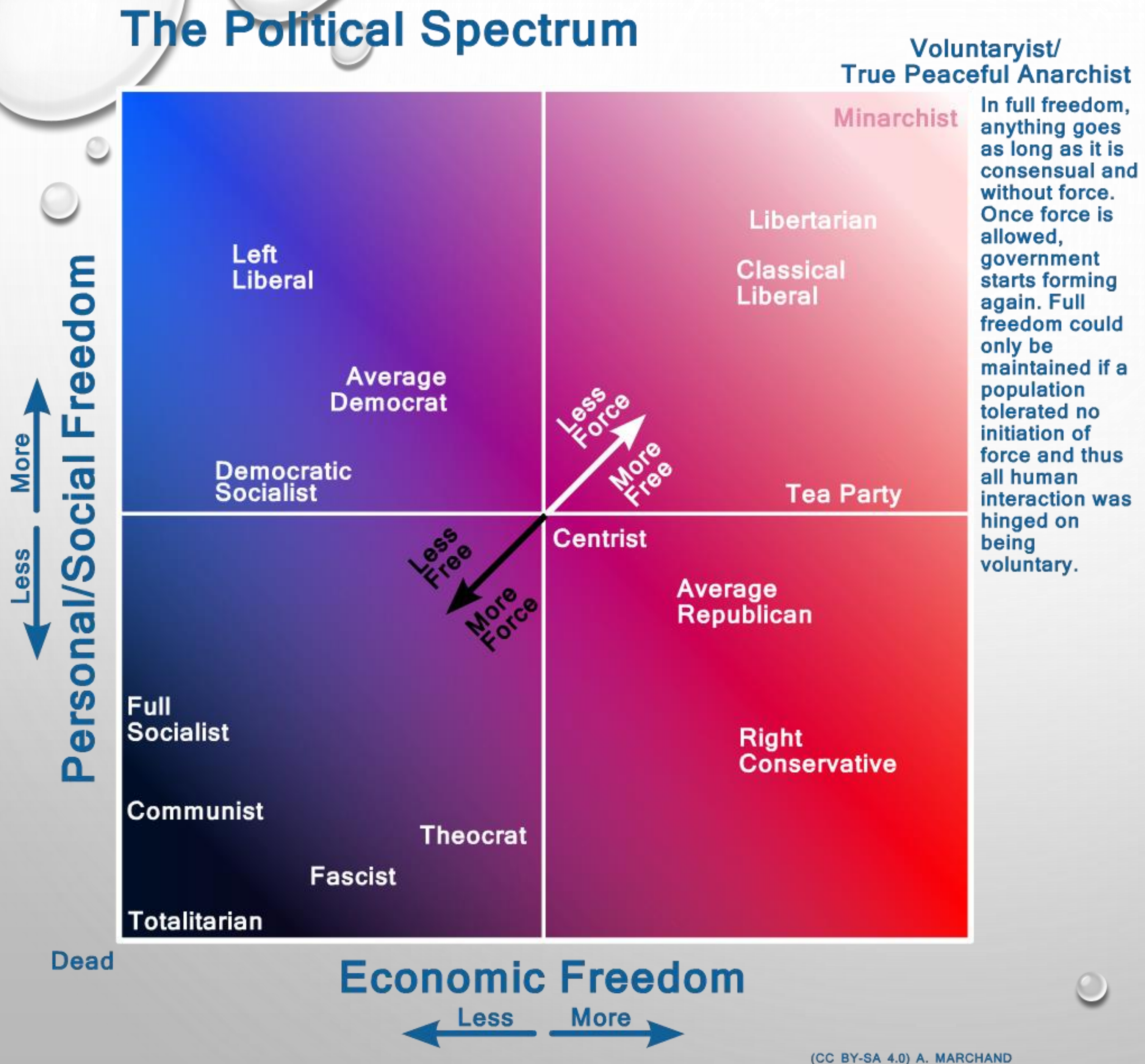
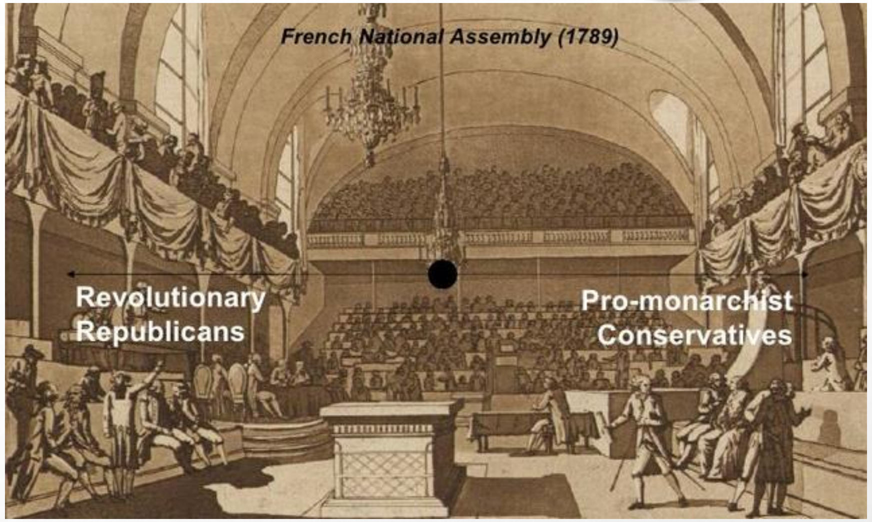
EE466 Political Economy of Development

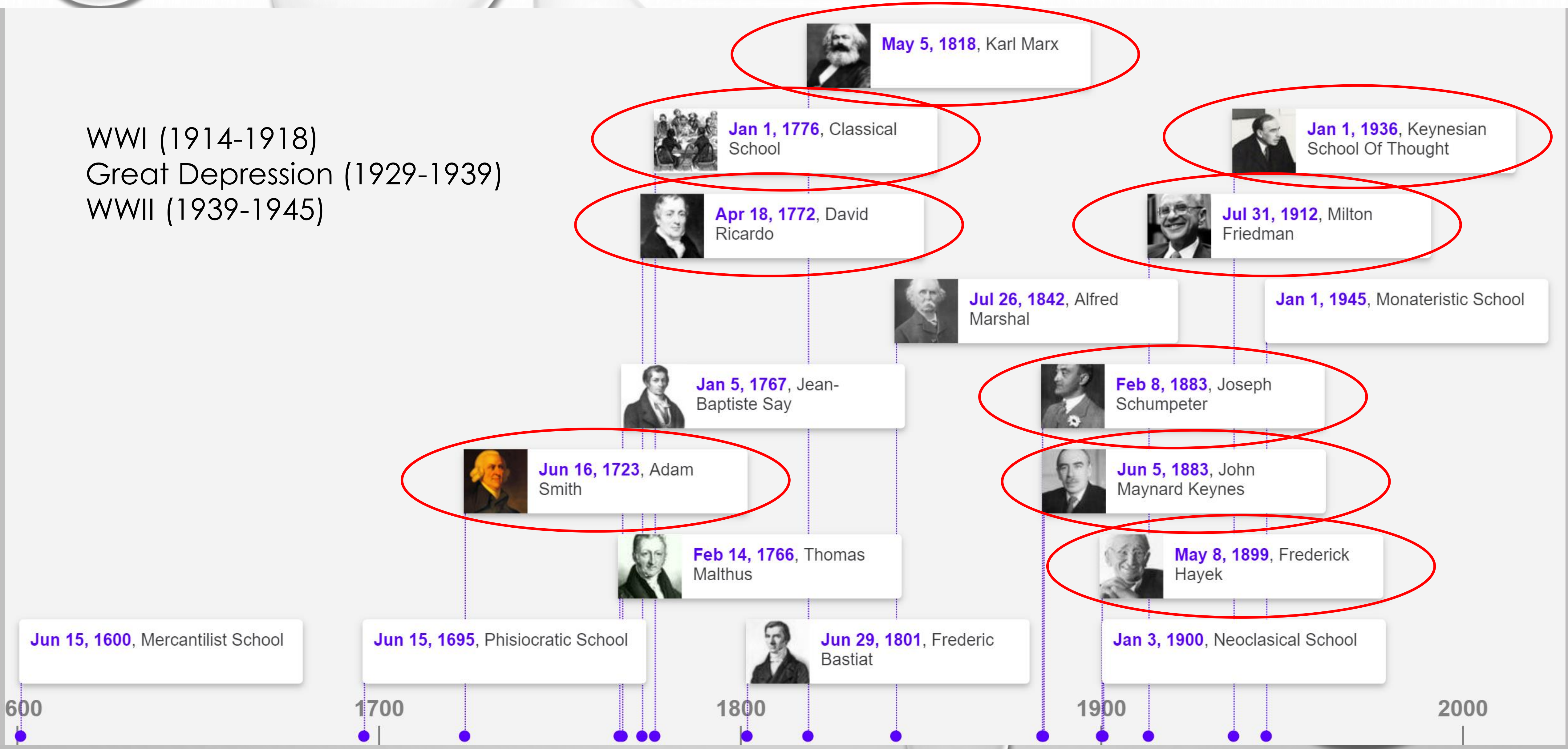
Historical Debates in Market Freedom & Political Freedom





- The terms **right** and **left** refer to political affiliations originating early in the French Revolutionary era of 1789–1799 and referred originally to the seating arrangements in the various legislative bodies of France. the aristocracy sat on the right (traditionally the seat of honor) and the commoners sat on the left, hence the terms right-wing politics and left-wing politics.
- However, the current terms of **"Left"** and **"Right"** are different among countries

WWI (1914-1918)
Great Depression (1929-1939)
WWII (1939-1945)



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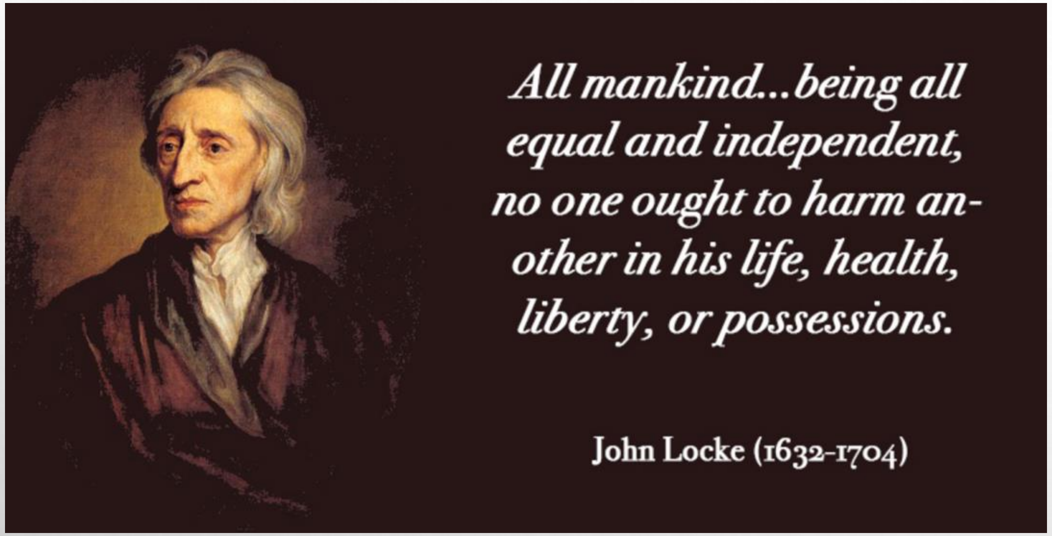
Outline

- Classical Liberalism (Smith & Ricardo)
- Austrian School (Hayek)
- Keynesianism (Keynes)
- Neoliberalism (Friedman)
- Schumpeterian (Schumpeter)
- Institutionalism (Chang; Acemoglu & Robinson)

CLASSICAL LIBERALISM

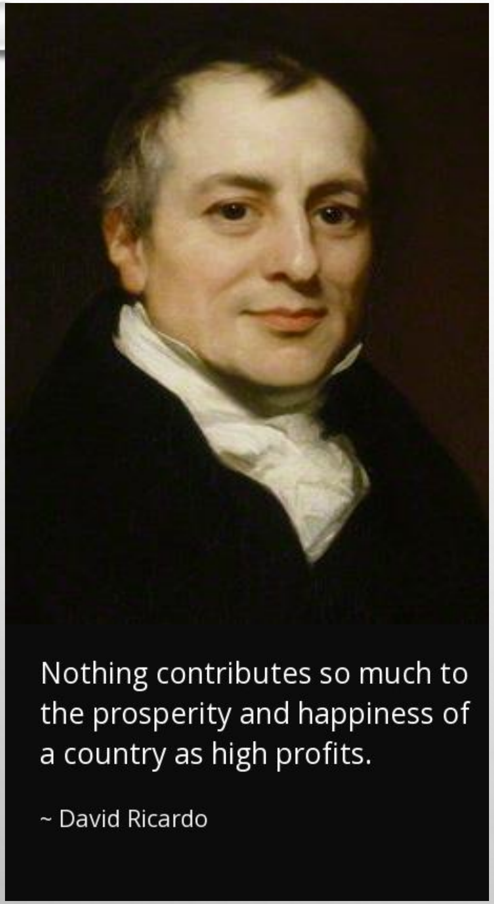


- **Classical liberalism** arose in tandem with the Enlightenment movement of the late 17th and the 18th centuries which proclaimed reason as the foundation of **individual freedom.**
- Enlightenment thinkers like ***John Locke*** argued that in the 'state of nature', ***all men were free and equal***.
- Naturally endowed with the right to life, liberty, and property, humans could legitimately establish only limited governments whose chief task consisted of securing and protecting these **individual rights**, especially **private property**.

CLASSICAL LIBERALISM

- The neoliberal ideal of the **‘self-regulating market’** as the main engine powering the individual’s rational pursuit of wealth – had been a core tenet of economists since the late 18th century.
- Opposed to the **mercantilism** of monarchs who exercised almost total control over the economy in their efforts to amass large quantities of gold.
- **‘Classical liberals’** like ***Adam Smith*** and ***David Ricardo*** preached the virtues of the **‘free market’** and **‘laissez-faire’** economics.
- Politically, their theories amounted to a powerful argument **against government interference with trade** in the19th century e.g. the protectionist Corn Laws in England.
- Bad economic times always reflected some form of **‘government failure’** – usually too much state interference resulting in distorted price signals.

CLASSICAL LIBERALISM



- ***Ricardo's theory*** of **'comparative advantage'** became the gospel of modern free traders.
- He argued that free trade amounted to a win–win situation for all trading partners involved, because it allowed each country to specialize in the production of those commodities for which it had a **comparative advantage**.
- For example, if Italy could produce wine more cheaply than England, and England could produce cloth more cheaply than Italy, then both countries would benefit from specialization and trade.

	David	William
Pies	6	4
Cakes	4	2

ROLES OF GOVERNMENT

- If the main benefit is local and the cost cannot be recovered by tolls, a local tax is best
- London taxpayers should pay for paving and streetlights in London

1: The maintenance of ***justice*** and ***the rule of law*** are therefore vital. Smith believes that the market economy can function and deliver its benefits only when its rules are observed – when property is secure and contracts are honored.

2: ***Defense***. If our property can be stolen by a foreign power, we are no better off than if our own neighbours steal it.

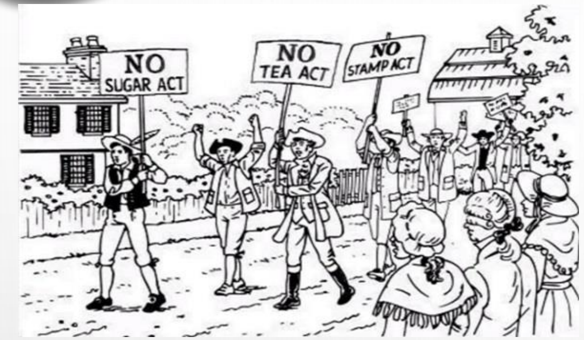
3: The duty of erecting and maintaining certain ***public works*** and certain public institutions, which it can never be for the interest of any individual, or small number of individuals, to erect and maintain'.

- These comprise ***infrastructure projects*** that facilitate ***commerce*** and ***education***, which helps make people a constructive part of the social and economic order.
- Smith insists that education is needed to correct it. Education should focus on the laboring poor, who suffer most from 'the division of labour' that repetitive tasks would inevitably narrow their views and interests .
- But while the state might pay for school buildings, it should not pay the whole of teachers' wages. If teachers rely on fees from students, their performance will be that much sharper.

ROLES OF GOVERNMENT

- **Civil government**, so far as it is instituted for the security of property, is **in reality** instituted for the **defence of the rich against the poor**, or of **those who have some property against those who have none at all**.
- The power to tax allows it to build up enormous resources, but it has much less incentive to manage its property as efficiently as would a private individual.

SMITH'S VIEWS ON TAXATION



- **Income Tax**: People should contribute in proportion to the income that they enjoy under the security of state protection.
- **Corporate Tax:** Taxation should not hamper industry and enterprise. A tax on companies is unwise, for example, because – as he observes with great insight – the capital on which our income depends is highly mobile. Too high tax could encourage evasion, such as smuggling.
- **Consumption Tax:** He opposes taxes on consumption, but supports a tax on luxuries (including things that we would think rather basic today, such as poultry)

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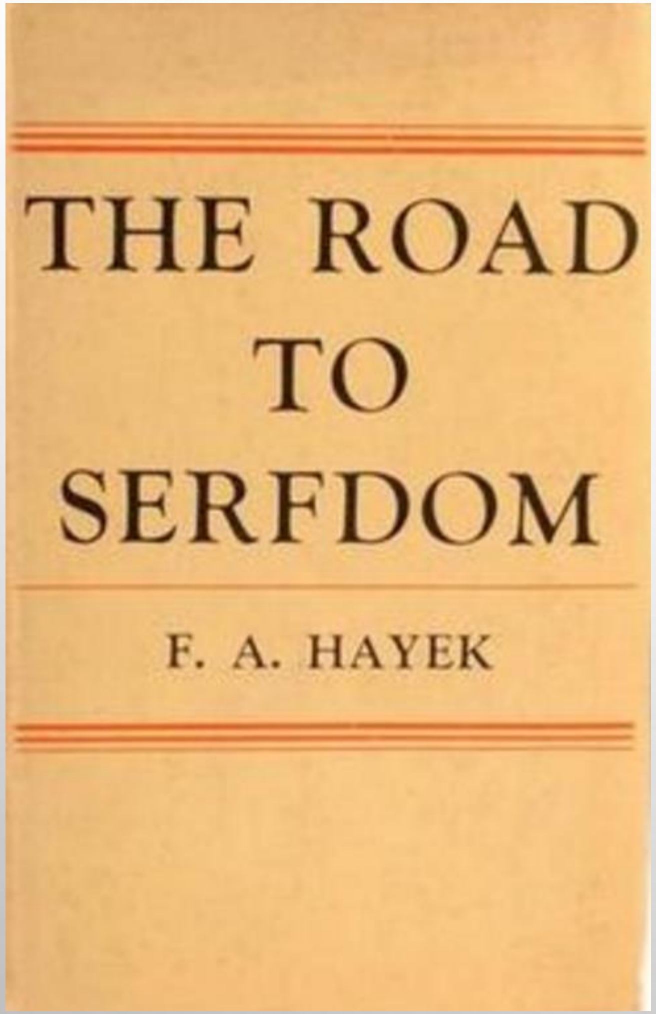
Friedrich Hayek

8 May 1899 – 23 March 1992

- Friedrich Hayek was an Austrian and British economist and philosopher best known for his defense of **classical liberalism**.
- His account of how changing prices communicate information which enables individuals to co-ordinate their plans is widely regarded as an important achievement in economics.
- Hayek shared the 1974 Nobel Memorial Prize in Economic Sciences with Gunnar Myrdal for his

"pioneering work in the theory of money and economic fluctuations and ... penetrating **analysis of the interdependence of economic, social and institutional phenomena**".

Friedrich Hayek



- Hayek served in World War I. He suffered damage to his hearing in his left ear during the war. He said that his experience in the war and his desire to help avoid the mistakes that had led to the war led him to his career.
- Hayek was concerned about the general view in Britain's academia that **fascism** was a capitalist reaction to socialism and ***The Road to Serfdom*** arose from those concerns.
- In the 1970s and 1980s, the writings of Hayek were also a major influence on many of the leaders of the "velvet" revolution in Central Europe during the collapse of the old Soviet Empire.

ROAD TO SERFDOM

- Hayek wrote the book after the WWII, when the world was rebuilding from **German fascism** and was threatened by **Communism**
- The objective of Hayek is to provide a good argument to counter the communist trend. He seeks to convince everyone of the merits of liberal ideas.
- He warns of the danger of **tyranny** that inevitably results from government control of economic decision-making through central planning
- He further argues that **the abandonment of individualism and classical liberalism inevitably leads to a loss of freedom**, the creation of an oppressive society, the tyranny of a dictator, and the serfdom of the individual.

