EXCHANGE AND AUTHORITY: THE MIXED ECONOMY

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ABSTRACT

Economics tends to concentrate on the market while politics is the study of governance and of leadership. The real world does not divide neatly along the lines that mark out the disciplines. The mixed economy, partly free enterprise and partly State management, is a case in point where trespass and synthesis are essential if an important real-world phenomenon is to be understood and, where appropriate, re-shaped. This paper seeks to map out the mixed economy. It strives in that way to provide a framework for discourse that clarifies the choices open to public policy.

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Political economy is about market *and* State. It is about exchange *and* authority, effective demand *and* social values. It is about contract *and* command, initiatives bottom-up *and* directives top-down. It is the study of the managed and the mixed economy. The most important concept in political economy is the *and*. Without the *and* there can be no political economy.

Economics is the study of the production, consumption, distribution and exchange of scarce goods and services where opportunity costs exist and marginal choices impact upon the maximum welfare that can be squeezed from a given input endowment. Its theoretical tools include the demand curve, the supply schedule, the production function, consumer and producer surplus, fixed and variable cost, the national product, the savings-income relationship, the investment multiplier, the interest-elasticity of money balances and the box diagram in the sense of Edgeworth that confirms the general equilibrium in the sense of Pareto that relies upon the price *tâtonnement* in the sense of Walras. Political economy is quick to make use of theoretical tools such as these which enable investigators to identify the *what is* of resource allocation with a view to the *what ought to be* of efficient deployment. What differentiates political economy from economics is that it incorporates the theoretical tools and then adds in the *and* that is something more: the rules and agreements that allow discrete individuals to live together peacefully in communities.

Sometimes the standards will be enforced by social pressures and informal sanctions. There can be order even in anarchy. Sometimes the compromise will require a governor from above. Chaos can result where there is no shepherd to guide the sheep. Sometimes the rules will be as diffuse as collective conventions, interpersonal and inter-temporal. Sometimes the constraints will be as much a manufacture as the division of labour that puts the leadership in charge. Always, however, the normative guidelines are the essence of political economy. The market defuses tensions by enabling the butcher and the brewer each to satisfy the other's revealed preferences. Rules and agreements settle disputes differently where the factored-down deal is believed not to be productive of the commonly-optimal endstate. Political economy is the study of exchange but also the study of authority when exchange falls short. Its central focus, in other words, is on the *and*.

This paper does not seek to trace back the etymology of political economy to the Greeks or to compare the kaleidoscopic meanings that have been assigned to it over time, from public administration in the sense of Mirabeau or the Cameralists to the anatomy of bourgeois society in the sense of Marx and the rational choice of policy-makers in the sense of Chicago and Virginia (Groenewegen, 1987). Taking the term today to mean exchange *and* authority, man not *versus* but *together with* the State, the paper sets out simply to clarify the meaning and scope of the theory of the mix. Its aim is to identify the contours and to map the roads that link up the double realm. Market and State may be substitutes but they are also fellow travellers. The cross-breed is already there. This paper, arriving *post festum*, tries to describe what everyone but the textbook neoclassicals and the island university departments knows to be the way that we today get things done.

The first section of the paper considers the *why*. It is entitled Market Failure. The second to the sixth sections deal with *how to*. They explore the various forms of collective intervention that are demanded and supplied when the gains from trade fall short. The final section, Government Failure, shows that countervailing power can veil and not merely counter the great social ills of waste, inequity and depredation. The essay concludes with an endorsement of an academic sub-discipline that builds its home defiantly upon the *and*. Ideologists begin at the end with first principles, *nostrums* and templates that require no real adaptation. Scientists have to make their own way by the light of their critical intelligence. Life is tough on the middle ground. But that's the way it is.

1. MARKET FAILURE

The basepoint is automaticity, gravity, homeostasis and decentralisation as if guided by an invisible hand with a strong commitment to the wealth of nations – and of households: 'Every individual is continually exerting himself to find out the most advantageous employment for whatever capital he can command. It is his own advantage, indeed, and not that of the society which he has in view. But the study of his own advantage naturally, or rather necessarily leads him to prefer that employment which is most advantageous to the society.' (Smith 1776, I, 475). Adam Smith, writing when the industrial revolution was poised to liberate British capitalism from feudal traditionalism and mercantilist restriction alike, was in favour of supply and demand because they transformed private vices into public virtues. He was much less confident about the economic consequences of self-abnegation, self-declared: 'I have never known much good done by those who affected to trade for the public good.' (Smith 1776, I, 478).

Adam Smith's theory is one of private selfishness converted into general affluence. Each self-interested gain-seeker must satisfy his customer in order himself to pocket his profit. It is with a view to his customer's utility and not to his own priorities that the seller sets the *what*, the *how much*, the *for whom*, that he selects the opening-hours most likely to maximise his throughput, that he cost-benefits the technology that will keep down his average cost. His motives are blinkered and self-regarding. The consequentialism more than compensates for the deontology. The outcome, unintended though it is, is the buyer's first-ranked commodity supplied at a price made competitive by competition. No one can take issue with that.

