"**Liberalism" -- Prof. Jeffrey Frankel, Harvard University,** December 24, 2015

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The word "liberal" is used in so many different ways, by many different people, that one must make a strong attempt to define it before one attempts to use it.

1. Definitions of liberalism

In Europe, "Liberalism" is usually used to mean something close to its original classic English sense from the 19th century: the belief in a system where individuals are free to make their own choices without coercion from powerful long-established institutions (such as monarchy, feudalism, dictatorship, aristocracy, or oligarchy). Liberalism includes the freedom to pursue individual economic interests, in deciding where to live, whom to work for, what to buy and consume, and so forth. The French concept of laissez-faire and the Austrian school associated with Friederich von Hayek are closely associated with liberalism in the classical 19th century British sense.[1] Outside of the economic sphere, liberalism also includes such civil rights as freedom of speech, freedom of the press, freedom to practice a religion of one's choice, and so forth.

Other definitions of liberalism go off in either one of two opposite directions. On the one hand, beginning in Latin America in the 1980s, the term "neo-liberalism" was revived and used to describe what was seen as an extreme belief in free-market or laissez-faire policies such as were ascribed by critics to Chilean dictator Augusto Pinochet, British Prime Minister Margaret Thatcher and US President Ronald Reagan. The term has spread beyond Latin America, but is almost always used disparagingly.

On the other hand, and confusingly, the policies of Pinochet, Thatcher, Reagan, and the modern U.S. Republican Party are in the United States universally termed, not "neo-liberal," but rather conservative. "Liberal" is here considered to mean precisely the opposite of these policies! That is, "liberals" are assumed to be in favor of a large role for the government, while conservatives are assumed to favor a small role for government. (At least that is assumed to describe the positions of the two groups on economic affairs. When it comes to military intervention abroad and some aspects of social policy such as religion, it is generally the other way around, with "conservatives" favoring a big role for the government and liberals a small role.)

This definition of liberalism became prominent in the 1930s with the policies of the American Democratic president Franklin Roosevelt. Since that time, Americans have presumed that liberal refers to the use of the government to protect and enhance the civil rights of everyone including minorities, to curtail the power of monopolies, and to make the distribution of income more equal.[2] The explanation of the paradox is that in previous centuries, governments had generally been used by powerful elite groups to accomplish the opposite goals in order to benefit themselves.

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[1] Hayek rejected the label of "conservative," preferring classical liberalism or, if necessary "libertarianism." Although his most famous work was a critique of socialism or central planning, he was in favor of a social safety net, including mandatory universal health care and unemployment insurance, which are opposed by American conservatives today.

[2] This movement existed before Franklin Roosevelt, but in the late 19th and early 20th centuries it had gone under the name "Progressivism."

If the term liberalism is to be used at all, it is probably best to return to the core definition, the belief in a system where individuals are free to make their own choices without coercion from powerful long-established institutions such as feudalism, monarchy, dictatorship, aristocracy, or oligarchy.

2. Origins of liberalism: The Enlightenment

Liberalism can be said to have been born in Western Europe in the 18th century movement known as the Enlightenment. The Enlightenment arose via meetings of scientists and writers, who communicated through books and pamphlets but also in person in the new coffee houses and in literary salons, especially in France. The members of the movement believed in the principles of reason, progress, and individual liberty; tolerance of different religions and social groups; and the separation of church and state – all of which was a challenge to the powers of absolute monarchy and the Roman Catholic Church. It was very strongly influenced by the scientific revolution that had begun in the 16th and 17th centuries (including the revolutionary theories of Copernicus, Galileo and Newton) and English and Dutch philosophers of the period (Bacon, Locke and Spinoza; and Descartes). The leading figures of the Enlightenment per se included Rousseau and Voltaire in France and Hume and Smith in England [also Diderot and Montesquieu in France and Kant in Germany].

