

# Free Trade and Laissez Faire: Has the Wheel Come Full Circle?

Deepak Lal

## 1. INTRODUCTION

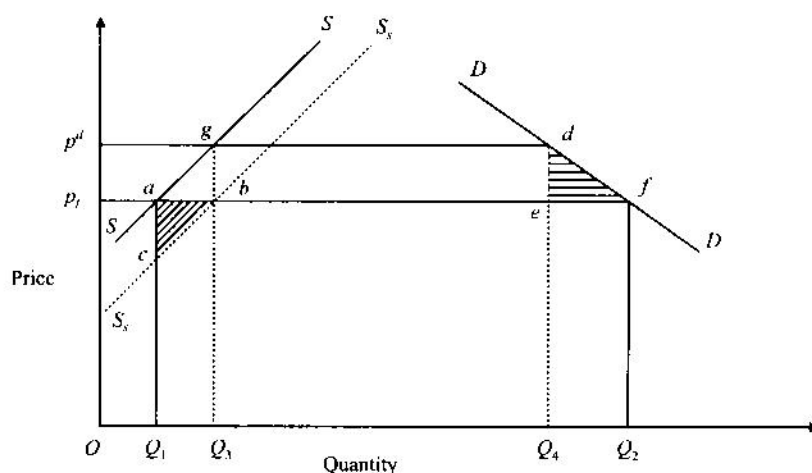
**I**FIRST met Max when he joined Nuffield College as Reader in International Economics at Oxford in the late 1960s and I was a junior research fellow at the college. He was at the time working on his masterly *Trade Policy and Economic Welfare* (TPEW), while I was associated with the 'shadow pricing' school around Ian Little and Maurice Scott. The two were complementary, and I have subsequently used TPEW for the international trade policy part of my courses in economic development for over 30 years at University College London, and now at UCLA. The famous partial equilibrium diagram from TPEW, which is reproduced with some variations as Figure 1 below, is an ideal piece of mental furniture which I hope my students have carried around with them, along with the equally useful diagram of the Salter-Swan model of the balance of payments adjustment of a small open economy (the so-called Australian model) from his equally useful *Inflation, Exchange Rates and the World Economy*. For the average mathematically challenged undergraduate, the clarity of rigorous but non-mathematical exposition of these two books, using only geometry, has been a godsend in understanding and analysing important contemporaneous policy issues. In this paper I will examine a hoary debate given by my title in this same fine English tradition of Marshall, Keynes, Hicks, Meade and Corden.

Max begins TPEW with a historical overview of the long-standing debate about protection and free trade. He distinguishes three stages of thought. The *first*, which I would label the 'classical liberal' phase covered the 19th century when:

the case for free trade was developed simultaneously with the case for laissez-faire. Indeed, the case for free trade was really a special case of the argument for laissez-faire (Corden, 1997, p. 2).

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DEEPAK LAL is James S. Coleman Professor of International Development Studies, University of California, Los Angeles.

FIGURE 1  
Effects of a tariff

The *second* which I would label 'collectivist' – for reasons to be set out in Section 3 – covered most of the early part of the 20th century till the end of the Second World War, during which numerous exceptions to 'laissez faire' were adumbrated and:

the arguments for protection emerged *pari passu* with the qualifications to the case for laissez-faire, and since there are numerous qualifications to the latter, there are also numerous arguments for protection (*ibid.*, p. 3).

In the *third* phase beginning in the late 1950s with the work of Meade (1955), Bhagwati and Ramaswami (1963) and Johnson (1965), which I would call 'social democratic' – and what Eichengreen calls 'embedded liberalism' – 'the link between the case for free trade and the case for laissez faire was broken'. The theory of domestic distortions which evolved as the contemporary theory of trade and welfare so clearly and ably expounded in TPEW, showed that apart from the optimum tariff argument, where a country with monopoly or monopsony power in foreign trade could successfully turn the terms of trade in its favour – and hence the optimum tariff was a first-best argument dealing with a divergence in foreign trade – all other arguments were second best, in the sense that there were superior tax-subsidy instruments compared with the tariff to deal with the domestic distortion in the working of the price mechanism which provided the *prima facie* case for protection. Thus while departures from laissez faire were required to implement the appropriate tax-subsidy measures to deal with the domestic distortion, departures from free trade were undesirable. In this part I want to argue, using the famous diagram from TPEW that there should logically now be a *fourth* stage where along with the case for free trade that for laissez faire is also restored.

