

ON THE MISSING MACROECONOMICS OF SOCIAL LIBERALISM: FROM PHYSIOCRATS TO PRE-WAR CHICAGOANS AND FREIBURG

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Abstract

Put in terms of the two fundamental theorems of welfare economics, social or welfare liberalism is being defined as the tenet criticizing classical liberalism for neglecting the second theorem, having nothing to say about the “liberalism” of macroeconomic policymaking. This note claims that the macroeconomic dimension of social liberalism is the one advanced by pre-war, Old Chicago, which, based on the quantity theory of money, was maintaining (i) that it abides by *laissez-faire* but against classical liberalism’s *laissez faire* of “let the cycle run its course”, and given (ii) that Old Chicago was seeing government intervention necessary for income-redistribution reasons, too. Which of the two liberalisms holds the true version of *laissez faire*? Going back to the Physiocrats who had coined the term, one realizes that they had done so from the welfare liberalist point of view abstracting from the macro-monetary issues raised of Jean Bodin separately. This abstraction continues until today neglecting the “fact” that what Old Chicago had really done was to integrate into social liberalism the quantity-theory-of-money macro-monetary considerations having started with Bodin. The German “experiment” with the Freiburg-School-inspired *Soziale Marktwirtschaft* - an experiment in social liberalism - attests to the need for “Chicago rules” if social liberalism is to stand out as a different system altogether. In sum, the only microeconomics-cum-macroeconomics consistent with the true, the socio-liberal *laissez-faire* is the Old Chicago economics. Examples in classical liberalism are Monetarism and Austrian economics whereas Keynesianism and Marxism abandon *laissez faire* altogether.

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JEL Codes: B1, B2, D02, E3, P1

1. Most modern economists would identify with Mainstream Economics, namely with one or more of neoclassical economics, monetarism, Keynesian economics, new classical economics, Austrian School, or behavioral economics. And, there are the Heterodox Economics of institutional economics, Marxian economics, feminist economics, socialist economics, binary economics, ecological economics, bioeconomics and thermoeconomics, ..., too. But, once it is recognized that the satisfaction of the basic human needs for food-clothing-shelter can never be based on autarky alone imposing own-resource-and-preference based exchange as well, the exchange arrangement becomes as indispensable to survival as production means are and the only relevant economics is the one acknowledging explicitly this reality.

Labor, land, and capital at the disposal of a household, produce output which cannot satisfy partly or fully the needs of the household before it enters the inter-household arrangement through which it can be traded based on its quantity and the consumption preferences of the household. And, according to economic history, this arrangement has been universally no other than the market, though as a necessity which is plagued by information asymmetries and hence, as a necessary but not sufficient condition towards efficiency-equitability-envy freeness (EEE), prompting subsequently at all times and places various quests for corrective market interventions (Boldeman 2007). Yet, these are quests being shaped primarily by the

relative economic and non-economic power of market agents and non-market actors and hence, of questionable policy effectiveness to the extent that EEE is sought. Is there a standard policy regime against which the discrepancy of policy effectiveness may be measured?

2. This note claims that such a regime is that under the *laissez faire – laissez passer/laissez aller* (let us alone—get out of the way, or *LF* in brief) doctrine, viewing it not only (i) from the “invisible-hand”, (individualistic, classical liberal/libertarian, minarch, Locke-Voltaire, or *lf* in brief), viewpoint of the first theorem of welfare economics, but also (ii) from the resource-redistribution (social liberal, welfare-state, Rousseau-*étatiste*/statist, or *ws* in brief) perspective of the second theorem of welfare economics, and (iii) from acknowledging explicitly the role of money in the general-equilibrium setting as this role is captured by quantity theory, adds the pre-war, Old Chicago School of Economic Thought (*CS*). René de Voyer, Marquis d'Argenson's (1751) motto “*pas trop gouverner*”, or as put in the US, “that government is best which governs least”, being attributed variously to Thomas Paine, Thomas Jefferson and Henry Thoreau (Fine 1964), are invisible-hand minded, disregarding the other two scales of the *LF* doctrine.

Once welfare maximization is acknowledged to involve income redistribution and money matters as well beyond free trade, the state does have to play a major role towards this end, and the *LF* doctrine maintains that the government that can play best this role is only the efficient one. Efficiency fostered by a welfare state and by a quantity theory (*qt*) based countercyclically balanced government budget, always safeguarding against bureaucracy. It is true that “any power corrupts” and a conflict between Pareto optimality and social liberal policymaking (Peacock and Rowley 1972) might ensue even if government intervention intentions were in the desirable direction. So, by the term “efficient government” is meant such a control of bureaucracy that allows Pareto-improving rather than the ideal of Pareto-optimum-restoring government intervention (Fahri and Werning 2013). Note that these considerations should be disconnected with social choice and ethical issues. The definition of social liberalism given here, namely that $LF \equiv CS = lf + ws + qt$, is economically quite clear and apart from an article on Rousseau (Froese 2001), no attempt is made in this volume to expand on issues raised for example by James Buchanan's social philosophy (Barry 1984) and/or Sen's social-choice rule limitations (Farrell 1976).