The abstract ideas of the Enlightenment were successfully put into practice in the American Revolution (as represented by the Declaration of Independence in 1776) and the founding of the American republic (as represented by the US Constitution in 1789). But they equally inspired the French Revolution in 1789, which was less successful in that it descended into the Reign of Terror, followed by the restoration of absolutist order under Napoleon.[3] Democracy as a political system was put into practice in England and elsewhere, but much more gradually.

The classic work of *economic* liberalism is Adam Smith's Wealth of Nations (published in 1776). Its most famous example is the pin factory, in which productivity is enhanced when everyone specializes in a particular job. Its most famous metaphor is the "invisible hand" according to which individual actors, in pursuing their own economic interest, are led to produce those things that are most in demand by consumers whom they probably do not even know. But the book in fact is a lot more than a statement of the case for laissez-faire. It includes the warning that large producers will collude with each other if they are allowed to, exercising monopoly power to raise prices artificially, above what would be justified in perfectly competitive markets.

A good illustration of liberal economics is the case of international trade. David Ricardo, building on Smith, pointed out the advantages of free trade, under which each country could specialize in the production and export of the commodity at which it had a comparative advantage. The free-traders presumed that the objective of a

[3] Edmund Burke's 1790 pamphlet "Reflections on the Revolution in France," is considered one of the founding documents of conservatism (and thus, presumably, the opposite of liberalism, in the modern American sense). Burke argued that the radical overthrow of long-standing institutions such as the French monarchy might lead, not to the utopia envisioned, but to anarchy or worse. This point is consistent with the word "conservatism" in the sense of wishing to avoid change that is too rapid. But modern self-described conservatives, such as some recent Republican politicians in the United States, tend to believe in a radical overthrow of the current order. They might seek to justify this as a return to an earlier better time in the history of their countries or to fundamental religious principles; but their interpretations often do not follow from the actual history of their countries or their religions.

country's policy should be to maximize the overall economic welfare of the total population of its individual citizens, not to maximize the gold or power in the hands of the monarch or some other elite. Free trade theory was put into effect in 1846 when Britain repealed the Corn Laws, which had blocked the import of lower-priced grain from abroad so as to benefit rich aristocratic rural landowners at the expense of workers and the new urban middle class. Efficiency, growth, and equality all benefited from the liberalization of trade. The technological progress of the Industrial Revolution and the liberal economics of the market system over time raised British GDP far above that of the old mercantilist states like Spain and Portugal.

3. Which economic system works best?

Classical or neo-classical economic theory says that free markets work best under certain very special conditions. The price of a commodity such as food should normally be set in competitive markets. Of course everyone would like to be able to buy food at a low price (while farmers would like to be able to sell it at a high price). But if the government keeps the price artificially low in an effort to make consumers happy, as in many developing countries, producers won't have the incentive to produce enough. There will be excess demand, with the available supply rationed by waiting in line, coupons, or bribery and corruption.[4]

Price controls are often justified by talking about the distribution of income. But in practice, in countries where the government controls the prices of food or fuel, the benefits go mostly to the well-connected and better-off, not to the poor.

a. Market failures

To be sure, there are many conditions under which free markets do not give the right answer. Each of these possible market failures calls for an appropriate role of the government. One market failure is the exercise of monopoly power; it calls for governments to pursue competition policy or anti-trust policy (the American term). Another market failure is the existence of externalities like pollution, which calls for environmental regulation, for example by taxing fossil fuels or banning the most dangerous substances outright. A third is the need for provision of public goods, such as a stable national currency. A fourth is inequality, which is best addressed through some form of income redistribution: progressive income taxation in advanced countries and conditional cash transfers in poor countries.

Each of these market failures can be addressed by well-targeted government intervention that is efficient in that it minimizes damage either to individual rights or to market-measured GDP. Each of them in practice is often used instead to justify clumsy government intervention, which sometimes does more damage than the market failure that is supposedly being addressed. For example, government often creates monopolies rather than reining them in. Fossil fuel subsidies produce even more pollution than the free market would on its own. Many policies justified by income redistribution accomplish little reduction in poverty at high cost, or even end up benefiting the rich at the expense of the poor.