To see this, consider Figure 1, based on TPEW, which depicts the price and quantity configuration for an importable, where  $DD$  is the demand and  $SS$  the market supply curve. Assume a factor market distortion due to either the wage differential argument of Manilosceu, or a market rate of interest above the social opportunity cost of capital, which is the basis of the infant industry argument due to Hamilton and List. The social supply curve – if there were no factor market distortion –  $S_s S_s$  will then lie below the market supply curve  $SS$ . With free trade and laissez-faire, the good can be imported at the world price,  $p_f$ , leading to  $OQ_2$  of the good being consumed of which  $OQ_1$  will be produced domestically, and  $Q_1 Q_2$  will be imported. But, because of the domestic distortion, domestic import substitute output will be less than the socially optimal level  $OQ_3$ , on the social supply curve  $S_s S_s$ . The first-best policy would be a lump subsidy financed by lump-sum taxation (assuming no collection and disbursement costs) to remove the factor market distortion which would lead to the market supply curve  $SS$  coinciding with the social supply curve  $S_s S_s$ , and producers would produce the optimum quantity  $OQ_3$ , leading to the net social production gain of the triangle  $abc$ . By contrast, if a tariff which raised the domestic price of the good to  $p^d$ , to evince the optimal output of  $OQ_3$  on the market supply curve  $SS$ , there would in addition to the production gain be a by-product distortion cost of the net consumer surplus lost of  $def$ , as consumption of the good shrinks to  $OQ_4$  because of the price rise. Depending upon the relevant elasticities there may be no net welfare gain at all from the tariff. In addition there would be the continuing distortion of the choice of techniques (unlike the case of the first-best factor price subsidy) in the production of the good, as the factor price ratio would still diverge from the socially optimal one. Furthermore, there would be a 'home market' bias. Hence, Corden's famous hierarchy of policies to deal with domestic distortions for this case, with a subsidy to the factor to remove the distortion at source dominating a production subsidy, which dominates a tariff-cum-export subsidy, followed by the tariff.

But, as lump-sum taxation and subsidies are infeasible, any realistic application of the above theory will have to be based upon using distortionary taxes with their own deadweight triangle losses like  $def$ , which will need to be taken into account in assessing the net welfare effects of the tax sum subsidy alternative to the tariff in dealing with domestic distortions. As a tariff is nothing else than, a production subsidy to producers financed by a consumption tax on consumers of the protected good, much of trade theory, as Ian Little (1970–71) put it, turns out:

to be simply public finance, and [if the unrealistic assumptions of no collection and disbursements costs is removed] indeed to boil down to such mundane matters as administrative costs (p. 132).

If one believes that the government is following the canons of optimal taxation by applying Ramsey taxes based on the inverse elasticity rule of taxing the goods in inelastic demand most highly, then a subsidy financed by suitable rearrangement

of these optimal taxes is likely to incur lower welfare costs than those associated with the tariff's implicit tax on the good being protected. I do not want to go into the complexities of these public finance arguments. Suffice it to say that even with distortionary taxation and administrative costs it is likely that the Corden hierarchical ordering of policies would still hold.

But, as the subsequent incorporation of the costs of 'rent seeking' and 'directly unproductive activities' (DUP) (Krueger, 1974; Tullock, 1967; and Bhagwati and Srinivasan, 1980) into the theory of trade and welfare shows, that is not the end of the story. For in the presence of rent seeking for the quota rents and/or tariff and revenue seeking, the area  $gdeb$  in Figure 1 would be entirely or partially dissipated in rent-seeking or DUP activities. That would outweigh any potential production gain  $abc$ . So, irrespective of the public finance argument there would now be a knock-down argument against protection in favour of the tax-subsidy solution. That is where the argument circa the 1980s seemed to stand.

