WHAT THE MERCANTILISTS GOT RIGHT

Dani Rodrik[1]
Harvard University
May 2025

1. Introduction

In 1980 the American public television station PBS aired the landmark TV series *Free to Choose.* Milton Friedman, a strong advocate of free markets, was the brainchild behind the series and acted as host. The timing could not have been better, as the year 1980 ushered a new era of economic policy, which came to be called market fundamentalism, neoliberalism, the Washington Consensus, or hyperglobalization. Ronald Reagan (who famously said government is not the solution but the problem) was elected president of the U.S. that year; Margaret Thatcher had come to office in Britain the year before. The stage was set for an age of greater market orientation and smaller government.

The most memorable moment in the broadcast came when Friedman held a yellow pencil in his hand to explicate the virtues of free markets. No single person could have produced the pencil on his own, Friedman told the camera. The wood came from trees cut down in the state of Washington. The saw used to cut the trees was made of steel, which in turn required iron ore mined somewhere else. The graphite inside the pencil likely came from Latin America. The rubber used for the eraser tip was probably from Malaysia. Not to mention the paint and the glue… Thousands of people around the world speaking different languages and practicing various faiths were involved in manufacturing the pencil. Yet not only did these people not know each other, there was no central authority that told them what to do or coordinated their actions. It was instead decentralized markets and the price system that was responsible for the feat. Could there be a better illustration of the magic of markets than this simple pencil?[2]

Friedman was of course channeling Adam Smith, who is known today as the father of the idea that markets allocate resources to their most efficient uses by fostering division of labor. Markets incentivize each individual to direct his enterprise, Smith argued, to the uses that will be most valuable – as if the individual were led by an invisible hand looking out for society at large. Economists today understand much better both the scope and limitations

[1] This is an essay prepared for a volume edited by Alex Trew to commemorate the 250th anniversary of the publication of Adam Smith's *The Wealth of Nations*.
[2] For the transcript of Friedman's discussion of the pencil, see Anne Elizabeth Moore, "Milton Friedman's Pencil," *The New Inquiry*, December 17, 2012, https://thenewinquiry.com/milton-friedmans-pencil/. The story of the pencil is based on Leonard E. Reed, "I, Pencil," 1958, https://www.econlib.org/library/Essays/rdPncl.html?chapter_num=2#book-reader.

of the “invisible hand theorem.” Caveats and wrinkles aside, Smith’s insight has proved invaluable over two-and-a-half centuries, animating policy makers and shaping conventional thinking about the economy. It has acted as a beacon for advocates of free markets such as Milton Friedman.

However, a latter-day Friedman telling the pencil story three decades later would have faced an interesting conundrum. By the 2010s, most of the world’s pencils were made in China. And it was much harder to explain how market forces alone could have been responsible for that outcome. China had no innate advantage in producing pencils. Forest reserves were more plentiful in Indonesia or Brazil. There were better sources of graphite in Mexico and South Korea. Germany and the United States had better technology. Of course, China had lots of cheap labor, but so did Bangladesh, Ethiopia, and scores of other low-income countries.

Indeed, any account of how China came to dominate the production of pencils (or most other manufactures, for that matter) that relied only on decentralized, impersonal market forces would be seriously incomplete. We would have to add to the story the visible hand of the government as well: the state-owned enterprises which absorbed and disseminated know-how, the role of credit and other subsidies that incentivized entrepreneurs, the management of the currency that gave Chinese producers a competitive edge on world markets. China, the most extraordinary case of economic growth in economic history, was, like virtually all other previous successes, a peculiar mix of private entrepreneurship and state direction.

What would Adam Smith have made of China? The policies that produced the country’s miraculous economic growth are hard to square with the caricature of Smithian thought that we have inherited from Milton Friedman and other free-market apostles. The Chicago School and contemporary practitioners of neoliberalism promoted free markets as a universal cure-all. Adam Smith was not an ideologue, however. He was a pragmatist who would have recognized China’s policy innovations as local adaptions of broad market-friendly principles to an extremely challenging institutional and political context. Adam Smith would have warned Chinese policy makers about the costs of cronyism and misallocation resulting from state intervention. But he would likely have been also sympathetic to the pragmatic, second-best approach they took to managing the economy.

But I am not sure *The Wealth of Nations* is entirely blameless in regard to modern economics’ blind spots in certain areas. We cannot absolve Adam Smith completely from responsibility for those. Like all revolutionary thinkers, Adam Smith needed a foil, and he made mercantilism his target. Economics students today learn about mercantilism almost exclusively through Smith’s prism, as a series of logical and policy errors that Smith clarified and settled for good. But far from settled doctrine, mercantilism (or the "mercantile system" as Smith called it) encapsulated a variety of practices and beliefs held by business people, traders, and government officials. It did favor a more active role for the government, but the core ideas ran the gamut from a preference for trade surpluses (associated with Thomas Mun) to a system of nation-building (associated with the German historical school). Far from disappearing, many aspects of mercantilism survived Smith's critique, often to good effect. They found echo in a continuous tradition of what later came to be called "developmentalism," running from Alexander Hamilton and Friedrich List's advocacy of trade protection, to Hans Singer and Raul Prebisch's ideas on import-substitution, and, more recently, to East Asian models of export-oriented industrialization. It would not be an exaggeration to say that there is a straight line that connects early 18th century mercantilism to Chinese and other East Asian growth miracles two-and-a-half centuries later.

