

# State and market

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*Source / Izvornik:* **Ekonomski vjesnik : Review of Contemporary Entrepreneurship, Business, and Economic Issues, 2014, XXVII, 113 - 126**

**Journal article, Published version**

**Rad u časopisu, Objavljena verzija rada (izdavačev PDF)**

*Permanent link / Trajna poveznica:* <https://urn.nsk.hr/urn:nbn:hr:145:931311>

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*Download date / Datum preuzimanja:* **2024-12-22**



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**UDK 330.82**

**Preliminary communication**

Received: May 9, 2014

Accepted for publishing: May 30, 2014

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# STATE AND MARKET

## ABSTRACT

The debate about the relationship between state and market, about their relative importance, does not cease to be topical, and there is no end of it in sight. The market (invisible hand) does need, more or less, the help of the state (visible) hand. Liberal sympathizers of the market prefer a “small” state whose ambitions include only providing an adaptable legal framework in which and by which the market functions, and (re) allocation of resources, because of the inherent defects of the market. Proponents of welfare economics will wish for progressive taxation and redistribution of income. Keynes’s mission to save capitalism meant an increase in the importance of the state and appearance of a new, stabilizing role of the state. Excessive unemployment is to be prevented by fine-tuning. Unfortunately, Keynes’s critics from the public choice camp will say that the state (government) is not perfect, and, as a rule, falls into the trap of asymmetry. Only and solely in theory will it apply that a perfect state means perfect functioning of an imperfect market.

**Keywords:** state, market, mercantilism, physiocracy, classical economics, welfare economics, economics of demand, monetarism, theory of public choice, Harvey Road mentality

## 1. Introduction

It is repeated as a mantra that neoliberal capitalism (neoliberal model of capitalism), which we, allegedly, practice, is to blame for the bad economic situation in Croatia. It was so at the beginning of the Croatian capitalist story, and so it is now. However, a “large”, expensive and inefficient state does not fit into this story, ostensibly imbued with great propensity towards the market.

A pragmatic sympathizer of the market<sup>1</sup> (miles away from market fundamentalism) is deeply aware of the imperfection of the market. When it comes

to malfunctioning of the market, things are fairly clear. Pareto suboptimality of the market (market failure) is caused by (at the microeconomic level)<sup>2</sup> market power (monopoly), public goods, imperfect – asymmetric information, externalities. Moreover, let us not forget that the market is a socially insensitive mechanism – market distribution is extremely uneven.

A pragmatic liberal, however, is also deeply aware of the many imperfections of the state, that is, less precisely, the government. He is doubtful regarding the ability of the state (government) to “fix” the market, always and infallibly, and ensure stable

economic growth. Croatia's (and not just its) economic actualities make him suspicious toward the "visible hand" and its abilities. A pragmatic liberal does not a priori perceive politics and politicians as a benevolent service that promotes public interest. Politics is, in his case, stripped of all idealizing and external shine.

Generally, we have become a bad society, a society that is unable to ensure solid economic growth. In a good society, "production and employment have to grow strongly and reliably each year. This reflects the needs and aspirations of the people who want to enjoy the greatest possible economic prosperity" (Galbraith, 2007:30)

Is the bad society, which we have turned into, a consequence, pro primo, of functioning of the "free" market? Is it possible to grant amnesty to the other side – state (government)? We believe that errors of the state (government failures) have contributed largely to such a situation. We believe, therefore, that failure of the state, government myopia can be much worse and have more serious consequences than those related to malfunctioning of the market.<sup>3</sup>

## 2. Mercantilism

Thomas Hobbes's doctrine insists on the existence of a strong and absolute supreme authority as the assumption for a peaceful and civilized life. An alternative to a strong sovereign (state), since man's nature is basically flawed and selfish, and man is prone to strife and wars, is the "natural state". So, when people live without a common authority that keeps them in "awe" (natural state) there is a war of everyone against everyone, which makes human life solitary, poor, and, of course, short. (Heyne, 1987:3) Hobbes's dilemma – state or anarchy – is a false, illusory dilemma. Time will turn this illusory dilemma into an actual dispute of such type – more state or less state.

The mercantilist answer is – more, much more state.

Thus, when it is believed that gold and silver represent wealth and when wealth can be increased (except in exceptional cases), only through foreign trade (active, positive trade balance), there is no choice but to restrict imports and encourage exports. The state, therefore, has a first-class role in conducting the "pulling money into the country" policy. Mercantilism is often described as a re-

sourceful and lucky blend of commercial and ruling interests. The symbiotic relationship between large merchants and rulers manifested in privileging and protecting merchants from, primarily, foreign, but also from domestic competition (customs duties and various forms of prohibition and restriction of imports, right to a monopoly, etc.) enabling them to generate revenues, which, through taxation, filled the ruler's treasury. Standing armies were then extremely expensive, and the wars even more expensive and frequent. Therefore, Jean Baptiste Colbert, the finance minister of Louis XIV, one of the most famous names of French mercantilism, will argue that trade is a source of public finances, and that finances are a vital means of warfare. (Spechler, 1990:10) In order to increase wealth, mercantilist state resorts to detailed regulation of manufacturing techniques in order to ensure quality of domestic products, which will satisfy, primarily, foreign buyers. Thus, Colbert will prescribe that fabric produced in Dijon must contain 1408 fibres.

