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The Classical Roots of Neo-classical Political Economy

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Neoclassical Political Economy applies the concepts and techniques of Neoclassical Analysis to elucidate the interrelations between the Economy, the Polity and the State.

The basic issues at hand were clearly stated by the social thinkers of the 17th, 18th and 19th Centuries., often referred to (admiringly or disparagingly) as the “Classics”

The “Classics” lacked the analytic techniques of contemporary social science. They had no access to statistical data and had no knowledge of quantitative methods. They lived in a universe much simpler than ours. They often failed to distinguish between the normative and the positive approach. Yet despite such limitations (or perhaps because of them) they often had an extraordinary clarity of vision. The insights of Hobbes, Locke, Hume, Adam Smith, of Madison and of Marx, are signal posts for to-day’s Political Economists.

Thomas Hobbes: A supply and demand analysis of government provision of “Law and Order”¹.

Anticipating by almost three centuries the modern approach, Thomas Hobbes (1588 - 1679) analyzed in terms of demand and supply why there is a need for the services of a Sovereign, and how the Sovereign fulfills that need..

The Hobbesian system is built on the basis of fundamental assumptions concerning the Nature of Man. All men, says Hobbes, "desire certain things...vertue generally in all sorts of subjects, is somewhat that is valued for eminence; and consisteth in comparison. For if all things were equally in all men, nothing would be prized". From this it follows that man has a "perpetual and restless desire for power" which Hobbes defines as “the present means to obtain some future apparent good”.

Since all people are endowed with similar abilities, there is no natural human hierarchy, and, as a consequence people struggle for power:

“Nature hath made men so equall, in the faculties of body and mind... [so that] when all is reckoned together, the difference between man and man is not so considerable as that one man can thereupon claim to himselfe any benefit, to which another may not pretend as well as he...

¹ We look at Hobbes, Locke and Hume as precursors of neoclassical political economy; the brief sketches that follows focus, therefore, on a small facet of their thought .

From this equality of ability ariseth equality of hope in the attaining of our Ends. And therefore if any two men desire the same thing, which nevertheless they cannot both enjoy, they become enemies; and in way to their end (which is principally their own conservation...) endeavour to destroy or subdue one an other. ... So in the nature of man, we find three principall causes of quarrel. First, Competition; Secondly, Diffidence; Thirdly Glory. The first maketh men invade for Gain; the second for Safety; and the third for Reputation....during the time men live without a common Power to keep them all in awe, they are in a condition which is called Warre; and such a warre as is of every man against every man....the nature of war consisteth not in actuall fighting; but in the known disposition thereto, during all the time there is no assurance to the contrary" (Hobbes, 1651, 1968, pp. 183 - 186)²

Most men prefer peace, in the absence Law and Order enforced by a Ruler, every one must take individual measures to defend himself against potential aggression. "Natural law" dictates that man should strive for self- preservation. From this follows "the First Rule of Reason" which says that if a man cannot obtain peace, "*he may seek, and use, all helps, and advantages of Warre*" (ibid. p. 190).

Reason dictates that, to avoid the hardships of self-defense, every individual should be willing to cede the role of defender to the ruler provided all other individuals do likewise. Hobbes' "Second Law of Nature" is : "That a man *be willing, when others are so too, as farre- forth, as for Peace and defence of himselfe he shall think it necessary, to lay down his right to all*

² All page references are to Hobbes (1968)

things; and be content with so much liberty against other men, as he would allow other men against himselfe" (ibid. p. 190). Self-interest dictates the forfeiting of individual good (self-defense) to acquire a collective good (Law and Order provided by the Ruler).

The sovereign is, by nature, no different from his subjects, and he too is motivated solely by self-interest. He therefore uses his monopoly power to enrich himself. But Sovereigns do not draw any "delight or profit" from "the damage or weakening of their Subjects" hence:

"the greatest, that in any forme of government can possibly happen to people in generall, is scarce sensible, in respect of the miseries, and horrible calamities, that accompany a Civil Warre; or that dissolute condition of masterless men." (Ibid. p. 238).

Empirical evidence supports Hobbes's assumption that the struggle for eminence is a motivational force. As early as 1949 Duesenberry showed that an individual's consumption behavior was conditioned by his standing within his reference group. At the time White and Black Americans were to a large extent socially separated. The "income pyramid" of Whites was much higher than that of the Blacks. Duesenberry demonstrated that the relative position within each income pyramid was a better predictor of the savings behavior than the absolute income level. (Duesenberry, 1949, especially ch. IV).

Sociological studies also indicate that an individual's feeling of satisfaction with his living standard depends on the relative position he occupies within his reference group. For instance, a 1991 British Household Panel Survey covering a random sample of some 10,000 individuals in 5,000 households shows that:

“Workers reported levels of well - being are at best weakly correlated with absolute income alone... measures of comparison income [the income of the peer group computed by regressing earnings on age, sex, education, and other characteristics] are significantly and negatively correlated with reported happiness at work” (Clark and Oswald, 1996 p. 360)

Summing up the studies carried out in the 1960s and the in the early 1970s Kohn concludes that:

“there is a consistent and meaningful relationship between people's social-class position and their values and orientation;... the class-values relationship has important implications for behavior; and...the class-values relationship, in turn, can be interpreted as resulting from systematic differences in conditions of life, occupational life in particular, associated with social-class position”(Kohn, 1977 p.xxv)

Though most neoclassical economists follow Adam Smith in assuming that consumers derive utility solely from their own consumption. (Blaug, 1992 p. 220)³, some do recognize the importance of relative standing. A ”radically Hobbesian” view is upheld, among others, by Scitovsky:

³ Since Becker's pioneering studies of “New Household Economics” the family, rather than the individual, is looked upon as the basic consumer unit.

“though our economic welfare is forever rising... we are no happier as a result.. The puzzle is that rising rank on the income scale seems to improve one’s chances of happiness, but a rise in everybody’s income rising does not” (Scitovsky 1992,p. 135)

Paradoxically, the view that the absolute income level is not an argument of the utility function is inconsistent with Hobbes’s hypothesis that everybody’s life can be improved by the elimination of anarchy. For if, under the Leviathan, every one enjoys the same degree of “eminence” as he did under anarchy, no one benefits from having more income. If the relative degree of “eminence” changes, some individuals gain, while others loose.

