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RESEARCH IN THE HISTORY OF ECONOMIC THOUGHT
AND METHODOLOGY VOLUME 40B

RESEARCH IN THE HISTORY OF ECONOMIC THOUGHT AND METHODOLOGY: INCLUDING A SYMPOSIUM ON THE WORK OF WILLIAM J. BAUMOL: HETERODOX INSPIRATIONS AND NEOCLASSICAL MODELS

EDITED BY

LUCA FIORITO
University of Palermo, Italy

SCOTT SCHEALL
Arizona State University, USA

AND

CARLOS EDUARDO SUPRINYAK
American University of Paris, France

United Kingdom – North America – Japan
India – Malaysia – China

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ABOUT THE EDITORS

Luca Fiorito received his PhD in Economics from the New School for Social Research in New York and is currently Professor at the University of Palermo. His main area of interest is the history of American economic thought in the Progressive Era and the interwar years. He has published many works on the contributions of the institutionalists and on the relationship between economics and eugenics.

Scott Scheall is Assistant Professor in the Faculty of Social Science in Arizona State University's College of Integrative Sciences and Arts. He has published extensively on topics related to the history and philosophy of the Austrian School of economics. Scott is the author of *F. A. Hayek and the Epistemology of Politics: The Curious Task of Economics* (Routledge, 2020).

Carlos Eduardo Suprinyak is Associate Professor of Economics at the American University of Paris. He specializes in the history of political economy, exploring the intersections between economics and politics in different historical contexts, from early modern England to Cold War Latin America. Besides numerous papers in peer-reviewed journals, he is also co-editor of *The Political Economy of Latin American Independence* (Routledge, 2017) and *Political Economy and International Order in Interwar Europe* (Palgrave, 2020).

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LIST OF CONTRIBUTORS

Victor A. Beker University of Belgrano and University of Buenos Aires, Buenos Aires, Argentina

Fabrizio Bientinesi University of Pisa, Pisa, Italy

Juan Pablo Castilla Universidad de los Andes, Bogota, Colombia

Alexandre Chirat Université Paris Nanterre, Nanterre, France

Caroline Colton University of Technology Sydney, Sydney, Australia

Erwin Dekker Mercatus Center, George Mason University, Fairfax, VA, USA

Luca Fiorito University of Palermo, Palermo, Italy

Jochen Hartwig Chemnitz University of Technology, Chemnitz, Germany

Magnus Henrekson Research Institute of Industrial Economics, Stockholm, Sweden

Hagen M. Krämer Karlsruhe University of Applied Sciences, Karlsruhe, Germany

Anna Noci Sant'Anna School of Advanced Studies, Pisa, Italy

Scott Scheall Arizona State University Polytechnic Campus, Mesa, AZ, USA

Mikael Stenkula Research Institute of Industrial Economics, Stockholm, Sweden

Carlos Eduardo Suprinyak American University of Paris, Paris, France

Alex Tabarrok George Mason University, Fairfax, VA, USA

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VOLUME INTRODUCTION

Volume 40B of *Research in the History of Economic Thought and Methodology* features a symposium on William Baumol, edited by Erwin Dekker and featuring contributions from Alex Tabarrok, Jochen Hartwig and Hagen M. Krämer, Alexandre Chirat, Victor A. Beker, Caroline Colton, Magnus Henrekson and Mikael Stenkula, and Anna Noci.

The volume also includes new general-research essays from Juan Pablo Castilla and Fabrizio Bientinesi.

The Editors of *Research in the History of Economic Thought and Methodology*
Luca Fiorito
Scott Scheall
Carlos Eduardo Suprinyak

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PART I

A SYMPOSIUM ON THE WORK OF WILLIAM J. BAUMOL: HETERODOX INSPIRATIONS AND NEOCLASSICAL MODELS

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INTRODUCTION – THE WORK OF WILLIAM J. BAUMOL: HETERODOX INSPIRATIONS AND NEOCLASSICAL MODELS

Erwin Dekker

There is a growing realization that the once-seemingly monolithic body of neoclassical economics housed much more pluralism than was alleged by both critics and proponents. The work of William Jack Baumol (1922–2017) is a case in point. His early attempts to integrate dynamics into economic theory were inspired by both Joseph Schumpeter and Karl Marx and created an essential and productive tension between the static allocation framework of neoclassical economics and the long-term macro-dynamics of the economy, which interested Baumol most.