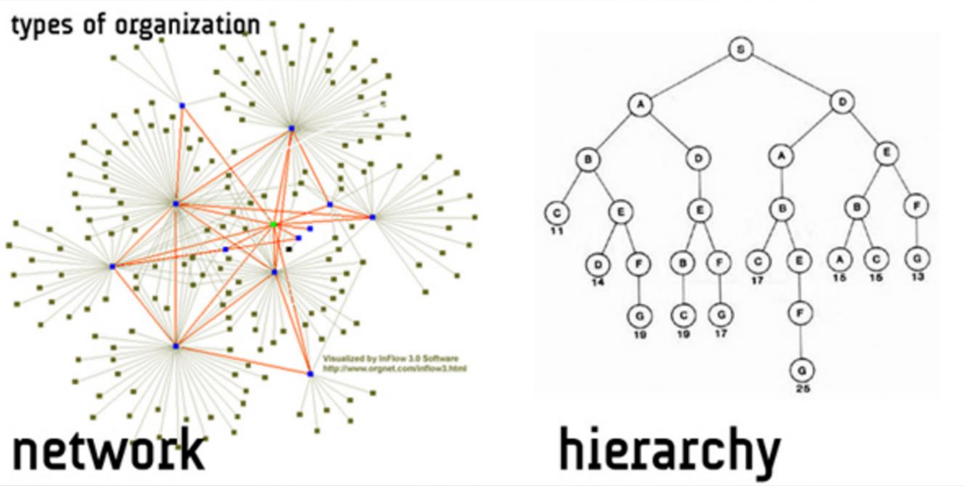
HOW DOES A FREEMAN BECAME A SERF?

- One thousand years ago it was by force or economic hardship, such as crop failures.
- Further, serfdom was inherited. That means if your children would be born into your situation of payment to the feudal lord.
- In Hayek's book he argues **the road to serfdom is through central government planning or managing of the economy.**
- **High taxes and large government** will have the same effect as it did 1000 years ago.

ROAD TO SERFDOM

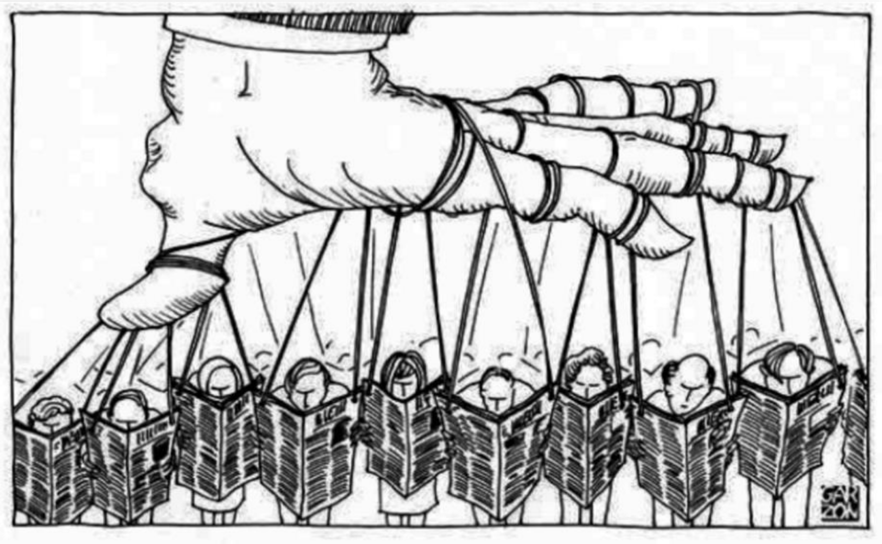
- Hayek distinguished three kinds of freedom resulting from this humanism: a **personal freedom**, **political freedom** and **economic freedom**.
- **The economic freedom which is the prerequisite of any other freedom** cannot be the freedom from economic care which the socialists promise us and which can be obtained only by relieving the individual at the same time of the necessity and of the power of choice:
- It must be the freedom of economic activity which, with **the right of choice**, inevitably also carries the risk and the responsibility of that right.
- The system of **private property** is the most important guarantee of freedom, not only for those who own property, but scarcely less for those who do not.
- We shall never prevent the abuse of power if we are not prepared to limit power in a way which occasionally may prevent its use for desirable purposes.

Spontaneous order



- Hayek viewed concept of the market as **a spontaneous order**
- Hayek viewed the free price system not as a conscious invention (that which is intentionally designed by man), but as spontaneous order or what he referred to as "that which is the result of human action but not of human design".
- Thus, Hayek put the price mechanism on the same level as, for example, language.
- He explained that **price signals** are the only means of enabling each economic decision maker to communicate **tacit knowledge** or dispersed knowledge to each other, to solve the economic calculation problem

COMPETITION

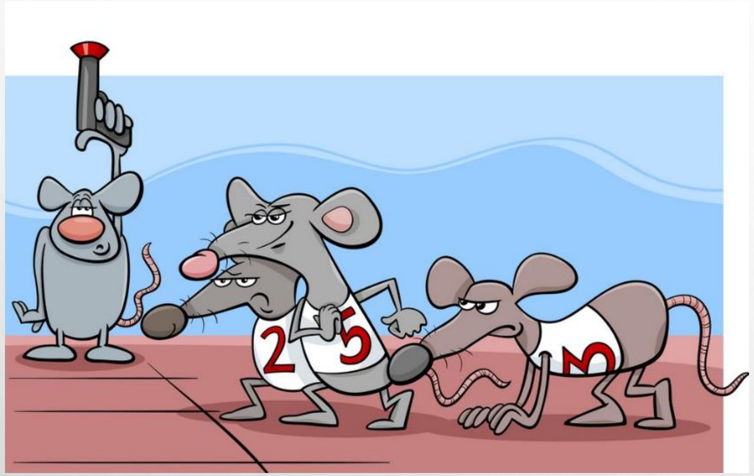


- **Liberalism** regards **competition** as superior methods of guiding economic activity, not only because in most circumstances it is the most efficient method known but because it is the only method which does not require the coercive or arbitrary intervention of authority.
- It dispenses with the need for '**conscious social control**' and gives individuals a chance to decide whether the prospects of a particular occupation are sufficient to compensate for the disadvantages connected with it.

PLANNING AND POWER

- Hayek argued that all forms of **collectivism** (even those theoretically based on voluntary co-operation) could only be maintained by a **central authority** of some kind.
- Hayek argued that **socialism** required **central economic planning** and that such planning in turn leads towards **totalitarianism**.
- A central planning authority would have to be endowed with powers that would impact and ultimately **control social life**, because **the knowledge** required for centrally planning an economy is inherently decentralized, and would need to be brought under control.

PLANNING AND COMPETITION



- The liberal argument does not advocate leaving things just as they are; It favors making the best possible use of the **forces of competition** as a means of coordinating human efforts.
- It is based on the conviction that, where effective competition can be created, it is a better way of guiding individual efforts than any other.
- It emphasizes that in order to make competition work beneficially a carefully thought-out legal framework is required, and that neither the past nor the existing legal rules are free from grave defects.
- Planning and competition can be combined only by ***planning for competition***, <u>*not*</u> by ***planning against competition***.

PLANNING AND COMPETITION

- For example, the harmful effects of deforestation or of the smoke of factories cannot be confined to the owner of the property in question.
- But the fact that we have to resort to **direct regulation by authority** where the conditions for the proper working of competition cannot be created does not prove that we should suppress competition where it can be made to function.
- To create conditions in which competition will be as effective as possible, to prevent fraud and deception, to break up monopolies – these tasks provide a wide and unquestioned field for **state activity**.

GOVERNMENT AND JUSTICE

- In Hayek's view, the central role of the state should be to maintain the **rule of law**, with as little arbitrary intervention as possible.
- Hayek disapproved of the notion of **'social justice'**. He compared the market to a game in which 'there is no point in calling the outcome just or unjust‘ and argued that 'social justice is an empty phrase with no determinable content.
- “*The results of the individual's efforts are necessarily unpredictable, and the question as to whether the resulting distribution of incomes is just has no meaning*".
- He generally regarded government **redistribution of income** or capital as **an unacceptable intrusion upon individual freedom**

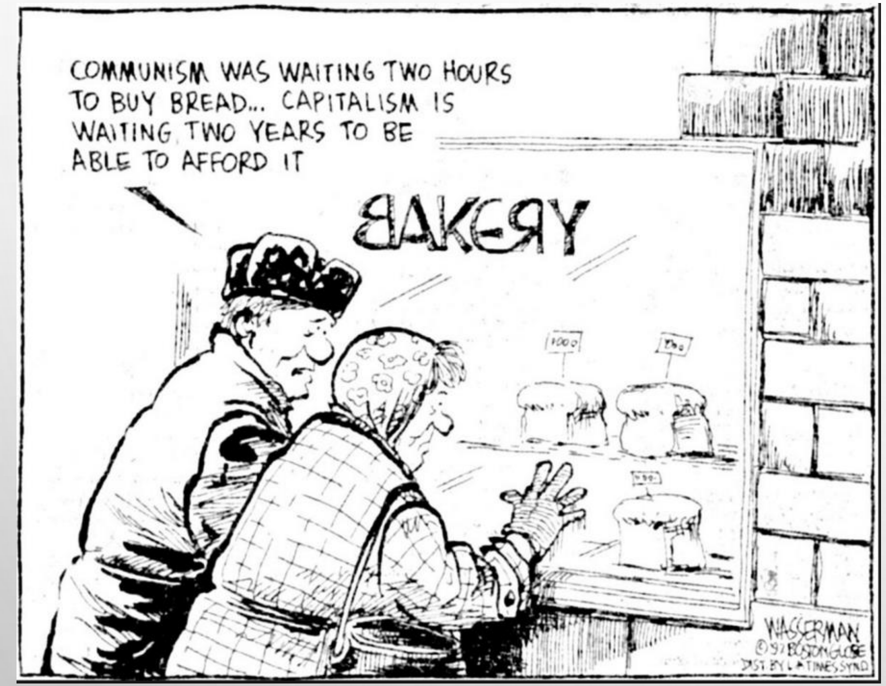
JUSTICE?

- *"The principle of **distributive justice**, once introduced, would not be fulfilled until the whole of society was organized in accordance with it. This would produce a kind of society which in all essential respects would be the opposite of a free society."*
- But the state can play a role in the economy, and specifically, in creating a **"safety net".**
- *"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**."*

PLANNING AND POWER

- The question is whether we should..
  - ..create conditions under which ***the knowledge and initiative of individuals*** are given the best scope so that they can plan most successfully;
  - ..or whether we should direct and organize all economic activities according to a '**blueprint**', that is, 'consciously direct the resources of society to conform to the planners' particular views of who should have what'.

DEMOCRACY AND SOCIALISM



- Democracy and socialism have nothing in common but one word: **equality**
- But notice the difference: while democracy seeks **equality in liberty**, socialism seeks **equality in restraint and servitude**
- Socialism was to bring 'economic freedom' without which political freedom was 'not worth having'
- The word '**freedom**' was subjected to a subtle change in meaning; from formerly meant freedom from coercion, from the arbitrary power of other men.
- Now it was made to mean freedom from necessity, release from the compulsion of the circumstances which inevitably limit the range of choice of all of us.

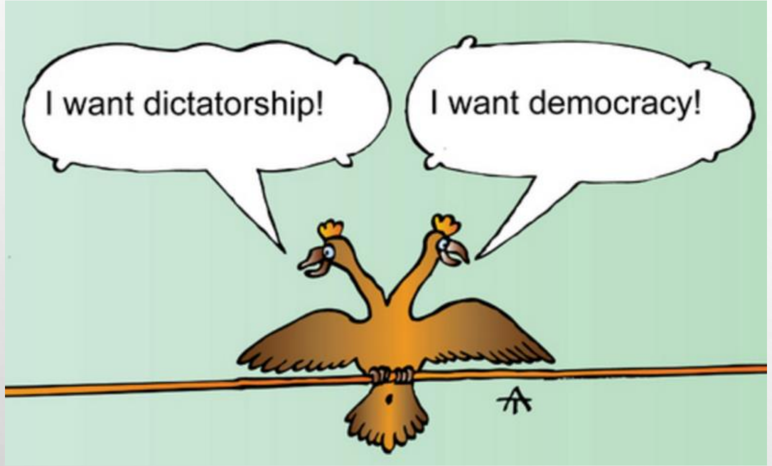
DEMOCRACY?

- In the democracies the majority of people still believe **that socialism and freedom can be combined.**
- The demand for the new freedom was thus only another name for the old demand for a redistribution of wealth. The goal of the planning will be described by some such vague term as ‘the general welfare’.
- It is rarely remembered now that socialism in its beginnings was frankly authoritarian. Yet socialism was early recognized by many thinkers as the gravest threat to freedom.
- The cry for an economic dictator is a characteristic stage in the movement toward planning.

DEMOCRACY?

- They believe that our economic life should be 'consciously directed', that we should substitute '**economic planning**' for the competitive system.
- Yet is there a greater tragedy imaginable than that, in our endeavour consciously to shape our future in accordance with high ideals, we should in fact unwittingly produce the very opposite of what we have been striving for?
- What is promised to us as the Road to Freedom is in fact the Highroad to Servitude!!
- They do not realize that **democratic socialism**, the great utopia of the last few generations, is not only unachievable, but that to strive for it produces something utterly different – **the very destruction of freedom itself**.

DEMOCRACY?



- **Democracy** is an obstacle to this suppression of freedom which the centralized direction of economic activity requires. Hence arises the clash between planning and democracy.
- Democratic assemblies cannot function as planning agencies.
- They cannot produce agreement on everything – the whole direction of the resources of the nation – for the number of possible courses of action will be legion.
- Even if a congress could, by proceeding step by step and compromising at each point, agree on some scheme, it would certainly in the end satisfy nobody.

DEMOCRACY?

- There will be a stronger and stronger demand that some board or some single individual should be given powers to act on their own responsibility.
- In order to achieve their ends, **the planners** must create **power** – power over men wielded by other men. Thus the legislative body will be reduced to choosing the persons who are to have practically **absolute power.**
- Planning leads to dictatorship because dictatorship is the most effective instrument of coercion and, as such, essential if central planning on a large scale is to be possible

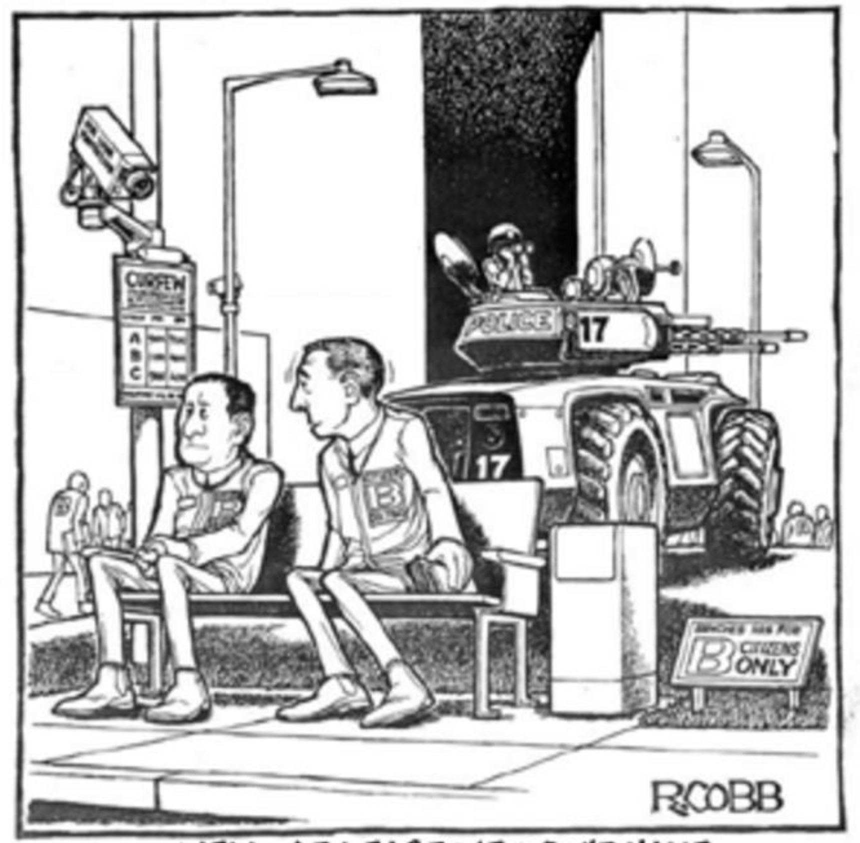
ROAD TO SERFDOM

- In the democracies at present, many who sincerely hate all of **Nazism**'s manifestations are working for ideals whose realization would lead straight to **the abhorred tyranny**.
- "*I now have an unpleasant truth to say: that we are in danger of the fate of Germany*".
- The link with **socialism** is established soon after: "*Few people are willing to recognize that the rise of fascism and Nazism was not a reaction against the socialist trends of the previous period, but an inevitable result of these trends*.
- *"The left parties as well as those on the right are mistaken in believing that National Socialism was in the service of capitalism and that he was opposed to any form of socialism. "*

ROAD TO SERFDOM

- It was at this demonstration Hayek tackle: how a political system that puts the center state (Nazism, communism etc.) can be done against the individual.
- The contention that only the peculiar wickedness of the Germans has produced the Nazi system is likely to become the excuse for forcing on us the very institutions which have produced that wickedness.
- **The more the state 'plans' the more difficult planning becomes for the individual.**
- The first need is to free ourselves of that worst form of contemporary obscurantism which tries to persuade us that what we have done in the recent past was all either wise or unavoidable.

THE UNFORESEEN CONSEQUENCES OF SOCIALISM



WELL, AT LEAST WE DON'T HAVE TO WORRY ABOUT ANARCHY ANYMORE.

- In the army, work and worker alike are allotted by authority, and this is the only system in which the individual can be conceded **full economic security**.
- In a society used to freedom it is unlikely that many people would be ready deliberately to purchase security at this price.
- But the policies which are followed now are nevertheless rapidly creating conditions in which the striving for **security** tends to become stronger than **the love of freedom.**
- If we are not to destroy individual freedom, competition must be left to function unobstructed.

TO BUILD A BETTER WORLD

- It is not those who cry for more ‘planning’ who show the necessary courage, nor those who preach a ‘**New Order**’, which is no more than a continuation of the tendencies of the past 40 years, and who can think of nothing better than to imitate Hitler. It is, indeed, those who cry loudest for a planned economy who are most completely under the sway of the ideas which have created this war and most of the evils from which we suffer.
- To build a better world, we must have the courage to make a new start. We must clear away the obstacles with which human folly has recently encumbered our path and release the creative energy of individuals.
- We must create conditions favorable to progress rather than ‘planning progress’
- The guiding principle in any attempt to create a world of free men must be this: **a policy of freedom for the individual is the only truly progressive policy**.

1

War forces "national planning"

To permit total mobilization of your country's economy, you gladly surrender many freedoms. You know regimentation was forced by your country's enemies.

2

Many want "planning" to stay . . .

Arguments for a "peace production board" are heard before the war ends. Wartime "planners" who want to stay in power, encourage the idea.

3

The "Planners" promise Utopias . . . .

A rosy plan for farmers goes well in rural areas, a plan for industrial workers is popular in cities—and so on. Many new "planners" are elected to office →

4

but they can't agree on ONE Utopia

With peace, a new legislature meets; but "win the war" unity is gone. The "planners" nearly come to blows. Each has his own pet plan, won't budge.

5

And citizens can't agree either . . . .

When the "planners" finally patch up a temporary plan months later, citizens in turn disagree. What the farmer likes, the factory worker doesn't like.

6

"Planners" hate to force agreement . . .

Most "national planners" are well-meaning idealists, balk at any use of force. They hope for some miracle of public agreement as to their patchwork plan.

7

They try to "sell" the plan to all . . .

In an unsuccessful effort to educate people to uniform views, "planners" establish a giant propaganda machine *—which coming dictator will find handy.*

8

The gullible do find agreement . . . .

Meanwhile, growing national confusion leads to protest meetings. The least educated—thrilled and convinced by fiery oratory, form a party.

9

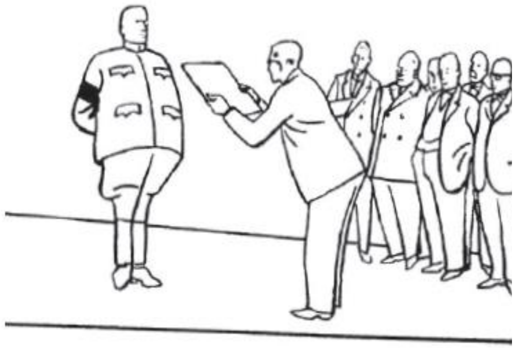
Confidence in "planners" fades . . . .

The more that the "planners" improvise, the greater the disturbance to normal business. Everybody suffers. People now feel—rightly—that "planners" *can't get things done!*

10

The "strong man" is given power . . .

In desperation, "planners" authorize the new party leader to hammer out a plan and force its obedience. Later, they'll dispense with him—or *so they think.*



11

The party takes over the country . . .

By now, confusion is so great that obedience to the new leader must be obtained at all costs. Maybe you join the party yourself to aid national unity.

12

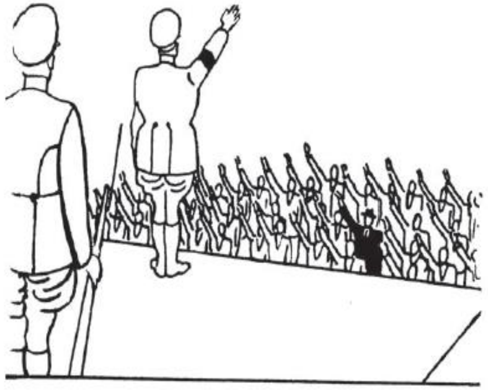
A *negative* aim welds party unity . . .

Early step of all dictators is to inflame the majority in common cause against some scapegoat minority. In Germany, the negative aim was *Anti-Semitism.*

13

No one opposes the leader's plan . . .

It would be suicide; new secret police are ruthless. Ability to force obedience always becomes the No. 1 virtue in the "planned state." Now *all* freedom is gone.