The baseline is finely-targeted choice and the freely-negotiated swap. The problem is that the market itself sometimes fails to live up to its own high expectations. Bounded rationality, sunk overheads and path-dependence make price-signalling backward-looking, strong on self-perpetuation but resistant to the new. Information impactedness and asymmetrical expertise can mean the concealment of house secrets concerning the life-expectancy and track record of a good or service. The framing bias, the endowment ratchet, the salience of the well-publicised can cause fixed bygones to be over-computed, low probabilities to be exaggerated, reference-points to be rubber-stamped. Product differentiation, brand name, manipulated loyalty, the knee-jerk repeat purchase that is the greatest of the first-mover advantages can mean that consumers will not prudently shop around in pursuit of the highest-attainable value for money. The behavioural stake of business bureaucrats not in maximum profits but in job-satisfaction, security and expansion closely resembles the organisational goals of State-sector bureaucrats to whom the entrepreneurially-minded are reluctant to look for 'creative destruction'. Closed-shop trade unions, professional cartels, giant corporations with entry-barrier economies of scale, accommodating oligopolies which put collusion above rivalry, all undermine confidence in the textbook account of economic optimality through the price-taking auction. None of this suggests that real-world markets typically fail. Still less does it imply that State-planned enterprise will typically out-perform the private-sector alternative in the way that the resigned older Schumpeter anticipated once the Weberians had pushed the Mengerians into the history of thought (Schumpeter 1942, 196). What it does mean is that the real-world outcomes are not precisely those that the pure Smithian ideal would lead the economic neoclassical to predict. Political economy must compare the real with the real. There is no point in comparing the real with the ideal, the ideal with the real, in a best-possible vacuum world that is not our own.

To say that the market sometimes fails to live up to its own high expectations is not the same as to say that the market typically fails to reach an acceptable threshold. Nor does the fact of a shortfall prove that politicians and civil servants would necessarily improve on the palpable second-bests that are delivered by households and firms who are unable to match the full flowering of the confident textbook's 'let us assume'. The alternative to the market sector's second-best could well be the public sector's third-best or fourth-best or even no best at all. It need not be the perfection of the faultless first-best which is common in Paradise and signally less common on Earth. Sometimes, however, there will be a strong conviction that *laissez-faire* has let the side down – and that the only salvation therefore lies in the State. Prominent among the areas of social life in which private individuals cannot bargain and buy their own solutions are more likely than not to be the following.

2. NATIONAL DEFENCE

Samuelson defines a public good as a stream of service 'which all enjoy in common in the sense that each individual's consumption of such a good leads to no subtraction from any other individual's consumption' (Samuelson 1954, 387). Defence by that standard would appear to be the ultimate public good. Non-rivalrous since ego's absorption does not imperil alter's access, non-exhaustible since one individual's protection leaves as much and as good for his fellows, non-excludable since the transaction cost of depriving the tax-averse of the umbrella would be prohibitive, defence is a commodity which profit-seeking capitalists are not in a position to seal in priced packets and sell for a user-charge. Assuming that the nation is in broad agreement on the need for this public good, there would seem then to be no alternative but to make it a publicly-contracted good and for the State sector to accept by default the warrior-role that no one else wants.

Public funding has an intuitive appeal where the technology does not exist to meter citizens for the guns, the bombs and the border-guards that are their share in the survival of their homeland, their kith and kin. Public provision is more controversial. Given that military hardware has long been bought in from private factories and that even superpower armies are successfully comprised of non-conscript professionals, it might make economic sense for competing businesses to tender for a fixed-term franchise in the whole of the national shield. Career mercenaries will have more hands-on experience and more of the killer instinct than will reluctant short-timers whose comparative advantage might better serve the public interest if channelled into the next-best foregone. Besides that, the very fact of competition itself would suggest to the free-market economist that value for money is more likely to be squeezed out of a given budget if there is sequential tendering than if a single supplier is promised the tenured say. Even the Royal Air Force or the United States Marines cannot reasonably expect to contract out of the search for efficiency which in the capitalist economy means choice between rival hawkers and not the *fiat* monopoly of the ministry that knows best.