But once one accepts this rent-seeking-DUP argument, there is still one further consideration to be taken into account. So far we have assumed that, the domestic distortion – which led to a consideration of the relative net welfare effects of tax-subsidy versus protection to deal with it – was genuine. Suppose it was not. But producers know that governments are in the subsidy game. Then they are as likely to lobby for a subsidy claiming a domestic distortion where none in fact exists. If successful they seek to gain the producer rents of  $p^d g_d p_f$  – as the market and social supply curve are in fact the same. In the limit this area will represent the rent-seeking costs associated with this *subsidy-seeking*. This is clearly a net welfare loss, as there is ex hypothesi no social production gain. As in practice it is virtually impossible to determine whether or not there is a domestic distortion (see Section 2 below) or more importantly the size of the distortion and hence the requisite subsidy, this form of cheating will be difficult to avoid. Alternatively, even if there is a domestic distortion so that  $S_s S_x$  lies below  $SS$ , producers are likely to dissipate the area  $p^d g_d p_f$  in lobbying to get the subsidy – on similar lines to the tariff-seeking argument, which could again outweigh the social production gain  $abc$ .<sup>1</sup> This implies that the tax-subsidy solution for dealing with domestic distortions too, need not lead to a welfare improvement, and hence the best policy may be to leave well alone – that is, *laissez-faire*! Even within the framework of the theory of domestic distortions, therefore, because of these political economy considerations the wheel does seem to have come full circle – free trade and *laissez-faire* as the classical liberals saw so clearly do hang together. Surprisingly, in the second edition of TPEW, Max does *not* seem to

<sup>1</sup> For a recent consolidated survey of where the theory of domestic distortions stands taking account of DUP activities including subsidy seeking see Srinivasan (1996). He also incorporates the numerous paradoxes, which are inevitable in comparing various second-best situations, when in theory, almost anything can happen.

draw this conclusion. It is interesting to see why not, as this also seems (as far as I can gather) to be the mainstream theoretical stance on trade and welfare.

## 2. THEORY OF ECONOMIC POLICY

In the conclusion of the second edition of TPEW Corden states:

this book has been concerned with what policies *should* be – that is with *normative* analysis – rather than with why various policies are actually followed. The latter is the sphere of the political economy of trade policy (Corden, 1997, p. 281).

There are two problems with this.

The first is that normative analysis presupposes some norms. Corden's clearly are those of second-best welfare theory, whose policy aspects are currently denoted as public economics, and as we have seen, as trade policy can be taken to be part of public finance, it becomes a branch of public economics. I have grave doubts now about the utility of this approach to the design of public policy, on which more below.

The second is that, a book about 'the theory of economic policy' (ibid., p. 283) cannot ignore the character of the agents implementing this policy. But this is part of political economy. Corden, realising this, states that:

to find this book useful one does not have to believe or assume that a country is ruled by a benevolent dictator who always seeks to pursue the national interest . . . but only that perceptions of the national interest play some role in the decision making process, along with the influence of sectional interest groups. . . . In recommending optimal trade policies one must bear in mind the potential pressures and self-interested motivations. The aim must be, among other things, *to minimize the potential for rent-seeking and, in general, the scope for manipulating the details of policies* (ibid., p. 282; italics added).

I agree with much of this. Platonic guardians are to be found in many high places, and occasionally during crises may be given their heads by predatory states – a small window of opportunity to serve the national weal.

What should they then do? Set up a cost-benefit analysis unit to devise optimal interventions to deal with market failures, or set up a system in which rent seeking and DUP activities are minimised? From the italicised statement Corden obviously would support the latter. But what would be such a system? It will obviously depend upon what is likely to replace the small window of opportunity, which is politics as usual. If that is predatory, as I will argue below it is usually, then they will have to think of ways – constitutionally enforceable if possible – to minimise predation. Which, as we have seen for optimal intervention to cure domestic distortions in the presence of rent-seeking and DUP activities means laissez-faire and free trade.

