COMMENTARY ON ECONOMIC PHILOSOPHY OF INSTITUTIONS: A MARKET AND STATE PERSPECTIVE

Fareeha Adil, Sustainable Development Policy Institute (SDPI), Islamabad, Pakistan

Rabia Nazir, Islamia University of Bahawalpur, Pakistan

ABSTRACT

This study investigates the philosophy of institutions by delving deeper into the constructs of economic doctrines and school of thoughts, especially from the crucial perspective of Market and State. How the Classicals Invisible hand-market and state philosophy is founded on Aristotelian philosophy of "distributive justice" and the maxims of self-interest. How Platonism inspired Keynes to put forth a market and state philosophy, planted in real world with no omissions of institutional arrangements. We further analyze how Neo-Classicals, Monetarism, New Classical and Institutionalism intervened and reshaped the institutional perspectives of Market and State over time.

Keywords: History of Economic Thought, Philosophy of Institutions, Institutionalism

INTRODUCTION

The philosophy of institution is as old as evolution; from the philosophies of mythologies where; Gods, Goddesses and deities suffer from *"collective action problem"*; exercise *"expropriation of power"* and violate each other's domain due to *"conflict of interest"* to the philosophy of scriptures where both Adam and Lucifer witness *"hamartia"* (the fall); the highest *"transaction cost"* ever paid for violating the *"rules of the game"* in heaven and for *"denouncing the order"*.

The philosophy descended from mythical world to material world where the *Platonism* of *"Republic"*; the Aristotelian philosophy of *"distributive justice"*; the *Roman law* that later nurtured British *"common law"* along with *Christian doctrine of unity*, combined to form a *"Great Charter"* of philosophy which grappled the ablest minds, unleashing the economic philosophies of modern times. However, nearly all economic philosophies are oscillations between above elements or their amalgamation, mounted on the institutional frame essentially built by age old common law.

Market and State Philosophy and School of Thoughts

The Classicals

The Classicals presented the economic doctrine of *"Invisible hand"*, one of the majestic ideas of intellectual history. The philosophical foundations Barber (2012) of this doctrine were based on the Aristotelian model of *"distributive justice"*, refined by John Locke's (1632-1704) conception of *"natural order"*, while the economic basis were the Smith's (1776) *"self-interest"* theory and Jean-Baptise Say's (1767-1832) law of market demand and supply. But most importantly it was erected on an implicit institutional structure that was a *"construct of millennia"*. In true sense the stage for the invisible hand was set up by the principles of *"Christian paternalistic ethics"* and the *"British Common Law"* which survived the test of times (dark ages) giving rise to sanctity of property rights and cradled a nascent form of capitalism that took birth in form of *"Invisible hand".*

"Invisible hand" market and state philosophy is founded on the maxims that *"market competition transmutes selfish and myopic individual actions into the wealth of nations" (1776).* Central direction is not required. Self-interest is motivational enough and local observation, informational enough. All that's demanded from participants is respect for *"contractual obligations"* and *"property rights"*. All that is commanded from government is to devise and enforce these laws and safeguard the society from external and internal enemies. Government interventions in market are inefficient as it impedes the individuals from making socially and mutually beneficial contracts and trade (Tobin, 1985); Tobin (1972); Humphrey (1999). In context of *"disorder"*, *"Invisible hand"* is silent, by design; because so profound is its belief in the strength of the system built on the British Common Law that Classicals were oblivious to the concept of *"disorder"* and *"expropriation of power"*.

This remarkable idea flourished for nearly two centuries. In the context of state ideology, it was the spirit of 19-century *"liberalism"* and 20th century *"conservatism"* (Tobin, 1985). Even Keynes, whose most famous economic stand was opposition of "Laissez-faire" admitted the remarkable success of the *"laissez-faire"* and attributed it to market philosophy of:
"Individualism, which assumed original individual property rights in a state of nature before entering into political society through a social contract" (Keynes; "The End of Laissez-fair, 1924) and state philosophy of *"democratic egalitarianism"* based on the notion of *"pluralistic, inclusive social process"* or *"greater happiness of the greater number" (Keynes 1974).* The philosophy of Smith (1776) was then refined by the ablest minds of Walras, Pareto, Hicks, Samuelson, Debreu and Arrow into the *"Walrasian system; the Magna Charta of market economics"* as Joseph Schumpeter calls it and general equilibrium theory which was termed as *"the only rule of the game",* giving rise to a different philosophy *"The Neo-Classicals".*

The Neo-Classicals

The *Neo-Classicals*, led by Alfred Marshall and followed by Jevons, Karl Menger and Walras integrated original classical theory with utility. The market philosophy is, agent maximizes utility, given his endowments, firms maximizes wealth of their owners, aggregate schedules of demand, supply, prices, lead to a competitive equilibrium Dumenil & Levy (1985) where competitive equilibrium is "*Pareto optimal*". Fallacy is that the market philosophy is based on dubious realism, "Pareto criterion", the notion of social optimality is weak; money is neutral, no requirement of holding *"intrinsically useless paper as store of value"* when the super *"Walrasian multi auctioneer"* exists (Tobin, 1985); Von Hayek (1991). Further in neoclassical philosophy there is an abstraction of reality where institutional arrangements are systematically excluded.