Baumol's parents were self-educated Jewish migrants who had fled Poland, then under Russian rule, to escape the pogroms and political persecution. His father Solomon came from a working-class background, his parents had run a tavern in which he also worked. His mother Lillian Itzkowitz came from an intellectual Jewish family in Lithuania, she had a more temperate and logical mind than his emotional father (Baumol, 1989, p. 209). Solomon Baumol was an ardent communist when he fled to the United States in the 1910s. In New York City, he worked as a grocery shop clerk. When he heard about the communist revolution in Russia, he returned with his family to Europe to join the communist movement. Upon arrival, he was immediately arrested and imprisoned, because the Bolsheviks assumed that he was an American spy. Fortunately, he managed to escape and return to the United States with his wife, and about two years later, their first son William was born, February 22, 1922, in the South Bronx in New York City.[1]

Despite this harrowing experience, Baumol's father remained a faithful communist for the rest of his life. His parents introduced William to economics at an early age as he participated in the constant discussions that were an integral part

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of family life. This environment instilled a strong social conscience in him, and throughout his life, he had a profound interest in poor and underdeveloped countries: "I was infected by their interests and their concerns" (Baumol, 1989, p. 209).

When he started college in 1939 at the public, tuition-free, City College of New York (CCNY), he was already acquainted with Thorstein Veblen, Karl Marx, and the work of the classical economists. He majored in economics – but also in art. Baumol's interest in art, his father was a great enthusiast of the performing arts, would profoundly influence his private as well as his professional life. Baumol was a pioneer of the economics of the arts, a subject on which he often worked with his wife, Hilda Missel (born 1923), who he met at CCNY.

Baumol was interested in oil painting and wood sculpting, and he taught graduate courses in sculpting at Princeton. His interest in wood sculpting was kindled by German POWs whom he met during the war. He was also responsible, alongside Abba Lerner and Harry Johnson for introducing art exhibits by economists at scientific conferences around the world. Toward the end of his life, he pioneered computer painting. The quality of economics teaching at CCNY was mediocre and dated, according to Baumol. To compensate, ambitious students organized their own classes to teach each other. There were vivid discussion groups that they could join. The students' dining hall was organized around different alcoves, each representing distinct discussion themes, including a Trotskyist and a socialist one (Baumol, 1989, p. 210).

After graduation in 1942, Baumol joined the US Department of Agriculture (USDA) before being drafted into the army and sent to France following the Allied landing in Normandy. Baumol did not idle away his free time in the army. He took correspondence courses in mathematics (linear algebra) and bought mathematics books, the only French books he could understand. After the war, he returned to the USDA before starting his postgraduate studies. At the USDA, he learned how economics could be applied in practice. Among other tasks, he had to analyze how a restricted quantity of US surplus grain should be distributed to a starving world population, introducing him to the complexity of the "calculations of fairness," a subject to which he would repeatedly return, for example in his 1986 book *Superfairness* (Baumol & Fischer, 1986).

In 1947, he applied to the London School of Economics. He was initially rejected, but after a second attempt, he was accepted into the master's degree program. When he showed up at the LSE, he threw himself into intense debates with senior professors at the seminars and was almost immediately transferred to the PhD program, although 'program' was a big name for the PhD degree, which was still uncommon in the British system. Not much later, he became a full-time member of the faculty and a lecturer responsible for teaching mathematical economic dynamics and the American economy. The former course later resulted in his first book "Economic Dynamics: An Introduction" (Baumol & Turvey, 1951).

Baumol once depicted the prestigious British Oxford Debating Society as a union "composed of amateurs and children" compared to the disputants and speakers at CCNY, which he characterized as a place for "dirty debating as a blood sport" (Krueger, 2001, p. 214). That characterization might be somewhat exaggerated, given his later experience as a visiting professor at the Stockholm

School of Economics (SSE) in 1968. Even though he described the SSE as a warm, friendly, and hospitable place, he found that Swedish economists had a brusque manner and avoided "sugar-coating" their arguments in discussions and debates, much to Baumol's dislike. There were two exceptions – the chivalric Bertil Ohlin and the deeply polite Erik Lundberg, who became a lifelong close friend of Baumol (1990b).[2]

At the LSE, Baumol met many influential and promising scholars, including Lionel Robbins, Friedrich Hayek, Arthur Lewis, James Meade as well as the philosopher Karl Popper and the political scientist Harold Laski. He also met and exchanged ideas with Joan Robinson and John Hicks, who were then at Cambridge. Baumol looked back upon the LSE as an extraordinarily stimulating place where he joined "Robbins' Circle," a group developing the basis for new welfare economics. Lionel Robbins also became his supervisor. Baumol wrote his thesis in a mere six weeks, which established his renown for writing quickly and seldom rewriting what had been committed to paper (Krueger, 2001, p. 230). He underscored, however, that much time might elapse – sometimes years – of thoughts and discussions with colleagues and friends before he started to write down his ideas. His thesis dealt with welfare economics and the Marshall–Pigou theory of externalities (Baumol, 1952).

