

Liberalism

I. Three Theories and Three Questions

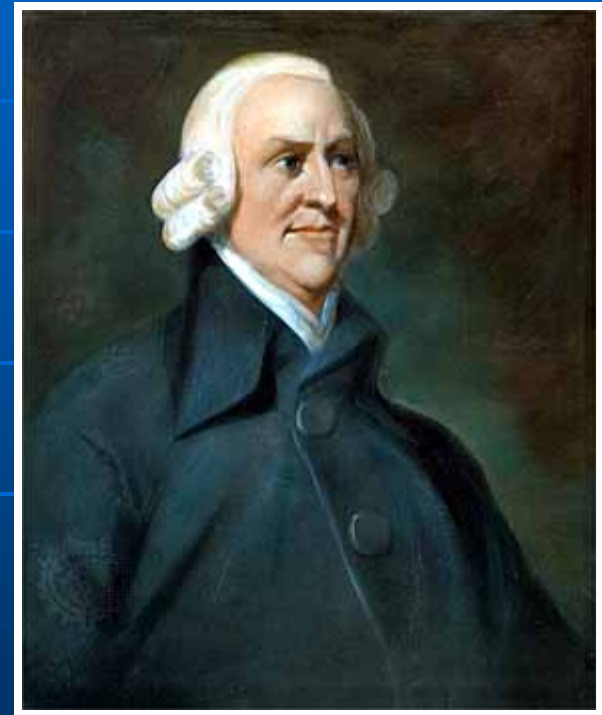
II. Liberalism

A. Three Questions

B. Policy Implications

III. Variants

IV. Strengths and Weaknesses



Adam Smith

Three Theories

- Liberalism (Laissez-faire)
- Mercantilism (Economic Nationalism)
- Structuralism (Marxism)

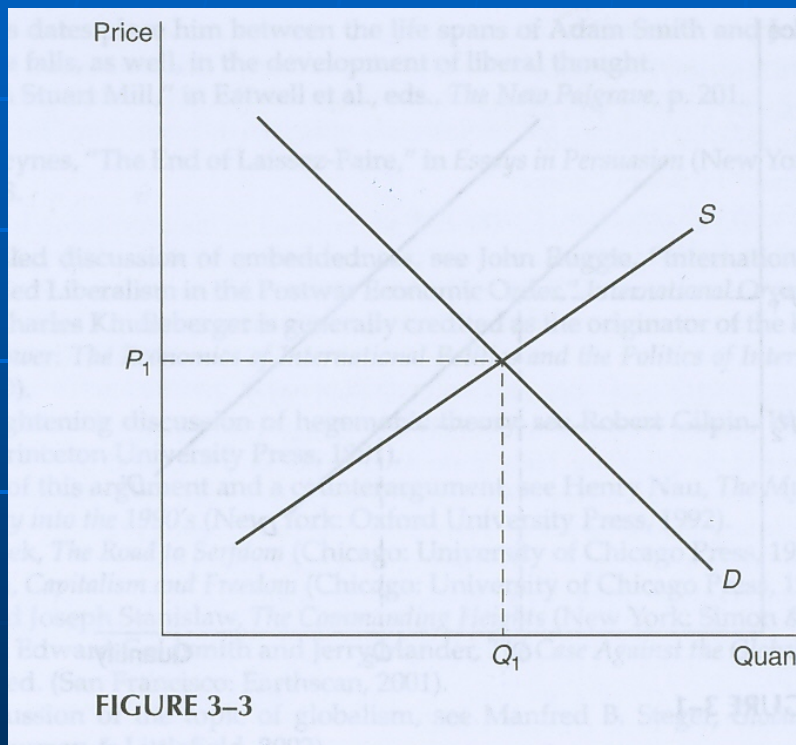
Three Questions

- How does the economy work?
 - *FUNCTION*
- What is the economy for?
 - *PURPOSE*
- 3. What is the relationship between politics and economics?
 - *STATE-MARKET NEXUS*

