Promises, Performance, and Prospects

Antonio Martino

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Essays on Political Economy 1980–1998

Antonio Martino

Edited and with a Foreword by Dwight Lee

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TO CAROL

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Foreword

This book consists of editorials, articles, and talks written by Antonio Martino between 1980 and 1998. The subject matter can be generally described as political economy, and more narrowly (and precisely) described as Italian economic concerns from a classical liberal/public choice perspective. The Italian focus is a useful one. Many of the political and economic problems facing Italy, and discussed by Martino, were worse than those facing the other industrialized democracies, especially during the earlier part of the period covered. But these same problems were endemic in all the industrialized democracies, with other countries catching up and passing Italy in terms of these problems by the end of the twentieth century. Although Martino's discussion in most chapters is motivated by the situation in Italy, his analysis is germane to problems that, to one degree or another, face all advanced democratic countries.

Martino's discussion highlights classical liberal principles of political economy that transcend the particulars of time and place. From Adam Smith to James Buchanan, the insights of political economists have been motivated by, and illustrated with, contemporary concerns that keep recurring in only slightly different guises. In 1980, when Martino was writing the earliest of the chapters contained here, the statist/Keynesian experiment had been running to mostly rave reviews from the political elite for several decades, but unmistakable evidence was accumulating that its performance had fallen far short of the promises. Government spending and budget deficits were expanding rapidly around the world, both in real terms and as percentages of national incomes, despite escalating tax burdens; inflation was debasing the major world currencies; and employment levels were rising—a combination of events that was beginning to destroy the Keynesian consensus.

By the late 1990s, the intellectual foundation being used to justify government control over the economy had largely crumbled. Socialism had either collapsed without pretense, as in the former Soviet Union, or been redefined to mean a move toward increased reliance on free markets, as in China. The classical liberal understanding of the benefits of limited government and free markets, almost completely lost by the end of World War II, experienced a genuine intellectual resurgence over the period of the articles in this volume. The articles published (in many cases republished) here provide a window on that resurgence by a scholar whose life has both contributed to and been greatly influenced by classical liberal thought.

Antonio Martino's classical liberalism can hardly be described as mainstream in Italy, but Martino's grandfather and father were classical liberals and successful politicians. His grandfather, also Antonio Martino, was the mayor of Messina at various intervals from 1899 to 1919, retiring from politics in opposition to the Fascist takeover. His father, Gaetano Martino, was a physician and a scientist who became one of the most prominent figures in post–World War II Italian politics. As Italy's minister of foreign affairs from 1954 to 1957, he played a major role in organizing the meetings that culminated in the 1957 Treaty of Rome, an early step toward European integration. Like his grandfather and father, Antonio did not start out as a politician, although given his family background, political issues were surely important in his intellectual development. Born in Messina in 1942, Martino graduated from the University of Messina Law School in 1964 and in the same year became an instructor of economics in the law school at the University of Rome. He took leave from the law school from 1966 to 1968 to pursue graduate studies in the department of economics at the University of Chicago, where he was a student of Milton Friedman and George Stigler. Martino remained at the University of Rome, serving as professor of economics (holding the chair of monetary history and policy from 1979 to 1992) until 1994, when he took parliamentary leave. He retired from the University of Rome in 2002.

As an academic, Martino was well known in Italy, and elsewhere, for his classical liberal views and positions on public policy. He frequently contributed to Italian and international magazines, he published numerous academic articles and twelve books, he was a frequent guest on Italian and international radio and television programs, he was highly sought after as a speaker by organizations from Italy to New Zealand, and he served as an academic adviser to think tanks around the world. From 1988 to 1990, he was president of the Mont Pèlerin Society, an organization of classical liberals founded in 1947 by Friedrich A. Hayek, and he has received a host of academic honors. Because, or maybe in spite of, Martino's well-known classical liberal views and recommendations, he was elected to Parliament in 1994, where he remains a member—being reelected in 1996 and 2001. He has served at the highest level of the Italian government, as minister of foreign affairs in the first Berlusconi government from May 1994 to January 1995 (the same position his father held forty years earlier) and as the minister of defense since June 2001 in the second Berlusconi government.