Just as there is an argument for enterprise, however, so there is a case for collectivisation. The money-motivated are less willing than are the patriotic to lay down their lives for the unnamed others who share their blood and soil. The money-motivated are more likely to be led by an invisible hand to re-sell their allegiance to an enemy aggressor if the price is right. Applying the unsentimental test of means-ends expediency, the quality of the product may well be inferior where defence is supplied through joint-stock companies and not by the State. Nationhood in any case is a mix of duties and emotions which is a thing apart from the departmental store in its summer sale. Nationhood is history and tradition, belonging and integration. Nationhood is the

German contra-cosmopolitan conservatism that situated the acculturated individual in his *Blut und Boden* and the English historical economics that inspired Cliffe Leslie to embed his *homo economicus* in 'a community one in blood, property, thought, moral responsibility, and manner of life' (Cliffe Leslie 1879, 230). Nationhood is the *Passport to Pimlico* that makes us fight them on the beaches because here is our home. Nationhood is more than a freely-negotiated swap.

Persuasive as it is, the demand for nationalisation on the grounds of nationhood is also profoundly unsettling. It makes the non-rational and the non-marginal the precondition for a society built around the primacy of utility and the independence of the individual. The principle conceded for defence, there is no reason why workers should not be expected to donate gratuitous shifts for national growth or accept that the euthanasia of the elderly is the way in which a body politick that lives as one concentrates its finite medical resources on those team-mates still able to score goals for the side. Nationalisation on the grounds of nationhood can be profoundly unsettling. Nationalisation on the grounds of market failure is, on the other hand, a plausible defence in a political economy that does not want to be stranded without stock.

3. LAW AND ORDER

Thomas Hobbes in the *Leviathan* in 1651 warned that human life in the state of nature would be 'solitary, poor, nasty, brutish, and short' (Hobbes 1651, 82). The Hobbesian vision is of a jungle red in tooth and claw. It is not the economist's utopia of the butcher, the brewer and the baker peaceably bargaining contracts that raise each other's satisfaction-levels, self-perceived.

Rules are needed; but that need not mean the State. People socialised into the norms and customs of a common culture fit in with tried-and-tested practices both because they do not want to be excluded from sociability and contact and because they fear the prick of conscience where they snatch quick gains and defect from alliances: 'Our continual observations upon the conduct of others, insensibly lead us to form to ourselves certain general rules concerning what is fit and proper either to be done or to be avoided.' (Smith 1759, 159). Also, individuals are normally situated in networks of kinship and friendship, proven trustworthiness and reputation for service: a good name is a commercial asset which the supplier and the demander have an economic incentive to keep in good repair. Internalised images and self-policing self-restraint are all around. Perhaps this is just as well since the paid enforcers will never be. As Fred Hirsch puts it: 'Only *I* can see everywhere I litter.' (Hirsch 1977, 139).

Social validation is vital: even acquisitive non-satiety, consumer sovereignty, the law of contract, the market mechanism itself, only enjoy perceived legitimacy because there is general consensus in the peer-group that they are somehow a part of a valued way of life. Consensus is the *sine qua non*. It is not, however, necessarily sufficient in itself. People violate even God's own Commandments where the bribe is judged to exceed the penalty. Economic logic is a high-powered thing.

Olson extends the pure theory of perfect competition to the microeconomics of avoidance, evasion, abstention and temptation. He establishes that there is a personal incentive to be a free rider on the Good Samaritanship of the non-calculating where the size of the group is large and the impact of each hidden member minimal: 'The rational individual in the economic system does not curtail his spending to prevent inflation…. because he knows, first, that his own efforts would not have a noticeable effect, and second, that he would get the benefits of any price stability that others achieved in any case.' (Olson 1965, 166). Large groups are always and everywhere a tiger in the path. Not only is there the Olson-like fallacy of composition, there is also the anonymity and the invisibility that Durkheim defined to be the world-class university of *anomie* or normlessness. Only a part of economic interaction is situated in a skein of recurrent contacts and familiar faces. Where the trade is one-off and the partners are unlikely to meet again, there is little need to invest in a social capital that will never have the occasion to pay back an economic return.

In such circumstances there is a social failure and citizens turn to the State for the policemen and the law-courts that are the bulwark against the beggar-my-neighbour nihilism of force and fraud. Whether a social failure is also a market failure is a good deal more debatable. Protection can be privatised by means of locks, alarms, bars and guards: while it may be cheaper to depend on the government than it is to buy a dog, that argument is not so much a demonstration that shopping lets the nation down as it is a reaffirmation that the pecuniary trade-off is a high-powered thing. Housing estates, shopping precincts and city parks can be made into private businesses on the model of the lighthouse-capitalists who once threatened non-paying harbour-masters with the darkness that would drive rational shipowners to competing ports: no one would buy, rent or visit if the proprietor who owned the titles were unprepared to ensure adequate security for person and property. Binding arbitration can take the place of generalist adjudication: where the division of labour puts a premium on specialist knowledge, there is much to be said for recourse by consent to a trusted insider personally skilled in the trade. The lesson that must be drawn from myriad possibilities such as these is a simple one. The market cannot be said to have failed until it has been given the chance to succeed.

