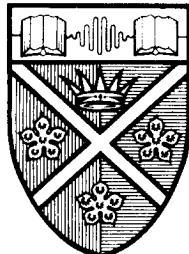


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## *CONSENSUS AND CONFLICT WITHIN NEO-LIBERALISM*

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CONSENSUS AND CONFLICT WITHIN NEO-LIBERALISM

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Neo-liberalism is the revival and development of classical liberal ideas, with the stress on the individual, the limited role of the state and the value of the free market. Neo-liberal ideas have made a major contribution to recent public policy debates, particularly with regard to economic policy. However, little attention has been given to the conflicts within neo-liberalism between the main economic schools, the Chicago School of Milton Friedman, the Austrian School of Friedrich Hayek, and Supply Side economics. These conflicts are interesting intellectually, and they also have had an impact upon debate within governments influenced by neo-liberal thought, and upon the policy outputs of those governments. The most obvious example is the contrast between the economic priorities of the Reagan and Thatcher Administrations, even while they share similarities in the broad thrust of their policies. The Conservative government has placed control of the money supply and reduction in the Public Sector Borrowing Requirement as the top priority to reduce inflation, while tax cuts are seen as dependent upon economic growth and the control of public expenditure, rather than as the way of achieving growth. The enactment and retention of the tax cuts of the Economic Recovery Act of 1981 has remained President Reagan's top priority, with deficits allowed to grow significantly. The intellectual source of these different economic policies can be found in the conflicting policy prescriptions of the three economic schools of neo-liberalism.

#### A. Milton Friedman and the Chicago School

Milton Friedman is the most well-known intellectual spokesman for free market economics in the world. He is the chief critic of the Keynesian economic ideas that dominated the post-war era and is the most prominent of the Chicago School of economists, who argue from their empirical analysis of the consequences of government actions that the market is more effective than government in achieving social goals. Friedman was a graduate student of the founders of this school at the University of Chicago, Frank Knight, Henry Simons, Arthur Burns and Jacob Viner. His academic reputation was established by his work on monetarism, especially his work with Anna Schwartz on The Monetary History of the United States, which was recognised by the award of the Nobel Prize in Economics in 1976 and his election as President of the American Economic Association in 1977.

He was not satisfied, however, with a purely academic audience and sought to reach a far wider audience. In 1962 his Capitalism and Freedom was published, as a fervent defence of capitalism and a demand for more limited government. Part of its impact was due to the presence within the book of a number of new policy proposals, such as education vouchers, which provided a strong contrast to the negativism of most of the defenders of free enterprise. Friedman has always been conscious of political possibilities and has been a frequent source of ideas that have reached the political arena. These ideas sought an even wider audience in the production of a television series called

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Free To Choose, shown in 1980. The themes of the television series were expanded into a bestselling book with the same title. It was, however, the increasing recognition that Keynesian macro-economic management was not successful that led to an increased interest in the ideas of Friedman as the chief critic of Keynesianism.

Friedman has had a major impact upon the academic study of economics, but our interest in the political impact of his ideas leads us to concentrate on five themes of his work: the role of the money supply in creating inflation; the relationship between capitalism and freedom; the failure of government intervention to achieve its objectives; the proposals for a social market economy; and his views on the appropriate role of government.

Friedman argues that the role of the money supply in creating inflation is an empirical fact, unrelated to views on the merits or otherwise of capitalism. He states "five simple truths of what we know about inflation" (Friedman, 1980, p. 329).

1. Inflation is a monetary phenomenon arising from a more rapid increase in the quantity of money than in output (though, of course, the reasons for the increase in money may be various).

2. In today's world government determines - or can determine - the quantity of money.

3. There is only one cure for inflation: a slower rate of increase in the quantity of money.

4. It takes time - measured in years, not months - for inflation to develop; it takes time for inflation to be cured.

5. Unpleasant side effects of the cure are unavoidable."

Keynesianism developed from the view that there were systemic causes of recession in a market economy, which could be corrected by government management of demand in the economy. This view gained widespread acceptance as a reaction to the depression of the 1930s. Friedman believes that the cause of the Great Depression was not inherent faults in capitalism but in the mismanagement of the U.S. central bank, the Federal Reserve System, in allowing a rapid decline in the money supply (Friedman, 1980, chapter 3).

"The Great Depression in the United States, far from being a sign of the inherent instability of the private enterprise system, is a testament to how much harm can be done by mistakes on the part of a few men when they yield vast power over the monetary system of the country". (Friedman, 1962, p. 50).

Inflation is caused by the same central banks by the opposite mistake, of allowing the money supply to grow faster than the output of the economy. Keynesians had convinced governments that the expansion of the money supply would stimulate the economy, reduce unemployment and create growth. Friedman's response was that these effects were only short-term and that the major effect would be inflation. Even worse, the beneficial effects would require ever greater injections of inflation to have the same effect. Friedman denied the existence of a trade-off between inflation and unemployment, as represented by the Phillips Curve, and this was confirmed by the existence together of both rising inflation and unemployment in the 1970s. (See Friedman, 1970, for his critique of Keynesianism).

