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The contribution of Herschel I. Grossman to political economy

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Abstract

Herschel Grossman was one of the most creative and productive economists of his generation in the field of political economy. This paper surveys his scientific contributions to the field.

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1. Introduction

> Throughout history the responses of human societies to the problems of distributing property and of allocating resources between productive and appropriative activities probably have had greater consequences for welfare than have their responses to the problem of allocating resources among different productive activities taking property as given, which is the problem on which economic analysis traditionally has focused (Herschel Grossman, 1994).

When Herschel I. Grossman left this world on October 9, 2004 while attending a conference in Marseilles, the economics profession lost one of the most creative and productive economists of his generation. His heritage is some 80 publications in refereed journals, unfinished projects, and inspiration to colleagues and students. His

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publications suggest two scholars, one in the field of Keynesian macroeconomics and another in political economy and contest theory. Herschel Grossman began his career very much inspired by Keynesian economics and he was especially puzzled by the economic rationale for and the consequences of inflation. His textbook with Robert Barro (Barro and Grossman, 1976) is a classic in its field. Interestingly, there exists a direct path from Herschel Grossman's early research to his work on conflict and political economy (which he emphasized in an interview with Webpondo).[1] At the heart of the Keynesian view of the economy is the connection between monetary and real variables, which contrasts with neoclassical neutrality. This latter placed the burden of proof on Keynesians, who had to explain how monetary policy could influence the real variables of the economy. Among the many answers, credibility, time consistency, and reputation most attracted Herschel Grossman's attention.

It is a commonplace in economics that every problem of credibility or time consistency can be solved by either a complete and perfectly (and costlessly enforceable) ex-ante contract, or by the design of a threat strategy in a repeated interaction as long as the discount factor of the contracting parties is sufficiently low. It is determination of this discount factor that is at the heart of the problem of time inconsistency and credibility. From a broader perspective, Grossman's attempt to explain lack of credibility and time consistency can be seen as part of the "Coasean program" (based on the seminal papers by Coase, 1937, 1960) that has been fruitful in the development of modern contract theory, information, conflict, and institutional economics: why should rational individuals not be able to find a way to exhaust all gains from trade? The common textbook answer "because of transaction costs" provides a convincing perspective from which the problem of sustainable inefficiencies can be analyzed. However, left unanswered are questions about the nature of and reasons for transaction costs. Exogenous costs can be incorporated into the standard models without difficulty because these are costs like 'ordinary' costs of production. A fruitful approach to the problem of transaction costs needs, however, to endogenize the concept. Yet, in that case, transaction costs of a particular institution are nothing more than losses due to a deviation between the realized and the fully efficient allocation, which brings the concept close to a tautology. However, it is an interesting tautology because it focuses attention on economic forces that underlie persistent deviations between a fully efficient and an actually implementable allocation: economists trying to explain persistent frictions and inefficiencies have to come up with convincing arguments that explain why it is impossible for individuals to overcome the obstacles that impede a Pareto-improving trade. Even more, in order to understand the advantages and disadvantages of specific institutions, one has to identify the institution-specific obstacles that explain the institution-specific transaction costs, which ultimately gives rise to a theory of optimal institutions.

Although he did not explicitly refer to the concept of transaction costs, Grossman's solution to the problem of non-neutrality was deeply rooted in this program: in any type of state or more general society, be it democratic or dictatorial, it is the ruling elite that is

[1] See Grossman (2004e).