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GOVERNMENT AND INTERNATIONAL TRADE

CHARLES P. KINDLEBERGER

INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS

PRINCETON UNIVERSITY

Princeton, New Jersey

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The author, Charles P. Kindleberger, is Professor of Economics Emeritus at the Massachusetts Institute of Technology. His latest books are ECONOMIC RESPONSE *(1978) and* MANIAS, PANICS AND CRASHES *(1978). He is the author of two Essays in International Finance,* BALANCE-OF-PAYMENTS DEFICITS AND THE INTERNATIONAL MARKET FOR LIQUIDITY *(1965) and* THE POLITICS OF INTERNATIONAL MONEY AND WORLD LANGUAGE *(1967), as well as one Study,* THE FORMATION OF FINANCIAL CENTERS *(1974). The present Essay was delivered as the Frank D. Graham Memorial Lecture at Princeton University in November 1977.*

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International Finance Section

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Government and International Trade

Introduction

My subject derives from one of the lines of attack in Frank Graham's opposition to the offer curve of John Stuart Mill:

> In any freely organized market, for any given internationally traded commodity, demand will be partly from residents of the country of the market in question, and partly from residents of other countries. . . . The price of any freely traded good is unaffected by the national origin of sellers or buyers and there is, in consequence, no occasion for grouping buyers or sellers into more or less antagonistic sectors (Graham, 1948, p. 158).

The same thought was expressed almost thirty years later by Marina Whitman, in extending an analysis of Cooper. Whitman went on, however, to qualify it profoundly:

> . . . the efficiency gains from market integration are maximized by ignoring the boundaries of the nation-state; for private transactions in goods and factors of production, the optimum size of the integrated area is the world. By implication, the economic justification for the nation-state must lie in the existence of public or collective goods—including stabilization targets, the distribution of income, and the regulatory climate—and of differences in national consumption preferences for such goods (Whitman, 1977, p. 3).

I propose to explore the theory of public goods, the role of government (or, in some formulations, the justification of the nation-state), and the durability of the nation-state in a world of mobile ideas, money, goods, and people. I shall illustrate various points with incidents from economic history, with which I have been agreeably occupying myself of late.

It is, of course, impossible in a short essay to offer a full-fledged theory of government as it relates to foreign trade. Let me start by breaking down Whitman's basket category, public or collective goods, into the three functions of government identified by Adam Smith. The duties of the sovereign, he said, are to protect the society from violence and invasion by other independent societies; to protect as far as possible every member of society from injustice and oppression by every other member of it, or to establish an exact administration of justice; and to erect and maintain those public institutions the profitability of which could never repay the expense to any individual or small number of individuals, such as roads, bridges, canals, and harbors (Smith, 1776, pp. 653, 669, 681-682). Free trade and limited laissez-faire, that is, take place within a system of "magistracy."

Two hundred years later, other views of government are offered by economists. One that is directly related to international trade, through the problem of economic integration among territories, is provided by Cooper (1974, p. 9), extending to four an earlier classification of the functions of government: stabilization, allocation, distribution, and regulation. In his paper before the International Economic Association meeting at Budapest in August 1974, Cooper put the case for regionalism in terms of public goods: stabilization, redistribution, and regulation. He went on to consider the optimal provision of public goods from the viewpoint of three technological factors—economies of scale, external effects, and effective stabilization—and from the viewpoint of the diversity of individual preferences for collective goods. Technological factors argue for one world; diversity of preferences argues for a pluralistic world of many nations (Cooper, 1977, passim).

Somewhat antithetical to this idealistic view of government is one set out by Lindbeck (1976) in his Ely lecture entitled "Stabilization Policy in Open Economies with Endogenous Politicians." Slightly modifying his scheme, we can distinguish three political-behavior functions for government: the normative, as in the writing of Tinbergen and Meade, where an idealistic and well-informed government works in the overall interest, along lines not very different from those of Cooper or even of Jeremy Bentham; the negative, as in the Chicago school, where markets are regarded as highly stable but the system is upset from time to time by destabilizing government action; and the political or popularity, as in the school of Anthony Downs, where politicians maximize their own personal welfare by selling policies for votes in a manner analogous to selling goods and services for money. Lindbeck prefers to make combinations among these. The normative and the popularity functions are additive, with varying weights. Before elections, the popularity function dominates the normative. After an election and until the next one approaches, the normative gains and popularity recedes. Commenting on the Chicago view, Lindbeck (1976, p. 11) states that it is better to think of both the economic-market and the political-administrative systems as containing instabilities and imperfections that interact with one another in a complex way.