Definitely, "according to mercantilist understanding, the state has the right and duty to intervene in economic life, with the aim to reach a certain predetermined economic impact for the individual and the community, which would not be achieved without this intervention, because economic life would have gone in another direction". (Lunaček, 1996:131)

Mercantilists believed in the ability of the state to direct economic life, and in the wake of that belief they have turned into (modern economics would say) rent seekers. Monopolistic privileges, protection from foreign competition, thanks to help from the state, have allowed merchants to generate higher profits. Alliance between traders and state also meant fuller state coffers. It is evident that here private interest of one group of people was identified, declared as interest of the whole society.

In the long-lived and not entirely homogenous mercantilist system there were also sparks, which when it comes to the role of state, anticipated the future. Our Matija Vlačić Ilirik only incidentally and rarely touched on economic issues. However, commenting on Vlačić's positions on basic economic objectives of the state, Stipetić will argue that we could "include Vlačić in predecessors of welfare economics..." (Stipetić, 2001:246) Namely, according to Vlačić's dictum, the primary objective of the ruler's policy should be the benefit (economic welfare, academic Stipetić would say) of subjects. "The first

basis and power of a good and praiseworthy (state administration – A/N) consists of two parts, namely that both sides, the ruler and the subjects, enjoy prosperity and what belongs to them. First, rulers must be respected, that they are given due respect and obedience by the subjects. But then again, the ordinary man must have protection and defence, peace, they have to be given attention, discipline must be held, rulers have to build schools and improve crafts... Power was given to rulers by God, not to use it to scare fair and honest people, but to punish those who do evil... The word of God requires that rulers do not abuse their power to their advantage, as is unfortunately often the case, but to use it for the benefit of their subjects". (Mirković, 1938:9)

It is possible that the following compliment will be highly forced, however, Vlačić's explicit doubt in rulers' always good and selfless intentions is unusually reminiscent of, "draw" on basic positions of the public choice theory.<sup>4</sup> "It is clear as the sun that in our time everything revolves around the stomach" (Stipetić, 2001:246), but not only around the "stomach" of common subjects, but also the rulers. Therefore, already Vlačić would point to the fact that the virus of private, selfish interest, can affect even the supreme authority.

### 3. Physiocracy

Physiocracy (the French reaction to mercantile teaching and practice) wants less state.

French mercantilist regulations (the so-called Colbertism) eventually became counter-productive. Namely, the rules governing the manufacture of some goods prohibited experimentation, innovation and improvement of manufacturing techniques in general. Moreover, those rules became redundant due to increased competition. Numerous trade privileges, granting monopolies, and restrictions of internal trade will also cause the physiocrats' revolt. Colbert's policy was too close to trading interests.

Teaching about natural order has the central position in physiocratic teaching. Human society is controlled by the natural order – natural laws "which were set by benevolent providence for the benefit of mankind..." (Roll, 1956:108) The physiocratic concept of natural order takes into account the laws that are superior to the laws of any monarch, which automatically govern human affairs. (Newman, 1952:41)

"Natural order (Quesnay would argue – A/N) is an outpour of God's will, and is therefore eternal and immutable... Natural order in the economic sphere is therefore exercised through the right of ownership and economic freedom for every citizen". (Lunaček, 1996:241)

State intervention – granting monopolies, various regulations in favour of traders, etc. – is clearly contrary to the natural order. According to physiocrats, the state has to follow the rule of theological *laissez-faire*; things should be left to themselves because they are governed by a higher force that ensures the best possible result.

Agriculture gained the dominant position in physiocratic teaching. Namely, only agriculture is able (thanks to the production power of nature) to create a pure product (*produit net*). Agriculture is the true source of wealth.<sup>5</sup> Other human occupations are sterile.

For this very reason, physiocratic liberalism meant freedom in the manufacture and trade of goods, reduction or abolition of road-tolls, improvement of transport infrastructure and, especially, elimination of the tax system that was truly exhausting agriculture, and introduction of a unified tax on the pure product, that is pure land rent.