14

Your profession is "planned" . . . .

The wider job choice promised by now defunct "planners" turns out to be a tragic farce. "Planners" never have delivered, never will be able to.

15

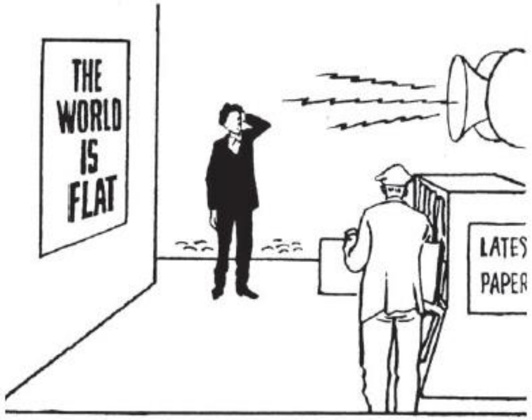
Your wages are "planned" . . . .

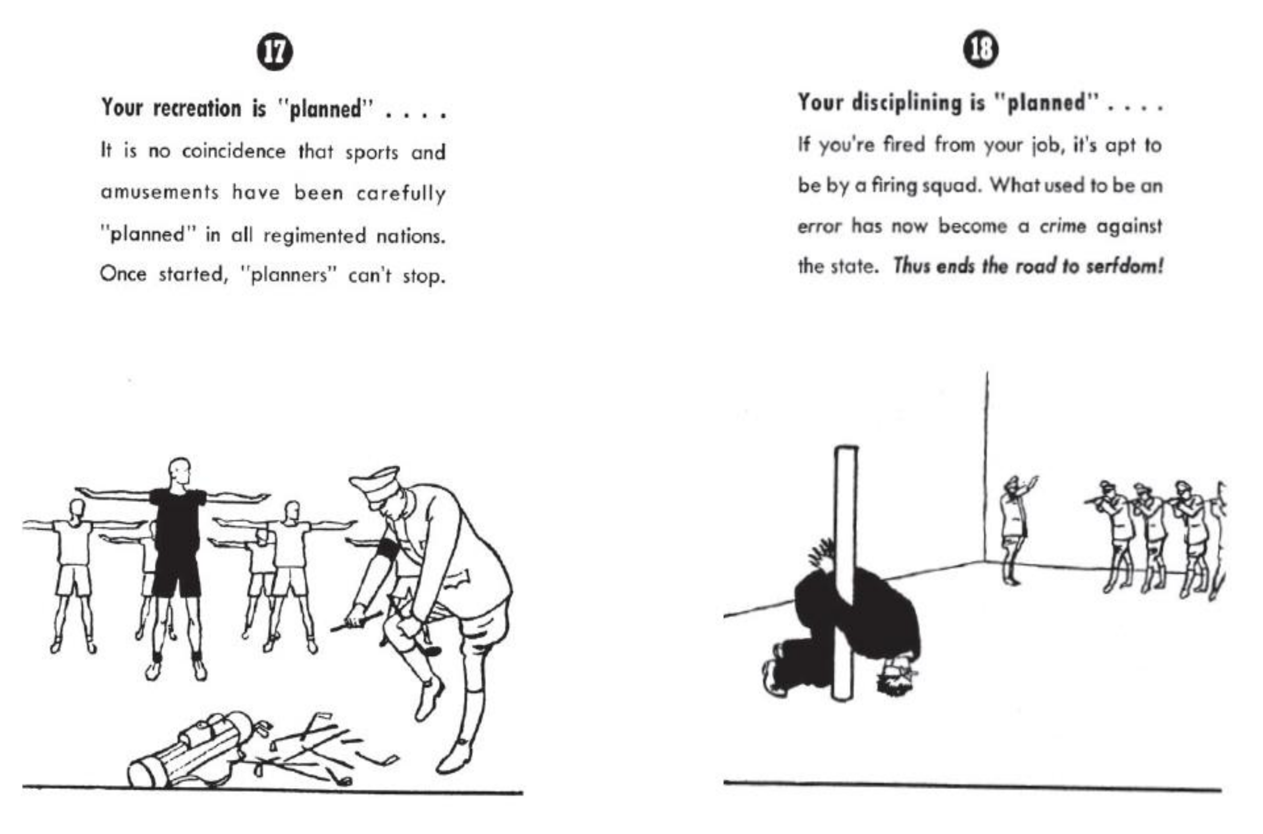
Divisions of the wage scale must be arbitrary and rigid. Running a "planned state" from central headquarters is *clumsy, unfair, inefficient.*

16

Your thinking is "planned" . . . .

In the dictatorship, unintentionally created by the planners, there is no room for difference of opinion. Posters, radio, press—*all tell you the same lies!*





WATCH

1984
https://www.youtube.com/watch?v=S_7guHTEF7w

How did Hitler rise to power?

https://www.youtube.com/watch?v=jFICRFKtAc4

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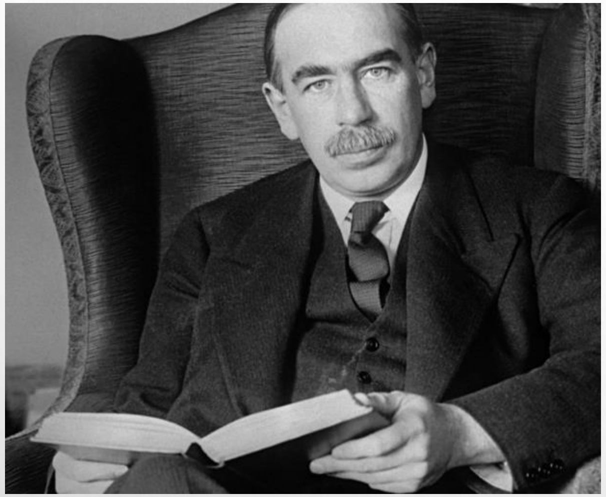
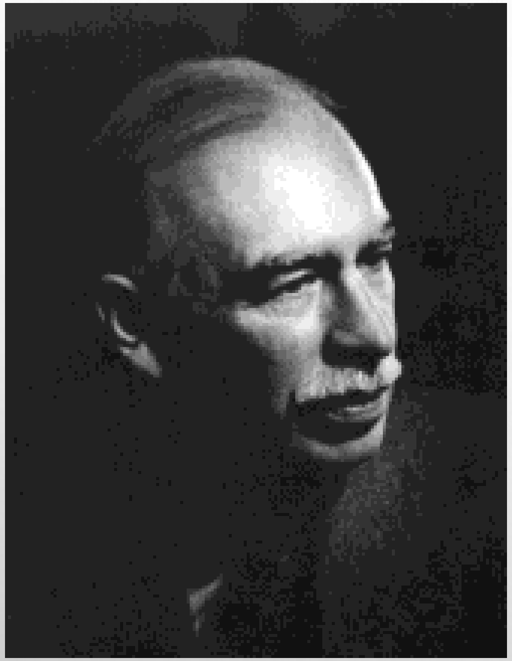
AGAINST CLASSICAL LIBERALISM



- The turbulent **20th century** soon cast a dark cloud on these 'truths' of classical liberalism
- The fury and longevity of the **Great Depression** convinced leading economic thinkers like ***John Maynard Keynes*** and ***Karl Polanyi*** that government was much more than a mere 'night watchman.
- ***Keynes*** committed to the market principle but opposed to the 'free market'. He advocated massive government spending in a time of economic crisis to create new jobs and lift consumer spending.
- '**Keynesianism**' even called for some **state ownership** of crucial national enterprises like railroads or energy companies.
- Government spending had lifted the U.S. economy out of the Great Depression with World War II preparation

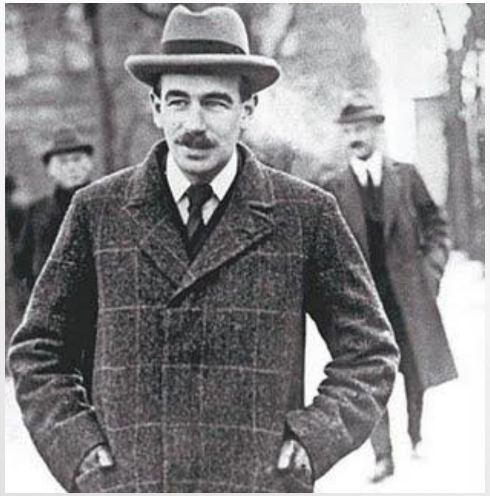
JOHN MAYNARD KEYNES

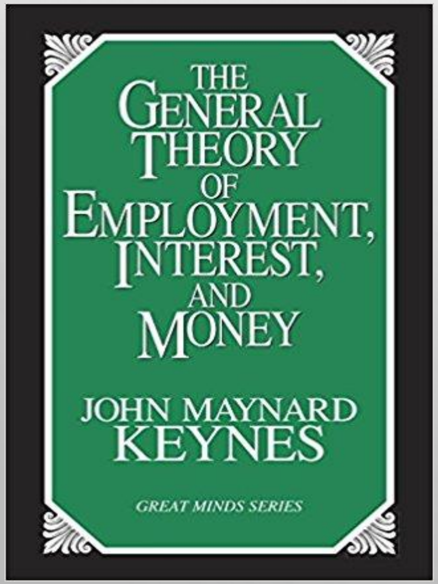


Born: 5 June 1883 in Cambridge, Cambridge shire, England
Died: 21 April 1946 in Firle, Sussex, England

- John Maynard Keynes was probably the most influential economist of the first half of the twentieth century.
- Won a scholarship to King's College, Cambridge. Studied economics for perhaps 1 year, but did poorly on his exams.
- President of the Student Union, President of the University Liberal Club, Became a member of the "Apostles", a secret and highly exclusive Cambridge intellectual society. Became a member of the literary set called "the Bloomsbury Group."
- Took a civil service exam and took a job at the India Office for 2 years.
- 1908, his father managed to get him a job as a lecturer at King's College. Later he became a Fellow.
- 1911, he became editor of the Economic Journal. Worked at the Treasury during WWI.

JOHN MAYNARD KEYNES



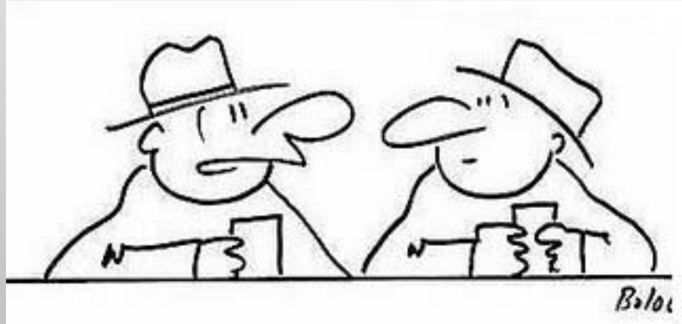


- 1921, he published **A Treatise on Probability**. This was his dissertation. It won him a fellowship at King's College, Cambridge.
- Keynes wrote **the Economic Consequences of the Peace** (1919), regarding reparation payments: Best Seller: Made him a public celebrity
- 1923, Tract on Monetary Reform (against returning to the pre-war gold standard)
- Economic Consequences of Mr. Churchill (1925, warned of depression)
- 1930, **Treatise On Money**.
- Makes millions in the stock market, commodity, and forex markets.
- His life was embedded in a dense mass of miscellaneous activities which both fertilized and distracted him from his writing. His failure to produce a major work of theory till 1930, when he was almost 50, was the price he paid.
- 1936, **General Theory of Employment, Interest and Money**
- 1946, he has a serious heart attack

General Theory of Employment, Interest and Money

- Refusal to raise bank rate soon or high enough had allowed the **inflationary boom** of 1919–20 to get out of hand;
- The maintenance of punitive real rates of interest right through the subsequent period of falling prices, output, and employment had made **the depression** far deeper than it need have been.
- Like all economists, Keynes expected British employment to recover to ‘normal’ (as measured by pre-war standards) when prices ‘settled down’ in 1922.
- But unemployment remained obstinately stuck at above 10%. It was its failure to come down much below this rate for the rest of the 1920s which alerted Keynes to the possibility that **the employment costs of a savage deflation** might be more than ‘transitional’, with the economy remaining ‘jammed’ in a low-employment trap.
- To explain how such an ‘**underemployment equilibrium**’ could occur would be the main object of his theoretical writing.

General Theory of Employment, Interest and Money



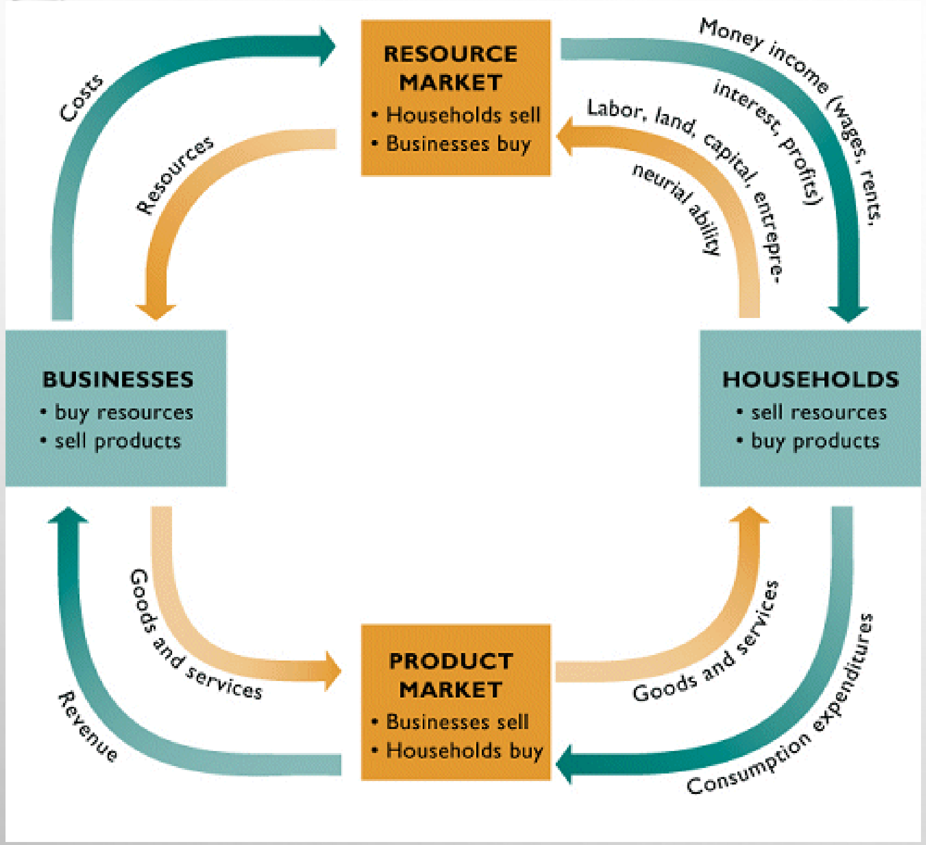
"My wife's a Keynesian — she's always spending herself out of depressions."

- By 1923, Keynes turned his attention to the emergence of persisting **mass unemployment** in Britain.
- The **Great Depression** bottomed out at the end of 1932, with British unemployment having reached 20%, American unemployment even higher.
- **Keynes**, in particular, advocated **massive government spending in a time of economic crisis to create new jobs and lift consumer spending.**
- He challenged classical liberal beliefs that the market mechanism would naturally correct itself in the event of an economic crisis and return to an equilibrium at full employment.
- Committed to the market principle but opposed to the 'free market', 'Keynesianism' even called for some state ownership of crucial national enterprises like railroads or energy companies.

General Theory of Employment, Interest and Money

- In essence, Keynes built an exceedingly complicated conceptual apparatus to show how an economy could, under certain conditions, fall into **a low-employment trap**.
- If **the monetary authority** was prevented from lowering the long-term **interest rate** to a level consonant with investors' expectations, and if domestic costs of production prevented the achievement of an export surplus equal to what people wished to lend abroad, the result would be **an 'excess' of saving over investment**, a sagging price level, and a 'jammed' economy.
- This was Britain's fate in the 1920s.

GENERAL THEORY



- According to the classical model, the consumer has **insatiable wants**.
- If the consumer is an economic optimizer, he/she must be unable to buy the goods they planned to buy because of some kind of constraint—risk, convention, social institutions, cash, etc.)
- The consumer sells his/her labor in exchange for enough income to buy the goods.
- The money value of the incomes received must be equal to the value of the output produced.
- If spending constraints are in effect, then there will be a difference between (unlimited) demand and "effective demand".
- Actual (effective) demand will usually be "deficient" to purchase total output.
- **Say's law cannot hold**. ("Supply creates its own demand.")

Paradox of Thrift

https://www.youtube.com/watch?v=A7_DqDze-vw
https://www.youtube.com/watch?v=reZWP6STkfU

- Microeconomics and macroeconomics do not operate on the same basis. One cannot assume that what is true for the economic agent at the level of the individual consumer or firm is true in aggregate. This amounts to the fallacy of composition.
- Individual savings are considered to be good, especially during the time of recession.
- However, **one man's income is another man's expense**.
- How can unsold goods pile up in warehouses, causing firms to lay off workers?
- So, **if there are more savings, there will be less income for the other person**. Hence, if everybody starts saving, there will be less demand. Lesser demand implies lesser consumption, lesser production, and lesser job opportunities.
- Thus, it will worsen the recession, and the total savings will automatically reduce.

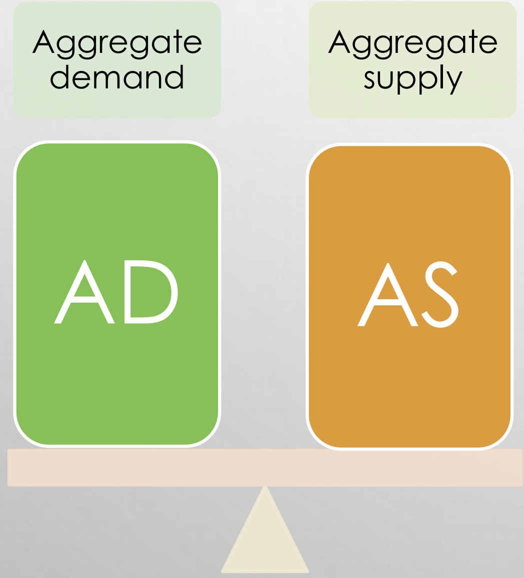
Paradox of Thrift

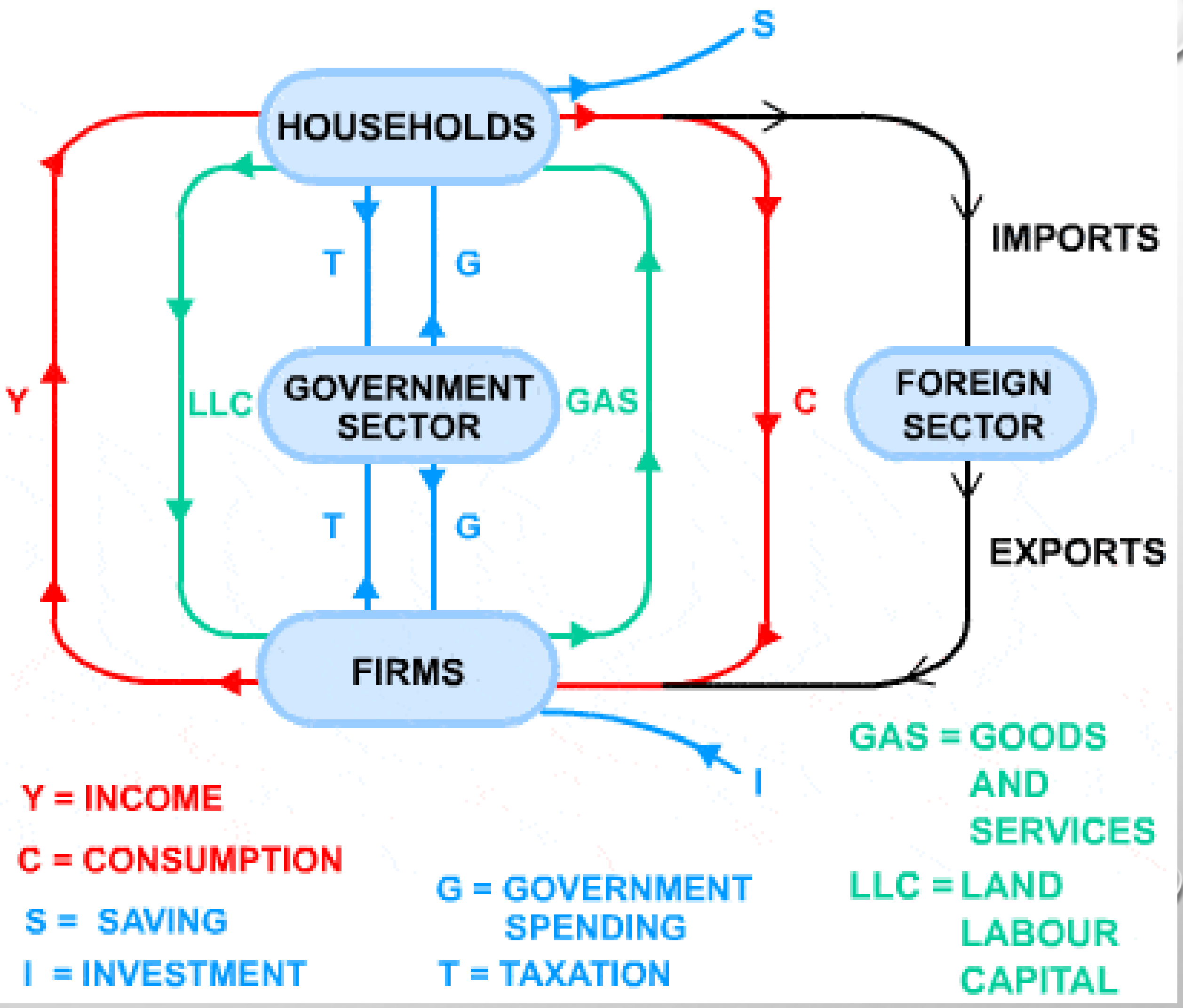
- Suppose a household spends USD 5,000 against an income of USD 4,900, it has a deficit of USD 100. A rational person will say that in order to curb this deficit, the household has to cut its expenses by USD 100.
- However, it is not as simple as that in case of an economy. If the government has to reduce its deficit by spending less, it will have many repercussions.
- With reduction in spending, there will be less growth opportunities for private individuals. With reduction in private wealth, there will be a reduction in taxes.
- Thus, if the reduction in government spending is too stringent, the government might end up increasing its deficit due to a fall in its income.
- Thus, **what holds true for a household will not hold true in case of an economy.**

$$GDP = C + I + G + (X - M)$$

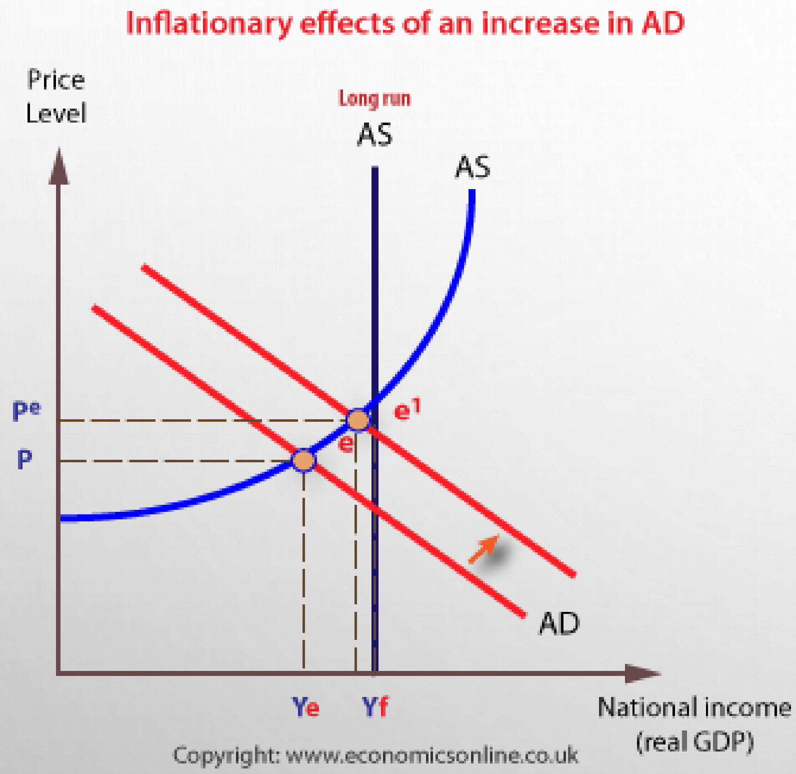
where

C (Consumption)
I (Investment)
G (Government spending)
and X – M (Net Exports)