These approaches are all insightful, but I shall break down the relations of government to international trade somewhat further. I propose first to discuss magistracy, or the institutional framework within which trade is carried on; second, more tangible public and collective goods, akin to the public works of Adam Smith; third, the view of government as a tool of private interests; fourth, the noneconomic purposes of govern-

ment; fifth, government as an ulcer, or independent source of muddle and instability; sixth, government as the filler of vacuums; and, finally, the notion that the nation-state is at bay and, if true, the possible need for international public goods that can and should be provided by the international system. In all this, I shall be dealing explicitly with international trade, although some of the separate points may be more general.

Magistracy

The tendency to identify free trade with laissez-faire arises naturally from the origin of laissez-faire in the physiocratic pressure to expand exports of grain and defeat the policy of restricting exports in order to feed the national population. While laissez-faire may be associated with minimal government, there is no necessary connection between free trade and laissez-faire, as, for example, Jacob Viner and Lord Robbins well knew (see Holmes, 1976). In Britain in the 1830s and 1840s, there was a movement to freer trade culminating in the repeal of the Corn Laws, timber duties, and Navigation Acts, in the elimination of restrictions on exports of machinery and coal, and in the rationalization of other import duties. Brebner (1948) has pointed out that this movement was accompanied by increasing government intervention in many other aspects of the economy, such as the conditions of work, the length of the working day, and the employment of women and children. Free trade was possible only within a framework of law, order, and equity—magistracy, to use Adam Smith's word. The suggestion has been made that Sir Robert Peel hesitated to press forward with repeal of the Corn Laws until he had been assured that the benefits would accrue to wage earners in manufacturing rather than swell the profits of the manufacturers (Chambers, 1968, p. 71).

Law and order are complements to foreign trade. The Coase theorem claims that institutional arrangements can be disregarded in economic outcomes, with certain exceptions for transaction costs. The standard illustration of the theorem is that land will be used for sheep grazing even if cattlemen own it if sheep are more profitable than cattle. Lowry (1976, p. 9) observes, however, that this illustration assumes that the disposition of the land is settled by owner use or a market rental rather than by, say, murder. Most relevant to our concerns is the problem of piracy. Safe passage on the high seas was and is a public good, historically underproduced much of the time but part of the magistracy needed for trade. "The suppression of piracy," states Parry (1971, p. 58) "was in almost everyone's interest, but it was nobody's specific business." It would

be hard to find a neater statement that public goods are underproduced because there is no way to exclude the free rider. Parry was talking about the eighteenth century. In the nineteenth century, protection from Moroccan pirates was from time to time a private national good rather than an international public one: When an English cruiser refused to assist a Prussian ship captured in the Mediterranean and held for ransom, the ship asked for protection from Sweden and was refused. At the end of the 1830s, German shipping was virtually excluded from the Mediterranean for lack of naval protection (Bondi, 1958, p. 53). Earlier, in the eighteenth century, Dutch East India Company vessels were heavily built to carry cannon and cannoneers for their own protection. Once Dutch naval escorts were provided to convoy merchantmen (a quasi-collective, quasi-public good), standard lightly built fluyt ships were constructed, reducing transport costs and fostering trade.

The complementarity between magistracy and foreign-trade theory is underlined by Samuelson's defense of the social indifference curve. The existence of the social indifference curve rests on the supposition that there is a government that treats the nation as a family, providing redistributive transfers from time to time to temper the effects of income redistributions arising from trade (Samuelson, 1956). This supposition thus underlies the use of social or community indifference curves in the construction of the offer curve so thoroughly detested by Graham, as it took the place of Meade's assumption of nations composed of individuals identical in tastes, income, and wealth, or alternatively of Scitovsky's compensation principle.

Scitovsky's compensation principle can, of course, be implemented by transfers effected by government, but the only historical attempt to apply the compensation principle of which I am aware proved a failure. In the 1830s in France, tariffs on colonial and foreign sugar induced an upsurge of domestic sugar-beet production. A government proposal motivated by the West Indian colonies called for suppressing the domestic industry and paying 40 million francs in compensation to inland refiners. It was rejected. Instead, the Chamber equalized the tax between French colonial sugar and domestic beet sugar, while protecting both of them against foreign supplies (Gouraud, 1854, pp. 342-345).

Adjustment assistance (with which the United States has been struggling since the Kennedy-round tariff legislation) is not exactly the same as compensation, though close to it in spirit. I have two historical examples of adjustment assistance from the nineteenth century. It is seldom mentioned that when the Corn Laws were repealed, a fund of £2 million was established to extend the draining techniques of high farm-

ing among the landowners in England, and another fund of £1 million was established for Ireland. In France, Louis Napoleon put 40 million francs into a loan fund for adjustment assistance to producers adversely affected by the Cobden-Chevalier treaty of 1860 (Dunham, 1930, pp. 145ff.). In the two cases, government made possible freer trade, or at least softened the rigors of transition to it.