Whether this is feasible is a question I will not address. But, at this stage in the argument, it should be clear that Corden's attempt to separate the normative from the political economy analysis of trade policy does not work. The normative

analysis is useful largely to counter the fallacious arguments for protection of those who seek to conceal their predatory purposes under the smokescreen of an appeal to the 'national interest'. It is also of immense use in training the intellectual muscles of the young. But if it is to be a guide to public policy, then taking the inevitable rent-seeking and DUP activities into the framework, it should also conclude with the fourth stage identified in Section 1, *viz.* that even in the presence of domestic distortions, taking account of the ubiquitous rent-seeking and DUP activities, it is second best to maintain laissez-faire and free trade.

### 3. PUBLIC ECONOMICS

I also have come to have grave doubts about the utility for public policy of public economics of which we have seen the theory of optimal interventions in the presence of domestic distortions is a branch (see Lal, 1998). The basis for this theory are the well known two Arrow-Debreu fundamental theorems of welfare economics, which theorists assert provides the justification for the superiority of a market economy, and thereby laissez-faire (see e.g. Dasgupta, 1980; Hahn, 1984; and Sen, 1983). If one or the other conditions for the existence of the Utopian state of perfect competition are not met, there is 'market failure' and thence a *prima facie* case for government intervention. This justification for 'dirigisme' has always seemed bizarre to me (see Lal, 1983 and 1987). To compare 'competition' in any actual market economy with an unattainable ideal is to use Demsetz's (1969) useful phrase, a form of 'nirvana economics'. For it is child's play to show that because of incomplete markets, external effects, and the existence of public goods, 'market failure' defined as deviations from a perfectly competitive norm is ubiquitous, but the corollary that this then justifies massive corrective public action is highly dubious.

Thus Stiglitz's (1994) claim that, neoclassical public economics – of which trade policy would be a branch – allows optimal tax-subsidy interventions to be derived to make Pareto improvements is belied by the qualifications that Greenwald and Stiglitz (1986) have to make. Thus on political economy they note in a footnote:

It might be noted that we ignore any discussion of the political processes by which the tax-subsidy schemes described below might be effected. Critics may claim that as a result we have not really shown that a Pareto improvement is actually possible (n. 7, p. 234).

Quite.

While on their claim:

that there exist Pareto-improving government interventions ... [and] that the kind of intervention required can be simply related to certain parameters that, in principle are observable (p. 231), they are forced to concede in their concluding comments:

we have considered relatively simple models, in which there is usually a single distortion . . . Though the basic qualitative proposition, that markets are constrained Pareto efficient, would obviously remain in a more general formulation, the simplicity of the policy prescriptions would disappear. Does this make our analysis of little policy relevance? The same objection, can of course, be raised against standard optimal tax theory. (Some critics might say, so much the worse for both) (p. 258).

Quite!

The trouble with this whole mode of policy analysis lies in not only its neglect of political economy but also its deviation from the classical liberal concept of competition. As Blaug (1987) notes there is a:

subtle but nevertheless unmistakable difference in the conception of 'competition' before and after the 'marginal revolution'. The modern concept of perfect competition, conceived as a market structure in which all producers are price takers and face perfectly elastic curves for their outputs, was born with Cournot in 1838 and is foreign to the classical conception of competition as a process of rivalry in the search for unrealized profit opportunities, whose outcome is uniformity in both the rate of return on capital invested and the prices of identical goods and services but not because producers are incapable of making prices. In other words, despite a steady tendency throughout the history of economic thought to place the accent on the end-state of competitive equilibrium rather than the process of disequilibrium adjustments leading up to it, this emphasis became remorseless after 1870 or thereabouts, whereas the much looser conception of 'free competition' with free but not instantaneous entry to industries is in evidence in the work of Smith, Ricardo, Mill, Marx and of course Marshall and modern Austrians. For that reason, if for no other, it can be misleading to label classical economics as a species of general equilibrium theory except in the innocuous sense of an awareness that 'everything depends on everything else' (p. 445).

The classical liberals also recognised from Adam Smith onwards that deviations from free competition like monopoly ultimately depended upon government action, which prevented potential rivals from competing. By contrast, the theoretical model as Demsetz (1988) notes:

*assumes* that monopoly power exists, it does not explain *how* monopoly power is exercised and maintained . . . [N]o good explanation is provided for how present and potential rivals are kept from competing without some governmentally provided restrictions on competitive activities (p. 94).