The cure for inflation required a monetary constitution which

would remove the discretionary powers of central banks to determine the money supply. The monetary authorities are unable to forecast precisely the impact of their interventions on the economy, and thus are faced with insurmountable limitations of knowledge. A monetary constitution would take the form of a fixed set of rules, which would remove the "extraordinary dependence on personalities, which fosters instability arising from accidental shifts in the particular people and the character of the people who are in charge" (Friedman, 1975, p. 86). Friedman has proposed a fixed annual growth rate in some measure of the stock of money.

"On average it could be expected to correspond with a roughly stable long-run level of final product prices.... A rate of 3% to 5% per year might be expected to correspond with [such a] price level". (Friedman, 1975, p. 19).

However, he emphasises that the content of the rule is less important than the existence of a rule, so that there is predictability and consistency.

The gradual decline in monetary growth required to reduce inflation will have the side effects of slow growth and higher unemployment. These side effects can be mitigated by the reduction of inflation "gradually but steadily by a policy announced in advance and adhered to so it becomes credible". (Friedman, 1980, p. 323). These side-effects cannot be avoided. The choice is between slow growth and higher unemployment as the result of inflation or as short-term side-effects of the cure of inflation. While the view that the

money supply does play a major role in the determination of inflation has become widely accepted amongst economists, Friedman's prescription of a reduction in the money supply has been much more controversial.

The second theme of Friedman's writings, and the core of Capitalism and Freedom, is the relationship between capitalism and freedom and democracy. Capitalism by definition for Friedman means economic freedom, because capitalism is the voluntary exchange of goods and services. This economic freedom is important in its own right as it affects the ability of individuals to make choices about their lives. Examples are given of the restrictions arising from the licencing of occupations, the control of foreign exchange and the enforced membership of the State pension scheme.

Economic freedom is also important because it promotes political freedom.

"I know of no example in time or place of a society that has been marked by a large measure of political freedom, and that has not also used something comparable to a free market to organise the bulk of economic activity.... History suggests only that capitalism is a necessary condition for political freedom. Clearly it is not a sufficient condition". (Friedman, 1962, pp. 9-10).

Fascist countries are examples of private enterprise economies without political freedom, but only in capitalist societies can there be freedom and democracy. "A society which is socialist cannot also be democratic, in the sense of guaranteeing freedom" (Friedman, 1962, p. 8). He argues this by asking how the freedom to advocate capitalism

could be protected in a socialist society. Because of the control of employment, resources and wealth by the state, it would be extremely difficult to effectively criticise the socialist state. Under capitalism, however, employment, resources and wealth are widely dispersed throughout society, so that a radical cause requires only the support of a few to be articulated. Witness the existence of many socialist publications in capitalist societies. Only when economic freedom is spread widely throughout society can there be an effective check on the power of the government.

The argument for capitalism is pursued even further. A major source of criticism of capitalism is the existence of inequality. Friedman notes that this requires more precise definition as inequality of outcome, and that the pursuit of such equality conflicts with liberty. To deny the ability of Muhammed Ali to earn millions of dollars for one fight would be to deny the opportunity to millions of people to watch him fight. The pursuit of equality not only reduces freedom but fails to achieve equality. The concentration of power required to impose equality would give tremendous unequal power to those with the responsibility to achieve equality, while capitalism provides opportunities for almost everyone to improve their position.

"A society that puts equality - in the sense of equality of outcome - ahead of sense of equality of outcome - ahead of freedom will end up with neither equality nor freedom. The use of force to achieve equality will destroy freedom, and the force, introduced for good purposes, will end up in the hands of people who use it to promote their own interests. On the other hand, a society that puts freedom first will, as a happy by-product, end up with both greater freedom and greater equality" (Friedman, 1980, p. 181).

Capitalism promotes prosperity, freedom, democracy and equality,

according to Friedman.

The third theme of Friedman is that government usually fails to achieve its objectives. The existence of market failure, such as monopolies, neighbourhood effects and the provision of public goods, is acknowledged, but the existence of government failure is even more pronounced.

"We now have several decades of experience with governmental intervention. It is no longer necessary to compare the market as it actually operates and government intervention as it ideally might operate. We can compare the actual with the actual. If we do so, it is clear that the difference between the actual operation of the market and its ideal operation - great though it undoubtedly is - is as nothing compared to the difference between the actual effects of government intervention and their intended effects". (Friedman, 1962, p. 197).

Friedman and other Chicago economists have examined a wide range of government policies and their consequences, and concluded that government normally fails to achieve its objectives. The minimum wage has destroyed low paid jobs and increased unemployment. Rent control has destroyed the private rental market, and made it more difficult for the poorer single tenant to find a home. Occupational licencing has protected the interests of the producers and not the consumers. Consumer protection has operated to exclude products from consumer choice. Protectionism has destroyed more jobs in other industries than have been saved in the protected industries. The attempt to prevent unemployment through Keynesian demand management has been to create more long term unemployment. The list of government failures is long, in the empirical studies of the Chicago

school.

"The greater part of the new ventures undertaken by government in the past few decades have failed to achieve their objectives... The central defect of these measures is that they seek through government to force people to act against their own immediate interests in order to promote a supposedly general interest....These measures are therefore countered by one of the strongest and most creative forces known to man - the attempt by millions of individuals to promote their own interests, to live their lives by their own values". (Friedman, 1962, p. 200).

