



illustration for
Ayn Rand,
*Atlas
Shrugged*

Intellectual Foundations of Market Liberalism

© Avner Offer, Oxford 2010

<http://images.google.co.uk/imgres?imgurl=http://www.mindspring.com/~tgordo/atlasshr.jpg&imgrefurl=http://www.mindspring.com/~tgordo/&h=798&w=592&sz=206&tbnid=zqSGJwJvYkorpM:&tbnh=142&tbnw=105&hl=en&start=8&prev=/images%3Fq%3Datlas%2Bshrugged%26svnum%3D10%26hl%3Den%26lr%3D%26client%3Dfirefox-a%26rls%3Dorg.mozilla:en-US:official%26sa%3DN>

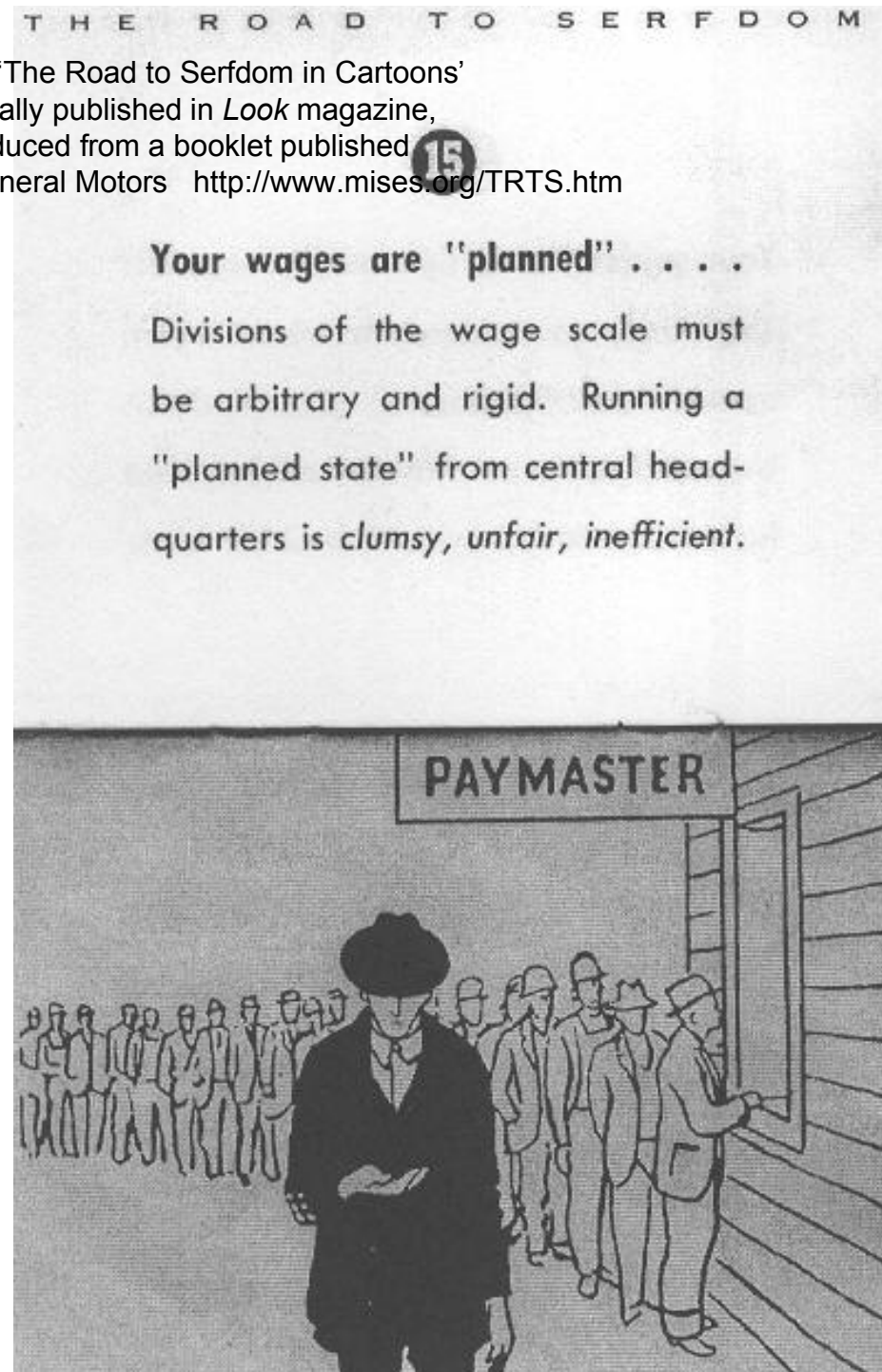
Market Liberal theory

- Hayek, Mises, Mont Pelerin: Freedom and Order
- Public Choice: Downs, Buchanan, Stigler, Olson, Niskanen, Krueger
- Friedman: monetarism
- Fama et al: Finance and efficient markets
- Lucas: Rational expectations, New Macro
- Wanniski Supply-side theory
- Prescott: Real business cycles

Friedrich Hayek, *The Road to Serfdom* (1944)

‘But there are two kinds of security: the certainty of a given minimum of sustenance for all and the security of a given standard of life, of the relative position which one person or group enjoys compared with others. There is no reason why, in a society which has reached the general level of wealth ours has, the first kind of security should not be guaranteed to all without endangering general freedom; that is: some minimum of food, shelter and clothing, sufficient to preserve health. Nor is there any reason why the state should not help to organize a comprehensive system of social insurance in providing for those common hazards of life against which few can make adequate provision. It is planning for security of the second kind which has such an insidious effect on liberty. It is planning designed to protect individuals or groups against diminutions of their incomes.’

From ‘The Road to Serfdom in Cartoons’
Originally published in *Look* magazine,
reproduced from a booklet published
by General Motors <http://www.mises.org/TRTS.htm>



Mandarins: governance by virtue

- a. Mandarins: Wise and benign. Platonic guardians.
- b. Politicians: elected democratically to pursue voter interests.
E.g. 'full employment commitment' at end of WW2.
- c. Civil servants. Selected by merit. Impartiality. Professional ethics. Northcote-Trevelyan principles. Weberian rationality. Competent implementators.
- d. Social-scientists: devoted to dispassionate inquiry, pursuing the truth wherever it leads.
 - 1. Positive rather than normative.
 - 2. Marshallian/Pigovian utilitarianism.
 - 3. Keynes and 'fine-tuning', in the public interest.
 - 4. **Monitoring economic aggregates.**
- e. Authority founded on virtue.

