

Lecture 9

Emergence of Neo-Liberal Ideology: Keynes, Hayek and Friedman

Reading: Keynes, von Hayek, the Friedmans

Topics

- What is Neo-Liberalism?
- The 1929 Stock Market Crash and the Great Depression
- More on *The General Theory*
- Von Hayek and The Struggle Against Collectivism
- Milton and Rose Friedman: *Free to Choose*
- Reagan, Thatcher and the WTO

What is Neo-Liberalism? (see RTWT, p.120-3)

- Neo-liberalism is an economic philosophy claiming that self-regulated 'free markets' are the most efficient approach to solving economic and social problems confronting modern society
 - Governments should minimize interference with markets by removing protectionist barriers to trade, privatizing government owned enterprises and liberalizing the movement of capital between countries
 - As an academic reference, neo-liberal connects to the 'free market' principles of neo-classical economics → opposed to the interventionist approach of Keynesian economics
 - The commutative justice ideology of neo-liberalism also facilitates the emergence of an elite capitalist class

The Philosophical Debate: (Neo-liberal) Commutative Justice vs. (Socialist) Distributive Justice

- Principles of **distributive justice** provide moral guidance for the political processes that affect **the distribution of benefits and burdens in societies**. Principles which offer moral guidance on distribution can be considered principles of distributive justice. (Stanford Encycl. of Phil.)
- **Commutative justice** deals with **fairness in exchange of goods** and fair participation for buyers and sellers in the system of exchanging goods for payment. Theories of commutative justice articulate the processes and social relationships that provide buyers and sellers with fair participation in the exchanges of goods for payment.

Neo-liberals emphasize concerns of commutative justice.

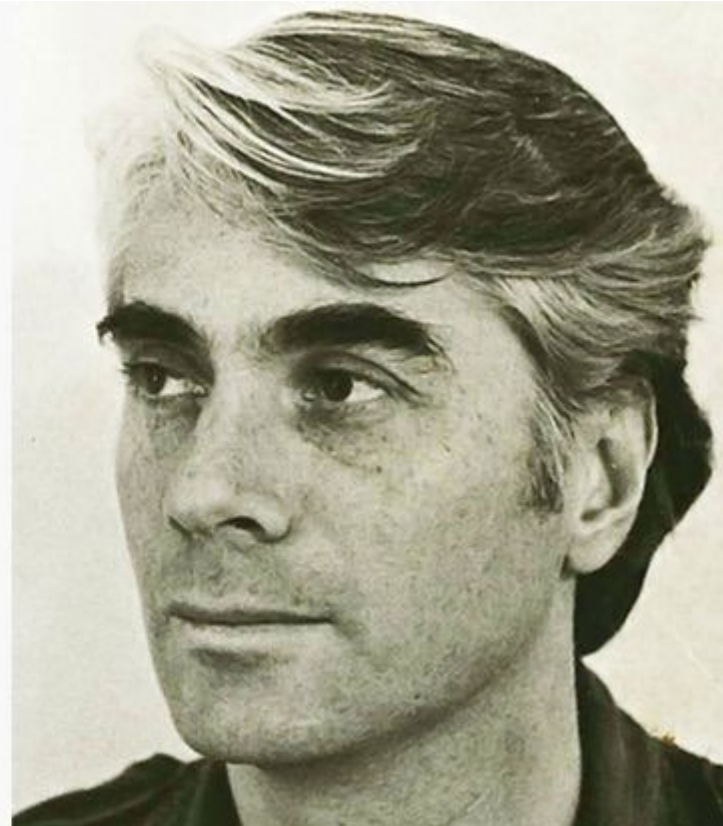
(Example: Theft of bread by a starving person violates the property rights inherent in commutative justice but may not violate distributive justice)



Robert Nozick (1938-2002), chaired Harvard philosophy professor. *Anarchy, State and Utopia* (1974) details the commutative justice response to the distributive justice of John Rawls, *A Theory of Justice* (1971).

Individuals have rights and there are things no person or group may do to them (without violating their rights). So strong and far-reaching are these rights that they raise the question of what, if anything, the state and its officials may do. How much room do individual rights leave for the state?

Robert Nozick



The Working-out of Neo-liberalism

- The globalization of neo-liberalism has produced a competition-driven cost reducing trend toward shifting output to lower wage locales with weaker environmental, consumer product and job-safety regulations
- In higher wage locales, neo-liberalism has facilitated erosion of labour union power and restriction on collective bargaining
- Neo-liberalism has also facilitated lowering of effective tax rates on capital income and increasing inequality in wealth and income.

