

# Conceptualising Role of the State in Light of Classical Economic Thought

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## Abstract

*This paper attempts to analyse and describe the role played by a state in promoting economic growth by contrasting two classical schools of political economy, the Keynesian school of thought and Neo-liberalism. The British economist, John Maynard Keynes proposed optimising market practices under a technocratic system of governance. In recent decades, this influential approach has exposed its vulnerabilities to the revival of neo-liberal laissez-faire arguments. In the age of globalisation, the integration of economies around the world has put new demands on the modern state at the very same time, in many ways, which have reduced their capacities to deal with those demands. The state today is squeezed, on the one side, by the forces of global economy and, on the other side, by the political demands for devolution of power. There is an important role for the state to play in the economic development, whether it is through intervention or deregulation, the ultimate choice lies with the society regarding which of the two forms to follow. In some dramatic role reversals, the yesteryear champions of laissez-faire (the US and UK) are moving towards protectionism, whereas, the earlier advocates (China and Russia) of closed economies are today arguing the case of free and fair international trade and globalisation per se. This is no coincidence as, ironically, both the school of thoughts have a lot in common in that they complement each other in many ways in terms of intellectual ideology.*

**Keywords:** Keynesian Economics, Neo-liberalism, Free Markets, Regulatory State, Economic Development.

## Introduction

The discussion about the role of a modern state in achieving economic development and progress has been going on for more than two centuries. However, the historical developments indicate that such a role is not fixed in

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time, for the same countries and across different countries. The decades following the end of the World War II witnessed a concerted effort to achieve a substantial economic growth across the globe. There were some success stories, mainly evident in the swift recovery of the Western Europe helped by the US Marshall Plan<sup>1</sup> but also many failures. These set off deliberations amongst the economists and policy makers that continue to this day, over just what the countries need to do, to achieve sustained economic development.

At the forefront of this debate, is the question of the proper role for a state in its national development. For a long time, the neo-liberals like Friedrich Hayek, Karl Popper and Milton Friedman have advocated unregulated market and non-interventionist state; based on the ability of freely functioning markets to achieve optimum efficiency during economic growth. This goes against the ideals of the Keynesian school of economic thought, whose proponents like Karl Polanyi, Michal Kalecki and Joan Robinson believe that a state has a major role to play in stabilising the economy and take to secure full employment, thus, eliminating recession. There was a sharp increase in public spending in the periods between the two world wars to finance the wars and deal with the ‘Great Depression’ (1910-1945).<sup>2</sup>

After 1945, the involvement of the states in their economies continued to increase, as they wanted to stabilise their economies through policies aimed at repairing the damage and preventing further decline. This period can be termed as the period of state interventionism.<sup>3</sup> The increased role of the state declined after 1974, but it still continued to grow, though, at a slower rate as compared to the preceding 30 years. This period can, therefore, be termed as a period of ‘retreat of the state.’<sup>4</sup> The intricate nature of the political infrastructure determines the relationship between the states (politics) and markets (economy), whether it is in a form of a big state, small market; or a small state, big market.

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<sup>1</sup> “Marshall Plan,” History.com, <http://www.history.com/topics/world-war-ii/marshall-plan>

<sup>2</sup> Vito Tanzi and Ludger Schuknecht, *Public Spending in The Twentieth Century: A Global Perspective* (Cambridge: Cambridge University Press, 2000).

<sup>3</sup> Tanisha M. Fazal, *State Death: The Politics and Geography of Conquest, Occupation, and Annexation* (New Jersey: Princeton University Press), 1-320.

<sup>4</sup> Susan Strange, *The Retreat of the State: The Diffusion of Power in the World Economy* (Cambridge: Cambridge University Press, 1996).

This paper will try to look at what the ‘economic role of the state’ be, and discuss historic evolution in the dominant state (regulatory) activities conceptually in light of the two classical school of thoughts in shaping policy formulation. Both concluded from the Great Depression that both the free market and the federal reserve had failed but they disagreed on which out of the two was the main culprit. Both, to forward their respective arguments, sought to essentially advocate the right equilibrium between the state’s footprint and the free market forces. They also agreed on economic governance rules and principles that form the essential pre-requisite to any success, whether of the state or of the market economy. Both saw the Great Depression as, at the bottom, a crisis of inadequate aggregate demand. Both wrote in favour of floating exchange rates and of government made money and both were on the side of freedom in the great ideological struggle of the 20th century.