The absolute norm of *laissez-faire*, however, because of the special place of agriculture as an exclusive source of wealth becomes relativized. Replacing mercantilist policy with a policy that would favour agriculture and related interests required, despite the principled condemnation of state control and regulation, a quite active state. "Thus Quesnay preached *laissez-faire* and free trade as an absolute standard of political wisdom. But those imperatives should be viewed in the light of physiocratic opposition to all kinds of privileges and many things that they perceived as misuse, among other monopolistic positions. Since those cannot be abolished without significant state "interference", Quesnay had demanded a truly active government policy, and certainly not that it doesn't do anything". (Schumpeter, 1975:190)

Furthermore, physiocrats have, relaxing the restrictions imposed on agricultural production, advocated subsidies for farmers, legal limitation of interest rates so as to reduce the cost of borrowing for landowners, and restricting exports of manufacturing products since boosting those exports results in lower food prices, in order for the costs of manufac-

turing of products intended for export to be acceptably low. (Medema, 2003:432)

This, still selective interpretation of *laissez-faire*, did not diminish the glory of physiocrats as fierce promoters and protectors of economic liberalism.

#### 4. Classical economics

Adam Smith (the first and most important) wants a state that is more than a “night watchman”.

Strong and impressive was Smith’s criticism of the trade system of political economy (mercantilism), but also of the agricultural system of political economy (physiocracy). “If the twig, as the proverb goes, is bent too much to one side, it must be bent as much to the other side in order to straighten it. It seems that the French philosophers who have proposed a system that shows farming as the only source of income and wealth of each country adopted that principle of folk wisdom. As the diligence of cities is certainly overestimated compared to the diligence of villages in Mr Colbert’s plan, it seems that the diligence of cities is certainly underestimated in the system of the French philosophers”. (Smith, 2005:644)

Incarnation of the wealth of nations is not gold and silver money, nor is it an agricultural pure product, just as the source of wealth is not foreign trade nor (only and solely) agriculture. The source of wealth, according to Smith’s dictum, is production in general, and wealth of a country is the annual product of its soil and labour. (Smith, 2005:260)

Smith holds favouring of a very specific private interest and its identifying with society’s interest harmful to society. There is no place for the privileged in Smith’s “system of natural liberty” – liberalism of an entirely secular nature.

It should, therefore, be allowed “for every man to follow their interest in their own way on the liberal basis of equality, freedom and justice”. (Smith, 2005:643) Human instinct for acquiring and standing out, human endeavour to improve own and well-being of those closest to them, human selfishness is able to discard ethically and morally acceptable results. The selfish human, human covered in blood under the skin, wants only and solely his winnings.

“However, an individual usually does not intend to promote the public interest, nor knows how much he promotes it... In that case, as well as in many other cases, he is led by an invisible hand, to promote the goal he never intended to achieve. The fact that it was not an individual’s intention to promote the society’s goal, is not always worse for the society. When he follows his own interest, he often promotes the interest of society more effectively than when he is indeed trying to promote it”. (Smith, 2005:446) “Human egoism can be put to the service of public interest. We do not expect lunch out of benevolence of a butcher, brewer or baker, but out of their keeping of their own interest. We don’t address their humanity, but their selfishness, and we never talk to them about our needs, but about their benefits”. (Smith, 2005:52)

Private interest should not be limited (except for laws of justice); it should not be directed since such efforts harm wealth creation. The natural liberty system demands a different role of state than it was before, especially in the mercantilist, but also in the physiocratic system.

“It is obvious that every individual in their local position can judge much better than any statesman or legislator what type of handcraft can employ their capital and which product will probably have the greatest value. A statesman who would attempt to determine how private individuals should use their capital, would not only be burdened by the most unnecessary concern, but would also take power that cannot be safely entrusted not only to any individual, but not to any council or senate, and which would be the most dangerous in the hands of a man who is crazy or vain enough to deem himself competent to exercise it”. (Smith, 2005:446)

Smith’s natural liberty system favours a quite peculiar amalgam of market and state – dominant market and subsidiary state. But, we hold that the Smith’s state was however more than a “night watchman”. Namely, Smith’s political economy is exploration of the nature and causes of wealth of nations. But only in the hands of “statesman or legislator is it capable of accomplishing two different objectives: first, procure subsistence or abundant income to the people, or better: enable people to procure subsistence or abundant income for themselves: and second, supply the state or community with income sufficient for public services”. (Smith, 2005:419)

Smith's dominant market needs a state that is committed to ideas of individualism and liberalism. The state cannot govern economic life, but without that "visible hand" (which creates and maintains the legal and other frameworks) there is no constructive discharge of energy of private interest. Some (Robbins, 1952:56) will go as far as to suggest that Smith's "invisible hand" is in fact the government itself. It is not, therefore, some deity's hand or hand of some natural force independent of human activity; it is the legislator's hand, the hand that prevents private interests from engaging in activities that are contrary to the public interest.

