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Updated Liberalism vs. Neo-liberalism: Policy  
Paradigms and the Structural Evolution of Western  
Industrial Economies after W.W. II

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**Abstract** - In this paper two basic policy paradigms are distinguished: *updated liberalism* that is fully aware of the limits to markets and therefore aims at their active regulation, and *neo-liberalism* that is based on market fundamentalism and aims at privatisation, deregulation and budgetary austerity. The paper discusses how updated liberalism emerged after W.W.II, became hegemonic in the 1950s and 1960s and started to decline in the 1970s, while neo-liberalism gathered momentum in the 1970s and became hegemonic in the 1980s and 1990s. This historical examination suggests that *neo-liberalism* is inconsistent not only with the *updated liberalism* of Keynes and Pigou (and their followers) but also with the *classical liberalism* of Adam Smith and Stuart Mill, resembling rather the simplistic and over-optimistic *laissez-faire* of Say and Bastiat. Concluding remarks discuss the connections between the historical pattern observed in the evolution of markets and the parallel evolution of paradigms of liberalism observed in the history of economic thought.

**Keywords:** liberalism, neo-liberalism, structural change.

**JEL Classification:** B0, B1, B2, N1, O1

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### 27.1 Introduction

This essay is rather unusual in scope, methodology, and contents. The scope is much broader than is considered sound within the research community, from the point of view of *time*, as it refers to more than half a century; *space*, as it refers to western industrialized countries in general;<sup>1</sup> *subject* as it refers to the evolution of the structural features of these economies in a broad sense.

Of course, the parable that we are going to tell in this paper does not fit exactly any of the countries of the reference group but aims to be representative of a few general features common in each period to most of them. The main motivation underlying this (perhaps too) daring approach is the conviction that to react to the loss of meaning determined by the increasing division of labour in economic research we have to work out higher-order cognitive structures based on the methods and results of the usual (first-order) economic research but overcoming some of its limitations.<sup>2</sup> The higher-order cognitive structures have the role of coordinating the new pieces of knowledge continuously produced by the advancement of first-order science, both between them and within the corpus of received knowledge, in order to extract all their semantic and pragmatic implications.

Higher-order science is not absent either in economics or in interdisciplinary research involving economics but in our opinion it is definitely underdeveloped. This is true in particular with the diachronic structures that coordinate the single pieces of information and knowledge according to a temporal order. Therefore this paper aims to suggest a few elementary diachronic structures that may help to interpret some crucial aspects of the recent history of economic facts and ideas. In this paper we will limit our analysis to a few simple, but controversial, historical patterns in industrialised countries after W.W. II concerning facts, policies and economic analysis, as well as their co-evolution. The scope of the paper is thus unusually broad although I am fully aware that more extension implies less detail

and depth. To the best of my knowledge and capacity there is no way to avoid this trade-off altogether.

The structure of this paper is as follows. In the second section the main features of the process of growth of industrialised countries after W.W.II are briefly described. It is maintained that structural change was directed by two basic guidelines: *welfarism* in the rapidly growing public sector and *Taylorism* in the productive processes. Our attention then focuses on the 1970s, a period of long economic crisis that caused a sharp turn in the direction of structural change. The reactions against the critical features of the pre-existing period of growth gradually shaped a new period of growth characterised by two new guidelines: systematic *privatisation* at the cost of (or with a view to) dismantling the welfare state, and *flexibility* in the productive process and in the architecture of organisations, replacing *Taylorism* with less rigid technological and organisational guidelines. Section three describes how a steadier, though lower, rate of growth resumed in the 1980s and 1990s under the new guidelines. In particular it is argued that the new growth paradigm based on monetarism and market fundamentalism is unsustainable mainly because the underlying neo-liberal policy paradigm does not take account of market limits. Up to this point, attention is focused on the actual behaviour of private and public decision makers. In section four the change in the objective function of policy makers is rapidly described, as well as its co-evolution with the parallel change in economic thought. We distinguish between two basic policy paradigms that have influenced the evolution of western industrialised economies, as well as the world economy: updated liberalism that is fully aware of the limits to markets and therefore aims at their active regulation, and neo-liberalism that is based on market fundamentalism and aims at privatisation, deregulation and budgetary austerity. The paper discusses how updated liberalism emerged after W.W.II, became hegemonic in the 1950s and 1960s and started to decline in the 1970s, while neo-liberalism gathered momentum in the 1970s and became hegemonic in the 1980s and 1990s. Concluding remarks follow in order to summarise the connections between the historical pattern observed in the history of events and the parallel evolution observed in the history of economic thought and policy paradigms. We claim in particular that neo-liberalism is inconsistent not only with the updated liberalism of Keynes and Pigou (and their followers) but also with the classical liberalism of Adam Smith and Stuart Mill, resembling rather the simplistic and over-optimistic *laissez-faire* of Say and Bastiat. It is also argued that neo-liberalism is unable to cope with crucial problems as it does not take account of the market failures which, together with the state failures, originated them. There is no alternative but further updating classical liberalism.