Keynesian IS-LM model

managing aggregates

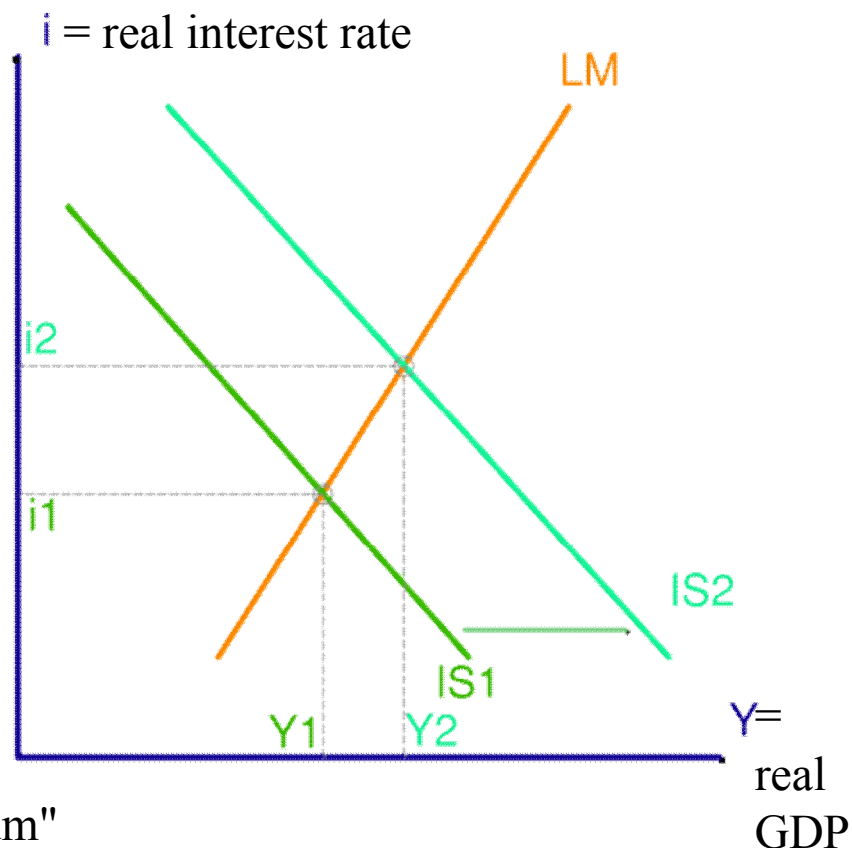
IS – investment/saving (total spending= Y)
[equilibria of real (non-financial) economy;
savings=investment] Link from falling
Interest rates to rising investment & output]

The **LM** schedule is an upward-sloping curve representing the role of finance and money.

The initials **LM** stand for

"**L**iquidity preference/**M**oney supply equilibrium"

but is easier to understand as the equilibrium of the demand to hold money as an asset and the supply of [money](#) by banks and the [central bank](#). The interest rate is determined along this line for each level of real GDP. Rising GDP (Y) implies an increased transactions demand for money and [liquidity preference](#). With a given and inelastic money supply curve, the equilibrium interest rate (i) rises. This explains the upward slope of the **LM** curve.



Intersection is short-run equilibrium of money and real sectors. Both interest rate and ⁶ GDP are determined.

Rational choice: A set of norms?

- a. Rationalism. Axiomatic/deductive rather than empirical.
- b. Methodological Individualism. Self-interest. Strategic behaviour. 'Opportunism with guile'
- c. Mathematical abstraction, rigour and modelling. Maximising.
- d. Agent/actor is omniscient.
- e. Micro and macro optimality. Invisible hand.
- f. 'Value-freedom'? Universalism. Positivism?
- g. Currency is 'preferences'; ordinal rankings.
- h. Science or ideology?
- i. Is it falsifiable?

'the characteristic premises grounding rational choice: individualism, universalism, objectivity, and rationality.'

'Rational choice liberalism, as the nonnormative, nonideological search for an institutional framework that respects individual liberty and coordinates individuals' self-interested ends, is a vibrant contribution to the two-centuries-long experiment with democracy and capitalism' [Amadae, 2003, p. 14]

- g. [Lakatos?]

New Classical Macroeconomics: ‘The five neutralities’ [Akerlof, 2007]

- The independence of consumption and current income (Friedman/Modigliani the life-cycle/permanent income hypothesis)
- the irrelevance of current profits to investment spending (the Modigliani-Miller theorem)
- the long-run independence of inflation and unemployment (Friedman’s natural rate theory)
- the inability of monetary policy to stabilize output (Lucas-Sargent Rational Expectations hypothesis)
- the irrelevance of taxes and budget deficits to consumption (Barro’s Ricardian equivalence)

The quest for ‘microfoundations’