For we now know from the theory of contestable markets (Baumol, Panzar and Willig, 1982) that, even with economies of scale and scope which limit the number of firms that can service a particular market, as long as potential rivals can contest the 'monopoly', the single eventual incumbent's pricing and output policies need not diverge from those under competition. The only rents such a 'monopolist' can acquire are the sunk costs of firm-specific assets essential for production.

#### 4. PREDATORY STATE

Thus, the nature of the government is crucial in recommending policy. The great classical liberals from Hume to Smith to Mill were aware of this. If, as I

have argued elsewhere (Lal, 1988, ch. 13.2; and Lal and Myint, 1996), most states are predatory – even democratic ones, where the predators are the median voter and successful pressure groups – concerned more with net revenue maximisation than with social welfare maximisation, then *normative* analysis based on assuming the government consists of Platonic Guardians can go horribly wrong.

To take one example, public economics argues that, to minimise the dead-weight social welfare losses associated with distortionary taxation, governments should levy the Ramsey optimal taxes to raise given revenue. But, suppose the government is predatory, interested in maximising its net revenue. What pattern of commodity taxation will it choose? Ramsey taxes! (see Lal, 1990; and Brennan and Buchanan, 1980). Thus, the tax recommendations of public economics are exactly those that would best serve the interests of a revenue maximising predatory government. If the normative analysis is in the interests of the prey, then what should be recommended is a system of taxation that prevents predatoriness while providing enough revenue for public good provision. This, as Brennan and Buchanan argue, would assign only goods with elastic demand to the government for taxation, not those in inelastic demand *à la* Ramsey.

For the essential problem of political economy is to devise ways in which the State will provide the essential public goods at least cost in terms of taxation. This was clearly recognised by the Classics, whose recommendation of *laissez-faire* was based on a realistic assessment of the nature of governments. The classical policy prescriptions have been caricatured 'by Carlisle's phrase anarchy plus the constable, or by Lasalles's simile of the night watchman' (Robbins, 1952, p. 37). But as Robbins (1952) and Myint (1948) have noted, this is a calumny. The classical liberals were not hostile to the State, nor did they believe that governments had only a minor role in economic life. Their view of the State was positive, and as Robbins indicates Adam Smith's famous statement of the three functions of the State (*viz.* (i) to protect society from foreign invaders, and (ii) every member, as far as feasible from oppression and injustice, by other members of society and (iii) provide and maintain various public works and public institutions which provided public goods (vol. ii, pp. 184–5)), is almost identical with Keynes' famous formulation in *The End of Laissez-Faire* ('the important thing for government is not to do things which individuals are doing already, but to do those things which at present are not done at all', pp. 46–47). The ensuing principles of economic liberalism were clearly set out in Mill's *Principles*, and their clearest modern reformulation is in Hayek's *The Constitution of Liberty*. In fact, the current 'Washington Consensus' is essentially a classical liberal policy package. So, I hope there will be growing acceptance of this classical liberal viewpoint.

By contrast, though the modern theory of trade policy does offer a limp hand to classical liberalism, its parent, the modern welfare economics school of public policy, as Myint (1987) noted:

with its emphasis on market failures, externalities, and the divergences between social and private costs, has for many decades been a powerful intellectual force behind interventionist policies (p. 108).

It needs to be eschewed. But, for various complicated sociological reasons like the self-interest of experts and the rise of professionals, it is unlikely to, as it provides them with rents.