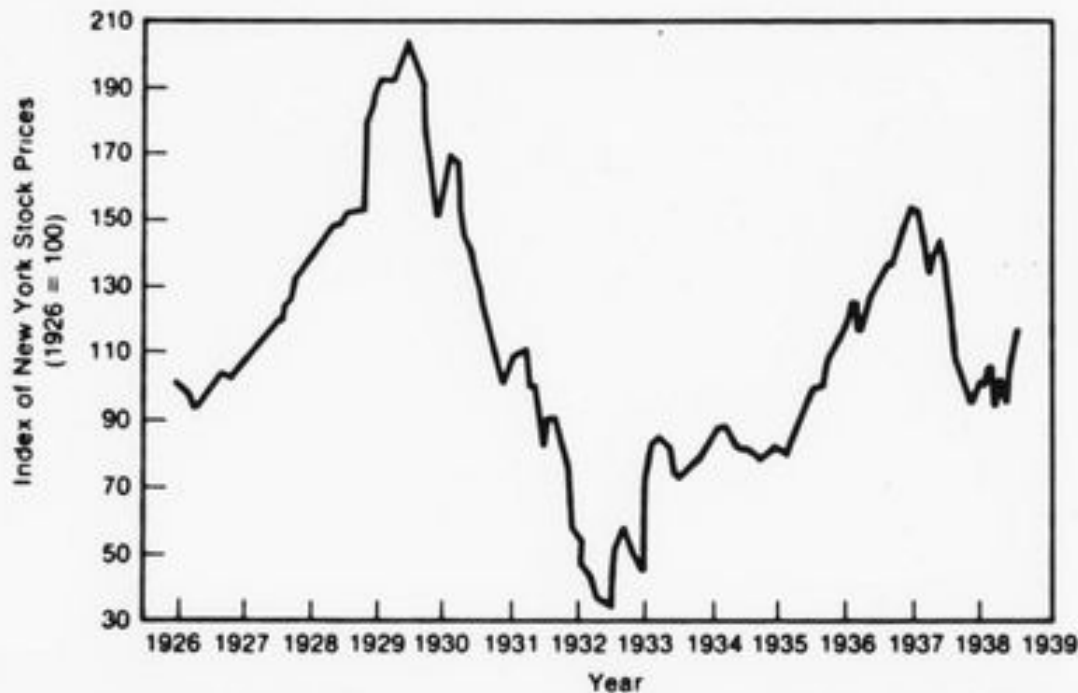
How did this ideology re-emerge after WWII?

Pre-History and the Stock Market Crash of 1929

- Long Period of Stock Market Expansion during the **Roaring 1920's**
 - Popularization of stock investing by general public, expansion into uninformed investing public: inappropriate touting, buying on margin and using stocks for speculation, as opposed to investment
 - Many elements of investor protection were absent, e.g. market manipulation using option pools was legal; insider trading was not restricted (→ Securities Act 1933)
 - DJIA rose 120% from 1925 to 3rd Q 1929
- Two major economists of the era, Fisher and Keynes, both felt – incorrectly -- the worst was over by 1930

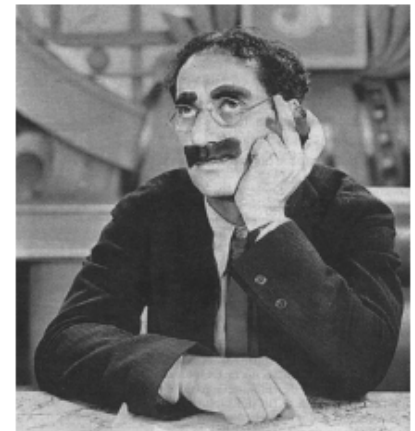
See Downloadable Background

NYSE Stock Prices and the Great Depression



“All I lost was two hundred and forty thousand dollars ...
I would have lost more but that was all the money I had.”

Groucho Marx joking about the losses he actually suffered
during the stock market collapse of 1929 (Klein 2001, p.231).





Key Events in the Great Depression

- ▣ See downloadable data page
- ▣ What Caused the Great Depression?
 - ▣ Reasons have been studied and debated for years → policy makers at the time at a loss
 - ▣ Monetary Explanations
 - Combination of Mismanagement by Fed and constraints of international gold standard
 - Restriction of money supply aimed at bursting stock market bubble precipitated three periods of widespread banking failures in US from 1930-2.
 - ▣ Institutional Failure
 - lack of Deposit Insurance, lack of government involvement (.e.g, TVA), lack of securities regulation



Depression and the Failure of Capitalism

- *Free to Choose* (p.5)
 - “the depression was widely interpreted as a failure of free market capitalism. That myth led the public to join the intellectuals in a changed view of the relative responsibilities of individuals and government”.
- The economics of the time was unable to come to grips with events that had led to the Depression → there was a need for a rethinking of economic policy
- Regulatory reforms following FDR election
 - Reconstruction Finance Corporation
 - Securities Act of 1933 and Securities Exchange Act of 1934
 - Glass–Steagall Act which strictly separated commercial banking and investment banking.
 - National Industrial Recovery Act (New Deal legislation)

Who was John Maynard Keynes (1883-1936)?