4. THE INFRASTRUCTURE

National defence and law and order are public goods, available to all if they are accessible to any. They are not the only goods said to have evaded the confines of supply and demand. The infrastructure of background facilities is an area of social life where ticketing of access is believed to be especially costly and unsatisfying. Where the State does not supply the street-lighting, it is argued, the pedestrian will have no option but to walk home in the dark.

Urban roads, historically speaking, have been a convincing case of a public good for which rationing by price would not be practical because of the transaction costs of toll-booths, administration and delay. Technologies evolve, however; and electronic beacons undeniably fill a market gap. One could say that the lump-sum incidence, regressive, falls more heavily on the poor than on the rich. One could say that road-owning profit-seekers will do what their monopoly of necessity would suggest and hold out for all that the traffic will bear. Equity in the former case, exploitation in the latter, one could conclude that the road-industry would better serve the social purpose if it were run by the State than if it handed over to trade. In drawing that inference, however, what one would really be saying is that urban roads ought ideally to be supplied as publicly-*provided* goods. One would not be proving that they are ideal-typical *public* goods which for market capitalism will have little economic appeal.

Education and health further illustrate the way in which the supporting infrastructure can be regarded as a public good. Education and health are often treated as 'merit goods', wants 'considered so meritorious that their satisfaction is provided for through the public budget, over and above what is provided for by private buyers' (Musgrave, 1959:13). Paternalism is built into the notion that an agency other than the individual himself is believed to have the information needed to decide what is in the individual's own best interest: where the citizen would feel better off in his own estimation if given equivalent cash rather than a free-on-demand service, it must require exceptional skill as a persuader to convince him that he will reverse his ordering *ex post* once he has sampled the merit consumable and yielded to his addiction. Crucially, however, merit goods will also be public goods in the dual sense that the community derives utility from the knowledge that it has uplifted the beneficiary and from the fact that a subsidised spillover has upgraded the neighbourhood. The nation needs schooling so as to expand the pool of skilled manpower essential for our export-drive. The nation needs immunisation because infectious diseases have a tendency to spread. The benefits accrue to *us* and not only to *them*. Privatisation would crowd out the State where ambitious parents paid for their own children's training and health-conscious smokers converted to an apple a day. Under-consumption, however, would be the result where discrete individuals saw no reason to shoulder the full burden of the cost. Under-consumption, T.H. Marshall writes, is not merely the free citizen's personal choice: 'Your body is part of the national capital, and must be looked after.' (Marshall 1965, 91). Wanting the well-being, the State would then have no alternative but to get involved in supply.

Infrastructure is provided by the State where the businesses lack the incentive and the households lack the drive. Infrastructure is also provided by the State on the grounds that natural monopoly makes it risky for the goods and services to be delegated to exchange. Increasing returns and a forward-falling supply curve are major barriers to new entry. High fixed but low marginal cost means that the incumbent can be in a strong position to take full advantage of an inelastic demand curve without the fear that its windfall will be contested by interlopers. This is an important reason why public utilities like water-supply, telecommunications, rail transport and the electricity grid have so frequently been nationalised in order to be operated as State-owned corporations accountable directly to the scrutiny of Parliament.

5. REGULATION

A nation that does not want to buy out private property-rights still has the opportunity to influence the use that is made of those socially-validated licenses and permits.

Situated between unalloyed socialism and unbridled business is the compromise of regulation that steers the ship along the required course.

Thus a nation that is concerned about natural monopoly might retain private ownership but set up a commission to supervise the price. Its task will not be an easy one. Where marginal cost is less than average cost, the perfectly-competitive standard of P=MC will involve the State in subsidising the loss. Where the regulator opts for P=AC, the mechanistic mark-up will always be a disincentive to cost-minimisation since the only reward will be a cut in price. Regulatory capture converts society's watchdogs after an acclimatisation-period into a lobby for the industry they are in place to keep in check. All things considered, Milton Friedman writes, the cure might actually be worse than the disease: 'I reluctantly conclude that, if tolerable, private monopoly may be the least of the evils.' (Friedman 1962, 28). Political economy, here as elsewhere, retains the vital brief of weighing the gains against the losses that the different policy-options will occasion.

Regulation can also be deployed to limit what the Sherman Act of 1890 calls the 'conspiracy in restraint of trade'. Laws can outlaw formal cartels and tacit follow-the-leader arrangements that fix prices or apportion quotas in such a way as to maximise the profits of an oligopoly colluding *de facto* into a single-seller monolith. Laws can prohibit mergers intended to consolidate market dominance, ban predatory under-cutting and exclusionary long contracts, prohibit pernicious product-tying and resale price maintenance. Laws can break up a giant firm into a multiplicity of viable competitors, shorten a patent to facilitate the challenge of generics, ensure an open road through the 'common carrier' principle of universal access. Such legislation, precisely like the repeal of a tariff, is pro-competitive and not anti-competitive. Regulation here helps the free market to become more fully itself.