For a Leviathan to be acceptable to all members of the Hobbesian polity, its members must derive satisfaction from their own consumption, as well as from the degree of “eminence” each of the enjoys. To shows this, let us express the ith individual’ s utility as:

$$u^i = u^i [\alpha^i c^i + (1 - \alpha^i) (c^i - c^j)] \quad 1.2a$$

and similarly for j:

$$u^j = u^j [\alpha^j c^j + (1 - \alpha^j) (c^j - c^i)] \quad 1.2b$$

where $1 \geq \alpha > 0$ is the relative weight individual i (individual j) attaches to his own consumption and $(1 - \alpha)$ is the weight he attaches to “eminence”. The payoffs to i and to j are shown in real terms (e.g. in thousands of dollars) in Table 1.1

	Player j	
	(1)	(2)
Player i	(1) c_{11}^i, c_{11}^j	c_{12}^i, c_{12}^j
	(2) c_{21}^i, c_{21}^j	c_{22}^i, c_{22}^j

Table. 1.1

Let $c_{11}^i > c_{21}^i$, $c_{12}^i > c_{22}^i$, $c_{11}^j > c_{12}^j$, $c_{12}^j > c_{22}^j$, $c_{11}^i > c_{11}^j$ and $c_{11}^j > c_{22}^j$. If both i and j derive utility only from the payoff each of them gets (that is, if, in eq. 1.2 $\alpha^i = \alpha^j = 1$, so that $u^i = u^i(c^i)$ and $u^j = u^j(c^j)$) then (1,1) is the dominant strategy and individual optimization leads to a joint optimum. However, in the presence of “eminence”, this happy result might not pertain. For a sufficiently small α^i , for the ith individual it must be true that

$$u^i [\alpha^i (c_{21}^i) + (1 - \alpha^i)(c_{21}^i - c_{21}^j)] > u^i [\alpha^i (c_{11}^i) + (1 - \alpha^i)(c_{11}^i - c_{11}^j)] \text{ and also}$$

$$u^i [\alpha^i (c_{22}^i) + (1 - \alpha^i)(c_{22}^i - c_{22}^j)] > u^i [\alpha^i (c_{12}^i) + (1 - \alpha^i)(c_{12}^i - c_{12}^j)]$$

which means that for the ith individual strategy 2 is dominant, and similarly for the jth individual. Both individuals would be better off, however, if they were prevented from adopting strategy 2.

A numerical example may be helpful in clarifying the above. Let two players i and j face the following payoff matrix

		Player j	
		(1)	(2)
Player i	(1)	10,10	4, 8
	(2)	8, 4	2, 2

Table. 1.2

Where the numbers represent quantities, such as thousands of dollars.

If each of the individual's utility depended solely on the payoff accruing to him, then $\alpha^i = \alpha^j = 1$ and the numbers given in matrix 1.2 could be interpreted as indicating utilities. Thus $u^i(1,1) = 10$, $u^i(1,2) = 8$ and so on. The dominant strategy is (1,1), leads to a Pareto - optimal outcome, with each of the players obtaining the highest attainable utility level.

Assume now that "eminence" matters, and let $\alpha^i = 3/5$, and $\alpha^j = 3/5$, meaning that each individual assigns a weight of 3/5 to his own payoff and of 2/5 to the difference between his payoff and that of the other player. In this case, $u^A(1,1) = [3/5 \cdot 10 + 2/5(10-10)] = 6$, while

$u^A(2)$, while $u^A(1,2)=[(3/5 \cdot 8) + 2/5(8 - 4)] = 6.4$, and so on. The utility matrix corresponding to the physical payoffs indicated in Table. 1.2 can be represented as:

		Player j	
		(1)	(2)
Player i	(1)	6.0, 6.0	0.8, 6.4
	(2)	6.4, 0.8	1.2, 1.2

Table. 1.3

The dominant strategy is (2,2) leading to a Pareto-inferior position.⁴ Both players would be better off if a Ruler forced both of them to adopt strategy 1. In physical terms the total payoff of Strategy (1,1) is equal to 20 units, while that of Strategy (2,2) is equal to 4 units. As long, therefore, as the Ruler exacts from the players no more than 16 units, the players are better off than they would be under anarchy.

The State can be destroyed by envy. We shall say that i envies j if the consumption of the latter affects negatively the utility of the former, as, for instance in the case in which $u^i = u^i(\alpha^i c^i - \beta^i c^j)$ where $\alpha^i > 0$ and $\beta^i > 0$. If $\beta^i > \alpha^i$ the i th individual is willing to impoverish himself in order to impoverish j . If the feeling is reciprocated by j , both prefer the horrors of war to peaceful co-existence. To illustrate this statement take the case in

⁴ This will be readily recognized as a “Prisoner’s Dilemma” game

which $\alpha^i = 2/5$ and $\beta^i = 3/5$ (and likewise for j) Applying these coefficients to the payoff matrix shown in fig.1 we see that strategy (2,2) is Pareto-efficient:

		Player j	
		(1)	(2)
Player i	(1)	-5, -5	-5, -1
	(2)	-1, -5	-1, -1

Table. 1.4

The imposition of Law and Order (i.e. the enforcement of strategy (1,1)) makes the society more prosperous, but the citizens are more unhappy than if they were permitted to enjoy mutual destruction. The armed intervention of NATO and of the UN in Bosnia-Herzegovina, Kosova, Sierra Leone and elsewhere reflects the belief that the suppression of “anarchy” improves the inhabitants’ well-being. But the imposition of Law and Order on individuals who attach greater weight to “eminence” than to their own consumption reduces their welfare. Some communities are, inherently non-viable, and a break up into separate entities might be the only viable solution.

John Locke (1632-1704) Order vs. Liberty.

For Locke men are, by nature, “all free, equal, and independent” (ch. VIII, § 95)⁵

⁵ All the references are to Locke’s *The Second Treatise of Government* in Locke (1988)

“The *State of Nature* has a Law of Nature to govern it, which obliges every one: and Reason, which is the Law, teaches all Mankind, who will but consult it, that being all equal and independent, no one ought to harm another in his Life, Health, Liberty, or Possessions”(ch.II, §6).