My purpose here is not to rehabilitate mercantilism or to put down Adam Smith. But it is useful to reflect on certain predispositions entrenched in economic thought by the Smithian paradigm. To this day, these lead economists to overlook some useful insights on the economy and the role of government policy associated with the mercantilist way of thinking.

2. Smithians versus mercantilists

To place these insights in sharper relief, consider some of the contrasts between contemporary economic thought and mercantilism. Perhaps the most significant disagreement between the two perspectives is whether consumption or production should be prioritized. Smith famously and lastingly placed consumers and their wellbeing at the center of economic analysis. Production was mainly a means to what later economists would conceptualize as "maximizing consumers' utility function." In Smith's words:

> Consumption is the sole end and purpose of all production; and the interest of the producer ought to be attended to, only so far as it may be necessary for promoting that of the consumer.

"The maxim is so perfectly self-evident," wrote Smith, "that it would be absurd to attempt to prove it." He criticized mercantilists for being biased towards the producers.

> But in the mercantile system, the interest of the consumer is almost constantly sacrificed to that of the producer; and it seems to consider production, and not consumption, as the ultimate end and object of all industry and commerce.[3]

The obsession for production and the supply side of the economy was reflected in what is mercantilism's best known – and most scorned – feature: the preference for surplus on the balance of international trade. Mercantilists presumed acquiring gold from the rest of the world was an important objective of economic policy. An excess of exports over imports was the way to achieve that end. As Smith convincingly showed, accumulating precious metals in the state's coffers serves no distinct purpose. It is at best a means to future consumption. But the need for trade surpluses can also be understood differently, as a desire to have domestic production exceed domestic consumption. It is an impulse that runs counter to contemporary economic thought, but one that many successful countries, most notably China, has put to good use.

Moreover, mercantilists had distinct views on the desirable structure of trade and production. They favored production and exports of finished goods (manufactures). Raw materials did not add value to the domestic economy and could be imported from foreign nations. This runs counter to the baseline view in contemporary economics that policy makers should remain neutral between different types of production. Since market prices are presumed to reflect social valuations, \$100 of finished goods is as valuable to society as \$100 of raw materials. Or as Michael Boskin, chair of President George H. W. Bush Council of Economic Advisers, is supposed to have replied when asked about policies to support the semiconductor industry, "Potato chips, computer chips—what's the difference?"[4]

Of course, all well trained economists realize that there are circumstances when the structure of production does matter. When the assumptions behind the invisible hand theorem – or the first fundamental theorem of welfare economics – fail to hold, markets will not necessarily allocate resources efficiently and consumption possibilities will not be maximized. There will be a potentially useful role for the government to intervene to promote certain sectors and tax others. For example, semiconductors may provide learning and technological spillovers to the rest of the economy. Or nascent industrial

---

[3] *The Glasgow Edition of the Works and Correspondence of Adam Smith*: *An Inquiry into the Nature and Causes of the Wealth of Nations*, Vol. 2 (1976), pp. 660-1, https://dx.doi.org/10.1093/actrade/9780199269570.div2.3.

[4] Robert D. Atkinson, "Computer Chips vs. Potato Chips: The Case for a U.S. Strategic-Industry Policy," Information Technology & Innovation Foundation, January 3, 2022, https://itif.org/publications/2022/01/03/computer-chips-vs-potato-chips-case-us-strategic-industry-policy/.

clusters may be prevented from getting off the ground by coordination failures arising from pervasive economies of scale. With the addition of such provisos, it is possible to attenuate the contrast between the Smithian and mercantilist perspectives and even reconcile them fully.

But the starting point matters. Every paradigm needs benchmark presumptions – maintained assumptions that are typically not questioned. Unless there is strong and compelling evidence to the contrary, a mainstream economist will generally oppose "picking winners." An analyst with a mercantilist or developmentalist bent, on the other hand, will not hesitate to make choices about what to produce and how. This reversal in who must bear the burden of proof – those who oppose or desire interventions in the productive sphere – sets up barriers of different height for government intervention on the supply side and carries significant implications for the conduct of economic policy. It leads us to treat East Asian style industrial policies as either natural or an aberration.