## **27.2 The Rise and Fall of Keynesian Growth (1951-1971) and the Transition to a New Economic Paradigm (1971-1981)**

Most industrialised countries grew very rapidly in the 1950s and 1960s. In some cases, as in Italy, the average rate of growth was considered miraculous because it happened to be so high and steady as to exceed the most sanguine expectations (Graziani, 1998). The economic paradigm<sup>3</sup> underlying this extraordinary episode of growth was based on the technological side by the systematic adoption of Taylorist techniques of division of labour that greatly increased the productivity of labour and progressively reduced the price of many consumption goods. Therefore many of them (bicycle, car, radio, telephone, television, electric appliances, etc.) could enter in the basket of mass consumption. This technological approach gave the best results within large hierarchical firms that could fully reap the potential economies of scale involved. Not by chance in this period did the average size of firms increase in most industrial countries (Storey, 1994). The high rate of growth of aggregate supply was absorbed by a high, and relatively steady, rate of growth of aggregate demand sustained by the gradual consolidation of the welfare state that progressively increased the share of public aggregate demand from 10-15 percent of the aggregate demand (according to the country) in the 1920s, to about 40 percent in the late 1960s (see, e.g. Boltho-Toniolo, 1999, table 2). In addition the rate of growth was stabilised by countercyclical Keynesian policies while income policies assured that the technological progress translated into growing real wages. The increasing welfare of workers therefore boosted private aggregate demand, absorbing the high rate of growth of the items of mass consumption made possible by Taylorism. The stabilisation of aggregate demand obtained through Keynesian countercyclical policies reduced systemic uncertainty to a very low level and encouraged investment in plants and machineries.

The gradual liberalisation of foreign trade promoted by frequent GATT (General Agreement on Tariffs and Trade) rounds increased at the same time the export of manufacturing goods from industrialised countries. As a consequence of growth rates exceeding the productivity rate, the unemployment rate diminished throughout the period so that by the early 1960s most industrialised countries reached the full employment barrier. As lucidly anticipated by Kalecky in the early 1950s, the economic paradigm based on Taylorism and welfarism proved to be unsustainable in conditions of persistent full employment within the existing institutional and political framework. He claimed that in these conditions the increasing power of labourers and trade unions would have induced an inflationary bias in the system, and that a reduction in flexibility would have implied a reduction in the rate of productivity growth.

In the late 1960s Kalecky's prophecy started to materialise. Most industrialised countries hit the barrier of full employment by the early 1960s. This increased the number of unionised workers in large hierarchical firms and decreased the deterrence of firing, unemployment being almost exclusively frictional. This encouraged wage increases and the concession of further contractual

improvements that increased unit labour costs inducing bouts of cost-push inflation.<sup>4</sup> The effects of the ensuing deflationary policies triggered countercyclical policies that added demand-pull inflationary tensions nurturing further rounds of wage increases, and so on. Such stop-and-go policies neither succeeded in maintaining monetary stability, nor in keeping full employment as inflationary expectations progressively increased. Since these tensions hit industrial countries differently in terms of extent and timing, the Bretton Woods System based on fixed exchange rates underwent increasing tensions. The situation rapidly became non-manageable such that the Bretton Woods System broke down. In 1971 the President Nixon declared the inconvertibility of the dollar. This decision put an end to the system of fixed exchange rates introduced in Bretton Woods. With fixed exchange rates the whole system of global governance of the world economy established in Bretton Woods was questioned. The philosophy underlying the Bretton Woods agreements was clearly inspired by the conviction, originating in the economic turmoil of the period encompassing the two world wars and strongly consolidated by the Great Crisis of the 1930s, that local and global markets must be regulated. This was not only the opinion of Keynes, the intellectual ‘godfather’ of these agreements, and of the British delegation led by him, but also of White, the powerful chief of the US delegation. The final architecture of the international economic system rested on two fundamental pillars playing quite different, complementary, roles. The IMF was supposed to play a role of active macroeconomic stabilisation of the member countries, while the World Bank had to intervene in structural matters (poverty, infrastructures, economic take-off, etc.)

The third pillar of Bretton Woods global governance was the coordinated set of policies meant to progressively liberalize trade between countries. This role was entrusted to GATT. However the process of liberalization of international trade was supposed to comply with the constraints put forward by other international agreements promoted by the UN and its main offshoots (UNESCO, OIL, WHO, UNEP, UNPD, etc) in order to foster social, humanitarian, health, and environmental goals. The decision on dollar convertibility of 1971 jeopardised the stability of the whole Bretton Woods architecture. It took about a decade before the international economic order could settle on a new equilibrium (see section 3).

The 1970s were difficult years characterized by bouts of inflation, increasing unemployment, and all the other typical characteristics of cyclical crises (falls in the stock exchange, sharp reduction in investment and growth, increase in bankruptcies, increase in systemic uncertainty, etc.) The crisis, however, lasted much longer than usual: it encompassed several business cycles that were shorter but more marked than in the two preceding decades. The cause of this anomalous behaviour is often ascribed simply to the two oil shocks occurring in 1973 and 1979, interpreted as purely exogenous factors. No doubt they had a great impact on the industrialised economies but they were partly endogenous and interacted with other important endogenous factors. In particular, the inflationary tensions accumulating at the end of the preceding period had greatly reduced by the early 1970s the terms of trade between oil (and other primary resources exported by

developing countries) and the industrial goods and services imported from the industrialised countries. The sudden quadruplication of the price of oil decided by OPEC in 1973 was not only a political move in reaction to the Kippur war but also an occasion to re-equilibrate the terms of exchange between industrialised countries and producers of commodities. In addition the suspension of the dollar convertibility in 1971 added the fear that the devaluation of the dollar could further worsen the terms of trade. The fall of the Bretton Woods regime in turn originated from the increasing inflationary tensions which had emerged in industrialised countries in the late 1960s. Such tensions, differing in timing and size in various countries, the tension on the system of fixed exchange rates became increasingly difficult to manage through official revisions of the exchange rates. We could therefore ante-date the beginning of the 'long crisis' (Vercelli, 1986) by a few years, more or less according to the specific country we have in mind. However the breakdown of the Bretton Woods system is a convenient conventional divide since it has the advantage of being a crucial event that affected all the industrialised economies, convincing most decision makers that the way out of the crisis had to be actively searched not within the framework of the pre-existing policy paradigm as in the 1950s and 1960s but in a different direction. In particular this event, that amounted to a complete deregulation of the currency exchange market, also heralded a crucial characteristic of the new economic paradigm: the systematic deregulation of markets. Market deregulation started to be universally considered as a recipe to be applied to all sorts of problems. However only in 1979 with the government of Mrs. Thatcher did a systematic strategy of deregulation start at the domestic level. This example was soon imitated in the USA by President Reagan, appointed in 1980, and then spread progressively to the other industrialised countries.