Listing the functions of the state – ruler (defence, judiciary), Smith would assert, since market is not an undisturbed good (his "hostile" attitude toward monopoly is well-known, as well as anticipating the market's inability to produce what will later be called public good by economic theory), that it is the state's duty to establish and support "those public institutions and those public works, which, although they may be useful to the fullest extent for a large society, are of such a nature that their profits could never recoup expenditures to an individual or a small number of individuals, because of which it cannot be expected that they would be established or supported by an individual or a small number of individuals". (Smith, 2005:696)

Smith's role of the state, therefore, is tied to the function that is today known as allocation of resources. (Tanzi, 2011:52)

Smith did not challenge the necessity to help the very poor, but he did not consider it to be the task of the state, but of religious municipalities. Smith did not deem help to the needy as redistribution of income, but a way to avert potential problems brought on by poverty. (Tanzi, 2011:59) And, finally, there is no place for stabilizing the role of the state in Smith's teaching, and there is also no understanding (just as in other classics) for the budget deficit (except, according to Smith, in some very special circumstances – wars, for example).

These positions will be the commonplace of economics until Keynes's revolution.

It is different, however, with the redistribution role of the state.

## 5. Neoclassical economics

Interesting is the way in which Arthur C. Pigou (theoretical father of welfare economics) tears down orthodox barriers and opens wide the (theoretical) doors to the redistribution function of the state.

Namely, the classical doctrine argued that the marginal utility of money for its owner, as opposed to the marginal utility of other goods, does not decline. The established theory furthermore asserted that it is not possible to compare utility (satisfaction) of different people. "Larger quantities of a certain good provide the user with a decreased marginal satisfaction (according to the Gossen's First Law – A/N). But it was not possible to say that to a man with more goods additional quantity of those goods provides less satisfaction than to those who have less. Feelings of different people were not comparable: such comparisons would be a denial of scientific ways of thinking to which all good and prominent economists aspired". (Galbraith, 1995:157)

Pigou has, however, made a significant departure from that direction of classical thought. Following Jevons's and Marshall's teaching, according to which marginal utility of money declines by increasing its quantity, Pigou will argue that "greater equality of incomes, in certain circumstances, may increase economic well-being". (Oser, 1970:379)

"Every transfer of income from a relatively rich man to a relatively poor man of similar character, since it enables satisfying a stronger need on the account of a need of lower intensity, must increase the total sum of satisfactions". (Pigou, 1932:89) In short, due to the declining utility of money, a poorer man is in the position to draw greater utility from additional income than a wealthier man. It was, as Galbraith had said (1995:157), a strong support to the redistribution role of the state.

However, Pigou will once more betray the classical orthodoxy. Specifically, he will oppose the idea that what is good for the individual is necessarily good for the society. In this regard, he differentiates the marginal social cost and marginal social benefit and the marginal private cost and marginal private benefit. Marginal private cost directly burdens the producer of an additional unit of a good or service. Marginal social cost is the cost or damage suffered by society because of production of an additional unit of a good or service. Marginal private benefit is determined by the selling price of a good, while

marginal social benefit is the total benefit that production of an additional unit of a good brings to the society. Social cost can be higher than the private cost, as there is a cost in addition to the private, which burdens the third, adjacent side. In this case, it is a negative externality because the marginal private net product is greater than the marginal social net product. A positive externality occurs when the marginal private net product is smaller than the marginal social net product. In this case, someone is spilling benefit with their activity and “rewards” benefit to the aforementioned third, adjacent side.

So, when positive or negative externalities occur, when positive or negative effects for the third, social side occur, the state is obliged to resort to extraordinary measures – extraordinary incentives or extraordinary restraints. When the market fails, when there is a mismatch of marginal private net product and marginal social net product, the state should equalize them using extraordinary measures – subsidies, taxes or legal regulations, with the goal of increasing prosperity. Pigou was optimistic regarding the ability of the state to correct the mistakes of the market. His “theory shows that perfect markets function perfectly, imperfect markets function imperfectly, and a perfect government can cause perfect functioning of imperfect markets”. (Medema, 2003:440)

## 6. Keynes's economics of demand

Classical and neoclassical economics were not burdened with macroeconomic issues. The stabilizing role of the state was not current. Thus, until the advent of Keynes, all economics was microeconomics. The reason for that was another “product” of classical economics – Say's law. Say's law will argue that supply creates its own demand. This simple statement means that the total income earned by producing an output must be equal to the value of that output, and that there is no loss of purchasing power in the economy – people save only to the extent to which they invest. If people save more than they invest, prices drop to accommodate smaller income. Consumption is again ensured, and purchasing power unchanged. (Galbraith, 1995:57) The capitalist economy, according to Say's interpretation, is automatically securing full employment and high growth rates. Despite some doubts expressed from within classical ranks (Malthus, for example)

Jean Baptiste Say and his law have ruled until the Great Depression. The Say's law and (neo)classical liberal paradigm were then abolished by Keynes's revolution. The essence of new, Keynes's teaching is the deficit financing of state spending in order to, in times of crises, stimulate aggregate demand and thus decrease unemployment, that is, ensure full employment.