Yet life in the State of Nature has certain “inconveniences”:

“*First*, There wants an established, settled, known *Law*, received and allowed by common consent to be the standard of Right and Wrong, and the common measure to decide all Controversies between them. For though the Law of Nature be plain and intelligible to all rational Creatures; yet men being biased by their Interest, as well as ignorant for want of study of it, are not to allow of it as a Law binding to them in the application of it to their particular Cases.

Secondly , in the State of Nature there wants a *known and indifferent Judge* , with Authority to determine all differences according to the established Law For everyone in that state being both Judge and Executioner of the Law of Nature, men being partial to themselves, Passion and revenge being apt to carry them too far, and too much heat in their own cases; as well as negligence and unconcernedness to make them too remiss, in other Mens.

Thirdly in the State of Nature there often wants *Power* to back and support the sentence when right, and to *give* it due *Execution*. They who are by Injustice offended, will seldom fail, when they are able, by force to make good their Injustice: such resistance many times makes resistance dangerous, and frequently destructive, to those who attempt it”(ch. IX, §§124-127)

There is a “ *plain difference between the State of Nature and the State of War*... Men living together according to Reason, without a common Superior on Earth, with Authority to judge between them, *is properly the State of Nature*. But force, or a declared design of force upon the Person of another, where there is no common Superior on Earth to appeal to for relief, *is the State of War*” (ch. III § 19)

The “State of Nature” may, however, degenerate into a “State of War”:

“...*in the State of Nature every one has the Executive Power* of the Law of Nature”...To this doctrine it may be objected “that it is unreasonable for Men to be Judges in their own cases. That Self-love will make men partial to themselves and to their Friends. And on the other side, that ill-nature, Passions and Revenge will carry them too far in punishing others “(ch.II, § 13)

“To avoid this State of War... is one great reason of *Mens putting themselves into Society* and quitting the State of Nature” (ch. II §21) Hence, says Locke, “I easily grant that *Civil Government* is the proper Remedy for the Inconveniences of the State of Nature”(ch. II §13)

Legitimate government is formed by consent:

“The only way whereby anyone divests himself of his Natural Liberty, and *puts on the bonds of Civil Society* is by agreeing with other Men to joyn and unite into a Community, for their Properties, and a greater Security against any that are not of it. This any number of Men may do, comfortable, safe, and peaceable living one amongst another, in a secure Enjoyment of their because it injures not the Freedom of the rest; they are left as they were in the Liberty of the State of Nature. When any number of Men have so *consented to make one Community* or government, they are thereby presently incorporated, and make *one Body Politick*, wherein the *Majority* have the right to act and conclude the rest”.(ch. VII, §95)⁶

Legitimacy requires that the same rules should apply to those who govern and to those who are governed. : “*No Man in a Civil Society can be exempted from the Laws of it*”(ch. VII, §94) A government which puts the ruler above the law has no legitimacy:

“*Absolute Monarchy ... is indeed inconsistent with Civil Society* and so can be no form of Civil Government at all. For the end of *Civil Society*, being to avoid, and remedy those inconveniences of the State of Nature, which necessarily follow from Man’s being Judge in his

⁶ In paragraph 99 Locke clarifies that majority rule should prevail unless the individuals who formed the community “expressly agreed to any number greater than the majority”

own Case, by setting up a known Authority, to which every one of that Society may appeal upon Injury received or controversies that may arise, and which everyone of the Society ought to obey; where-ever, any persons are, who have not such an Authority to appeal to, for the decision of any differences between them, there those persons are still *in the State of Nature*... and under all the inconveniences of it” (ch. VII §90)

Legitimate government calls for majority rule, rather than for unanimity. “Infirmities of Health” and “Avocations of Business” are bound to keep many members of a Civil Society from attending a public Assembly. Moreover, in any society there is a “variety of opinions and contrariety of interests” making unanimity well - nigh impossible. (ch. VIII § 98)

Every government, regardless of its form, should act in conformity with “Laws of God and Nature”: first, the authorities should act in conformity with generally applicable promulgated laws. Secondly, the laws ought to be designed for the good of the people. Third, the authorities may not raise taxes, except with the consent of the majority. Fourth, the legislature cannot transfer the law-making authority to any body not subject to majority control.

By surrendering their freedom the governed give power over themselves to those who govern. He who holds executive power (Locke’s Prince) “*may endeavour to take away or*

destroy the property of the people or to reduce them to Slavery under Arbitrary Power” (chs. XIX.& 221 A government which turns into a Leviathan is guilty of a breach of trust:. “By this breach of Trust they [the government] *forfeit the Power* ... and it devolves to the People, who have the Right to resume their original Liberty”(ch. XIX § 222 and they are free to establish a new government.

David Hume (1711 - 1776) and the need for a framework regulating property relations

Man is not motivated by “eminence”. On the contrary,

”though it be rare to meet one who loves any person better than himself, yet it is as rare to meet one in whom all the kind affections, taken together, do not overbalance all the selfish” (Hume 1739, 1948, p. 57).

Therefore,

“[the] *poetical* fiction of the *golden age* is in some respects of a piece with the *philosophical* fiction of the *state of nature*; only that the former is represented at the most charming and most peaceable condition which can possibly be imagined, whereas the latter is painted out as a state of mutual war and violence attended with the most extreme necessity” (Hume 1751, 1948, p. 189)⁷.

⁷ Hume also took a gentler view of the government than :Hobbes: In every country ”the many are governed by the few”, hence “force is always on the side of the governed “ and therefore “governments have nothing to support them but opinion, where opinion means the “general advantage which is reaped from government, together with the persuasion that the particular

The need for a Sovereign arises not out of the struggle for “eminence” but out of man’s “insatiable, perpetual, universal and directly destructive of society avidity of acquiring goods and possessions for himself and for his relatives” (Hume 1739, 1948, p. 61)⁸. Despite such aggressively acquisitive tendencies, men have

“a general sense of common interest... which induces them to regulate their conduct by certain rules. I observe, that it will be for my interest to leave another in possession of his goods, *provided* he will act in the same manner with regard to me. He is sensible of a like interest in the regulation of his conduct. When this common sense of interest is mutually expressed, and is known to both, it produces a suitable resolution and behaviour. And this may properly enough be called a convention or agreement betwixt us...”(Hume, 1739, 1948 p. 59).