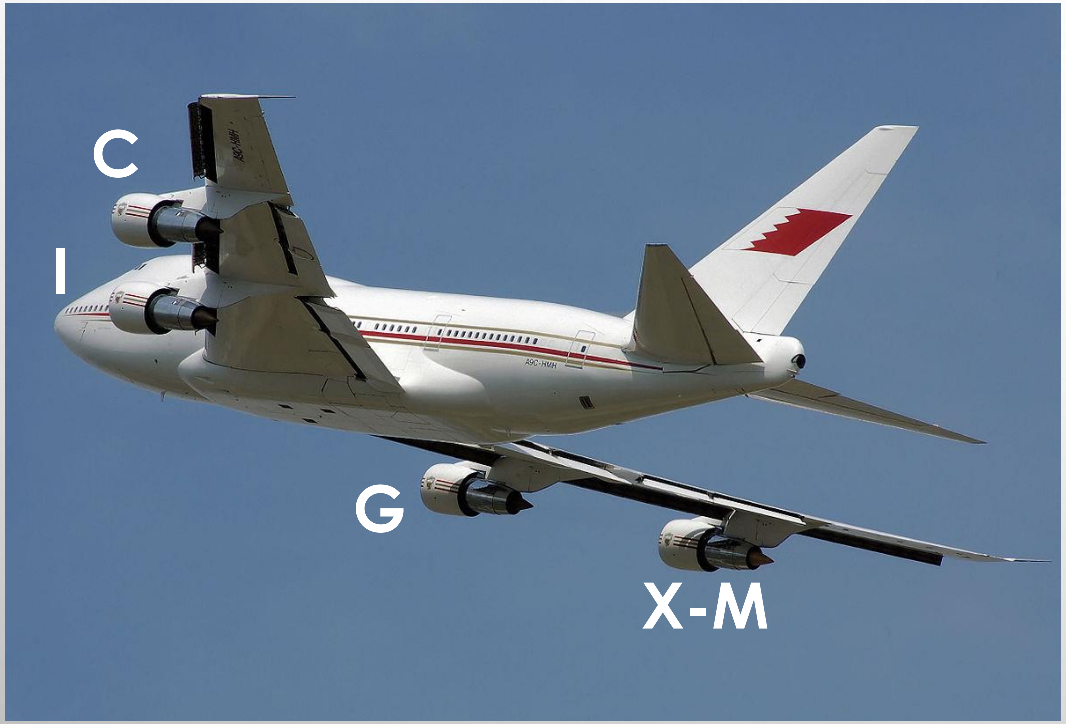


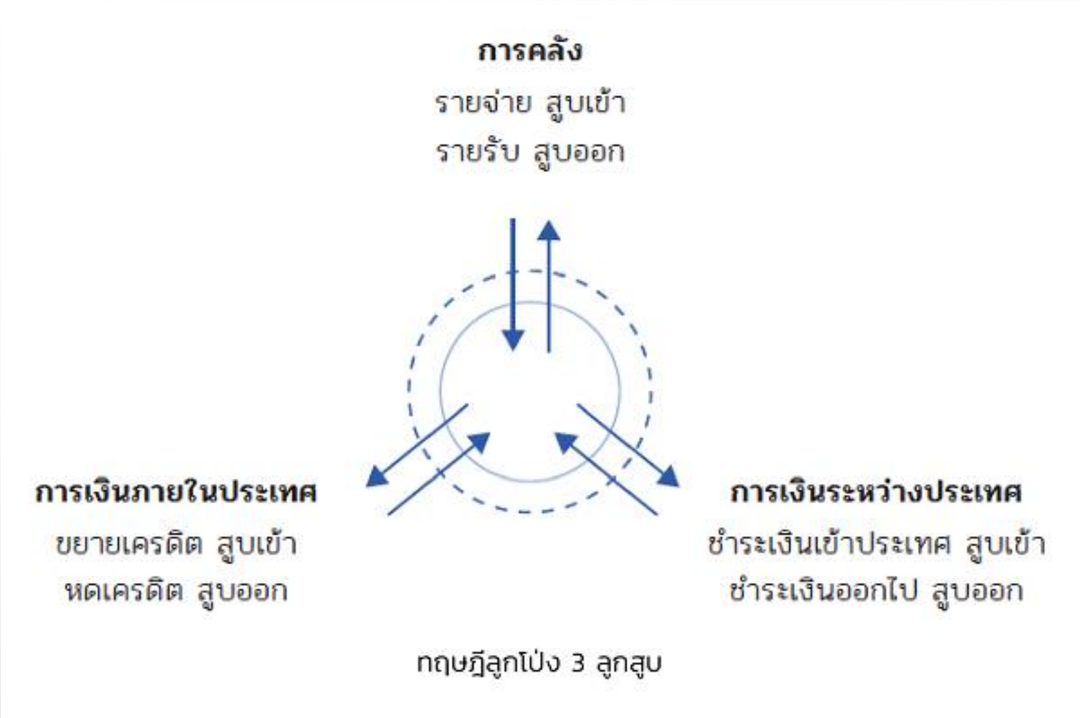
General Theory of Employment, Interest and Money



- A significant contribution of Keynes is clearly that an economy can be at equilibrium while not at full employment.
- It may be a natural outcome of the organization and institutions of modern economies that **prices and wages may not be fully flexible.**
- This would result in markets (like the labor and goods markets) being unable to clear, leading to **unemployment** and **aggregate supply exceeding demand.**
- Since AD = C + I + G + (X-M), if investment demand is deficient, then AD < AS, and inventories may pile up, with unemployment a natural outcome.
- Without the coordinating variable, this will be the normal outcome, with AD = AS only happening accidentally.

General Theory of Employment, Interest and Money

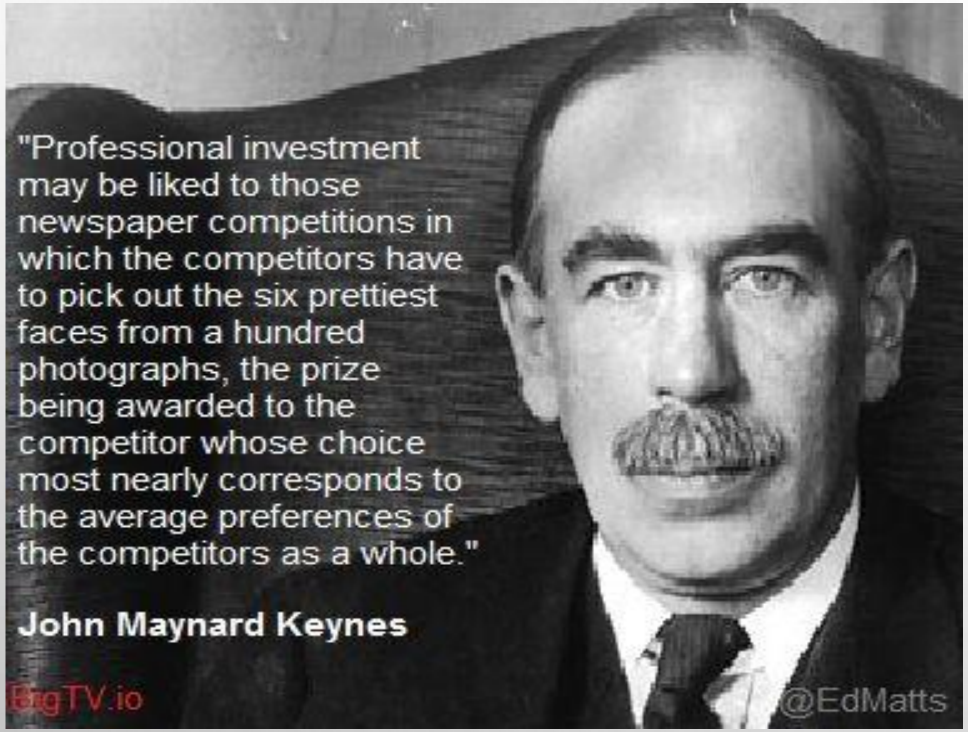




General Theory of Employment, Interest and Money

- **Money** plays a key role in the economy.
- **Interest rates** are established in the money market.
- People may rationally hoard money, holding money for purposes other then making transactions.
- An argument about what has classically been known as the dangers of **hoarding**, i.e., the potentially pernicious consequences of an economy-wide increase in the **demand for money** that is not met by a corresponding increase in the supply of money.
- "It is agreed that hoarding money, whether in cash or in idle balances, is deflationary in its effects. No one thinks that deflation is in itself desirable."

KEYNES'S BEAUTY-CONTEST ANALOGY



- Keynes thought that professional **money managers** were playing an intricate guessing game.
- He likened it to a common newspaper game "in which the competitors have to pick out the six prettiest faces from 100 photographs, the prize being awarded to the competitor whose choice most nearly corresponds to the average preferences of the competitors as a whole: so that each competitor has to pick, not those faces that he himself finds prettiest, but those that he thinks likeliest to catch the fancy of the other competitors

KEYNES'S BEAUTY-CONTEST ANALOGY

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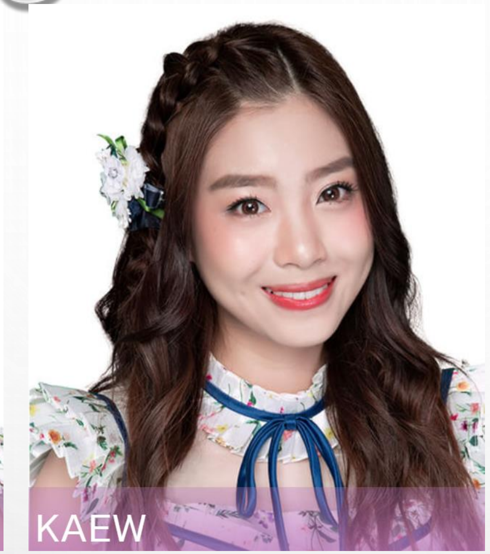

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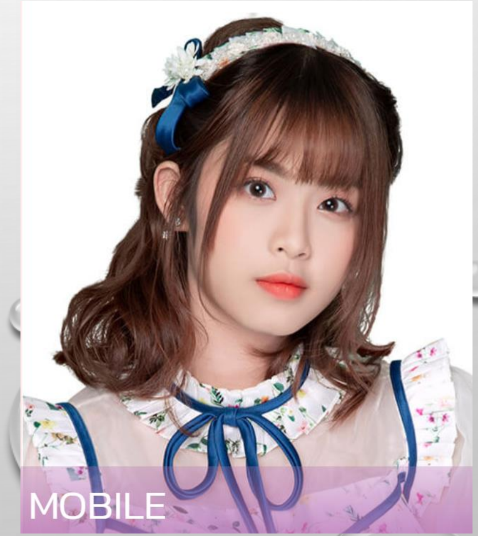

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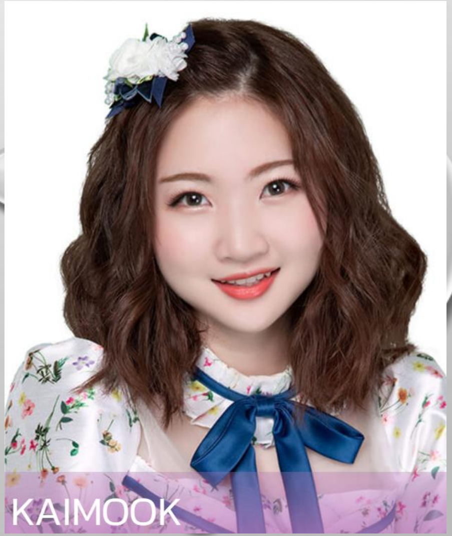

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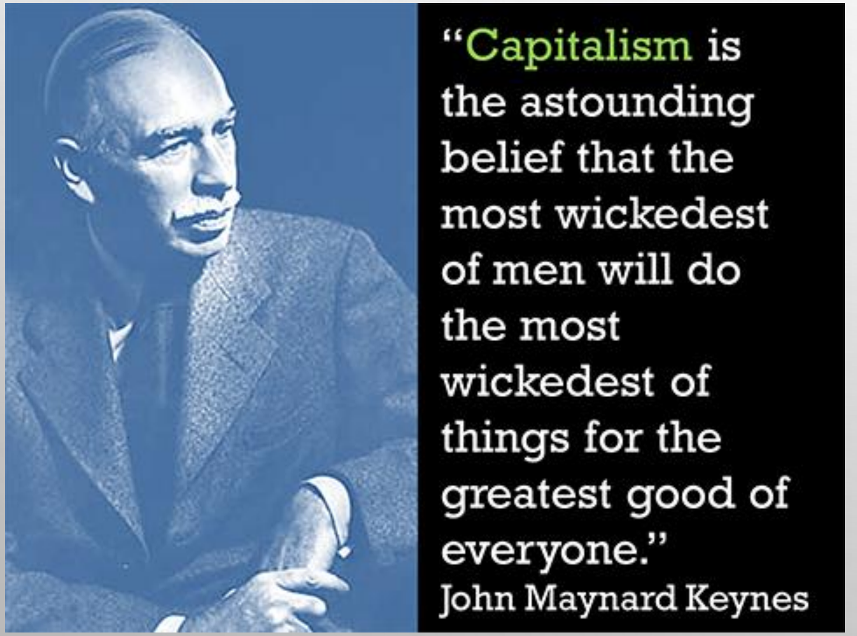
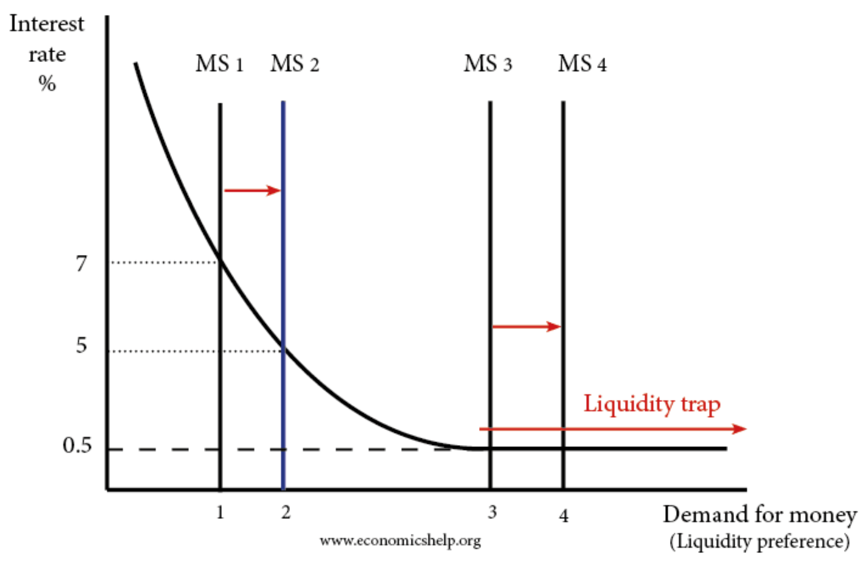
KEYNES'S BEAUTY-CONTEST ANALOGY



- Many investors call themselves "**value managers**", meaning they try to buy stocks that are cheap. Others call themselves "growth managers", meaning they try to buy stocks that will grow quickly.
- But of course no one is seeking to buy stocks that are expensive or stocks of companies that will shrink. So what these managers are really trying to do is buy stocks that will go up in value — or, in other words, stocks that they think other investors will later decide should be worth more.

General Theory of Employment, Interest and Money



Monetary Policy: Liquidity Trap

- "Private economy" was the culprit that impeded a return to prosperity. If a person decides to save, there is no assurance that the funds "will find their way into investment in new capital construction by public or private concerns."
- They cite a "**lack of confidence**" as the reason that savings is not intermediated into investment.
- Since the monetary policy can not legislate increase autonomous Consumption or autonomous Investment then the only alternative is Government expenditures.

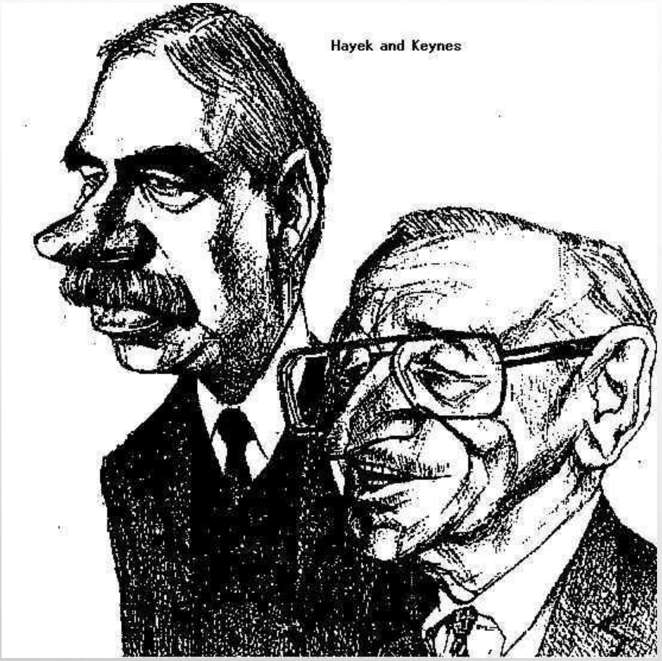
General Theory of Employment, Interest and Money

- This was equivalent to saying that there was no automatic mechanism in the system to adjust **aggregate demand to supply**.
- One possible implication of Keynesian theory is that the government's budget should be used to balance the accounts of the nation, not just the government, to ensure that aggregate supply and demand are equal at full employment.
- Keynes found his rationale for a programme of loan-financed public works to increase employment.
- "**Spending on public works would produce a 'cumulative' wave of prosperity**".
- **Taxation** should be slashed so that people had cash to spend on goods that would create jobs.
- But his proposals made little headway at the time.