But, there is more to this. It is ultimately a question of political philosophy, in particular of the view of the purposes of the State. Michael Oakeshott (1993) has distinguished between two alternative views of the functions of a State in European political thought. The first which derives from ancient Greece, views the State as a civil association, in which the government is seen as custodian of laws which do not seek to impose any preferred pattern of ends (including abstractions like the general [social] welfare, or fundamental rights) but which merely facilitate the pursuance of individual ends. It is more in the nature of an umpire, upholding what Adam Smith labelled the system of 'natural liberty'. This view of the State and its relationship with society and the economy has been challenged by a rival conception of the State as an enterprise association, which Oakeshott maintains has its roots in the Judaeo-Christian tradition. The State is now seen as the manager of an enterprise, which seeks to use the law for its own substantive purposes, and in particular the legislation of morality. The major substantive purposes sought by states have been (a) religious – as in Calvinist Geneva, or in our own day in Khomeini's Iran; (b) nation-building – as in the absolute monarchies of post-Renaissance Europe, and in the newly independent states of the Third World; (c) the promotion of some form of egalitarianism – in an extreme form in the collectivist societies of the now defunct Second World, and in the milder form of social democracy.

From this classification, we can see that the three-stage evolution of thought on trade policy enumerated by Corden in TPEW correspond to two secular views of the State identified above: *viz.* the classical liberal view which sees the State as a civil association, and the egalitarian enterprise view of the State, with its sub-division into the collectivist and social democratic. Modern welfare economics subverts collectivism but supports social democracy. But, by embracing egalitarianism<sup>2</sup> it retains an enterprise view of the State – it is only 'liberal' in the American not classical sense. For, from Smith to Hayek to Friedman, classical liberals have maintained, equality comes into conflict with liberty, and a true 'liberal is not an egalitarian' (Hayek, 1960, p. 402). For as Nozick (1974) demonstrated brilliantly with his Wilt Chamberlain example:

no end-state principle or distributional patterned principle can be continuously realized without continuous interference with people's lives [as any patterned distribution can be upset by

<sup>2</sup> As the major exponent of this view and Corden's mentor James Meade admitted: 'I am an incurable egalitarian' (Meade, 1975, p. 68).

people's voluntary actions in exchange]. The socialist society would have to forbid capitalist acts between consenting adults (p. 163).

Classical liberals have, however, always advocated public transfers if private transfers are unavailable to help the 'deserving poor' (see the discussion in Lal and Myint, 1996), and also, since Mill, the public *financing* but not *provision* of merit goods, such as health and education for those unable to afford them. Just as in the case of the economic package, the social package promoted by social democrats is increasingly coming to resemble these classical liberal prescriptions, except for merit goods. Thus, eschewing egalitarianism in taxation – in practice if not in rhetoric – and by attempting to reform welfare states to confine the benefits to the 'deserving poor', both the New Democrats under Clinton in the US and New Labour under Blair in the UK, are closer to the classical liberal viewpoint than they imagine. But, still imbued with the 'enterprise view' of the State, they are not converts but merely opportunists who recognise that the social democratic panaceas do not deliver the productivist goals of another enterprise – creating abundance and wealth. Their interventions on that score are increasingly chasing another chimera. This reluctant and limp embrace of classical liberalism has, nevertheless, undermined the policy relevance of modern welfare economics and its progeny, public economics, of which the theory of trade and welfare is a part.

## 5. CONCLUSIONS

There are a number of conclusions I would like to emphasise arising from this discussion. First, normative analysis of the type expounded so clearly and cogently in TPEW, cannot be separated from political economy and in particular with a view of the purposes of the State. To claim it can, and that its prescriptions (what governments *should* do) have universal validity, is to indulge in 'mathematical politics' in favour of one view of the role of the State – the social democratic. Second, even within this framework both theory (taking account of the simplest facts of political economy, *viz.* rent seeking and DUP) and experience (see Lal and Myint, 1996), suggest overwhelmingly the validity of the classical liberal case for laissez-faire and free trade – where laissez-faire is not to be interpreted in its narrow caricature, but on the lines of the actual prescriptions of classical liberal economists. Third, as in practice, social democrats have accepted virtually the whole of the classical liberal policy prescriptions (except on merit goods), it is time for them to eschew the enterprise view of the State they still cling to, and accept the civil association view of the State of classical liberalism. For this alone can provide a bulwark against some old or new-fangled notion of perfection, which an enterprise state is urged to implement, with all the attendant dangers of the dysfunctional 'dirigisme' that would promote. Within every social

democrat – including Max – there is a classical liberal trying to escape. I hope, from this essay in his honour, Max is persuaded that it is time to come out of the closet!

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