Pillars: The 'Logic' and the 'Theory' of Economic Policy

This chapter provides an overview of the process through which the discipline of economic policy, to some extent autonomous from economic analysis, emerged in Scandinavian countries and the Netherlands. Such a discipline had, first, to justify (on democratic grounds) the action of a public institution after Adam Smith's statement about the virtues of competitive markets. In other words, there should have been a part of it to justify policy activity, what Federico Caffè called the 'logic' of economic policy (Caffè 1966a: 86). In addition, it should have prescribed a set of rules for consistent and effective public action. In other words, it should also have contained a 'theory' of economic policy (Tinbergen 1952: 3, again in the words of Caffè 1966a). These two branches would constitute the two 'pillars' of the discipline, to be applied to real situations of specific countries or regions according to their historical and institutional backgrounds.

This chapter briefly deals also with some factors that brought the discipline to a decline – in particular, as an effect of the destructive critique of a part of its 'core' (by moving to what we will call 'vital' objections, in addition to minor ones) – and with some recent theoretical advances that could or should contribute to its resurgence. Finally, this chapter devotes some space to how the discipline developed in Italy, as some such advances have recently appeared there.[1]

Section 1.2 offers an overview of how the discipline developed. Section 1.3 defines the exact contents of positions to resist in order to provide contents to the core, such as those of the 'invisible hand' and the 'night-watchman' state. Section 1.4 takes account of the long accumulation of elements for the definition of the logic of economic policy, beginning in the last quarter of the nineteenth century through the interwar period and after World War II. Section 1.5 deals instead with the shorter (though decades long) gestation of the theory of economic policy. Section 1.6 tries to explain why this discipline flourished in some countries of Continental Europe mainly and in Australia. Section 1.7 deals with developments of the discipline which occurred in Italy in the 1960s. Box 1.1 underlines the role of Federico Caffè in anticipating economic policy as a discipline. Section 1.8 concludes and hints at the critiques moved to its core as a possible explanation of both the limited extension and impact of the discipline outside Europe and its demise after the 1970s in most countries where it had first developed.

Subsequent chapters will continue to analyse the possible explanations, first, for the limited impact of the discipline and its setback in the 1970s and the following decades and then not only for rehabilitating the two pillars of the discipline in more recent years but also for keeping them together in a unitary discipline, the link being provided by a theory of institutions.

1.2 Overview of the Development of the Discipline

Adam Smith first suggested a theory of institutions and a role for the state, claiming that the action of individuals

[1] This chapter draws on Acocella (2017).

motivated by self-interest would ensure, as led by an 'invisible hand', some kind of social benefit, thus limiting government action to a few essential actions (Smith 1776). After Smith, in the course of the nineteenth century, a stiffer line of reasoning had developed in the economic discipline, asserting the reasons for a 'night-watchman' state (*Nachtwächterstaat*).

Over the years, the night-watchman position became an exception, as most classical and marginalist economists tended to state a number of specific or general cases, in addition to those claimed by Smith and supporters of the night-watchman argument, where government intervention was in order. All the same, until the 1930s, there were only some 'general' principles, stated mainly by Pigou, justifying microeconomic government intervention in a market economy, due to divergences between the marginal private and social net product. However, in most cases, only a set of practical rules was stated, aiming at asserting technical procedures of government intervention in the realm of microeconomics (in particular, customs policy, price controls and taxation) and banking and monetary theory. Theoretical contributions on the theory of international trade and the balance-of-payments adjustment were considered as specific parts of the economic discipline. In Italy, the analyses of Pareto's 'Manual' (1906) and Barone (1908) had left only limited (but significant, as we will see) seeds on the side of mathematical economics.

A more general setting for market failures and government intervention had to wait for a number of innovations. These were (1) the foundations of macroeconomic government intervention introduced by Michał Kalecki, Ragnar Frisch and John Maynard Keynes (pertaining to the logic of economic policy),[2] (2) a number of other developments in the 1930s, and more importantly and (3) the statement in the

[2] This does not imply an absence of any kinds of macroeconomic interventions in previous years. To be true, these were generally 'negative' (tending e.g. to balanced budgets) rather than 'active' or 'positive' actions.