General Theory of Employment, Interest and Money

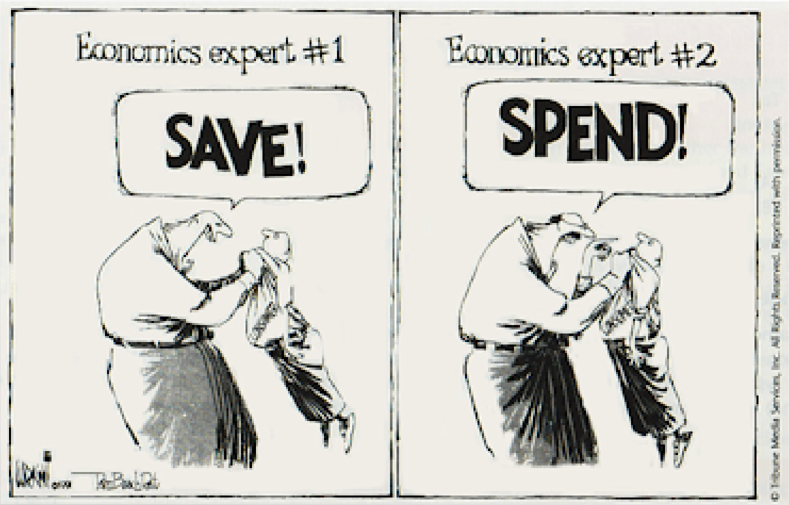
- "**Spending on public works would produce a 'cumulative' wave of prosperity**".
- He was not particular either of the type of expenditure the government did, for instance, hiring individuals one day to dig a hole and place bottles in that hole. The next day hire same or other individuals to dig and bottles out. The next day bury them again, etc.
- **Taxation** should be slashed so that people had cash to spend on goods that would create jobs.
- But his proposals made little headway at the time.

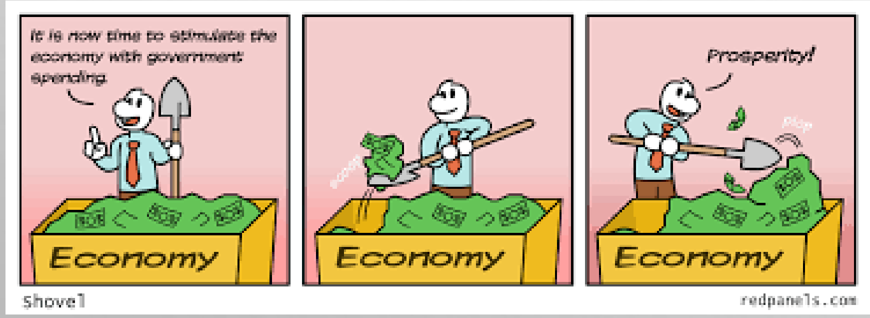
'KEYNES' VS. 'HAYEK' DEBATE



- On Oct. 17, 1932, *the Times* published a lengthy letter from John Maynard Keynes and five other academic economists. Keynes, et al. (Keynes for short), made the case for spending — of any kind, private or public, whether on consumption or investment.
- Two days later, on Oct. 19, 1932, four professors at the University of London, including F. **Hayek**, responded to the Keynes letter.
- The argument about whether it is best to stimulate an economy in the face of large scale unemployment or rather, let the market find its own solutions

‘KEYNES’ VS. ‘HAYEK’ DEBATE

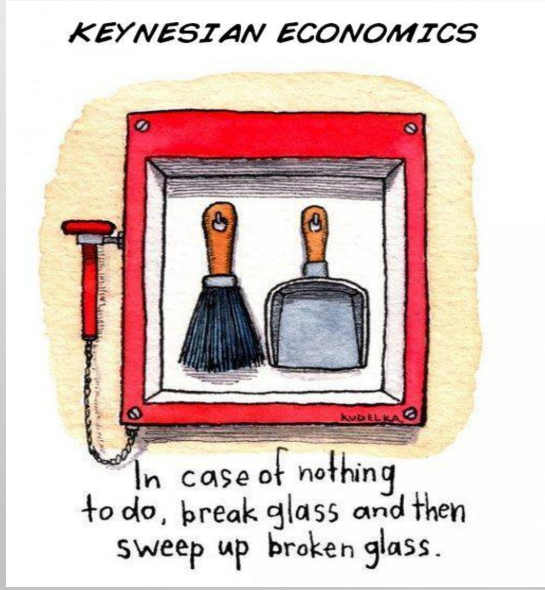




- **Hayek** disputed that it mattered not the form spending took, whether on consumption or investment.
- They saw a “revival of investment as peculiarly desirable,” as do today’s proponents of **supply-side economics**.
- They distinguish between hoarding of money and savings that flows into securities, and reaffirm the importance of the securities markets in transforming savings into investment.
- “The existence of public debt on a large scale imposes frictions and obstacles to readjustment very much greater than the frictions and obstacles imposed by the existence of private debt.”
- This was not the time for “new municipal swimming baths”.

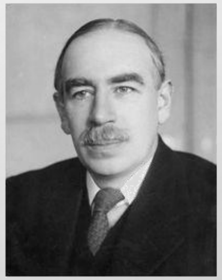
‘KEYNES’ VS. ‘HAYEK’ DEBATE

- **Hayek** argued that while a Keynesian stimulus may well put some people to work, in the **medium to long term** the market would become so distorted that when the stimulus was removed employers would be left making goods that were no longer needed.



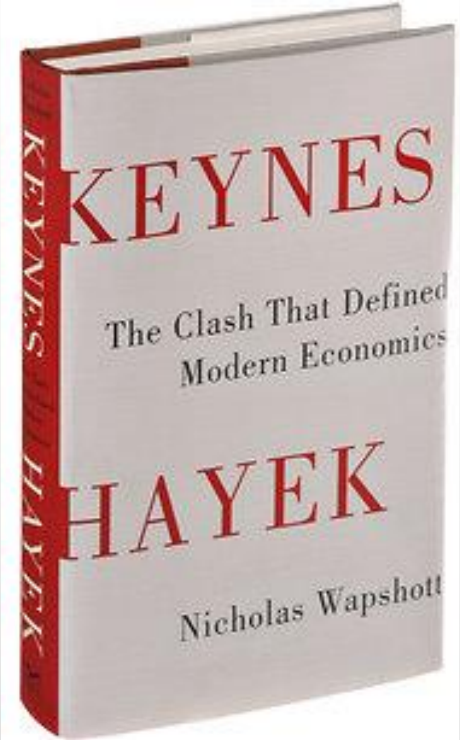
J.M. Keynes

“The long run is a misleading guide to current affairs. In the long run we are all dead. Economists set themselves too easy, too useless a task if in tempestuous seasons they can only tell us when the storm is long past, the ocean will be flat.”



The General Theory of Employment, Interest and Money

'KEYNES' VS. 'HAYEK' DEBATE



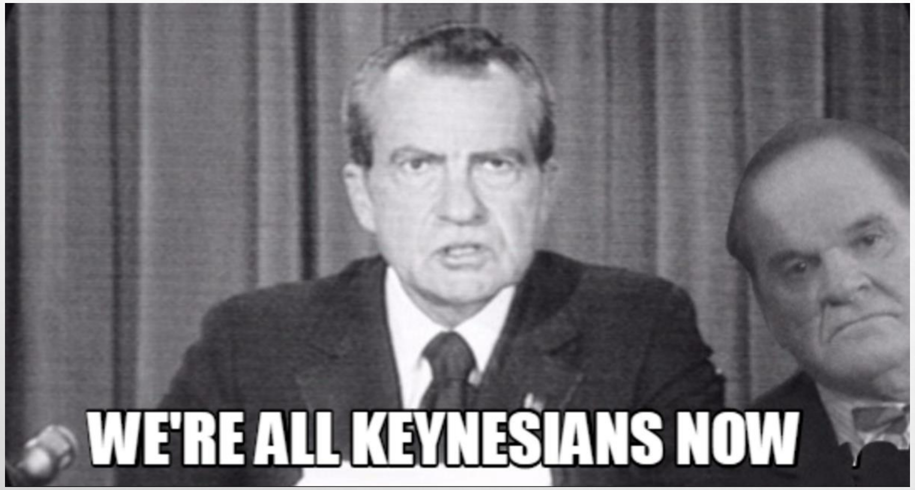
- **Hayek** came to believe "that those who advocated large-scale public spending programs to cure unemployment were inviting not just uncontrollable inflation but political tyranny."
- **Keynes** didn't expect that his findings would lead to an infringement of personal liberty. Instead, the author writes, Keynes believed "that a prosperous society in which everyone is employed was the surest way of maintaining the independence of thought and action he considered the guarantor of true democracy."
- Keynes reminded Hayek that the rise of National Socialism was fueled not by big government but by mass unemployment and a failure of capitalism.

'KEYNES' VS. 'HAYEK' DEBATE

https://www.youtube.com/watch?v=d0nERTFo-Sk

- In America, an identical argument is going on. In early 2009, Obama started spending an $800 billion Keynesian stimulus. The stimulus halted the precipitous economic decline that threatened to drag the country into a Great Recession.
- However, by the midterm elections of 2010, Obama's attempts to add more stimulus money to the still flagging economy was halted by members of Congress, who were inspired by Hayek's ideas and were suffering from borrowers' remorse.
- So the ideas that Keynes and Hayek engaged in 81 years ago persist to this day.
- Economists have clothed the debate with ever greater mathematical complexity, but the underlying issues remain the same.

AGE OF CONTROLLED CAPITALISM (1945-1947)



- The political applications of Keynesian ideas inspired what some economists called ***the 'golden age of controlled capitalism'***, which lasted roughly from 1945 to 1975.
- It was the Keynesian advocacy of an interventionist state and regulated markets that gave 'liberalism' its modern economic meaning.
- A doctrine favoring a large, active government, regulation of industry, high taxes for the rich, and extensive social welfare programs for all. National governments controlled money flows in and out of their territories.
- These delivered spectacular economic growth rates, high wages, low inflation, and unprecedented levels of material wellbeing and social security.

AGE OF CONTROLLED CAPITALISM (1945-1947)

- After WWII, many Western countries followed this path of *Keynesian-led* '**welfarism**' model as a broad political consensus.
  - e.g. The American 'New Deal' and 'Great Society' programmes spearheaded by FDR and President Lyndon Johnson, the model of Swedish social democracy, the British social welfare system , etc.
- **High taxation** on wealthy individuals and profitable corporations led to the expansion of **the welfare state**.
- **Rising wages** and **increased social services** in the wealthy countries of the global North offered workers entry into **the middle class**.
- Some pundits proclaimed this age as the 'end of ideology'.

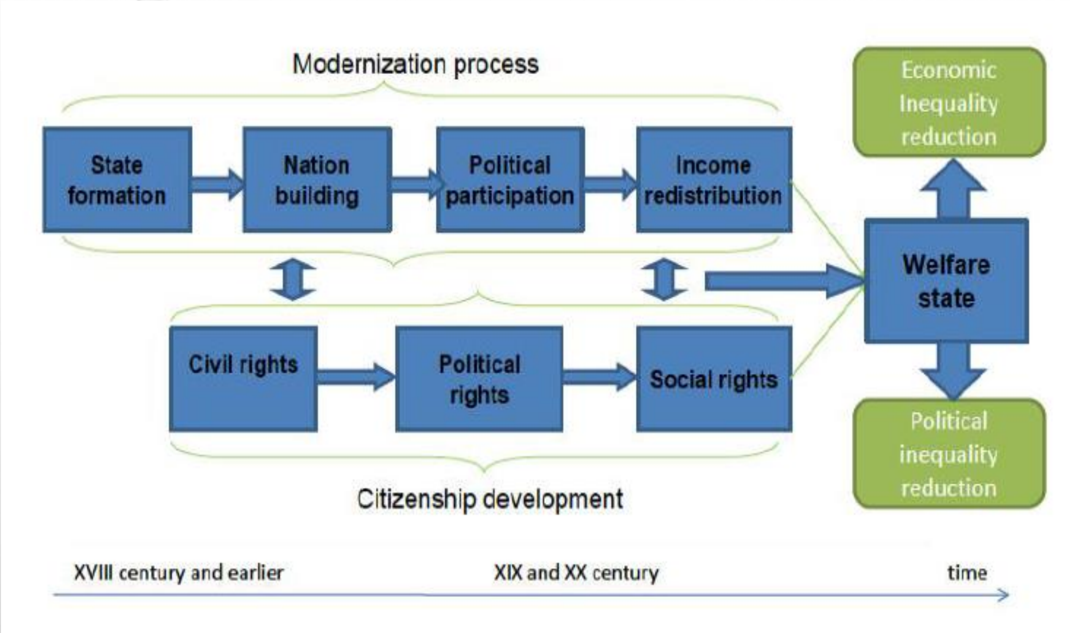
SOCIAL DEMOCRACY

- During the Keynesian era, **social democrats** had viewed **welfare systems** as a matter of collective rights or social citizen.
- This raised new questions for social democracy:
    - Had **capitalism** been changed by **social democracy** so that its values were now incorporated in the system? Or
    - Had **capitalism** in advanced industrial countries become so successful that it could now afford concessions to the working classes whether or not these were demanded by **social democracy**?

Social Democracy

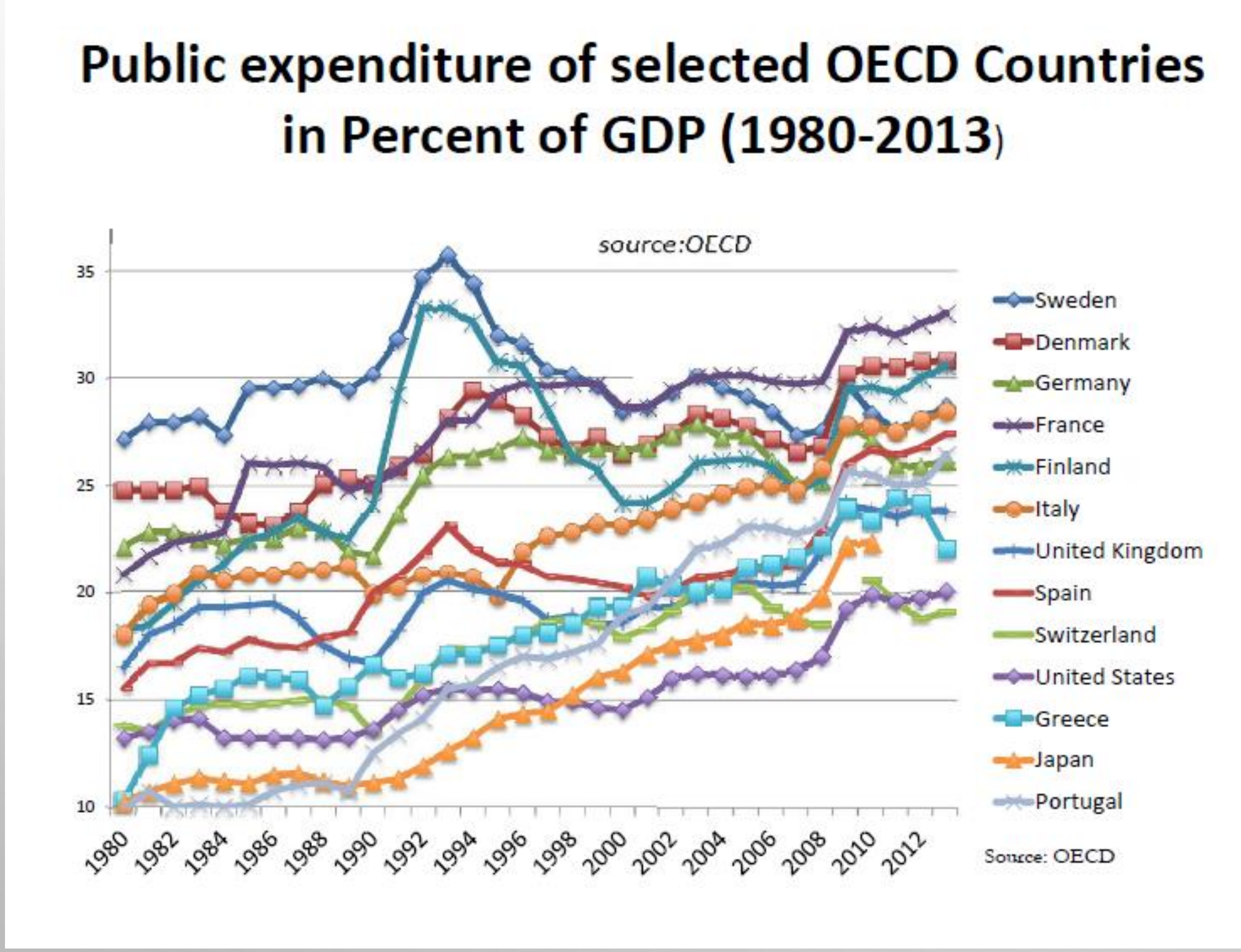
- The association between **Keynesianism** and **social democracy** was of particular importance as **social expenditure** increased and full employment was established, most social democratic parties underwent a further evolution.
- Most now became more openly committed to the goal of **progressive social reform**, rather than the total elimination of the capitalist system.
- The new system strengthened the bargaining role of the organized working class through **trade unions**, which were able to influence the direction of economic and social policy, and some states operated a system in which government, capital, and labour were recognized as **tripartite interests** in an ongoing **bargaining relationship**.
- Social democracy could now be characterized as a tradition seeking to promote increasing benefits for the working classes within a primarily capitalist system.

Social Democracy



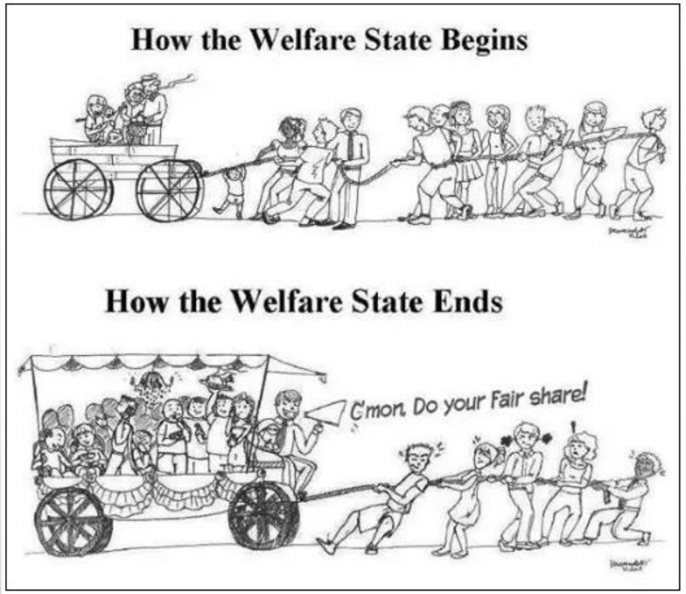
- During the Keynesian era, social democrats had viewed welfare systems as a matter of **collective rights** or **social citizenship**
- Core idea of a welfare state: **Right-based system** of social welfare → "Rights linked directly to citizenship".
- Welfare entitlement should be based on citizenship; removing stigmatization of those receiving economic assistance.
- **Equal access to services** such as health provision, education, economic assistance for those in need, and other social services, etc.
- However, social rights imply some redistribution of goods. Social citizenship includes also a duty to improve oneself and contribute productively to the economy of the nation.

Social Democracy



- The heyday of social democracy in the advanced capitalist societies of Western Europe coincided broadly **with the long post-war boom from the late 1940s until the 1970s**.
- During the 1950s and 1960s the average growth rate in the advanced capitalist economies of the OECD was nearly 5% per year, and this was the basis for the rapid increase in social expenditure as a proportion of GDP, particularly in Western Europe.
- Thus, in 1949 **social expenditure** averaged 9% of GDP in 13 West European countries, and by 1970, it had reached 15.8%, rising to 22.4% by 1977, with the fastest increase, of 5.4 percentage points.

Social Democracy



> We used to think that you could just spend your way out of a recession and increase employment by cutting taxes and boosting government spending. I tell you, in all candour, that the option no longer exists, and that insofar as it did exist, it only worked by injecting a bigger dose of inflation into the economy followed by higher levels of unemployment as the next step.

James Callaghan, the British Labour prime minister, announced the end of the era in the 1976 Party conference

The Downfall

- However, in 1974 the average OECD growth rate was 2%, while in the next year nine OECD economies had negative growth. In 1975 Unemployment in the OECD economies was at easily its highest post-war level of 15 million.
- '**G**' was not helping. The situation now differed from that of the inter-war period because of the phenomenon of '**stagflation**' – the combination of economic recession and high inflation.
- Three years later, the **Thatcher government** deliberately sought to create a situation that would permanently remove the existing basis for social democracy.

Outline

- Classical Liberalism (Smith & Ricardo)
- Austrian School (Hayek)
- Keynesianism (Keynes)
- Neoliberalism (Friedman)
- Schumpeterian (Schumpeter)
- Institutionalism (Chang; Acemoglu & Robinson)

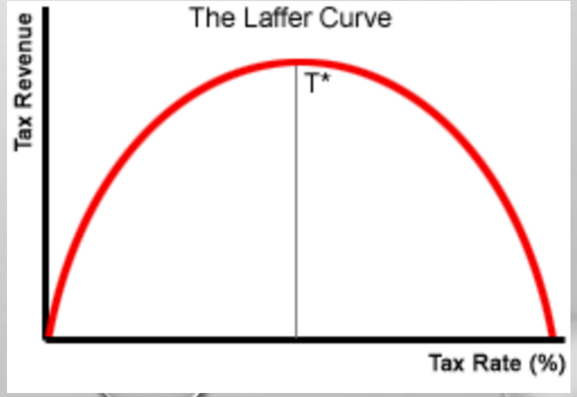
REMARKETIZED CAPITALISM

- In the 1980s, a successful ideological crusade against **Keynesian-style 'big government'** and **state 'interference' in the market**.
- ***Reaganomics*** and ***Thatcherism*****:** Anchored in common principles centered on **releasing the entrepreneurial energies of the individual**, but distinct approaches to issues such as the relative importance accorded to budget deficits and taxes. Both advocated **a reduced role of government.**
- After a brief period of **expansionist policies** immediately after taking office, this administration turned towards **austerity** measures in 1982, apparently burying the idea of Keynesianism in a single country.

