Economists and the rise of neo-liberalism

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From the mixed economy to neo-liberalism

At the end of the Second World War, there was, outside the Soviet bloc, broad acceptance of the need for a mixed economy. There were differences over where to draw the line between the private and public sectors (for example, should basic industries be nationalised?), over the best form of economic planning, and over the appropriate level of redistribution, but the principle of a state presence in economic activity was widely accepted.

By the end of the twentieth century, the climate of opinion had changed dramatically in two inter-related ways. The most obvious change is that those who denounced any form of government action as 'socialism' had become much more prominent (1). The other was the emergence of a pervasive scepticism about whether direct state action, either by directing industry or redistributing income and wealth, could ever raise social welfare, a scepticism that has affected even those who profess social-democratic ideals.

What was the role of economists, in particular academic economists, in this process? (2) It is probably true to say that only a small minority of academic economists could legitimately be described as neo-liberal. And yet over the past three or four decades, economists have developed theories that have supported this move from government action towards market solutions to economic problems. To explore the connections between academic economics and neo-liberalism, it is useful to start with Friedrich Hayek, a central figure in neo-liberalism, but after the 1930s an outsider to academic economics.

Hayek's programme

Alarmed by the spread of socialist ideas, Hayek sought, in 'The intellectuals and socialism' (1949), to explain why they had become so influential. He argued that the key group was a class of people he called intellectuals, whom he later called the 'dealers in second hand ideas'. They included 'journalists, teachers, ministers, lecturers, publicists, radio commentators, writers of fiction, cartoonists and artists' (Hayek, 1949, 418) – professional communicators but amateurs as regards the substance of their ideas. Their authority derived from getting hold of ideas before their audience. Not being professionals, they judged ideas according to whether they fitted with fashionable general assumptions that might be called the climate of opinion. But intellectuals helped shape the climate of opinion, choosing to support certain ideas and be critical of others.

Because people interested in abstract ideas were more likely to be socialist, and because critics of the *status quo* would have fewer career opportunities (propositions for which he produced no evidence), Hayek argued that intellectuals would be predominantly socialist in their outlook. To counter socialism, the right strategy was to focus on converting these 'dealers in second hand ideas'.

Hayek organised, in September 1947, a meeting of people interested in developing a 'philosophy of freedom'. Its outcome was the Mont Pèlerin Society, named after the location of this first meeting. The Society's aim was not to exert an immediate influence on policy but to have a long-term influence on the climate of opinion. Hayek compared its task explicitly with that facing the socialist and New Liberal intellectuals who had formed the Fabian Society. Though he had wanted to include more historians and philosophers, the Society contained a high proportion of economists.

Though many, such as Milton Friedman, later became highly influential, Hayek was the dominant figure. The main reason was his book, *The Road to Serfdom* (1944). As John Maynard Keynes symbolised the philosophy against which they were fighting, Hayek's book provided the manifesto of the new movement. In Britain, according to one commentator, it 'succeeded in redefining the political debate ... in a way that no single book or statement of belief has done since' (Cockett, 1994, 97). In the United States, the book achieved a wide readership through a condensed version in the *Reader's Digest*.

The Mont Pèlerin Society became the centre of a network that included individuals and organisations concerned to sponsor free-market ideas, think tanks and academic economists, including many who were either members of the Chicago School of economics or had been trained there. Amongst such organisations, the Mont Pèlerin Society was unique in the range of its contacts (including libertarians, Austrians and mainstream economists) and in the period over which it operated.

Patronage and the landscape of economics

Whilst Hayek was preparing for the initial meeting of the Mont Pèlerin Society, he was approached by a businessman, Anthony Fisher, who had recently read *The Road to Serfdom* and wanted advice about influencing public policy for the better (3). Hayek's response was:

> I would join with others in forming a scholarly research organisation to supply intellectuals in universities, schools, journalism and broadcasting with authoritative studies of the economic theory of markets and its application to practical affairs. (quoted in Cockett, 1994, 124)

This eventually materialised, in 1955, as the Institute of Economic Affairs (IEA).

The IEA was, as a registered charity, strictly non-political, its aims referring not to free markets (which might have sounded political) but to 'the study of markets and pricing systems as technical devices for registering preferences and apportioning resources' (Cockett, 1994, 132). However, it published a series of pamphlets and books, by academic economists as well as by journalists and political figures, exploring market solutions to economic problems, advancing many ideas (such as privatisation, deregulation, and methods for creating markets) that eventually became government policy.