- Son of John Neville Keynes, Cambridge economist and logician
 - JMK educated at Eton and King's College, Cambridge
- Three key life long elements
 - After a brief stint in Foreign Service and periodic stints on government duty, JMK served as Fellow at King's College.
 - Editor of *Economic Journal* from 1911 almost until death
 - Member of Bloomsbury Group (upper crust group of intellectuals – Bloomsbury is an area of London) containing Leonard and Virginia Woolf, EM Forster, Clive Bell and Lytton Strachey – originally started at Cambridge c.1900 and continued until WWII
 - Considerable speculation on the sexual orientation of members of this group; bisexuals and homosexuals

**J.M. Keynes,
(1883-1946),
*The General
Theory of
Employment,
Interest and Money*
(1936)**



Important Pre-GT Work by JM Keynes

- First book *Indian Currency and Finance* (based on his brief time in Foreign Office)
- *Economic Consequence of the Peace* (1919)
 - Identified vindictive nature of the peace settlement due to devastating consequences of the heavy "reparations" payments imposed on Germany.
 - JMK resigns from the conference, and publication brings JMK into the public spotlight.
- *Treatise on Probability* (1921)
 - Foundational work on "logical-relationist" probability
- *Tract on Monetary Reform* (1923) (important for Q theory)
- *Treatise on Money* (1930), two volumes
 - Contains many rudiments of GT
 - Heavily criticized by von Hayek

The General Theory (1936)

- *The General Theory* inspired the Keynesian revolution and, more recently, Post Keynesian Economics
 - Three key features:
 - The marginal propensity to consume (the percentage of any increase in their income that people chose to spend on goods and services)
 - The marginal efficiency of investment (dependent on anticipated rates of return)
 - The rate of interest
- The weak demand during a depression creates a difficulty in getting the economy to move forward more vigorously
 - Government (the public sector) can increase aggregate demand by increasing its expenditures financed by borrowing
 - Public-sector borrowing will not increase interest rates sufficiently to undermine the effectiveness of such a policy.

Chapter 12 of the General Theory

Reading: Handout

- Chapter 12 of *General Theory* is a scathing criticism of the social reliance on the stock market to allocate capital
 - “economic prosperity is excessively dependent on a political and social atmosphere which is congenial to the average business man” (p.162)
 - “The measure of success attained by Wall Street cannot be claimed as one of the outstanding triumphs of *laissez-faire* capitalism” (p.159) → Keynes is calling for some form of stock market regulation

More from Chapter 12

- “A conventional valuation which is established as the outcome of the mass psychology of a large number of ignorant individuals is liable to change violently as the result of a sudden fluctuation of opinion due to factors which do not really make much difference to the prospective yield” (p.154)
- “They are concerned, not with what an investment is really worth to a man who buys it ‘for keeps’, but with what the market will value it at, under the influence of mass psychology, three months or a year hence.” (p.155)
- “Investment based on genuine long-term expectation is so difficult to-day as to be scarcely practicable. He who attempts it must surely lead much more laborious days and run greater risks than he who tries to guess better than the crowd how the crowd will behave; and given equal intelligence, he may make more disastrous mistakes”. (p.157)

Preconditions for the Neo-Liberal Order

- The FDR New Deal in the US and similar interventionist policies were introduced to address economic ills of the Great Depression
 - Policies carried forward post-WWII, Marshall Plan to rebuild Europe, creation of transnational entities, esp. UN, Bretton Woods monetary system, GATT, World Bank, IMF, BIS, etc.
 - Rise of democratic socialism in Britain and strengthening of ability of labour to organize
 - **Cold War and the battle of ideologies**
 - McCarthyism and the Communist purge of Hollywood, labour unions, etc. in the 1950's

Senator Joseph McCarthy was a prominent anticommunist crusader who rose to prominence in the US in 1950 mounting a general attack on the foreign policy agenda of President Truman and, specifically, charging the State Department and its Secretary Dean Acheson of harboring “traitorous” Communists.

Following the Republican party gaining control of Congress in 1952, McCarthy chaired the Senate Subcommittee on Investigations and proceeded to target numerous government agencies, the broadcasting and defense industries, universities, and the United Nations.

Following the nationally televised Army-McCarthy hearings, the Senate voted to condemn McCarthy.

McCarthy was also prominent in the ‘Lavender Scare’ of the 1950’s where gay men and lesbians were claimed to be security risks and communist sympathizers, which led to the call to remove them from government employment.

McCarthy is pictured below with Committee counsel Roy Cohn, later to be ‘fixer’ in NYC politics and to be a mentor and representative for a younger Donald Trump.



Early Beginnings: The Mont Pelerin Society

- The post-WWII period found a world divided into distinct ideological camps – USSR, PRC, a rebuilding and divided Europe, US, a Third World emerging from the grips of colonialism
- The Mont Pelerin Society was a group of passionate advocates with early neo-liberal views – primarily distinguished academics – that founded the Mont Pelerin Society in 1947 (so-named for the Swiss spa where the group initially met)
 - The Society continues to the present
 - Initial members included Hayek, Frank Knight, Ludwig von Mises, George Stigler, Karl Popper and Milton Friedman

Who was Friedrich August von Hayek (1889-1992)?