The point is an important one. To permit the competition and free trade that Graham thought natural, some institutions may be necessary to protect a country from the most untoward effects of competition from abroad. The European Investment Fund and the European Social Fund, established under the Rome treaty of 1957 to contain "backwash" effects, point in this direction. Myrdal (1956) has noted that free trade can lead to factor-price equalization only when countries are sufficiently similar in their factor endowments to tolerate the consequences of free trade, which may then be able to close the remaining gap. At a more fundamental level, the difference between interregional and international trade explored by Ohlin lies in the existence within a nation of a government that tempers the wind to the shorn lamb through various redistributive devices, while in international trade such mechanisms (e.g., foreign aid) are rudimentary, if they do in fact exist. It has been said that international trade is between "us" and "them." If "we" are bound together in a social compact under which we undertake to modify by budgetary (i.e., nonmarket) means the undesirable hurts arising from trade, the aggregation into offer curves of trading firms within our nation can be thought of, not as antagonistic, but in Meade-Tinbergen terms as helpful to the optimization process.

One intangible public good or institution is the state itself. In economic history, we have the device of the "counterfactual," that is, looking for causes by trying to establish what would have happened, or what the situation would have been like, in the absence of the event or institution the effects of which are being examined. Graham objected to the nation-state because he considered its counterfactual to be worldwide laissez-faire. This is understandable only as an *a priori* view. Historically, the counterfactual to the nation over wide areas was not anarchy but scores, hundreds, perhaps thousands, of smaller political units, each interfering with trade. In 1790, what later became Germany had 1,700 tariff boundaries and 300 rulers levying tolls as they pleased (Henderson, 1959, pp. 1, 21). Prussia alone had 67 local tariffs in 1800 (Böhme, 1968, p. 9). As late as 1848, despite the clearing up of barriers—first under the Napoleonic occupation of the Rhineland, second through the Maassen tariff of 1818 in Prussia, and third by the Zollverein of 1828—there were

18 toll houses on the Rhine, 3 in Holland, 7 in Prussia, 2 each in Nassau, Hesse, and Baden, and 1 each in Bavaria and France (Banfield, 1848, p. 30). On the whole, mercantilism has a bad name, associated as it is with the fallacies of export surpluses and gold accumulation. The appropriate counterfactual to mercantilism, however, was not internationalism but parochialism. Mercantilism enlarged rather than shrank market space, in particular as it built the national institutions necessary for trade, especially standards and national money.

Standards are sometimes a public, sometimes a collective, good. Napoleon laid down the metric system of weights and measures. British Parliament sought unsuccessfully to decree the width of railroad track in the Standard Gauge Act of 1846, a standard adopted through most of England and on the Continent (except Russia) but not by the Great Western Railroad until almost half a century later. Standards may be set by industry as well as by government, by a cartel, a dominant firm, an organized exchange, a group of merchants. A lack of standards does not prevent trade, but it adds to costs and reduces efficiency. An effort in Britain to adopt decimalization in the middle of the nineteenth century failed to overcome national resistance, and not until the computer required decimalization did the changeover occur a century later. It took a war to achieve adoption of the common British-American standard for the pitch of the screwthread. The U.S. government's attempt to lead the United States to the metric system in distance, weights, and temperature seems to make progress by inches or, perhaps better, centimeters. The public good of standards presents great complexity. The more widely the standard is applied, the more difficult it is to abandon for a superior one. Cost-benefit problems of deciding when to change to a superior standard or to alter a universal one are among the most difficult for democratic governments. And there are benefits in parochial diversity, as is clear when one contemplates the rivalry among musicians in the courts of eighteenth-century German principalities. But consider trade in the absence of standards: Indian exports of cotton in the cotton famine of the 1860s were full of dirt; Turkish wheat exports in the early 1950s were said to be replete with rocks and dead mice. While it is true that government is not essential for setting standards, where the collective good of standards is underproduced it may be necessary to have government undertake the task.

It is probably not necessary to defend national money as a public good, again not essential to international trade but very helpful. International money would be still better, to be sure, and not every national money is managed at all times so as to minimize problems. At the 2-

by-2-by-2 level, international trade theory proceeds in general equilibrium without the need for money. In the real world, above the primitive levels of exchanges of gifts and silent trade, trade needs money, as the inefficiencies of clearing in the 1930s forcefully demonstrated. Moreover, the fact that national moneys occasionally or more frequently depart from purchasing-power parities justifies the aggregation of demanders and suppliers in a given country into a national offer curve, representing net demand or net supply.

Public Works

It was perhaps the fallacy of misplaced concreteness that led Adam Smith to separate out "roads, bridges, canals and harbours" from public or collective goods such as law, order, justice, weights and measures, and stable money. For trade, there is perhaps little distinction between the London docks built at the end of the eighteenth century and the collective institution, the "liner," that replaced the casual ship in New York in 1818. That was the date when the Black Ball Company undertook to dispatch a sailing ship to Liverpool each Saturday whether it had a full cargo or not (Albion, 1939, pp. 13, 15). Until the nineteenth century, goods shipped out of London were lightered. In 1799, the British government built the West India Dock. The other London docks were undertaken privately in exchange for the government grant of a twenty-one year monopoly on imported tobacco, rice, wine, and brandy, except from the East and West Indies (Gayer *et al.*, 1953, Vol. II, p. 421). These public and collective goods helped London and Britain to pull decisively ahead of Amsterdam, where the port was too shallow for deep-draft vessels.

