

## CHAPTER 2

### “LAISSEZ-FAIRE”: THE ECONOMIC LIBERAL PERSPECTIVE

#### **Overview**

This chapter outlines the liberal perspective in International Political Economy (IPE), linking the recent rise of the economic liberal view to its historical roots. We trace the broader idea of liberalism from eighteenth century France, through nineteenth century England, to the twenty-first century. We also consider some events that shaped this point of view such as the case of the nineteenth-century Corn Laws and the Great Depression.

We discuss some of the words and arguments of famous political economists such as Adam Smith, David Ricardo, John Maynard Keynes, Friedrich Hayek, and Milton Friedman. We stress that liberalism (like all the IPE perspectives) has evolved, and it contains many strands of thinking. As we suggest, Keynes sits somewhat uncomfortably within the liberal school of thought. We discuss his challenge to classical liberalism and explain how the Keynesian compromise and embedded liberalism were dominant from the 1940s to the 1970s.

After discussing the ideas of Friedman and Hayek, we date the rise of neoliberalism in practice to the early 1980s and trace its connection to globalization. There is also a discussion of some critiques of globalization in the 1990s and 2000s from liberals themselves and from global activists. The final section of the chapter highlights differences between orthodox and heterodox economic liberals, especially in light of the global financial crisis of 2008-2009. We stress, however, that due to entrenched beliefs, influential supporters, and other reasons, economic liberalism itself continues to strongly influence state policies.

#### **Key Terms**

- economic liberalism
- rent-seeking
- Corn Laws
- positive-sum game
- zero-sum game
- Keynesianism
- paradox of thrift
- Keynesian compromise
- embedded liberalism
- hegemonic stability theory
- public goods
- neoliberalism
- orthodox economic liberals
- heterodox economic liberals
- new constitutionalism
- ordoliberalism

### **Teaching Tips**

- This chapter contains many quotations that can be used effectively in class to bring out the power and complexity of liberal ideas. Instructors may also want to bring into class other pithy quotations. Smith and Keynes provide especially good material for understanding the complexity of these thinker's views and student reaction to them.
- This chapter traces the evolution of liberal ideas and discusses their consequences for state–market relations and different policies. Some students will be confused by the fact that classical liberalism and conservatism are nearly synonymous, in the sense that these terms are sometimes used in IPE. It is a good idea to address this confusion right at the start. Ask students to carefully distinguish between classical liberalism and economic liberalism as we understand it today. Ask them why they think there is now so much tension between orthodox economic liberals and those who, in U.S. politics today, are considered “liberals.”
- It is good to ask the question “What makes Mill and Keynes liberals?” This is a controversial question with respect to Keynes, but the quotations provided (and especially the suggested reading by Skidelsky) make the answer clear.
- Push students to see the differences between Keynesian economic liberals and orthodox economic liberals. Ask students why economic liberals do not accept mercantilist arguments.
- One element of economic liberal thought that merits discussion is the importance of competition in truly free markets. Box 2.2 on ordoliberalism provides a good basis to elaborate on competition. Instructors may also want to bring in the section in Chapter 6 titled “Trends in Competition between Corporations” to show some current trends toward market concentration.

### **Sample Essay Questions**

1. Adam Smith and John Maynard Keynes are both liberals, in the broad sense in which this term is used in IPE. Explain what views Smith and Keynes share regarding the market, the state, human nature, and power. How do they differ?
2. Explain the key assumptions and assertions of classical liberalism.
3. How do liberals such as David Ricardo view international trade? Why do they hold this opinion? Explain how the Corn Laws debate in nineteenth-century Britain illustrates the conflict between mercantilist and economic liberal views of international trade.
4. John Stuart Mill and John Maynard Keynes thought that government could and should play a positive role in correcting problems in the market. Discuss the specific types of “market failures” that Mill and Keynes perceived and the types of government actions they advocated. What kinds of policy recommendations do you think Mill and Keynes would favor today?

Explain.

5. Explain several key arguments of John Maynard Keynes.
6. Economic liberal values and policies have been relatively more popular in the United States than in other developed countries. Why?
7. In what ways does ordoliberalism differ from neoliberalism?