- Austrian-born British economist and political philosopher
 - Defender of liberal democracy and free-market capitalism
 - Fierce opponent of socialist and collectivist philosophies
 - One of the most influential members of the Austrian school of economics
 - Austrian School members were opposed to Keynesian revolution
 - Also made significant contributions in jurisprudence and cognitive science
- Awarded Nobel Memorial Prize in 1974
 - Experienced a revival with the rise of conservatism during 1980's



"A claim for equality of material position can be met only by a government with totalitarian powers."

Friedrich August von Hayek

The Road to Serfdom (1944)

- Written during WWII, argues that totalitarianism is the enemy (not just the Nazis) – modern defense of *laissez-faire*
 - “Socialism is slavery” (p.13)
 - “That democratic socialism, the great utopia of the last few generations, is not only unachievable, but that to strive for it produces something so utterly different that few of those who now wish it would be prepared to accept the consequences” (p.31)
 - “Socialism is a species of collectivism” (p.33)
- Emphasized the connection between individualism, economic freedom and political freedom
 - Individualism is at the core of Western civilization
 - “respect for the individual man *qua* man ... recognition of his own views and tastes as supreme in his own sphere ... and the belief that it is desirable that men should develop their own individual gifts and bents” (p.14)

Milton Friedman and the Rise of Neo-Conservatism

- ▣ Who is Milton Friedman (1912-2006)?
 - ▣ Leader of the Monetarist School of economists, associated with the U. of Chicago, that sharply criticised Keynesian economics and proposed a more conservative approach
 - ▣ Winner of Nobel Memorial Prize in 1976
 - Contributions include: *Monetary History of United States* (1963) with Anna Schwartz- founding work of monetarist school
 - Other important contributions: Permanent Income Hypothesis; Friedman-Savage risk paradox; Introduction to 'positive economics'.
 - Proposed use of Rules vs. discretionary government intervention of Keynesian economists

Milton Friedman (1912-2006)

“The Social Responsibility of Business is to Maximize Profits”



Free to Choose (1980)

- Popularization of *Capitalism and Freedom* (1962) – argues for restricted scope for government action in economic sphere
 - **Strongly influenced by views of Hayek**
 - “We have not yet reached the point of no return. We are still free as a people to choose whether we shall continue speeding down the ‘road to serfdom’” (p.6)
- “The story of the United States is the story of an economic miracle that was made possible by the translation into practice of two sets of ideas ... published in the same year 1776” (p.1)
 - The invisible hand
 - Ideals of the Declaration of Independence and the protect of ‘Life, Liberty and the pursuit of Happiness’
 - As in Hayek, an explicit connection between economic freedom and political freedom

Economic and Political Freedom

- “Economic freedom is an essential requisite for political freedom” (p.2)
 - “By enabling people to cooperate with one another without coercion or central direction, it reduces the area over which political power is exercised. In addition, by dispersing power, the free market provides an offset to whatever concentration of political power may arise. The combination of economic and political *power* in the same hands is a sure recipe for tyranny” (p.3)
 - Friedman also saw an ‘invisible hand’ in the political sphere (p.6)
- The Social Responsibility of Business is to Maximize Profits

Who is Rose Director Friedman?

- ▣ See Link on GLS Links Page
 - ▣ ABD from U. of Chicago in economics
 - ▣ Later worked for FDIC and NBER
 - ▣ Collaborated with Milton Friedman on three public policy books:
 - ▣ Capitalism and Freedom (University of Chicago Press, 1962)
 - ▣ Free to Choose (Harcourt Brace Jovanovich, 1980),
 - ▣ Tyranny of the Status Quo (Harcourt Brace Jovanovich, 1984).
 - ▣ She also served as associate producer of the PBS television series, "Free to Choose."

Reagan and Thatcher Ideology

- The economic and social havoc produced by the Vietnam war, uncontrollable stagflation, oppressive interest rates of the 1970's laid the groundwork for the rise of power of Margaret Thatcher in 1979 and Ronald Reagan in 1980
 - Both Reagan and Thatcher claimed a mandate for implementing a radical shift to neo-liberal policies
 - Key events: Thatcher confronted union power, rolled back welfare state commitments, privatized public companies, reduced taxes encouraged inflow of investment capital
 - Reagan followed a similar road map – reappointed Paul Volcker in support of high interest policy

From GATT to the WTO

- A keystone of neo-liberalism is the removal of barriers to global trade and capital investment.
 - The multilateral General Agreement on Tariffs and Trade (GATT) was signed by 23 countries in 1947 governing trade in goods from 1948 to 1995
 - Creation of World Trade Organization in 1995 extended multilateral trade to services and intellectual property and provided for new settlement dispute procedures
 - 2001 Doha round further lowered trade barriers and revised trading rules. Key feature was extension of multilateral trading agreement to developing countries.
 - WTO currently includes 164 members encompassing 98% of international trade in items covered by the Agreements.

The Struggle Against Neo-liberalism?