The role of government in the provision of these collective or public goods differed from country to country. Adam Smith (1776, p. 115) was not entirely accurate when he stated that banking, insurance, canals, and water works might need government capital but nothing else. Actually, the capital was often furnished privately in Britain (but publicly in France), but government permission was always needed. In France, the government prepared the master plan for canals and railroads. In Britain, there were no such plans, but massive local initiative had to secure government authorization. Whatever the arrangement, public works spurred trade. The construction of canals and turnpikes in the 1750s and 1760s was critical to the surge of exports in the 1770s and especially the 1780s. The woolen manufacturers of Leeds may not have depended on the Aire and Calder Canal to take their products to Hull for export, but Wedg-

wood's difficulties in moving his new, hard, and therefore brittle china by pack train explained his strong leadership, along with Boulton and Watt, in promoting the Grand Trunk Canal that linked Hull, the Potteries, and Liverpool via the Trent and the Mersey.

Tool of the Interests

When providing institutions or tangible public works, government may not always have acted, in Meade-Tinbergen fashion, in the general interest—all wise and all just. Public works, for example, benefited some groups and hurt others. Canals were an object of dispute, at all stages, between millers who wanted a good head of water and bargemen who found the weirs a barrier to navigation (Ashton, 1959, p. 8) and between the navigational interests who wanted high water and the landed gentry who wanted their land irrigated rather than drained (Gayer *et al.*, 1953, Vol. II, p. 418). The necessity for government to choose among competing interests gives rise to the Marxian view that government is principally the tool of the ruling class.

In the context of international trade, we account for this possibility in the Stolper-Samuelson theorem. That theorem explains how tariffs imposed by government benefit the scarce factor in a country, with the corollary that free trade may be imposed on a country in the interest of the abundant factor (Stolper and Samuelson, 1941). On this showing, the choice between tariffs and free trade turns on which interest group controls the sinews of government. If the abundant factor does so, it may display faith in general equilibrium and in Hume's law that imports generate exports. Or it may, as Semmel (1970) seeks to show for Britain in the first half of the nineteenth century, think in more specific terms of free-trade imperialism, adopting free trade in an effort to divert investment abroad away from competitive manufacturing and into agriculture.

The theory that the tariff may be regarded as a collective good has been shown to apply to the United States tariff of 1824. Widely diffused interests did not receive tariffs as high as those obtained by industries that were concentrated in a few states, because of the willingness of the concentrated industries to bear the transactions costs of getting the tariffs levied (Pincus, 1977). Conversely, the benefits of free trade to consumers are generally neglected because their interests are diffused; in other words, the collective good, free trade, is underproduced because no one bears the transactions costs and all are would-be free riders. Analogously, the Department of State is continuously complaining that

it lacks a domestic constituency like those of the Departments of Commerce (business), Treasury (finance), and Labor among government bureaus, or like the constituency of Congress.

The notion that vested interests favor tariffs fails to take account of a number of additional factors besides the vested interest of the abundant factor, which merges so comfortably into the general interest. Theoretical preoccupation with the 2-by-2-by-2 model tends to neglect traders themselves, as well as collective interests that favor free trade or low tariffs. For traders, see the free-trade policies of the Dutch, who were uninterested in exports of domestic produce or output of import-competing goods but were committed to turning over goods both produced and consumed abroad. Turnover was maximized by maintaining customs duties at very low levels and imposing on labor the taxes needed to support the navy that protected trade (Wright, 1955). For collective interests that favor free trade or low tariffs, see industries that process or consume imported intermediate goods. There is no duty on newsprint in the United States: the press is too powerful. Generally, effective rates of protection are well above the nominal because the influence of consumers of raw materials is exerted to keep tariffs low on those materials compared with tariffs on finished products. The free-trade movement in France was promoted intellectually by the ports of Bordeaux, Lyons, and Paris, but the action came at the peaks of the business cycle in the 1820s, 1830s, 1840s, and 1850s, when iron foundries wanted relaxation of the duty on coal.

It is occasionally suggested that the movement to freer trade comes from government, which has sharper insight into the true interest of business groups than have business groups themselves. The classic example is Finance Minister William Huskisson's reduction of the tariff on silk in the 1820s, which stimulated the boroughs of Macclesfield and Spitalfield through the competitive effect more than it hurt them through the negative protective and redistribution effects. The European Common Market has also been justified on the Schumpeterian grounds that competitive imports galvanize industry. Lhomme (1960, p. 179) explains away the Cobden-Chevalier tariff, insofar as it interferes with his thesis that bourgeois forces ran France, with the dubious proposition that Louis Napoleon knew the interests of the powerful classes better than they did themselves. A less tortured explanation is that Louis Napoleon was buying a noneconomic value—British neutrality toward his anti-Austrian and pro-Italian foreign policies—in an economic coin that had little value for its own sake.