A second important difference relates to the way the government should relate to business. Smith disliked government intervention in the economy not simply because it would lead to inefficiency, but also because it would lead to what today we would call "crony capitalism." The more the government was involved in business, the more business would succeed in capturing economic policy and driving it towards particularistic ends that benefit it at the expense of society. Those prospective gains would in turn produce lobbying and other wasteful expenditures by firms looking to reap them. In the language of contemporary political economy and public choice, the result is pervasive rent-seeking behavior. Notably, the cost of rent-seeking can be far greater than that of policies which created the rents in the first place. Allocative inefficiency produces deadweight losses shaped in the form of triangles. The waste engendered by rent-seeking behavior, on the other hand, comes in the form of much larger rectangles![5]

A general lesson follows from such concerns: government should avoid close interactions with firms. Policy makers do have to intervene in the economy occasionally, as they must when they face anti-competitive behavior or clear externalities. But they must do so in a manner that keeps firms at bay, minimizing the risks of capture. This is reflected in contemporary models of economic regulation in which the regulator relates to regulated firms in a top-down, arm's length manner. Facing asymmetric information, the regulator sets a schedule of rewards and fines to elicit the desired behavior from firms. In such frameworks, direct interaction or communication with firms would be pointless at best – since firms have the incentive to misrepresent – and harmful at worst – since it would

[5] The classic statement is Anne O. Krueger, "The Political Economy of the Rent-Seeking Society," *American Economic Review*, June 1974, pp. 291-303.

facilitate capture and rent-seeking. In dynamic settings, regulators have to make hard, credible commitments to their policies. They must not deviate from ex-ante desirable rules in response to outcomes that depend on firms' behavior since that would provide an opportunity for firms to game the government.[6]

Mercantilist and developmentalist practices permit, and in fact encourage, much greater interaction between government and business. Policies are shaped in consultation and cooperation with firms. The collaboration continues over time and policies are revised by taking into account both changing circumstances and feedback from firms. This close, iterative relationship effectively weights the tradeoff between the benefits of information and risks of capture differently. It maximizes the opportunities for learning from firms – about the constraints and opportunities they face – and revising policies accordingly. It minimizes a different kind of risk, namely the risk that top-down, arm's length policy design and implementation will be ineffective because the requisite information is complex and multi-dimensional and cannot be elicited through conventional principal-agent relationships. The theory behind this alternative mode of regulation has been developed by Charles Sabel and various co-authors, who call it "experimentalist governance."[7]

A third important difference is that the Smithian worldview has been absorbed in the economics canon as a universal paradigm that offers general, context-free ideas about the virtues of free markets and private enterprise. That is certainly how Milton Friedman and other members of the Chicago school conveyed Smith's wisdom to their audiences, as well as how distinguished practitioners such as Margaret Thatcher and Ronald Reagan understood it. In reality, this perspective undersells and misrepresents the real Adam Smith. As Jonathan Levy has argued, Smith did not believe in universal, abstract truths about the market, and much less in laissez-faire as a general doctrine to which all policy makers should subscribe.[8] Nevertheless, his instincts were in favor of free markets and against government intervention. He was prone to dismiss successful instances of government intervention in the economy as exceptions rather than something that could be

---

[6] A typical concern is dynamic inconsistency of industrial policies. A government tries to encourage firms to invest more by providing subsidies or trade protection. It promises to take the incentives away if the investment does not materialize. But it has the incentive to continue subsidizing firms even when it does not. See Kiminori Matsuyama, "Perfect Equilibria in a Trade Liberalization Game," *American Economic Review* LXXX, 1990, pp. 480-92.

[7] Charles F. Sabel and Jonathan Zeitlin, "Experimentalist Governance," in David Levi-Faur, ed., *The Oxford Handbook of Governance* (Oxford University Press, 2012), pp. 169-83; Dani Rodrik and Charles F. Sabel, "Building a Good Jobs Economy," in Danielle Allen et al., eds., *A Political Economy of Justice* (University of Chicago Press, 2022); Charles Sabel and David Victor, *Fixing the Climate: Strategies for an Uncertain World* (Princeton University Press, 2022).

[8] Jonathan Levy, "The Localist," *Boston Review*, June 28, 2023, https://www.bostonreview.net/articles/the-localist/.

emulated in other settings. For example, he conceded that the post office was a successful public enterprise:

> The post office is properly a mercantile project. The government advances the expense of establishing the different offices, and of buying or hiring the necessary horses or carriages, and is repaid, with a large profit, by the duties upon what is carried. It is, perhaps, the only mercantile project which has been successfully managed by, I believe, every sort of government. The capital to be advanced is not very considerable. There is no mystery in the business. The returns are not only certain but immediate.
>
> Princes, however, have frequently engaged in many other mercantile projects, and have been willing, like private persons, to mend their fortunes, by becoming adventurers in the common branches of trade. They have scarce ever succeeded.[9]

In other words, don't be fooled by successful government enterprise in this instance. It's a special case! It is perhaps not surprising therefore that Smith has come to be associated with a set of "best practices" linked to free markets.

Mercantilists, by contrast, were less interested in general theories and universal prescriptions. As practical men of commerce, trade, and government, their concerns were about everyday matters and immediate results. They would have been instinctively sympathetic to Xiaoping Deng's view that "It doesn't matter whether a cat is black or white, as long as it catches mice."

Table 1 summarizes these key contrasts between the Smithian and mercantilist worldviews. The differences form the backdrop to the discussion that follows. I will elaborate on the relevance and significance of overlooked mercantilist insights in three domains in turn: growth strategies, the globalization backlash, and the climate transition.