Reason dictates that men, in their self-interest submit themselves to common rules:

“[Men are]naturally induced to lay themselves under the restraint of such rules as may render their commerce more safe and commodious. (Hume, 1793,1948 p. 67). “[I]t is impossible they

government which is established is equally advantageous with any other that could easily be settled” (op. cit.. p. 313). It follows that though “A great sacrifice of liberty must necessarily be made in every government, yet the authority which confines liberty can never and perhaps ought never in any constitution to become quite entire and uncontrollable.” (ibid. p. 307). History furnishes, unfortunately, many instances showing that Hume’ optimism was unwarranted.

8 Conflicts regarding property may arise even among altruistic individuals. For consider the problem of division of a consumption good between two individuals, *i* and *j*, each of whom derives utility from his own consumption as well as from that of the other. An optimal allocation from *i*’s point of view may, nevertheless, apportion a larger share of the good to himself than would an optimal allocation from *j*’s point of view. A loving father may give a lower allowance to his sons than the loving sons would desire . On this issue, see Stark (1995)

should maintain a society of any kind without justice, and the observance of those three fundamental laws concerning the stability of possession, its translation by consent, and the performance of promises” (Hume, 1793, 1948 p. 103) “To the imposition, then, and observance of these rules, both in general and in every particular instance, they are at first induced only by a regard of interest; and this motive, on the first formation of society, is sufficiently strong and forcible.” (Hume, 1793,1948 p. 67)

It may be possible for men “to maintain a small uncultivated society without government “(Hume, 1793,1948 p. 103). But when society has become numerous... this interest is more remote; nor do men so readily perceive that disorder and confusion follow upon every breach of these rules, as in a more narrow and contracted society.” (Hume, 1793,1948 p. 67)

Even men do not strive for “eminence” they may benefit through the imposition of common rules. Consider, again, Table 1.1:

		Player j	
		(1)	(2)
Player i	(1)	c_{11}^i, c_{11}^j	c_{12}^i, c_{12}^j
	(2)	c_{21}^i, c_{21}^j	c_{22}^i, c_{22}^j

Table 1.1

Let strategy (1) represent the payoff in the absence of individual expenditures on arms which could be used either defensively or aggressively, and strategy (2) the payoff when such expenditures are incurred, which means that $c_{11}^i < c_{21}^i$, $c_{12}^i < c_{22}^i$, $c_{12}^j < c_{11}^j$, $c_{21}^j < c_{22}^j$, and also $c_{22}^i < c_{11}^i$, $c_{22}^j < c_{11}^j$. In the absence of mutual trust, both will choose strategy 2. If the government provides security, both will strategy (1), and both will be better off.

The above result pertains in the absence of struggle for “eminence” Indeed, a PD situation may arise even in the case of altruism. For let j stand for the average poor who number n and let i be one of the m rich. Write c^i for i 's consumption and $C^j = nc^j$ for the aggregate consumption of the poor. Individual i may be altruistic in the sense that $u^i((c^i - t), (C^j + nt/m)) > u^i(c^i, C^j)$, but $u^i((c^i - t), (C^j + t)) < u^i(c^i, C^j)$, and also $u^i((c^i - t), (C^j + (n-1)t/m)) > u^i(c^i, C^j)$. In words: i 's utility would increase if every rich (including himself) contributed t to the poor, but he would be worse off if he were the only contributor, and he would be best if all the rich (except himself) contributed to the poor.

Hume's major contention is that economic efficiency is contingent upon the imposition and the maintenance of “the rule for stability of possession”. History has validated his argument. Over the past three Centuries, because of the growing complexity of the economic system, the

institutional framework became ever more important.. Perhaps nothing shows as clearly the current relevance of Hume's thought as the institutional problems facing the so-called developing countries, and especially by the countries in transition from the Soviet system.

Sir William Petty (1623 - 1687)

In his *Treatise of Taxes and Contributions* Sir William Petty lists seven "sorts of Publick charges". The first is that of "*defense by land and sea... of peace at home and abroad*". The second, "The maintenance of Governors, Chief and Subordinate". The third is that of "the *Patronage of Mens Souls*", that is, the maintenance of the clergy. The fourth, the administration of justice; the fifth, "the charge of schools and universities" The sixth – "that of the *maintenance of orphans, found and exposed children* and also of impotents of all sorts, and moreover of such as want employment" and "a last branch may be, the charge of high-ways, Navigable Rivers, Aqueducts, Bridges, Havens and other things of universal good and concernment". This list contains only duties which, in Petty's opinion, are "chief and most obvious of the rest...Other branches may be thought on, which let other men refer unto these, or add over and above." (Petty, 1667, pp.1- 3)

In contrast to his predecessors Petty lists social as well as economic reasons for government interference in the economy. The State should support orphans and of those incapable of work: “For the permitting of any to beg is a more chargeable way to maintain them... besides it is unjust to let them starve” (op. cit. pp. 2 -3). The State should finance the schools and universities to “Furnish all imaginable help unto the highest and finest Natural Wits... The which Wits should not be selected for that work, according to the fond conceits of their parents and friends... but rather by the approbation of others more impartial”⁹. The argument for the public support of the clergy shows Petty’s awareness of the close linkage between the social and the economic sphere:

“One would think (because it respects another world, and the particular interest of each man there)”[that the State should not support the religious establishment, yet] “if we consider how easy it is to elude the law of man there follows a necessity of contributing toward a public charge, wherewith to have men instructed in the Laws of God, that take notice of evil thoughts and designs and much more of secret deeds, and punish them eternally in another world, that men can but slightly chastise in this” (ibid. p. 2)

Express the frequency of crime as a function $F_{CR}(Y_{DIST}, P, k, \alpha)$ where Y_{DIST} stands for income distribution, P for the probability of detection, k for the severity of punishment, and α for what we shall call propensity to commit crimes. To fight crime the government disposes of

9 . One could also argue that even with full knowledge, market allocation of educational facilities would not be efficient because of financial market imperfections. Poor people, lacking the collateral, are unable to secure financing needed for their schooling.

two instruments: it may raise P , by devoting resources to “Law and Order”, or it may reduce α by inculcating in the population principles of morality¹⁰.