Noneconomic Objectives

Not all public and collective goods are complementary to private goods—like more, or less, foreign trade—and some may indeed be substitutes. Nationalism is one such good. In some circumstances, nationalism can be thought of as an investment good. The nationalistic euphoria of Germany in the *Gründerzeit* was a strong stimulus to economic expansion that rode through the depression of the 1870s. But Johnson (1970, p. 50) thought of Canadian nationalism and xenophobia as consumption goods. A country may choose autarchy for nationalistic reasons, including national defense or just a national mood of exaltation, of togetherness. Developing governments build pyramids, including inefficient manufacturing industry, at a net cost in national income, because such noneconomic or uneconomic goods are arguments in the national objective function (Cooper and Massell, 1965).

This is nation building, not unrelated to the mercantilism discussed earlier, and each may or may not be productive. Nation building appeals far more to political scientists than it does to economists. The heroes of political science, by and large, are not the internationalists—Smith, Cobden, Chevalier, or even Marx—but the strong nationalists—Bismarck, de Gaulle, perhaps Kissinger—who tend to think of economics as uninteresting in itself but possibly useful in the conduct of foreign policy. Before 1875, Bismarck was content with low tariffs, since they embarrassed Austria by preventing her from joining the Zollverein. After Austria was defeated in 1866, he finally found foreign-policy virtue in the union of iron and rye. For a time in 1878, Bismarck showed some interest in the Frenchman Molinari's suggestion that the Continent form a customs union to secure Europe's future in the face of American, British, and Russian competition (Epstein, 1967, p. 111), as the Zollverein had been used to advance Prussian political ends in 1828. In 1879, domestic politics drove the country in the opposite direction, in a manner one might predict by invoking the Stolper-Samuelson theorem. De Gaulle attributed his advocacy of the gold standard to the analysis of Jacques Rueff, who attacked the gold-exchange standard on the grounds of inflation and instability. But de Gaulle's real opposition was based on the fact that the dollar, and not the French franc, had displaced gold.

The question arises particularly with respect to colonies. Were they acquired for economic ends, as Hobson, Lenin, Magdoff, and others maintain, or for *la gloire*? It is hard to make the case that any colony acquired after 1880 was economically justified, save for the Belgian Congo and the Witwatersrand of the Boer War. Elsewhere, colonies served to bolster

national prestige at the general expense. Certain groups in society benefited—in Britain the upper classes, for whom the Empire constituted outdoor relief, or in France the army, the ports of Marseilles and Toulon, and the cotton interests of Rouen and Mulhouse. Typically, these were not interests that could dictate governmental decisions. The matter is better put by D'Estournelles de Constant à propos the French budget of 1899: "First the joy of conquest, and then the necessity to pay" (Brunschwig, 1960, p. 144).

Ulcer or Muddle

Graham would have been sympathetic with the Friedman view that government may be well-meaning but is certainly incompetent. In a footnote in *The Theory of International Values,* Graham wondered how it was that the U.S. government, created to win the rights of its people to buy and sell freely in the most advantageous markets possible, should so often deprive its citizen of those rights (Graham, 1948, p. 22n).

The Anthony Downs view of politicians as being in business for their own ends is perhaps epitomized by the deathbed remark of Louis XIV: "Too many palaces, too many wars." But even when government is properly motivated, à la Meade and Tinbergen, it may make a mess of it. The princes of Serendip, who did everything badly with fortunate results, are outnumbered by the disciples of the engineer Murphy, for whom anything that can go wrong will go wrong.

Part of the difficulty may be that government typically uses too simple a model, usually a partial-equilibrium model that assumes other things unchanged, when, in fact, an action can set in motion forces that change "other things." Charging reparations after wars, getting exchange rates wrong, attempting to maintain independent monetary policies in money and capital markets that are joined, imposing import-substitution policies, and propping up commodity prices are among the many examples. If one wants a lavish recent example, contemplate the attempt of the U.S. government to improve its balance of payments by tying aid, applying the Interest Equalization Tax, and then chasing the capital flows via the Gore amendment, the Voluntary Credit Restraint Program, and the expansion of this program, the Mandatory Restraint Program. In the end, it proved useful to sweep all the restrictions away. A similar recommendation has been made by Joseph Pechman for the income tax: Start over again. ("When everybody is somebody, nobody is anybody.") Economic history affords two outstanding examples. *Gewerbefoederung,* or the promotion of industry through patents, privileges, and monopolies granted

to individuals under restrictions as to exporting, employment, conservation, education of workers, etc., became so complex in Baden than in the end *Gewerbefoederung* was junked in exchange for *Gewerbefreiheit*, or freedom of occupation (Fischer, 1962, p. 82). In the same fashion, the Navigation Laws in Britain, started in the seventeenth century and increasingly detailed in their application in the nineteenth, became so intricate that finally, according to W. L. Harle, they were "understood only by a few official persons and a few inquirers in political economy" (quoted by Clapham, 1910, p. 161).