- Keynesian macroeconomics manipulate aggregates. Not motivated by individual preferences.
- Orthodox, subtle, superficially compelling. Accepted even by Keynesians. Suspend judgment. ‘Maybe they are right?’
- But difficult to justify and apply.
- Reductionist. Why don’t we have just one science?
- Molecular biology does not explain animal behaviour.
- NCM does not genuinely scale up from individual behaviour, but assumes that population is a single actor, i.e. models behaviour of ‘representative agent’.
- ‘Neutrality conditions only apply in case of hypothetical single omniscient (multi-generational) rational actor’.
- Counter-intuitive.
- Alternative is ‘emergent properties’:
‘an emergent property of a system, in this context, is one that is not a property of any component of that system, but is still a feature of the system as a whole.’ [Wikipedia]

The Ricardian Vice

‘...[Ricardo] piled one simplifying assumption upon another until, having really settled Everything by these assumptions, he was left with only a few aggregative variables between which, given these assumptions, he set up simple one-way relations, so that, in the end, the desired results emerged almost as tautologies... [example of theory that profits depend on price of wheat] ... It is an excellent theory that can never be refuted and lacks nothing save sense. The habit of applying results of this character to the solution of Practical problems we shall call the Ricardian Vice.’

[Joseph Schumpeter, *History of Economic Analysis* (1954), p. 473]

[deductive reasoning – everything is in the premises]

Dependence of consumption on wealth, not income

Standard theory tells us that under only somewhat special conditions, consumption depends on *wealth*, which is the value of current assets plus the discounted value of future earnings. Thus there is no tendency for people to make their expenditures conform to the pattern of their income receipts (as long as their wealth is given). Changes in the pattern of current income that leave overall wealth constant are *neutral* in their effects on current consumption.

See Friedman (1957) and Modigliani and Brumberg (1954).

The Modigliani-Miller Theorem

One version of the Modigliani-Miller theorem says that a firm's investment strategy is totally independent of its liquidity position. Thus, for example, a corporation with an unexpected windfall will not spend any additional investment dollars. Instead it will pass the windfall on to shareholders or seek other financial investments, since it will only make investments whose risk-adjusted rate of return exceeds the rate of return on capital. Changes in the firm's finances will thus be *neutral* in their effect on current investment.

See Modigliani and Miller (1958).

Natural Rate Theory

According to Natural Rate Theory there is some *single* rate of unemployment that is the only level that could be permanently maintained without ever-increasing inflation or ever-increasing deflation. A fiscal/monetary policy mix that sought to maintain employment that was any higher would result in *permanently increasing* inflation. A fiscal/monetary mix that sought to maintain employment that was any lower would result in *permanently decreasing* inflation. Fiscal/monetary mixes that yield different levels of long-term (steady) inflation will thus be *neutral* in their effects on long-term unemployment. See Phelps (1968) and Friedman (1968).