- From the time that the Mont Pelerin Society was formed until the emergence of Reagan and Thatcher, neo-liberal was used as a reference primarily by economists and other academics promoting that ideology
- Since that time, neo-liberalism has been increasingly used as a pejorative term by those outside of economics and by a subset of heterodox economists
- Increasingly over time, symptoms of neo-liberalism especially of increasing wealth and income inequality have attracted attention within economics while the social and political implications have attracted attention outside economics
- **Can neo-liberalism be reformed as a policy buffet?**

Prior to the Ascendancy of Neo-Liberal Ideology

- Two general tracts in prior US and Canadian academic contributions can be discerned
 - Keynesian, in favour of discretionary government policy intervention, vs. 'Monetarists', in favour of rules based policy
 - High interest rate policy to control inflation was an outcome of monetarist strategy to control inflation by restricting money supply growth combined with reduced tax rates (and restriction of labour power) to stimulate economic growth
 - Alleviation of poverty in the Third World
 - Backstop for foreign aid policies of developed countries in conjunction with World Bank programs
- Ascendancy of neo-liberal ideology to dominate government policy, especially in the US and UK, was driven by political forces – wider scholarly debate was stifled

Amartya Sen, and 'Old School Concerns'

Collective Choice and Social Welfare (1970)

- With John Harsanyi (1920-2000) explored the use of restricted cardinal utility to make social decisions
 - *Collective Choice and Social Welfare* provides conditions needed to resolve intransitivity
- Concern with 'positive freedom' and limited cardinal utility to resolving poverty and famine
 - Sen contributed to the measurement of inequality
 - Found famine in India not usually due to lack of food locally but to the lack of income to purchase

Amartya Sen (b. 1933) – Brahman from W. Bengal
***Poverty and Famines* (1982), *On Ethics and Economics* (1987),
Hunger and Public Action (1989), *Identity and Violence* (2006)**



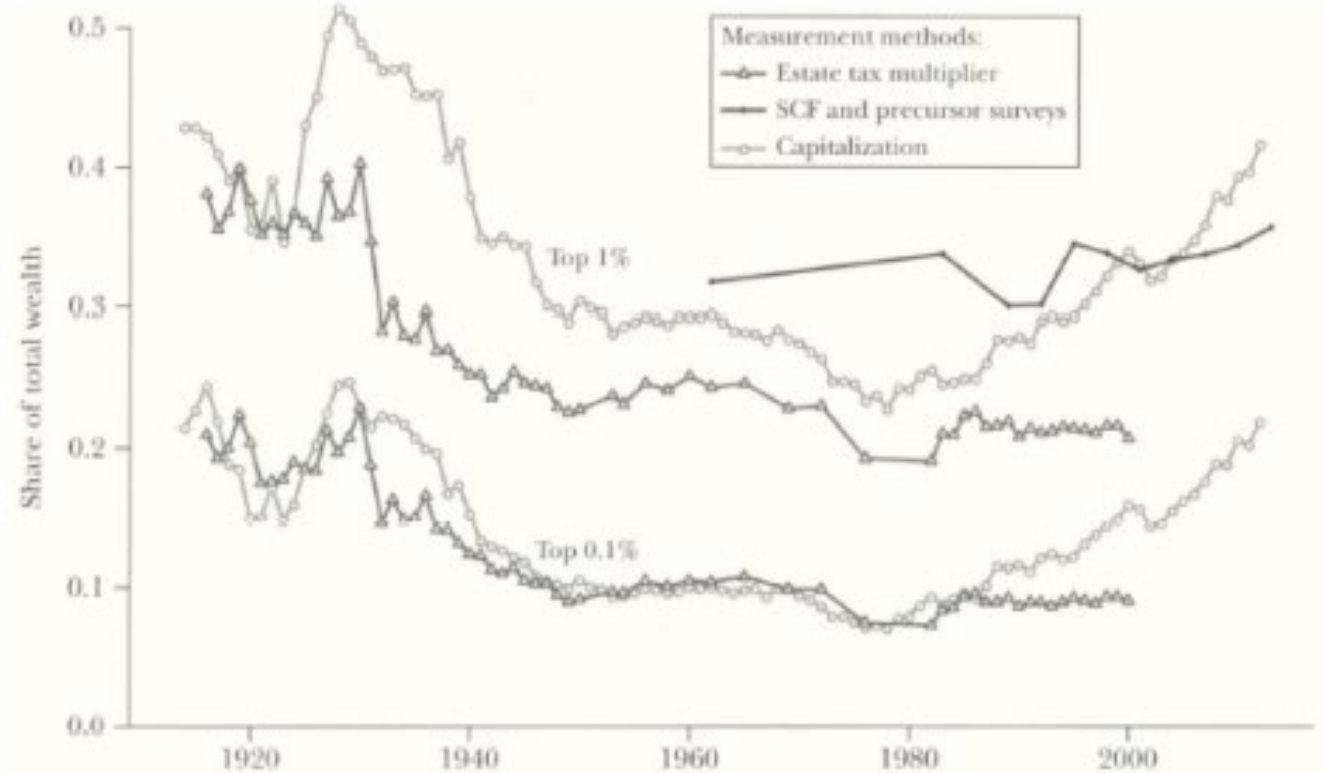
"People's identities as Indians, as Asians, or as members of the human race, seemed to give way - quite suddenly - to sectarian identification with Hindu, Muslim, or Sikh communities."