1950s of the principles for coordinated and consistent policy action (the so-called theory of economic policy developed by Jan Tinbergen). Our understanding of economic policy completely changed after the above-mentioned additions. Economic policy as a discipline had a core including a complete logic of government interventions from both microeconomic and macroeconomic perspectives and a full guide for consistent and effective policy action.

Until the 1950s, public finance had a higher status than economic policy worldwide, as it had developed a theory of public goods and a conception of the role of the state, with important contributions by Italian and Scandinavian scholars (Pantaleoni 1883; De Viti De Marco 1888; Mazzola 1890; Wicksell 1896; Lindahl 1919). According to Einaudi (1934), Italian economists' contributions made it possible for public finance to acquire a scientific status. A similar appreciation came later by Musgrave and Peacock (1958) and Buchanan (1960). Scandinavian contributions were well known in other countries, as Lindahl (1919) was originally published in German and soon reviewed in an English-speaking journal (Peck 1921).

A subject such as macroeconomic analysis and policy barely existed, as these only started with Kalecki's (1933)[3] and Keynes' (1936) contributions, which, however, were not easily accepted in Italy and some other European countries. In the 1930s and following decades, further essential theoretical seeds were added, partly following the emergence of new pressing practical requirements. On the side of the logic for government intervention in market economies, a debate began involving some leading economists of the time. This concerned the principles of government intervention, the

An exception was interventions of the Bank of England reacting to deficits of the UK balance of payments.

3 Kalecki's contributions remained practically unknown in Western countries, at least until 1935, when they appeared in *Econometrica* and *Revue d'Economie Politique* (see Kalecki 1935a, 1935b).

role of distributive considerations vis-à-vis those of efficiency, the need for effective or potential compensation and the possibility of taking both efficiency and distributional aspects into consideration in order to maximise a society's economic welfare starting from individual preferences. The concept of macroeconomic market failures also emerged in addition to the microeconomic ones already stated by Sidgwick, Marshall, Pigou and others. On the other side, the possibility of empirical testing of theoretical propositions as a consequence of the birth of econometrics offered the opportunity to take into account the multiple interrelations that exist in an economic system for coordinating government interventions directed at a set of different targets.

These advances made it possible for an autonomous discipline to finally sprout in Scandinavian countries and the Netherlands in the 1950s. The geographical location of the fathers of the discipline was the product of a number of circumstances: not only the political trends and social substrate prevailing in those countries but also their full participation in – or even anticipation of – the wave of theoretical innovations that had produced the slow but steady developments of the essential seeds of the discipline. Italy had been rather isolated from such developments – at least those in which we are interested – during the Fascist phase, but in the 1950s it was ready to import theoretical advances from abroad as a result of the concurrence of specific circumstances rather different, however, from those operating in Scandinavian countries and the Netherlands. Starting late did not prevent theorists in this country from soon borrowing the new discipline in the early 1960s. Moreover, they offered – in the years after 2005, together with other theorists well trained in the original, classical theory – possibly decisive advances for its re-emergence, after a long decline starting in the 1970s, as an effect of what seemed to be a fatal critique of part of its core, i.e. the theory of economic policy.

1.3 The 'Invisible Hand' and the 'Night-Watchman' State

Obviously, economic policy as a discipline could not have emerged in the absence of a diffuse position of economists in favour of state intervention to correct or substitute markets. The birth of the economic science – if we date it back to Adam Smith – was characterised by a position opposed to such a wide involvement of the state in economic and social activity.[4] This was expressed by the founder of the discipline and can be indicated synthetically by the term 'invisible hand' to refer to the unintended social benefits accruing from the actions of individuals pursuing their personal interest in a market.

