International Initiative for Promoting Political Economy
Conference 2011
University of Istanbul 20-22 May 2011
Neoliberalism and the Crises of Economic Science

Plenary address

Neoliberalism and Decommissioning Democracy

John Weeks
Professor Emeritus
School of Oriental & African Studies
University of London

Neoliberalism and Decommissioning Democracy[1]

Introduction

In terms of formal analysis, bourgeois macroeconomics divides into two broad theoretical frameworks, one demand constrained and the other price constrained.[2] A *price determined economy* is either in a unique full employment general equilibrium, or prevented from achieving that general equilibrium by private or public price "distortions". An economy is *demand determined* when its level of output is limited by one or all of the components of aggregate demand: consumption, private investment, government expenditure, or exports.

The price controlled framework is the *sine qua non* of neoclassical economics, while the introduction of an aggregate demand constraint was the contribution and remains the legacy of John Maynard Keynes. Even the most superficial knowledge of bourgeois economics makes it obvious that price constrained analysis provides the theoretical basis for arguments in defense of private markets and against public intervention. It is equally obvious that whatever else Keynes may have intended, the central message of his demand constrained analysis was and is that markets are unstable and public intervention is essential to the effective functioning of a capitalist economy.

The formal similarity of the two categories disguises a profound ideological division, which sets the limits to the permissible debate over the role of the public sector in advanced capitalist societies. The price constrained framework is the policy ideology of the tiny minority that controls production and finance. The demand constrained framework provides the defense of public intervention that is analytical foundation of social democracy. In the former analysis, unemployment is voluntary and any public sector intervention in markets is a threat to efficiency and social welfare. In the latter, unemployment is an inherent curse of capitalism and in the absence of public intervention markets are unstable and dysfunctional.

The price determined framework is non-credible to the point of absurdity and beyond. In no other intellectual discipline would such a chaotic collection of logical

---

[1] This paper is a shorter version of the penultimate chapter of Weeks (2012, forthcoming).

[2] I stress that in this paper I refer to bourgeois economics. I develop Marx's macroeconomics in Weeks (2011).

inconsistencies and arbitrary assumptions be taken seriously. The price constrained framework is based on an unambiguously false premise: that the normal condition of capitalist economies is full employment. Yet, today, unlike in the immediate post-WW II years, the price constrained framework dominates mainstream economics, the media and political debate. The demand constrained framework, as obviously sensible as its opposite is absurd, has been relegated to the margins of the discipline.

This inversion, in which the absurd is embraced as sensible and the sensible is dismissed as absurd, reflects the great political victory of the minority over the majority during the final decades of the twentieth century, after a brief interruption during the middle of the century. For almost sixty years, 1870-1930, a relatively primitive form of the price constrained framework dominated the emerging economics profession. During the early stages of development of this framework, the undisguised purpose of leading economists was to refute Karl Marx and justify capitalism.[3]

Two great human disasters prompted a mainstream rebellion against the free market doctrine, the Great Depression and the Second World War. It was obvious to all that the first resulted from the excesses of a capitalism unconstrained by public regulation. The second was the consequence of the first. Denying this chain of causally requires considerable intellectual invention. By the end of the war a broad consensus emerged in Europe and North America that the excesses of capitalism demanded strict regulation of markets, and especially of the financial sector. This consensus could be found in the most prestigious journal of the profession, the *Economic Journal*, where social democrat K. W. Rothschild asserted that fascism was the fruit of unregulated markets:

> …[W]hen we enter the field of rivalry between [corporate] giants, the traditional separation of the political from the economic can no longer be maintained. Once we have recognised that the desire for a strong position ranks equally with the desire for immediate maximum profits we must follow this new dual approach to its logical end.

---

[3] See the discussion in Henry (1983), which focuses on the American economist John Bates Clark.

> Fascism…has been largely brought into power by this very struggle in an attempt of the most powerful oligopolists to strengthen, through political action, their position in the labour market and vis-à-vis their smaller competitors, and finally to strike out in order to change the world market situation in their favour. (Rothschild 1946: 317)

The minority that controlled production and finance considered this consensus a temporary arrangement to be destroyed as soon as possible, because its main economic consequence was to limit the freedom of capital. Those who judged post war regulated capitalism as a new norm would be quickly proved wrong. The system of international regulation of exchange rates ended in 1970, deregulation of the financial sector in the United States and parts of Europe began in the 1980s, and the decline of the political base for a managed capitalism, the trade unions, fell into secular decline in most advanced countries. The collapse of the Soviet Union complemented these trends, eliminating the global rival to unmanaged capitalism.