Social liberalism as defined herein differs from the traditional definition of the term (Brack et al. 2007, Mintz 2009) in that the macro-monetary dimension is added. The social liberalist view of *LF* held herein is no other than the free-enterprise system envisioned by *CS*. Microeconomically, Frank Knight (1939) identifies *laissez-faire* with *LF* uniformly, including Adam Smith's version.¹ Or, in Henry Simon's (1936, 1-2) words, “*A liberal system...would involve a large measure of political control: outright collectivism in some areas; deliberate enforcement of competition in others; prevention of extreme inequality, largely via taxation, in the distribution of property, income, and power.*” And, macroeconomically, Davis (1968), Patinkin (1969), and Tavlas (1997), clarifying pre-war Chicago economics and differentiating it from post-war Chicago, explain that: “*In a significant way, the policy proposals of Keynes and the Chicago economists were remarkably similar during the early 1930s... [but] the group which had labored in behalf of the notion of compensatory public spending was unsympathetic towards the notion of secular public spending which they read into Keynes' General Theory*” (Davis 1968, 481). The social liberalist welfare-countercyclical state differs from the Keynesian mixed economy in that state intervention in the latter is permanent, with unclear welfare objectives since it lacks microeconomic foundation and dismisses *lf*. In essence, Keynesianism is a theory of statism rejecting *laissez-faire* in the same spirit but absolved from the totalitarianism of Marxist and Fascist statism. *Étatisme* does not reject *lf*; it should be subject to a *Rousseauesque* social contract complementing the Lockean one to which *lf* should be subject.

3. Indeed, according to Anne-Robert-Jacques-Turgot (1759 [1844]), the maxim *laissez faire* was popularized by Jean Claude-Marie Vincent, Seigneur de Gournay, who supported that “*les intérêts des nations et les succès d'un bon gouvernement se réduisent au respect religieux pour la liberté des personnes et du travail, à la conservation inviolable des droits de propriété, à la justice envers tous, d'où résulteront nécessairement la multiplication des subsistances, l'accroissement des richesses, l'augmentation des jouissances, des lumières et de tous les moyens de bonheur ... [il] s'attachait à dévoiler l'intérêt caché qui avait fait demander, comme utiles, des règlements dont tout l'objet était de mettre de plus en plus le pauvre à la merci du riche*”. And, at the same time, Pierre Bezbakh (2011) notes that Gournay, “*voulait également que l'Etat fasse baisser les taux d'intérêt et joue un rôle actif dans le financement de l'économie, comme Keynes le préconisera deux siècles plus tard*.” In sum, Gournay, appears to be the first social liberalist, completely in line with the theses of Old Chicago. Social liberalism respects the role of “invisible hand” acknowledging at the same time that microeconomically, “*unfettered markets often not only do not lead to social justice, but do not even produce efficient outcomes*” (Stiglitz 2007), and that macroeconomically, “*a plethora of frictions or departures from Arrow-Debreu's assumptions, [open] the door to ...government interventions, ...even if policy instruments... fall short of reestablishing the first-best outcome*” (Fahri and Werning 2013, 1).

The role of the state is not confined to being only a passive policeman, protecting private property and administering justice, as classical liberalism wants it, but derives from the ancient Chinese term “*wu-wei*”, coined by François Quesnay as *laissez faire – laissez passer* (Maverick 1946 [1767]), and meaning not inactive, but “efficient government” as very well Gerlach (2005) notes. Samuels (1961, 109-110) writes for the Physiocrats in general that, “*The concept of social function was thus correlative to that of private right, and for practical purposes the former would govern the latter. ... in the implementation of the Physiocratic programs of social construction, economic development and economic stability*”. This is how specifically Physiocrats saw *wu-wei*, what efficient government means in practice, and what is really meant by the original, the genuine use of the dictum *laissez faire – laissez passer*. This is the heart of social liberalism, which Old Chicago perfected based on quantity theory and by trying to set rules in the interaction between social function and private rights; rules permeated by *Rousseauesque* social contract mentality exactly as private affairs should be in line with some Lockean social contract. Bureaucracy, which is a term coined sarcastically by de Gournay too (Starbuck 2003, 149), is the “enemy”, not the state.