Unemployment is the problem that Keynes is trying to solve and thus save capitalism.<sup>6</sup> Solving the problem required a different and more significant (stabilizing) role of the state. Keynes considers that, as he stated in a letter to Roosevelt, “increase of national purchasing power is absolutely the most important, an increase resulting from governmental expenditure, which is financed by loans”. (Harrod, 1951:121) Namely, if savings surpass investments,<sup>7</sup> spending will be reduced and inventories will be accumulating, the number of employees is reduced and production is reduced. The therapy imposes itself. The harmful effects of savings have to be suppressed, which is achieved through investing by the state. Thus, a balance can be achieved at a high level of production and full employment.

The state, therefore, and this is Keynes's basic message, must be responsible for creating the conditions of full employment. In short, Keynes recommends increasing state spending in times of crisis. Both fiscal and monetary policies are becoming powerful tools for stabilizing the business cycle. Keynes significantly changes the classical relationship between market and state, in favour of the state.

Unemployment was a first-class problem. It is interesting, however, that Keynes “was not a passionate social reformer”. (Skidelsky, 2000:265) Despite revolutionary reversal in economic thought, there is no clear statement by Keynes that a state must strengthen social justice, that is, a welfare state.<sup>8</sup> For Keynes, in our opinion, realization of full employment was the way of “treating” injustice and inequality.

Expanding the functions of the state can be perceived as undermining individualism, but Keynes sees this strengthening of the state as the only practical means of preserving capital and personal initiative. The economic advantages of individualism, which are a consequence of use of private interest and its efforts on economic efficiency and innovation, can be preserved despite the existence of strong state intervention.

“Therefore I imagine that socialized investing will to a significant extent turn out to be the only way to ensure nearly full employment, but that does not exclude a series of compromises and ways in which public authorities collaborate with private entrepreneurs. But beyond that, it is difficult to derive obvious advantages of a system of state socialism, which would encompass most aspects of economic life of the community. Taking over the ownership of the means for production is not the key thing that the state must do”. (Keynes, 1987:213) If the capitalist economy and its survival require an expanded role of the state, the entire system of capitalist individualism obviously cannot be brought into question. Therefore, in Keynes’s opinion, in his teaching “there remains a very wide field of action for the manifestation of private entrepreneurship and individual responsibility. The usual advantages of individualism will apply in those areas”. (Keynes, 1987:214)

But who, in Keynes’s view, should run the state, who should lead the economic policy of full employment, stabilization policy?

Keynes believed that the (British) political system will be in the hands of, that is, the economic policy will be led by the intellectual elite recruited from the upper middle class (to which he himself belonged), which shared his views with regard to public service. His assumption is, thus, that economic policy will be led by intellectual aristocracy, bureaucratic elite, capable and moral and therefore unencumbered by political bias and weaknesses of any kind. This Keynes’s position was once called “The Harvey Road mentality”<sup>9</sup> and was the subject of strong criticism, primarily by the theory of public choice. Solomonic wisdom and integrity of a saint, which Keynes assumes in the conduct of public affairs, contradict his own personal experience and opinion about politicians, which he had the opportunity to acquire as a public servant, in the time between World War I and World War II. Terms such as half-crazy, lunatic in power, horrible and inhuman nonsense, which Keynes used to describe some of the politicians of the time, definitely cannot be perceived as compliments to the *homo politicus*. (Buchanan, Wagner, Burton, 1978:48) Nevertheless, Keynes did not change his presumption of impeccable and moral intellectual aristocracy.

## 7. Neoliberal criticism of the Keynesian state

The theoretical father of neoliberalism – Friedrich Hayek was one of the first and fiercest critics of Keynes.

The crucial difference between Keynes’s and Hayek’s teaching is understanding the conditions that will provide an environment in which entrepreneurship will be the most productive. For Keynes, uncertainty and lack of knowledge do not mean that there is nothing we can do, while for Hayek uncertainty and lack of knowledge dictate us to do nothing and let the social order overcome the unimaginable complexity of economic life. (Parsons, 2003:62)

Dispersed and limited knowledge can be coordinated only and solely by a price system. “Price system enables entrepreneurs, taking into account a relatively small number of prices, just as an engine-driver monitors hands of a small number of dials, to adapt their activities to the activities of other entrepreneurs”. (Hayek, 2001:82)

The market – competition is the very best coordinator of individual efforts, but also guardian of individual freedoms. The state, i.e. a certain type of state, is seen by Hayek as a threat to freedom. “Centralised planning assumes that problems are solved by the community instead of the individual, which further assumes that the community, that is, its representatives, decide about the relative importance of various needs... Economic control is not merely control of a single area of human life, separable from the others; it is the control over the means necessary for all our goals. Those who oversee those means must decide which objectives should be served, which values should be valued more, and which less, what should people believe in and what should they aspire to”. (Hayek, 2001:116)