## Early Beginnings

Through his book, *Wealth of Nations in 1776*, Adam Smith was the first economist who challenged the orthodox beliefs of his time, which assumed it was the state that led the development process.<sup>5</sup> Smith argued instead that economic progress was achieved by the individuals who worked through the market to specialise in the production of one particular item and then exchanged that commodity in the market for other goods.<sup>6</sup> This division of labour would lead eventually to the creation of an efficient economic system, centred on the unregulated market. The market system would form a prosperous society, with each individual following his self-interest, with the minimal role of the state through the provision of defence, law and order and overseeing enforcement of contracts through public institutions.

Smith was writing at a time of enlightenment in Europe in the mid-17th century. In Britain, at least, his ideals dominated development thinking for much of the country’s growth in the 1800s, as the policy makers of the nation promoted free trade with the state and religion playing a minimal role

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<sup>5</sup> Adam Smith, ed., *The Wealth of Nations* (New York: Modern Library, 2000).

<sup>6</sup> Robert L. Heilbroner, “The Wonderful World of Adam Smith,” in *The Worldly Philosophers: The Lives, Times and Ideas of the Great Economic Thinkers* (New York: Simon & Schuster), 53-57.

in the economy.<sup>7</sup> Elsewhere, the state often played a major role in the development of economies. David Ricardo and Karl Marx continued Smith's tradition of classical economic thought in the 19th century even though Marx drew different conclusions from Smith about the workings of the free market system. After Marx and Ricardo, the attention of the economists shifted towards studying as to how the market system worked rather than economic growth, which was hitherto taken for granted. This brought an end to the classical tradition of economics.

### **Inter and Post-war Periods**

The focus changed dramatically after the end of the World War II, which had devastated much of the Western Europe and Japan. The challenge now faced by the policy makers was how to achieve economic recovery. The solution arrived in the form of the Marshall Plan, through which the US supplied US\$25 billion to rebuild the Western Europe, with immediate and far reaching results. Within a couple of decades, Europe recovered, with the Gross Domestic Product (GDP) growing so quickly that these countries caught up with the level of income that they would have achieved if they had not been consumed by the war. The main reason was the Western Europe's fully developed legal and educational systems, which was designed for a modern industrial economy, coupled with a large trained population capable of organising, both in bureaucracy and the private sector, along with the understanding of modern technology, even though most of the physical infrastructure had been destroyed by the war.<sup>8</sup>

In the West, there was the obvious realisation on the part of the policy makers that markets had not performed according to the expectations before the war; a glaring example was the Great Depression of the 1930s. The economists had long been aware that all economies suffer from market failures, albeit on a varying scale. The question they now faced was to determine the prevalence of the market failures and the role the state should play in rectifying them. The Keynesian principles were adopted in public policy after the World War II, a period in which the state played a major

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<sup>7</sup> Barry Eichengreen, *The European Economy Since 1945: Coordinated Capitalism and Beyond* (Princeton University Press), 1-520.

<sup>8</sup> Allan M. Williams, *The Western European Economy A Geography of Post-war Development* (Routledge: Routledge Library Editions: Economic Geography), 1-354.

role in the resurrection of the economic institutions in the Western world.<sup>9</sup> The Keynesian economics emerged as an outcome of the Great Depression of the 1930s championed by the British economist Maynard Keynes, who envisioned a strong role of the state in working of the market system so as to provide stable economic structure required for growth. According to Keynes, in the long run, the market-oriented economies provide the goods and financial benefits by going through the periods of booms and troughs. The state should intervene to eliminate the troughs by investing in infrastructure during periods of boom in order to stabilise the economy and lead it towards the level of full employment, through the process of countercyclical policies, which is a virtuous cycle. Furthermore, the Keynesians also believe that controlling the monetary policy, which deals with interest rates and money supply, is useless in stabilising the economy; compared with the fiscal policy, which deals with government spending and taxes.<sup>10</sup>

Following the Keynes economic theory, Karl Polanyi advocated public management of societies, especially in times of recession and did not support the notion of a free market, working to decide the interests of the individuals and society as a whole.<sup>11</sup> They maintained that the state's involvement was necessary to ensure that factors like production, land and labour were used efficiently to bring about economic growth. They also argued against the division of a society into economic and political spheres, as is the case with capitalist economies, unless the society fulfils the necessary requirements to adopt such changes. Otherwise, it would be detrimental to the whole society and would destabilise the existing economic systems. The inference they drew was that a market economy can only exist in the market societies.

