l. Introduction

The principle of laissez-faire endures as a compelling idea in economic thinking. In essence, this standard suggests that, in economic affairs, a harmony of public and private interests exists such that maximum social welfare is guaranteed given individual choice in free markets. Its attraction is manifold. Economic theories premised on individual maximization in free markets assure determinant solutions. Corollary policy recommendations are simple and direct: the scope for government intervention is limited to the provision of a legal framework to maintain competition and of limited public goods such as defense and education. In relation to philosophy, laissez-faire connotes a natural design principle that appeals to the search for an underlying order of natural law.[1] In relation to social philosophy, laissez-faire complements the democratic ideal of individualism with its emphasis on the primacy of private choice in all decisions.

Thus it is not surprising that laissez-faire would serve as a standard in the minds of economists as they construct theories with corollary policy recommendations. And in fact the development of American economics in the twentieth century substantiates this position.[2]

At the turn of the century, the majority of American economists accepted the notion that the research of Alfred Marshall and John Bates Clark had produced a 'satisfactory logical synthesis of the older classical and the utility school doctrines', a union which had preserved the laissez-faire doctrine as a point of departure in policy considerations (Dorfman 1959:5, p. 464). At the same time, American economists confronted contemporary industrial conditions that evidenced increasing concentration of business enterprise and mounting dissatisfaction of the working class. In response, initially they focused on microeconomic phenomena, constructing theories that recommended selective government intervention in particular industries (Dorfman 1949:3, p. 352). With the onset of the Great Depression, research extended to macroeconomic concerns. American economists worked from the Investment-Saving Liquidity-Money (ISLM) model developed by John R. Hicks

(1937) and Alvin Hansen (1953) in their reinterpretation of the economics of John Maynard Keynes (1936) to reject laissez-faire in favor of discretionary stabilization policy. By the 1960s this model served as the standard for macroeconomic analysis, and researchers concentrated on finding more precise functional relationships among dependent and independent variables in order to facilitate fine-tuning of the national economy (Klamer 1983, p. 2).

In startling contrast, beginning in the 1970s a presumption in favor of laissez-faire once again became the predominant policy recommendation in macroeconomics. From monetarism[3] to public choice theory[4] to new classical macroeconomics[5] the trend was the same. Laissez-faire no longer stood as the exceptional policy for recommendation in rare occurrences of competitive markets; rather it represented the optimal policy standard for approximation in fact or by design.

Thus over the course of the twentieth century, while the ideal of laissez-faire remained a touchstone in the thinking of economists, a dramatic change in attitude toward this doctrine unquestionably occurred. The intriguing question becomes why this remarkable evolution has taken place. Can economists attribute it to the internal development of analytic tools and methods that induced them to develop novel theories, which recommended laissez-faire policies rather than public intervention? Did an external economic problem lead economists to ask new questions with theoretical responses that recommended private control? Or did economists succumb to the influence of the conservative ideology that began to spread through America during the last quarter of the century?

Macroeconomists themselves offer all three views as explanations for the revival of laissez-faire. For example, Harry G. Johnson attributed the rise of monetarism to an external social problem:

> It is no surprise that the appearance of monetarism as a strong intellectual movement has had to wait until the aftermath of the escalation of the war in Viet Nam in 1965. It is even less of an accident that its current success has depended on a prior Keynesian claim to, and acceptance of, responsibility for efforts to stop inflation by Keynesian fiscal means . . . [Keynesian economics] encountered disaster when it tried to sell reverse Keynesian policies to a non-Keynesian problem [inflation]. And the monetarist counter-revolution has been cashing in on that mistake of intellectual strategy. (Johnson 1971, pp. 7–8)

Robert E. Lucas, Jr, Nobel Laureate and new classical economist, credited the ascent of his school to theoretical developments: 'Recent macroeconomic controversy seems to me much more easily interpreted as a surface manifestation of much deeper and more important developments in economic theory' (Lucas 1987, p. 1). James Tobin, Nobel Laureate and Keynesian economist, conjectured that the revival of laissez-faire in macroeconomics reflected the influence of the general tide of conservatism that surfaced in the 1970s:

> Economists know the restrictive conditions of these proofs [of the theory of general competitive equilibrium]; they can list the standard caveats and qualifications. These are lost in the arena of the politician and public opinion, and they are increasingly glossed over by economists themselves. At the same time and for the same reason that conservative ideology was gaining public favour, its counterpart in economic theory was being more and more uncritically accepted throughout the economics profession. (Tobin 1987, p. 70)