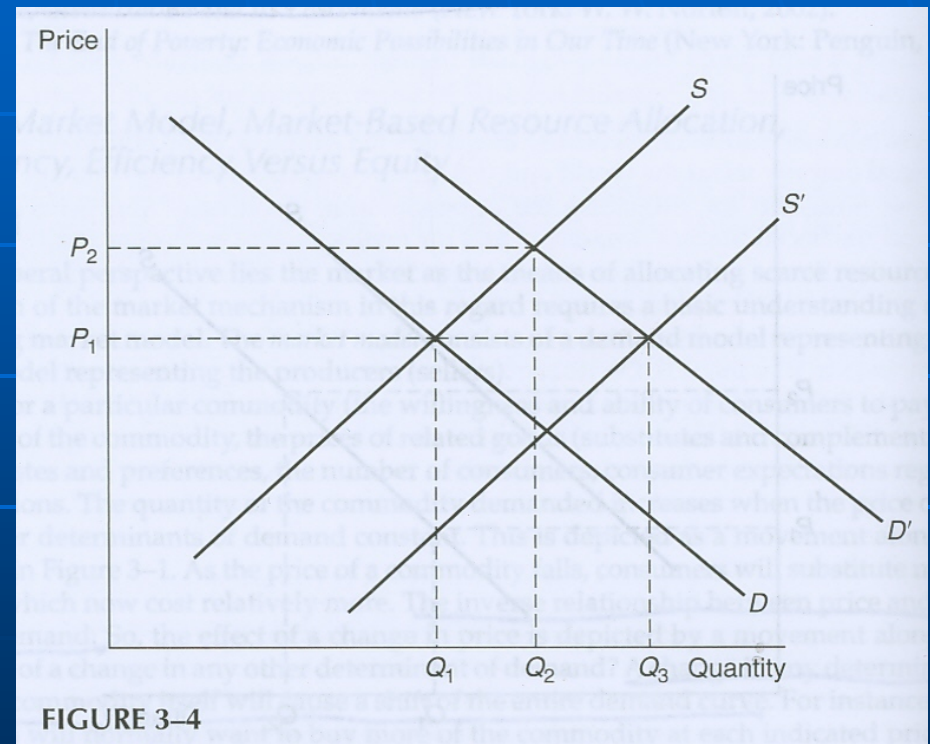
Liberalism: How does the economy work?

- Crucial role of **MARKETS** in the economy.
- Markets use **PRICES** to connect buyers to sellers
- Cumulated across whole economy, means resources put to best use
- If rely on markets, get higher economic growth (because of more efficient use of resources).

The Basic Market Model



Supply and Demand
(Relationships between
prices and quantities)



Shifts in Supply and
Demand Curves

Liberalism: How does the economy work?

- Market behavior motivated by individual self-interest
 - *“It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from regard to their own interest.”* (Adam Smith)
- Liberals see the collective interest as being best served by the free exercise of individual self interest (tempered by competition)
- The “Invisible Hand”

Liberalism: What is the economy for?

- Improve the economic condition of PRIVATE ACTORS (individuals, firms, entrepreneurs)
- Best achieved by increasing OVERALL growth (Bigger 'economic pie')
- Less concerned with distribution of wealth
 - Market justice v. distributive justice
- Poor best served by a strong economy

Liberalism: What is the relationship between politics and economics?

- Market decisions more effective than political decisions (government failure)
- Laissez-faire, laissez-passer (“let be, let pass”)
 - “State which governs least governs best”
- Government sets ‘rules of the game’ (i.e., competition policy) and serves as a referee (i.e., antitrust enforcement)
- Direct intervention **ONLY** with:
 - public goods (indivisible and inexcludable)
 - (*clear*) market failure : when markets fail to bring about socially desirable outcomes
 - EX: Basic (non-patentable) research

Liberalism: Assumptions

- Economic Rationality (*homo economicus*)
- Markets as Information Mechanisms
 - Prices as “Complete Information”
- Laws of Supply/Demand Determine Outcomes
- Harmony of Interests (“Positive-Sum Game”)

Liberalism: Policy Implications

DOMESTIC

- Limited government role in economy (provide public goods)
 - ‘Creative Destruction’ (Joseph Schumpeter)
- Uphold competitive markets (i.e., antitrust laws)