Despite its non-partisan position, it exerted a particularly strong influence on the Conservative Party under Margaret Thatcher. Beyond this, it arguably helped to change the climate of opinion through advocating policies that had previously not been taken seriously (the 'Thinking the Unthinkable' of Cockett 1994) and through providing a stream of material that, in addition to being accessible to policymakers, was attractive to students as applications of microeconomic theory.

In setting up the IEA, Fisher was influenced by the Foundation for Economic Education (FEE) in New York, representatives from which had been present at the initial Mont Pèlerin Society meeting, and which he visited in 1952. This had been founded in 1946 by Leonard E. Read, supported by the Austrian economist Ludwig von Mises and the journalist Henry Hazlitt, to 'educate the world on the principles of free-market economics: individual freedom, private property, limited government and free trade' (4). Like the IEA, the FEE focused on retailing free market ideas not on academic research. The same was true of the American Enterprise Institute (AEI), founded in 1943. Education in the principles of liberty was also the aim of the Liberty Fund, established in 1960 by Pierre F. Goodrich. Goodrich was closely involved with the Mont Pèlerin Society from 1951 until his death in 1973, when he left most of his estate to the Liberty Fund, which used it to finance an extensive programme of conferences and publications.

The IEA, AEI and FEE were not the first think tanks to be formed in Britain or the United States to analyse social policy. In Britain, there was the Fabian Society (established in 1884), the National Institute for Economic and Social Research (1931) and Political and Economic Planning (1931). In the United States, there was the Russell Sage Foundation (1907), the Brookings Institution (1916), and the National Bureau of Economic Research (1920). Leaving aside the Fabian Society, these were primarily academic research organisations. Their work was based on the premise that disinterested social-scientific inquiry could, even if only in the long-term, contribute to better policymaking.

During the 1970s there occurred an expansion in the number of free-market think tanks, the Mont Pèlerin Society and the IEA providing a network that linked the key movers in this process. In Britain there emerged the Centre for Policy Studies (1974), the Adam Smith Institute (1977) and the Social Affairs Unit (1980), the last set up with the active support of the IEA. Fisher, the IEA's founder, was also instrumental in setting up the Canadian Fraser Institute (1975) and the International Center for Economic Policy Studies (1977), which later became the Manhattan Institute. Encouraged by these, in 1981, Fisher embarked on a programme to create institutes across the world by creating Atlas: 'a non-profit 501(c)(3) organization headquartered in Fairfax, Virginia, that brings freedom to the world by helping develop and strengthen a network of market-oriented think tanks that spans the globe', its mission being

> [t]o discover, develop and support intellectual entrepreneurs worldwide who have the potential to create independent public policy institutes and related programs, which advance our vision; and to provide ongoing support as such institutes and programs mature. (5)

At a dinner to celebrate the thirtieth anniversary of the IEA, Fisher referred to 'a family of 40 institutes in 20 countries' (Frost, 2002, 161). By the end of the century, Atlas was working with or supporting 150 such bodies (6).

In the United States, the most important development was probably the Heritage Foundation, established in 1973. Despite the existence of the AEI, it was felt that there was a need for a more aggressive conservative body to influence policy to counter the efficiency with which liberal (left) ideas were translated into policy via the Brookings Institution, seen as part of the left's 'finely-tuned policy-making machine' (Edwards, 1997, 2-3), a feeling that became more acute after the defeat of Barry Goldwater's 1964 Presidential campaign.

A group centred on Strom Thurmond and two other Republican Senators, backed by brewing magnate Joseph Coors, set up the Analysis and Research Association (ARA) in 1971, which in 1973 became the Heritage Foundation, through which its President, Edwin Feulner, sought to create 'a new conservative coalition that would replace the New Deal coalition which had dominated American politics for half a century' (Edwards, 1997, 32). In 1979, Heritage designed a conservative programme that an incoming Republican administration could take up – *Mandate for Leadership*, which sold 15,000 copies in the first year. Under Ronald Reagan, Heritage became established in the policymaking process, its income reaching $35 million by 1997, larger than even the much longer-established Brookings Institution.

There also emerged foundations committed to supporting free-market ideas within academia. Up to the 1960s, there were only two significant foundations committed to explicitly free-market ideas: the Volker Fund and the Earhart Foundation, but from the 1970s, there emerged a number of other foundations that consistently supported academics promoting free-market ideas: the Scaife Foundations, the Lynde and Harry Bradley Foundation, and the John M. Olin Foundation. The resources of this group of foundations were, when compared with Ford, Carnegie and Rockefeller, very small. But they focused on a small group of institutions, providing them with long-term funding that enabled them to develop, examples being the centres concerned with what became known as public choice at the Virginia Polytechnic Institute and George Mason University, and Law and Economics at Chicago, both of which became important in the 1970s and 1980s.