### **Sample Multiple-Choice Questions**

- 1) Adam Smith favored “laissez-faire” policies, where individuals, guided by the “invisible hand,” would produce social benefits. The invisible hand stands for
  - a) government regulation.
  - b) individual self-interests and choices.\*
  - c) hegemonic stability.
  - d) hidden income taxes.
- 2) Which of the following best states Smith’s ideas related to moral sentiments?
  - a) No society can flourish and be happy if the far greater number of its members is poor and miserable.\*
  - b) Parliament should always represent the interests of the working class.
  - c) Bankers and special interests should have more influence in the legislature given the economic benefit derived from their investments in industry.
  - d) Serving one’s own interests in a competitive society means competing to best serve the interests of industrial society.
- 3) David Ricardo favored free international markets. Which of the following ideas about free, open markets is *not* associated with Ricardo?
  - a) Open markets promote efficiency.
  - b) Free trade binds nations together and promotes the universal good.
  - c) Free trade is a zero-sum game\*
  - d) Open markets lead to greater wealth.
- 4) John Stuart Mill is most noted for changing liberalism to reflect
  - a) the need for less state regulation of the economy.
  - b) that states should do more to stimulate industrial output and free trade.
  - c) that selective state action is needed when individual initiative inadequately promote social welfare.\*
  - d) that strong powers have legitimate interests in promoting social progress in their colonies.
- 5) Which of the following is *not* one of the main elements of capitalism listed by the authors?
  - a) the existence of markets for land, labor, commodities, and money
  - b) freedom of enterprise
  - c) democratic institutions\*

- d) the right to private property
  - e) markets coordinate society's economic activities
- 6) Embedded liberalism can be summed up in which of the following statements?
- a) International markets should be subject to political regulations in order to protect domestic social interests.\*
  - b) Foreign aid should be used in some cases where markets have failed to help the poor.
  - c) Consumers make rational (individual) choices that result in unexpected damaging outcomes that hurt the community.
  - d) The state needs to intervene in the economy because markets fail.
- 7) In the liberal view today, a hegemon is
- a) a rich and powerful state that supplies the international public goods necessary for a peaceful and prosperous global economy.\*
  - b) a strong nation that uses its wealth and power to set the rules of the IPE, so as to gain more wealth and power for itself.
  - c) a free rider.
  - d) a strong capitalist nation that uses its power to exploit less developed countries.
- 8) Which of the following statements about the views of President Reagan and Prime Minister Thatcher is *incorrect*?
- a) They both favored market deregulation.
  - b) They both owe a lot to the ideas of Adam Smith, David Ricardo, and Milton Friedman.
  - c) They both recommended selling off (privatizing) public industries to allow for more competition and competitive pricing.
  - d) They both agreed that the United States should have an empire like Great Britain did in the nineteenth century.\*
- 9) This supporter of globalization argues that if a country wants to benefit from globalization, it must put on a "golden straightjacket," i.e., the country must adopt economic liberal policies and accept some limits on state sovereignty.
- a) Joseph Stiglitz
  - b) Paul Collier
  - c) William Easterly
  - d) Thomas Friedman\*
- 10) Heterodox economic liberals recommend all of these policies *except*
- a) more redistribution of wealth to the lower social classes.
  - b) getting away from the "one-size-fits-all" mentality in the IMF and World Bank.
  - c) reducing developed countries' subsidization of their own industries.
  - d) harmonizing all major regulations across developed countries.\*
- 11) Who admitted before a U.S. congressional committee in 2008 that his assumptions about financial markets and banks were flawed?
- a) Ben Bernanke
  - b) Simon Johnson

- c) George W. Bush
- d) Alan Greenspan\*

- 12) Ordoliberals would agree with each of the following statement *except* which one?
- a) Markets are naturally self-regulating.\*
  - b) Private decisions should guide much of society's resource allocation, but the state may need to ensure some income redistribution.
  - c) A society needs "sound money."
  - d) The market requires an appropriate set of legal and political institutions.
- 13) Compared to neoliberals, heterodox economical liberals are less likely to believe in
- a) the efficient market hypothesis.
  - b) the ability of markets to self-govern.
  - c) the need to cut taxes on the wealthy to spur investment.
  - d) the new constitutionalism.
  - e) all of the above.\*

### **Suggested Readings and Links**

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Smith, Adam. *The Wealth of Nations*. New York: Dutton, 1964.