3. Growth strategies

The TV series *Free to Choose* opens with a sequence in which Milton Friedman is in Hong Kong. Against a panorama of Hong Kong harbor, Friedman recounts the rags-to-riches tale of the city-state and the role played by free markets in enabling that transformation. Friedman thought the city was managed by true disciples of Adam Smith. With the notable exception of public investment in housing, Hong Kong was a sort of free market Utopia.

---

[9] *The Glasgow Edition of the Works and Correspondence of Adam Smith*: *An Inquiry into the Nature and Causes of the Wealth of Nations*, Vol. 2 (1976), p. 818, https://dx.doi.org/10.1093/actrade/9780199269570.div2.3.

International trade was free, regulation minimal, and the state small. And the city's economy had grown rapidly on the back of labor-intensive exports such as garments and toys. "If you want to see how the free market really works, *this* is the place to come," Friedman states.[10]

Hong Kong was indeed special, not because it provided a particularly useful example of growth through free trade and free markets but because it was the *only* such case. Among successful countries in East Asia and elsewhere, it stood out very much as an exception. Japan, Taiwan, and South Korea all managed trade heavily and engaged in extensive industrial policies.[11] Singapore did practice free trade, but also resorted to extensive subsidies to encourage inward investment and diversify its economy. And China, of course, has been hardly a free market economy, despite its general orientation towards markets and the world economy after the late 1970s.

The institutional arrangements in each of these cases departed significantly from Western norms or what adherents to the Washington Consensus advocated and were closer to the mercantilist paradigm.[12] In the standard model, property rights are supposed to be private and secure. East Asian rulers did not always abide by that expectation. In South Korea, one of the earliest acts of President Park Chung-hee after taking power in a military coup in 1961 was to imprison scores of the country's leading businessmen. Park threatened to confiscate their businesses and released them only after he obtained pledges that they would meet export targets and "donate all their property when required for national construction."[13] In China, private property was not formally recognized until the 2000s and state ownership continues to exert a significant role in industry. Similarly, in Western-type economies, anti-trust is supposed to ensure decentralized, competitive markets. But economies such as Japan and Korea have been dominated by large conglomerates, with occasional reliance on government-mandated cartels. Japan's traditional lifetime employment practices defied the idea of competitive labor markets. And industrial policies have been pervasive in all of the region's economies, with the exception of Hong Kong.

---

[10] Jamie Peck, "Milton Friedman's Favorite Economy: Hong Kong in the Neoliberal Imagination," March 10, 2021, https://lpeproject.org/blog/hong-kong-as-neoliberal-devotional-object/.

[11] Dani Rodrik, "Getting Interventions Right: How South Korea and Taiwan Grew Rich," *Economic Policy* 20, 1995.

[12] Dani Rodrik, "Growth Strategies," in Philippe Aghion and Steven Durlauf, eds., *Handbook of Economic Growth* 1A, North-Holland, 2005.

[13] David Adler, "Korean Industrial Policy: From the Arrest of the Millionaires to Hallyu," *American Affairs*, Spring 2020, https://americanaffairsjournal.org/2020/02/korean-industrial-policy-from-the-arrest-of-the-millionaires-to-hallyu/.

Most of these policies have entailed close cooperation and collaboration between governments and firms, violating the norm that business should be held at arm's length.

In the public imagination, East Asia constitutes a different, alternative model of economic policymaking compared to the Smithian paradigm. But while there are some commonalities across the practices in different countries, there are plenty of differences as well. I have mentioned one of them already: Hong Kong and Singapore practiced free trade, while the others retained high levels of trade barriers decades into their economic take-off. China embarked on its export drive through a highly distinctive path: establishing special economic zones which operated under free-trade rules while the rest of the economy remained heavily protected. China also went farthest among East Asian nations in explicitly adopting the mercantilist prescription of running a trade surplus. (South Korea, by contrast, typically ran a trade deficit during its takeoff decades.) Even when there was a common orientation, the specific policies differed. South Korea incentivized industrialization through cheap bank credit, for example, while Taiwan relied mainly on tax incentives. The idea of an "East Asian model" hides nearly as much as it reveals.

Now, none of these practices necessarily violates economic principles, properly understood. Contemporary economic theory is rich enough that it allows us to justify all these variations as instances of adaptation to local constraints in second-best fashion. Industrial policies can be understood as a response to pervasive learning spillovers and coordination failures. Anomalies in corporate governance or industrial organization can be viewed as the consequence of poorly functioning financial markets. Mixed property rights regimes can be rationalized by referring to weaknesses in third-party enforcement in the context of weak legal administration. Two-track pricing systems – liberalization at the margin while large chunks of the economy remain controlled – can make sense against the backdrop of concerns about redistribution or unemployment. As one economist put it, more than fifty years ago, "by now any bright graduate student, by choosing his assumptions ... carefully, can produce a consistent model yielding just about any policy recommendation he favored at the start."[14]

But that would also be missing the point. It is clear that East Asian policy makers themselves were not really thinking at the time in terms of externalities or second-best constraints. They pursued exports, competitiveness, investment, domestic linkages and domestic value added – objectives that make much more sense from a mercantilist lens