Regulation can, of course, be overtly anti-competitive as well. The minimum wage arguably reduces job-openings for new entrants and the sub-proletarian unskilled but it also ensures a decent standard of living for the sweatshop poor in work. Rent controls arguably reduce the number of housing units available to let but they also meet the community's requirement that long tenancy must create a moral right to one's home. Maternity leave, on-the-job training, health and safety minima – all of this comes under the rubric of intervention implemented not so much to improve productivity and accelerate growth as to put teeth into the perception that there is more to fairness than is picked up by the economist's equation of the willingness to pay with the willingness to sell. As the intensely *political* economist Tawney once put it: 'The mother of liberty has, in fact, been law.' (Tawney 1949, 169). Hobhouse, and still earlier Green, had been there before when he wrote that the new liberalism of freedom *to* had to be not the Gladstonian repeal of directives that crush out the spirit but rather an empowering hand up that made for 'the fuller liberty of the life of the mind': 'The function of State coercion is to override individual coercion.' (Hobhouse 1911, 203,71). The function of State coercion is to enable each of us to be free.

Regulation can be macroeconomic as well as microeconomic. Determined to contain inflation or to defeat involuntary unemployment, the State might turn to monetary and fiscal policy to restore the balance between demand and supply. Anxious about the haphazard outcomes and the confrontational divisiveness of collective bargaining, the State might set up a tripartite commission to bring indicative planning to the settlement of wages. Convinced that free-market exchange rates destabilise business plans and import rising prices, the State might peg the international parity and use its currency reserves to lean against the prevailing winds. There is much that can be achieved where the State has good statistics on cause and effect, leads and lags, knock-ons and surprises. There is somewhat less that can be achieved where the future keeps its own counsel and unknowledge is the only certainty. A constitutional clause to fix the money-supply or to prohibit a budget deficit might in such circumstances more successfully smooth out the fluctuations in economic activity than would discretionary fine-tuning stumbling about in the dark. It is possible in addition that much of macroeconomic imbalance is the consequence of law-making itself and not *prima facie* the proof that the market has failed. Unemployment benefits which calm the worried mind and stabilise the level of total demand but also extend artificially the uneconomic slack of frictional job-search may be a case in point.

Individuals in a downturn respond rationally to the spectre of redundancy through an increase in their savings. What one can do, all cannot; since it is the paradox of thrift that an across-the-board fall in consumption would only make the feared recession that much worse. In macroeconomics and in microeconomics alike, the problem of dispersion and numbers is a major obstacle to the attainment even of a goal on which there is unanimity of consensus. Here too, however, the leaderly State can still succeed where unorchestrated spontaneity must fail. It can coordinate the moves and responses even of the autonomous and the ununited. A will save if all will save: the State makes saving mandatory. B will vote if all will vote: the State makes voting compulsory. Legislation in such circumstances leads directly to cooperation whereas decision-making in isolation will mean the dominance of a sub-optimal strategy. Yet it would be wrong prematurely to write off the invisible hand. Education for women and promotion in line with productivity raise the opportunity cost of a large family: it is the functional equivalent of a 'Stop at One' edict. The privatisation of public property causes the commons-capitalist to ration grazing-rights in such a way as to prevent the minus-sum depletion of the pasturage: it is the functional equivalent of a quota on the sheep. Coercion can contribute to the establishment of the highest-valued outcome. So, however, can commerce itself.

The State can impose order where the interests are the same: seasonal adjustment in the clocks and a directive on left-hand driving are illustrations of rules from which all members of the community stand to reap a welfare gain. The State can also impose order where the interests are in conflict. Externalities and spillovers are an illustration of the challenge. The smoking chimney means more medical bills and more laundry bills. The draining of a swamp means less malaria and less absenteeism. The former an over-supplied cost, the latter an under-provided benefit, it is often argued that the market will fail to allocate scarce resources with maximal efficiency in the absence of a wise and regulatory State.

Prescription is one way of dealing with the side-effects of other people's contracts. It is the reason why the State decrees ceiling-limits on CO_2 emissions and pesticide residues. The State prohibits the dumping of radioactive waste in a local stream. It places preservation orders on historic buildings. It zones to exclude noisy factories from green-belt beauty spots. It compels all catering staff to undergo regular health checks and demands that all production-lines be fitted out with goggles and visors. Legislation, in short, is given a prescriptive role. It takes on the duty of ensuring that third parties and innocent bystanders are not made the victims of omission and commission occurring in the course of self-interested supply and demand.

Prescription is a command strategy; but that is not to say that it cannot be made compatible with exchange. It would be a useful compromise for the regulatory State first to re-design the incentive structure and then to rely upon market pricing to put subjective values upon the new set of rules.