Stiglitz, Joseph. *Making Globalization Work*. New York: W. W. Norton, 2006.

Yergin, Daniel, and Joseph Stanislaw. *The Commanding Heights*. Paperback ed. New York: Simon & Schuster, 2002.

### **Audiovisual Resources**

***Capitalism. Part 1, Adam Smith: The Birth of the Free Market.*** Ilan Ziv, dir. Brooklyn, NY: Icarus Films, 2015.

***Capitalism. Part 2, The Wealth of Nations: A New Gospel?*** Ilan Ziv, dir. Brooklyn, NY: Icarus Films, 2015.

***Capitalism. Part 3, Ricardo and Malthus: Did You Say Freedom?*** Ilan Ziv, dir. Brooklyn, NY: Icarus Films, 2015.

***Capitalism. Part 5, Keynes vs Hayek: A Fake Debate?*** Ilan Ziv, dir. Brooklyn, NY: Icarus Films, 2015.

***Commanding Heights: The Battle for the World Economy.*** William Cran, dir. Invision Productions Limited in association with Heights Productions and WGBH Boston. Boston: WGBH Boston Video, 2002. For related resources, see the website <http://www.pbs.org/wgbh/commandingheights/lo/index.html>.

***Free to Choose.*** A PBS TV series by Milton Friedman, originally broadcast in 1980. Watch the slightly updated 1990 versions of the episodes “The Power of the Market” (introduced by Arnold Schwarzenegger) and “The Tyranny of Control” (introduced by George Schultz) at <https://m.youtube.com/watch?v=Jlg2i9Z2rU4> and <https://m.youtube.com/watch?v=zHB8jkkfCfo>.

***Masters of Money.*** Three episodes on John Maynard Keynes, Friedrich Hayek, and Karl Marx. BBC Open University, 2012. “BBC economics editor Stephanie Flanders examines how three extraordinary thinkers, Keynes, Hayek and Marx, helped shape the 20th century” (BBC website).

### **Supplementary Materials**

**These supplementary discussions for Chapter 2 were written by Professor Ross Singleton and originally appeared in the 4<sup>th</sup> edition of this textbook. They are:**

- **“The Market Model”**
- **“Market-Based Resource Allocation”**
- **“Economic Efficiency”**
- **“Efficiency vs. Equity”**

### **The Market Model**

At the heart of the liberal perspective lies the market as the means of allocating scarce resources among competing uses. An appreciation of the market mechanism in this regard requires a basic understanding of the market as captured in the following market model. The market model consists of a demand model representing the consumers (buyers) and a supply model representing the producers (sellers).

The demand for a particular commodity (the willingness and ability of consumers to pay for the commodity) depends on the price of the commodity, the prices of related goods (substitutes and complements), the income of consumers, consumer tastes and preferences, the number of consumers, consumer expectations regarding future prices, and other considerations. The quantity of the commodity demanded increases when the price of the commodity decreases, holding other determinants of demand constant. This is depicted as a movement along the demand curve, from P1, Q1 to P2, Q2 in Figure 3–1. As the price of a commodity falls, consumers will substitute more of that commodity for other goods, which now cost relatively more. The inverse relationship between price and quantity demanded reflects the law of demand. So, the effect of a change in price is depicted by a movement along the demand curve. How about the effect of a change in any other determinant of demand? A change in any determinant of demand other than the price of the commodity itself will cause a shift of the entire demand curve. For instance, if consumer income increases, consumers will normally want to buy more of the commodity at each indicated price. Consequently, the entire demand curve shifts to Demand as in Figure 3–1. This is referred to as a change in demand—an increase in demand.