[14] Carlos Diaz-Alejandro, "Trade Policies and Economic Development," in Peter B. Kenen, ed., *International Trade and Finance: Frontiers for Research* (Cambridge University Press, 1974). For a defense of Economics as the art of choosing among an inventory of models, with different contextual assumptions and different results, see Dani Rodrik, *Economics Rules: The Rights and Wrongs of the Dismal Science* (W.W. Norton, 2015).

than under mainstream economic theory. South Korean policy makers are said to have derived their industrial priorities by examining what Japan produced a couple of decades previously and pushing their firms to emulate that production structure. It is also the case that policy makers there were not operating out of the standard guidebook of the Washington Consensus. They were much more open to experimentation and policy innovation than mainstream economics would allow.

In sum, it is fair to say that we would not have a full understanding of the East Asia growth story – the most miraculous experience of economic development in history – without bringing in key elements of mercantilist thought and practice. This is true not just in the descriptive sense that East Asian policy makers often pursued policies more akin to mercantilism than laissez faire. It is also true in the explanatory sense: it is difficult to explain how and why those policies worked without insights from the mercantilist rulebook. Of course, there are many countries that did terribly by also pursuing mercantilist-inspired policies. But Hong Kong aside, we do not have examples of countries that performed better (or equivalently) by sticking closer to free market policies. Another important lesson from East Asia is that adjusting policies to context is everything.

4. The globalization backlash

In 1935, in the throes of the Great Depression, the Roosevelt administration launched a program for unemployed writers. Between 1935 and 1939, hundreds of writers carried out interviews with ordinary Americans around the country and collected oral histories. The Writers' Project, as it was called, aimed to produce state guidebooks informed by local perspectives. In the process, thousands of individual life stories were recorded in the interviewees' own words. Economists David Lagakos, Stelios Michalopoulos, and Hans-Joachim Voth have used this corpus of documents to ask: what do these accounts tell us about what people value and derive meaning from?[15] They combined human readings with large language models (LLMs) to draw a picture of life satisfaction.

Unsurprisingly, family and community were an important determinant of life satisfaction in these descriptions. More surprisingly, to economists, work also played a very significant role:

> In addition to the importance of relationships and family, we find that the roles of work and of contributing to communities and society loom large. Men and women reminisce proudly about how they learned their trades, emphasizing their mastery

[15] David Lagakos et al., "American Life Histories," NBER Working Paper 33373, January 2025.

> of complex tasks. Such pride is by no means limited to the professionals in our dataset; they emphasize how their work allows them to leverage their skills like the librarian putting their love of learning to good use. Many respondents eagerly share their insights into mundane businesses, from the turpentine industry to bone-collecting after droughts. Work in these life narratives is not necessarily drudgery, reluctantly endured; in most cases, it is a source of pride, joy, social recognition, and standing in the community. In other words, many of the men and women in the American Life Histories corpus are homo faber ("man the maker" in Latin) – creatures that need to work, produce, and contribute to flourish.[16]

"Having found meaning in one's work and the community," note Lagakos er al., "are the two strongest predictors of overall happiness."[17] Jobs are important as a source of social recognition, dignity, and meaning.

The importance of work is echoed in other recent empirical work on happiness. Specifically, scholars of life satisfaction have found across a variety of cultural and national contexts that job loss is one of the most severe shocks to individual well-being. One way of measuring the impact is to ask how much money would be needed to compensate those who become unemployed in order to maintain their subjective well-being unchanged. The answer is typically a multiple of the disposable income of the individual.[18] These losses are compounded by the negative externalities experienced by society at large.[19] The sociologist William Julius Wilson demonstrated in his seminal work *When Work Disappears* the costs that communities bear when blue-collar jobs move elsewhere, including crime, drug abuse, and broken families.[20]

There is a puzzle here from the standpoint of mainstream economics. Contemporary economists take their cue from Adam Smith's *Wealth of Nations* in modeling individual preferences as a function defined over consumption bundles. (*The Theory of Moral Sentiments* would of course yield a much richer picture.) In this utility function, leisure enters positively and, by implication, work negatively. In other words, work detracts from well-being rather than enhancing it! Work plays a positive role in well-being only to the extent that it is a source of income and hence relaxes the budget constraint.

---

[16] Lagakos et al., p. 56.
[17] Lagakos et al., p. 4.
[18] Nicolai Suppa, "Unemployment and Subjective Well-being," GLO Discussion Paper Series 760, Global Labor Organization (GLO), 2021, https://ideas.repec.org/p/zbw/glodps/760.html.
[19] Dani Rodrik and Charles F. Sabel, "Building a Good Jobs Economy," in Danielle Allen et al., eds., *A Political Economy of Justice* (University of Chicago Press, 2022).
[20] William Julius Wilson, *When Work Disappears: The World of the New Urban Poor*, (Alfred A. Knopf, 1996).