In the meantime, in the 1970s the industrial economies had reacted to the crisis by modifying their industrial structure. In the new environment with its intense industrial conflict, sudden unexpected fluctuations and strong systemic uncertainty, the Taylorist organisation of industry proved soon to be inadequate. This led to the demise of the traditional assembly line, to the decentralisation of production in smaller plants and/or the externalisation of many phases of the productive process in favour of small and medium enterprises (SMEs). As a result of such developments the share of employment in SMEs that had declined progressively in the 1950s and 1960s changed direction in the 1970s and continued to grow throughout the 1980s and 1990s (see e.g. Storey, 1994).

### **27.3 Monetarist Growth and the Rise of Market Fundamentalism (1980-2000)**

Most industrialised countries reacted to the first oil shock in the traditional Keynesian way by lowering the interest rate and increasing public expenditure in order to sustain employment. However, in the new scenario with its supply-push

inflation, this policy aggravated the problems, producing more inflation and increasing the public deficit towards unsustainable levels. The simplistic so-called Keynesian stance inspiring policy in those years failed to realise that the economic crisis hitting industrialised countries was completely different from that of the 1930s that originated Keynes's own approach, as the macroeconomic disequilibria (monetary, budgetary, balance of payments, unemployment itself) were now brought about by excessive, rather than insufficient, aggregate demand. Therefore the most common initial reaction to the failures of the traditional Keynesian policies was explored in the direction of more ambitious versions of traditional policies (fine tuning, huge public expenditure programmes, etc.) that failed to redress the situation (see Boltho-Toniolo, 1999). In time, industrialised countries reacted to the second oil shock in a completely different way by adopting strict monetarist policies. This was a crucial turn around since from then on economic policy in most industrialised countries substantially adopted and maintained a, more or less rigorous, monetarist inspiration by prioritising strict control of monetary stability and the elimination of public deficit rather than the mitigation of structural unemployment. In addition most industrialised countries started to privatise public economic activities and public services systematically. After the election of Mrs. Thatcher (1979) Britain was the first country to frame this new policy within the radical project of a systematic dismantling of the welfare state. It was soon imitated by the Reagan administration (in charge since 1980) and then by most industrialised countries, albeit differing in timing and detail. These policies contributed to recover macroeconomic stability by curbing inflation and reducing the primary public deficit. However, as a result, in the 1980s the real rate of interest in industrialised countries became exceptionally high, increasing public debt in some of them (like Italy), while the average rate of growth remained rather moderate leading to creeping increases in unemployment.

As a consequence of the new policy, technological and organisational decentralisation gradually consolidated and spread a new economic paradigm whose hallmarks were Deregulation and Flexibility (from now on the DF economic paradigm). The two basic tenets of the new paradigm were flags waived respectively against Welfarism and Taylorism, and – more in general - against the previously dominant Keynesism. However, sound Keynesism would be perfectly consistent with technological and organisational flexibility, although not with indiscriminate flexibility in labour markets. On the contrary, in the new policy approach, deregulation was taken to mean flexibility in all markets, including labour markets. Moreover flexibility in labour markets and industrial relations implied a shift of power from employees and their trade unions to the employers, while deregulation implied a shift of power from the electorate and their political representatives to managers and entrepreneurs.

The transition towards the DF paradigm in national economies was accompanied and favoured by a parallel transition towards neo-liberal globalisation. The three pillars of global economic governance sharply changed direction in the early 1980s, abandoning the original Keynesian orientation in



favour of monetarism and market fundamentalism. In particular the IMF stopped worrying about over-restrictive policies of member countries identifying in inflation the main evil to be tamed. In the early 1980s also the WB aligned on the neo-liberal line.<sup>5</sup> The new active macroeconomic policies were reduced to deregulation and privatisation in the simplistic conviction, based on market fundamentalism, that once property rights are well defined and attributed to private subjects, unfettered markets are able to maximise welfare and eventually relaunch and sustain growth. This new global policy stance was christened the 'Washington consensus' (see, e.g., Chomsky, 1999; Stiglitz, 2002), i.e. policy approved by the Washington-based IMF, WB, and the US Treasury.<sup>6</sup> The original complementarity between the IMF and the WB was progressively replaced by a sort of hierarchical subordination of the WB to the IMF that in turn typically acted in agreement with the American Treasury (Stiglitz, 2002). After 1981 the WB *de facto* accepted this asymmetrical link since it agreed to grant its structural adjustment loans subject to the approval of the IMF.<sup>7</sup> The rationale for this dependence was apparently based on the recognition of the influence of structural policies (under the jurisdiction of the WB) on macroeconomic stabilisation policies (under the jurisdiction of the IMF). However in this way the feedback of macroeconomic policies on the structural features of the economy was completely disregarded. This led to the implementation of macroeconomic and structural policies in developing countries that involved negative, often dramatic, structural consequences such as sharp increases in persistent unemployment, poverty and inequality, and rapid deterioration in environmental and social conditions (*ibidem*, 2002).