The term was first employed by Smith with respect to income distribution in his *The Theory of Moral Sentiments* (Smith 1759). Here he claims that increased wealth of the rich 'trickles down' to the poor (a concept also used after World War II in the theory of development to sustain a line of action of the World Bank). Use of the term with reference to production is made in *The Wealth of Nations* (Smith 1776). The exact expression – but not the concept that it encapsulates – is used just three times in

[4] In doing this we are conscious that, in giving primacy to the birth of economic policy vis-à-vis economic analysis, positions such as bullionism and neomercantilism were common before Smith. These had developed arguments in favour of state intervention and studied proper policies to this end. Our historical account of the development of the different economic disciplines within economic science would change if we dated their birth back to other periods or authors before Smith. We think we are justified in our choice for two reasons. On the one side, Smith is usually believed to be the founder of the discipline of economic analysis. On the other, we would anchor – whenever possible and being conscious of a number of cases where this is not true – the development of economic disciplines with economic history. Bullionism and neomercantilism are typical of periods of very active state intervention, whereas Smith marks the triumph of a free-trade attitude and capitalism. On the links between the evolution of economic ideas and economic reality, see e.g. Screpanti and Zamagni (1989).

Smith's writings. The concept might have been borrowed from Richard Cantillon, who developed both economic applications (Cantillon 1755).

We are conscious that the prevailing interpretation of the meaning of Smith's 'invisible hand', as a naive idea of Smith's fully pro-market position, is unfounded in his works. This interpretation has been criticised by a number of authors (e.g. Grampp 2000; Rothschild 2001; Roncaglia 2005; Marglin 2008). These critiques refer, first, to the inappropriateness of the use of the term 'invisible hand'. This with respect to either the letter of Smith's work (particularly in *The Wealth of Nations*) or the context where Smith makes use of this term to argue in favour of the virtues of the market (typical is the case of the home bias in Smith 1776: book IV, chap. 2). Moreover, according to these critiques, the term is not fully representative of Smith's thought. From a substantive point of view, undoubtedly Smith gives a positive assessment of the market, whose operation – in his opinion – usually tends to pursue the public good in a number of ways, especially by favouring the division of labour. However, he also believes that governments play an important role not only in defence but also in fields that can be labelled as being more directly relevant to economic activity, such as infrastructure and education. In any case, for the sake of brevity, we will use the term 'invisible hand' as a metaphor of the Smithian position as well as of later theories, in particular, neoclassical thinking, that have then prevailed, even if the latter are deprived of some social aspects of the working of the market that certainly were in the work of Adam Smith.

The 'night-watchman' position is advocacy of a minimal role for the state, which should be limited to ensuring defence of the members of a community from external assault and internal violence, theft, breach of contract and fraud. This position is also called 'minarchism', a form of libertarianism, as it advocates for the state only the minimal protection needed to avoid chaos. This is indeed different from 'anarchy', which, apart from its many possible interpretations, we intend in essence as a community which is governed by members basing their action on 'we rationality' (with a *homo reciprocans*), where then a true state becomes useless, as cooperative behaviour arises and conflicts tend to disappear (see e.g. Smerilli 2007).

This position was inaugurated by Bastiat (1850) and Spencer (1850) and was later resumed by Pareto's *Cours d'Economie Politique* (Pareto 1896–97), leading more recently to the economic and philosophical schools of evolutionists such as Hayek (1960) and Nozick (1974) and contractualists such as Buchanan (1975) and Tullock (1976). In Italy, the 'minimal state' doctrine had a number of followers, starting with Ferrara (e.g. 1859) and, as already mentioned, Pareto.

The rationales for the night-watchman position may be numerous: defence of power relations, protection from the pressure of lobbies and parties, an attempt to reconcile laissez-faire with democracy, moral limitations on the use of state force and belief in the superior performance of institutions based on a market economy, with few external constraints. The practical issues behind some of these positions and the different arguments put forward in support of some minimal state doctrines are reconstructed by Romani (2015). According to Screpanti and Zamagni (1989: chap. 11), the post–World War II contributions having this same orientation can be considered as reappraisals of Smith's project in favour of a minimal state as a consequence of comparing different institutions. After World War II this orientation reacted, on the one hand, to the negative experience of planned economies and, on the other, to the tendency of welfare economics to confine analysis of institutions to that branch of the economic discipline and in terms of efficiency only.