This basic framework left economists unprepared for the social and political consequences of labor market dislocations after the 1990s, and the broader backlash against the prevailing economic order. Wilson's research, mentioned above, had focused on African Americans living in inner-city neighborhoods of the U.S. A very similar phenomenon played out on a greater scale as a result of the China trade shock during the 2000s. David Autor, David Dorn, and Gordon Hanson found that the surge in imports from China left many local communities around the U.S. scarred for a very long time. Communities where the greatest number of jobs were lost to Chinese imports experienced long-term "idleness" among young males, a rise in male mortality due to drug and alcohol abuse, HIV/AIDS, and homicide, and an increase in the fraction of unwed mothers, of children in single-headed households, and of children living in poverty.[21] The conventional economic model predicted that workers, especially younger ones, losing their jobs would move elsewhere. There were plenty of labor markets in the coastal areas that benefited handsomely from globalization. Yet unemployed workers exhibited remarkable attachments to their local communities and resisted relocation.

Even more striking has been the political aftermath of labor market dislocation. A series of papers have linked the rise in ethno-nationalist right-wing populist movements in the U.S. and Europe in recent decades to adverse employment consequences in local labor markets, whether due to globalization, automation, or fiscal austerity. Where jobs have disappeared, far right political movements have made gains. In an extension of their work on the local labor market effects of the China shock, Autor and co-authors found that the biggest political winners were those on the farthest right (conservative Republicans). They estimate that had the China trade between 2000 and 2014 been only half as large, Democrats would have won in 2016 in the key battleground states of Pennsylvania, Wisconsin, and Michigan, which would would have swept Hillary Clinton to the Oval Office in lieu of Donald Trump.[22] In Sweden, a reduction in the number of secure, protected jobs benefited mainly the right-wing, anti-immigrant Sweden Democrats party. The pro-Brexit vote was greater in U.K. regions with larger import penetration from China. The China trade shock also played a statistically (and quantitatively) significant role across European regions in increasing support for nationalist parties and strengthening radical right-wing

[21] David Autor, David Dorn, and Gordon Hanson, "The China Shock: Learning from Labor Market Adjustment to Large Changes in Trade," *Annual Review of Economics* 8, October 2016, pp. 205-240; David Autor, David Dorn, and Gordon Hanson, "When Work Disappears: Manufacturing Decline and the Falling Marriage-Market Value of Young Men," *American Economic Review: Insights* 1 (2), September 2019.
[22] David Autor, David Dorn, Gordon Hanson, and Kaveh Majlesi, "Importing Political Polarization? The Electoral Consequences of Rising Trade Exposure," *American Economic Review* 110 (10), 2020, pp. 3139–83. Also see the authors' "A Note on the Effect of Rising Trade Exposure on the 2016 Presidential Election," appendix to Autor, Dorn, Hanson, and Majlesi, "Importing Political Polarization? The Electoral Consequences of Rising Trade Exposure," 2017.

parties. These changes in electoral outcomes were mediated partly through an increase in authoritarian values and hostility to out-groups (racial minorities or immigrants).[23]

In short, the loss of good jobs due to the labor market dislocations spurred by international trade has played a forceful role in the backlash against globalization and the rise in support for authoritarian populists. The social and political salience of jobs would have been naturally on the radar screen of mercantilists, with their focus on what, how, and where we produce. Economists brought up in the Smithian tradition largely overlooked it until it was too late.

5. The green transition

Smithians believe in market solutions, even when they understand markets do not work very well on their own. Global warming is a good example. There is a well-recognized externality here: my carbon emissions in my corner of the world contributes to an increase in global greenhouse gases, creating added climate risk for everyone everywhere. A totally free market leads to all emitters free riding and too much global warming, with possibly catastrophic consequences for our planet.

But there is a market-based solution. Governments can simply impose a tax on the emission of carbon and other greenhouse gases and let the markets do their job. With the tax set at the appropriate, social cost of carbon, markets will ensure that emissions will be reduced to the level that achieves social optimality inclusive of climate risks. Ideally, the carbon tax would be global. But even if the tax is limited to the large emitters, we would get close enough to the social optimum. Equivalently, we can institute a cap-and-trade system, under which emitters are allocated specific quotas of allowable emissions which they can trade with other emitters. Such a market-based trading system allows emission reductions to take place where it is cheaper to do so: if it is too costly for me to bring my emissions below my quota, I can buy “emission permits” from someone who can deliver emission cuts at lower cost. When we place a high premium on meeting our emission-reduction targets and are unsure of price elasticities, the cap-and-trade system would be even better than the carbon tax.[24]

Economists marvel at the genius of these arrangements and have long pushed them on policy makers. Their impact on emissions has been limited, however. Even though carbon pricing and cap-and-trade regimes have proliferated around the world – with the EU’s

---

[23] For a revies and discussion of these and other studies, see Dani Rodrik, “Why Does Globalization Fuel Populism: Economics, Culture, and the Rise of Right-Wing Populism,” *Annual Review of Economics* 23, 2021.
[24] Martin L. Weitzman, “Prices vs. Quantities,” *Review of Economic Studies* 41 (4), October 1974, pp. 477-491.

emission trading system (ETS) the best known – they have remained too permissive and limited to certain kinds of emissions. The greatest gains in the fight against climate change have come through an entirely different avenue: industrial policies that promote the development of renewables and green industries.