Amartya Sen

Growth of Wealth and Income Inequality

- Along with many other economists that focused on the income and wealth disparity between developed and developing nations, the implications of neo-liberal programs for increasing wealth and income inequality in developed nations did not attract attention until well into the 21st century
- Support for multilateral and bilateral removal of trade barriers and restrictions on capital flows to sustain global 'economic growth' facilitated the movement of industrial production to countries, especially China, with weaker environmental and labour standards that exacerbated increasing wealth and income inequality in developed countries
- Who is benefiting from the gamut of neo-liberal policies?

Top 0.1% and Top 1% Wealth Shares

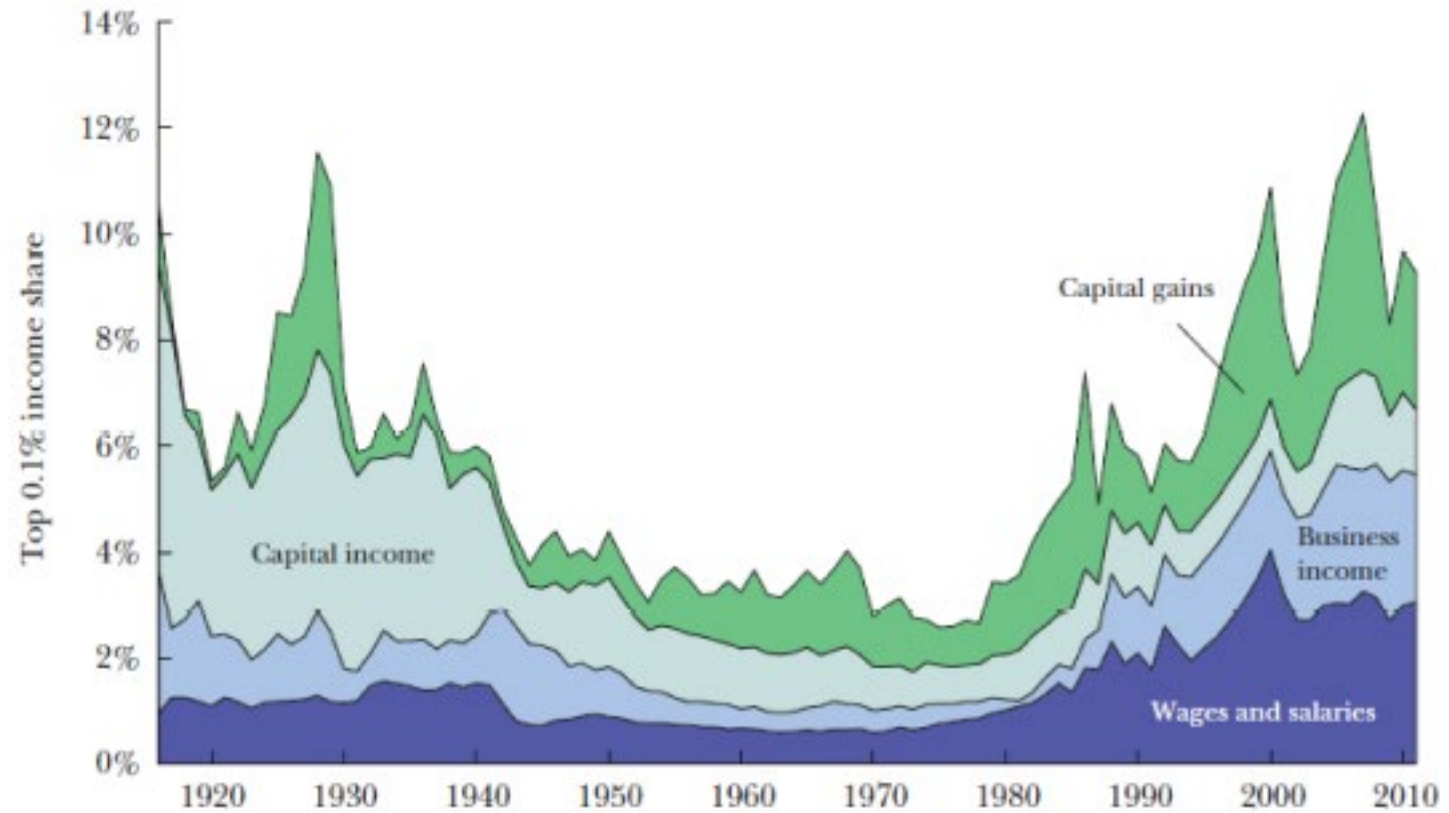


Source: Author using data described in the text.