REMARKETIZED CAPITALISM

Executive leader	Core neoliberal beliefs	Secondary beliefs	Core neoliberal policy issue	Secondary policy issue
Reagan (supply-sider)	Government is inefficient. Government predation leads to poor economic performance.	Monetary and fiscal stability is necessary for economic growth.	Restrict the extent of government predation through minimal taxation.	Create economic stability through deficit reduction and spending restraint.
Thatcher (monetarist)	Government is inefficient. Monetary and fiscal stability is necessary for economic growth.	Government predation leads to poor economic performance.	Create economic stability through deficit reduction and spending restraint.	Restrict the extent of predation through minimal taxation.

A. Reaganomics and Thatcherism: supply-side and monetarist neoliberalism



REMARKETIZED CAPITALISM

- By the mid-1980s, the new conventional wisdom was that **individuals could and should take care of themselves** rather than relying on the state, and that the costs of welfare needed to be kept under control so that taxation would not be at 'prohibitive' levels.
- The tendency was to claim that **public provision** always needed to be justified, for people were more interested in **the quality of the service** than its source.

REMARKETIZED CAPITALISM

A critique of the Keynesian welfare state.

- **First**, - **uneconomic**, in displacing the necessary disciplines and incentives of the marketplace, undermining the incentive of capital to invest and of labour to work.
- **Second**, - **unproductive** in encouraging the rapid growth of public bureaucracy and in forcing capital and human resources out of the productive private sector of the economy. At the same time, the monopoly of state welfare provision had enabled workers within the public sector to command inflationary wage increases.
- **Third**, - **inefficient** since the state's monopoly of welfare provision and sponsorship of the special interests of trade unions led to an inefficient delivery of services and a system geared to the interests of organized producers rather than consumers.
- **Finally**, - **ineffective** in failing to eliminate poverty and deprivation, despite the resources devoted to welfare.

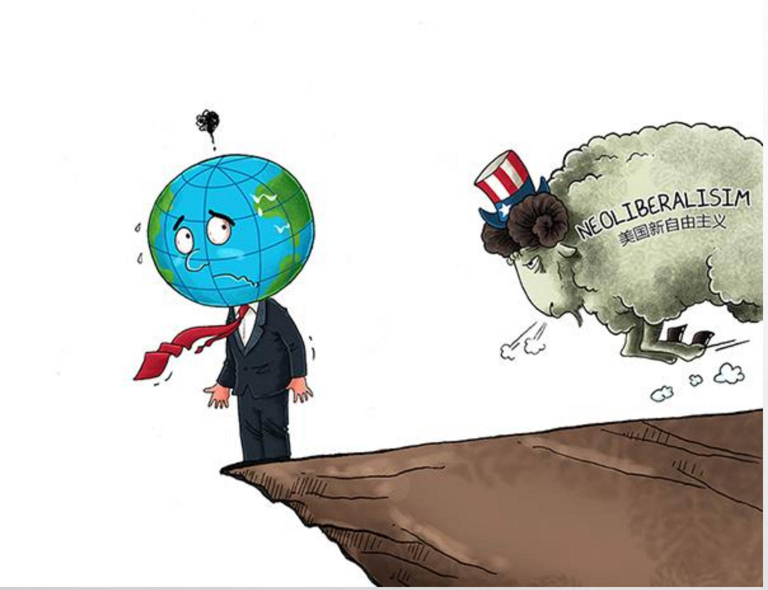
REMARKETIZED CAPITALISM

- **Welfare expenditure** **was cut** through the restriction of benefit payments, particularly the payment of unemployment benefit, by the replacement of grants with loans, as students know to their cost, and by increases in charges.
- A shift from income tax to **indirect taxes** which, it was claimed, at least gave people greater choice, since they did not have to buy the products that carried these taxes.
- Public sector industries and services were returned to the market-place through various forms of **privatization**.
- In 1983, for example, all district health authorities were required to introduce competitive tendering for the provision of cleaning, laundry, and catering services.
- New areas through the device of **public-private partnerships**

NEOLIBERALISM

- **'Neoliberals'** subscribed to a common set of ideological and political principles dedicated to the worldwide spread of an economic model emphasizing free markets and free trade.
- But they emphasized different parts of their theory according to their particular social contexts.
- The term **'Neoliberalism'** was first coined in post-World War I Germany by a small circle of economists and legal scholars to refer to their moderate programme of reviving classical liberalism.

NEOLIBERALISM

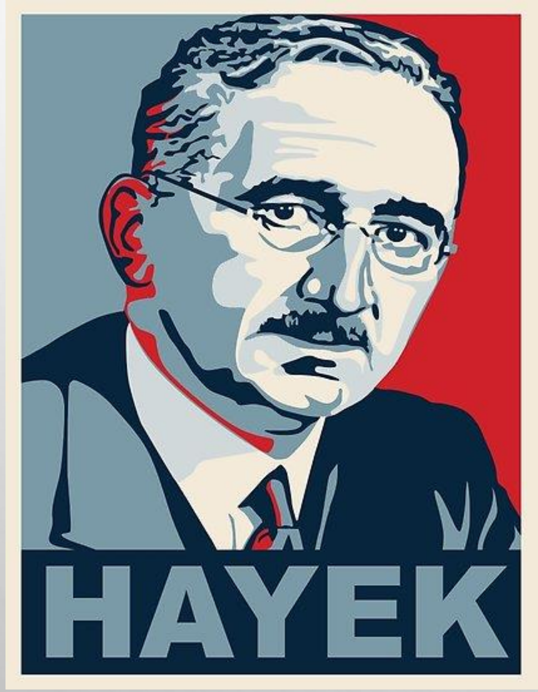


- In the 1970s, a group of Latin American economists adopted ***neoliberalismo*** for their **pro-market model**.
- **Detested by the Keynesians**, the Neoliberals argued that crippling government regulation, exorbitant public spending, and high tariff barriers to international trade had been responsible for creating conditions that led to high inflation and poor economic growth throughout the industrial countries in the 1970s.
- The 1991 demise of the Soviet Union and the acceleration of market-oriented reforms in communist China led to the unprecedented dominance of the neoliberal model in the 1990s. It ate its way into the heart of **the former Soviet bloc**.
- In its heyday during the 1990s, neoliberalism bestrode the world like a colossus.

NEOLIBERALISM

- Still others saw neoliberalism was invented for the purpose of downgrading the intellectual achievements of neoclassical economists such as Nobel-prize winners ***Milton Friedman*** and ***Friedrich von Hayek***.
- So, it was seen as a postmodern version of quaint 18th-century '***laissez-faire talk***' glorifying individual self-interest, economic efficiency, and unbridled competition..
- Such ideas were constantly propounded from the late 1970s, with an insistence on the **superiority of the market** over any form of **government intervention**.

LIBERTARIANISM



- Libertarianism is a political creed hostile to government intervention
- Often associated with the economic doctrines of **Friedrich von Hayek and Milton Friedman**, libertarianism is a political creed hostile to government intervention.
- Hayek and his colleagues sought to revive classical liberalism in their attempt to challenge the dominance of Keynesian ideas.
- While sharing general agreement with mainstream liberalism on the primacy of individual liberty, **most libertarians are strictly opposed to other liberal values such as equality, solidarity, and social responsibility**.
- Rejecting modern governments as illegitimate for their use of **'coercive' policies**, many libertarians subscribe to **the utopian ideal of a loose 'society' of autonomous individuals engaged in strictly voluntary forms of exchange**.
- Some libertarians go even so far as to demand the wholesale abolition of the state.

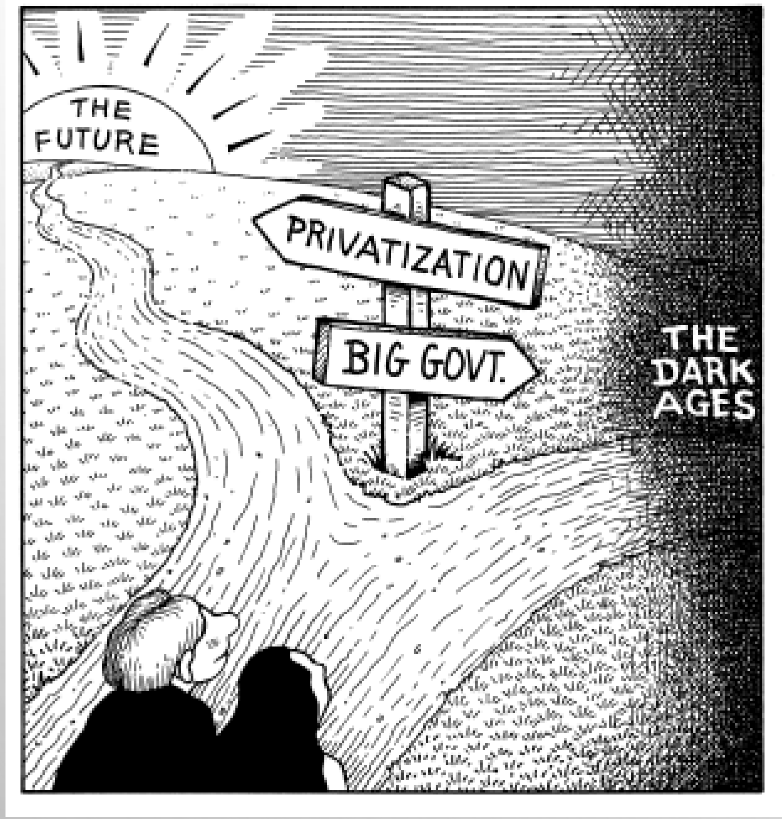
LIBERTARIANISM

- The neoliberal principles advocated by Hayek’s Society greatly influenced the American economist **Milton Friedman**, winner of the 1976 Nobel Prize.
- The charismatic leader of the **Chicago School of Economics** (based at the University of Chicago), Friedman had an influential hand in guiding neoliberalism from constituting a mere minority view in the 1950s to becoming **the ruling economic orthodoxy** in the 1990s.
- Friedman's challenges to what he later called **"naive Keynesian" theory**
- **Monetary policies** should take precedence over fiscal policy (taxation and redistribution policies) devised by ‘big government.
- Friedman was an advisor to Republican President Ronald Reagan and Conservative British Prime Minister Margaret Thatcher.

LIBERTARIANISM

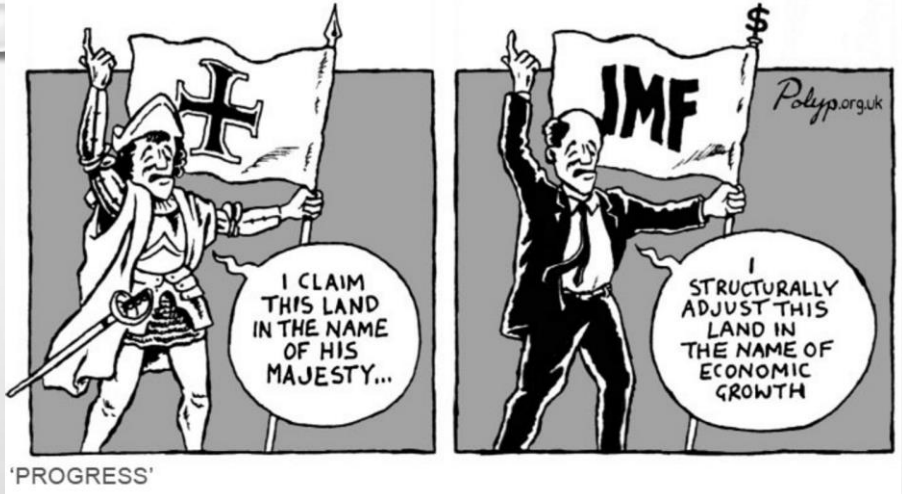
- Friedman talks about the need to move to a classically liberal society, that **free markets** would help nations and individuals in the long-run and fix the efficiency problems currently faced by the United States and other major countries of the 1950s and 1960s.
- Government should stay out of matters that do not need and should only involve itself when absolutely necessary for the survival of its people and the country.
- Friedman rejected the use of **fiscal policy** as a tool of **demand management**
- He advocated policies such as a volunteer military, freely floating exchange rates, abolition of medical licenses, a negative income tax and school vouchers, opposing the war on drugs, and support for school choice.

WASHINGTON CONSENSUS



- By early 1990s, left-leaning critics of market reform in the **global South** had imbued 'neoliberalism' with pejorative meanings associated with the '**Washington Consensus**' – a set of economic institutions and policies alleged to have been designed by the **United States** to globalize American capitalism and its associated cultural system.
- It was described as the 'lowest common denominator of policy advice' directed at mostly Latin American countries by **the IMF, the World Bank, and other Washington-based international economic institutions and think tanks**.
- It confronted countries of the global South with the new rules and conditions for their economic development.

WASHINGTON CONSENSUS



- A global neoliberal development agenda based primarily on so-called **'structural adjustment programmes'** and **international free-trade agreements**.
- Powerful economic institutions like **the International Monetary Fund** and **the World Bank imposed** their neoliberal agenda on heavily indebted developing countries in return for much needed loans.
- In the 1990s, it became the global framework for 'proper' economic development.
- In exchange for much-needed loans and debt-restructuring schemes, governments in the global South were required to adhere to the Washington Consensus by following its **ten-point programme**.

WASHINGTON CONSENSUS

- Related policy measures include;
  - Massive tax cuts (especially for businesses and high-income earners);
  - Reduction of social services and welfare programmes;
  - Replacing welfare with ‘workfare’;
  - The downsizing of government;
  - Tax havens for domestic and foreign corporations willing to invest in designated economic zones;
  - New commercial urban spaces shaped by market imperatives;
  - Anti-unionization drives in the name of enhancing productivity and ‘labour flexibility’;
  - Regional and global integration of national economies;
  - The creation of new political institutions, think tanks, and practices designed to reproduce the neoliberal paradigm

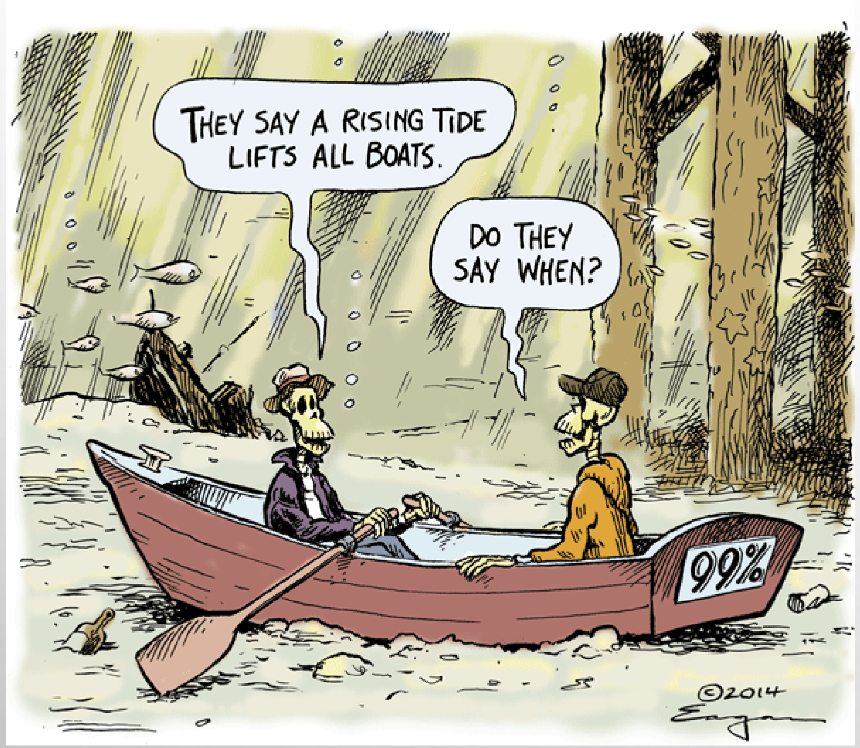
NEOLIBERALISM

- The codifiers of neoliberalism are global power elites that include
  - Managers and executives of large transnational corporations,
  - Corporate lobbyists,
  - Influential journalists and public-relations specialists,
  - Intellectuals writing for a large public audience,
  - Celebrities and top entertainers,
  - State bureaucrats,
  - Politicians
- Serving as the chief advocates of neoliberalism, these individuals saturate the public discourse with idealized images of a consumerist, free-market world.

NEOLIBERALISM

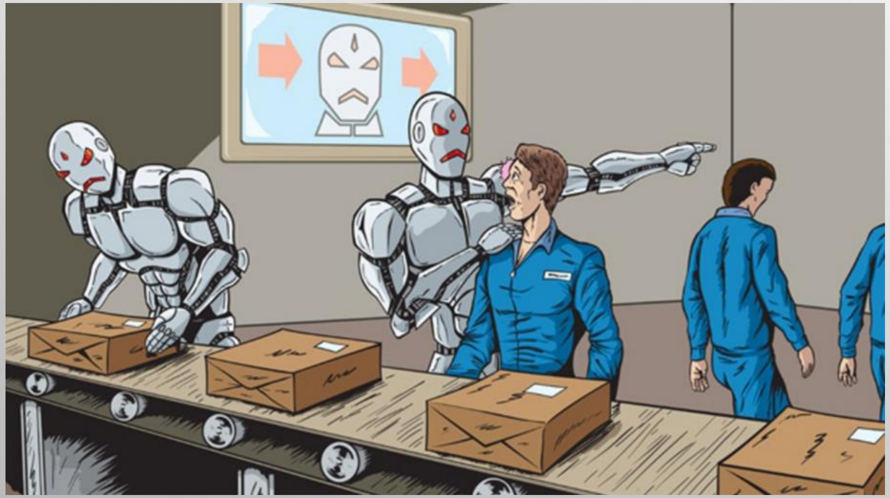
- At the dawn of the new century, however, neoliberalism has been discredited as the global economy built on its principles has been shaken to its core by a financial calamity not seen since the dark years of the 1930s.
- **The global economic crisis of 2008–9** is only the latest in a series of challenges to the still dominant free-market paradigm.
- The huge budget deficits created by the crisis will force governments to reduce public investments and welfare entitlements significantly, negatively affecting economic growth, poverty and social stability – possibly for decades

NEOLIBERALISM



Arguments

- A free economy requires **a strong state** !? : The reviving of market forces actually increased state regulation
- The trend is currently towards a less regulated form of capitalism which provides greater choice and more freedom for the individual but also **a less secure life, intensified work pressures, and greater inequality** both within and between states.
- The gap has widened between those trapped in low-wage occupations who face insecure futures and those able to exploit the new opportunities to accumulate wealth.



NEOLIBERALISM

- Skillfully interacting with the media to sell their preferred version of **a single global marketplace** to the public, they portray globalizing markets in a positive light as **an indispensable tool for the realization of a better world**.
- Such market visions of globalization pervade public opinion and political choices in many parts of the world.
- A neoliberal governmentality is rooted in entrepreneurial values such as **competitiveness, self-interest, and decentralization**.
- Individual aspiration has been a central value within capitalism that has been internalized by populations
- It celebrates individual empowerment and the devolution of central state power to smaller localized units.

NEOLIBERALISM

- Neoliberal modes of governance encourage the transformation of bureaucratic mentalities into entrepreneurial identities
- **Government workers** see themselves no longer as public servants and guardians of a qualitatively defined ‘public good’ ..
- but as **self-interested actors** responsible to the market and contributing to the monetary success of slimmed-down state ‘enterprises’.
- The neoliberal mode of governance for public servants redefined citizens as ‘customers’ or ‘clients’ and encouraged administrators to cultivate an ‘**entrepreneurial spirit**’.

SOCIALISM IN THE 20TH CENTURY

- At the same time, it is also clear that many people in capitalist societies regret **the absence of social solidarity or community**.
- Many believe that there was once **a greater sense of shared values** and think that crime, drugs, violence, and the constant breakdown of relationships have something to do with **the excessive individualism of contemporary life** (Yet this can also be a theme of the political Right, which calls for the restoration of traditional values.)
- At its worst, this can be coupled with racism and xenophobia, with the argument that social breakdown and the loss of the old sense of community have been caused by migrants or asylum seekers. In less extreme versions, the notion of community counterpoised to individualism often takes the form of nationalism.
- All this has therefore become difficult terrain for socialists.

NEW LEFTS

- Contemporary transformations were not the ‘death of class’ or the ‘end of the working class’ per se.
- Not only male blue-collar workers should have been ‘objectified’ as ‘the working class’.
- Living and working conditions that were historically associated with the labour movement were decoupled. The working class, however defined, was becoming more segmented.
- With a general ethos encouraging individualism, it becomes much more difficult for socialists to advocate cooperation and social solidarity.
- In the UK, **unionization** declined sharply from its peak of 55.4% in 1979 to 37.7% in 1990, and was only 30% by 1997.