The cost of renewable energy has fallen dramatically over the last decade, by 80 percent in solar, 73 percent in offshore wind, 57 percent in onshore wind, and 80 percent in electric batteries.[25] In many parts of the world, solar and wind energy is cheaper to deploy today than fossil fuels like oil and coal. These are industries with significant learning curves, so cost declines and demand expansion feed on each other. As a result, the deployment of renewables has been far more rapid than even the most optimistic projections had anticipated.

The most significant factor behind this remarkable transition in the energy picture has been China's industrial policies over the last decade and a half. While China remains the world's largest emitter of carbon, these policies have also made it the global leader in renewable energy. In 2023, China added more solar power capacity in a single year than the entire installed capacity of the U.S.[26] More recently under President Biden, the U.S. embarked on its own version of green industrial policies with its misnamed Inflation Reduction Act (IRA). Given its scale, running into a trillion of dollars in subsidies for green projects, many viewed the IRA as a game changer for the energy transition. President Trump has of course taken the U.S. in a very different direction.

China's green industrial policies bear the hallmarks of mercantilist statecraft. Elizabeth Thurbon and her co-authors call it "developmental environmentalism," a modern-day developmentalism adapted to the challenge of the climate transition.[27] Following the global financial crisis in 2009, Chinese leaders realized that their traditional growth model was unsustainable economically, environmentally, and politically. They effectively adopted the green transition as their new national project. Like previous national projects, this one emphasized public-private collaboration, national autonomy, structural transformation (in the direction of green industries in this case), and geopolitical objectives all at once.

---

[25] Kingsmill Bond et al., "X-change: Electricity – On Track for Net Zero," Bezos Earth Fund, July 2023, https://rmi.org/wp-content/uploads/dlm_uploads/2023/07/rmi_x_change_electricity_2023.pdf.
[26] Ivy Tyn, "Infographic: China's Solar Capacity Growth in 2023 Sets New Record," S&P Global, February 8, 2024, https://www.spglobal.com/commodityinsights/en/market-insights/latest-news/energy-transition/020824-infographic-china-solar-capacity-coal-electricity-renewable-energy-hydro-wind.
[27] Elizabeth Thurbon, Sung-Young Kim, Hao Tan, and John A. Mathews, *Developmental Environmentalism: State Ambition and Creative Destruction in East Asia's Green Energy Transition* (Oxford University Press, 2023).

Chinese industrial policies took many forms. Many localities established public venture capital funds to promote startups in solar panels, electric vehicles, or other green investments. There were subsidies, directed credit, public procurement, state-owned enterprises, public R&D, customized infrastructure, preferential access to raw materials, demonstration projects, specialized training, and regulatory and administrative privileges. The policies spanned the national government, provinces, and municipalities, in mutually supportive but occasionally also competing fashion. As in previous industrial policies, the approach was explicitly experimental. The national government set broad objectives. A variety of industrial policies were deployed in different industries and locations, followed by close monitoring, iteration, and revision when required. As Thurbon and her co-authors emphasize, the Chinese government played the role of a "collaborative catalyst" rather than a central planner. In solar, for example, government officials periodically solicited feedback from industry leaders, which in turn helped shape their diagnoses of bottlenecks and possible solutions.

There was an element of Smithian competition too in the Chinese strategy, but competition featured less among firms and more among cities and provinces. Subnational leaders competed with each other to attract investment and build capacity. The result, critics often complained, was over-capacity. But rapid price reduction was another, welcome consequence. The beneficiaries were not just Chinese firms (many of whom, in fact, failed to become profitable), but also the rest of the world. Consumers and electricity providers worldwide gained from the dramatically lower costs.

As is typical with mercantilist arrangements, the strategy has both economic and political logic. The economic logic is that industries that provide learning spillovers need to be subsidized. Moreover, as long as carbon emissions are not priced adequately, there is an additional, second-best argument for subsidizing renewables and green products. So green industrial policy has a strong economic rationale with which mainstream economists can identify. However, these arguments are attenuated when we take the global nature of the carbon externality into account. From the standpoint of an individual country, such as China, free riding would have made more sense from a narrow economic perspective. Why should Chinese taxpayers and consumers pay the price for addressing a global problem? But, once again, it is not at all clear that Chinese policy makers were driven by such considerations. Their economic objectives revolved around exports and competitiveness rather than internalizing externalities.

Compared to carbon taxation, green industrial policies have a major political advantage: they entail carrots rather than sticks.[28] Their immediate impact is to create winners – recipients of subsidies and other incentives – rather than losers in the form of taxpayers. Nobody likes being taxed, but everyone loves subsidies. This helps explains, for example, why industrial policies allowed the Biden administration to progress on its climate agenda while previous Democratic administrations failed relying on carbon pricing. From a purely economic standpoint, the distinction between taxing "dirty" activities and subsidizing "green" ones is immaterial; in general equilibrium, one is the same as the other. The real world can be different. In the presence of cognitive limitations and pervasive uncertainty, consumers, communities, and corporations cannot see through the full economy-wide implications of different policies. In politics, immediate, visible impacts greatly outweigh indirect and future consequences. This can render subsidies and other forms of government support politically a much more attractive path for the green transition than carbon pricing or other approaches that directly harm fossil fuel interests.