Acceptance of any of these suppositions regarding the origins of the return to laissez-faire implies much regarding the character of economics. For if this change occurred in response to new tools or methods, then the revival of laissez-faire emerges as analytically based. If this change occurred in response to theoretical resolutions of contemporary economic problems, then the revival of laissez-faire materializes as a convergence of the analytic and the ideological. In this case, the analyst draws on his judgment as to what constitutes a social problem and the proper method to obtain its solution and then selects analytic techniques to conduct his investigation. If the evolution occurred in response to ideological influences, then the analytic character of economics is called into question. Discriminating among these contradictory claims becomes critical in identifying the appropriate role the models recommending laissez-faire should fulfill in policy debates. For an analytically based recommendation for laissez-faire is of an entirely different character than an ideologically based one, and decision-makers should assess alternative policy actions with that knowledge in hand. Thus with the objective of distinguishing among these conflicting claims, this book will provide an interpretation of the evolution of the stance on laissez-faire on the part of some leading thinkers in twentieth-century American economics.

Perhaps the most fertile field for this analysis comprises the writings of those pioneers who dominated the origination and diffusion of ideas that sustained the laissez-faire doctrine over the course of the twentieth century in America. First, the debate regarding the revival of laissez-faire has been both confusing and acrimonious, and, as such, would benefit from clarification.[6] Second, an interpretation of the cases made by the pioneers for laissez-faire provides a means to uncover whether the revival occurred due to significant theoretical developments, external challenges or ideological influence. Third, analysis of this research will reveal much about the intellectual process of economic theorizing, in particular, how economists incorporate new tools, methods and external challenges into their models. With these objectives in mind, this book will reconstruct the cases for laissez-faire developed by early pioneers – Frank Knight, Henry Simons and Friedrich von Hayek – to serve as reference points for later ground-breaking research conducted by Milton Friedman, James M. Buchanan and Robert E. Lucas, Jr.

In carrying out their research all of these individuals used some variety of neoclassical economics. The models constituting neoclassical economics originated in the research of the economists William Stanley Jevons ([1871] 1965), Leon Walras (1874), Carl Menger (1871) and Alfred Marshall ([1890] 1920). These innovating economists had constructed a new paradigm in response to their observations of continuing aggregate growth coupled with persistent poverty and the apparent inability of classical economics to explain this phenomenon.[7] In constructing the neoclassical paradigm they merged a new theoretical perspective, the role of utility in the determination of value, with a mathematical tool, the concept of the marginal increment, to study the workings of competition. A revolutionary reorientation in economic theory ensued such that a microeconomic focus on the optimal allocation of given resources among alternative uses replaced the earlier classical focus on aggregate growth. On the basis of this research, these economists attributed the observed defects in the competitive order to external factors – a lack of general education and rare instances of market failure. Consequently, they continued general recommendation of laissez-faire supplemented with increased public support of education and selective public intervention to regulate or administer commodity provisions in imperfectly competitive markets.[8]

In developing this paradigm, the neoclassical economists responded to their value judgment that the problem of poverty in the midst of plenty constituted an appropriate object of economic analysis. In their choice of marginal analysis they certified the importance of individual choice as the foundation of economic investigation. Moreover, in their general recommendation of laissez-faire, the marginalists attested to the inherent stability of the competitive economic system. In interpreting the research of the laissez-faire pioneers, it is crucial to remember that they implicitly accepted the value judgments of the developers of the neoclassical paradigm. Yet at the same time, this acceptance did not imply that the laissez-faire pioneers erased their personal value judgments from their research. Rather, just as the founders of neoclassical economics drew on their value judgments to select the elements of their novel paradigm, the laissez-faire pioneers drew on their value judgments to decide on the direction of their subsequent research. When doing so, they determined which theories required extension and the research methods appropriate to that task, decisions that were colored both by their individual perceptions of prevailing intellectual, political and social trends and contemporary economic problems and their membership in a particular community of practitioners.[9]

Thus in interpreting the research of the laissez-faire pioneers, I will devote particular attention to two aspects of their work. First, I will make explicit the pre-analytic foundations of their research, including the pivotal value judgments they made when setting its direction.[10] Second, I will investigate the social relations among the pioneers, as teachers, as students, as colleagues, as fellow economists. In those steps, I will possess a means to evaluate the possibility of the influence of external challenges and ideology, as well as theoretical developments, on the revival of laissez-faire.