The state ideology of neo Classicals asserts no government intervention and regulation. Neo Classicals believed that free movement of trade and capital unhindered by government intervention will result in rapid economic growth and overall welfare, but ironically neoclassical theory itself developed *"anatomy of market failures"* which ultimately requires government intervention like monopolies, externalities, extra market ways in which one can harm or benefit other.

Keynesian Philosophy

Then appeared John Maynard Keynes on the horizon of economic philosophy with all the answers to the puzzles and hamartia of "*Great Depression*"; Keynes and his "*General theory*" both became eternal. A complete contradiction of classical philosophy, his market philosophy had the audacity to claim market failures, he presented the concept of effective demand; spoke to Say's through ages that supply not necessarily creates its own demand; that market equilibrium can occur below optimal level; that supply side is not the only *"rule of the game";* demand side also effect real variables; that money is not a *"veil, past i can see";* it competes with other assets; rejecting neutrality Cooper & Huitchinson (1997), Robertson (1936).

His market philosophy was planted in real world with no omissions of institutional arrangements; there is ample evident that he considered property rights, law enforcement and exchangeable institutions crucial for market growth. His most famous philosophy is his opposition of laissez-faire and his deep confidence in the government involvement in the economy. Where the Classicals are silent about *disorder*, Keynes was pioneer in understanding it, had a foresight for *"monopoly in violence"* and the consequent *" risk of expropriation"* by absolutist authority; in this respect he stated that :

"Modern mixed economy cannot enjoy more than any two of the three desiderata: price stability, full employment and freedom from price/wages controls; for all three government must regulate and control" (General theory) but well imagined the *"risk of expropriation"* by state and called excessive state power and nationalization/militarization as "hideous doctrine"; considered Marxism as *"extremist and vile sort of Benthamite Socialism"* and rejected it because of its reliance on violent revolution.

In his political philosophy *"Keynes was a Cambridge Platonist*" (Hayek, 1944). Platonism was extraordinarily important to him; his philosophy of state comprised of control by an elite class similar to the "Philosopher guardians", the ruling class in Plato's Republic.

"Philosopher guardians, for Keynes, it was the intelligentsia who were most fitted for position of state power" (O, Donnell, 1989).

He believed that the state rulers should depict a level of *"disinterestedness"* for efficient and just distribution of surplus; he proposed that

"governmental bodies staffed by those whose criterion of action within their own field is solely the public good as they understand it and from whose deliberations, motives of private (rents) advantages are excluded" (Keynes, The end of Laissez-faire). He believed in the supremacy of parliament and considered rulers as *"subjects in the last resort to the sovereignty of the democracy expressed through parliament" (Keynes; 1971*).

Rise of the Monetarists

Sadly the Keynesian theory proved incapable of envisaging the inflation of 1960's and 1970's, moreover guilt clause applied to Keynesian economics for actually promoting inflation by overriding the Phillip's curve. This brought wide spread support to the *"Monetarist"* counter revolution led by Friedman, (1967) & Robert Lucas. The market and state philosophy of monetarist was a modern classical theory that believed in laissez-faire, price wage flexibility. Like classical theorist they believed government should not be a part of economic stabilization, opposing activist stabilization policy of any kind, assigning minimal role to fiscal policy, advocating central bank policies on stable growth of money unchanged by any concern for other variables; and above all the most fundamental neo classical proposition "neutrality of money" Friedman *"told the world that inflation is everywhere; at all times a monetary phenomenon"*; *"it is costless and painless"*. Very much like neo Classicals, monetarism is silent on *disorder* and its manifestations but unlike neo Classicals it includes the institutional structure by method and design. It deals with a real world of affairs Fisher (1911) & Kaldor (1970) where institutions smooth the friction; mega role, more than state is assigned to the central bank. In short run, even money is non-neutral and state is important as it is required to smoothen, money, demand and supply shocks. This market and state philosophy survived because it had all the answers to the inflation and stagflation crisis of 1970's contrary to Keynesians.

The New-Classicals (amalgamation of Keynes and Classical)

In 1970's the economic philosophy of *"New classicals"* (Monetarism II/ Rational expectations/RBC) emerged. This doctrine was a philosophy amalgamation of both the worlds; classicals and Keynes. Unlike Keynes, new classicals believe the neutrality of money even more then monetarism I. The market doctrine is deep rooted in individual optimization based on expectations, it believes that markets are highly competitive, there is no *"conflict of interests"*, agents are highly informed, and they even anticipate inflation. Its political philosophy does not require the role of government; as people act per their expectations.. Whether slump or boom, government intervention is not required. The market economy will itself converge to equilibrium.