His later Free to Choose shows the influence of the Public Choice explanation of government failure, but this reinforced his belief that the success of government intervention requires policies which harness the desire for self-improvement rather than override it.

This can be demonstrated in the fourth Friedmanite theme, that the good objectives of the welfare state can best be achieved through the use of the market. Government failure is as pronounced in the welfare state as anywhere.

"The objectives have all been noble, the results disappointing. Social security expenditures have skyrocketed, and the system is in deep financial trouble. Public housing and urban renewal programs have subtracted rather than added to the housing available to the poor. Public assistance rolls mount despite growing employment. By general agreement, the welfare program is a 'mess' saturated with fraud and corruption... both patients and physicians complain of rocketing costs and of the increasing impersonality of medicine. In education, student performance has dropped". (Friedman, 1980, p. 124)

Friedman believes that the causes of the failure of the welfare state are similar to the failure of other government programmes. The solution is to make greater use of the market, while ensuring a safety

net for every person. He proposes the replacement of the welfare system by a comprehensive negative income tax, whereby the poor would receive direct cash payments to bring them up to a minimum standard so they could purchase their own goods and services, rather than the provision by government.

"Its main purpose is... to provide a straightforward means of assuring every family a minimum amount, while at the same time avoiding a massive bureaucracy preserving a considerable measure of individual responsibility, and retaining an incentive for individuals to work and earn enough to pay taxes instead of receiving a subsidy". (Friedman, 1980, p. 152).

Such a programme is designed to enable the poor to be active participants in the market.

Other proposals include the privatisation of the social security system, the introduction of education vouchers which parents could spend at any recognised school, the replacement of government subsidies for higher education by student loans, and the replacement of public housing by cash grants. Friedman recognises an obligation to assist the poor and the weak in society, but believes that the welfare state operates in the interests of the middle classes, and that his proposals would give economic power to the poor and promote their welfare more effectively.

An important role for government is supported by Friedman, but it must be a strictly limited role. Following Adam Smith's views, Friedman identifies four areas of government activity. First, the

protection of individuals in society from external coercion; secondly, the administration of justice; thirdly, the provision of public goods and the settling of certain problems arising from neighbourhood effects; and fourthly, the protection of the irresponsible such as the mad and children. (Friedman, 1980, pp. 47-54). This is a significant list of responsibilities, and Friedman was aware that within them was the potential for bigger government than he desired.

"The scope of government must be limited. Its major function might be to protect our freedom both from the enemies outside our gates and from our fellow-citizens, to preserve law and order, to enforce private contracts, to foster competitive markets. Beyond this major function, government may enable us at times to accomplish jointly what we would find it more difficult or expensive to accomplish severally. However, any such use of government is fraught with danger. We should not and cannot avoid using government in this way. But there should be a clear and large balance of advantages before we do". (Friedman, 1962, pp. 2-3).

How to make and keep government limited became a growing concern for Friedman. Under the influence of public choice theorists, he recognised that it was insufficient to convince people of the merits of limited government, while the special interests wanted government intervention in their favour and had an excessive influence over the political process. The problem with the money supply was to be solved by a monetary constitution, so Friedman was attracted to the idea of constitutional reform to provide limited government. At the end of Free to Choose he proposes a series of constitutional amendments, especially limitations on taxation through a balanced budget and on expenditures through a fixed percentage of the Gross

National Product in government expenditures. (Friedman, 1980, chapter 10 See Friedman, 1984, chapter 3). Friedman desires a strictly limited government, together with the effective enforcement of it's legitimate and still extensive functions.

B. Friedrich Hayek and the Austrians

Amongst neo-liberal economists, there is much debate between Chicago and Austrian economists, for the latter have significant methodological and policy prescriptive differences from the dominant Chicago economists, which leads them to take a more principled stand in favour of *laissez-faire*. Carl Menger founded the Austrian school in Vienna in the late nineteenth century, but after the victory of Keynesianism in the 1930s their ideas were barely kept alive by Ludwig von Mises and Friedrich Hayek, until the 1970s when there was a explosion of interest amongst younger economists, such as Israel Kirzner in America and John Burton in Britain. Mises played a very important role in preserving Austrian ideas from his position at New York University (see Kirzner, 1980), but Hayek has had the greatest impact upon the resurgent interest in Austrian economics.

The foundation of Austrian economics rests on three basic principles: that social science is the study of purposeful human action; that only individuals are the appropriate unit for study, methodological individualism; and that value is in 'the eye of the beholder', the subjective theory of value. Human behaviour is purposeful, an attempt to achieve goals, and therefore is neither

random nor deterministic. It is the role of social science to identify the goals underlying human action and to examine whether those actions successfully achieve their goals. Austrians are not concerned with whether the goals are worthy, although of course they will have their own views, but as social scientists they are morally neutral. Social science is the study of the purposes and consequences of human action. Methodological individualism states that only individuals act purposefully or choose, and therefore the subject of study should be individual choices, and not the behaviour of abstract entities. "Fictitious entities such as 'classes', 'states' or 'societies' do not act, think, save, consume or invest; only individuals can do those things." (Barry, 1983, p. 99). The subjective theory of value says that as choices are made by individuals, with their own individual preferences and tastes, that the value of a good or an action is subjective, different with each person. This means that nothing has any intrinsic value but only the value attributed to it by people, for example oil had no value until the combustion engine was invented. These rather abstract principles have major policy implications when they are developed by the Austrians.