Rational Expectations

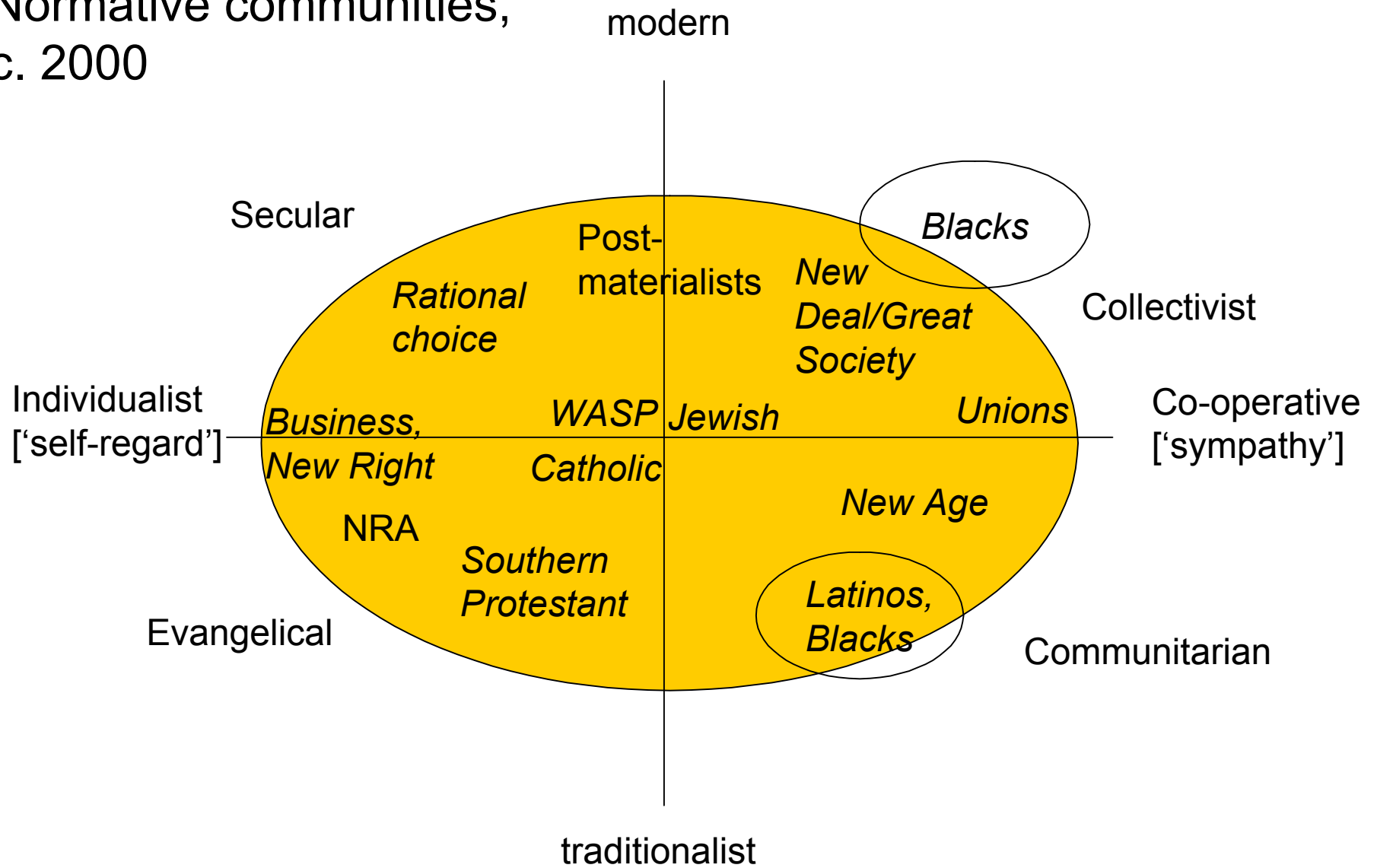
According to Rational Expectations Theory a systematic response of monetary policy to the business cycle will have no effect on the stability of the macroeconomy. Wage and price setters will foresee the systematic component of the money supply; they will raise or lower prices and wages exactly proportionally, and thereby neutralize its effect on demand. The stability of the economy is thus *neutral* with respect to the systematic reaction of monetary policy to the business cycle. See Lucas (1972), Sargent (1973) and Lucas and Sargent (1979).

Ricardian equivalence

According to Ricardian equivalence, under somewhat special conditions, a representative consumer who receives a lump-sum intergenerational transfer (for example, in the form of a social security payment) will not spend a single dime extra. Instead she will pass on the whole extra income, dollar-for-dollar, to her heirs, who will have to pay the higher tax bills necessary to retire the increased debt incurred in funding the transfer to the previous generation. The transfer is *neutral* in its effect on current consumption. See Barro (1974) for the modern reincarnation of these ideas, first discovered by Ricardo.

