Liberalism

I. Three Theories and Three Questions

II. Liberalism
   A. Three Questions
   B. Policy Implications

III. Variants

IV. Strengths and Weaknesses
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

**FIGURE 3–3**
Supply and Demand
(*Relationships* between prices and quantities)

**FIGURE 3–4**
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)
  - (clean) 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

- Business Peak
- Long-Term Growth Trend Line
- Contraction
- Expansion
- Recessionary Trough
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