The chapters in this volume have been organized into six parts, each concentrating on a particular issue, or a set of related issues, that together tell a story of the promises and failures of government attempts to improve economic performance by expanding its control over the economy.

The first part ("Tax Revenues Increase and Government Increases More") discusses the government budget situation in Italy during the mid-1980s and contrasts this situation with that of the previous two decades with some comparisons with the United States. In 1981, the cost of government, measured as a percentage of national income, was 40 percent higher in Italy than in the United States. Italy's fiscal background raises a number of questions, not all dealt with in great depth in this opening section. What, for example, explains the explosion in government growth, and why did it occur when it did? Is there any evidence that the additional spending could be justified by improvements in government services? What is the connection between inflation and government taxation and spending? Are there ways of ensuring that fiscal decisions better reflect the social costs and benefits of government expenditures? Are large deficits a measure of fiscal irresponsibility or a means of controlling irresponsible government spending? Martino begins to address some of these questions in the last chapter in this part, "Budget Deficits and Constitutional Constraints." But most of these questions, and others, are considered in the following parts.

The title of the second part ("Hopes Betrayed") provides more than a hint of Martino's response to one question in the previous paragraph: Are the increased government spending and taxes justified by better government services? In addressing this question, Martino first considers the outcomes of more government spending and asks if they are worth what they cost. He points out, for example, that despite large increases in spending on education, schools and universities are overcrowded and perform poorly; and despite large increases in spending on poverty programs sufficient to eliminate poverty (if the money had gone to the poor), the poor remain. Martino observes that even prominent members of the Italian Socialist party (which had advocated nationalizing all economic activity, with the possible exception of barbershops) were beginning to express doubts about the outcomes of statist policies by the late 1980s.

Martino also draws on the public choice literature that provides a process explanation for excessive government. He points out that the political process enables organized interest groups to capture concentrated benefits and spread the costs over the general public. The result is that most of the benefits are considered, most of the costs are ignored, and government spending is increased beyond efficient limits.

Martino has a short personal story ("Inside the Labyrinth") in part 2 that illustrates what is commonly recognized as a problem with government—the problem of red tape. There has to be some form of accountability in the use of scarce resources. When they are allocated through markets, prices, profits, and losses impose accountability so effectively that little, if any, red tape is required. When we resort to government allocation, however, markets aren't typically available (or allowed) to impose accountability, and it has to be imposed in another way. Bureaucratic red tape—clumsy, inflexible, and excessive—is a very poor substitute for market accountability, but it results inevitably from the lack of market accountability. And the same process that Martino argues is generating too much government also generates the red tape.

Part 2 is the longest in the book, containing an analysis of several areas in which government has increased its involvement. Throughout part 2, Martino argues that the left's hopes invested in a larger and more active government were destined to be dashed. The higher the tax rate on income and profits, and the more extensive and detailed the regulations on business, the more motivation people have to move into the underground economy, which is the topic of the two chapters in part 3. As Adam Smith pointed out in *The Theory of Moral Sentiments,* advocates of government controls (men of systems) like to see people as pieces on a chessboard with no principle of motion other than what government authorities mandate. People have their own principles of motion, however, and will leave the chessboard (go underground) when government mandates are not to their liking.

As Martino points out, we cannot know exactly how large the underground economy is, but we can estimate its size. One interesting method of estimation that Martino discusses is to examine the ratio of currency to national income. Two things happen as more people shift into the underground economy: (1) the need for currency increases as more exchanges take place without leaving a paper trail (although this is not as important in Italy as in other countries because checking accounts in Italy are secret—or were in the early 1980s); (2) the official measures understate national income and overstate unemployment. Martino points out, among other things, that Keynesian-motivated attempts to fine-tune the economy with monetary and fiscal policy, difficult under the best conditions, are particularly difficult when the authorities cannot accurately measure what they are trying to fine-tune—the national income. Martino recognizes that the underground economy mitigates some of the harmful consequences of government laws, but he favors changing the laws, not breaking them.