USA

Normative communities,
c. 2000



Rational Choice vs. the Welfare State

- a. Source of entitlement:
 - 1. Market power [but assumption of perfect competition]
 - a) No market power, no entitlement. E.g. housewives, children, disabled, unemployed. [male theory?]
- b. Indifferent to initial endowment, and to bequest.
 - c) Indifferent to inequality, fairness.
 - d) Implicit assumption of strong property rights.
 - e) Implicit assumption of legal transparency and state enforcement. [explicit 'rules of the game']
- c. No transaction costs.
 - 1. Markets clear.
- c. No intertemporal allocation, contracting problem. Markets available for all time periods. Measure of value is net present value. Future defined away by means of exponential discounting.
- d. No common good. Impossibility theorem. 'No such thing as society'.
- e. Pareto optimality as macro rule; Hicks-Kaldor compensation rule.

Reminder: alternative sources of entitlement

1. Humanity [need]
2. Citizenship.
3. Equality.
4. Fairness/Justice.
5. Compassion.
6. Luck.
7. Divine right.
8. Ethnicity
9. Etc.?

How congruent with Cold War?

- a. What was Cold War about?
 - 1. Socialism claims to represent labour against capital.
(blurring distinction btwn socialism and communism). Anti-Marxism.
 - 2. Useful in domestic class struggle as well. Diversion?
 - a) Unions.
 - b) Blacks.
 - c) Women.
 - d) Jews?
 - e) Welfare?
 - 3. Problem for New Deal Liberals.
 - 4. Need to be seen to be 'tough' on communism externally, not socialist domestically.
- b. Paradox: intensely individualistic doctrine mobilized to defend the community.
- c. Rational Choice and quest for efficiency: mobilizing comparative advantage.
'Thinking the unthinkable'.
- d. **Timing of shift:** 1970s: Collapse of 'Keynsian' 'golden age'. Contemporary with other drastic shifts of the 1970s. Any connection? – New Deal discredited by crises of Great Society, Vietnam, Bretton Woods, 1970s inflation and slowdown.
- e. Creates re-opening for market theory.

Conservative theory of the state

- a. Challenge of Socialism, and planning debate.
- b. Hayek. 'Spontaneous order'. vs. 'Road to Serfdom'.
- c. Role of RAND. Develops basic analytical package. Spur to axioms of rationality. [Savage] Also discover prisoner's dilemma. Develop game theory.
 - 1. Core is 'rational choice'.
 - 2. Attempt to use USA resources efficiently in cold war.
 - 3. Curiously, some roots on socialist side. Not anti-capitalist. Liberals.
 - 4. Highly rationalistic, individualistic, efficiency-oriented, strategic.
- d. Downs, public choice movement.
 - 1. Argument that state power illegitimate. 'Leviathan' -- Buchanan and Tullock.
 - 2. Becker -- deadweight loss of taxation.
- e. Niskanen – bureaucracy and rent-seeking.
- f. Stigler and regulatory capture.
- g. Privileges/justifies self-interest.
- h. Undermines Mandarin claims.
- i. 'Supply siders': advocate and achieve deep tax cuts.

New Classical Macroeconomics: Market alternative to Keynes

- a. Challenge to Keynesians.
 - 1. Vulnerable: shared premises and method.
 - 2. Compels belief: Why?
 - 3. 'Maybe they are right?'
- b. Monetarism.
- c. Rational Expectations.
- d. Real business cycles
- e. Were NCM mandarins?
 - 1. Yes.
 - a) Esoteric language.
 - b) Pursuit of the truth.
 - c) Disinterested?
 - d) Paradox: mandarin [disinterested] authority legitimizes extreme self-interest.
- f. New Keynesian challenge based on imperfections of actors and markets.