The destruction the post war regulatory consensus liberated capital from civilizing constraints. The macroeconomics of Keynes and those he influenced provided both the theoretical explanation for why these constraints were needed and the practical policy tools to manage an economy within those constraints. The "Keynesian revolution" briefly institutionalized the singularly sensible principle that governments have policy tools that they can use to pursue the welfare of the populations they were elected to serve. The most important of the tools are fiscal policy, monetary policy and management of the exchange rate. The active use of all these tools was implied by another sensible proposition, the Tinbergen Rule, that achieving several policy goals requires an equal number of policy instruments.[4] For example, a government seeking internal and external stability would use fiscal policy to reach a desired unemployment rate, monetary policy to make that unemployment rate consistent with a target inflation rate, and adjustment of the exchange rate to maintain a sustainable balance of payments.

The obviously sensible proposition that governments should use the tools available to them to pursue the public welfare, while enforcing constraints on the

---

[4] Jan Tinbergen shared the 1969 Nobel Prize for Economics with Ragnar Frisch. Jan Tinbergen has the unique distinction of being a Nobel prize winner in a family with another winner, his brother Nikolaas (in physiology).

excesses of capitalism, has been discredited in public debate by repeated ideological attacks beginning in the 1970s. The constraints have been dismantled and tools de-commissioned by increasingly reactionary governments. Against weak internal opposition the economics profession would provide the ideology for the de-commissioning of the policy tools to support those constraints.

De-commissioning Fiscal Policy

Until the Great Depression of the 1930s macroeconomic policy in the advanced countries meant monetary policy, with exchange rates tied to an international gold mechanism and fiscal policy constrained by the goal to balance public budgets. Fiscal policy was used by a few governments during the depression, notably in the United States, but in an *ad hoc* manner. Perhaps the first clear legal commitment to an active fiscal policy was the US Full Employment Act of 1946, the preamble of which states,

> The [US] Congress hereby declares that it is the continuing policy and responsibility of the Federal Government to use all practicable means…with the assistance and cooperation of industry, agriculture, labor, and State and local governments...to promote maximum employment, production, and purchasing power.

In the early 1970s, elements in the economics profession would initiate an assault on this legal commitment, with an analytical de-commissioning of fiscal policy. The overtly ideological analysis was a follows. In the simple case of a closed, full employment (price constrained), one commodity economy with no public sector, all markets clear in an instantaneous process. No exchanges occur at prices other than those in the price set which would prevail at full employment general equilibrium (no 'false trading'). Consumers and producers take prices as 'signals' to determine the quantities they buy and sell. In this system governments have no role except the enforcement of contracts and keeping public order.

Thus, the first argument to decommission fiscal policy is that it is unnecessary. It cannot contribute to employment, which is achieved to its maximum possible value automatically. However, this is a rather weak argument against fiscal policy, if the economy is plagued by unemployment. The argument that an active fiscal policy is

unnecessary is reinforced by two mutually complementary arguments, first, that the unemployment one observes is almost entirely voluntary, and, second, an active fiscal policy would make unemployment, voluntary or involuntary, worse.

Pre-Keynesian economists argued that the unemployment one observes is voluntary, the result of minimum wages and trade union pressure in labor negotiations. The membership and economic strength of trade unions declined in most advanced countries, and problems of enforcement and erosion through inflation made minimum wages a weak reed for a general theory of voluntary unemployment. Unemployment compensation itself, a major reform arising from the Great Depression, offered an alternative explanation: unemployment persists because payments to the unemployed reduce the incentive to seek work, an argument that would garner the Nobel Prize in Economics in 2010. The argument carries great political power, because it converts involuntary misery into willing avoidance of work, and cautions that well-meaning reforms make matters worse.

The combination of Walrasian general equilibrium and benefit-induced unemployment are necessary elements to de-commission fiscal policy. The sufficient argument is that active fiscal measures, even if they were to temporarily reduce unemployment, are intrinsically undesirable. An active fiscal policy is rendered undesirable through three complementary and equally fallacious arguments, all focusing on public sector deficits: direct crowding out of private expenditure, inflationary impact and reduction of private confidence.

The possibility that a fiscal expansion might directly reduce private expenditure (crowding out) would be caused through a rise in interest rates. If the economy is below full employment, the extent of crowding out depends on how a fiscal expansion is financed and the elasticity of investment with respect to interest rates. In a recession the latter will be low, and crowding out is completely avoided by monetizing the fiscal expansion. The fiscal-expansion-causes-inflation argument is in part designed to rescue the crowding out argument. Financing through bond sales is rejected because of its putative impact on interest rates and private investment. The alternative method of finance, monetization, is slandered as "printing money" and alleged to invariably cause

inflation.[5] The inflation allegation is contrary to neoclassical analysis itself, which unambiguously concludes that an increase in the money supply when an economy is below full employment increases output, and the accompanying increase in the price of output is not by any definition inflationary, but a necessary adjustment to a lower real wage.