In part 4 ("Fantasies Collide with Reality"), Martino considers how advocates of state control over the economy have reluctantly modified their views as evidence contrary to their hopes became too obvious to ignore. In the chapter "Was Keynes a Keynesian?" Martino points out that Keynes was not a socialist and disagreed with many views and recommendations of his "Keynesian" followers. Martino contends that Keynes was himself badly confused about important issues, particularly the effects of money on the real economy and the connection between money and inflation, and his confusion is largely responsible for

Keynesians' embracing many policies with which Keynes would have disagreed.

Following the chapter on Keynes, Martino considers how "The Modern Mask of Socialism" has been changed by its encounter with reality. From advocating the abolition of private ownership and total state control of the economy, respectable statists began shifting in the 1950s and 1960s to the softer socialism of Keynesianism, which saw government exerting somewhat less direct control over the economy through the "stabilizing" influence of monetary and fiscal policy. By the late 1970s, the combination of persistent, and escalating, inflation and high unemployment (a combination that the Keynesian model simply couldn't explain) was discrediting the claims of the Keynesian fine-tuners. In the 1980s, the economic successes of deregulation, privatization, and tax cutting in restoring balanced economic growth in advanced countries, and the dramatic contrast between those developing countries that relied largely on markets and those that suppressed markets through detailed state control, further reduced the confidence of socialists. And the collapse of the Soviet Union and its control over its Eastern European satellites made it almost impossible to remain both credible and socialist. Martino argues, however, that the rhetoric regarding socialism has changed much more than has economic policy. Government controls over economic decisions in many areas have actually increased despite the results of those controls. As James Buchanan has said, "Socialism is dead, but leviathan lives on."

The importance of money and monetary policy, with an emphasis on the European situation, is the topic of part 5. In the opening chapter in this part, "Toward Monetary Stability?" Martino points out that, although the connection between monetary growth and changes in the general price level is one of the best-established relationships in economics, supposedly good economists write entire books on inflation and never mention the quantity of money. And although central bankers commonly comment on the importance of monetary growth, more often than not their decisions ignore that importance. Martino sees the difficulty of maintaining stable, predictable, and noninflationary monetary growth as a symptom of a more fundamental problem, excessive monetary growth and budget deficits, which put pressure on the monetary authorities to monetize the debt. This argument had more credibility in the early 1980s, when Martino wrote this chapter, than it may appear to now. Since the early 1980s, government budget deficits have generally remained high, and have escalated in some countries, but inflation rates have declined. Large deficits don't have to be monetized, and central bankers can resist the political temptation to monetize them, especially when the public is aware of the connection between monetary growth and inflation through the persistent efforts of respected economists. But the inflationary temptations created by large budget deficits should not be ignored. As Martino points out, the story of government management of the money supply is "a very long story," and not one that inspires much optimism about monetary stability.

The next two chapters consider the prospects for a common European currency, the euro, before it was introduced. Martino presents arguments both for and against the euro, concluding that the most important consideration in whether a common currency will be an improvement over national currencies is the monetary constitution, in which the key consideration is rules versus discretion. He sees discretionary monetary policy as the source of monetary instability at the national level, and sees this as a bigger concern when monetary policy is determined at the European level. Martino also considers the pros and cons of an interesting way of introducing the euro.

In the final chapter in this part on monetary policy, Martino argues that the resource misallocations that result from monetary instability particularly harm countries making the transition from socialism. These countries urgently need monetary constitutions that greatly reduce the discretion of political authorities over monetary growth. Martino believes that agreeing on the need for such a constitution is more important than its exact formulation. He considers possible monetary constitutions based on the gold standard, Friedman's constant monetary-growth rule, and competing currencies, pointing out that none is perfect and that reliance on markets and limits on government are preconditions for any successful monetary constitution.