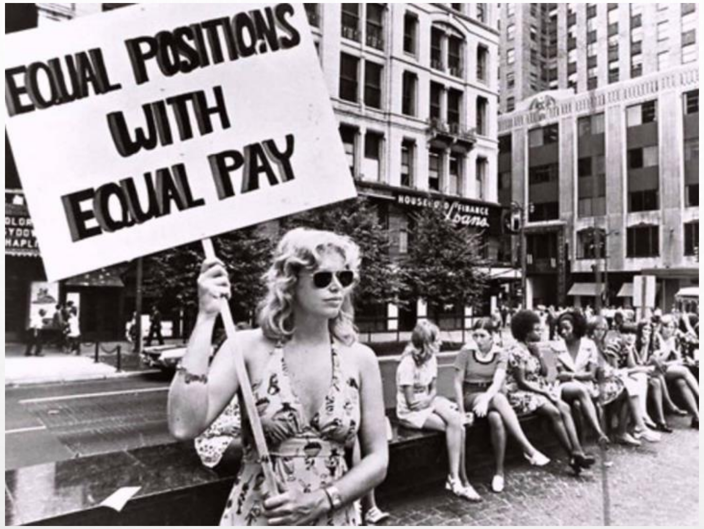
NEW LEFTS

- **New Left** had generated **new social movements.**
- Others who rejected social democracy as too timid were drawn to new forms of **extra-parliamentary politics** that challenged existing theories and practices across a whole range of activity.
- Revolutionary transformation would now depend on 'outsiders', including ethnic minorities and radical intellectuals.
- They had marginalized or ignored the issues that were now being raised, and they argued that socialism could be enriched by broadening its range.
- Marx's concept of **'alienation'** brought together the realms of consciousness and economic exploitation.
- Battling against existing power structures and sexual conventions, students hold their aspirations to create a new world.

NEW LEFTS

Anti-war

Feminist Socialism

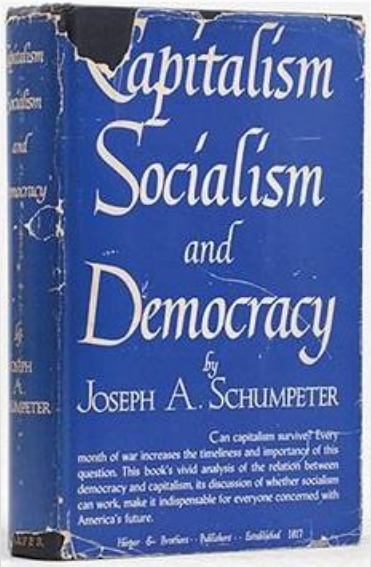


Green Socialism

Outline

- Classical Liberalism (Smith & Ricardo)
- Austrian School (Hayek)
- Keynesianism (Keynes)
- Neoliberalism (Friedman)
- Schumpeterian (Schumpeter)
- Institutionalism (Chang; Acemoglu & Robinson)

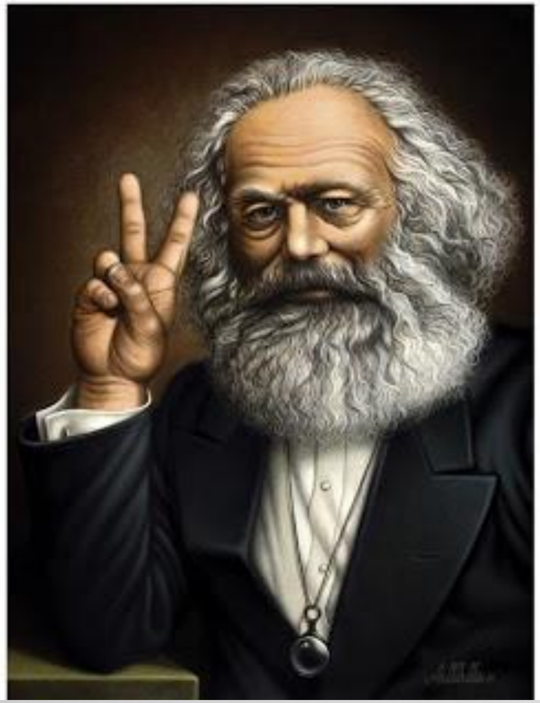
JOSEPH A. SCHUMPETER



Joseph A. Schumpeter
(1883-1950)

- Born and educated in Austria.
- Schumpeter began his career studying law at the University of Vienna, taking his PhD in 1906.
- In 1909, he became a professor of economics and government at the University of Czernowitz. In 1911, he joined the University of Graz, where he remained until World War I
- In 1919, Schumpeter became Minister of Finance in Austria, presiding over the hyperinflation of the period, and was dismissed later that year.
- He returned in 1921 to the private sector and became the president of a small Viennese bank, which collapsed in 1924.
- He emigrated to the United States in 1932, and became professor at Harvard.
- He published several books, but *Capitalism, Socialism, and Democracy* (1942) stands out.

SCHUMPETER'S ON MARXISM



- When Schumpeter's visionary *Theory of Economic Development* (1912) was published, classical and neoclassical thought as well as Marx's *Das Kapital* had already been exposed to scholarly scrutiny by the learned community for some time.
- Schumpeter developed the concept out of a careful reading of Marx's thought, arguing that the creative-destructive forces unleashed by capitalism would eventually lead to its demise as a system.
- His theory replaced Marx's view of greed-driven capitalism with dynamic, innovative entrepreneurship, clearly differentiating the capitalist from the entrepreneur.
- Schumpeter also became known for his opposition to Marxism and socialism that he thought would lead to dictatorship.

MARX'S CREATIVE DESTRUCTION

Hudist god Shiva is simultaneously destroyer and creator

- In Marxist economic theory, Marx establishes a necessary link between the generative or creative forces of production in capitalism and the destruction of capital value as one of the key ways in which capitalism attempts to overcome its internal contradictions.
- In The Communist Manifesto of 1848, Karl Marx and Friedrich Engels described the crisis tendencies of capitalism in terms of "the enforced destruction of a mass of productive forces", the epidemic of **over-production**
- In modern bourgeois society: the destruction of **exchange value** combined with the preservation of **use value** presents clear opportunities for new capital investment and hence for the repetition of the production-devaluation cycle.

MARX'S CREATIVE DESTRUCTION

- The destruction of capital through crises means the depreciation of values which prevents them from later renewing their reproduction process as capital on the same scale. This is the ruinous effect of **the fall in the prices of commodities**. It does not cause the destruction of any use-values. What one loses, the other gains.
- Values used as capital are prevented from acting again as capital in the hands of the same person. The old capitalists go bankrupt. [...]
- Society suddenly finds itself put back into a state of momentary barbarism; it appears as if a famine, a universal war of devastation, had cut off the supply of every means of subsistence; industry and commerce seem to be destroyed.
- That is to say, by paving the way for more extensive and more destructive crises, and by diminishing the means whereby crises are prevented.

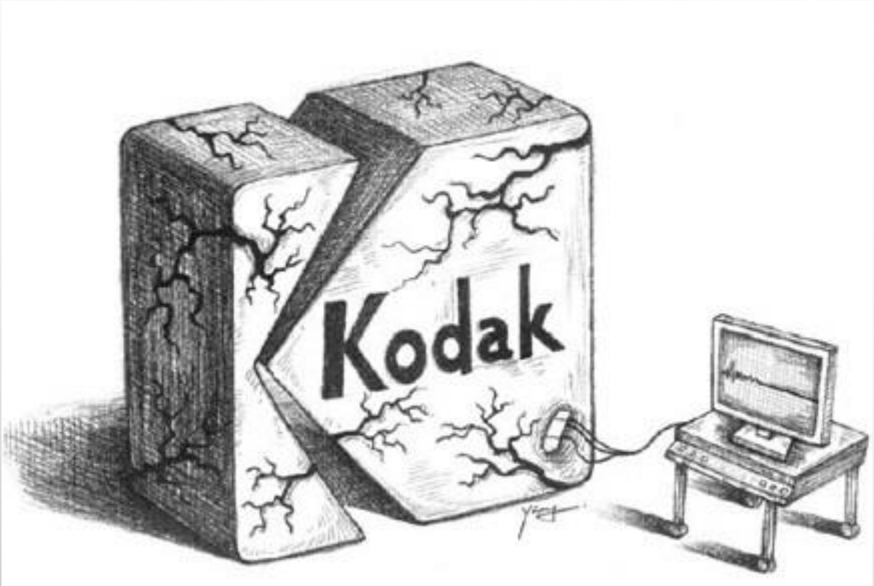
SCHUMPETER'S CREATIVE DESTRUCTION

- While Marx clearly admired capitalism's creativity Schumpeter strongly emphasized its self-destructiveness: **"The creation of something new usually requires that something old be eliminated,** for example, changes in the structure of demand or production result in structural unemployment."
- The key to an analysis of capitalism, which Schumpeter understood as being inseparable from the existence of constant change, was to comprehend how it destroyed and, at the same time, recreated itself.
- According to Schumpeter, the **"gale of creative destruction"** describes the **"process of industrial mutation that incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one".**
- The Schumpeterian have all along gloried in capitalism's endless creativity while treating the destructiveness as mostly a matter of the normal costs of doing business".

SCHUMPETER'SCREATIVE DESTRUCTION

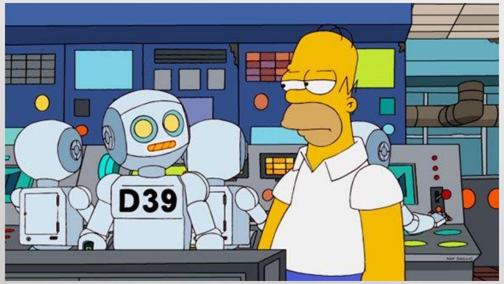
- The opening up of new markets, foreign or domestic, and the organizational development from the craft shop and factory to such concerns as U.S. Steel illustrate the process of industrial mutation that incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one.
- "The railroadization of the Middle West as it was initiated by the Illinois Central."
- He wrote, "The Illinois Central not only meant very good business whilst it was built and whilst new cities were built around it and land was cultivated, but it spelled the death sentence for the [old] agriculture of the West.".

SCHUMPETER'SCREATIVE DESTRUCTION



- Companies that once revolutionized and dominated new industries – for example, Xerox in copiers or Polaroid in instant photography – have seen their profits fall and their dominance vanish as rivals launched improved designs or cut manufacturing costs.
- In technology, the cassette tape replaced the 8-track, only to be replaced in turn by the compact disc, which was undercut by downloads to MP3 players, which is now being usurped by web-based streaming services.
- Companies which made money out of technology which becomes obsolete do not necessarily adapt well to the business environment created by the new technologies.

SCHUMPETER’SCREATIVE DESTRUCTION



- In Schumpeter's vision of capitalism, **innovative entry by entrepreneurs was the disruptive force that sustained economic growth**, even as it destroyed the value of established companies and laborers that enjoyed some degree of monopoly power derived from previous technological, organizational, regulatory, and economic paradigms.
- In breaking down the pre-capitalist framework of society, capitalism thus broke not only barriers that impeded its progress but also flying buttresses that prevented its collapse.
- That process, was not merely a matter of removing institutional deadwood, but of removing partners of the capitalist stratum, symbiosis with whom was an essential element of the capitalist schema.
- Creative destruction is a powerful economic concept because it can explain many of the dynamics or kinetics of industrial change: the transition from a competitive to a monopolistic market, and back again.
- It has been the inspiration of endogenous growth theory and also of evolutionary economics.

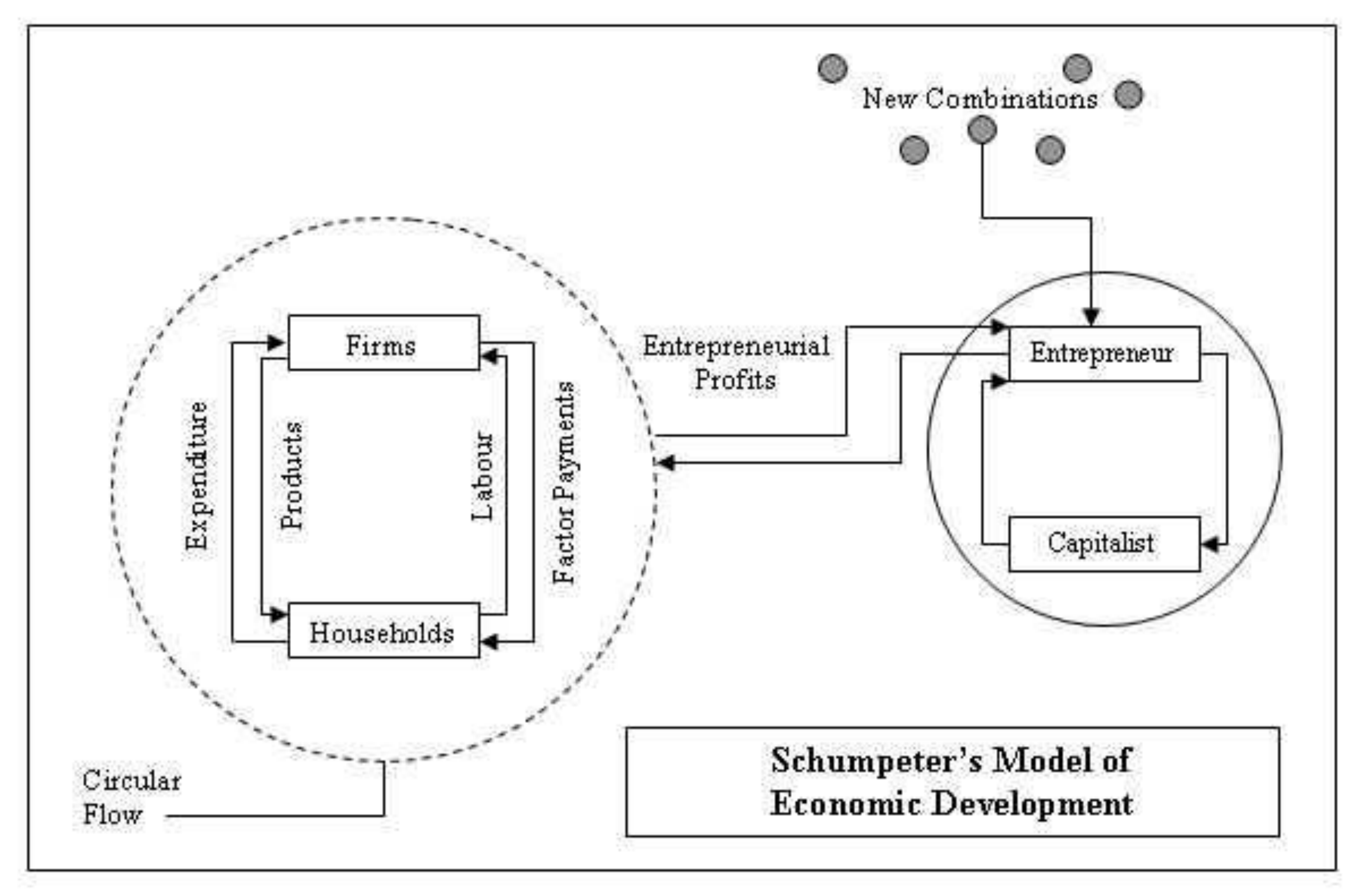
ECONOMIC DYNAMICS

- All economic action in the traditional **circular flow** is repetitive and based on prior experience. As in all theories of stationary equilibrium, the aggregate quantities of supply and demand, expenditures and receipts, tend toward equality
- However, Schumpeter saw capitalism as a form or method of economic change and not only never is but never can be stationary.
- He arrived at his model of the circular flow: highlighting **"Entrepreneur"**, who initiates the process of innovation as the central of the process of economic development.
- Entrepreneurs are neither capitalists nor inventors; they see the potential of inventions and assume risk in innovating.

- The basic driving force behind structural economic growth is the introduction of **new combinations** of materials and forces, not the creation of new possibilities. This concept covers the following five cases:

  (i) The introduction of a new good – that is one with which consumers are not yet familiar – or a new quality of a good.
  (ii) The introduction of a new method of production – that is one not yet tested.
  (iii) The opening of a new market – that is a market into which the country in question has not previously entered.
  (iv) The conquest of a new source of supply of raw materials or half-manufactured goods.
  (v) The carrying out of the new organization of any industry, like the breaking up of a monopoly position.

SCHUMPETER'S CREATIVE DESTRUCTION



- Economic evolution is based on cyclical disruptions and breaks of economic structures, an endogenous transformation that results from the 'process of creative destruction' as an essential feature of modern capitalism.

SCHUMPETER'SCREATIVE DESTRUCTION

- Successful **innovation** is normally a source of temporary market power, eroding the profits and position of old firms, yet ultimately succumbing to the pressure of new inventions commercialized by competing entrants.
- Schumpeter identified innovation as the critical dimension of **economic change**.
- He argued that economic change revolves around **innovation, entrepreneurial activities, and market power**.
- He sought to prove that innovation-originated market power can provide better results than the invisible hand and price competition.
- He argues that **technological innovation** often creates temporary **monopolies**, allowing abnormal profits that would soon be competed away by rivals and imitators.
- These temporary monopolies were necessary to provide the incentive for firms to develop new products and processes.

CAPITALSIM

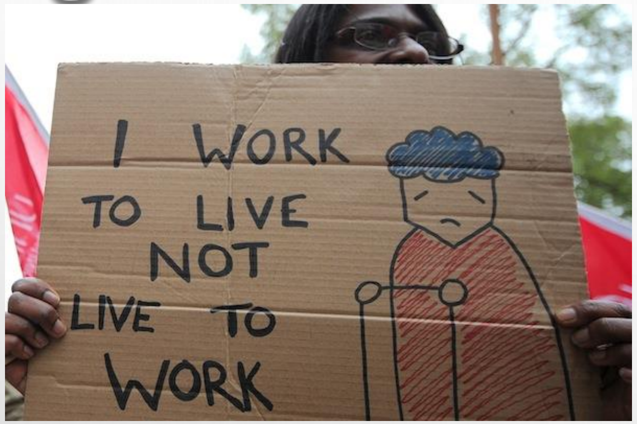
- Can Capitalism Survive?, Schumpeter answers "**no**" .
- But he says, “If a doctor predicts that his patient will die presently,” he wrote, “this does not mean that he desires it.”
- Schumpeter agrees with Karl Marx that capitalism will collapse and be replaced by **socialism**. But he predicts a different way this will come about.
- Marx predicted that capitalism would be overthrown by a violent proletarian revolution, which actually occurred in the least capitalist countries
- Schumpeter believed that capitalism would gradually weaken by itself and eventually collapse.

CAPITALSIM

- Schumpeter, as he himself stated, agreed with "the Marxian proposition that the economic process tends to socialize itself - and also the human soul.

- The **rationalization of everything in life** also results in the breaking up of the family and of the home as an institution at the base of society.
- In line with the socialization process, **entrepreneurial activity increasingly falls into the hands of big business and government.** The entrepreneur is replaced by the bureaucratic manager.
- Entrepreneurial capitalism evolves through its own logic into "fettered" capitalism, or in other words, capitalism as its manifests itself in the "trustified" stage in which big business dominates.

CAPITALISM WITH DEMOCRACY



- Capitalism, by its very nature, creates a social group with a vested interest in social criticism (i.e., the intellectuals).
- **"Intellectuals"** are a social class in a position to critique societal matters for which they are not directly responsible and to stand up for the interests of other classes.
- Intellectuals tend to have a negative outlook of capitalism, even while relying on it for prestige, because their professions rely on antagonism toward it.
- The growing number of people with higher education is a great advantage of capitalism, according to Schumpeter.
- Yet, unemployment and a lack of fulfilling work will cause intellectual critique, discontent and protests.
- The intellectual will develop critical ideas against free markets and private property, even though these institutions are necessary for their existence.

CAPITALISM WITH DEMOCRACY

- Parliaments will increasingly elect **social democratic parties**, and democratic majorities will vote for restrictions on entrepreneurship.
- Increasing workers' self-management, industrial democracy and regulatory institutions would evolve non-politically into **"liberal capitalism"**.
- Thus, the intellectual and social climate needed for thriving entrepreneurship will be replaced by some form of **"laborism"**.
- Schumpeter noted that increases of taxes, public policies favoring labour organisations, price controls, and licensing requirements that increase the costs of doing business are the greatest impediments to entrepreneurship.
- Under oppressive conditions, for example, the former Soviet Union, China, and present day Islamic societies, very few people innovate.