One is left with the private sector confidence argument, whose great strength lies in its vagueness, making it almost impossible to refute. In 2010 the right wing British government presented this argument under the imaginatively oxymoronic title of an "expansionary fiscal contraction", reinforced with the pseudo-analytical "structural deficit". The essence of this and similar arguments against fiscal policy is that the public sector deficit and the debt it creates are themselves a direct cause of the reduction of private sector "confidence", which results in a fall in private sector investment. At the end of the 2000s and into the following decade, the marginally more plausible crowding out argument could not be made because nominal interest rates were close to zero and could not fall further.

The more respectable version of this anti-deficit argument suggests that private agents consider that a fiscal deficit is equivalent to a future tax increase, and reduce their expenditures accordingly (so-called Ricardian Equivalence).[6] Even were this the case, the increase in the individual tax burden would be very low, as well as discounted into the future. George Irvin demonstrated the absurdity of this argument, pointing out that it opportunistically stresses the cost of public borrowing while ignoring the cost of the output foregone if the absence of a fiscal stimulus.[7] All such arguments against public deficits and debt fail to accept that the public bonds held by the private sector are income generating assets. If they represent outside wealth, then they should stimulate private expenditure. If the Ricardian Equivalence holds, then they are inside wealth and cancel themselves out.

[5] While monetization is formally equivalent to printing currency notes, this is also the case when a commercial bank uses its excess reserves to extend a new loan. No one calls what a bank does "printing money".
[6] It is so called because of an article by David Ricardo, "Essay on the Funding System", which might be interpreted as implying this equivalence.
[7] See Irvin's article at http://www.guardian.co.uk/commentisfree/2010/nov/07/myths-swallowed-by-george-osborne.

These ideological arguments against an active fiscal policy have inspired political moves in the US Congress to restrict the federal government from deficit finance, such as the Budget Enforcement Act of 1990. The essential purpose of this and other legislation to restrict public sector deficits is to remove fiscal policy from the democratic process of bourgeois society, however flawed that process may be. The de-commissioning of fiscal policy is presented as a technical measure, designed to prevent irresponsible politicians from embarking on "populist" vote-buying expenditure programs that undermine the general welfare (Dornbusch and Edwards 1991).

There is an important sense in which fiscal deficits do, indeed, reduce "business confidence". The driving mission of the capitalist class at the beginning of the twentieth century is to minimize the role of the public sector in order to maximize the power of capital. Discretionary fiscal policy is a barrier to achieving that mission. The minority that controls production and finance has made considerable progress in de-commissioning fiscal policy by the second decade of the twenty-first century. In the case of monetary policy its de-commissioning was almost complete.

De-commissioning Monetary Policy

The often reactionary rule of US central bankers has obscured one of the few progressive aspects of US economic policy institutions, the legislatively mandated political oversight of the central bank, the Federal Reserve System (FRS). This oversight is through mandated reports to Congress, which typically take the form of testimony by the FRS chairman. In addition there is a requirement that the board of governors of the Federal Reserve System have "fair representation of the financial, agricultural, industrial, and commercial interests and geographical divisions of the country". Perhaps more important, the Federal Reserve System has a mandate that requires it to consider employment as well as inflation: "to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates" (Mishkin 2007). In practice the effectiveness of the political oversight has had little importance.

Conventional wisdom holds that in the final decades of the twentieth century the power of central banks increased dramatically in almost all countries, including the United States. The truth is quite the opposite. The role of central banks in most

countries, advanced and underdeveloped, narrowed substantially towards the end of the twentieth century. The vehicle for this narrowing was their so-called operational independence.

The inherently reactionary nature of neoclassical economics is manifested in a broadly held preference in the profession for the complete separation of central banking from political oversight. This predilection is justified by the argument that without independence, governments will force central banks to pursue reckless monetary expansion to fuel populist fiscal policy. Vindication of this argument is found in evidence allegedly showing that the more independent a central bank, the lower the inflation rate in a country (Grilli, Masciandaro and Tabellini 1991; Crowe and Meade 2008).