In a short final part, Martino speculates on the "Future of Freedom." The first of the three chapters in this part is a comment on Orwell's *Nineteen Eighty-four* (actually a comment on a book review of the book) written in, not surprisingly, 1984, before the collapse of the Berlin Wall and the liberation of Eastern Europe. Martino defends *Nineteen Eighty-four* against the charge that its prophecy was wrong. He counterargues that *Nineteen Eighty-four* was important because it predicted something that was not inevitable. As Martino says, "When the outcome is inevitable, prophecy is essentially useless." One is reminded of Schumpeter's observation in his preface to *Capitalism, Socialism and Democracy:* "The report that a given ship is sinking is not defeatist. Only the spirit in which this report is received can be defeatist: The crew can sit down and drink. But it can also rush to the pumps." Classical liberals rushed to the pumps, and their success in preventing a deluge of statism from completely swamping the private sector in more and more countries made it reasonable for Martino to ask in the next chapter, "Are We Winning?" Martino is moderately optimistic because (1) ideas and political rhetoric have dramatically shifted in favor of free markets and limited government, and (2) policy victories have been achieved in the form of deregulation, privatization, and marginal tax reductions. But he worries that these victories can be easily reversed, since the fundamental constitutional reforms needed to resist the unrelenting pressures for more government have not been achieved.

Martino continues his combination of moderate optimism and worried vigilance in the last chapter, "Liberalism in the Coming Decade," written after the fall of the Berlin Wall but before the collapse of the Soviet Union. He worries that the loss of faith in socialism has not been accompanied by an increased understanding and appreciation of markets or reduced pressure for more government. But ending on a more optimistic note, Martino emphasizes the importance of ideas. Keynes was right on the importance of ideas, but because of the power of correct ideas he was only partly right when he said that in the long run we are all dead. Martino tells us that Keynes and Marx are indeed dead, both physically and through their intellectual influence, but classical liberal thinkers such as John Locke, Adam Smith, and David Hume live on through the power of their ideas.

The struggle between the forces for freedom and those for more state control continues in many arenas and on many margins. There will never be a final victory for freedom, but neither will there be a final defeat. Just as flowers will always find openings to grow even if we attempt to pave over the entire earth, human freedom will always find openings through which to flourish despite attempts to suppress it. Martino's work can be considered nourishment for those flowers of freedom that can never be completely paved over by the forces of statism.

Dwight Lee

Part 1

Tax Revenues Increase and Government Increases More

Italy's Lesson: Higher Taxes, Bigger Deficit

Those who, like Walter Mondale, worry about the magnitude of the U.S. federal deficit and advocate tax increases as an indispensable step toward the deficit's reduction might benefit from the experience of other countries that have experienced similar problems. One such country is Italy.

According to International Monetary Fund figures, in 1980 the government deficit in Italy amounted to 37,138 billion lire, or 11 percent of the gross domestic product. To get a proper idea of the magnitude of such a deficit, one must put it in perspective of the U.S. government's 1983 deficit of $195 billion, which amounted to a "mere" 6.1 percent of America's gross national product. A U.S. deficit equal to 11 percent of its GNP would have amounted to over $350 billion.

In other words, the Italian deficit of 1980 was a staggering figure, requiring (if one is to follow Mr. Mondale's logic) the most drastic fiscal measures. If tax increases are needed to reduce a deficit equal to 6.1 percent of GNP, obviously they must be essential when the deficit is nearly twice that percentage.

Higher and Higher Taxes

And an increase in taxes is what Italy got: From 1980 to 1983 the total tax revenue increased 90 percent in nominal terms, jumping from 39.8 percent of GDP to 47.8 percent. This is indeed an extremely large increase, made all the more painful by the fact that there was

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