Government Abhorring a Vacuum

A somewhat undeveloped theory of government suggests that government may be called upon to undertake tasks that the private economy happens not to undertake spontaneously and to act, so to speak, like nature in filling the resultant vacuums. Earlier I indicated that some goods, like standards, are occasionally produced collectively, sometimes by government. Gerschenkron's (1952) theory of backwardness asserts that the more backward a country as it begins economic development, the more likely it is that government (and banks) will substitute for private entrepreneurship in markets. Railroad building, education, financing of housing, and technological improvements in agriculture furnish ready examples. A more general statement can be offered as a theory of the second best: When markets don't work efficiently, don't use them. In these circumstances, government is often substituted for the market.

Examples are less abundant in international than in domestic trade, and are not always successful. Markets may not work well, but—because of the muddle of government—they may work better than the substitute. In many circumstances related to particular countries and conditions, it is debatable whether markets or governments are more effective in allocating and distributing income, even when it is clear that neither perform these tasks perfectly. Bulk purchasing and international commodity agreements are among the most contentious issues in international trade. I maintain, nevertheless, that there are occasions when government intervention is required because of market failure or breakdown, if one assumes governmental ability no worse than 1 standard deviation below the average. Let me cite three examples, the first from trade and the others from finance.

In 1938, with much more foresight than the private market, Herbert Feis, the economic adviser to the Department of State, foresaw that the outbreak of war might disrupt the flow of commodity imports to the

United States and that for purposes of national defense it would be advantageous to undertake a program of stockpiling imported raw materials. As so often happens with government, sound advice was produced but there was no one to receive it. Eventually, however, the office of the economic adviser in the Department was assigned the task of stockpiling, and Feis, with his assistants Horace White and Leroy Stinebower, embarked on a program of importing for government account. The market may have failed to anticipate the need for stocks of raw materials because the need was further forward than the 90 or at most 180 days in which futures markets for a limited number of assets work effectively (Arrow, 1974, p. 9). Or it may have failed because national stocks, like insurance, are a collective rather than a private good, although no stockpiling companies comparable to insurance companies sprang into being to provide the service (Feis, 1947, Episode One).

Let me turn to finance. The Italian capital market is underdeveloped, and an Italian company that is solvent but facing liquidity problems is sometimes unable to borrow in the local market. One solution is to sell the company to a multinational enterprise with access to adequate liquidity abroad. But if this is possible only at a sacrifice price, it may be better to let government credit substitute for the inadequate capital market and have the firm acquired by IRI, ENI, EMI, or another of the various semi-state agencies.

Finally, in Brazil, a liquidity crisis was precipitated some years ago by an attempt to follow the advice of the International Monetary Fund. The prices of stocks of a number of Brazilian companies collapsed, and controlling interests in some of them were bought by foreigners. Present Brazilian controls on direct investment are so rigid as to inhibit trade and investment unduly, but the origin of such controls is perhaps understandable.

Government is often called on to fill the vacuum as lender of last resort, both nationally and internationally. A minority, a small minority if my estimate is right, think that there is never a need for a lender of last resort because markets always appropriately discount the information available to them in correcting today's prices for future events and that, in any financial crisis, worthy borrowers can obtain the loans they need at some interest rate. I do not propose to dwell on the subject, as I discuss it in a forthcoming publication, but I have doubts. It may nevertheless be granted that last-resort lending has costs as well as benefits. If firms, banks, and institutions know that they will be bailed out when they get into trouble, they will be tempted to take greater risks and to be less self-reliant.

The existence of a government that will take on neglected tasks may tend in many circumstances to undermine the readiness of private institutions and individuals to look after themselves. It is often first-best to improve the functioning of markets by assisting entry and exit, limiting monopoly, and providing better information. Nonetheless, there will be occasions when government is needed to repair omissions of the market. Public, collective, and private goods constitute a continuum in which the lines are drawn differently in different societies and in the same society at different times. Government should be ready to fill in, though perhaps not aggressively, when the collectivities of the economy and the private market leave important gaps.

Sovereignty at Bay?

My taxonomic approach to government and international trade has suggested that national government sometimes produces useful public goods, sometimes makes difficulties, sometimes serves the ends of narrow groups, and sometimes is called upon to come to the rescue when markets break down. Whatever the role of national government, it exists, and its existence and that of national governmental policies undermine Graham's contention that firms within a given state should not be aggregated into a national offer curve representing net demands for some commodities and supplies of others.