One illustration of the compromise would be the sale by auction of licenses to congest, deplete or pollute. Here the State determines the allowable maximum of the agreed-upon diswelfare but leaves it to the private sector to allocate the entitlements in line with the willingness to pay. A dynamic outcome of the creation of a market in the right to despoil could be the adoption of less-polluting technology in an attempt to keep down the overhead of consent.

Another illustration of the compromise would be the internalisation of the externalities. Pigou observed that there could be a disparity between the private and the social calculus. Social costs exceed private costs in the case of driving while drunk: the motorist puts at risk not just his own life but the lives of others as well. Social benefits exceed private benefits in the case of education and training: the profit-seeker will rationally under-invest so long as the skills that he develops can move sideways to a rival. Concerned about an equilibrium that was not, unassisted, an optimum, Pigou therefore recommended taxes on bad neighbours (‘uncharged disservices’), subsidies for spillover benefactors (‘uncompensated services’), in such a way as to bring into line the net private and the net social cost-benefit relationship. (Pigou 1932, 191). What Pigou did not explain was how the relevant states of personal well-being – as perceptual as the nuisance value of ugliness, as objective as lives made shorter by lead in petrol – were actually to be measured in a real world where data is deficient. Nor did Pigou recognise the extent to which different people might have different preferences: if A is opposed to noxious effluent that threatens his enjoyment of swimming and fishing, then B is opposed to the loss of employment-opportunities which a cleaner environment would cost. Ronald Coase, sensitive to the information-gap and to the ordinal and cardinal disparities, is happy to treat Pigou on regulation as ‘blackboard economics’ that passes the time. Still, however, it is his conclusion that there is no way to convert fiscal socialism into practical policy in a real-world context where knowledge is the ultimate scarce commodity: ‘Such tax proposals are the stuff that dreams are made of.’ (Coase 1988, 85).

Coase, sensitive to the difficulties, is in favour not of State regulation but rather the privatisation of the choice. The proprietors of a new airport would have to offer compensation sufficient to buy in the agreement of the afflicted. The manufacturers of a wonder-drug would know that insufficient testing would be penalised by a class-action in the courts. The transaction costs of uniting a dispersed pool are admittedly high; and redress by law-suit is in itself an expensive road to travel. Focusing on the benefits, however, it is Coase's contention that revealed preference and voluntary exchange have the advantage that they leave each individual the best judge of his own personal welfare. No government, however democratic, could be more in tune with the unique one-off than that.

Thus a doctor losing clients because of a noisy confectioner next door could offer to buy out some or all of the manufacturer's rights to the pursuit of an honest income (Coase 1960). A bee-keeper dependent on an adjacent orchard for the nectar from which his honey is made could contract with the orchard-owner to supply bees for pollination in exchange for apple-trees for blossoms (Meade 1952; Cheung 1973). Horizontal integration would ensure that marginal cost and marginal revenue were made equal for each of the component lines, the joint products. Coase's message, that rights (irrespective of the original endowment) are better traded by individuals than sequestrated by their leaders, is not a new one. Workers have long been taking a view on the value of life that is right for them by negotiating a danger-differential for deep-sea diving and building at heights. Consumers have long been operationalising their trade-off of money for injury by travelling cheaply in unlicensed taxis and playing sports which carry a small but non-negligible risk of paralysis or death. Coase would suggest that regulation should not be so intrusive as to deprive the individual of the freedom to make choices such as these. In Hillman's words: 'We can think of externalities as reflecting missing markets… Private ownership can rescue a society from the tragedy of the commons.' (Hillman 2003, 233).

Yet the social interest cannot always be entrusted to dyadic reciprocation alone. A is willing to chance his money in a bank that makes speculative investments – but the failure of the deposit-taker has ripples that go beyond its own sub-set of risk-loving customers. B is unafraid that he will be depraved and corrupted when he watches a violent film – but the position is different when the under-age and the impressionable are attracted into copy-cat crime. Social values are hostile to vote-selling even in elections where the citizen has no personal preference. Social values are unsympathetic to child labour even if the families denied the wages go hungry as a result. Directives to favour disadvantaged minorities, restrictions to censor inflammatory racism, are, no doubt, non-price constraints on the sovereign consumer's valued freedom to shop. Social values, however, have other ends besides efficiency; and so do philosopher-rulers in the sense of Plato who, omniscient and beneficent, have the wisdom to recognise a hidden need. Whether leading the consensus or following it, what is clear is that there can be State regulation that goes beyond the minimal scenario of good title protected and enforced.

6. WELFARE

Economic theory concentrates on the choices made within the tramlines of effective demand. It has little to say about the felt utility of would-be maximisers who lack the money to pay. Political economy, in contrast, takes on board the distress of the deprived and the excluded when they cannot reach the social or even the physical minimum.