To pick out these organisations is not to imply that longer-established sources of patronage, such as the Rockefeller and Carnegie foundations, were ideologically 'neutral'. However, aside from supporting 'American values', which could shade into anti-Communism, they had no explicit political commitments. The think tanks they supported, notably the Brookings Institution and the National Bureau of Economic Research (NBER), had no explicit ideological agenda. Many on the right might see them as part of a finely-tuned left-leaning policy machine, linked with the New Deal, but though they might develop some ideas on social reform, the pressures from their sponsors were, if anything, conservative (7).

Like most of the social sciences, economics was profoundly affected by the Second World War (8): higher education, including the social sciences, expanded massively in most countries. Government funding became much more important, and in the US some of this came from defence agencies – the US Air Force, the US Navy and the CIA. Philanthropic foundations – notably Ford, Rockefeller, and Carnegie – became major players in shaping the social sciences, at times becoming entangled with the US defence establishment. That was symbolised by the links between the Ford Foundation, RAND, a think tank linked with the US Air Force, and Robert McNamara. RAND was important in the 1950s as one of the few places where game theory, seen as providing a way to think rationally about the nuclear stand-off between the United States and the Soviet Union, and which later became central to economics, was developed. RAND's systems analysis focused on the quantifiable dimensions of social problems.

Another significant example is the enormous investment made by the Ford Foundation in business schools in the 1950s. In order to foster a new approach to business, it supported five 'Centres of Excellence', the main one being the Graduate School of Business Administration (GSIA) at what became Carnegie-Mellon University (9), involving the development and application of quantitative techniques. Though a business school, its tone was set by its Dean, economist Lee Bach. As will become clear later, the GSIA was important because it fostered a view of economics in which firms and economic agents were seen as information-processing systems, the behaviour of which could be analysed using formal mathematical techniques.

Though the so-called 'military-industrial-academic' complex was in no sense left-leaning (anti-communism clearly created difficulty for those on the left), it did not share the hostility to government found in the Mont Pèlerin Society. Rather, the focus was on developing quantitative techniques that could be used to organise resources efficiently, whether in the private or the public sector, exemplified by the work done at RAND and the GSIA. This work could draw in economists with a range of political views. In the 1970s, these various strands came together in the changes that took place in economics.

The transformation of economic theory, 1965–1985

In the 1950s, as can be shown by analysing the leading academic journals (10), economics slowly became more mathematical, increasingly modelling the world as if agents (whether households or firms) were rational, maximising individuals buying and selling in competitive markets. This was a simplified view of the world, and arguably at odds, as some economists realised, with developments elsewhere in the social sciences where the human factor, and hence psychology, was seen as central (11). The use of a simplified model of behaviour and the use of mathematical techniques were linked, for mathematical analysis of more complex forms of behaviour, certainly at an abstract level, would not have been possible given the tools available to economists at the time.

The result was that, by the 1960s, it was becoming normal, though far from universal, to see economics simply as dealing with the analysis of choice under conditions of scarcity (12). The ideal form of explanation, even in macroeconomics, which was dominated by the Keynesian theory of employment, was believed to be a mathematical model in which all behaviour was modelled explicitly as the outcome of individuals' rational maximising decisions. At least outside the Chicago School (in which Mont Pèlerin Society founder-members Milton Friedman and George Stigler were influential), policy analysis involved identifying market failures and using formal models to work out the optimal policy response (whether regulation, taxes on specific products, or monetary and fiscal policy).

However, as late as the 1960s, it was still widely accepted that though it might be desirable to have formal models, it was not realistic to expect such methods to explain everything. For example, there was no good theory of markets dominated by a few firms; macroeconomic phenomena could not be fully explained by microeconomics; and economic development needed its own type of theory. But in the 1960s and 1970s, this began to change. Economists increasingly turned to game theory to analyse strategic behaviour by firms, and they developed theories about behaviour when information was limited and costly to acquire. The most profound transformations, however, were in macroeconomics and in the analysis of non-market behaviour.