Although, therefore, the state (the state that wants to “consciously manage” social resources) can threaten individual freedoms, Hayek’s neoliberalism does not claim that the market and individual freedoms can survive without the state. The market cannot take care of everything. “In no system that can be rationally defended would the state just do nothing”. (Hayek, 2001:73) The first assumption of functioning of the market system is a “smartly organised and constantly adaptable legal framework... preventing fraud and deception (including abuse of ignorance), is a big, and in no case yet fully achieved objective of legislative activity”. (Hayek, 2001:73)



Hayek will also not oppose the state's (re)allocation activity in the case of production of public goods, and state intervention will be caused by emergence of externalities.

State services, Hayek says, are in accordance with the liberal tradition as long as, among other things, "raising funds through taxation is carried out according to uniform principles and taxation is not used as an instrument of redistribution of income". (Mises, Hayek, 1997:181) Hayek's state is definitely not a welfare state, but social sensitivity is not lacking. Hayek's state has to provide certain security (the first type of security, which, according to Hayek, is security available to everyone and does not represent a privilege) to everyone.

Hence, "there is no reason why in a society that has reached a general level of well-being (which our society has reached) the first level of security should not be guaranteed to everyone without endangering general freedom... There is no doubt that everyone can be secured a certain minimum of food, residence and clothing, sufficient for maintaining health and working ability... Where – as in case of illness and accident – the desire to avoid trouble and efforts to overcome their consequences do not help..., the reasons for the state's assistance in organization of comprehensive welfare systems are very strong... There is no principled irreconcilability between the state which thusly provides greater security and the preservation of personal freedom... Increasing security through the state's aid to victims of "acts of God", such as earthquakes and floods, belongs to the same category". (Hayek, 2001:140)

Hayek recognizes mass unemployment as one of the most difficult problems of our time. Naturally, the Keynesian policy of realization of nearly full employment does not suit him because overall economic activity increasingly has to depend on the "direction and size of government spending". (Hayek, 2001:141)

Many economists are looking for the remedy for unemployment in the field of monetary policy, which, according to Hayek (2001:141), is not incompatible even with the nineteenth century liberalism. With this, Hayek announces the emergence of monetarism and his successor Milton Friedman.

Monetarists' attention is focused on the problem of inflation. Functioning of the economy is much more stable than it is presumed by the Keynesian model. Therefore, deficit spending of the "big" and

very active Keynesian state, in order to mitigate the business cycle, makes the economy extremely vulnerable to inflation. Keynes did not, monetarists say, sufficiently understand the importance of the supply of money and favoured fiscal over monetary policy. And precisely a self-regulating, market-steered economy necessarily needs a stable monetary framework.

Namely, Friedman will say, based on studying monetary history, that depressions are related to a decrease of money in circulation (and vice versa), and that strong inflations are always accompanied by a significant increase in the quantity of money (and vice versa).

"The Great Depression that gripped the United States was not a sign of inherent instability of the system of private enterprise, but testimony of the damage a few individuals can cause when they have vast power over the monetary system of a country in their hands". (Friedman, 1992:59)

Discretionary monetary policy poses a threat to individual freedom since independent monetary power to the greatest extent affects prices and employment in the economy. Monetary power should be reined in, unskillfully managed discretion monetary policy<sup>10</sup> subjected to rules in order for it to cease doing harm to individuals and the economy as a whole. Friedman's monetary rule mandates that the growth of money supply is aligned with attainable economic growth.<sup>11</sup>

The neoliberal monetarist basket consists of the state, "muffled" in Friedman's way (monetary policy is restrained by monetary rule, and similar is true for fiscal policy – it has to be managed according to the balanced budget principle<sup>12</sup>), and the standard (neo)liberal faith in the market as the very best protector of economic and political freedoms. But, according to Friedman's dictum also, the market cannot exist without the state, and, since it is not perfect, it needs the state "that conducts law and order, establishes ownership rights, serves as a means to modify ownership rights and other rules of the economic game, which arbitrates disputes over interpretation of the rules, ensures the importance of contracts, promotes competition, ensures monetary framework, engages in activities against technical monopolies and is trying to overcome neighbouring effects that are generally deemed important enough to justify state intervention, a state that complements charity and family in protecting

the unaccountable, whether mentally deranged or children". (Friedman, 1992:44)

Friedman considers discretionary macroeconomic "meddling" of the state to be ignorant and harmful, and restricts it with rules. When given discretionary powers, the "visible hand" brings more harm than good.