Hayek is the most influential Austrian mainly because of the wide-ranging nature of his work. He has contributed knowledge not only to economics, but also to politics, political philosophy, intellectual history, psychology and scientific methodology. Born in Vienna in 1899, he was based in Vienna in the 1920s, the London School of Economics in the 1930s and 1940s, Chicago University in the 1950s,

and in Freiburg and Salzburg in the 1960s and since. Hayek was the founder in 1947 of the Mont Pelerin Society, an international organisation of liberal intellectuals which continues to meet regularly. He achieved international recognition with the award of the Nobel Prize in Economics in 1974, jointly with the Swedish socialist economist Gunnar Myrdal. Now in his 80s he continues to write.

Unlike Friedman, Hayek has usually avoided becoming involved in contemporary political issues and elections. Hayek believed that the scholar's commitment should be to seek and present the truth, as they see it, and not to consider the political possibilities. The power of ideals is through the contrast they provide between the existing state of affairs and the ideal society presented to the public. The development and articulation of that ideal is the role of the thinkers, but such a role is dismissed by the practical men of affairs as impractical and unrealistic. Influence upon immediate issues can only be achieved by surrendering the concern with general principles. Hayek has never written a popular version of his ideas, such as Friedman's Free To Choose, and has never been afraid to express ideas that are easily dismissed as unrealistic.

Numerous books, articles and reviews have been written by Hayek (For a lengthy but still incomplete bibliography, see Gray, 1982). Three books have been particularly influential. The Road to Serfdom in 1944 argues that socialist planning requires some person or institution to have the power to force people to behave in the ways

required for the successful achievement of the plan. The choices of individuals will become more and more restricted to fit the requirements of the plan, so that socialism gradually leads to serfdom, a totalitarian society. Socialism is incompatible with freedom and democracy. The Constitution of Liberty (1960) presents the fundamental principles of a liberal society and examines the policies that a liberal society should pursue. The three-volume Law, Legislation and Liberty (1973, 1976, 1979) discusses the legal and constitutional arrangements of a liberal society, and rejects the principles of social justice and majority rule.

These and his other works present and develop certain constant themes. Firstly, society is a spontaneous order, neither the result of nature nor of deliberate creation. Secondly, the value of liberty is that it uses dispersed knowledge to the greatest extent. Thirdly, socialism is both impossible and dangerous. Fourthly the concept of social justice is meaningless. Fifthly, there are certain principles of a free society, such as the rule of law, and finally the causes and cures of inflation and unemployment are identified.

Hayek believes that social institutions and practices are unplanned, the consequence of the actions of millions of individuals, a 'spontaneous order'. They are neither 'natural', in the sense of irregular or unstructured, nor 'invented', in the sense that anyone has chosen them. Rather the structures have successfully evolved and survived because they benefit those who adopt them. Social institutions are the result of human action, not of human design.

Language and the market are examples of unplanned yet structured institutions that follow certain rules. A successful society, what Hayek describes as 'the Great Society', will be one which identifies and follows the best rules. Hayek firmly rejects the view that existing laws and institutions can be scrapped and replaced by something completely new, an approach Hayek calls 'constructivist rationalism'. Traditions, rules and institutions are the product of evolution, not of the human mind, and part of a spontaneous order which benefits humans even when they do not understand the sources of those structures. An evolved, spontaneous order is to be preferred to a planned society.

Liberty for Hayek is "the state in which a man is not subject to coercion by the arbitrary will of another or others" (Hayek, 1960, p. 11). Absolute freedom is impossible, but the aim should be to minimize coercion or its harmful effects. Liberty has instrumental value for Hayek because it makes best use of widely dispersed knowledge and provides for the unpredictable growth of knowledge. Knowledge, especially that of preferences and tastes, is dispersed amongst individuals, because of the subjective nature of value. This knowledge is not theoretical but practical knowledge of concrete situations, "knowledge of people, of local conditions, and of special circumstances" (Hayek, 1976, p. 80). Liberty provides for the unpredictable, allowing individuals to experiment with new ideas and techniques, many or most of which will not be fruitful, but we cannot predict in advance which new ideas will be successful. A planned society which seeks to command progress cannot be a creative society.

Freedom is to be supported not because we know what it will provide, but precisely because of its unpredictability. "Our faith in freedom does not rest on the foreseeable results in particular circumstances but on the belief that it will, on balance, release more forces for the good than for the bad" (Hayek, 1960, p. 31).

The limits of the knowledge available to any one person makes Hayek very aware of the limits of social science. In The Counter-Revolution of Science, he attacked attempts to use the supposed methods of the natural sciences in the study of the social sciences, a method he calls 'scientism'. As Austrians believe that social sciences are about purposive behaviour, social sciences which ignore motives and attitudes are impossible. Under the influence of Sir Karl Popper, Hayek came to accept the essential unity of scientific method, but the social sciences are only able to identify broad patterns of events, and not able to predict specific events. Social scientists should be very aware of the limits of their ability to predict the consequences of social actions, and be modest in their claims of knowledge.