The conditions imposed by the IMF on macroeconomic (and indirectly structural) adjustment loans to countries in a critical financial situation were deregulation of markets, privatisation, and budgetary austerity in the adamant conviction that these measures were necessary and sufficient conditions to stabilise the single economies and the world economy. However the rapid deregulation of markets in countries lacking the necessary institutions for regulating their activity (efficient legal system, effective antitrust authority, safety nets for the unemployed and the poor, etc.) brought about more unemployment, poverty and corruption without increasing the average wealth of the country. In particular, excessively rapid lifting of the trade barriers in developing countries produced the destruction of emerging local industry. In addition industrialised countries often pushed developing countries to eliminate trade barriers but did not dismantle their own barriers (e.g. in agriculture, farming and textiles). In addition the premature and too rapid liberalisation of capital markets greatly contributed to global instabilities triggered by the sudden vagaries of huge sums of "hot money" of investors and speculators exhibiting increasingly pronounced herd behaviour (Shiller, 2000; Vercelli, 2001). This was considered the single main cause of most recent financial crises including those of Far-Eastern countries in 1997-98 and Argentina in 2001 (see, e.g., Stiglitz, 2002).

In order to avoid these catastrophic events it is not at all sufficient to develop the strength of markets through an indiscriminate process of privatisation. Many

recent examples of rushed programs of privatisation strongly supported by the IMF without preparing the necessary conditions for their success (efficient legal system and regulation of markets) have led to economic and social disasters: 'briberisation', private monopolies, higher prices and lower quality of goods and services provided (Russia is a particularly impressive case in point: see Stiglitz, 2002).

Finally, budgetary austerity was often imposed on countries already suffering from insufficient aggregate demand, further increasing unemployment and reducing growth. The beggar-thy-neighbour policies that greatly contributed to the birth and persistence of the Great Depression were replaced by 'beggar-thyself' policies that had similar catastrophic effects on the countries adopting them and on the world economy through spill-over effects.

Summing up, the mistake made in the 1930s of reacting to economic depression caused by insufficient aggregate demand through deflationary measures was resumed under the aegis of the Washington Consensus after the brief interlude of Keynesian policies in the 1950s and 1960s. This produced new set-backs: financial crises (Mexico, the Far East, Brazil, Russia, Argentina), growing unemployment (in particular in Russia and Argentina), an increase in poverty in all the above cases and in most areas of the globe (with the only exception of far-east Asia; see Collier-Dollar, 2002; Vercelli, 2003). These acute crises were not greater only because the G7 countries, unlike in the 1930s, did not follow the same policy. In particular the USA throughout the period reacted to the first signs of recession with extreme energy by reducing the discount rate and engineering expansionary policies (in particular the FED governor Alan Greenspan was extremely successful in this game before September 11).<sup>8</sup> However it is not clear, and not explained by neo-liberal supporters, why economic policy should adopt this double standard.

From the early 1980s onwards, the humanitarian and economic transfers to developing countries fell sharply while the deregulation of international markets was pursued with increasing energy. In particular the GATT Rounds accelerated their action to establish free trade at the world level. This action was particularly successful with capital flows. This brought about an extraordinary increase in the size of international capital flows with a progressively growing share motivated by speculative goals: in 1971 90% of international financial transactions concerned the real economy (foreign direct investment) and only 10% was speculative (short positions in foreign securities), while at the end of the 1990s more than 95% was speculative.

The internationalisation of economic and financial markets, interrupted and to some extent reversed in the period between the two world wars, was resumed after the second world war and continued from then on reaching and, in some cases, surpassing the level reached at the end of the 19th century. This process was favoured by a series of eight GATT Rounds that managed to reduce to some extent the tariff and non-tariff barriers to trade.

The Uruguay round, starting in 1984, progressively introduced and enforced a new philosophy of deregulation of international markets fully consistent with the

neo-liberalist tenets. This process culminated in 1995 with the establishment of the WTO, a new international organisation with the mission of deregulating not only the traditional markets for goods and capital, but also the new markets for services, intellectual property rights, etc. With respect to the previous situation, the new arrangement might even create benefits for developing countries. In particular, it had the authority, lacking within the GATT agreements, to apply sanctions to G7 countries including the USA for barriers to trade towards developing countries. Indeed in a few cases these countries were effectively sanctioned by the WTO. However on the whole the activity of the WTO was carried on in such a way as to sweep away many environmental, health and humanitarian constraints introduced by nation states, international organisations (such as UNEP, ILO, WHO, UNESCO, etc) and even by international agreements ratified by the countries that participate in the WTO itself. In fact the humanitarian, environmental, social and health constraints to trade were often interpreted as non-tariff barriers to trade that could not escape severe sanctions (see Wallach-Sforza, 1999; Esty, 2002).

This new philosophy of management of international trade further consolidated free trade and increased the rate of growth of the participating countries. Yet at the same time it contributed to a further progressive worsening of global income inequality and the environmental health of the planet.<sup>9</sup> This raises the question whether the neo-liberal view of development may be considered sustainable in the long run. The answer must be negative because it violates the two basic conditions of sustainable development: the environmental condition of a substantial preservation of the global environment and the social condition of sufficient equity in the distribution of income, wealth and use of resources (see Borghesi-Vercelli, 2003 and Vercelli, 2002). The way out may be found only by further updating the *updated liberalism* of Keynes and Pigou.

#### **27.4 The Co-evolution of Economic Thought: Three Types of Liberalism**

The structural evolution of industrial economies was accompanied by a parallel evolution in the cultural and scientific sphere. We are not going to discuss on this occasion to what extent one evolutionary path affected the other. However, casual observation suggests that the complex process of causation went both ways. In this essay we restrict our analysis to the evolution of liberalism in economic thought and its interaction with the evolution of events and policies.