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[4] Similarly, if the price of food is set artificially high, to make farmers happy, as in many industrialized countries, there will be excess supply, with the difference bought from well-connected farmers by the government and wasted.

b. **The 1989 victory of capitalism over communism**

The writings of Karl Marx and the arrival of communism in Russia in 1917 were largely motivated by the (accurate) perception that the capitalist system had produced tremendous inequality. But by 1989, when the Berlin Wall fell, it had become clear not only that the experiment had huge costs in terms of the loss of human rights and other individual freedoms, but also that it had failed as a model for economic development. Developing countries looked around and saw that the communist systems had failed and the market system had succeeded.

c. Different models of capitalism

This leaves the question which model of capitalism is the right one. There are many.

i. **Asian models of capitalism --** Japanese capitalism was said in the 1980s to be superior to the Anglo-American kind, because of such features as long-term horizons in corporate governance, relationship banking in finance, lifetime employment and year-end bonuses in labor markets, administrative guidance, and strategic trade policy. Success in other Asian countries was similarly attributed to Confucian values.

ii. **The Anglo-American model** -- Then in the 1990s, when Japanese growth ground to a halt and financial crises hit Thailand, Korea, Indonesia and other Asian countries, the conventional wisdom turned around 180 degrees. Now the Asian countries were said to be afflicted with crony capitalism. Anglo-American system was said to work best, with firms that maximized profits, arms-length lending and share-holder capitalism, flexible labor markets, and American-style accounting standards, bankruptcy laws and securities markets. But soon financial crises in the United States and the United Kingdom in the 2000s seriously undermined the credibility of that system as well.[5]

iii. **Ordoliberalism –** German ordoliberalism believes in classical liberalism, supported by a democratic constitution and government that enforces the rules under which economic agents play the game.[6] This school of thought includes strong government intervention to address market failures like monopoly. The recognition that laissez faire does not necessarily lead to perfect competition is welcome. Unfortunately, ordoliberalism includes a strong aversion to counter-cyclical fiscal or monetary policies, arising from a strong belief in rules in general, which has led Germany to bear some blame for exacerbating the euro crisis since 2010.

iv. **Social liberalism –** Many Western European economies after World War II sought to combine capitalist economics with greater social protection, including a more extensive social safety net

[5] Much of the earlier preaching to Asian countries in the 1990s about the virtues of good governance and the evils of crony capitalism turned out to be true; but it turned out that the United States needed to hear and absorb the same sermons. Even after the 2008-09 financial crisis that started in the US and UK, it is not clear that the lessons have been learned.
[6] It arose in Germany as an alternative to Nazism in the 1930s.

and a bigger government role in areas such as health care and education, than is found in the United States. For example, Ludwig Erhard, the architect of successful reconstruction of Germany after the war, developed the concept of Social Market Economy ("Soziale Marktwirtschaft").

v. In most European countries the social welfare state became so large, with excessive regulation and excessive budget deficits, that by the 1970s it was clearly hurting growth. For example overall tax rates were so high as to discourage work, both at the high end of the income ladder and the low end. The new **Nordic model**, pertaining to the Scandinavian countries (including Finland), features a comprehensive system of social protection combined with a return to free markets and responsible fiscal policy. Similarly, reforms liberalized labor markets in the Netherlands in the 1990s and Germany in the 2000s. In each case, the long-term result was improved economic performance in terms of output and employment, together with more equality, security, and mobility than achieved in the United States.[7]

d. Big lessons from small countries

There is no reason to look only to large countries such as the United States, Japan, or European countries for economic models. Small countries may have some answers. They are often better able to experiment with innovative policies and institutions and some of the results are worthy of emulation.