NOTES

1. See Charles M.A. Clark (1992) for an extended discussion of the relationship between natural philosophy and economics.
2. Numerous analysts have studied the place of laissez-faire in American social thought. See for example Goldman (1952) and Fine (1964) for discussions of the departure from advocacy for laissez-faire in American thought beginning with industrialization after the Civil War and up until the reform movements leading to Roosevelt's New Deal.
3. Friedman led the way in developing the monetarist model as a counter-example to the ISLM analysis. In essence, Friedman used the theory of consumer choice to argue that the demand for money was fairly stable over time. He revived the quantity theory of money to establish that changes in the nominal quantity of money can lead to short-term, but not long-term, changes in the levels of output and employment. On the assumption that the monetary authority can control the nominal supply of money, monetarists recommend the institution of a money-growth rule to prevent money from becoming a disturbing force in the aggregate economy. For further details of analysis see Chapter 5.
4. Buchanan led the way in developing public choice theory, which extends the postulates of neoclassical price theory to the analysis of political behavior. In essence, the theory suggests that the self-interested motives of politicians and constituents induce politicians to vote for inflationary budget deficits. As a result, public choice theorists

recommend the passage of a balanced-budget amendment in order to replace the discretionary authority of politicians with a laissez-faire framework of rules. For further details of this analysis see Chapter 6.

5. Lucas played a leading role in developing new classical macroeconomics, which employs the rational expectations hypothesis and general equilibrium analysis to reconcile the natural rate hypothesis developed by Friedman (1966 and 1968a) and Edmund Phelps (1967) and the theory of business cycles. Models based on these premises suggest that discretionary fiscal policy is both ineffective and leads to greater instability; hence indicative of the principle of laissez-faire, the government's proper role constitutes the provision of a framework of rules to enable steady economic growth. For additional details of these models, see Chapter 7.
6. See Arjo Klamer (1983) for a recounting of conversations he had with leading members of the new classical, Keynesian, monetarist, Marxist and post-Keynesian schools of macroeconomics. Brian Snowdon et al. (1994) added conversations with representatives of the real business cycle, new Keynesian and Austrian schools. Snowdon and Howard R. Vane (1999) updates Klamer's conversations. All of these exchanges summarize the issues and reflect the acrimonious quality of the debates about macroeconomics during the last quarter of the twentieth century in America.
7. Thomas S. Kuhn developed the notion of a paradigm in conjunction with his theory of the discontinuous growth of knowledge in the natural sciences. On a technical level, a paradigm represents 'universally recognized scientific achievements that for a time provide model problems and solutions to a community of practitioners' (Kuhn [1962] 1970, p. viii). On a sociological level, a paradigm represents 'the entire constellation of beliefs, values, techniques and so on shared by members of a given community' (Kuhn 1962, p. 175). A paradigm originates in 'extraordinary' research that members of the community undertake to resolve an apparent anomaly between theory and fact that analysts could not solve using existent techniques. In developing the paradigm these individuals explicitly or implicitly incorporate their beliefs and values about the surrounding world, views that necessarily reflect factors external to the scientific community. Practitioners of 'normal science' go on to refine, extend or articulate the paradigm, implicitly accepting the values, beliefs and techniques that entered into its development.
8. Ellen Frankel Paul has argued that the apparent inconsistency of their supplementary policy proposals with the doctrine of laissez-faire followed from a change in the ethical base of laissez-faire from Adam Smith's natural rights position to Jeremy Bentham's utilitarianism. In essence, the theories the neoclassical innovators developed of particular sectors of the economy demonstrated that public provision of certain goods and services assured a greater happiness for a greater number of citizens than private provision. On that basis, they could consistently recommend laissez-faire and selective intervention in the economy (see Paul 1979).
9. Note that this approach of interpreting the research of laissez-faire pioneers implicitly rejects the notion of value neutrality inherent in the positive-normative dichotomy put forward by many neoclassical economists. Ernest Nagel (1961) and Mark Blaug (1992) offer support for the possibility of value neutrality in scientific research. In contrast, Kuhn ([1962] 1970), Joseph Schumpeter (1954), Gunnar Myrdal (1944, 1958, 1961, and 1968) and Hans E. Jensen (1976) provide arguments for my view on the value permutation inherent in scientific research.
10. I have adopted the term 'pre-analytic' from Schumpeter who contended that all economic analysis 'begins with the material provided by our [pre-analytic] vision of things' (Schumpeter 1954, p. 42). Schumpeter argued that this vision guided the analyst in 'visualiz[ing] a distinct set of coherent phenomena as a worthwhile object of analytic efforts' (Schumpeter 1954, p. 41).