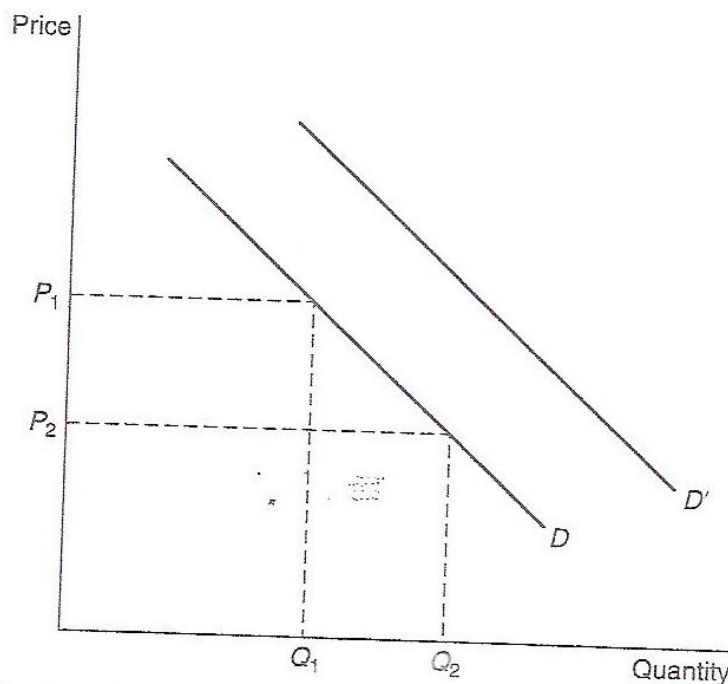


FIGURE 3-1

The supply of a particular commodity (the willingness and ability of producers to supply the commodity) depends on the price of the commodity, the prices of resources needed to produce the commodity, production technology, the number of producers, and other factors. The quantity of the commodity supplied increases when the price of the commodity increases, holding other determinants of supply constant. This is depicted as a movement along the supply curve, from  $P_1, Q_1$  to  $P_2, Q_2$  in Figure 3-2. The profit-maximizing response to a higher price is to expand production. The direct relationship between price and quantity supplied reflects the law of supply. A change in any determinant other than the price of the commodity itself will cause a shift of the entire supply curve. For instance, if the price of a resource needed to produce the commodity increases, producers will react by producing less of the commodity at each price. Consequently, the entire supply curve shifts to Supply as in Figure 3-2. This is referred to as a change in supply—a decrease in supply.

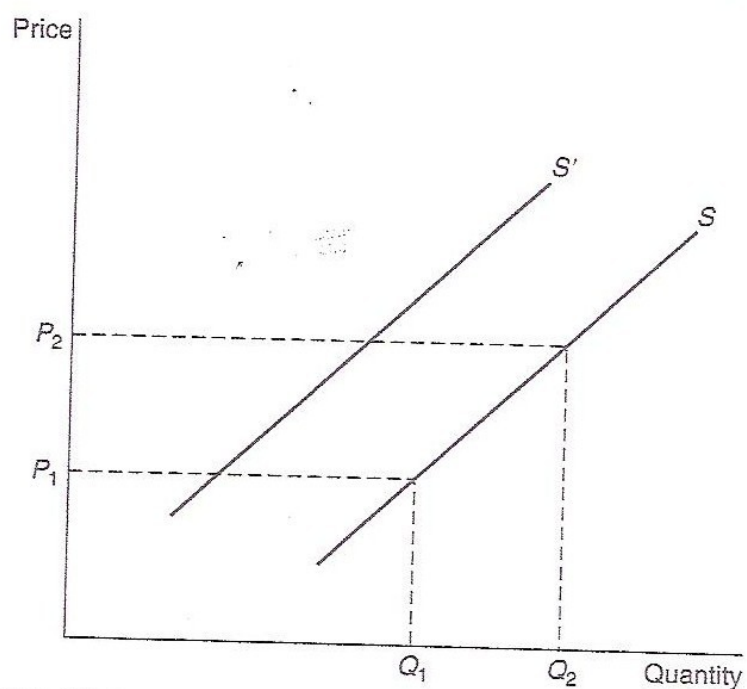


FIGURE 3-2

The market is in equilibrium at the price at which the quantity demanded and the quantity supplied are in balance. In Figure 3-3,  $P_1$  and  $Q_1$  are the equilibrium price and quantity, respectively.