Traditional liberalism, as codified by the great classical economists (Smith and Ricardo) at the end of the 18th century and developed by their followers (in particular John Stuart Mill and Marshall) in the 19th century, underlined the virtues of free markets but never forgot their limits. The founding fathers of classical liberalism were fully aware of the crucial importance of a thorough analysis of the limits of markets in order to understand where they had to be supplemented by the intervention of the state.<sup>10</sup> The legal system, education, defence and the health system are examples of services that the market was not

believed to be able to provide efficiently and reliably and that had to be provided by the state. The liberal tradition dedicated much effort to careful definition of the limits of markets and of the best way to cope with them through public intervention.

In the beginning the main focus was on the forms of competition. It was soon clarified that only ideal markets of perfect competition possess the virtues of optimal static allocation of resources and that in an unregulated market monopolistic and oligopolistic situations tend to emerge and consolidate spontaneously. This calls for some sort of market regulation able to prevent such degenerations from occurring.

The model of general equilibrium elaborated since the early 1870s by Walras and Pareto further clarified another crucial limit of the markets. A perfectly competitive market is unable by definition to solve the distributional problems since the distribution of wealth and resources is given in each period described by the model. In the multiperiod version of the model the distribution of income is to some extent endogenised but its actual path depends on the initial distribution of resources and wealth and there is no tendency whatsoever to assure the convergence of this path to some sort of acceptable level. Typically unfettered markets increase inequality and only vigorous redistributive policies may improve the status quo (see, e.g. Vercelli, 2003). Economic policy therefore cannot avoid tackling distributive problems and intervening to assure acceptable distributive standards. Hence updated liberalism introduced income policies meant to preserve a fair distribution between profits and wages. Its practical implementations were much criticised but their foundations were, and still are, absolutely sound.

In the 1920s and 1930s two crucial steps forward were made to understand the limits of competitive markets and the way to remedy them.

Pigou, in his epoch-making book *The economics of welfare* (1920), elaborating on ideas sketched by Marshall, his academic mentor, clarified a fundamental reason for the existence of market failures: the existence of economic externalities, i.e. costs or benefits that cannot be registered by the market. He pointed out at the same time how to remedy them in principle (internalisation of externalities through subsidies or taxes). Pigou thus provided the microeconomic foundations for welfare economics and for the establishment of the welfare state previously supported with passion but weak foundations by political figures such as Lord Beveridge and political movements such as the Fabian Society. A few years later Keynes in the *General Theory* (1936) provided the macroeconomic foundations of a theory of market failures and of the macroeconomic policy required to mend them. These two fundamental contributions were in a sense complementary and were later on merged in a model of updated liberalist regulation (called in this essay *updated liberalism*) that spread after the second world war up to the 1970s.<sup>11</sup> Its success was fostered by the soaring power of trade unions in the 1950s and 1960s as the growth of big firms increased the union base and diminishing unemployment increased their strength.

Subsequent research clarified that there are further important reasons that distinguish real markets from ideal ones and require active regulation. In particular, a competitive market ensures the optimal allocation of resources among alternative uses only under very stringent assumptions underlying the abstract model of perfect competition, namely: completeness of markets, zero transaction costs, absence of serious uncertainty that is guaranteed only when the agents have perfect foresight or rational expectations, sufficient thickness and extension of markets that is assured in principle only when the number of traders tends to infinity, dynamic and structural stability of markets. The trouble is that real markets never comply with all these conditions. On the contrary very often they fail to comply with most of them. This is particularly true in developing countries. However, in principle, the process of globalisation could push the real markets closer to the abstract model of perfect competition; therefore it improves the economic and financial efficiency of markets by enhancing their extension and thickness (Vercelli, 2001). However the allocation of resources of unregulated global markets cannot be considered optimal for a host of reasons.

First of all the *uncertainty* intrinsic in the working of the markets raises serious problems because it is often endogenous and/or inconsistent with the usual axioms of decision theory under uncertainty (as expressed, e.g., by Savage, 1956). It implies that the expectations of economic agents are in general neither correct nor rational (see, e.g., Shiller, 2000, Vercelli, 2002). Moreover, when information is imperfect or asymmetric, competitive equilibrium is not Pareto-efficient (Greenwald-Stiglitz, 1986).

In addition markets are *incomplete*; in particular most future markets are missing and cannot be easily established. What is worse, it can be proved that in principle markets cannot be made complete, in particular as far as future markets are concerned; in any case, the optimal intertemporal allocation of resources cannot be realized by real markets even if they are relatively competitive because, since future markets are missing, the more expectations refer to the distant future the more they are liable to be systematically incorrect.

Also *transaction costs* are often quite sizeable. In particular the costs necessary to match demand and supply may involve significant material costs, such as travel costs, or immaterial costs, such as those involved in the gathering and elaboration of information about the relevant characteristics of potential demand and supply. Their existence is sufficient to jeopardize the ability of a competitive market to achieve the optimal allocation of resources (see Arrow and Hahn, 1999, for a recent assessment of the problem).

*Externalities* are particularly important in real markets because incomplete markets by definition cannot register all the costs and benefits of economic decisions, and because the property rights on goods and resources are not always well defined, as is typical with many environmental resources such as the global commons (water, air, biodiversity, etc.)

There are in addition a few important markets that are fairly *unstable* from three different points of view. Competitive markets tend to be *institutionally*

unstable in the sense that they tend to lose their competitive nature as a consequence of the exploitation of scale and scope economies, or of discretionary power in disequilibria, or of monopolist and oligopolist practices. In addition markets may be *dynamically* unstable in the sense that they do not recover their equilibrium position easily whenever they are displaced from it by a shock. Finally markets may be *structurally* unstable in the sense that a small shock may alter the qualitative characteristics of their dynamic behaviour.<sup>12</sup>

We must conclude from the above arguments that for sound reasons global markets cannot be left unregulated. Their active regulation is necessary for maintaining and perfecting competition, improving the intertemporal allocation of resources, reducing uncertainty and mitigating its effects, internalizing externalities. In addition, as argued above, the distribution of resources, income, and wealth cannot be left to unregulated global markets because even perfectly competitive markets cannot assure their fairness.