Some people fall into dependency as a life-style choice: illustrations would include irresponsible parenting in excess of resources, self-selected unemployment as an alternative to work, self-inflicted incapacity brought on by drug addiction and live-for-today promiscuity. Other people become dependent on others through no fault of their own: where a job simply cannot be found, where a dread disease has exhausted the family's capital, where a businessman loses his home because the bailiffs foreclose on his loan, where an old person who has outlived his savings cannot afford to keep warm in the cold, there it is more difficult to say that the undeserving poor have only themselves to blame for their distress. It is in any case too late to reverse the causality when a neglected child is dressed in rags and a driver who did not wear a seatbelt lies bleeding in the wreckage by the road. Bygones are forever bygone and we start from here. One consequence is that the safety net of the friend in need is always and everywhere vulnerable to the blackmailer who seeks to travel free on the compassion of the committed, the unquestioning and the generous. There is a lot of ruin in a *Gemeinschaft*.

Ex post the only alternative to assistance is for the community to refuse to get involved. *Ex ante* a welfare-minded State has more discretion in proposing measures that will nip the vicious cycle in the bud. Macroeconomic policies that ensure full employment invest in self-respect by guaranteeing the self-reliant the chance to earn and achieve. Lifetime retraining schemes and minimum entry-barriers keep down the structural unemployment that separates one pay-cheque from the next. Compulsory savings-plans force even the less frugal to defer gratification into their retirement years. Compulsory health-insurance gives each citizen a premium-based entitlement that serves as a cushion against the vicissitudes of accident and illness. *Ex ante* prevention must, in short, be regarded as fulfilling the same function as *ex post* relief. Picking up the pieces is welfare after the storm. A stitch in time is a humane alternative that reduces the incidence of shattered lives.

Yet there will always be contingencies for which generalised home-ownership and universal free education will not be the safety-net that breaks the fall. It is in the circumstances of just such a welfare vacuum that there will be a voiced demand for a welfare State. Theorists of self-interest will defend the multi-period constitutional shield on the grounds of the thick veil of ignorance that conceals what the future has in store and makes each anxious risk-averter a leveller and an insurer out of fear: 'Social and economic inequalities are to be arranged so that they are…. to the greatest benefit of the least advantaged.' (Rawls 1972, 302). Theorists of sharing and altruism will defend the payment of benefits in cash and kind on the basis of empathy, sympathy, the 'biological need to help' (Titmuss 1973, 223) and the observed fact confirmed by blood-donation that the integrated members of the national family care passionately even about fellow-beings whom they will never meet: 'To "love" themselves they recognized the need to "love" strangers.' (Titmuss 1973, 269: Reisman 2005, 291-4). Private charity is unpredictable and subject to under-subscription by virtue of the public-goods problem of insignificance in a crowd. It can also be shaming, stigmatising and judgmental, felt to be an unwelcome intrusion into private grief at the very time when the self-image is most under threat. Thus it is that people, some driven by anxiety into compulsive maximin, others encouraged by kind-heartedness to obey the Golden Rule, turn to the State for the actualisation of their welfare rights.

7. GOVERNMENT FAILURE

Economics, formulating its theories in the language of market exchange and not the discipline of the barracks, is nonetheless open to political tinkering where supply and demand are believed to have fallen short of the attainable potential. The two-stage approach has a bias that is reminiscent of religion. When man fails, he turns to God. God is omniscient and benevolent. God is our refuge of last resort. God will never let us down.

In God we trust. The State, however, need not be as reliable or as self-denying an ally. Just as there can be market failure, so there can be government failure. The most that can be said *a priori* is that the sensible community will select the tool most likely to deliver the desired end. It may or may not be the market. It may or may not be the State.

Uncertainty and ignorance can leave the social engineer without a tried-and-tested plan. The market is a discovery process, a graveyard of experiments and bankruptcies even as it is a playing-field in which luck, intuition, judgement and competence can score the winning goals. Without the market's signals the State will often lack essential information on the nature and strength of consumers' wants, on the opportunity costs that are the *sine qua non* for maximisation by means of trade-off. Economic planning is handicapped by the shortcomings of science. No planner in any case can ever be wise enough to predict the opportunities and challenges that to-be-created history holds up its sleeve.

The State can lack knowledge. It can also lack probity. People attracted to the exercise of power are often natural bullies. Self-righteous and opinionated, they are the very members of the society who are the most to be feared when they accede to the monopoly of force. Money too can lead to public policies and public expenditures that are seriously at variance with anything the social consensus would validate as the national interest. A road is built in a desert where a cabinet minister is hoping to open a hotel. A contract is given to a computer-firm in which the president's brother holds a controlling interest. Money in economics makes the world go round. People are people even when they work for the State.