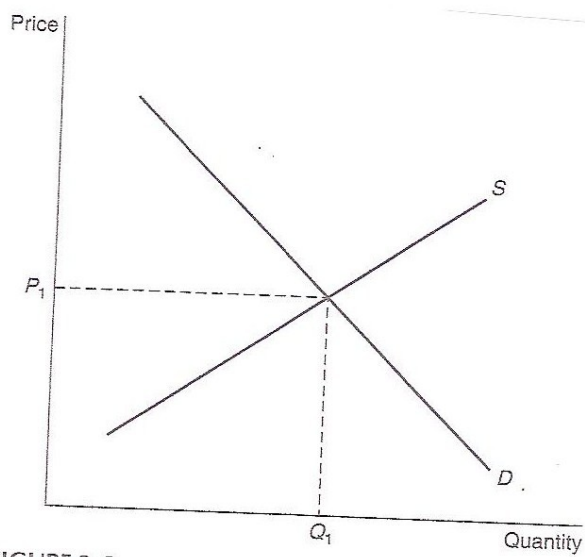


FIGURE 3-3

### Market-Based Resource Allocation

Using this simple model, we can now describe how resources are allocated and reallocated via the market. Assume that consumer tastes and preferences turn in favor of the particular commodity, the market for which is depicted in Figure 3–4. The demand for this commodity will increase. The demand curve will shift to the right to Demand. At price  $P_1$ , a shortage of the commodity ( $Q_3 - Q_1$ ) will be created as the quantity demanded exceeds the quantity supplied. The shortage in turn will cause the price of the commodity to rise, and as the price rises, consumers and producers will respond. Consumers will buy less of the commodity, moving up Demand from  $Q_3$  to  $Q_2$ . Consumers will conserve on their use of the commodity and/or buy relatively less expensive alternatives. Producers will respond by increasing production (moving up the supply curve from  $Q_1$  to  $Q_2$ ). Producers increase production (in order to maximize profit) by hiring more labor, purchasing more raw materials, using more energy—acquiring more resources necessary to produce this commodity.

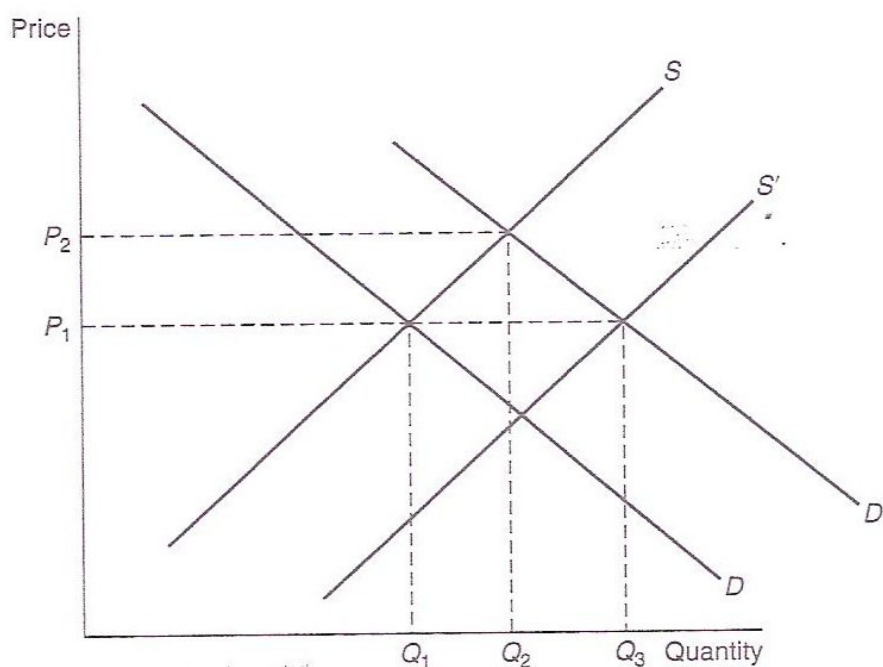


FIGURE 3–4

These resources will be bid away from other lesser-valued uses. Consequently, resources will be reallocated away from other uses and to this use in accordance with changing consumer tastes and preferences. No central agency or authority oversees this resource reallocation process; rather, this reallocation occurs in response to the incentives created by the higher price for the

commodity. That is, producers increase production in an effort to increase their profitability, not out of concern for the well-being of consumers and not because they have been directed to do so by a central planning authority. Yet the producer's self-interested behavior ultimately serves consumers, who are able to enjoy more of the commodity. In the long run, the profits made by producers in this market will attract entry by new producers into this industry. When those new firms enter (bringing resources with them), the supply of the commodity will expand to Supply and the price will eventually fall to  $P_1$  and the associated equilibrium quantity will expand to  $Q_3$ . In the long run, consumers will enjoy more of the product while paying only the original price. (Students of economics will recognize the implicit assumption that the market in question is a constant-cost market—a market in which entry has no effect on input prices.)