CAPITALISM WITH DEMOCRACY

capitalist civilization is rationalist and "anti-heroic." The two go together of course. Success in industry and commerce requires a lot of stamina, yet industrial and commercial activity is essentially unheroic in the knight's sense — no flourishing of swords about it, not much physical prowess, no chance to gallop the armoured horse into the enemy, preferably a heretic or a heathen — and the ideology that glorifies the idea of fighting for fighting's sake and of victory for victory's sake understandably withers in the office among all the columns and figures.[33]

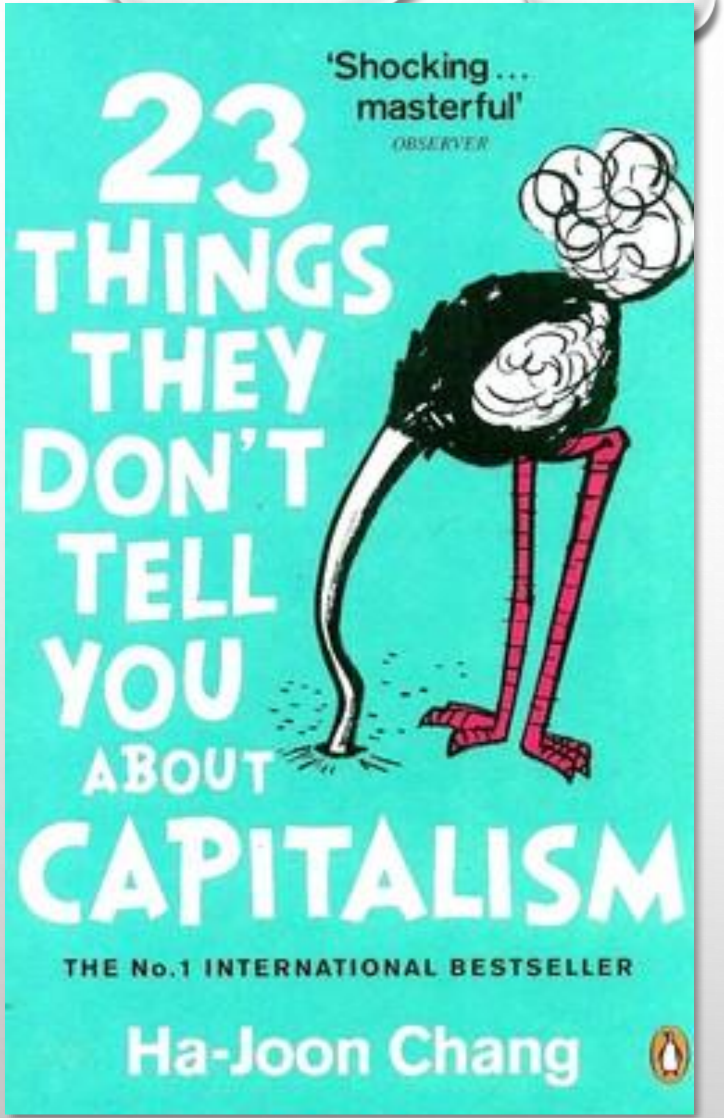
- The success of capitalism would lead to **corporatism** and to values hostile to capitalism, especially among **intellectuals**.
- The progressive development of rationalization, the **levelling of social barriers, democratization**, etc., all serve to reduce the importance of leadership in the economy.
- In his view, the ideology of accumulation for accumulation's sake is obviously less effective than the warrior ideology.
- As the economic process is rationalized, however, innovation itself becomes liable to such rational calculation and it becomes increasingly difficult for the individual entrepreneur to stay ahead of the game.
- It becomes more and more difficult for the individual entrepreneur to find the investment channels in which "he" can receive an adequate return on "his" investment.
- This will restrict "creative destruction" and so will burden and destroy the capitalist structure.

CAPITALISM & SOCIALISM??

- There will not be a revolution, but merely a trend for social democratic parties to be elected to parliaments as part of the democratic process.
- He argued that **capitalism's collapse from within** will come about as majorities vote for **the creation of a welfare state** and place restrictions upon entrepreneurship that will burden and eventually destroy the capitalist structure.
- In Schumpeter's view, **socialism** will ensure that the production of goods and services is directed towards meeting the 'authentic needs' of the people
- It will overcome some innate tendencies of capitalism such as conjecture fluctuation, unemployment, etc.

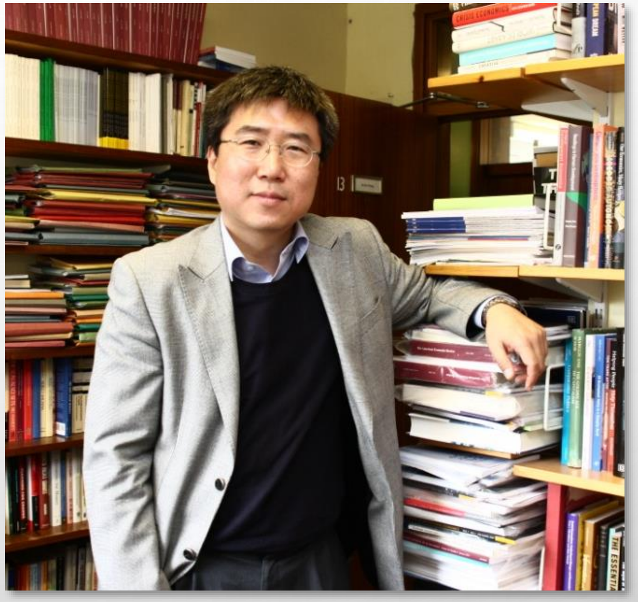
Outline

- Classical Liberalism (Smith & Ricardo)
- Austrian School (Hayek)
- Keynesianism (Keynes)
- Neoliberalism (Friedman)
- Schumpeterian (Schumpeter)
- Institutionalism (Chang; Acemoglu & Robinson)



23 THINGS THEY DON'T TELL YOU ABOUT CAPITALISM

- HA JOON-CHANG



THERE IS NO SUCH THING AS A FREE MARKET [THING 1]

A Kungfu master & piano wire

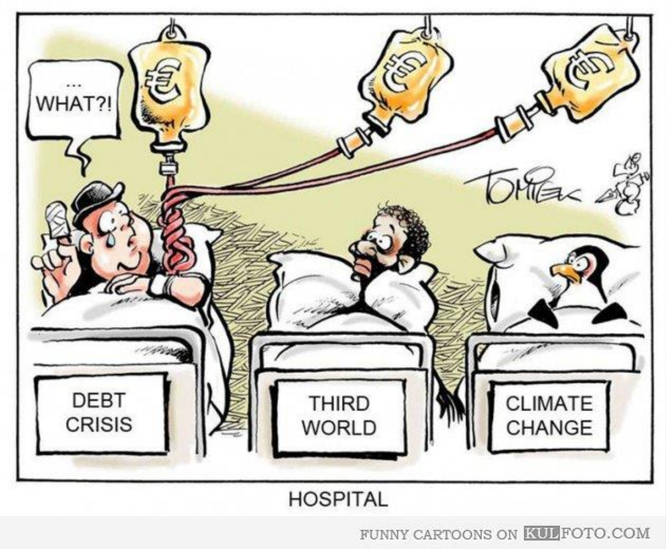
- ***What they tell you:***
  - Markets need to be free.
  - People must be left ‘free to choose’
- ***What they don’t tell you***
  - Every market has some rules and boundaries that restrict freedom of choice.
  - Government is always involved

- The ‘freedom’ of a market is, like beauty, in the eyes of the beholder.
- There is really no objective way to define how free that market is.
- If some markets *look* free, it is only because we so totally accept the regulations that are propping them up that they become invisible.

WE ARE NOT SMART ENOUGH TO LEAVE THINGS TO THE MARKET [THING 16]

- **Companies** operate with **'productive routines':** which simplify their options and search paths. They build certain **decision-making structures, formal rules and conventions** that automatically restrict the range of possible avenues that they explore, even when the avenues thus excluded outright may have been more profitable.
- Suppose that a new CEO arrived in a company and said: 'I am a great believer in market forces. In this fast-changing world, we should not have a fixed strategy and should maintain maximum possible flexibility. So, from now on, everyone in this company is going to be guided by ever-changing market prices, and not by some rigid plan.' What do you think would happen?
- The question is not whether you plan or not. It is about planning the right things at the right levels.

GOVERNMENTS CAN PICK WINNERS [THING 12]



What they tell you

- The theory tells us that capitalism works best when people are allowed to take care of their own businesses without any government interference.

What they don't tell you

- Dominant economic theory fails to recognize that there could be a clash between **business interests** and **national interests**.
- The reality is that winners are being picked all the time both by the government and by the private sector, but the most successful ones tend to be done in joint efforts between the two: possibilities for economic development through public–private joint efforts.
- Government decision-makers – politicians and bureaucrats – are driven by the desire to maximize power, rather than profits. Therefore, they are bound to go for white elephant projects that have high visibility and political symbolism, regardless of their economic feasibility.
- Moreover, since government officials ***play with 'other people's money'***, they do not really have to worry about the economic viability of the project that they are promoting.
- Governments are also likely to pick losers.

GOVERNMENTS CAN PICK WINNERS [THING 12]

- Many of the businesses in Korea promoted by the government turned out to be great successes.
- In the 1960s, the LG group, the electronics giant, was banned by the government from entering its desired textile industry and was forced to enter the electric cable industry. The cable company became the foundation of its electronics business, for which LG is currently world-famous.
- In the 1970s, the Korean government put enormous pressure on Mr. Chunk Ju-Yung, the legendary founder of the Hyundai Group, famous for his risk appetite, to start a shipbuilding company. Today, the Hyundai shipbuilding company is one of the biggest shipbuilders in the world.

- Concorde project, jointly financed by the British and the French governments in the 1960s. It remains one of the most impressive feats of engineering in human history. However, considering all the money spent on its development and the subsidies that the two governments had to give to British Airways and Air France even to buy the aircrafts, Concorde was a resounding business failure.
- The Indonesian aircraft industry was started in the 1970s, when the country was one of the poorest in the world. This decision was made only because Dr. Bacharuddin Habibie, number two to President Suharto for over twenty years (and the country's president for just over a year, after his fall), happened to be an aerospace engineer who had trained and worked in Germany.

DESPITE THE FALL OF COMMUNISM, WE ARE STILL LIVING IN PLANNED ECONOMIES [THING 19]

What they tell you

- In complex modern economies, planning is neither possible nor desirable
- Only decentralized decisions through the market mechanism, based on individuals and firms being always on the lookout for a profitable opportunity, are capable of sustaining a complex modern economy.

What they don't tell you

- Governments in capitalist economies practice planning too, albeit on a more limited basis than under communist central planning.
- Many capitalist governments plan the future shape of individual industrial sectors through sectoral industrial policy or even that of the national economy through ***indicative planning*** by mobilizing various carrots (e.g., subsidies, granting of monopoly rights) and sticks (e.g., regulations, influence through state-owned banks) at its disposal.
- The share of State-owned Enterprises (SOES) in national output could be as high as 20 per cent-plus, in the case of Singapore, or as low as 1 per cent, in the case of the US, but the international average is around 10 per cent.

FREE-MARKET POLICIES RARELY MAKE POOR COUNTRIES RICH [THING 7]

What they tell you

- All of today's rich countries, with the exception of Japan (and possibly Korea, although there is debate on that), have become rich through free-market policies, especially through free trade with the rest of the world.
- Developing countries that have more fully embraced such policies have done better in the recent period.

What they don't tell you

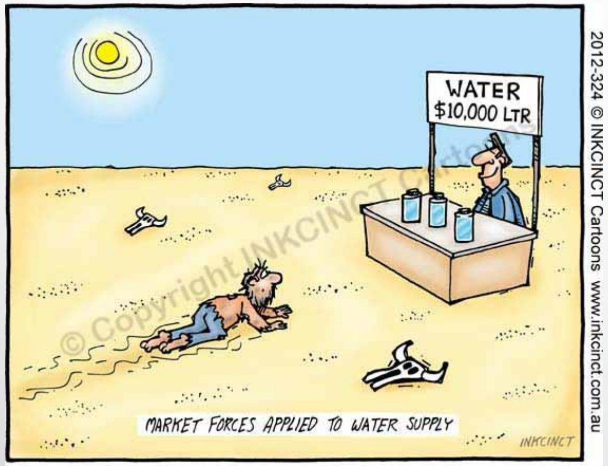
- Virtually all of today's rich countries used protectionism and subsidies to promote their infant industries.
- Developing countries did not do badly at all during the 'bad old days' of protectionism and state intervention in the 1960s and 70s.

FREE-MARKET POLICIES RARELY MAKE POOR COUNTRIES RICH [THING 7]

WHAT COUNTRY IS THIS? **:**

- The industrial tariff rate was at 40–55 per cent. The country's trade policy has literally been the most protectionist in the world for the last few decades.
- In the banking sector, foreigners are prohibited from becoming directors while foreign shareholders cannot even exercise their voting rights unless they are resident in the country.
- It does not have a competition law, permitting cartels and other forms of monopoly to grow unchecked.

WHAT IS GOOD FOR GENERAL MOTORS IS NOT NECESSARILY GOOD FOR THE UNITED STATES [THING 18]



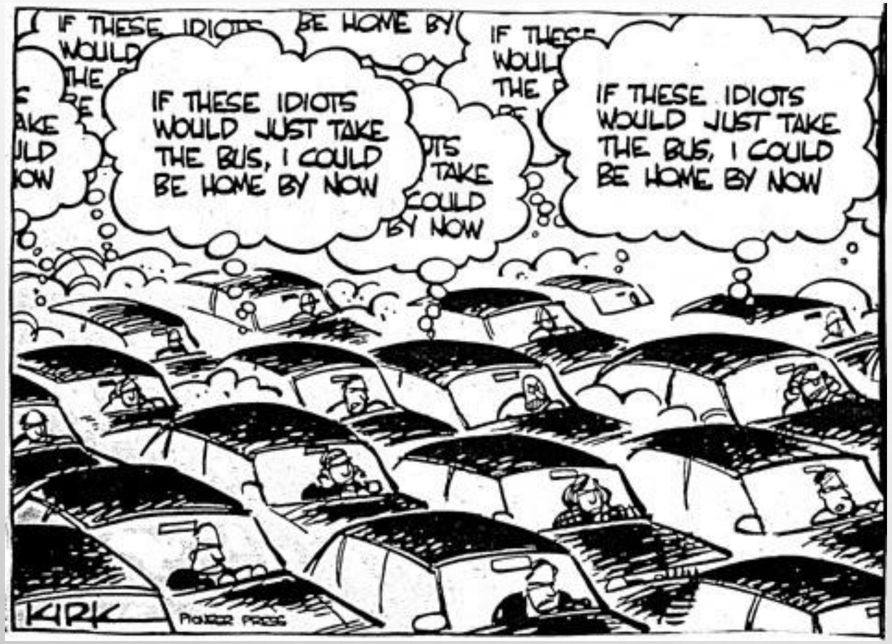
What they tell you

- At the heart of the capitalist system is the corporate sector; this is where things are produced, jobs created and new technologies invented
- What is good for business, therefore, is good for the national economy
- Government needs to give the maximum degree of freedom to business

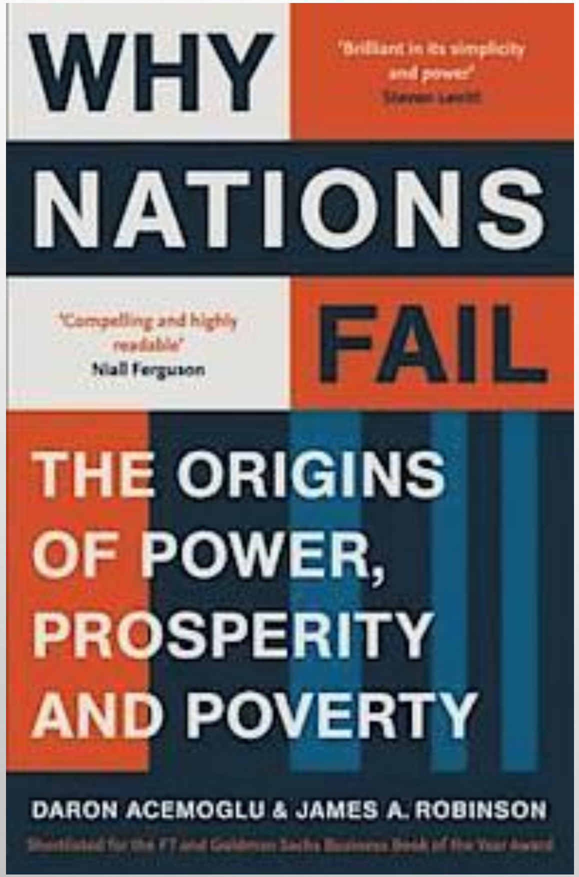
What they don't tell you

- Regulation can help firms by preventing them from undermining the basis of their long-term sustainability.

WHAT IS GOOD FOR GENERAL MOTORS IS NOT NECESSARILY GOOD FOR THE UNITED STATES [THING 18]



- Sometimes regulations help business by limiting the ability of firms to engage in activities that bring them greater profits in the short run but ultimately destroy the common resource that all business firms need.
- For example, regulating the intensity of fish farming may reduce the profits of individual fish farms but help the fish-farming industry as a whole by preserving the quality of water that all the fish farms have to use.
- A widespread use of child labor will lower the quality of the labor force in the longer run by stunting the physical and mental development of children. In such a case, child labor regulation can actually benefit the entire business sector in the long run.
- What matters is not the quantity but the *quality* of business regulation



WHY NATIONS FAIL

THE ORIGINS OF POWER, PROSPERITY, AND POVERTY

DARON ACEMOGLU AND JAMES A. ROBINSON

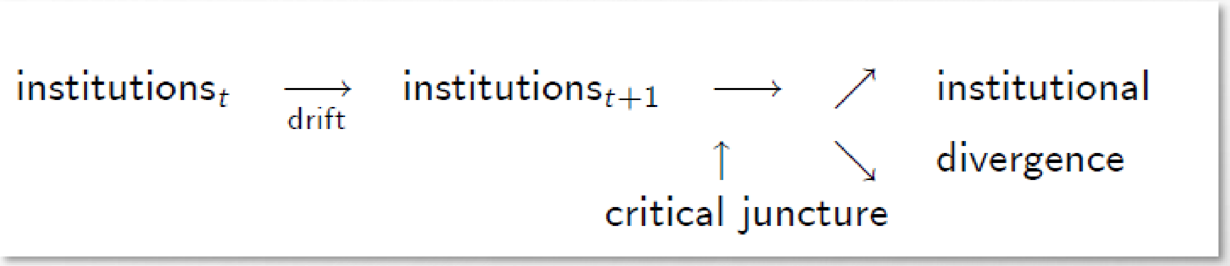
THEORIES THAT WON'T WORK

- Many economists tried to explain why nations fail
- Three main hypotheses are used to explain
  1. **The geography hypothesis**
     - Climate affects agricultural productivity and there exists diseases that only occur in hot climate.
     - North Korea and South Korea?
  2. **The culture hypothesis**
     - The specific culture that has an impact on how economy develops.
  3. **The ignorance hypothesis**
     - Simply because rulers **DO NOT KNOW** how to make poor countries rich.
     - Chinese communist party did not suddenly realized that collective ownership created terrible economic incentives?

- Nogales, Arizona (USA) and Nogales, Sonora (Mexico). Same people, same culture, same location. The part in the US has about three times higher household income than that in Mexico

INSTITUTIONS MATTER

- **The institutional dynamics** ultimately determined which countries took advantage of the major opportunities and which ones failed to do so.
- The roots of the world inequality today can be found in this **divergence**.
- The rich countries are those that embarked on **the process of industrialization and technological change**.
- Sometimes, **critical juncture** happened but the country failed to capture it.



- Industrial revolution created a critical juncture that affected almost every country.
- Many lagged behind as they blocked or did nothing to encourage the spread of industry.

ECONOMIC INSTITUTIONS

- **Inclusive economic institution**
  - Secure private property
  - An unbiased system of law
  - A provision of public services that provides a level playing field in which people can exchange and contract
  - Permit the entry of new businesses
  - Free career choices
  - Incentivize people to work hard and be innovative as they have a chance to live a better life and make the choices they wished

Extractive economic institution

- Lack of law and order
- Insecure property rights
- Entry barriers and regulations preventing functioning of markets
- The surplus of the economy is being extracted by rulers
- Allocating resource to the productivity activities controlled by elites
- People are not free to choose their economic choices.
- Causing people to become ignorant in their improvement as they cannot do anything to improve their lives.

POLITICAL INSTITUTIONS

- Politics is the process by which a society chooses the rulers that will govern it
- The political institutions of a society are the rules that govern incentives in politics.
- How the government is chosen and its rights to do what.

Inclusive Political Institutions

- Political institutions allowing broad participation
- Pluralism
- Placing constraints and checks on politicians
- Rule of law (closely related to pluralism)
- Some degree of political centralization for the states to be able to effectively enforce law and order

Extractive political institutions

- Political institutions concentrating power in the hands of a few
- Without constraints, checks and balances or rule of law..
- Absolutism

INCLUSIVE VS. EXTRACTIVE INSTITUTIONS

- **Strong synergy between economic and political institutions.**

		Economic Institutions: Inclusive	Economic Institutions: Extractive
Political Institutions	Inclusive	↻	⟵↓
	Extractive	↑⟶	↻

- Great Britain, France, the United States, Australia, and Japan are the examples of those countries that successfully grabbed the opportunity and changed its institution from **extractive** to **inclusive.**
- Meanwhile, Eastern European countries and China are the examples of those countries where its citizens lost in the fight of institution transformation and **could not** change from extractive institution to inclusive institution.

INCLUSIVE VS. EXTRACTIVE INSTITUTIONS

- Main thesis is that **growth** is much more likely under **inclusive institutions than exclusive institutions**
- Developed countries are wealthy because of 'inclusive economic institutions' – basically a combination of state and free market in which

1. The state creates **incentives** for people **to invest and innovate** – (through guaranteeing private property rights and enforcing contract law)
2. The state enables investment and growth through providing education and infrastructure, which private business uses,
3. The state is controlled by its citizens, rather than monopolized by a small elite. Crucially, there needs to be a democratic principle at work in which people in politics establish institutions and laws which work for the majority of people, rather than just working to make them rich.
4. The state also needs to maintain a monopoly on violence.

INCLUSIVE VS. EXTRACTIVE INSTITUTIONS

- **Extractive political institution**:
  - The elites in extractive political institutions usually choose extractive economic institutions to extract surplus for themselves.
  - When relatively in secure position, the elites may wish to allow the emergence of relatively inclusive economic institutions under their controls.
  - They fear of '**Creative Destruction**' from competition and become the political and economic losers
  - Though growth was possible, it will not be a sustained growth!

THE "RESOURCE CURSE" HYPOTHESIS

- **"Paradox of plenty"** states with point resources (oil, diamonds) perform poorly & are subject to violence
- Large quantities of revenues make limited contribution to development
- Widespread poverty is often present
- Corruption, bribery, etc. become commonplace
- Competition for control of resources develops
- Power struggles follow & can turn violent
- Groups seek to assert control over resources
- Revenues can fund internal warfare