Whether the i 'th member of society decides to devote his time to income generation or to illegal appropriation of income depends on whether:

$$u(w) \geq \text{or} < Pu(\alpha q) + (1-P)u(k)$$

Or, assuming risk neutrality:

$$w \geq \text{or} < P(\alpha q) + (1-P)k$$

An absolutely moral individual (for whom $\alpha = 0$) will never do anything illegal. A pure hedonist (for whom $\alpha = 1$) does not care whether the money comes through legal or through illegal means so he will do whatever has the higher payoff. A marginal increase in expenditure on “Law and Order” decreases the payoff of illegal activities by $(\alpha q - k) \cdot \partial P / \partial g$, while a marginal increase in expenditure on moral instruction cuts it down by $Pq \cdot \partial \alpha / \partial g$. Notice that the effect of expenditure on “Law and Order” is the greater, the less “moral” the population, whereas the effect of expenditure on morality is the greater, the more lax is the enforcement of law.

10 Other things being equal, the frequency of criminal behavior is likely to be an increasing function of income dispersion. It is, however, difficult to imagine a society which adopts income equalization measures in order to reduce the crime rate. Crimes are deterred by punishment; we assume here that k represents the most severe punishment acceptable to the given society.

Petty's treatment of the positive economics of the State is very rudimentary. Much like Hobbes's Leviathan, Petty's Sovereign is guided by enlightened self-interest which dictates restraint. The Sovereign may "ask for more than he needs". But

"if the sovereign were sure to have what he wanted in due time, it were his own great damage to draw money away out of his subjects' hands, who by trade increase it, and to hoard it up in his own coffers, where it is of no use even to himself, but liable to be begged away or vainly expended" (ibid. p. 14).

James Steuart - Denham (1712 - 1780)

In *An Inquiry into the Principles of Political Oeconomy* Sir James Steuart-Denham, a near-contemporary of Adam Smith, seeks to define the pre-conditions of a "free society" whose members could enjoy the fruits of the division of labor. "The best way of binding a free society together is by multiplying reciprocal obligations, and creating a general dependence between all its members" (Steuart 1767, 1966 vol. I p. 207)¹¹ For this purpose the State should promulgate and enforce of laws defining mutual relations. A possible interpretation of this is that, in Stewart's opinion, a system of mutual obligations cements society and mitigates conflicts among interest groups.

¹¹ All page references are to Steuart-Denham 1966

Steuart's approach is strictly normative. The objective of the *Inquiry* "is to examine the consequences of what we feel and see daily passing, and to point out how the bad may be avoided and the good turned to best advantage" (ibid. vol. I p.76). A good government should not only preserve Law and Order. It should also come to the aid of those who, through no fault of their own, fall victim of economic evolution:

"In treating every question of political economy, I constantly suppose a statesman at the head of government, systematically conducting every part of it, so as to prevent the vicissitudes of manners, and innovations, by their natural effects from hurting any interest in the commonwealth... if a number of machines are all at once introduced in the manufactures of an industrial nation... it becomes the business of the statesman to interest himself so far in the consequences, as to provide a remedy for the inconveniences resulting from the sudden alteration" (ibid. vol. I p. 122)

An economic shock, such as the introduction of a new technology, or the abolition of trade barriers, may raise the living standards of certain sectors of society, and lower the living standards of others. Steuart advances a purely humanitarian reason for the compensation of those who, through no fault of their own, suffer a loss of physical or of human capital. One may also argue for compensation on purely pragmatic grounds: unless compensation is paid, the losing group may block the change, to the detriment of society as a whole. The blocking tactics are all too familiar to those who have followed the uncertain path of de-communization of the countries in the former Soviet Block, or the attempts at liberalization of World trade in agricultural products.

Adam Smith (1723 -1790)

Prior to Adam Smith the political economists considered how to restrain human passions to make man fit to live peacefully in society (Hume, op. cit. pp. 61-62). Smith is the first to show that the pursuit of “passions” results in a common good:

“[i]n civilized society...[man] stands at all times in need of the cooperation and assistance of great multitudes... and it is in vain for him to expect it from their benevolence only. He will be more likely to prevail if he can interest their self-love in his favor, and show that it is for their own advantage to do for him what he requires of them” (Smith, 1776, 1976, Book I, ch. ii, vol. I p. 18)

Therefore the Sovereign:

"has only three duties to attend to, three duties of great importance, indeed, but plain and intelligible to common understanding: first, the duty of protecting the society from the violence and invasion of other independent societies; secondly, the duty of protecting, as far as possible, every member of the society from the injustice or oppression of every other member of it, or the duty of establishing an exact administration of justice; and thirdly, the duty of erecting and maintaining certain public works and certain public institutions, which it can never be for the interest of any individual, or small number of individuals, though it may frequently do much more than repay it to a great society" (ibid. Book iv, ch. ix, vol. II pp. 208-209)

The State has to possess the contract-enforcing authority because

“Commerce and manufactures can seldom flourish long in any state which does not enjoy a regular administration of justice, in which people do not feel secure in the possession of their property, in which faith in contracts is not supported by law, and the authority of state is not supposed to be regularly employed in enforcing the payment of debts” (ibid. Book V, ch. iii, vol. II p. 445)

The need for authority arises out of economic inequality:

"Envy, malice or resentment, are the only passions which can prompt one man to injure another in his person or reputation. But the greater part of men are not frequently under the influence of those passions... Men may live together in society with some tolerable degree of security, though there is no civil magistrate to protect them from the injustice of those passions" (ibid. Bk. V, ch. I, pt.ii, vol. II, pp. 231 - 232)

The three "duties of the sovereign" reflect the collective interests of the entire polity.

But the interests of the rich clash with those of the poor. Anticipating Marx, Smith maintains that the government is run mainly in the interest of the former:

"The affluence of the rich excites the indignation of the poor, who are often both driven by want, and prompted by envy, to invade his possessions. It is only under the shelter of the magistrate that the owner of that valuable property... can sleep a single night with security" (Ibid. Bk. V, ch. I pt.ii, vol. II, p. 233)

and therefore:

"The rich, in particular, are necessarily interested to support that order of things, which can alone secure them in the possession of their own advantages... Civil government, so far as it is instituted for the security of property, is in reality instituted for the defence of the rich against the poor, or of those who have some property against those who have none at all" (Ibid. Book. V, ch.i pt. I, vol. II p. 236)

moreover,

"Whenever the legislature attempts to regulate the differences between masters and their workmen, its counselors are always the masters. When the regulation, therefore, is in favour of the workmen, it is always just and equitable, but it is sometimes otherwise when in favour of the masters" (Ibid, Bk I. , ch. x pt. II, vol. I pp. 158-159)

Smith was far, however, from being a proto-Marxian. In contrast to Steuart, who sought compensation for workers – victims of otherwise beneficial economic change – Smith was concerned lest the large-scale capitalists be hurt by the reforms which he favored. Thus, the trade barriers, which he opposed, should not be abolished all at once, lest the import-substituting industries suffer losses:

“The undertaker of a great manufacture who, by the home markets being suddenly laid open to competition of foreigners, should be obliged to abandon his trade, would no doubt suffer very considerably.... [T]hat part of it [i.e. of his capital] which was fixed in workhouses, and in instruments of trade, could scarce be disposed of without considerable loss. The equitable regard, therefore, to his interests requires that changes of this kind should never be introduced suddenly, but slowly, gradually, and after a very long warning” (Ibid. Bk. IV, Ch. II, vol. II p. 494)

In fact, government policies are molded under the influence of special interest groups ¹².