If, instead, consumers' tastes and preferences move away from a particular good, the demand for that good will decline—the demand curve will shift left. Consequently, there will be a surplus of the good at the original equilibrium price. This surplus in turn will cause the price to fall. As the price falls, producers will reduce production and will redeploy resources to other, more highly valued uses. In the long run, the lower price will mean economic losses, and firms will leave the industry (taking resources with them). Consequently, the supply of the commodity will decrease and the price will increase to the original level.

### Economic Efficiency

The concept of economic efficiency is central to the study of IPE. Public policies, and even entire economic systems, are evaluated based on their “efficiency.” But what does this term mean? It is a slippery term, in part, because of the various meanings implied or intended by its use. Efficiency may mean one thing to an economist, another to a sociologist, and something else again to a political theorist.

Economists’ conceptions of economic efficiency include allocative, production, and dynamic efficiency. Allocative efficiency concerns the allocation of scarce resources among competing uses—a fundamental task that every society must undertake in one way or another. We will use the market model we have developed to illustrate the concept of allocative efficiency in some detail in the following paragraphs. First, however, it is important to note, if only in passing, the additional meanings of this term as commonly used by economists. Production efficiency concerns how well resources are used in a particular use. How efficiently is steel produced? How efficiently are health care services delivered? When production efficiency exists, goods and services are produced at the lowest possible cost. Dynamic efficiency concerns the rate of technological progress in an industry or within an economy. Technological progress is, in large part, the result of investment in research and development (R&D). Dynamic efficiency exists when the current level of investment in R&D results in an optimal rate of technological progress. We will have more to say about dynamic efficiency in Chapter 10.

Resources are best allocated among various goods and services by the state (structural perspective) or by the market (liberal perspective) or by some combination of the two. Regardless of the mechanism, the goal is, presumably, to allocate scarce resources to their most highly valued uses in order to maximize social welfare.

Social welfare from the perspective of an economist has a very particular meaning. The social welfare that can be derived from a particular commodity (a good or service) is the total benefit derived from that commodity minus the total cost of producing that commodity. This idea of social welfare takes into account the dictum, “There is no such thing as a free lunch.” Social welfare is a measure of not only the benefit of using resources in a particular way but also the costs of doing so.

The allocation process using the market is decentralized in the extreme—no one is in charge. Rather, the interactions of individual consumers and producers as reflected in demand and supply result in an efficient allocation of resources (absent the many well-known causes of market failure, including monopoly, externalities, public goods, and information problems). Recall that the demand curve represents the prices that consumers are willing and able to pay for additional units of a commodity. Economic theory suggests, in turn, that the price a consumer is willing and able to pay for an additional unit of a commodity reflects the additional or marginal benefit the consumer anticipates from consuming that unit. The demand curve, then, is a marginal benefit curve. The supply curve reflects the prices at which producers are willing and able to supply the commodity. Economic theory demonstrates that these supply prices reflect the additional or marginal cost of producing each additional unit of output—the supply curve, then, is a marginal cost curve. When the market for a particular commodity is in equilibrium—demand equals

supply—the marginal benefit (MB) of the last unit produced exactly equals its marginal cost (MC), as in Figure 3–5 for commodity A.