The so-called independence of central banks, a dogma zealously pursued by the International Monetary Fund, is profoundly anti-democratic. The essence of the argument is that monetary policy is a technical matter, and any degree of democratic oversight results in reckless and irresponsible policies. As for fiscal policy, monetary decisions are not a matter for public involvement. They should be under the dictatorship of a technical elite.

Who Decides Policy?

The neoclassical version of an open economy reaches the conclusion that flexible exchange rates automatically bring external balance, leaving governments free to concentrate fiscal and monetary policy on domestic goals. However, an active fiscal policy is rejected as unnecessary (the domestic economy will correct itself automatically) and counter-productive (deficits crowd out private expenditure). While monetary policy is necessary, its focus should be control of inflation. Taken together, these allegedly technical arguments produce a profoundly reactionary program of public sector inaction.

The reactionary program is especially pernicious because it need not be defended on its intrinsic merits. Its ultimate justification is the infamous TINA principle: there is no alternative. The theoretical conclusion that flexible exchange rates stabilize economies may prove wrong in practice, but would be of no practical consequence because there is no alternative. A balanced public budget may have a pro-cyclical effect

on the economy, depending recessions and exaggerating booms, but deficits would produce worse outcomes. Using monetary policy in the single-minded pursuit of lower inflation may result in persistent unemployment and slow growth, but failing to do so courts disaster. Balanced budgets, low inflation and flexible exchange rates are all necessary to prevent adverse reaction in "financial markets.

The power of these arguments comes from their repetition, not from their theoretical or empirical validity. They are all based on a theory that is internally contradictory and ideologically driven. The fog of neoclassical ideology can be cleared in a simple manner. The fundamental issue in a democratic society is not whether inflation, deficits or unemployment are too high or too low. The fundamental issue is, who decides? The general rule in bourgeois democratic societies is that experts advise and democratically elected representatives decide. Mainstream economics provides the ideological foundation for canceling that rule: elected representatives enact laws that make the advice of neoclassical experts legally binding and beyond popular control. Thus, the danger that the many may pressure for policies that limit the privileges of the few is minimized.

Capitalism Fit for Human Life

There is an alternative to the Hobbesian neoclassical world in which the capitalist minority defines and limits social and economic policy.[8] As happened in the 1930s in the United States, the crisis of the 2000s demonstrated that a range of government actions could be effective to rescue national economies from collapse. The experience of the United States and Western Europe after the Second World War, during the so-called golden age of capitalism, suggests what the component parts of the alternative must be. The reconstruction of that managed capitalism will require, above all, the reassertion of the strength of the working class in the advanced countries.

[8] Thomas Hobbes, with more insight than Adam Smith, recognized that pursuit of individual self interest result in a "state of war" and lives that would be "solitary, poor, nasty, brutish, and short" (Leviathan I, 13).

Controlling capitalism would require four fundamental reforms, whose purpose would be to severely restrict the economic and political power of capital.[9] First, because capitalist economies do not automatically adjust to full employment, governments must institutionalize an active countercyclical macroeconomic program. The active element in the countercyclical program would be fiscal policy, supported by an accommodating monetary policy, and, if necessary, exchange rate management and capital controls to stabilize the balance of payments.

Countercyclical policies, and many other sensible and humane economic measures, are dismissed as impractical because of the alleged affect they might have on "financial markets". This personification of markets, universal in the media and appallingly common in the economics profession, is an essential part of the justification of a capitalist economy free from the constraints of democratic oversight. This personification is applied across all types of markets, as if the market itself were an independent actor in society. In the twenty-first century it became integral to the justification of a socially dysfunctional financial system, national and global.

This personification, an ideological abstraction from the real world of speculators and financial fraud, is an essential part of the mystification of financial behavior. It facilitates the mythology that the dysfunctional financial system is not the work of men and women (mostly the former) within institutions that have socially irrational rules and norms. It promotes the disempowering argument that financial dysfunction is a manifestation of the inexorable operation of laws of nature that no government can change. It seeks to hide that specific financial speculators wish to coerce governments to take actions in their narrow economic interests.

While it is in the interests of capital to exaggerate the power of finance, the dire warnings about the behavior of financial markets carry some truth. The solution to this threat to humane macroeconomic policies is to tame financial markets, not to yield to them. The manner to tame them is public control of finance. In part this could be through direct nationalization, and in part by conversion of financial activities into non-profit or limited profit associations such as mutual societies and savings and loan

[9] The four measures are much the same as those in the program of the British Labor Party in 1945, which was more radical than what was implemented during 1945-1951. http://www.unionhistory.info/timeline/1945_1960.php

institutions (building societies). Even in the United States, the heartland of minimalist public regulation, non-profit and limited profit financial institutions have been common in the past.