“The law of England... favors agriculture not only indirectly by the protection of commerce, but by several direct encouragements. Except in times of scarcity, the exportation of corn is... encouraged by a bounty. In times of moderate plenty, the importation of foreign corn is loaded with duties that amount to a prohibition. These encouragements... demonstrate at least the good intentions of the legislature to favour agriculture” (Book III ch. iv vol. Ii p.443,

Individual industries, such as woolen manufacturing also receive protection from foreign competition at the expense of the polity as a whole (Book IV ch.ii, vol. Ii, p. 474.

Those who govern also constitute an interest group. Governments are rapacious:

“The violence and injustice of the rulers of mankind is an ancient evil, for which... the nature of human affairs can scarce admit a remedy” are they are venal: “[T]here is no art that one

12 Stigler (1975) found in the *Wealth of Nations* 26 examples of special interest policies

government sooner learns from another than that of draining money from the pockets of the people” (ibid. Bk. V, ch.ii, pt.ii, Vol. ii p. 390).

Officials are often more interested in building monuments to themselves than they are in serving the people:

“The proud minister of an ostentatious court may frequently take pleasure in executing a work of splendour and magnificence... But to execute a great number of little works, in which nothing that can be done can make any great appearance, or excite the smallest degree of admiration, and which, in short, have nothing to recommend them but their extreme utility, is a business which appears in every respect too mean and paultry to merit the attention of so great a minister”. (Ibid. Bk.V, ch. i, pt.iii, Art.i, Vol ii p. 251)

Indeed, Smith sometimes doubts whether governments are capable of fulfilling some of their “three great duties”. He opposes the proposal that the government should manage the English turnpikes and make a revenue from them, because there would be temptation to raise the level of duties, and to neglect the roads: “A large revenue might thus be levied upon the people, without any part of it being applied to the only purpose to which a revenue levied in this manner ought ever to be applied” (Ibid. Bk.V, ch. i, pt.iii, Art.i, vol. II p. 250)

Though the government is far from being an impartial; body working for the Common Good,

“The natural effort of every individual to better his own condition, when suffered to exert itself with freedom and security, is so powerful a principle that it is alone, and without any assistance, not only capable of carrying on the society to wealth and prosperity, but surmounting a hundred

impertinent obstructions with which the folly of human laws too often encumbers its operations” (Ibid. Bk. IV, ch. v, vol. II pp. 49 - 50)¹³.

James Madison

For Madison the central duty of the government is to find solutions acceptable to the various “fractions” of society. The division of society into “fractions” follows from the very nature of man:

“As long as the reason of man continues fallible, and he is at liberty to exercise it, different opinions will be formed .. The latent causes of faction are thus sown in the nature of men... A zeal for different opinions concerning religion, concerning government, and many other points , as well of speculation as of practice... divided men into parties, inflamed them with mutual animosity, and rendered them much more disposed to vex and oppress each other than to co-

¹³ Smith’s attitude toward the relations between the State and the Economy are subject to a diversity of interpretations. Joseph Copsey (1957) holds that, according to Smith, commerce generates freedom and , at the same time, free institutions are indispensable to the preservation of commerce.- a view for which Duncan Forbes (in Skinner and Wilson, 1976) finds no support. According to Hirschman Smith thinks that as long as the government is “good enough“ the invisible hand will prevail: ”It appears that Smith advocates less a state with minimal functions than one whose capacity for folly would have some ceiling“ (Hirschman, 1977 p. 104) . Stigler chides Smith for failing to develop a full-fledged positive theory of government. According to Stigler in Smith’s works ”little attention is paid to the political process, and that little is tantalizingly diverse. In some respects the sovereign is an incompetent manager. In general, however, Smith’s attitude toward political behavior was that of a parent toward a child: the child was often mistaken and sometimes perverse, but normally it would improve in conduct if properly instructed”. Stigler, 1976 pp. 242 - 243)

operate for their common good”, but “the most common and durable source of factions has been the various and unequal distribution of property.”¹⁴

Here Madison echoes Hume who also drew a distinction between “personal” factions, reflecting individual loyalties and dislikes, and “real” factions “founded on some real difference of sentiment or interest”(*Essay VIII: Of Parties in General* (in Hume, 1963 p.55)) The real factions may be further subdivided “into those from *interest* from *principle* and from *affection*” The factions from interest “are the most reasonable and the most excusable... [because] [t]he distinct orders of men, nobles and people, soldiers and merchants, have all a distinct interest”.(ibid. p.58)

Hume, considers, however, that all factions, even those which are “the most reasonable and the most excusable” are an evil that ought to be wiped out. A government dominated by factions will not act in the Common Good:

“Where two orders of man, such as the nobles and people, have a distinct authority in a government, not very accurately balanced and modeled, they naturally follow a distinct interest; nor can we reasonably expect a different conduct , considering that degree of selfishness implanted in human nature”(ibid. p.58)

and therefore,

¹⁴ James Madison *The Federalist No. X, November 23, 1787* reprinted in Madison, (1953) p. 51

“As much as legislators and founders of states ought to be honoured and respected among men, as much ought the founders of sects and fractions be detested and hated; because ... Factions subvert government, render laws impotent, and beget the fiercest animosities among men of the same nation, who ought to give mutual assistance to each other.”(ibid. p. 55)

By contrast, for Madison factions are a natural outgrowth of liberty: “No free Country has ever been without parties which are a natural offspring of freedom.”¹⁵ The suppression of the former is tantamount to the suppression of the latter:

“Liberty is to faction what air is to fire, an ailment without which it instantly expires. But it could not be less folly to abolish liberty, which is essential to political life, because it nourishes faction, than it would be to wish the annihilation of air, which is essential to animal life, because it imparts to fire its destructive agency”¹⁶

Rather than suppressing factions, governments should seek to find compromise solutions:

“Those who hold and those who are without property have ever formed distinct interests in society. Those who are creditors, and those who are debtors, fall under a like discrimination. A landed interest, a manufacturing interest, a mercantile interest, a moneyed interest, with many lesser interests, grow up of necessity in civilized nations, and divide them into classes, actuated by different sentiments and views. The regulation of these various and interfering interests forms the principal task of modern legislation, and involves the spirit of party and faction in the necessary and ordinary operations of the government”¹⁷

The Madisonian government should act as an arbiter between the interest groups and as a representative of the interests of society as a whole:

15 James Madison, Note to Speech on the Right of Suffrage, ca. 1821, in Madison (1953) p. 38

16 *Ibid.*

17 *Ibid.*

“The great desideratum in Government is such a modification in sovereignty as will render it sufficiently neutral between the different interests and factions, to control one part of the society from invading the rights of another, and at the same time sufficiently controlled itself, from setting up an interest adverse to that of the whole Society”¹⁸

The rights of the minority must be protected, for “it would be in the interest of the majority in every community to despoil and enslave the minority of individuals”¹⁹ In particular, the system of checks and balances “ought to be so constituted as to protect the minority of the opulent against the majority”²⁰ The poor should, however, be protected against the rich, for “there are various ways in which the rich may oppress the poor”²¹

What motivates the government? On this issue Madison was silent. The completion of a model of a democratic government was not accomplished until the development of neo classical political economy

Karl Marx (1818-83) and Friedrich Engels (1820-95)

Marx and Engels consider the evolution of the state in function of the changing property relations. “In primitive times, the whole public authority in time of peace was exclusively judicial, and rested on the popular authority of the hundred, the shire, or of the whole tribe”²² With the increase in the degree of inequality “Society divides into classes; the privileged

18 James Madison, “*Observations*” April 1787 reprinted in Madison (1953) p. 29

19 James Madison, letter to James Monroe, October 5, 1786, reprinted in Madison (1953) p. 45

20 James Madison, in Federal Convention, 1787, reprinted in Madison (1953) p. 45

21 James Madison, Note to “Speech on the Right of Suffrage” ca. 1821, reprinted in Madison (1953) p. 37

22 F. Engels *The Peasant War in Germany* Moscow: Foreign Languages Publishing House, 1956 p. 170, quoted in

and the dispossessed, the exploiters and the exploited, the rulers and the ruled; and the State... from this stage onwards... acquires... the function of maintaining by force the conditions of existence and domination of the ruling class against the subject class”²³ .

The State is not, however, a mere instrument of oppression: “society gives rise to certain functions which it cannot dispense with” which the State fulfills.²⁴ But neither Marx nor Engels devote much attention to the “duties of the sovereign”. Indeed, “Classical Marxism contained only a very incomplete theorization of politics, and of the institution of the state” (Shaw, 1985, p. 246) Moreover,

though the role of the class concept in Marxism is “immense”... “...it is astonishing not to find a definition of this concept... anywhere in the works of either Marx or Engels. ... The term ‘class’ has for them a variable denotation: that is, it refers to groups differentiated in various ways within a more inclusive category, such as the category of groups with common economic interests, or the category of groups whose members share economic conditions that are identical in a certain respect. The sharing of permanent economic interests is a particularly important characteristic of classes in Marxian doctrine, and for this reason it has been easy to overlook the fact that although it is in the Marxian view, *a necessary* condition it does not constitute *a sufficient* condition for a valid definition of a social class” (Osowski, 1963, p. 71)

The roster of classes in a particular society is determined by the mode of production. However,

Draper, (1977) p. 243

23 F. Engels, *Anti-Duhrig Herr Eugen Duhrig's Revolution in Science* 2nd ed. Moscow: Foreign Languages Publishing House, 1959, p. 205, quoted in Draper (1977) p. 245

24 *ibid.* footnote 14 p. 246

“There is no rule-of-thumb definition which decides whether the chief of an armed band who resides in a stronghold and lives off the surplus labor of unfree producers, etc. is or is not a member of a *feudal* class. The point can be settled... only by a concrete examination of the overall social relations of the society. Similarly, merchants become a separate *class* not simply because they buy and sell, but only when their buying and selling begins to play a certain role in a given society” (Draper, 1977, p. 507)

In advanced capitalism the basic dichotomy between the oppressors and the oppressed “crystallized into a division of society into a small, excessively rich class, and a large, propertyless class of wage workers”²⁵ The property owners do not constitute, however, a homogenous group. In *Das Kapital*, Marx draws a distinction between the owners of labor power, the owners of capital, and the owners of land²⁶; elsewhere he recognizes even smaller sub-groups.²⁷ At times, the interest groups cooperate with each other: Marx speaks, for instance of “the permanent alliance between the [English] bourgeoisie and the greater part of the big landlords”²⁸ But the diversity of interests gives rise to conflicts: as is the case of France where there is a conflict of interests between the bourgeoisie, and the “Financiers [who] seek to enrich themselves not through production but through appropriation”²⁹, while the struggle between the

25 F. Engels, Introduction to *Marx's Wage Labor and Capital*, in Karl Marx and Frederick Engels, *Selected Works in Two Volumes*. Moscow: Foreign Language Publishing House, 1951, vol. I p. 73

26 Karl Marx, *Capital* vol. III Moscow: Foreign Language Publishing House, 1959, p. 862

27 According to Osowski, in his division of society into classes Marx applies two different criteria: one is ownership or means of production or lack thereof, and the second is employment status. Thus the self-employed petty bourgeoisie constitutes a distinct class from capitalists and from hired labor. (Osowski, 1963, pp. 75-76)

28 Karl Marx “Review of Guizot” *Articles on Britain* Moscow 1972, p. 93 quoted in Maguire (1978) p. 173

29 Karl Marx *The Class Struggle in France 1848-1850* in Marx and Engels, op. cit. vol I pp 128-129

Orleanists and the Legitimists can be seen in terms of a competition between the owners of capital and the landlords³⁰