Indeed, “*‘Political economy’ was understood [by the Physiocrats] as both a system of reflection on the organisation of society, and as form of knowledge exercised in the public sphere — according to the dictates of reason — in order to assess the justifications advanced in favor of government policy*” (Faccarello and Steiner 2012, 325). Physiocrats emerged in reaction to Jean-Baptiste Colbert’s *bureaucratie* in which they saw the evils of their contemporary French economy: “*Under Louis XV (1710–1774) and Louis XVI (1774–1793), France was plagued by ruinously expensive warfare along with economic instability*” (McElroy 2010). Physiocrats thought that these adverse economic consequences of royal despotism could have been prevented if the comptroller general of finance Colbert had chosen to compensate state despotism by economic freedoms instead of extending despotism to the economy as well. They had to emphasize economic freedoms but that did not mean that they were minarches, that they were seeing no role for the state other than the night-watchman’s one. They were *Rousseauesque*, *étatiste*, rather than Voltaire, individualistic, liberalists, and this is the reason they were actively involved in the French Revolution given that it was the Revolution that would inspire subsequently the emergence of national states in Continental Europe in the first place.

Physiocrats were mostly laymen, who when persecuted eventually by the Jacobins, their ideas had not been fully worked out and just fade away, leaving only the legacy of *laissez faire* to pass on to Adam Smith in the form of “invisible hand” in line with the traditional at the times

British, Lockean, individualistic, liberalism. As such it was immediately embraced by the socioeconomic elites of the times, blurring even further the “picture” about the Physiocrats, inducing later Henry Higgs (2001 [1897], 6) to note that: “*The Physiocrats have been the subjects of so many and such divergent appreciations by historians, philosophers, economists, and students of political science*”. Social liberalism did resurge later but only politically and philosophically in response to the subsequent deepening of income inequality (Richardson 2001). Adam Smith had already raised second welfare theorem issues (Pack 2010), but he probably saw an inconsistency between the need for the intervention of an economic actor who from the viewpoint of the first welfare theorem acts distortedly. And so he avoided this matter altogether, making thereby his theory exploitable by all sorts of the ruling economic and non-economic interests. Nevertheless, Adam Smith’s second thoughts about the welfare implications of the “invisible hand”, did lay the ground for the development of the British *étatisme* of Matthew Arnold (1965 [1869]) and Thomas Hill Green (1999 [1883]), calling upon state intervention to free people from poverty and ignorance, and leading to disintegration the traditionally conservative British Liberal Party (Cranston 2006 [1967]).

4. The British were “discovering” social liberalism themselves at the same time either type of liberalism, being interpreted at will by political opponents, was becoming conceptually more and more obscure in France until it was abandoned altogether with the rebellion of 1848; *libéralisme* would resurge in its Lockean form by Émile Faguet (1903) and in its statist form by Jean de Grandvilliers (1914). In America, the calls against the deepening inequality under the individualistic Gilded Age (1870s-1890s), resulted in the Progressive Era (1890s-1920s) characterized by the belief “*in a powerful, centralized state, conceiving of government as the best means for promoting the social good and rejecting the individualism of (classical) liberalism; ...[in] social efficiency; ...in the epistemic and moral authority of science*” (Leonard 2009, 109). Social liberalism had found its way in America too, and did gain by Old Chicago, by actually a minority amidst the “red” or so pre-war Chicago as DeLong (1990) notes, the scientific and moral status which the progressives would like it to have. These and only details about the circumstances surrounding Old Chicago suffice to see why classical liberalism did not stand a chance in such an environment, and why DeLong is wrong when he opposes theses like those from Coase and Williamson (in Kitch 1983) who dissociate pre-war Chicago from classical liberalism. The major contribution of pre-war, Old Chicago to social liberalism was to resurface the role of money the way Jean Bodin (1947 [1568-78]) had started seeing it, in perfect conformity with the Physiocrats, who yet had left money out of consideration (Faccarello and Steiner 2012). Social liberalism continues this “practice” of Physiocrats, the neglect in general of the macro-monetary element, even today (Brack et al. 2007, Mintz 2009), and it is time to amend the concept for this shortcoming.