His critique of socialism is based on his views of knowledge. Firstly, socialism requires a common purpose, but (except on rare occasions such as war) there is no agreed purpose, with every individual pursuing his own purposes. Common rules, such as the recognition of private property or the rules of contract, exist to enable individuals to pursue their own aims, not in order to reach common aims. Secondly, socialism is undemocratic, because the power

over what must be produced is determined by a few, not by the mass of consumers. State control of the economy requires very detailed decisions, which are beyond the possibility of any elected parliament, and must be delegated to bureaucratic experts, with wide discretion and their own views on what is good for the public.

"It would scarcely be an exaggeration to say that the greatest danger to liberty today comes from the men who are most needed and most powerful in modern government, namely, the efficient expert administrators exclusively concerned with what they regard as the public good." (Hayek, 1960, p. 262)

Thirdly, socialism inevitably becomes totalitarian, whatever the desire of democratic socialists, because economic planning requires the use of coercion to force people to behave in the ways required by the plan, and this coercion will become more and more complete if the plan is to be achieved. (Hayek, 1944). Finally, Hayek develops the argument of Mises in the 'Economic Calculation debate' that socialist planners have no way of predicting consumer demands without the role of prices. Prices in a market economy are a signal measure to producers as to consumer preferences and the price that they are willing to pay for their demands. The role of competition is a discovery procedure where entrepreneurs identify opportunities when consumer demands are not properly met. Without market prices, the planner does not know what to produce and at what cost. This is why Communist countries use prices in the world markets to influence their own decisions. Socialism is seen by Hayek as impossible and it's pursuit dangerous.

The fourth major feature of Hayekian thought, and one of his most controversial, is the argument that the concept of 'social justice' is meaningless. Social or distributive justice as a principle of state action requires agreement on who deserves what and the existence of sufficient power in the hands of the state to decide who gets what. The first condition is based on the view that some concept of merit should be the determinant of the distribution of goods and income, but everyone has a different view on who deserves what. The value of an action to others is not determined by merit. A good voice or a beautiful face is valued but is not a consequence of merit. There is no consensus in a free society of what would be the 'correct' distribution of goods. The second condition requires that the State has the power to achieve social justice, to determine who gets what. Whoever controls the State would determine what they thought people deserved, which would lead to a tremendous concentration of power. Income would be determined not by the ability to satisfy consumers but by political influences and government becomes a scramble between the interest groups for influence over the political allocation of income. "Once politics becomes a tug-of-war for shares in the income pie, decent government is impossible" (Hayek, 1979, p. 150). Hayek believes that justice must be procedural, that just rules establish fair procedures and are not directed to a particular end. Just rules of income would be the stability of possession, transfer by consent and the keeping of promises. In a free society, the distribution of income that results from these rules is not the legitimate concern of government.

"It is neither desirable nor practicable that material regards should be made generally to correspond to what men recognise as merit and that it is an essential characteristic of a free society that an individual's position should not necessarily depend on the views that his fellows hold about the merit he has acquired". (Hayek, 1960, p. 94, See Hayek, 1976, chapters 8, 9).

A growing concern to Hayek is the establishment of the principles of a Liberal Constitution, in which the role of government is to establish the rules necessary for individuals to pursue their own ends.

"The task of government is to create a framework within which individuals and groups can successfully pursue their respective ends, and sometimes to use its coercive powers of raising revenue to provide services for which for one reason or another the market cannot supply". (Hayek, 1979, p. 139)

The role of government would thus include the establishment of security against external and internal coercive powers, and the provision of public goods the consumption of which is difficult to control, e.g. defence is provided for all within a certain area whether or not everyone pays for it. In these circumstances, it is legitimate for the state to use force. How much of a role for government this means can be open for discussion (see Hayek, 1960, Part III), but it is clearly not anarchy, and it provides for a limited state.

The problem for Hayek is how should the State be constructed to ensure that its role goes no further than these limits. The first principle is the distinction between law, the general rules of justice, discovered by judges without any agreed end, and legislation, the rules of organisation with a particular end determined by

parliaments. In modern societies, this distinction has been lost, so that politicians feel no longer bound by law, but behave as if law is what they determine. The second principle is the Rule of Law, that government should establish general rules, that these must be known and articulated, that the law applies equally to all, that independent judges should determine any conflicts under the law, and that private actions should be protected. (Butler, 1983, p. 128) The third principle is that democracy should not have unlimited power. "Democracy is essentially a means, a utilitarian device for safeguarding peace and individual freedom. As such it is by no means infallible or certain". (Hayek, 1944, p. 52). Elected politicians have increasingly come under the influence of interest groups, which seek to use political power for their own purposes. "The chief evil is unlimited government, and nobody is qualified to wield unlimited power". (Hayek, 1960, p. 403). There must exist a constitution, which is higher than the elected assembly, and that constitution must be protected by the separation of powers. Democracy must be limited by a constitution. The fourth principle is that there should be two chambers, with different compositions and functions. The first chamber would determine the general rules of action, 'the legislative assembly', while the second would be concerned with the administration of government services, under the rules established by the first chamber. Any disputes on competences would be settled by a constitutional court. Hayek's proposals for the composition of the two chambers has been widely criticised, but the principle of a bicameral legislature, with one chamber acting as a check on the other is more familiar, even while the specific functions of the chambers

presented by Hayek are more innovative.