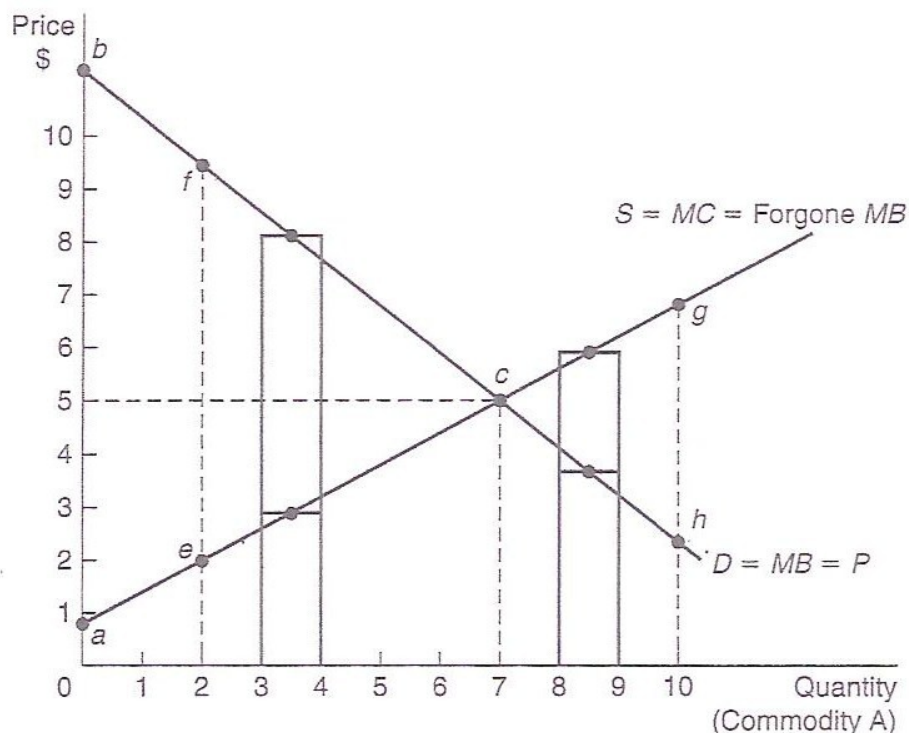


FIGURE 3–5

The significance of this outcome can best be appreciated if we consider the notion of opportunity cost. The opportunity cost of using resources in one use is the benefit foregone of not using those resources in their best alternative use. For example, the opportunity cost of reading this paragraph is the benefit you otherwise would have realized from using your time (a very scarce resource) in its best alternative use (perhaps watching a rerun of *Seinfeld*, or working on a cure for malaria). The marginal cost of producing an additional unit of commodity A, say, the fourth unit in Figure 3–5, is \$3. This implies that there is some other use for the resources necessary to produce this fourth unit of A that would yield a marginal benefit of \$3. Should resources be allocated to produce the fourth unit of A? Yes! The marginal benefit of the fourth unit is \$8. The foregone marginal benefit associated with the production of the fourth unit is \$3. Clearly, allocating resources to this use rather than their next best use is appropriate. Social welfare (benefit minus cost) will increase by \$5.

Producers acting from the profit motive will expand production (as long as price exceeds marginal cost) until marginal cost equals market price. Producers in this market will bid sufficient resources away from other uses to produce the equilibrium (and profit-maximizing) quantity of seven units. When the market is in equilibrium, every unit will be produced for which marginal benefit exceeds or (at equilibrium) just equals marginal cost. Area  $abc$  in Figure 3–5 represents the social welfare derived from this commodity. If fewer than seven units, say, two

units, were produced, a social welfare loss equal to the area  $efc$  would be incurred from the underallocation of resources to this commodity. For example, the marginal benefit of the fourth unit is \$8, and its marginal cost is \$3. If resources are not allocated to the production of this unit, \$5 in social welfare will be lost. If more than seven units are produced, say, ten units, a social welfare loss equal to  $cgh$  will be incurred from the overallocation of resources to this commodity. For example, the marginal cost of the ninth unit is \$6 and the marginal benefit is \$3.50. If resources are allocated to the production of this unit, a welfare loss of \$2.50 will be sustained. Resources should have instead been allocated to their best alternative use, where \$6 in marginal benefit would have been realized rather than the \$3.50 in marginal benefit realized by the production of the ninth unit.

The magic of the market is that the equilibrium level of output is also the social welfare—maximizing level of output. The market process, then, results in an efficient allocation of resources.