The belief that the state (government) is imperfect will be deepened and strengthened by the teaching of the theory of public choice. The main difference between the public choice economists and others (the so-called conventional understanding of politics) is that others believe politicians, and those prone to the theory of public choice do not.

Classical – neoclassical presumption of rationality (but also selfishness) of humans in the economic sphere of their life will be expanded to other aspects (political, public) of human life by Buchanan and Tullock. There is no, or it is extremely difficult to define, public interest. There are only partial, individual interests and goals. Therefore, political power will not free you of your personal or group interests – political power is not going to make you impeccable. The state (government) is a priori not a benevolent agent with only the interests of the public in mind. Government failure is the consequence of the simple fact that government is comprised of rational people, who, naturally, take care of their own interests and the interests of groups close to them, people who want to maximise their utility (the government is seeking to increase its power, influence, re-election, etc.). Therefore, it is necessary to limit political power with detailed rules, that is, laws. Like Friedman, representatives of the public choice theory advocate a balanced budget. It should not come as a surprise that some are proposing a legal ban on budget deficit. And again, the state, such as it is, does more harm than good.

After presenting things in that manner, the question arises: How did Keynes acquire hard and even (somewhat) naive faith in the political elite?

Buchanan, Wagner and Burton (1978:47,48) are going to search for the foundations of Keynes's faith in the political elite (the so-called Harvey Road mentality) in his belief that unquestionably responsible and capable intelligence is able to define public interest. Wise and responsible – philosopher kings (such as the philosopher in Plato's "The Republic") are able to lead Britain using methods of persuasion. The said intellectual aristocracy is capable of

convincing the public in the correctness of the current policy.

Keynes did not consider the possibility that the elite is malevolent (consumed with their own, and not the public interest). Progressive growth of state spending was indeed not the aim of Keynes's economics. However, stabilization policy (Keynesian insistence on a near natural rate of unemployment and the corresponding level of aggregate demand) is very often accompanied by asymmetry, which leads, over a longer period of time, to an increasing share of state spending in the gross domestic product. Progressive growth of state spending, emergence and growth of budget deficit, growth of public debt can be regarded as by-products of Keynesian orthodoxy.<sup>13</sup> So, the reason for that is the willingness of policy creators to increase public spending during the recession, but not (it is more comfortable that way) the readiness to decrease state spending during the expansion. (Tanzi, 2011:126)

For the school of public choice, the rhetoric of public interest, which is used by both politicians and bureaucrats, is in the function of concealing the fact that both are acting in a manner that ensures maximization of political and bureaucratic interests. (Parsons, 2003:66)

The market, evidently, has many shortcomings and deficiencies, but so does the state. The latter may be more difficult and worse than those of the market.

## 8. Instead of a conclusion

The debate about the relationship between state and market, about their relative importance, does not cease to be topical, and there is no end of it in sight.<sup>14</sup> An optimal amalgam of state and market has not been patented yet. This, of course, should not be surprising, since both components are far from perfect. Actual markets are, more or less, far from their role model – a market of perfect competition. However, it is excessive to claim that the "invisible hand" is invisible because it does not exist. Nobody disputes that the market (invisible hand) needs the help of the state (visible) hand.

Liberal sympathizers of the market prefer a "small" state whose ambitions include only providing a legal framework in which and by which the market functions, and (re)allocation of resources, for the purpose of correcting the inherent defects of the

market (public goods, externalities, monopolies, etc.). Neither Hayek nor Friedman provide a justification for progressive taxation and redistribution of income, but there is no denying the necessity to help the needy. This is certainly not sufficient for the supporters of welfare economics.

Keynes's mission to save capitalism meant an increase in the importance of the state and appearance of a new, stabilizing role of the state. Growth of state spending financed by loans had been the breakthrough remedy, with the purpose to, in times of recession, ensure a satisfactory level of aggregate demand and an acceptable, for capitalism and its health, harmless, benign level of unemployment.

However, Keynes's critics from the public choice camp will say that his stabilization policy is coupled with an extremely dangerous companion. The famous asymmetry, growth of state spending, growth of budget deficits, growth of public debt, is a consequence of Keynes's economics, since it has removed

former classical barriers to the growth of state spending. One of the biggest mistakes of the state (government) is the accumulation of budget deficits, over-indebtedness, which, we have witnessed, prevents the realization of Keynes's anti-cyclical policy. The size of state spending or public debt, as a too high percentage of the gross domestic product, is most often an indicator of government failure.

To get the best of both worlds, state and market, would possibly entail such a combination of the two (market paternalism, cohabitation of two orthodoxies, a hybrid of liberalism and Keynesian paternalism) that sought to remove the "real" market failures, which will more closely regulate the market instead of replacing it with non-market arrangements, which will not fall into the trap of asymmetry, which will keep state spending focused and efficient and which will endeavour more strongly to eliminate the growing inequalities in the society.