The final area of Hayek's thought to be considered is his views on the causes of inflation and unemployment. The Austrian view on inflation is monetarist to the extent that it recognises that inflation is caused by an increase in the money supply beyond the increase in production, but it has significant differences with Friedmanite monetarism. Orthodox monetarists concentrate on the impact of changes in the money supply on the general price level, i.e. the impact upon different prices is assumed to be uniform. The Austrians concentrate on relative prices, as the point at which money enters the economy has a differential impact. The increase in the availability of credit reduces its price to businessmen so that activities become profitable that would not be in a situation of stable money. Malinvestment in certain goods, firms and industries occurs, and so when an attempt is made to reduce inflation, those elements of the economy will go bankrupt. These industrial failures, and the resulting unemployment, are the inevitable consequences of any attempt to control inflation. They can only be kept alive in the long term by ever increasing levels of inflation. The Friedmanite solution of a gradual slow-down in the increase of the money supply to produce a gradual decline in the general price level is rejected by the Austrians as continuing the disruption of the economy. A quick end to inflation would result in massive unemployment in those firms affected by malinvestment but, as the factors of production were released for more productive use, jobs would soon be created to absorb the unemployed and the evil of inflation would be removed to enable

the natural growth of the economy. The first principle of Austrian economic policy is that inflation must be ended completely and as quickly as possible.

"The first necessity now is to stop the increase of the quantity of money - or at least to reduce it to the rate of the real growth of production - and this cannot happen soon enough. Moreover, I can see no advantage in the gradual deceleration". (Hayek, 1975, p. 25): "Inflation must be stopped dead." (Hayek, 1980, p. 23)

A second important difference between Friedman and Hayek is their assessment of the role of trade unions. Friedman argues that as the money supply determines inflation the trade unions have no long term impact on inflation or unemployment. Hayek argues, however, that trade unions are able to raise wages above the market level by limiting the supply of workers thus creating unemployment. Unions do not create inflation, but they prevent an effective labour market, where workers can easily move from jobs with an excess supply of labour to where there is a shortage, and thus they prevent the economy from adapting quickly to the changes necessary to control inflation. The unemployment that will result from seeking to stop inflation will be temporary if the labour market is effective in moving workers from unproductive to productive work, which will require changes in relative wage-rates. The biggest obstacle to those necessary changes are the trade unions, who prevent flexibility in wage rates and therefore would increase both the size and period of unemployment. Hayek supports the existence of unions and the right to strike, but would deny them the right to force others to strike. Therefore there should be an end to the legal privileges of unions, established in the

U.S. Sherman and Norris-La Guardia Acts and the British Trades Disputes Act of 1906. Mass picketing should be prohibited as coercive, closed and union shop contracts should be treated as restraints on trade and denied protection under the law, and no union would have the sole right to negotiate contracts for all workers, including non-members. The same principles of law that apply to everybody else should be applied to trade unions as well. The third difference with monetarism is that Hayek does not have the confidence that the independent monetary authority favoured by Friedman would behave responsibly. Many Austrians favour a return to the gold standard (or another commodity base) to prevent central banks artificially increasing bank credit. Hayek favoured a system of fixed exchange rates, which imposed an obligation on government to maintain the international value of their currency in contrast to Friedman's support for floating exchange rates. Recently, Hayek has proposed a more radical solution, the 'denationalisation of money', whereby the banks create their own money and foreign currencies would be allowed to circulate in competition with government money. The devaluation of government money would lead to an exodus to other forms of money and thus place a restraint upon the government (Hayek, 1978).

Hayek shares with Friedman the rejection of Keynesian economics, but provides a different analysis of the consequences of Keynesian demand management and the necessary remedies.

### C. Supply Side Economics

Before 1975, hardly anyone used the term 'supply side', but by the election of Ronald Reagan in 1980 it has become one of the most widely discussed (and also widely misunderstood) terms in economic debate in the USA. To summarise it briefly, supply side economics says that a reduction in the rate of taxation is the single most effective method of restoring economic growth. This view is firmly based in neo-classical microeconomic theory, and explicitly rejects important elements of the economic views of the monetarists and the Austrians.

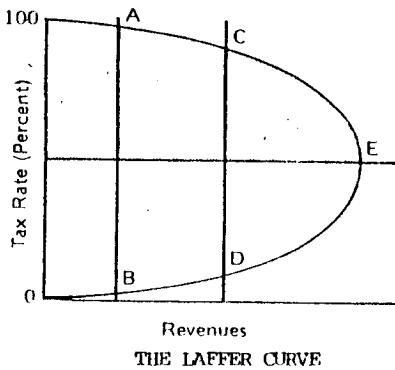
In technical economic language the central argument of supply-siders is that increased government-induced demand, the traditional Keynesian solution, has its significant impact upon marginal prices, rather than the general price level as argued by monetarists. The most important consequence of this is to affect the relative prices of two alternative decisions: the trade-off between work and leisure, and the trade-off between saving and consumption. Higher taxation increases the cost of work and reduces the price of leisure, and increases the cost of saving and reduces the cost of consumption. It is therefore no surprise that the consequence is a reduction in work and saving, and an increase in leisure and consumption, with the result that the production of goods and services and the availability of capital (dependent upon saving) necessary for investment, both decline. That is the central cause of poor economic growth.