Of course, if market failures require some amount of regulation, the failures of regulation are no less harmful. Both experience and the theoretical analysis of bureaucratic and political processes have shown that regulatory failures are systematic and may be even worse than market failures. In addition the failures of regulation are much more visible than market failures that they are supposed to mend. The disillusionment on the efficiency of regulation has been so strong that an irrational faith has spread, particularly since the 1970s, in the power of unregulated markets. The ensuing process of deregulation has been successful in dismantling many degenerated forms of regulation and must go on to this end, but in a few cases it has gone too far, also dismantling the necessary forms of regulation such as those that set environmental, health, humanitarian and ethical standards. In addition the relationship between regulators and regulated agents has proved to be a sort of evolutionary game: the regulated agents always try to elude the rules set by the regulators who must therefore continuously update them. Therefore a continuous process of re-regulation must accompany the process of deregulation meant to dismantle obsolete or inefficient rules in order to introduce the most efficient minimal necessary rules in the evolving context. However, the mistrust in regulation has gone so far as to cloud the need to regulate the markets. Of course market regulation must be kept to a minimum in order to avoid as far as possible the disruptive potential of regulation failures but cannot be altogether absent. Finally we wish to emphasize that the same reasons that cause the failures of state regulation lead to no less disruptive failures in deregulation (Russia is a case in point: see Stiglitz, 2002).

The prophets of the *neo-liberalist* counter-revolution ignored the arguments on the limits of real markets accumulated not only by *updated liberalism* but also by *classical liberalism* that demonstrated the necessity of active regulation of markets in order to maximise their contribution to social welfare. In this essay I limit myself to briefly examining the crucial contributions of three of the most important founding-fathers of neo-liberalism.

The microfoundations of the *neo-liberalist* stance was originally suggested by Coase (1960). He did not deny that real markets are subject to failures but in his opinion this happens whenever property rights are not well defined, as in the case of environmental commons. Therefore the remedy suggested was quite different from that of *updated liberalism*. This new explanation was not seen by the neo-liberal followers of Coase as an additional explanation of market failures, that could well be considered consistent with those pointed out by updated liberalism, but as the ultimate cause of observed market failures that in principle substitutes all the other explanations analysed by both classical and updated liberalism. To the best of my knowledge, the reason why the other causes of market failures were ignored by this stream of thought has never been spelled out with thorough scientific arguments. This extremist interpretation<sup>13</sup> of the Coase approach led to a very simplistic policy rule vis-à-vis the regulation of markets: 'let's define property rights on all the goods, including public goods (such as, e.g., environmental goods, global commons, etc). The unregulated markets will solve by itself all the other problems'. This was a very radical departure not only from updated liberalism but also from classical liberalism. All the areas reserved to the state by classical liberalism, including education, are now considered in principle as better manageable by unregulated markets. In addition, one particular aspect of the Coase theorem – it does not matter to whom property rights are attributed (rich or poor, polluter or polluted, etc.) - was interpreted as if distributional problems were immaterial for social wealth.

Friedman suggested macroeconomic foundations against updated liberalism from the early 1950s onwards by arguing that countercyclical policies are harmful for the economy, at least in the long run, as they tend to increase the structural inflation rate and the natural rate of unemployment (see e.g. Friedman, 1969). His approach shares a few aspects of the dynamic methodology of Keynes and Pigou descending from the influence of Marshall,<sup>14</sup> that focuses on the crucial role of disequilibrium dynamics, but this is turned against Keynes. The main argument is that the Keynesian attempts to stabilise the economy are bound to increase its instability by nurturing increasingly inflationary expectations. However the whole argument is based on severe undervaluation of the intrinsic instability of unfettered markets in a sophisticated monetary economy (see e.g. Vercelli, 2000, and the literature therein cited)

A few years later Lucas provided different, and much more radical, macroeconomic foundations to the neo-liberal stance: the existence of a perfectly competitive equilibrium is just assumed. Provided that the model based on this assumption mimics reality sufficiently well, all the deviations from the perfectly competitive paradigm (disequilibrium, oligopoly, monopoly, etc.) are considered as irrelevant for economic analysis (see Vercelli, 1991). Under these assumptions Lucas proved that what is generally defined as Keynesian anticyclical economic policy is impossible, or at least fully unreliable, as it is disturbed in an unpredictable way by the structural instability of a monetary economy and is bound to increase structural uncertainty. Lucas argues that disequilibrium

concepts, such as unemployment and out-of-equilibrium dynamics are meaningless so that he remains without any method for detecting market failures and remedying them.

Friedman advocated a fixed monetary policy and systematic deregulation. Therefore in this view the only structural intervention considered sound was privatisation. Lucas does not rule out some scope for further structural policies that increase the efficiency of free markets, but both deny any scope for active regulation of competitive markets. Since the late 1970s the macroeconomic school of new classical economists inspired by Lucas has ousted both the Keynesian school and Friedman's monetarism as the mainstream school in macroeconomics, fully consonant with the contemporaneous rise of neo-liberalism.

