Economic Liberal Theories of Political Economy

http://www.youtube.com/watch?v=JfdRpyfEmBE
Are you here, focused, ready to learn?

- A. yes
- B. no
Takeaways from Last Week: Political Economy is about Power, Purpose, AND Wealth.
Purpose (goals), Theory, and Policy

The **Goals:** Freedom, equality, Community Goals are value-based and can’t be tested

- Why does the State/government have to intervene in the economy to achieve its purpose?
- Because resources are limited and society’s desire for them is unlimited
- Each purpose demands a different kind and size of state/government to allocate resources according to purpose.

- Theories are arguments about
  - what policies/Institutions are needed to achieve a particular goal.
  - And about desirable kinds and sizes of governments and policies.

- These arguments based on assumptions (about human nature, about justice, about what we deserve with regard to power and wealth) Not true or false….can’t be tested

- Based on these arguments (theories) governments devise policies to achieve social goals.
- \( \rightarrow \) hypotheses about cause-effect (example of price gouging laws vs markets) (policy) \( \rightarrow \) predictions/policy prescriptions
  - Assumptions can’t be proved true or false, but policies are like hypotheses that can be “tested”
  - the test: do policies achieve the intended effect to fulfill the policy purpose?
If the goal is to maximize individual freedom, then theories of Economic Liberalism shape Policy

- What does “liberal” mean here? (click on the best answer)

A. A big welfare state?

B. A highly regulated economy protecting workers rights, the environment, etc.?

C. Liberty ...... especially from state control

D. The opposite of conservative
Theories of Economic Liberalism: Classical Theorists, Hayek, and Friedman (and some from PE 100)

• Assumptions
  – Individual is at the center (Hobbes, Locke, Rousseau)
  – Individuals are self interested (Hobbes)
  – Desire for freedom of choice is natural (Hobbes, Locke, Rousseau)
  – We are all born equal in our freedom to choose (H, L, R)
  – Our choices are rational (H, L, R, Bentham and Mill)
  – Private property is natural (Locke)
  – Given all of the above, Markets arise “spontaneously” (Smith)

• The hypothesis (cause-effect relationship) (Adam Smith, Ricardo)
  Markets: voluntary exchange → buyers demand goods → sellers produce them → buyers choose rationally (price and quality) → competition among sellers → efficiency → Division of Labor

• The Prediction (Smith, Ricardo)
  – For the Individual: More freedom
  – For production: More Efficiency
  – For all: Freedom, Growth, Welfare, and Peace
Assumption: Individuals are self interested
Examples
What is the role of the government:

- To uphold the “rule of law”
- Clicker question: After the Gulf Oil Spill of 2010, The Obama Administration required BP to set up an escrow account to clean up the Gulf. This decision was
  1. Arbitrary and against the Rule of Law
  2. Within the role of Government authority to protect national territory
Clicker quiz: After the Gulf Oil Spill of 2010, The Obama Administration required BP to set up an escrow account to clean up the Gulf. This decision was....... 

1. breaking the Rule of Law

2. Within the government’s authority to protect national territory
What is the role of the government:

• To ensure competition in the market
• Why?
  • It’s the most efficient
  • Ensures the most freedom
• If the state doesn’t ensure competition, monopolies will develop—undermining freedom
• States also protect competition by regulating externalities

Fred Hayek
Clicker quiz: What would Friedman and Hayek think of Lyft and Uber

• A. They would approve
• B. They would disapprove
Example: A spontaneous Cocaine market

In an ideal economic system, goods worth more than they cost to produce get produced, goods worth less than they cost to produce do not;

In a perfectly competitive private property system, producers pay the value of the inputs they use when they buy them from their owners and receive the value of what they produce when they sell it. If a good sells for more than it costs to produce, the producer receives more than he pays and makes a profit; if the good sells for less than it costs to produce he takes a loss. So goods that should be produced are produced and goods that should not be produced are not.
Market system of Resource Allocation

Supply (production) is driven by demand
Coca supply is abundant.....production costs low... processing is easy and cheap, market is large
Demand is High and steady
Should price be high or low in a perfect competitive market for cocaine?
Illegality represses demand and supply, raising the price
So It’s rational to produce cocoa.....

Corn: $150 per acre
Livestock: few $ per acre
Cocoa: $5-10,000 per acre

What crop would a rational farmer grow?
And rational to sell it.....
Why should the State ensure competition?

- Because monopolies limit alternatives for consumers
- Because monopolies block competitors from entering a market
- And therefore block freedom of exchange
- Therefore governments must determine and enforce rules of competition......
So...applied to the drug trade: Illegality and high prices create drug lords with market monopoly. Monopoly creates.....

**Obscene profits for drug lords**

Pomona, CA
1/18/2006

$1,390,965.00 U.S. Currency

![Image of cash seized by DEA](image-url)
Govt. efforts to make the market illegal means coercion
And creating a nightmare of jails filled with casual drug users....
The Economic Liberal believes: The War on Drugs suppresses Freedom...
Summary:

- People make rational choices
- Rational people create spontaneous markets,
- Thus markets are “natural” and should be free
- Free exchange creates “true” prices—the most important information
- Thus states should stay out of markets.....
- Their job is to ensure competition
- They will never be powerful or wise enough to suppress natural and spontaneous markets
Institutions of Resource Allocation with varying degrees of state intervention according to social purpose

Community: Traditional Economy

Communism

Equality: Planned Economy

Combining Freedom and Equality Mixed Economy

Freedom: Market economy
Free to choose? REALLY?