Politicians and civil servants in some countries are notorious for their corruption, nepotism, graft, kickbacks, cronyism, bribery, favouritism. Their licenses, rebates and exemptions are the best that money can buy. In other countries, of course, the elected and the appointed are led by checks and balances in the constitution, by a rigorously-independent corrupt practices bureau, by a multiple audit of all receipts and disbursements, by a public-service ethos of self-policing workmanship, by a fear of exposure in the press and in the Assembly, to keep their selfish greed within the limits defined as acceptable by their fellow citizens. There is no law that can ensure the concentration of power in the hands of the honest to the exclusion of the opportunistic. Democracy at least relies upon the economic logic of market competition to keep down the windfalls and the rents that might otherwise accrue to a monopoly supplier.

Yet democracy as a system builds in distortions of its own. Because it is rational to be under-informed about areas in which one has no significant stake, economic policy will be biased away from consumers who spend on many products and in favour of producers who earn in one industry alone. (Downs 1957). Because interest-groups and privilege-seekers lobby together for their own special cause, economic policy will reflect the needs of the vocal more than it will the interests of the unassociated. (Olson 1982). Because preference-ranking can be disparate and irreconcilable, economic policy can be subject to cyclical churning as neglected voters strive forever to replace an incumbent coalition. (Arrow 1963). Because office must be earned through voter-pleasing intervention, economic policy is exposed to a political business-cycle when Machiavellian maximisers go for austerity just after one election and then for expansion in the run-up to the next. (Alt and Chrystal 1983). Because citizens welcome public spending but are resentful of higher taxes, economic policy will shunt the burden of the current cohort's pleasures, via borrowing and deficit finance, on to an unconsulted future that will have to pay the cost. (Buchanan 1960). Corrupt politicians buy votes with cash. Democratic governments bribe a marginal constituency with a new airport that the nation as a whole does not need and cannot afford.

The market, whatever its failures, does not compel absentees to settle other people's debts or supply a product for which there is no groundswell of demand. It is precisely because decentralised exchange screens out the imperfections of democracy and of autocracy alike that the market recommends itself so strongly to political minimalists, prepared to countenance the loss of good policies if the slimmed-down agenda is able also to prevent the apocalypse that would be brought about by a megalomaniac like Napoleon or a madman like Hitler. There is a certain logic in the argument that a life-saving wonder-drug ought to be banned from the start because of the remote but real possibility that in the wrong hands it would be used as a murder weapon to cleanse away a minority tribe. A more pragmatic position would, however, be to minimise the ideological *a priori*s and to evaluate each set of opportunities and risks on its own merits alone. The market, reliable as it so frequently will be, is particularly prone to under-performance in areas such as national defence, law and order, the infrastructure, regulation and welfare; and there it might make good economic sense to invite the State to complete the circuit. The most important concept in political economy is the *and*. The most important asset in the study of the mixed economy is an open mind.

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EXPLAINING CREDIT PROBLEMS IN THE U.S. CONSUMER DURABLE GOODS INDUSTRY IN THE 1930'S: CREDIT CHANNEL OR BANK LIQUIDITY PREFERENCE?

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ABSTRACT

Argument is made, contra Temin, that the recovery of the consumer durable goods industry in the 1930's was stalled by a breakdown in markets for dealers' inventory financing and consumer installment credit. The Friedman-Schwartz-Hamilton-Bernanke view holds that durable goods sector credit problems in the Depression were linked to Federal Reserve tightening measures via the "credit" channel of the transmission mechanism. The view is expressed that , though the FED could have done more to ease conditions, congestion in markets for wholesale and retail finance developed for reasons largely unrelated to the prevailing course of monetary policy. A shift, beginning in late 1930, in the average preference of banks for liquid and/or re-discountable portfolio assets, or a change in bank liquidity preference, is interpreted to be a primary cause of diminished credit available to durable goods retailers and buyers during the 1931-33 period. The bank liquidity preference hypothesis is supported by data on the shifting composition of bank assets in favor of investment grade securities, a fall in the ratio of loans to deposits, a steepening of the Treasury yield curve, as well as the time path of high-powered money after 1930.

JEL Classification Codes: *N22, E21, E44*

Key words: *Great Depression; Liquidity Preference; Credit Channel*

> Credit is the pavement along which production travels; and the bankers if knew their duty, would provide the transport facilities to just the extent that is required in order that the productive powers of the community can be employed to full capacity.
>
> J.M. Keynes, *Treatise on Money*, II, 220.

1. INTRODUCTION

The nature and significance of monetary factors in business cycle fluctuations is an especially difficult and controversial issue. A constitutive principle of the New Classical economics is that changes in the quantity of money not fully anticipated by agents are capable of (temporarily) dislodging the economy from its long run growth path (see Lucas 1977). For all its formal elegance, the New Classical approach is subject to the criticism that, in its strict reliance on noisy price signals to produce non-neutral money, it ignores much of what is known about the real world connection of monetary factors to

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