As we have seen in the above brief analysis of the contributions of three of the most important prophets of neo-liberalism, departure not only from the updated liberalism of Keynes and Pigou, but also from the classical liberalism of Smith and Ricardo, was very radical. Active economic regulation was completely ruled out. In this view deregulation and privatisation must characterise a transition period towards the golden age of unfettered, perfectly competitive, free markets. The main role of the state remains that of defining and defending property rights. If we seek a precedent after the revolution of classical economists we have to refer not to their genuine followers but to Say, Bastiat<sup>15</sup> and the other economists that Marx, impolitely but not without reason, called 'vulgar economists'.

### **27.5 Concluding Remarks**

The basic thesis argued in this essay is that the long crisis of the 1970s produced a crucial redirection in the path of structural change in industrial economies by replacing the pre-existing economic WT paradigm with a new DF paradigm and replacing at the same time the updated liberalist regulation of markets with neo-liberal deregulation. This interpretation is by no means the usual one, as it has to compete with at least two alternative hypotheses that have many supporters.

Many observers believe that it is artificial to detect general diachronic structures in historical evolution and see a fundamental homogeneity in the evolutionary process apart from exogenous shocks (see, e.g., Lucas, 1981). We have mentioned elsewhere a few good reasons for rejecting this point of view (Vercelli, 1991 and 2002).

The other point of view that we have to mention here was, and is, very popular and greatly contributed to the rise of the neo-liberal approach and now contributes to its consolidation. In this view the Keynesism that spread after the second world war up to the 1970s is seen as a deviation from sound liberal principles as it led the policy authorities to impose growing constraints on the market, restricting its scope and therefore its ability to regulate the economy. Thus, in the neo-liberal view, the counterrevolution that has spread since the late 1970s is interpreted as the healthy restoration of traditional, supposedly sound, liberalist principles. However we have seen in the previous section that the market fundamentalism that characterizes neo-



liberal thought and policies has nothing to do with classical liberalism and that on the contrary the 'Keynesian' paradigm, based on seminal works such as *The General Theory* by Keynes and *The Economics of Welfare* by Pigou, was nothing but a further step in the evolution of liberalism.

Of course the actual applications of both paradigms in industrialised countries are full of inconsistencies. Anticyclical policies were abused, particularly since the late 1960s, ignoring the constraints of basic monetary stability that Keynes never ignored. In general the intervention of the state in the economy went far beyond what Keynes and Pigou would have considered sound, both in size and method. A reaction to these degenerations became necessary in the 1970s, and to some extent monetarism, supply economics and systematic deregulation went for a while in a sensible direction, that even Keynes and Pigou could have approved of.

Analogously the actual applications of neo-liberal regulation were not at all consistent. The abuse of anticyclical policies continued, although they were now openly orientated towards the interests of business rather than of workers. The corruption and conflicts of interests that accompanied the growing role of the state in the WT liberalism changed nature but did not diminish. Pensions in the WT liberalism were jeopardized by the growing debt of the state, while in the neo-liberal era they were threatened by the unstable market value of Pension Funds recently shaken by the stock market crisis nurtured by bankruptcies and conflicts of interests.

Of course the reconstruction of a diachronic structure requires a strong simplification of reality in order to discern a few essential patterns from the chaotic, and apparently contradictory, noise of raw empirical evidence. In particular we have to stress that classical liberalism, updated liberalism and neo-liberalism coexisted in both periods. In what we have called WT growth, in the beginning the classical liberal approach was still dominant, while a sort of prodromic neo-liberal approach (traditional laissez-faire) was not at all absent but lacked sound foundations. However this period was characterized by a progressive strengthening of updated liberalism that officially took over economic policy, starting with the Labour government of Wilson in 1964 in the UK and the Democratic administrations of Kennedy (1960-63) and Johnson (1963-68) in the USA under the banner of 'new economics'. The other industrialised countries followed their lead. For example, Italy officially adopted a Keynesian policy only with the centre-left government in 1962, although the preceding governments supported by coalitions led by the Christian Democratic party pursued a socially-constrained liberal policy under the influence of the social doctrine of the Catholic church rather than of Keynes and Pigou.

By the same token, in the PF growth period updated liberalism retained much of its influence. A case in point is the emergence and development of environmental policies. They were inaugurated only in the 1970s and were mainly inspired by the Pigouvian approach. Only with the Bush administration was there outright rejection of the Pigouvian approach in favour of a Coasian approach more consistent with the neo-liberal drive. On the other hand left-wing governments

tried on many occasions to resume in part the basic idea of updated liberalism (e.g. under the Carter and Clinton administrations in the USA, under the Prodi government in Italy, the Jospin government in France, and so on). However, notwithstanding these political fluctuations, since the early 1980s on the whole updated liberalism has declined while neo-liberalism has progressively increased its influence also with left-wing parties and governments. (A case in point is the policy of the Blair Government strongly influenced by neo-liberal ideas.) This change of direction is visible by comparing the actual policies realised before and after the long crisis of 1970s. By the early 1980s deregulation, privatisation, dismantling of the welfare state, and so on, were pursued with increasing determination by most governments in industrialised countries.

It is not the purpose of this essay to discuss whether there could have been better ways out of the serious problems that affected the industrialised economies at the end of the Millennium. However it is by now quite clear that neo-liberalism was unable to provide the much needed remedies to market and state failures and is likely to aggravate them further because by definition it cannot tackle the causes of market failures as their existence is denied in principle. The neo-liberal approach seemed successful for a while because it reacted to the abuses of updated liberalism in a direction that to some extent was compulsory (stabilization of monetary and budgetary policy and check to the excessive interference of the state on the economy). But the way in which this was done and the further steps taken afterwards could have been different, for example tackling the causes rather than the symptoms of economic disease. This could be done by resuming the physiological evolution of liberalism as updated by Keynes and Pigou. Of course also their contribution should be updated in the light of the historical experience in the second part of the last century.