INTERNATIONAL

- Free Trade
- Free Flows of Capital
- Open Economies

Liberalism: Three Answers

1. How does the economy work?

- MARKETS guided by PRICES increase economic efficiency

2. What is the economy for?

- To increase INDIVIDUALS' economic well-being

3. What is the relationship between politics and economics?

- The two realms are/should be SEPARATE

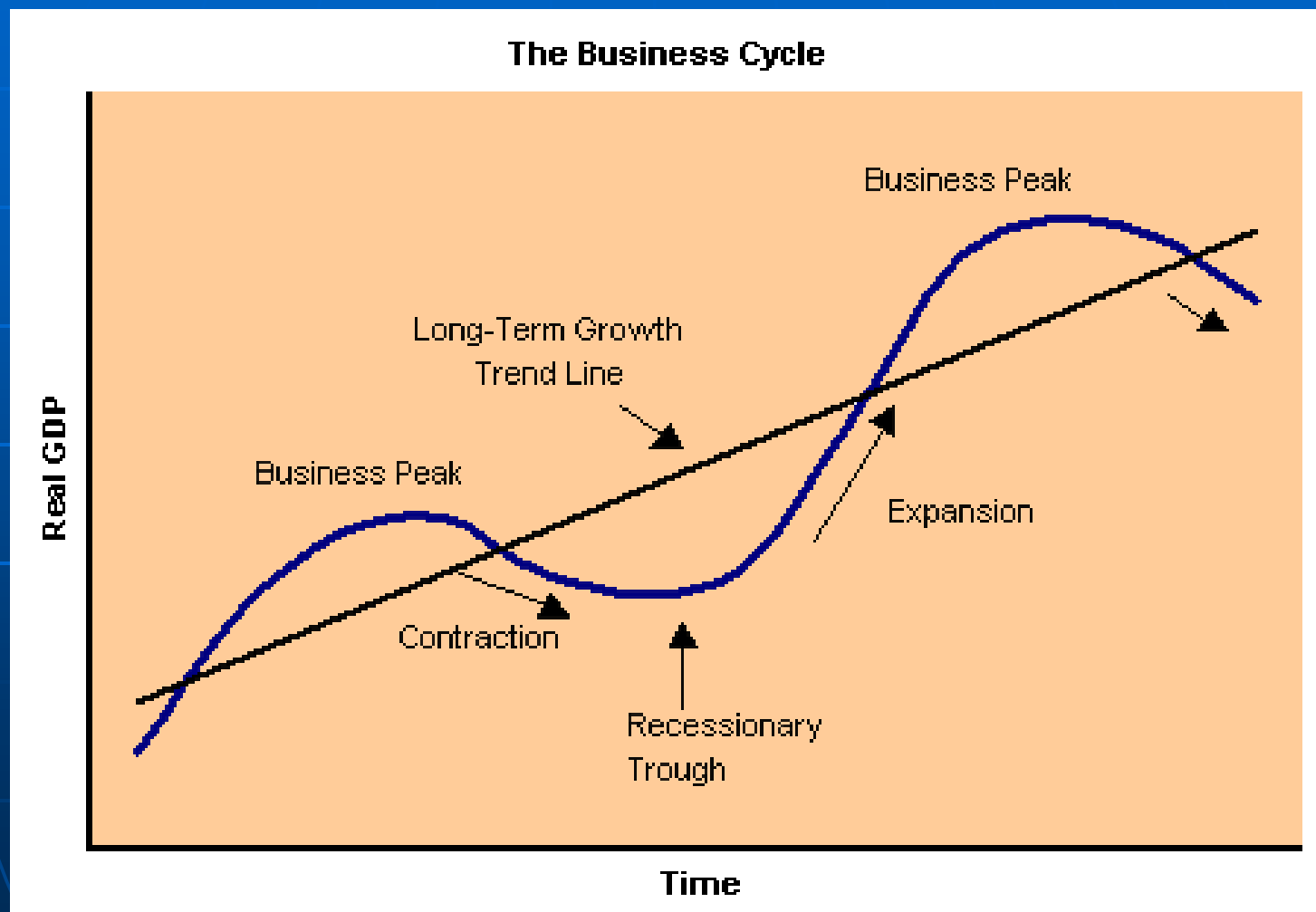
IF governments don't interfere → increased economic growth →
increased wealth → increased personal well-being

Markets allow EVERYONE to WIN!!!

Liberalism: Variants

- Orthodox Liberalism
 - Laissez-Faire
- Interventionist Liberalism (Keynesianism)
 - Developed by John Maynard Keynes
 - Countercyclical Demand Management
- International Liberalism (Hegemonic Stability)
 - International Public Goods
 - Free Rider Problem
- Ordoliberalism (social market economies)

The Business Cycle



Liberalism: Strengths

- Logical Connection from Individual Interest to Collective Behavior
- Strong Historical Evidence
- Clear Guide to Policy-Makers
- Maximizes Personal Freedom

Liberalism: Weaknesses

- Circular Logic Regarding Optimal Outcomes
- Favors Efficiency over Equity (or other values)
- Assumes a Level Playing Field
- Role of the State
- Free Markets and the Crash