In the seventeenth and eighteenth centuries, Graham's contention was more nearly right. In *The Wealth of Nations*, Adam Smith wrote:

> A merchant, it has been said very properly, is not necessarily the citizen of any particular country. It is in great measure indifferent to him from what places he carries on his trade; and a very trifling disgust will make him move his capital, and together with it the industry which it supports, from one country to another (Smith, 1776, p. 395).

Violet Barbour extended the time frame:

> The international capitalist from his earliest to his latest appearance has generally been, where business was concerned, a Man without a Country, and the seventeenth-century Amsterdammer though by no means a man without a city, was strikingly uninhibited by abstract considerations of patriotism or by theories of economic nationalism (Barbour, 1966, p. 130).

To bring the literature from Smith, Barbour, and Graham down to the last few years, it is necessary only to cite Cooper's Wicksell lecture, entitled "Economic Mobility and National Economic Policy" (Cooper, 1974), or Lindbeck's little book, *The National State in an Internationalized World Economy* (Lindbeck, 1973). Analogous views can be found

in current discussions of relations between multinational firms and the governments of countries in which they operate. The firms are described as cosmopolitan, transnational actors that refuse to submit to the typically second-best economic (and frequently noneconomic) policies of the countries in which they are located.

It is evident that national sovereignty is increasingly undermined by the mobility of goods, capital, enterprise, and people. At the same time, international trade and some of the public goods needed to optimize it are being damaged by strong demands at the national level for collective goods: full employment, particular distributions of income, independent rates of inflation. A number of political scientists object to the growth of the optimum economic area to a world scale; they believe it undermines the nation-state and subverts its functions. Even economists tend to become nationalist in orientation as they contemplate monetary, fiscal, employment, and labor policies, and they turn to supposed panaceas such as floating exchange rates that are believed capable of providing national autonomy.

Optimization of international trade is perhaps not the *summum bonum*, but interference with the mobility of goods, capital, enterprise, and people runs grave risks of muddle. It is preferable to try to provide some of the public goods needed as complements to trade at the international level, notably international money, harmonization of policies to forestall private capital movements that respond to policy differences rather than to basic scarcities, organs for responding to market breakdown, and lenders of last resort.

Political scientists properly place a high value on pluralism (see, e.g., Hoffmann, 1977) and object to such hierarchical structures as are implicit in a gold standard managed by London or a dollar standard dominated by the United States. The same pluralism, it should be noted, argues for restraint on national government when it dominates the local level. But pluralism tends to underproduce vital public goods and to overproduce a public bad, neo-nationalism. The fallacy of composition ensures that, at least in a few instances, if each locality, region, or nation takes care of itself, the wider national and international interest may suffer, and with it the interests of all lesser units. The free rider is the bane of pluralism, just as the imperious leader—exploiting others, allegedly in their own interest—is the bane of hierarchy, or what some observers call the hegemonial system.

Lacking a world government or any reasonable prospect of one in the immediate future, the task is the delicate one of performing certain limited functions at the international level. There is insufficient space

to address the nature of a new world order after the breakdown of the dollar system—if it has in fact broken down. But the elements, some of which have already been mentioned, would not depart widely from Whitman's (1977) list: stabilization, redistribution of income, and regulation of abuses.

Let me conclude by going some distance with Frank Graham on the subject of separate firms, though not so far as to deny the validity of the offer curve. I agree with the view implicit in the Graham-Smith-Barbour position that business and government should specialize and exchange, the one producing profits and the other providing the setting of magistracy—public works and regulation—in which business is free to maximize. I do not go so far, nor do I think would Graham, Smith, or Barbour, as to condone the Dutch traders and financiers who were willing to trade with and lend to the enemy when they were not busy arming privateers to prey on the shipping of their countrymen (Barbour, 1966, pp. 130-131). To be sure, I ignore some complex gray areas, such as whether business can legitimately shape the laws through lobbying or whether foreign business should obey the letter of the law when the local population does not. It makes little sense, however, to ask a firm to help achieve macroeconomic targets in national employment, to improve the balance of payments, or patriotically to carry out ill-defined national objectives not embodied in law. The breakdown of national magistracy calls for internationally agreed rules to be observed by traders and investors rather than for appeals to patriotism.

Hirschman's analysis in *Exit, Voice and Loyalty* (1970) is useful in this connection. Exit means ceasing to buy, moving away, resigning. Voice means speaking up, putting forward one's own ideas, attempting to effect change. Loyalty slows down resort to exit. In Hirschman's analysis, exit, modified more or less by loyalty, is the appropriate response to economic dissatisfaction, while voice is the appropriate response to sociopolitical dissatisfaction with the family, tribe, church, or state.