Government officials exploit the conflicts among the various possessing . They form a new branch of division of labor *within* society. This gives them particular interests, distinct, too, from the interests of those who empower them; they make themselves independent of the latter.”³¹ As a consequence, as pointed out by Theda Sockpol “fundamental conflicts of interest might exist between the dominant class or set of groups on the one hand, and the state rulers on the other”³²

Ideologically, Marx and Engels stand on the opposite pole from Adam Smith; the Marxian method of approach to Political Economy also differs markedly from that of the Classics. Yet, except for differences in emphasis, the two traditions have a very similar conception of the economic role of the State. Both traditions recognize that the State supplies socially useful goods and services which the market fails to provide. Adam Smith sees that the government is of major importance to the possessing classes whose interests it presumably

30 Karl Marx *The Eighteenth Brumaire of Louis Bonaparte* *ibid.* vol. I pp. 247-253

31 F. Engels, letter to C. Schmidt, 27 October 1890 in Marx and Engels, *Selected Correspondence* (2nd ed. 1965) p. 421, quoted in Draper (1977) p. 246.

32 Sockpol (1979) p. 27, cited by Shaw (1985) p. 249

serves, while Marx and Engels perceive the government as a tool which the possessing classes utilize to exploit the dispossessed. But Marx and Engels, no less than the Classics, recognize that among the possessing classes there is heterogeneity of interests which By acting as arbiter, or by allying itself with some interests against others the government gains autonomy. The government is not a mere tool: it is a major player the politico-economic game.

John Stewart Mill (1806 - 1873)

Mill's *Principles of Political Economy* are the apogee of the classical political economy. Like his predecessors Mill endeavored to treat the entire socio-politico-economic Gestalt. Thus in the preface to the second edition of his Principles we read that:

“Except on matters of mere detail, there are perhaps no practical questions, even among those which approach nearest to the character of purely economical questions, which admit on being decided on economical premises alone” (Mill 1909, 1968, pp. xxvii - xxviii)³³

Mill draws a clear line between “economic laws” and social objectives

“The laws and conditions of the production of wealth partake of the character of physical truths. There is nothing optional or arbitrary in them”. But “it is not so with the distribution of wealth. That is a matter of human institutions solely... The distribution of wealth... depends on the laws and customs of society” (Ibid. pp. 199 -200)

³³ All page references are to Mill (1968)

Neoclassical analysis accepts, as a matter of convenience, Mill's distinction between economic laws and social goals. The two types of problems, in truth, are not separable. As noted by Adam Smith, the greater the inequality of possessions, the greater the need for "Law and Order". It is, indeed, difficult to think of a public good the demand for which is independent from income distribution, though Mill was clearly right in drawing a distinction between narrowly defined economic efficiency and social equity.

Corresponding to the dual nature of economics, the political economist has two distinct tasks: to discover and to analyze the "physical truths" and to prescribe policies favoring the establishment of a good society. In contrast to earlier "classics" Mill tends to discount the effects of pressure groups on policies. Thus, in his discussion of protectionist policies Mill demonstrates that the imposition of trade restrictions create a deadweight loss, but he fails to acknowledge that trade barriers are advantageous to import-competing industries. On the contrary, he argues that "Those who are supposed to be benefited, namely the makers of the protected articles (unless they form an exclusive company, and have a monopoly against their won countrymen as well as against foreigners) do not obtain profits higher than other people". (ibid. p. 917). Protectionism, he continues was "originally grounded on what is called the Mercantile System... The principle of Mercantile Theory is now given up even by writers and governments who still cling to the

restrictive system” Unlike Adam Smith, Mill does not perceive that interest groups pressure governments to pursue policies that may be inimical to the common good. Such policies, in Mill’s opinion, reflect the policy makers’ imperfect understanding of “physical truths. The economist’s duty is to enlighten the policy maker and enable him to carry out his duties so as to promote the common good.

Some government functions, for example rules providing for standards of weights and measures, are “inseparable from the idea of a government, or are exercised habitually and without objection by all governments”. But when it comes to other rules, such as those determining maximum or minimum prices “it has been considered questionable whether governments should exercise them or not” (ibid. p. 796) Mill thinks, therefore, that the compilation of a list of Duties of the Sovereign is a futile task. Instead on page 950 of his Principles, he proposes a pragmatic rule which many find to be valid to this day: “*Laissez-faire* ... should be the general practice: every departure from it unless required by some general good, is a certain evil”. To be sure not all private institutions function efficiently:

“Government management is, indeed, proverbially jobbing, careless, and ineffective, but so likewise has been joint-stock management. The directors of a joint stock company, it is true, are always shareholders; but also members of the government are invariably taxpayers; and in the case of directors, no more than in the case of governors, is their proportional share of the benefits of good management equal to the interest they may possibly have in mismanagement, even without reckoning the interest of their ease” (ibid. p. 961)

Nevertheless, since the government is less efficient than the “invisible hand” government should step in only where it is demonstrably able to outperform the private sector.

The pragmatic rule advocated by Mill is of major importance. For consider, again, the example of the “game” (shown in figs. 1.2 and 1.3) where the market leads to a Pareto-inferior position. State interference could improve all the players’ welfare, provided the cost of interference were less than 16. If the cost were to be higher, it would be better not to interfere. Thus “market failure” does not constitute a sufficient reason for State interference. The State should step in only if the benefit from its action exceeds the cost.

Lessons from the “Classics”

We owe to Hobbes the basic notion that a selfish citizenry derives benefits from the subordination to a selfish ruler who imposes “Law and Order” to foster his own good. Locke, by contrast, looks upon the State as a voluntary association of equals who surrender a degree of freedom for the sake of the Common Good. Hume sees the need for an authority to regulate property rights. Petty draws attention to the need of State action to achieve economic efficiency and social justice – the latter aspect being of major interest to Steuart. Adam Smith takes it for

granted that even a selfish government is capable of providing an institutional framework permitting people to strive for individual betterment, such strivings fostering a common good. Madison develops the ideas of the “Agency Government” whose purpose to keep a balance among conflicting interests, while Marx looks upon the government as a tool to foster the interests of the economically powerful. Such ideas – including JS Mill’s pragmatic advice to leave all activities to the private sector, unless the government is capable of doing a better job- have retained their relevancy to this day.

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