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**(ENDNOTES)**

- 1 "If it turns out that functioning of the market inflicts real damage to the community and if it is proved that some form of restriction or replacement of the market with another mechanism of social coordination can correct operation of the market, there is no dogmatic argument why the free market should be defended to the last drop of blood". (Šonje, 2005:107)
- 2 Keynes will waive the market's ability, at the macroeconomic level, of realization of full employment.
- 3 Accumulation of extensive public debt, especially large and unfunded liabilities in pension and health care systems can be considered obvious examples of short-sightedness of policy makers or government myopia. (Tanzi,2011)
- 4 Authorities were not completely indifferent towards Vlačić's criticism. Namely, "Vlačić personally handed the book (it is the most famous of Vlačić's work "About the Transfer of the Roman Empire to Germans" – A/N) to Emperor Maximilian, who ordered Vlačić to be arrested the next day". (Cеровac, 1980:46)
- 5 "Agriculture is the source of all wealth of the State and the wealth of citizens." (Galbraith, 1995:39)
- 6 Keynes's works, from 1920 to "The General Theory of Employment, Interest and Money" and later, are dominated by fear that liberalism and individual freedom are not going to survive if the role of the state is not aligned with economic life.
- 7 Already in "A Treatise on Money" Keynes shows that the relationship between savings and investments ( $S=I$ ) is not automatic. Savings does not always have to be translated directly into investments. Savings does not necessarily have to result in investments. Interaction of different variables will lead to equilibrium ( $S=I$ ), but only over a long period of time. And, in a long time period, we are all dead.
- 8 "Certainly, he had little to do with the emergence of the welfare state". (Tanzi, 2011:126)
- 9 Keynes's family house was located in Harvey Road, Cambridge.
- 10 "Friedman's perception of the functioning of the Board of Federal Reserve was similar to that of a nervous teenager who is learning to drive. When he presses the accelerator (i.e. increases the amount of money), our shy novice often gives the car too much fuel; when he steps on the brakes (decreases the amount of money), he does it too hard... Instead of a smooth movement on the path of economic growth, the economy is subjected to successive stoppages and movements, which causes inflation and / or depression..." (Ekelund, Hebert, 1997:550)
- 11 "This rule seems to me the only viable and currently available means with which we will transform monetary policy into a pillar of free society, instead of a threat to its foundations". (Friedman, 1992:63)
- 12 Friedman also notes the asymmetry that accompanies the implementation of Keynesian fiscal policy in reality. Curbing unemployment means an increase in state spending and an increase in the deficit. The decline in unemployment, expansion, logically, has to mean a decrease in state spending and the emergence of a surplus or at least a balanced budget. However, as Friedman says, the mechanism of balance is not balanced. The state, i.e. the state budget is in constant deficit. Namely, it is not good, and also politically very unpopular, to compromise "healthy" expansion by reducing state spending. "Both in monetary and fiscal policy, when we set all political considerations aside, we simply do not know enough to know how to use the conceived changes in taxation or spending as a sensitive mechanism of stabilization..." (Friedman, 1992:85-86).
- 13 Keynes's idealized political ambience is ruled by symmetry. Asymmetry, an almost continuous deficit financing of state spending, and related incurred budget deficits, are consequences of a state that is completely imperfect, and oriented to itself and its interests.
- 14 Fukuyama's enthusiasm and optimism regarding the end of history and its happy ending (the perfect mix of state and market) was premature and exaggerated.

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## **DRŽAVA I TRŽIŠTE**

### **SAŽETAK**

Rasprava o odnosu države i tržišta, o njihovoj relativnoj važnosti, ne prestaje biti aktualna i ne nazire joj se kraj. Tržištu (nevidljivoj ruci) jest potrebna, veća ili manja, pomoć državne (vidljive) ruke. Liberalnim simpatizerima tržišta odgovara „mala“ država čije ambicije uključuju tek pružanje prilagodljivog pravnog okvira u kojemu i pomoću kojega tržište funkcionira te (re)alokacija potencijala, a zbog urođenih nedostataka tržišta. Pristalice ekonomike blagostanja poželjet će progresivno oporezivanje i redistribuciju dohotka. Keynesova misija spašavanja kapitalizma značila je povećanje značaja države i pojavu nove, stabilizacijske uloge države. Fine tuning ima spriječiti prekomjernu nezaposlenost. Nažalost, reći će Keynesovi kritičari iz tabora javnog izbora, država (vlada) nije savršena i, u pravilu, upada u zamku asimetrije. Samo i jedino u teoriji će vrijediti da savršena država znači savršeno funkcioniranje nesavršenog tržišta.

**Ključne riječi:** država, tržište, merkantilizam, fiziokratizam, klasična ekonomika, ekonomika blagostanja, ekonomika potražnje, monetarizam, teorija javnog izbora, Harvey Road mentalitet