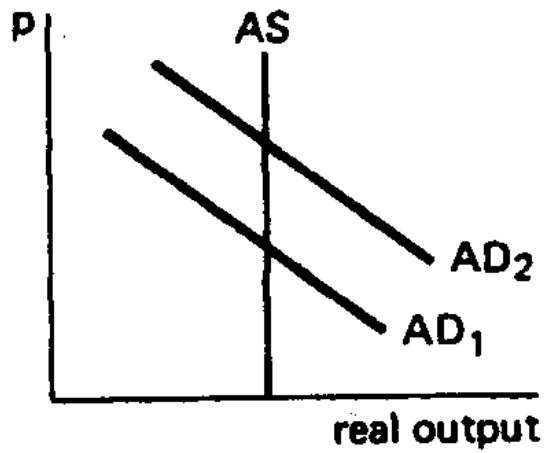
Nobel Memorial Prize in Economics

1969	Ragnar Frisch, Jan Tinbergen	1990	Harry M. Markowitz, Merton H. Miller, William F. Sharpe
1970	Paul A. Samuelson	1991	Ronald H. Coase
1971	Simon Kuznets	1992	Gary S. Becker
1972	John R. Hicks, Kenneth J. Arrow	1993	Robert W. Fogel, Douglass C. North
1973	Wassily Leontief	1994	John C. Harsanyi, John F. Nash Jr., Reinhard Selten
1974	Gunnar Myrdal, Friedrich August von Hayek	1995	Robert E. Lucas Jr.
1975	Leonid Vitaliyevich Kantorovich, Tjalling C. Koopmans	1996	James A. Mirrlees, William Vickrey
1976	Milton Friedman	1997	Robert C. Merton, Myron S. Scholes
1977	Bertil Ohlin, James E. Meade	1998	Amartya Sen
1978	Herbert A. Simon	1999	Robert A. Mundell
1979	Theodore W. Schultz, Sir Arthur Lewis	2000	James J. Heckman, Daniel L. McFadden
1980	Lawrence R. Klein	2001	George A. Akerlof, A. Michael Spence, Joseph E. Stiglitz
1981	James Tobin	2002	Daniel Kahneman, Vernon L. Smith
1982	George J. Stigler	2003	Robert F. Engle III, Clive W.J. Granger
1983	Gerard Debreu	2004	Finn E. Kydland, Edward C. Prescott
1984	Richard Stone	2005	Robert J. Aumann, Thomas C. Schelling
1985	Franco Modigliani	2006	Edmund S. Phelps
1986	James M. Buchanan Jr.	2007	Leonid Hurwicz, Eric S. Maskin, Roger B. Myerson
1987	Robert M. Solow	2008	Paul Krugman
1988	Maurice Allais	2009	Elinor Ostrom, Oliver E. Williamson
1989	Trygve Haavelmo		20

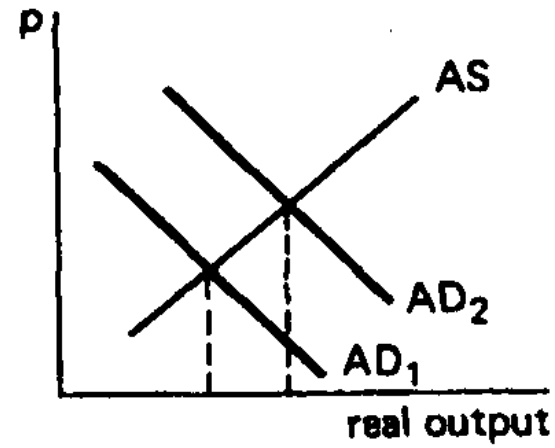
Challenges to Rational Choice?

- Demise of New Classical Macroeconomics
- Asymmetric information
- Failure of Monetarism
- Recovery of New Keynesianism
- New Institutional Economics [works both ways]
- Ambiguity of privatisation/deregulation record
- Rising inequality
- Bounded rationality
- Behavioural economics – economics of fairness
- Game theory [‘folk theorem’]
- Anti-globalisation
- ‘Well-being’ research
- Russian marketisation experience
- Crisis of neo-liberalism
- Persistence of welfare state
- Ambiguity of ‘structural adjustment’ development programmes.
- Anti-globalisation movement
- Climate change
- Etc.