Note: SCF is the Survey of Consumer Finances.

Source: Kopczuk (2015)

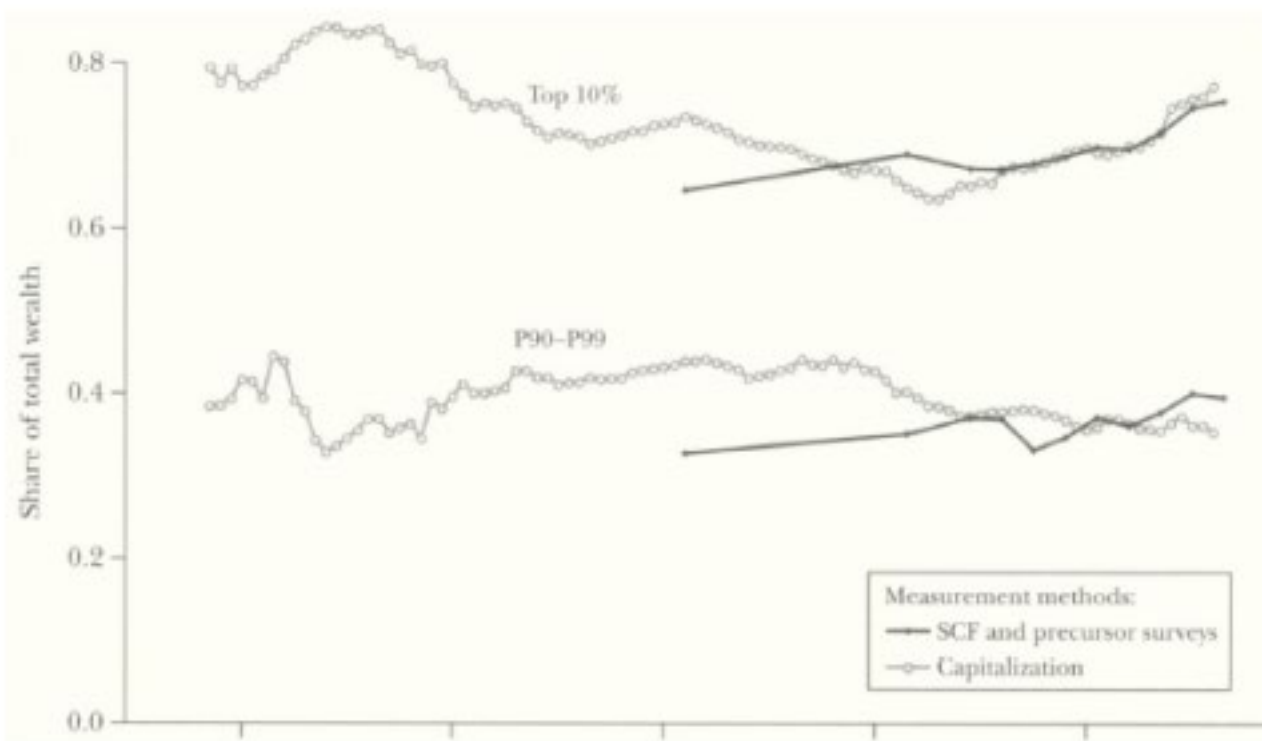
The Top 0.1 Percent Income Share and Its Composition, 1916–2011



Source: These data are taken from the "data-Fig4B" tab of the September 2013 update of the spreadsheet appendix to Piketty and Saez (2003).

Source: Jones (2015), p.32

Wealth Shares for Top 10% and 90th–99th Percentiles (P90–P99) in Terms of Wealth



Source: Author using data described in the text.

Note: SCF is the Survey of Consumer Finances.

Piketty and the Paris School of Economics

- Piketty, Saez and other affiliated with the Paris School of Economics and the World Inequality Lab have spearheaded the scholarly study within economics of increasing wealth and inequality
- *Capital in the 21st Century* (2014) has attracted widespread attention both from inside and outside economics (best seller on NYT non-fiction list)
 - Key $r > g$ argument: because the rate of return on capital r exceeds the growth rate of the economy g , the inequality of wealth is destined to increase indefinitely over time
 - Piketty hedges this argument by including “Institutional changes and political shocks” and lack of relevance to inequality of labour income

It is one thing to identify a problem, another to suggest feasible solutions → Piketty is weak on solutions