Moreover, green subsidies can make it easier to mount a more frontal attack on fossil fuels eventually. China began promoting exit from coal around 2015, several years after the ramping up of green subsidies. It deployed a fully operational emission trading system a few years later, in 2021. And carbon reduction was articulated as an explicit goal for the first time in the Chinese Communist Party's third plenum in 2024.

6. Concluding remarks

Adam Smith may have won the battle of ideas, but his record is rather more mixed in the war for the minds of policy makers. President Donald Trump's full-throated adoption of mercantilism during his second term in office is a case in point. And in view of China's phenomenal rise in recent decades, some might even claim we are now living in a world that is increasingly the product of mercantilism, yet again.

This is not to defend Trump's policies or mercantilist practices in general. Economists are right to denigrate Trump's obsession with the trade balance and his resort to tariffs as an all-purpose cure for all that ails America. But the examples I have provided should also give us pause before we write off mercantilism altogether. Key mercantilist ideas have survived and have been put to good use in devising growth strategies and embarking on the green transition. Closer attention to them might have helped policy makers prevent a backlash

[28] Dani Rodrik, *Shared Prosperity in a Fractured World: A New Economics for the Middle Class, the Global Poor, and Our Climate* (Princeton University Press, 2025). On the political economy of the green transition more broadly see Alexander F. Gazmararian and Dustin Tingley, *Uncertain Futures: The Politics of Climate Change* (Cambridge University Press, 2023).

against globalization and what has come to be called neoliberalism. The primacy of production over consumption, the importance of the structure of production and employment in addition to the benefits of specialization and division of labor, the value of government-business interactions versus arm's length relationships, the visible hand of the state in addition to the invisible hand of the market, the focus on local context and contingency over global/universal rules – these are all insights that sit awkwardly with the lessons contemporary economists have taken from *The Wealth of Nations*. Yet they have a useful role to play in thinking about the economy and the role of government in it.

Most economists believe that their discipline works by way of better theories successively replacing older, disproved theories. In this perspective, Adam Smith's *Wealth of Nations* clearly displaced mercantilist ideas. And subsequent advances tweaked and refined the invisible hand theorem further to reflect empirical reality better. But this is not how economics really works in practice. The discipline moves horizontally rather than vertically: new models do not displace old ones; they enrich our understanding of different contexts (imperfect competition, asymmetric information, irrational behavior, etc.). Given the almost infinite plasticity of social reality, a library of models serves us better than the search for a universal model that works best regardless of context. As is typical, John Maynard Keynes put it best when he described economics as the "science of thinking in terms of models joined to the art of choosing models which are relevant to the contemporary world."[29]

The real Adam Smith, as opposed to the caricature that has been handed to contemporary economists, would have been sympathetic. Jacob Viner, a Chicago economist from an earlier vintage than Milton Friedman, said nearly as much in his 1927 essay, "Adam Smith and Laissez Faire." Viner wrote:

> Adam Smith was not a doctrinaire advocate of laissez faire. He saw a wide and elastic range of activity for government, and he was prepared to extend it even farther if government, by improving its standards of competence, honesty, and public spirit, showed itself enticed to wider responsibilities. . . . He devoted more effort to the presentation of his case for individual freedom than to exploring the possibilities of service through government. . . . [but] Smith saw that self-interest and competition were sometimes treacherous to the public interest they were supposed to serve, and he was prepared. . . . to rely upon government for the performance of many tasks which individuals as such would not do, or could not do, or could do only badly. He did not believe that laissez faire was always good, or

[29] This was in a letter to Roy Harrod in 1938.

> always bad. It depended on circumstances; and as best he could, Adam Smith took into account all of the circumstances he could find.[30]

Indeed, important ideas that seem in tension can co-exist and enrich each other. Private incentives, market competition and the division of labor are powerful engines of prosperity, as Adam Smith taught us. But unleashing them often requires unorthodox policies and the guidance of the state. A certain dose of mercantilism works in the right context. Ultimately, it is the judicious combination of the two perspectives that serves us best.

[30] The essay is quoted in the Jonathan Levy piece cited earlier. Jacob Viner, "Adam Smith and Laissez Faire," *Journal of Political Economy* 35 (2), April 1927, pp. 198-232.

Table 1: Key tenets

Adam Smith/modern economics	***Mercantilists/developmentalists***
Consumption is what matters	Production and jobs are key What and how you produce matters
Don’t obsess with trade surplus or gold reserves	Maximize gold holdings; hence trade surplus inherently good
Markets and price system maximize efficiency and consumer benefits Limited role of government in supporting markets	State support for new activities is essential
Strict separation of govt and business	Government must work together with business instead of keeping it at arms’ length
Economics and politics are and should remain different domains	Economics and politics are intertwined
Universal recipes/best practices	Adaptation to local conditions