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<sup>9</sup> Sarwat Jahan, Ahmed Saber Mahmud and Chris Papageorgiou, "What Is Keynesian Economics?" *Finance & Development* 51, no. 3 (September, 2014).

<sup>10</sup> Stephen Bell, "The Instruments and Tasks of Economic Policy," in *Un-governing the Economy: The Political Economy of Australian Economic Policy* (Melbourne: Oxford University Press, 1997), 9-17.

<sup>11</sup> Karl Polanyi, "The Self-regulating Market," in *The Great Transformation: The Political and Economic Origins of Our Time* (Boston: Beacon Press, 1944), 68-76.

## Welfare State and Beyond

In the decades following the war till the 1970s, fiscal policy was the favoured tool of the policy makers, through which the state intervened to stabilise the market and lead the country towards economic growth by making public sector investments. The countries with large public sectors were thought to be less prone to business cycles, which led to the expansion of the state involvement in the public sector spending. This was the beginning of a welfare state system.<sup>12</sup> In promoting this expanded role, the state required much larger finances, which were obtained from the introduction of progressive income taxes and value added taxes; and also from public borrowing.

The public borrowing led to budget deficits, which the Keynesians viewed as a necessary vice for economic management during the periods of recession. The growth of social transfers was one of the major facets of the welfare state's involvement in the economy. The social transfers have increased in the Organisation for Economic Cooperation and Development (OECD) countries at an even faster rate than the overall public spending as a percentage of the GDP over the last 100 years.<sup>13</sup> The social transfers increased from almost 2 per cent in 1900 to almost 25 per cent in 2005, implying that one fourth of the income of the people living in the OECD countries comprised of the public-sector transfers, unrelated to their level of productivity. The social transfers as per cent of the GDP grew exponentially in the 1950s and 1960s, the decades in which the Keynesian principles were used by the state to control the workings of the market. However, its growth slowed down since the 1990s in the OECD countries.

In the 1970s, two major developments occurred which had a deep impact on how the role of the state in development was perceived. The first development was the rise in oil prices by the Organisation of the Petroleum Exporting Countries (OPEC) in 1973 and 1979, coupled with the Iranian revolution in 1979, which led to an increase in the prices of general commodities around the world. The second development was the borrowing of money by the developing countries from the international banks at low

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<sup>12</sup> Klaus Schubert, Paloma de Villota and Johanna Kuhlmann, eds., *Challenges to European Welfare Systems* (Switzerland: Springer International Publishing), 1-863.

<sup>13</sup> Peter Lindert, *Growing Public: Social Spending and Economic Growth Since the Eighteenth Century* (Cambridge University Press, vol. 1, 2nd ed., 2004), 1-396.

interest rates in the 1970s for development purposes.<sup>14</sup> By the mid-1980s, many of the borrower countries had defaulted on their payments, due to a global increase in prices, caused by the oil price shocks. The state intervention was unable to deal with the rising global inflation. Many countries were forced to contract the size of their economies by implementing monetary policies to reduce money supply in the market. Counter to the argument of Keynesian state intervention in the economy, Neo-liberalism gained ground in the 1970s, bringing back the idea of a minimal state and the free market system. According to the neo-liberals, the countries like Japan and Germany, which had little state intervention in the market system coped better with rising prices than the countries like the US whose economy was regulated by state policies, which led to a period of recession.

## Debate

In the 1970s, there was a realisation on part of the policy makers that state intervention in the market had been accompanied by negligence towards the core activities of the state. There was an unproductive use of the public resources, leading towards a deterioration of the services and goods provided by the state. The neo-liberals argued that state interventionism had caused hindrance in the proper functioning of the market system, due to distortion of commodity prices. Neo-liberalists wanted to transfer control of the economy from the public domain to the private sector, in essence, reduction of the role of the state in the economy and allowing the market to function freely without any barriers. This, they believed, would lead to an efficient state and improve the economy.

