Economic Liberal Theories of Political Economy

http://www.youtube.com/watch?v=JfdRpyfEmBE
Review

• What is Political Economy?
Today’s Menu

- What is Theory?
- What is a state
- Sovereignty
- What are Systems of resource allocation?
- Institutions of Resource Allocation
- Liberal Systems and Institutions of Resource Allocation: The political Economy of Freedom
- Liberal Theory of Resource Allocation
- Assumption: Individuals are Rational
- Assumption: Individuals are self interested
- How do Liberals feel about the role of the State?
- Bailouts
- Example: The Drug Trade
What is Theory (the way we will use it here)?

• Theories are arguments based on assumptions
  – Some assumptions about human nature
  – Some assumptions about institutions
  – Some assumptions about values/goals

Is there anything objective about this? These assumptions combine to determine a justification for the theory’s stance on the “proper” relationship between states’ resource allocation.
What is a state? How is a state different than a government?

- A state is a set of institutions that possess the authority to make the rules that govern the people. These institutions comprise the "government" of a state, but the term "state" is a broader one, comprising the government, nation, resources of a particular territory. The state is the basic political unit of the world, the most central concept in the study of politics.

- State institutions, even the institutions that govern the economy, are created for a variety of reasons—rational, irrational, even capricious. They are sometimes the outcome of a social contract; the state amasses power to protect society and in turn, individual members of the state give up some of their freedom and submit to state authority.

- States exercise power over everything within state territory.

- (Within a federal system, the term state also refers to political units, not sovereign themselves, but subject to the authority of the larger state, or federal union, such as the "states" in the United States and the Länder in the Federal Republic of Germany.)

- A. States: Three Characteristics

  1. Their institutions have to rule over a definable territory. This rules out, for example, the al-Qaeda as a state.

  2. The territory has to have people living on it. Antarctica, which has no permanent human population, is not a state.

  3. The state, to have power over the people in the territory has to have an army, a source of revenue, and a bureaucracy. (states have to have power and they have to use their power to create wealth)

- And if you have these characteristics, you, as a state, are sovereign in the international system.
Sovereignty

• Over People in their territory (citizens)
• In the International System

When a state possesses the characteristics mentioned above, we say that it is sovereign—meaning that the state has supreme power over citizens. States do not share their sovereignty with any other power. The U.S. government is sovereign over American citizens, the supreme political authority over our lives.

• Sovereign states can do things that individual citizens cannot to legitimately>
• Example: We are not allowed to kill one another but the sovereign state may provide for the execution of criminals.

• Sovereign states in the form of police and national guard exercise the only legitimate use of force in society.

• States in the international system are sovereign, no matter how much power they have.

• All states in the international system claim sovereignty, no matter how big they are.

– Gambia has a population of 370,000, about as big as Tulsa, Oklahoma.
– It covers about 4,000 square miles or four-fifths as much as Connecticut.
– Its main commodity is peanuts, the sale of which gives it a GNP of about $50 million a year, or the budget of a small American city.
– Yet Gambia is sovereign.

• No authority above the Gambians can tell them what to do.

• The U.S. has no more authority to dictate policy to Gambia than Gambia does to the U.S.

• Currently, Palestine is not an independent state, as it does not have any sovereignty over its claimed territory.

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a state's sovereignty is not conditional upon the diplomatic recognition of the state's claim to independence by other states. However the capacity of a state to enter into various international relations and treaties is conditional upon such recognition. Degrees of recognition and sovereignty may vary. However any degree of recognition, even the majority recognition, is not binding on third-party states.
Resource allocation

Assumption: Limited Resources, Unlimited Wants

• How should resources be allocated?

States (sovereign institutions that exercise power) decide this based on certain values:
Institutions of Resource Allocation with varying degrees of state intervention

- Traditional Economy
- Planned Economy
- Mixed Economy
- Communism
- Market economy

Production → Distribution → Consumption
Liberal Theory of Resource Allocation

Assumptions
- Individual is at the center
- Desire for freedom is natural
- Humans are rational
- Humans are self-interested

The model
- The market
  - Non-coerced Exchange
  - Private Property
  - Division of Labor
  - Markets clear through supply, demand, and price

Goals and Effects if the model is followed
- Efficiency
- Growth
- Welfare
- Peace
Assumption: Individuals are self interested

• Individuals are at the center of all social activity
• self-interest is not the same as "selfishness"
• self-interest in rational choice theory is premised on the idea that all individuals have specific ("reasonable") goals and that they behave in a way that best enables them to achieve those goals

• http://www.youtube.com/watch?v=RWsx1X8PV_A&feature=related
How do economic liberals want to limit the state?

• Liberalism is classically defined as an attempt to limit the power of the state for the sake of individual freedom.

• Does this mean they want weak states?

• In fact, they want state power to do a lot of things.

• Liberals aren’t opposed to authority, only to certain kinds of authority.
What is the role of the state:

- To ensure competition in the market?
- Why?
- It’s the most efficient
- Ensures the most freedom

Fred Hayek • Any other method the state uses to guide economic activity will create huge problems. (like making certain activities illegal)

• If the state doesn’t ensure competition, monopolies will develop—undermining freedom
Milton Friedman on the role of the state in the economy

- [http://www.youtube.com/watch?v=0PaN9M4WwHw&feature=related](http://www.youtube.com/watch?v=0PaN9M4WwHw&feature=related)
Example: A spontaneous Drug 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.
Institutions of Resource Allocation

Supply (production) is driven by demand
Demand is High and steady
Supply is actually abundant.....production costs low... processing is easy and cheap
Market is large. 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.....
So the State does have an important role:

- Limit working hours
- Require sanitation
- Provide social services
- All three fully compatible with competition if applied to all.....
- Main job: “create conditions in which competition will be as effective as possible”
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
Over 30,000 drug-related deaths in Mexico since 2006
Govt. efforts to make the market illegal means using the military to try to get rid of the market
And imposing Harsh Penalties for participating in the market
And fostering corruption......
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
• 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
Obama: Why is he thought of as both a Nazi and a Socialist? Is it Heyak’s fault?
Role of the State

• Create social trust
• Rule of Law
• Ensure competition except when inefficient (public goods)
• Limit negative externalities
• Critique: issues of basic needs are not addressed by the liberal paradigm—also, there is high demand for basic human needs to be met; calls forth supply but price is too high?
• Liberals see in a bipolar way: markets or no markets