The influence of the Austrians can be identified in the supply side emphasis on human motivation, and the real choices faced by individuals in their economic and everyday behaviour. George Gilder in Wealth and Poverty attacks macro-economic models which deal with false abstractions rather than real individuals (Gilder, 1981). Rejecting the classical model of perfect competition, Gilder borrows from the Austrian school the importance of entrepreneurs in the acquisition and manipulation of knowledge. Supply-siders therefore reject the conservative preoccupation with statistics of money supply and deficits and the Keynesian concern with aggregate demand and consumer expenditure, as the creation of abstract macro-economic aggregates by the economists themselves and irrelevant to the actual behaviour of people in the marketplace. Thus supply siders have a clear preference for microeconomics over macroeconomics.

Professor Arthur Laffer explains the impact of government intervention as a 'wedge model', with marginal taxes as a wedge "between what an employer pays his factors of production and what they ultimately receive in after-tax income" (Wanniski, 1978, p. 85). All taxes, whether income tax, sales tax or social security tax, reduce the employer's demand for productive factors, such as labour or capital, and reduce the desire by those productive factors, such as the employee, potential employee or investor, to be employed. The wedge includes the impact of all government burdens on economic transactions, including the burdens of regulation, which would not be identified in either taxation or government expenditure. The main element of the wedge, however, is taxes.

The existence of the wedge has a major impact upon economic behaviour. It leads to (i) more leisure because of its reduced cost, (ii) more employment in the black economy to escape taxes, (iii) the greater use of barter, (iv) an increase in people doing their own work rather than employing others, such as do-it-yourself, (v) the growth of tax evasion. The wedge leads to considerable misallocation of resources and a decline in economic growth. Reductions in the wedge will lead to growth in the money economy, either through the introduction of new transactions which now become worthwhile, or the transfer to the money economy from the black economy. This leads us to the Laffer Curve.

The Laffer Curve was invented by Professor Arthur Laffer to explain his theory that "there are always two tax rates that yield the same revenues".



(From Wanniski, 1978, p.87).

"When the tax rate is 100%, all production ceases in the money economy. People will not work in the money economy if all the fruits of their labour are confiscated by the government... if the tax rate is zero, people can keep 100% of what they produce

in the money economy. There is no government wedge, and thus no governmental barrier to production, so production is maximised." (Wanniski, 1978, p. 97).

At a tax rate of either 100% or zero, the revenues will be the same, zero.

The phenomenon of two rates yielding the same revenue exists at other places on the curve. The same revenue can be achieved either at a high rate of taxation on a low level of production (A) or a low rate of taxation on a high rate of production (B). Thus two rates of taxation produce the same revenue. From A, it is possible to reduce the rate of taxation to C, while increasing revenue.

"Revenues plus production are maximised at point E. If, at point E, the government lowers the tax rate again, output will increase, but revenues will fall. If the tax rate is raised, both output and revenue will decline" (Wanniski, 1978, p. 98).

Where the British or the American people are on the curve is not fixed, but depends on the attitudes and behaviour of people. During a war, people may be willing to accept high rates of taxation while maintaining production, but in peaceful times (and especially if they consider much of the taxation to be wasted) even relatively low rates of taxation could have a detrimental effect on production. Supply siders differ over exactly where Britain and the USA are on the curve, but they all agree that a reduction in marginal tax rates will increase production. Paul Craig Roberts rejected, in common with all supply siders, the Keynesian view that increased rates of taxation would increase production in order to make up the loss of income

(Roberts, 1978).

Supply siders all agree that America and Britain are high on the Laffer curve, although divided as to whether it has gone beyond point E, when a reduction in the tax rate would actually lead to an increase in revenue. Both Laffer and Wanniski seem to argue that America at least is in the top half of the curve, so that tax reduction would lead to higher revenue (although they disagree between themselves as to whether E as the maximum government revenue is the optimal point). Most supply siders, however, do not believe that tax cuts would pay for themselves. Norman Ture dismisses, as excessive, claims that "supply side tax reductions will so expand GNP as to generate larger tax revenues than will be realised without the tax cuts. This sort of financial alchemy elicited derision from many economists and policy-makers" (Raboy, 1982, p. 11, See Roberts, 1984, p. 40). They argue that supply side economics is not based on the view that tax cuts pay for themselves, only that tax revenues would not fall to anything like the same extent as predicted by conventional economic theories and in certain circumstances could actually rise. Supply siders point to the size of the black economy and the growth of tax shelters as evidence that America and Britain are high on the Laffer curve.