Milton Friedman, one of the foremost neo-liberal economists of the time in the US, championed the role of free market for economic development and thought of it as a cornerstone for sustained economic growth. Friedman believed that a price system set out by the free market and not by any state regulation will send out signals, which become incentives for efficient allocation of resources around the world without encroaching on the self-

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<sup>14</sup> Robert K. Schaeffer, *Understanding Globalisation: The Social Consequences of Political, Economic, and Environmental Change* (Rowman & Littlefield, 2005), 1-329.

interest of the individual; thus, the unintended consequence is the formation of a stable economic order.<sup>15</sup>

The neo-liberals envision a limited role for the state in the economy, which defines as a mechanism for voluntary cooperation as a way for the individuals to achieve some of their interests in an efficient manner.<sup>16</sup> The state is there to provide public goods and services, which the people are free to choose from, for instance, whether to live in one community or the other depending on the type of public services and their cost. An important role of the state is the use of legitimate force that is taxation over which it has a monopoly to provide law and order, enforce social contracts and protect the people against invaders. The Public Choice theorists, who form the hard-core group among the neo-liberals, also support the view of limited state intervention and further argue that there should be an implicit fiscal constitution, which does not allow the state to enter into debt.<sup>17</sup>

Furthermore, consumers are the key part of the market and the state's role is to ensure the provision of a stable environment in which these consumers can interact freely in the market. According to them, minimal role of the government and low taxation would provide the most efficient economic system. Some neo-liberals like Philip Lewis concede to the necessity of a state's intervention in free markets during the times of market failure.<sup>18</sup> These market failures can arise from lack of legislation to enforce contracts, lack of competition, negative externalities, asymmetric information and inefficient or inadequate provision of public goods. In case of a market failure, timely intervention of the state with effective policies can help restore the market and stabilise the economic system. Also, a productive social sector depends on good state policies because the private sector is not self-sufficient, it needs an equally efficient public sector to function. This possibly goes against Friedman's

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<sup>15</sup> Milton Friedman and Rose Friedman, "The Roles of Prices and the Role of Government," in *Free to Choose: A Personal Statement* (London: Secker and Warburg, 1980), 13-14, 27-29.

<sup>16</sup> David Harvey, *A Brief History of Neo-liberalism*, (Oxford: Oxford University Press 2007), 1-256.

<sup>17</sup> Hugh Stretton, *What Private Enterprises Need from Government: A Short Summary, Economics: a New Introduction* (UNSW Press, 1999), 442-443.

<sup>18</sup> Philip Lewis, Anne Garnett, Malcolm Treadgold and Kim Hawtrey, "Economic Basis for Public Policy," in *Australian Economy: Your Guide*. Pearson. (2010), 70-71.



views of a limited state intervention even in times of crisis because, according to him, the market system tends to be self-regulating.

For the last quarter of the century, the push for a minimal role of the state has been ostensibly intensified, due to globalisation and neo-liberal reforms, implemented on the advice of multilateral agencies like the World Bank and the World Trade Organisation (WTO). This was based on the growing sense of the policy makers in the 1970s, based on research and experience, that many of the state interventions did not produce the desired results and instead created obstacles in the way of sustained economic growth. To overcome the development challenges, the World Bank proposed a different approach from state interventionism, termed as the 'structural adjustment.'<sup>19</sup> Structural adjustment included new reforms, targeted at the structure of the economy, making it more market oriented, efficient and open to international trade, by focusing more on the production of tradable goods. The immediate result was a wide array of reform proposals imposed as conditionality on the countries that wanted to receive assistance from the World Bank or other aid agencies. The major objective of the structural adjustment reforms was to address the market distortions, caused by state intervention, to facilitate proper functioning of a deregulated market. The 1980s and 1990s, witnessed a significant shift towards the reform agenda in the developing world, with greater emphasis on fiscal restraint, accompanied by privatisation of state-owned corporations.

With the return of the neo-liberal policy makers in the 1970s, the focus of the economy moved from the public to the private sphere. This also led to the changes in the institutional structures. According to the new institutional economic approaches of the neo-liberals, the public institutions are not able to perform their job properly, hence, hindered the working of free markets.<sup>20</sup> The regulatory institutions, which instead of addressing the issues of market problems, made them worse, were considered as the main culprits. It was that their large bureaucratic structures lead to inefficiency. Furthermore, it is impossible to presume that there are high minded, complacent bureaucrats working towards the functioning of an efficient institution. In fact they

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<sup>19</sup> Patrick A. Imam, "Effect of IMF Structural Adjustment Programs on Expectations: The Case of Transition Economies," International Monetary Fund, 2007.