Third, government regulation of internal markets would be based on the principle of the International Labor Organization that "labor is not a commodity".[10] The purpose would be to eliminate unemployment as an instrument of labor discipline. The most effective method to achieve this would be a universal basic income program.[11] A properly designed universal income program would facilitate labor mobility, by reducing the extent to which people were tied to their specific employer. Also, by reducing the volatility of household income, it would provide an automatic stabilizer at the base of the economy. It would be similar to the automatic stabilizing effect of unemployment compensation, and more effective.

Fourth, and the basis for all of all others would be the protection of workers' right to organize. The program of fundamental reform of capitalism would be based on the political power of the working class, in alliance with elements of the middle classes. This is the political alliance that brought about major reforms throughout Europe after the Second World War. An effective reform of capitalism that constrains its economic and social outrages requires a democracy of labor and its allies in which the political power of capital is marginalized.

For three hundred years a struggle has waxed and waned to restrict, control or eliminate the ills generated by capitalist accumulation: exploitation of labor, class and ethic repression, international armed conflict, and despoiling of the environment. When a progressive majority has allied, this struggle has brought important gains. When capitalists, the tiny minority, have been successful in creating their own anti-reform and counter-revolutionary majority much is lost. The last thirty years of the twentieth century and into the twenty-first was such an anti-reform period during which capital achieved a

---

[10] This principle can be found at http://www.ilo.org/ilolex/english/iloconst.htm. It is sometimes called the Declaration of Philadelphia, where it was adopted in 1944 at the twenty-six conference of the International Labor Organization.

[11] A universal basic income would be paid to the employed as well as the unemployed. Possible specifications for such programmes are explained in detail at http://www.basicincome.org/bien/. See Standing (2011: 299ff).

degree of liberation it had not enjoyed since before the Great Depression. With the rise of capital many of the more absurd elements of neoclassical economics, such as the alleged stabilizing effect of financial speculation, manifested themselves in reality, as nature imitated bad art.

At the beginning I pointed out that the sufferings caused by the Great Depression of the 1930s, quickly followed by the horrors of the Second World War, generated a broad reform consensus in the developed countries. This consensus agreed on the need for public intervention to protect people against the instability and criminality that results from the accumulation of economic and political power by great corporations. Franklin D. Roosevelt, four times elected president of the United States, had this dangerous power in mind when he addressed the US Congress in 1938:

> Unhappy events abroad have retaught us two simple truths about the liberty of a democratic people. The first truth is that the liberty of a democracy is not safe if the people tolerate the growth of private power to a point where it becomes stronger than their democratic State itself. That, in its essence, is fascism — ownership of government by an individual, by a group or by any other controlling private power. The second truth is that the liberty of a democracy is not safe if its business system does not provide employment and produce and distribute goods in such a way as to sustain an acceptable standard of living. Both lessons hit home. Among us today a concentration of private power without equal in history is growing.

The advanced industrial countries, especially the United States and the United Kingdom, reached the point early in the twenty-first century in which private power was stronger than "their democratic state". This private power manifested itself in unconstrained corporate power that over-rides democratic decisions, justified by an ideology of self-adjusting markets. Rejection of that ideology and fundamental reform of those markets is required to prevent unconstrained corporate power from a latter-day fulfillment of Roosevelt's warning against fascism.

References

Crowe, Christopher, and Ellen E. Meade

2008 "Central Bank Independence and Transparency: Evolution and Effectiveness," *IMF Working Paper* WP 08/119 (Washington, DC: IMF)

Dorbusch, Rudiger and Sebastian Edwards (eds.)

1991 *The Macroeconomics of Populism in Latin America* (Cambridge, Mass: MIT Press)

Grilli, Vittorio, Donato Masciandaro and Guido Tabellini

1991 "Political and Monetary Institutions and Public Financial Policies in the Industrial Countries," *Economic Policy* 13, 341-392

Henry, John F.

1983 "John Bates Clark and the marginal product: an historical inquiry into the origins of value-free economic theory," *History of Political Economy* 15, 3, 375-389

Rothschild, K. W.

1946 "Price Theory and Oligopoly," *Economic Journal* 57, 299-320

Standing, Guy

2011 *Work after Globalization: Building Occupational Citizenship* (Cheltenham, UK: Edward Elgar)

Weeks, John

2011 *Capital, Exploitation and Economic Crises* (London: Routledge)

2012 (forthcoming) *The Irreconcilable Inconsistencies of Neoclassical Macroeconomics: False Paradigm* (London: Routledge)