After receiving his PhD, Baumol returned to the United States, where he took up a research position at Princeton University and soon became a full professor. In 1971, he decided to split his time between Princeton and New York, where he joined the faculty at New York University (NYU). Until 1992, he retained his dual appointment, and he remained a professor at NYU until he died in 2017. When Baumol started his position at NYU, the place was a hub for economists for the heterodox (neo-)Austrian school, which had a lively interest in entrepreneurship and economic dynamics. At Princeton, he had been colleagues with Oskar Morgenstern and Fritz Machlup who received their training in interwar Vienna by the third generation of the Austrian School, and who upon their retirement joined NYU. There should have been plenty of time and opportunities for Baumol to interact with Austrian-minded colleagues, including Israel Kirzner at NYU. But Baumol's credit to and cooperation with scholars of this tradition were very limited, even though he wrote about many of the same subjects as his Austrian colleagues, most notably competition and entrepreneurship.

The cost disease he identified with his former graduate student William G. Bowen in the performing arts was an excellent example of the heterodox inspiration of Baumol and his interest in long-run dynamics. The study was undertaken at the initiative of Twentieth Century Fund and the Rockefeller foundation who were interested in a systematic investigation of the performing arts industry in the United States. The scope of the study was broad and included audience surveys, questionnaires to many organizations, but the main outcome was the identification of the so-called Cost Disease (Baumol & Bowen, 1966). Baumol and Bowen (1965) identified differential productivity growth rates between service and industrial sectors. The famous example of the string quartet illustrated that for some goods no productivity gains had been made during the nearly 200 years since the Industrial Revolution had first taken hold. This uneven dynamic, which directly

recalled the Marxian theory of imbalances due to differences between sectors (Gehrke, 2018) as well as the classical dual-sector model of Lewis (1954), created structural imbalances, which resulted from a process of economic development. The study by Baumol and Bowen kickstarted the field of the economics of the arts, but its focus on macro-economic productivity trends sat uneasily with the later development of this field as applied microeconomics (Dekker, 2017), as well as with Baumol's own self-presentation as an applied microeconomist.

Later discussions of Baumol's Cost Disease or the Baumol Effect as Alex Tabarrok (this volume) prefers to call it, tended to emphasize substitution effects by consumers and criticized the one-sided attention to production in Baumol's model. How, for instance, could we differentiate between the substitution away from the horse and buggy toward the car and from the string quartet to the Beatles? They were relevant criticism of a model, which was rooted in the classical production perspective on the market, and therefore mostly neglected the consumption side of the economy.

Classical economics and Marx were never far from Baumol's mind. Anna Noci's contribution to this volume details the idiosyncratic way in which Baumol and Paul Samuelson, two leading American neoclassical economists, discussed Marx's transformation problem. Although both were wedded to a reinterpretation of Marx's theory into the formalisms of the 1970s, they differed substantially on the way one should approach Marx's work. Baumol favored a more charitable reading inspired by the intended purpose and meaning of the great socialist economist. Samuelson provided a Whiggish interpretation of Marx's contributions, which allowed him to dismiss the transformation problem as one big confusion. The episode is not merely telling of Baumol's deep interest in Marx, which was inspired by his parents, but also of the roundabout way neoclassical economists engaged with heterodox authors.

Baumol's interest in dynamics, production, and classical dynamics of capitalism is what drove him to return time and again to the entrepreneur. Explicitly inspired by Schumpeter, he sought to integrate the elusive character into the neoclassical framework of his days, with mixed results as Magnus Henrekson and Mikael Stenkula demonstrate in their contribution. The NYU economists Baumol and Kirzner have both pursued their own paths to integrate entrepreneurship into equilibrium economics. Kirzner positioned himself in friendly opposition to mainstream economics, while at the same time seeking to revive Austrian economics in the United States. Baumol on the other hand kept looking for a way to formalize and fully integrate the entrepreneur into the maximization framework of neoclassical economics, such as in one of his later books "The Free-Market Innovation Machine" (Baumol, 2002).

The chapter by Alexandre Chirat on Baumol's exchange with John Kenneth Galbraith on managerial theories of the firm further confirms the pattern of heterodox inspiration and neoclassical formulation. Galbraith was the most prominent institutionally oriented economist of the postwar period in the United States and sought to develop the groundbreaking work by Berle and Means on the consequences of the separation between ownership and management for the modern corporation. Baumol displayed extensive interest in Galbraith's work and sought

to develop his model of oligopolistic firms. The senior management of large, typically oligopolistic, corporations was not interested in maximizing profit but rather in increasing sales volume or market share in order to increase their managerial scope of control, argued Baumol.