To do so, social liberalism should be contemplated as an economic system rather than as policy interventions to a classical liberal regime. And, on this, one basic lesson from the post-war German experience of trying to apply it in practice has to be stressed. The system of *Soziale Marktwirtschaft*, i.e. of the post-war Social Market German Economy, rest theoretically as an economic system upon the Freiburg School, and identifying its political philosophy with Ordoliberalism, was supposed to be in the spirit of social liberalism. Indeed, this is what Old Chicagoans would have abided with microeconomically under the circumstances that had produced this German model.² Going over Goldschmidt (2004) and Goldschmidt and Wohlgemuth (2008), one is struck by similarities in thought that induce one to claim that the Freiburg School echoes the American pre-war Chicago School up to the point of “rules”, as we shall see soon, and pre-war Chicago echoes the German Freiburg School stripped of the socialist overtones by some of its members. For example, according to Müller-Armack (1978, 327f): “*Unlike the advocates of Classical Liberalism, we know that the machinery of competition has certain deficiencies caused by imperfect markets, oligopolies and monopolies. ... Above all, the competitive order requires legal safeguards making sure that the market parties do not destroy it by pushing it into an anti-market direction. ... [Also, w]e know today that the market economy does not sufficiently satisfy certain requirements of*

social conciliation and security. We should, therefore, strive to build in appropriate stabilizers.” This connotes Knight! And, as Röpke (1979, 157)³ adds, the state’s “*independence from interest groups and the uncompromising assertion of its authority and dignity make it the champion of the general interest.*” This reminds Simons!

Buchanan (2010) and Köhler and Kolev (2011) are among those that would agree with these considerations. But, Freiburg is not exactly Old Chicago, since Rousseau and Simons would urge to found the socioeconomic model “*on rules of principle that lead to gains from joint commitment based on voluntary agreement by the citizens affected*” (Goldschmidt and Wohlgemuth 2008, 274), too. Freedom and security, efficiency and equity, are the trade-offs of classical liberalism that only such rules can relax, becoming thus a *sine qua non* of a social liberal economic system. And, the German model is not working well simply because its premises are on Freiburg, and unlike Old Chicago, Freiburg is unclear about the matter of rules (Goldschmidt and Wohlgemuth 2008). As advanced, the Social Market is like any other market. But, this reality does direct one to the importance of rules, which pre-war Chicagoans wanted for the macroeconomy as well: “*It is this danger of substituting authorities for rules which especially deserves attention among students of money*” (Simons 1936, 2). Constitutionalized rules are indispensable to Social liberalism if it is to be standing out as a distinct regime having merit *per se* and not as a statist intervention to an otherwise classical liberal regime. Not only the Social Market but any intervention of social democracy anywhere around the globe has failed because of the neglect of this aspect of social liberalism. They were policy interventions with Keynesian or Marxian flavor to the classical liberal regime, “patches of the system” whereas under “constitutionalized social liberalism”, cries for *lf* will be the ones becoming the patches of the system...

NOTES

1. “The *laissez-faire* economists of the straightest sect made exceptions of a sort which opened the way to much wider departures from the principle when and as changed conditions might seem to demand. This applies particularly to the great apostle of the movement, Adam Smith. All liberal individualists have recognized the necessity for restrictions on individual freedom, and also for action by the state, for purposes of defence [*sic!*] and police, and for carrying out various public functions, including “certain public works” of obvious public utility but which it would not be profitable for any individual or private group to construct and maintain. The state was to be supported, of course, by taxation, and the liberal notions of tax policy always inclined rather to equalizing the burden than to imposts in accord with benefit received. Moreover, liberalism has always accepted without question the doctrine that every member of society has a right to live at some minimum standard, at the expense of society as a whole-i.e., out of taxation levied as indicated above-if unable to provide such subsistence through his own efforts, the proceeds of sale of services, or through help from his family or voluntary private charity. Finally, Adam Smith and other liberals recognized as a legitimate function and task of the state, provision for the education of the youth, and, in varying degrees, for activities designed to promote the diffusion of knowledge and the advancement of science, art, and general culture” (Knight 1939, 6).

2. “Both Erhard and Eucken were born at the end of the 19th century and experienced the free market caricature – demoralized by private power and a weak state – that existed in the cartel-dominated economy during the Weimar Republic. Erhard described this period as “the years of the degeneration of the free market economy, forcing us to make a choice: either re-establish well-functioning markets by reinstating liberty, or decide to transform serfdom and servitude into a general economic principle.” Equally shocked by these circumstances, Eucken criticised how “the industry left the realm of competition to be controlled by the state and the cartels took over.” Eucken and Erhard came to the same conclusions concerning their historical experience during the “period of experiments”. And their insights about the war economy and the Third Reich led them to recommend the same therapies: instead of having

state control or state intervention through a planned economy on the one hand, or a powerless state in the face of private economic interests on the other hand, both believed the solution was a “strong state” that was able to counter all special interests.” (Goldschmidt 2004, 14).

3. Translated and quoted by Goldschmidt (2004, 14).

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