## Notes

- 1 The assertions and arguments of the paper refer to the G7 countries with the exclusion of Japan (i.e. the USA, the UK, Germany, France, Italy, and Canada). Japan, like other industrialised countries excluded from our reference group, is also affected by the tendencies underlined in this paper but these interact with peculiar cultural and institutional features. Of course also the other industrialised countries have peculiarities that we cannot mention in this paper; however we believe that a thorough analysis of their impact, fully absent in this paper, would add very important qualifications to the arguments developed herein without jeopardising their substantial soundness.
- 2 What we call here first-order science (research) has in turn a hierarchical structure, but the prevailing criterion of division of labour is vertical, i.e. based on the specificity of subjects, rather than horizontal, i.e. referring to a hierarchical layer (a case in point is the classification adopted by the J.E.L.). Therefore, for the sake of simplicity, we ignore here the hierarchical structure of current science (research) calling it first-order science (research). Of course, we may find in it fragments of what we call higher-order science

(research) that we implicitly hive off to the latter. On these methodological points see Vercelli (1999 and 2002).

- 3 As is well known the school of Freeman introduced the notion of technological paradigm (see Dosi, 1984) building upon the notion of scientific paradigm introduced by Kuhn (1970). We use the concept of economic paradigm in order to extend the concept beyond technological aspects, encompassing also the organisational and institutional aspects of the mode of production and distribution of goods and services (Vercelli, 1989).
- 4 The recognition of this causal nexus does not imply that the blame for rising inflation and the ensuing breakdown of the Bretton Woods system should be laid on workers or trade unions. The expansionist monetary policy that immediately followed a wage rise beyond productivity growth in order to save profits was another necessary link of the causal chain. In any case the problem could have been solved, and could be solved, through systematic adoption of a participatory method involving far-sighted agreement between the social parts. Unfortunately the income policies implemented in the late 1960s and 1970s did not succeed in obtaining these results. Their failure resulted in the unwarranted conclusion being drawn that the updated liberalism of the 1950s and 1960s was not viable and had to be substituted by a different economic paradigm.
- 5 We may identify a clear-cut conventional date for this turnaround. In 1981 Robert MacNamara, president of the WB since 1968 and the chief of economic research Hollis Chenery who had acted according to the updated liberal stance, were abruptly replaced respectively by William Clausen and Ann Krueger who began to act according to the neo-liberal doctrine.
- 6 This expression that became very popular with both experts and mass-media has two alternative meanings: either 'international consensus coalesced in Washington' or 'consensus forced by Washington (i.e. the US Treasury)'. The second is strictly related to early worries expressed by Keynes himself when the decision was taken, against his opinion, of locating both the IMF and WB in Washington. He forcibly opposed the last-minute decision of the USA to transfer the head office of these institutions from New York to Washington. He observed in particular that the location in New York of these institutions would have the advantage of assuring a better link with the UN and the international financial community while shielding them from the excessive influence of the US government and Congress (see Harrod, 1951, chap. 15).
- 7 Recently there was a serious attempt by the WB, under the influence of Stiglitz appointed chief economist in 1997, to recover its original autonomy resuming an approach based on a further updated liberalism based on a full awareness of the limits to markets, but after only three years he was forced to resign (see Stiglitz, 2002).
- 8 However, it is now clear that he was definitely 'too successful' on the occasion of the long speculative bubble of the new economy that was inflated also by his permissive attitude.
- 9 In most OECD countries the indexes of inequality slightly diminished in the Bretton Woods era (1950s and 1960s) but have increased progressively since the early 1980s (see in particular Brandolini, 2002 and the comments in Vercelli, 2003).
- 10 In particular Adam Smith developed these themes in chap. 2 of book 4 of the *Wealth of Nations* (Smith, 1776), while Stuart Mill dedicated to them chaps. 8-11 of his *Principles of Political Economy* (1848), the most influential 19<sup>th</sup> century economic textbook in Britain.
- 11 There can be no doubt that these fundamental contributions of Keynes and Pigou were fully consistent with the basic tenets of *classical liberalism*. Not by chance both elaborated ideas already present in germinal form in the works of their common master

Marshall. The potential complementarity of these two contributions was not recognized by the two protagonists partly due to personal reasons (possibly a Freudian jealousy between the best pupils of the same master) and partly due to methodological reasons (acceptance by Pigou and rebuttal by Keynes of the General Equilibrium approach) although the latter difference was considered by some followers not insurmountable and was soon somehow mended by the founders of the neoclassical synthesis (Hicks, Samuelson, Modigliani, Patinkin). We do not discuss here to what extent this suggested synthesis was realized in a satisfactory way (the critical opinions of the author are expressed in Vercelli, 1991).

- 12 See Vercelli (1991) for a discussion of the different concepts of instability.
- 13 We have to stress that this interpretation is highly misleading as it ignores the full argument of Coase (1960) and its qualifications. See on this Pagano (2000).
- 14 If we define Keynes and Pigou as 'left-wing' Marshallian, Friedman may be defined as 'right-wing Marshallian'. Indeed, he accepts the partial equilibrium approach and the need to analyse disequilibrium positions and paths. However, he assumes an instrumentalist epistemological stance in contrast with the requirement of realism of the hypotheses underlined by Keynes. The latter aspect of Friedman's vision prepares the ground for the rise of the new classical school.
- 15 In particular Say believed that unfettered competitive markets are also able to realise the fair distribution of incomes, a thesis that was definitely swept away by the General Equilibrium theory. In addition he believed that we should not worry about unemployment because an excess supply of labour force would push wages below the subsistence level, thereby eliminating the problem. Also this cynicism is not altogether absent in the neo-liberal approach (see Stiglitz, 2002, for a host of examples).

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