Institutionalism

However the last-most dramatic modern addition in economic philosophy was the institutional philosophy itself, also called *"institutionalism"*. Institutional philosophy mainly focuses on how institutions evolve and change and how changes affect economic system/outcome and economic performance. The major contribution to the institutional philosophy was by Frederick Hayek & Ronald Coase (1995), inspired by the classical socio-philosophies of Max-Webber and Montesquieu. Hayek examined the transformation mechanism of institutions, the temporal evolution and concluded that institutions result from human action Groenewegen, et al. (1995). He argued that there exist a spontaneous order is which certain institutions survive while other (non-workable) disappear. Coase philosophy was that rational economics logic creates institutions when transaction costs are too high.

Major philosophical additions in terms of philosophy were made by Douglas North, Mancur Olson and Gordon Tullock; using the classical notion of *'self-interest' and "rationality"* to explain the evolution and the economic impact of institutions. This philosophy majorly highlighted issues of *rent seeking, property rights and distribution coalitions* and proposed that institutional transformation is explainable Hunt (2016); Hunt & Lautzenheiser (2015); Hass (2020) Inglehart (2020); Pasinetti (2020); in terms of changes in transaction cost, property rights and information asymmetry.

The political philosophy comprised on a set of variables entirely different from any other prior state philosophy. It did a catharsis of colonial origins; type of institutions under colonial origins (extractive/settlement); feasibility of settlement; tropics, germs and endowments; leading to a state structure that cradled similar economic structure.

Concluding Remarks

The study is designed to deliberate the constructs of economic doctrines and school of thoughts, especially from the crucial perspective of Market and State. The study maintains that the foundation of the Classical Invisible hand-market and state philosophy is founded on Aristotelian philosophy of "*distributive justice*" and the maxims of self-interest. Further, the study argues that Keynes put forth a market and state philosophy, planted in real world with no omissions of institutional arrangements inspired by the Platonism. We further analyze how Neo-Classicals, Monetarism, New Classical and Institutionalism intervened and reshaped the institutional perspectives of Market and State over time. In sum the study claims that the economic philosophy of institutions, woven over ages, evolved and survived the test of times, with remarkable resilience and innovation.

REFERENCES

Barber, W.J. (2012). *A history of economic thought*. Wesleyan University Press.

Barro, R.J. (1974) 'Are Government Bonds Net Wealth?' *Journal of Political Economy*, 82 (November/December): 1095–1117.

Cooper, J.M., & Hutchinson, D.S. (Eds.). (1997). Plato: complete works. Hackett Publishing.

Fisher, I. (1911) The Purchasing Power of Money, New York: Macmillan.

Coase, R.H. (1995). Essays on economics and economists. University of Chicago Press.

Groenewegen, J., Kerstholt, F., & Nagelkerke, A. (1995). On integrating new and old institutionalism: Douglass North building bridges. Journal of economic issues, 29(2), 467-475.

Humphrey, T.M. (1999). Mercantilists and classicals: insights from doctrinal history. FRB Richmond Economic Quarterly, 85(2), 55-82.

Hunt, E.K. (2016). Property and Prophets: The Evolution of Economic Institutions and Ideologies: The Evolution of Economic Institutions and Ideologies. Routledge.

Inglehart, R. (2020). Modernization and postmodernization: Cultural, economic, and political change in 43 societies. Princeton university press.

Kahn, R.F., Kahn, R., & Kahn, R.K.B. (1984). The making of Keynes' general theory. Cambridge University Press.

Kaldor, N. (1970). The new monetarism. Lloyds Bank Review, 97(1),

Keynes, J.M. (2018). The general theory of employment, interest, and money. Springer.

Friedman, M. (1956) 'The Quantity Theory of Money–A Restatement', Studies in the Quantity Theory of Money, Chicago: University of Chicago Press, pp. 3–24.

Hunt, E.K., & Lautzenheiser, M. (2015). History of economic thought: A critical perspective. Routledge.

Hass, J.K. (2020). Economic sociology: An introduction. Routledge.

Keynes, J.M. (1936) The General Theory of Employment, Interest, and Money, London: Macmillan.

Pasinetti, L.L. (2020). Economic theory and institutions. Structural Change and Economic Dynamics.

Phelps, E. (1967) 'Phillips Curves, Expectations of Inflation, and Optimal Unemployment over Time', Economica, 34 (August): 254–81.

Robertson, D.H. (1936). Some notes on Mr. Keynes' general theory of employment. The Quarterly Journal of Economics, 51(1), 168-191.

Tobin, J. (1972). Friedman's theoretical framework. *Journal of Political Economy*, *80*(5), 852-863.

Duménil, G., & Lévy, D. (1985). The classicals and the neoclassicals: a rejoinder to Frank Hahn. *Cambridge Journal of Economics*, *9*(4), 327-345.

Smith, A. (1776) *The Wealth of Nations*, New York: E. P. Dutton.

Tobin, J. (1985). Theoretical issues in macroeconomics. In *Issues in Contemporary Macroeconomics and Distribution* (pp. 103-133). Palgrave Macmillan, London.

Von Hayek, F. (1991). Spontaneous (‘grown’) order and organized (‘made’) order. *Markets, Hierarchies, and Networks (Sage, London) pp*, 293-301.