But whereas Galbraith was also interested in a critique of the oligopolistic structure of American capitalism and the power of the so-called technostructure, Baumol smoothed out the rough edges. He shared the interest of Galbraith in a higher degree of realism in theory but was unwilling to accept that this would come at the cost of theoretical unification. In his interview with Alan B. Krueger (2001) explained that "he was always looking for the theory.". For Baumol, this had a highly specific meaning: something he could formalize in line with the dominant maximization framework. Unlike his colleague at Princeton Richard A. Lester, he was not out to attack marginalism (Lester, 1946). Attacking existing theories was of little use according to Baumol: "While you may convince many readers, they do not see how to proceed once they leave the neoclassical terrain" (Baumol cited in Beker, this volume).

Baumol's (1990a) most remarkable paper, given his desire to fit phenomena into the neoclassical framework, is therefore his seminal "Entrepreneurship: Productive, Unproductive and Destructive." It stands out because it puts economic institutions at the heart of the analysis: if institutions foster entrepreneurship into productive directions a country will get economic development, but if property rights are not enforced or entrepreneurs can curb legislation in their favor, it might have unproductive or even destructive consequences. Perhaps, characteristically, Baumol himself never pursued this institutional line of analysis to further investigate the nature of institutions required to obtain positive outcomes. From the overview of his work in this area by Henrekson and Stenkula, one might even get the impression that Baumol was primarily motivated to work on the subject by the theoretical anomaly that other accounts had to rely on the unrealistic assumption that the supply of entrepreneurship varied widely across societies, instead of the problem of economic development. But as they demonstrate, Baumol's theory was also a way to connect the micro-dynamics of entrepreneurship back to the macro-dynamics of the economy, a relationship that had interested him from the very start of his career.

These macro-economic dynamics are also at the heart of two contributions that discuss the contemporary implications of the Baumol effect. Alex Tabarrok demonstrates in his article that Baumol's effect can be interpreted as an instance of deep microeconomic reasoning about relative prices, which can help explain macro-dynamics in the economy, most importantly the rising share of income that is spent on service sectors such as education and healthcare. Tabarrok prefers to call it the Baumol effect, because it is an inevitable consequence of the falling costs of production (and hence prices) of some goods, that other goods will become *relatively* more expensive. Tabarrok, therefore, argues that the Baumol effect is no reason to worry, but rather a natural effect of (uneven) economic development that expands the overall production-possibility frontier of an economy. Income effects will consequently offset price effects, and the net effect on welfare will be positive.

Jochen Hartwig and Hagen M. Krämer do not dispute Tabarrok's analysis but analyze the Baumol effect in conjunction with rising levels of income inequality. They argue that in the absence of state intervention many low-income groups would lose access to the goods most affected by the Baumol effect, including healthcare and education. The underlying question here is one that goes deeper than merely the Baumol effect. In the analysis of Hartwig and Krämer, the extensive government intervention in these sectors can be explained through the fact that they sought to keep them available to lower-income groups. Tabarrok wonders to what degree the Baumol effect is the sole cause underlying the price increases in these sectors, are not rent-seeking and a lack of incentives for innovation in these state-regulated also to blame? As such, the Baumol effect raises both structural and institutional questions.

Caroline Colton's examination of Baumol's work as an economic consultant for AT&T rightfully asks the question whether epistemological concerns were the only motives of Baumol, or whether his view of competition and market structure was not also inspired by his work for large companies. Baumol's theory of contestable markets, which he presented in 1982, argued that the potential threat of competition could be as effective in driving prices down as actual competition. If there were no or very few barriers to entry, oligopolists would have an incentive to charge consumers competitive market prices, because they might otherwise suffer so-called hit-and-run competition.

Baumol's theory of contestable markets was developed in the context of the political desire of the late 1970s and 1980s to denationalize various state-owned industries and to introduce competition to previously monopolized markets. The chapter by Victor Beker on the work of Baumol in the field of telecommunications illustrates from a first-hand perspective how the break-up of AT&T posed new problems for the regulation of the telecommunications industry, including the determination of competitive price levels. The "efficient-component pricing rule" that Baumol developed was based on the idea that firms, which owned key infrastructures for industry, could not charge their competitors more for the use of this infrastructure than what they (implicitly) charged themselves. Jointly the chapters by Colton and Beker provide the context in which what we now call platform markets emerged. This changed notions of market power, competition and efficiency to which Baumol contributed not merely through economic analysis but also through the development of corporate strategies, the design of new regulations, and ultimately the design of markets.

The essential tension between the dynamic macro-effects that interested Baumol and the static neoclassical maximization framework in this manner also transforms into another tension, between the timeless universal tendencies or laws of economics and the institutional specificity of his work on the development of oligopolistic and platform markets as well as his later contributions to entrepreneurship. This tension was by no means lost on Baumol himself, who in 1983 presented a paper on "Marx and the Iron Law of Wages" at the meetings of the American Economic Association (Baumol, 1983). His presentation, which relied very heavily on direct quotations of Marx, insisted that Marx never argued for an iron law of wages independent of capitalist institutions. After all,