<sup>20</sup> J. Wallis and Brian Drollery, "New Institutional Economies, New Public Management and Government Failure," in *Market Failure, Government Failure, Leadership and Public Policy* (London: Macmillan Press. 1999), 61-70.

replicate a non-market system within the market system because individuals cater to their own self-interests rather than that of the organisation, a principal-agent problem. There is also a problem of free riders – the employees who take all the benefits – and provide a minimal return. Another problem is the extensive bureaucratic budget spending leading to a situation of moral hazard. The solution being dictated budgets and separation from interventionist policies of high public spending. New Institutionalism approach also states that both public and private institutions must decide whether they are going to participate in the market or not, which comes under the transaction cost analysis. The transaction costs between the sellers and buyers determine, whether the organisation participates in the market or not.

There is a clear division in different economic schools of thought regarding the role, which state plays in the economy. For the most part, thinking about the role of the state has been a learning process, as successes and failures have helped develop a more refined understanding of the role of the state and its institutions. There are success stories on both sides of the divide, which can be seen in the case of Japan, which has a minimal state role and China in which the state has played a significant role in economic development. Even though, over the last two decades, the role of the state in the market has been curtailed through deregulation policies around the globe, the size of the state continues to grow; which can be gauged from the public-sector spending over the last 100 years.<sup>21</sup> Friedman argues against any form of state intervention as, he believes, it makes the market inefficient and curtails the individual's self-interest. However, according to Polanyi, there is a double movement: forces which attempt to create market systems and those that oppose it go on simultaneously and are countercyclical to each other.

## **Conclusion**

The performance of a government does not depend on its size, meaning its level of interference in the economy but rather on the policies it implements to stimulate economic growth. Despite all the development debates, since the 1950s, a large portion of the globe still

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<sup>21</sup> Vito Tanzi and Ludger Schuknecht, "Public Spending in the Twentieth Century: A Global Perspective," *OECD Economic Outlook*, 91 (2000): 6-7.

remains undeveloped. In this scenario, China provides an important example of a large economy that adopted a mixture of policies from both the Keynesian and neo-liberal school of thought for their development, along with the four Asian Tigers, which remained the success stories of the last few decades. The growth of public sector through infrastructure development can play an important role in the economic activity and can have a positive impact on the private sector as well, as can be seen in the case of the OECD, albeit to varying degrees of success.

Keynes's insights basically focus on two broad categories: Why do economies go into a downturn; and why the stay in one? He showed that contrary to the beliefs of the classical economists, supply did not always create its own demand and that the governments needed to step in to prevent persistent underemployment. Friedman, on the other hand, believed that one could not spend one's way out of recession and such a policy would only instill inflation and pain. A lead up to 2008, and post-financial crisis in 2008, it was observed that both were partly right and partly wrong. Indeed, the US did was able to ease some of its pain through quantitative easing but then again with all the monetary easing injected by both the Federal Reserve and the European Central Bank, the so-called developed western economies still continue to remain in the grip of recession.

The modern-day answer, perhaps, lies in striking due discipline and the right balance by combining the might of the state with the efficiency of the private sector-cum-free market entrepreneurial juices – a fact amply displayed by looking at some of the present day economic success stories in many ways. Politics and governance do have an important role to play in the economy, whether it is through intervention or liberalisation. According to Joan Robinson, the states did not fully adopt the Keynesian principles after the WWII, as governments did not invest much in the public-sector development due to the boom caused by the reconstruction and because of this there would be periods of recession in the West (as witnessed during the Global Financial Crisis of 2008).<sup>22</sup> One, therefore, cannot be overly critical of the performance of state interventionism in the 30 years after the war. Thus, there is an important role for the state to play in the economic development, whether it is through intervention or deregulation, by

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<sup>22</sup> Joan Robinson, "What has Become of the Keynesian Revolution?," in *After Keynes*, ed., J Robinson (Oxford: Basil Blackwell, 1973), 1-11.

providing the necessary ingredients of human capital and stable political environment. The recent failure of the Alan Greenspan model of unbridled market, driven by the economy in the US, adequately proves the point.