If you believe that government is dominated by business interests, you believe that business already exercises voice. If, on the contrary, you think of government as a muddle and of business as innocently engaged in making money, to use Samuel Johnson's phrase, the appropriate response for business in unsatisfactory circumstances is exit, to take advantage of the world's increasing mobility and move on. The government has no right to demand brand loyalty if it fails to provide safety, justice, and needed public works, or if it fails to exercise restraint and moves too far in the Anthony Downs (Napoleon, Bismarck, de Gaulle) direction.

But exit should not allow trade and investment to escape altogether from their obligations to civilization. Mobility may provide an appropriate escape from danger, injustice, and insufficient public goods in a given country, but the international system must ensure macro-stability, a Meade-Tinbergen redistribution to temper the harsh edges of competition, and equitable allocation of the system's costs. There may be too much government at the national level, as Graham thought, but there may also be too little government internationally. World government is not yet, and in any case would have to be limited to a few functions. But the need to build world federal functionalism, to use Cooper's (1974) phrase, has surely arrived.

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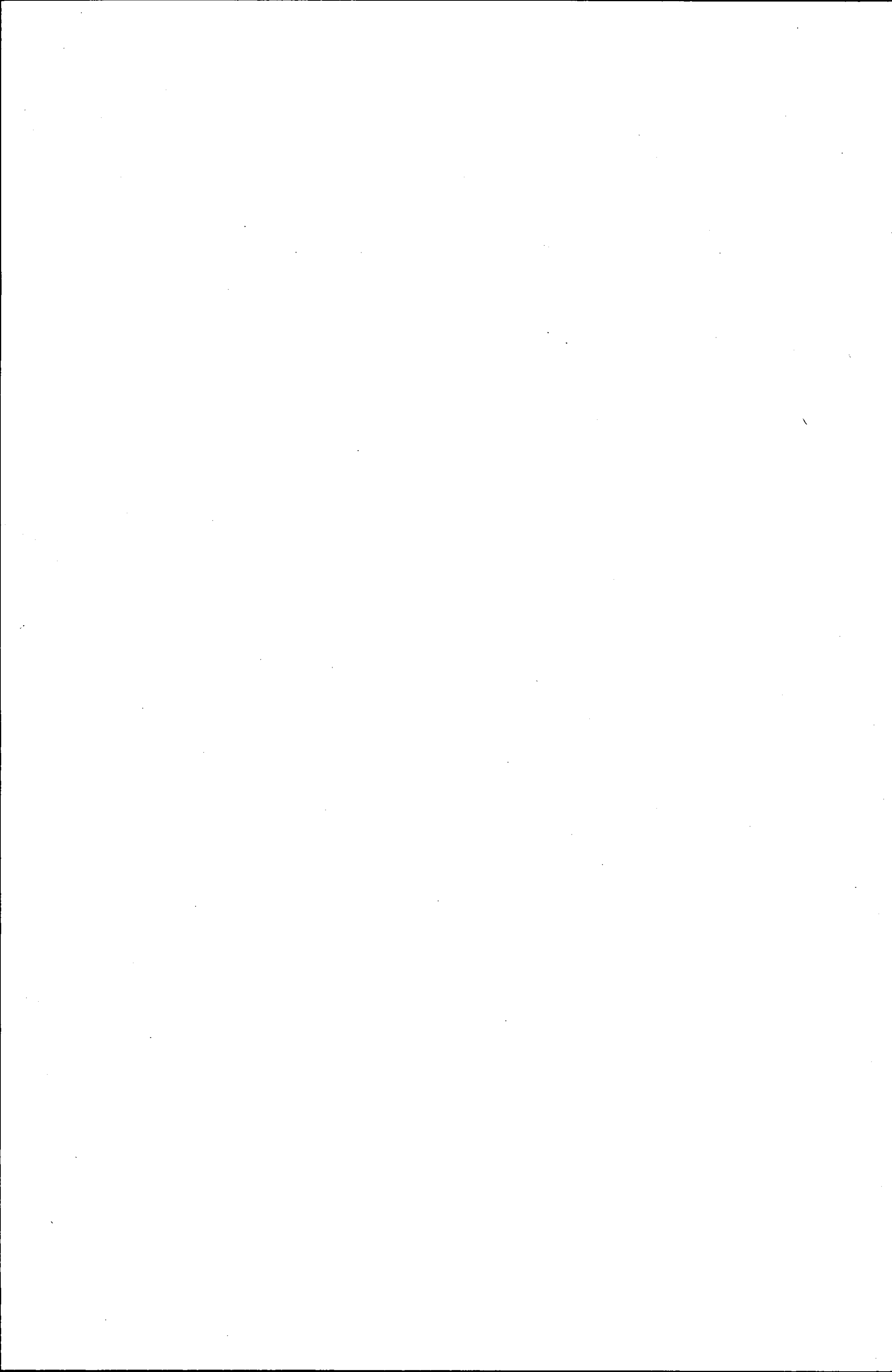

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