Supply siders explicitly reject the policy solutions of Keynesians, monetarists, Austrians and balanced budget conservatives, while they acknowledge the influence of some of the others thinking upon their own. Keynesianism is rejected for its concern with

government manipulation of aggregate demand and its refusal to examine the effects of government actions on supply, while Keynes is viewed as more sympathetic to problems of supply than his followers (Gilder, 1981, pp. 46-51; Wanniski, 1978, chapter 8). Monetarism is accepted as a valuable analysis of the impact of the money supply on inflation, but the policy prescriptions of the monetarists are rejected. The problem is that "like aggregate demand, the money supply is an essentially mathematical concept that means less than it seems" (Gilder, 1981, p. 231). The importance of high tax rates is not that it increases the money supply but that it reduces the supply of goods. The numerous definitions of money supply is seen to confirm that it is an abstraction beyond the control of government. This is not to say that governments cannot affect the money supply, as they have clearly done so under Keynesianism, but they cannot control it. Alan Reynolds, in his critique of monetarism, argues that monetarism is a method of analysis but not a policy (Reynolds, 1982). The inability of monetarism to ensure the stable value of money has led many supply siders to be 'gold bugs', in favour of a return to the gold standard.

While Austrian economics has been very influential in the supply side analysis (such as the role of individual motivation and entrepreneurship), the policy prescriptions are unacceptable. Hayek's view that inflation must be stopped dead, and can only be achieved through a brief but deep recession with a short-lived but high rate of unemployment, is condemned as 'deep-root canal' economics. Laffer invented the term to describe the view that if it hurts, then it must be good for you. Ture rejects "the view that

price-level stability can be purchased only at the cost of unacceptably high levels of 'unemployment'" (Raboy, 1982, p. 27). Tax cuts are counter-inflationary because they increase the supply of goods, thus dealing with the problem of 'too much money chasing too few goods' by increasing the goods rather than reducing the money.

Another school attacked by supply-siders is the balanced budget school, led by Herbert Stein, Arthur Burns and Paul Volcker. This school argues that the first priority is to control inflation, that budget deficits are a primary cause of inflation, and that budgets must be balanced even at the price of tax increases. Roberts describes this as the Treasury View, long held by the British Treasury. Supply siders such as Norman Ture argue that deficits are not per se inflationary, unless they are monetised i.e. paid for by an increase in the money supply. Deficits can be paid for by tax cuts, which both increase production and therefore revenue and increase savings and therefore capital available for government borrowing. The balanced budget approach is condemned as creating a recession, and during a recession expenditure will necessarily rise through welfare expenditures while the deficit will correct itself after the end of the recession. On a more political note, the political costs of such a policy are too high, and is an important explanation for the failure of past Republican economic policy to win support.

Supply siders are keen to reject two major criticisms : that supply side economics is a political theory lacking substantive economic theoretical support; and that there is no historical

evidence for the existence of the Laffer Curve. It is claimed by supply siders that their views are based on those of Adam Smith, Jean-Baptiste Say, and Leon Walras. (Raboy, 1982, chapter 3). Smith contributed the insight, so frequently neglected, that wealth existed in goods and services and not in aggregates such as money or gold. Say contributed Say's Law, that supply creates its own demand, and Gilder states that "Say's Law in all its variations is the essential enactment of supply-side theory" (Gilder, 1981, p. 56). Walras provided general equilibrium theory that supply-sider Robert Mundell has used to explain why Keynesian and monetarist policies have "detrimental secondary effects far in excess of the primary beneficial effects", through its impact on the world economy. (Wanniski, 1978, p. xi).

Historical examples are provided of the success of supply side policies. Their historical analysis begins with the causes of the Great Depression. Whilst acknowledging that the rapid decline in the money supply was a factor as argued by the monetarists, they place great emphasis on the role of protectionism in the Smoot-Hawley Tariff Act and the massive tax increases introduced by Hoover. (Wanniski, 1978, chapter 7; Gilder, 1981, p. 49). Three historical examples of the benefits of tax cuts are presented : the Mellon tax cuts which led to the boom of the 1920s; the Kennedy tax cuts of 1963-64, which boosted production and savings, not consumer demand as Keynesians argue; and Puerto Rico since 1976 (Wanniski, 1978, chapters 7-12).

#### D. Conclusion

Neo-liberalism displays a consensus in the rejection of Keynesianism, in the control of the money supply, in a limited role for government and in the priority of the conquest of inflation, but within that consensus there are significant differences. Keynesianism is rejected by monetarists because of its failure to recognise the role of the money supply; by Austrians for its claim to the knowledge and ability to fine-tune the economy; and by supply siders for its neglect of the impact of government expenditure and taxation upon the structure of incentives. The control of the money supply is accepted, but the monetarists seek to achieve it through a monetary rule on a fixed annual growth rate in the stock of money; the Austrians through the competition of currencies; and the supply siders through a return to the gold standard. The conquest of inflation is necessary for a successful economy, but for the monetarist this should be achieved through a moderate, gradual and predictable reduction in the growth in the money supply, for Austrians by a drastic reduction in the money supply to meet real growth, and for supply siders through tax cuts that will increase production and saving. There is agreement on a limited role for government, with the Chicago emphasis on a social market economy which pursues social objectives through the market, the Austrian rejection of the concept of social justice central to a social market approach, and the supply side concern that government expenditure should not be at the expense of economic growth. Much of the current economic policy debate cannot be understood without an understanding of the consensus and conflict within neo-liberalism.

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