The Realization Principle

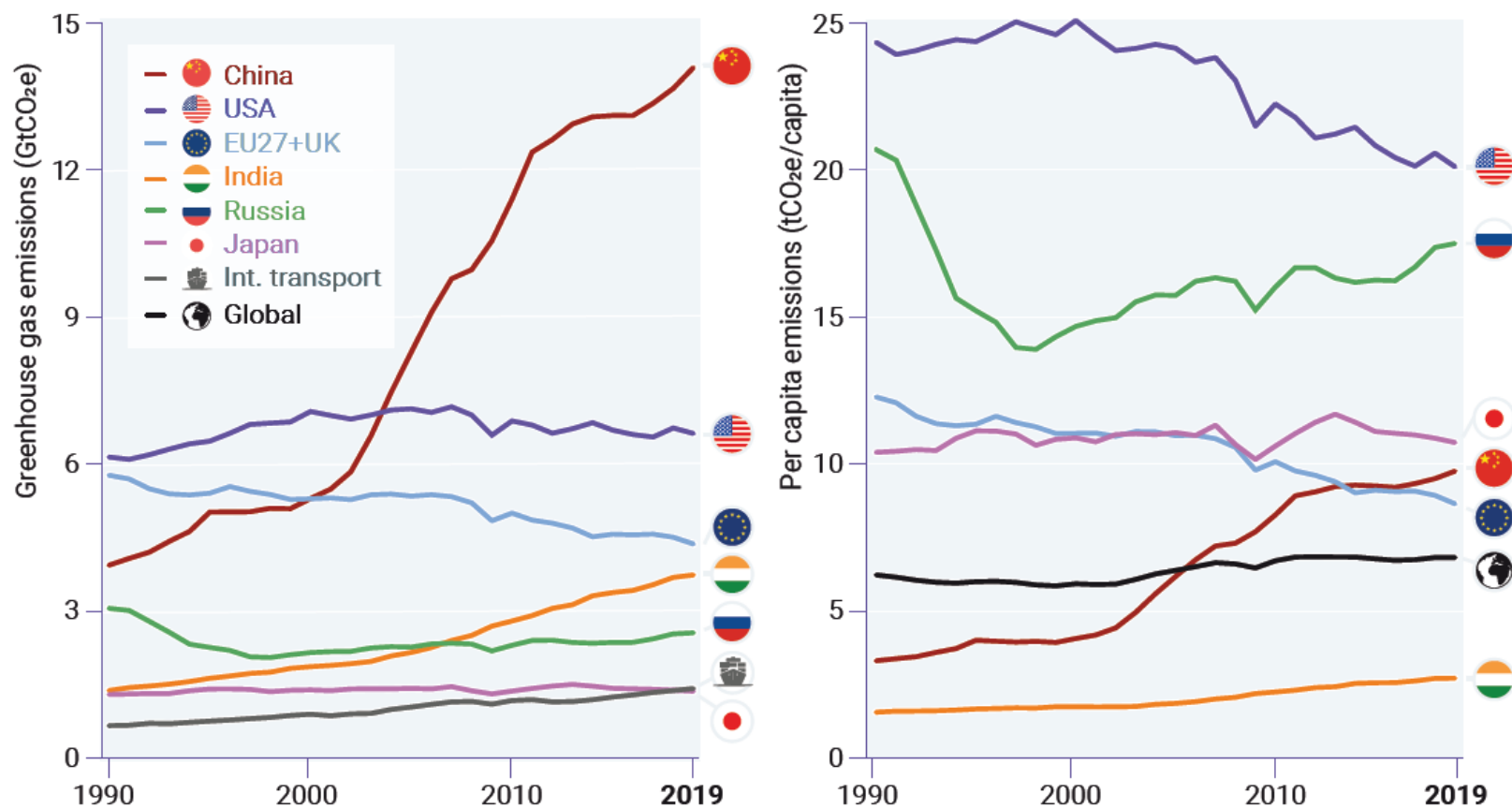
- Though a subject of debate when broad based income taxes were introduced during WWII, the Realization Principle has become an entrenched, unremovable feature of capitalist society
 - The realization principle is a rule for assessing taxes on capital income that dictates income tax is assessed when a capital asset is sold (gain or loss realized)
 - Consequently, the wealthiest individuals (1%'s) are able to defer tax on the capital income gains indefinitely while individuals generating wage and salary income are taxed in the period in which income is earned.

Neo-liberalism and Climate Change

- An implicit objective of neo-liberalism is sustaining economic growth to further the advancement of individual freedom → stated US goals for intervention in Mideast conflicts (bombing peasants in Afghanistan!)
- The basic arithmetic of climate change dictates a degrowth strategy is needed to control increasing anthropogenic GHG emissions
 - Key multilateral institutions have mandates that conflict with degrowth → UN development initiatives for developing countries + UN declaration of human rights that identifies the right to propagate ; GATT and WTO expanding the global trade networks; IMF and World Bank providing backstops for maintaining economic growth



Figure ES.2. Absolute GHG emissions of the top six emitters (excluding LUC emissions) and international transport (left) and per capita emissions of the top six emitters and the global average (right)



From the NDC for India:

Developed countries can certainly bring down their emission intensity by moderating their consumption, and substantially utilize their investments by employing them for development activities in countries housing a vast majority of people barely living at subsistence level ... Mahatma Gandhi's famous exhortation: “Earth has enough resources to meet people’s needs, but will never have enough to satisfy people's greed”. ... Habit and attitude are as much a part of the solution as Technology and Finance. It must be understood that ... the extravagant way of life and a profligate pattern of consumerism [is] a grave threat to environment.