Consider a short list of examples. Some of them come from small advanced countries: New Zealand's Inflation Targeting, Estonia's flat tax, Switzerland's debt brake, Ireland's policy with respect to Foreign Direct Investment, and Canada's banking structure. Some examples come from countries that were considered "developing" 40 years ago, but have since industrialized. Korea stands for education. Among Singapore's innovative polices were forced saving and traffic congestion pricing. Costa Rica and Mauritius outperformed their respective regions by, among other policies, foreswearing standing armies. Mexico experimented successfully with Conditional Cash Transfers. A final set of examples come from countries that export oil, mineral and agricultural commodities -- historically vulnerable to the "resource curse" -- but that have learned how to avoid the pitfalls: Chile's structural budget rules, Mexico's hedging of oil export revenues via options, and Botswana's "Pula Fund" as a model for Sovereign Wealth Funds.[8]

4. What do Middle Eastern countries need, for good economic performance?

It has been observed that countries in the Mideast tend to have lower growth rates than many others. We don't know why this is for sure.

a. Is Islam compatible with capitalism?

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[7] They have also achieved smaller budget deficits than those American Republican politicians who describe themselves as fiscal conservatives.

[8] Frankel, "What Small Countries Can Teach the World," *Business Economics* 47, no.2, April 2012, pp.97-103. CID WP 232, Harvard Kennedy School.

Some might say that Islam must be incompatible with market capitalism. But it is hard to see what there might be in Islam that should make this so. Consider one example. The prohibition of riba (usually translated as usury) is interpreted by many to mean a prohibition on all interest. Even under this interpretation however, Islamic banking seems like a perfectly workable alternative – perhaps an improvement if it avoids the bankruptcies and financial crises that sometime accompanying conventional bonds and bank loans.

Econometric studies seem to show that poor economic performance in the Mideast is not statistically related to Islam per se, but to other factors common in the region. These factors include autocratic governments and low literacy and labor force participation among women.

b. The Natural Resource Curse

Disappointing economic performance in the Middle Eastern countries seems to have more to do with oil than with other factors. This seems surprising, if one expect oils to be a source of wealth. But it is an example of the Natural Resource Curse that to some extent applies also to minerals. Natural resource wealth often – though not always – leads to illiberal economic and social systems. One theory is that in a country where physical possession of the natural resource is all that a government or ruling elite needs in order to finance itself, they have no reason to foster the liberal system of individual rights and decentralized decision making that is necessary for success in manufacturing and services.[9]

c. The case of Iran

Every country has its own history, its own culture, and its own institutions. But some fundamental lessons work well for all. A package appropriate for everyone would start with a presumption of free markets and human rights, combined with well-targeted government intervention to limit (rather than worsen) such specific market failures as monopoly, environmental externalities, and unequal income distribution. I would like to apply the word "liberalism" to that package of policy principles.

In the case of Iran, one more thing would be needed: the end of international sanctions. Economic sanctions against some countries have little effect. In other cases, such as US sanctions against Cuba, their biggest effect has been to give the government a plausible-sounding excuse for its long-standing failure to

[9] One study showing that oil rents lead to corruption is Rabah Arezki and Markus Brückner, 2011, "Oil Rents, Corruption, and State Stability: Evidence From Panel Data Regressions," *European Economic Review*, 55, no. 7, October, 955–963; IMF Working Papers 09/267. For a survey of the Natural Resource Curse, see Frankel "The Natural Resource Curse: A Survey of Diagnoses and Some Prescriptions," in *Commodity Price Volatility and Inclusive Growth in Low-Income Countries,* 2012, edited by Rabah Arezki, Catherine Patillo, Marc Quintyn and Min Zhu (International Monetary Fund: Washington DC); CID WP 233 April 2012. Studies of Iran include Hussein Mahdavy, 1970, "The Patterns and Problems of Economic Development in Rentier States: The Case of Iran," in M.A. Cook, editor, *Studies in the Economic History of the Middle East* (Oxford University Press: London); Theda Skocpol, 1982, "Rentier State and Shi'a Islam in the Iranian Revolution" *Theory and Society* 11, 3: 265-283; Benjamin Smith, 2007, *Hard Times in the Land of Plenty: Oil Politics in Iran and Indonesia* (Cornell University Press: Ithaca NY).

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manage the economy. But in the case of Iran, international sanctions really have crippled the economy. If Iran achieved liberalism in the sense just defined and the rest of the world liberalized economic restrictions against Iran, the road to economic development would be wide open.