### Efficiency Versus Equity

The question remains: Is an efficient allocation of resources necessarily an equitable (fair) allocation of resources? In fact, the concept of allocative efficiency is based on a very particular (some might say peculiar) definition of social welfare. Recall that social welfare is defined as total benefit minus total costs. Further, marginal benefit is reflected in the price that consumers are willing and able to pay. Unless a consumer is both willing and able to pay, his or her preferences regarding the allocation of resources will not be reflected in the market. Consumers “vote” (on resource allocation) with their dollars. The more dollars any individual possesses, the more votes she can cast. The particular allocation of resources to the production of various goods and services, then, reflects a particular distribution of income. If income is redistributed, then a different efficient allocation of resources will be realized. The question that opens this paragraph can then be answered: An efficient allocation of resources is also an equitable allocation of resources if income is distributed in an equitable manner.

The next logical question is: What constitutes an equitable distribution of income? There is, of course, no easy answer to this question. However, we can contrast the liberal perspective and the structural perspective in this regard.

Those in tune with the liberal perspective tend to think in terms of market justice. Market justice implies that the income each member of society enjoys (and therefore the votes he can cast in the market) equals the contribution each member makes to national output. Brain surgeons are rich (and deserve to be) because they render services that are highly valued—they contribute substantially to national output. Star athletes or entertainers are ultrarich because they provide entertainment services that many consumers value very highly indeed (You paid how much for those Knicks tickets?). Entrepreneurs are sometimes spectacularly rich (and deserve to be) because of astonishing innovations they pioneer and bring to the market. On the other hand, those of us with more ordinary skills, talents, training, education, or creativity make more ordinary contributions to national output and deserve more ordinary incomes. The liberal dictum might be, “From each according to his ability and to each according to his ability.”

Market justice also means that those of us who might be disadvantaged regarding our ability to contribute to national output due to circumstances beyond our control (physical or mental disability, born to a drug-addicted single mom, discriminated against in the workplace based on race or religion, etc.) will earn very little income and therefore have little access to the goods and services produced within our own economy. We will be on the outside looking in. There are, of course, ways of taking the hard edges off market justice—income supplements to the poor or, better yet, enhancing economic opportunity via training, education, and public works programs, for instance. Perhaps this is what President George H. W. Bush meant by “compassionate conservatism.”

While market justice can be harsh, it does undeniably create strong incentives to be productive. By establishing a direct link between effort and reward, individuals are rewarded for their hard work, their investment, their creativity, their drive, their dependability, their adaptability, and their willingness to take risks. Margaret Thatcher, the British Prime Minister who instituted liberal reforms in Great Britain, in effect argued that market justice would promote the “vigorous virtues” of individual initiative, deferral of gratification, personal responsibility, independence,

and entrepreneurship. Attending to the needs of the poor is recognized, then, as something of a balancing act. Providing government income or housing or other supplements dulls incentives and undermines the “vigorous virtues” by severing the link between effort and reward.

Against the liberal notion of market justice stands the ideal of distributive justice as associated with structuralism. The essence of distributive justice is captured in Karl Marx’s dictum, “From each according to his ability and to each according to his need.” In a society that really adheres to the principle of distributive justice, income is determined by the needs of the various members of society. A worker who supports a large family receives more income than an unmarried worker. Both workers, however, contribute to national output based on their individual capabilities. An unmarried brain surgeon works long hours for relatively little pay, knowing that her services benefit the members of her community. The father of a large family works long hours in the steel mill, knowing his services benefit the members of his community and confident that his remuneration will be sufficient to provide for his family.

Or ...does the would-be brain surgeon choose not to undertake the arduous years of necessary training, knowing that her efforts will not lead to commensurate monetary rewards? Does the mill worker fail to show up on Mondays and Fridays? Does the entrepreneur bother to innovate? Who invests? In other words, what about incentive? Also, how is relative need assessed, and by whom? The state? Who controls the state apparatus? Won’t these interests have unchecked power? Won’t growing dependency on the state wither the “vigorous virtues” and undermine the dynamism of the economy? Asking these obvious questions reveals some of the concerns about distributive justice that have been voiced by liberal critics. Nevertheless, the appeal of distributive justice is undeniable. It is a dream that has driven revolutions.