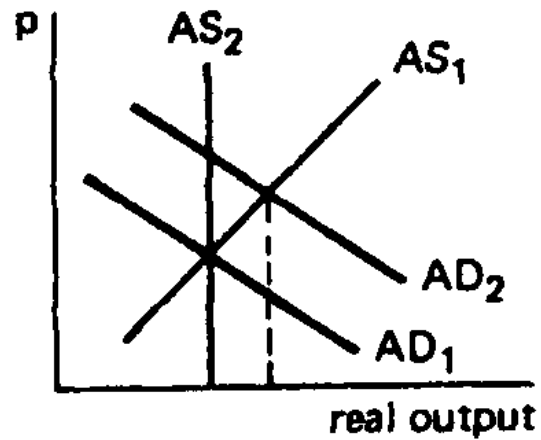
All treat Rational Choice as hegemonic conventional wisdom



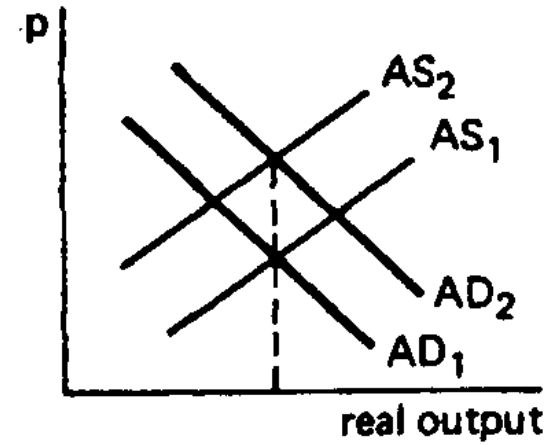
I Classical



II Neo-Keynesian



III Monetarist



IV New Classical

Klamer, 1984, p. 17

AD = Aggregate demand
AS = Aggregate supply

Ethics as an ‘omitted variable’

- Bad theory begets bad policy
- Concept from Social-psychology: “Just-World Theories”
- Everyone gets what they deserve
 - E.g. Counter-reformation and Inquisition. Burn heretics at the stake – that’s what they deserve.
 - Bolshevism
 - Rawls
 - Neo-classical economics
- Classic Liberalism (e.g. Milton Friedman) also a “Just-World Theory”
- Privileges “freedom”, takes difference in initial endowments as irrelevant.
- One of Sen’s innovations is to query this neglect of initial endowments

How do we criticise a just-world theory?

- Ethical problem: Impossible to agree on nature of the good
- Perhaps agree on avoiding the bad?
- A parsimonious criterion: do not cause *unwarranted* pain or death
- Hard to disagree with. Focus is on the warrant.
- Evaluate the warrant for death or pain by ethical criterion. Moral intuitions? Impartial spectator?
- Criterion does a lot with a little. Not only in ethics, but also in economics.

Apply to American health care

- Medical ethic: 'Do no harm'. Duty of care on provider
- Market-liberal ethic: 'Caveat emptor': Duty of care on recipient.
- Asymmetry of knowledge. Gives Medics market power. [both professionals and insurers]
- Tolerable/justified in view of their avowed duty of care.
- But professional ethical codes are in conflict with market liberalism. See as restraints on trade.
- 1975. Supreme Court removes professional anti-trust immunity [*Goldfarb vs. Virginia State Bar*]

Consequences:

- Ethical constraints removed, but market power is not.
- Market power of Medics has driven up costs to the point of macro-economic disorder.
- Exclusion from medical markets inflicts pain and death.
- Warranted by market-liberal doctrine of 'freedom'.
- Current USA health-care reform driven by ethical revulsion at market exclusion.
- But fails to address issue market power.
- Demonstration of how ethical neglect can lead to bad policies. Not only health.
- Banking: neglect of fiduciary duty
- Not only on in USA.
- [New Labour disability reforms transfers decisions on pain and death from professionals with an ethical commitment.
- To market contractors, whose only incentive is to make money]