In the wake of the turmoil that followed the first oil crisis of 1973-4, when inflation and unemployment rose dramatically across the industrialised world, and when conventional forecasting models broke down, economists began to develop dramatically different models of how the economy operated. The world had become one where firms and workers virtually had to be modelled as taking account of inflationary expectations – as information-processors (recall the discussion of GSIA). Friedman had, in 1967, argued that correct modelling of inflationary expectations fatally undermined the reigning Keynesian theory: if governments increased aggregate demand and pushed unemployment below its 'natural' rate, the result would be an unsustainable wage-price spiral and accelerating inflation. Instead, he argued that stabilisation of the economy required controlling the growth rate of the money supply, a policy that came to be known as monetarism.

However, in the 1970s, it was not Friedman's theory, but that of Robert Lucas, who moved from the GSIA to Chicago in 1975, that transformed the subject. Where Friedman had argued that policy was in practice destabilising, Lucas demonstrated that, if private agents were completely rational and if markets were competitive (two assumptions that appealed to many economists, irrespective of their politics), it would be *impossible* for government to stabilise the economy. Furthermore, Lucas made his case by constructing mathematical models that chimed with the consensus view of how economic theories should be constructed, opening up a new research agenda for economists trained in the appropriate mathematical techniques.

The 1960s also saw the application of economic models to non-market behaviour, the process often named 'economics imperialism'. Gary Becker, another Chicago economist, tackled problems of discrimination, crime and the family. At Chicago, Richard Posner and Aaron Director applied economic analysis to the law. James Buchanan, a Chicago-trained economist who had gone to Virginia, Gordon Tullock, and others turned to non-market decision-making, whether by bureaucracies or through political processes, creating the field of public choice theory. Bureaucrats and politicians were individuals seeking their own advantage, meaning that policy could not be seen as something 'outside' the economic system and that government failure was as likely (or perhaps more likely) than market failure. The result was that, whereas economists had previously focused on the analysis of market failure, from the 1980s they began to develop formal models of government failure (13).

The outcome was that by the 1980s, economics looked dramatically different – it was more mathematical and there were new theories. Many of the new theories were undoubtedly more supportive of free-market positions. Though there still were vigorous attempts to provide a theoretical basis for government intervention, the burden of proof had shifted, and supporters of intervention were increasingly on the defensive. More important, economists had begun to look at economic policy in new ways, seeing government failure as a problem that needed to be overcome.

Economic theory and ideology

The obvious interpretation to consider is that these changes in economics were driven by economists hostile to socialism, in institutions that were supported by the same foundations that were funding free-market think tanks.

Several Chicago or Chicago-trained economists were crucial to the process. Director, Friedman, Stigler, Becker, Lucas, Buchanan and Tullock were members of the Mont Pèlerin Society. Not surprisingly, they developed theories that supported free markets and opposed government intervention. Lucas's macroeconomics questioned whether stabilisation policy could ever work; Friedman, Buchanan and others constructed theories that suggested that free markets would work better than government intervention.

The new think tanks supported these developments in two ways. They pushed the new ideas developed in academia into the public arena and into policymaking circles. They also 'thought the unthinkable', very publicly, for many years, when few academic economists were doing so, preparing the ground for academic economists and policymakers, when faced with a dramatic economic shock, to consider ideas that would not previously have been taken seriously. Such an interpretation would vindicate Hayek's view of how ideas changed.

However, though the facts are right, there are problems with this interpretation. These economists had an ideological agenda, but they were using ideas that had been central to the discipline for many decades. Furthermore, such economists were in a minority and many of the most important ideas came from elsewhere.

A major development was the way game theory, which as late as 1960 was still an 'exotic' subject pursued by a minority, became central to economic theory during the 1970s and 1980s, being used to analyse problems ranging from the regulation of industry to the effectiveness of monetary policy. Game theory came not from Chicago but from RAND and Princeton. The importance of Carnegie-Mellon's GSIA was that it influenced not only Lucas but also Franco Modigliani, one of those responsible for the modern theory of finance and, after he moved to MIT, one of the leading opponents of Friedman's monetarism. The changes that took place in economics were thus the result of developments that were far broader and by economists with ideologies that were far removed from those of the Mont Pèlerin Society.

If attention is paid to developments after the 1970s, to what has been described as 'the reinvention of the bazaar' (McMillan, 2002) – the development of market solutions to problems ranging from controlling sulphur dioxide emissions to allocating mobile phone licences – it becomes even more difficult to associate the move towards market economics with neo-liberalism as represented by the Mont Pèlerin Society. Many economists see no inconsistency between exploring such solutions and holding 'social-democratic' views on the need for government to manage the economy, redistribute income and support a welfare state. Government policy is a matter of balancing, case by case, market failure against government failure, ignoring neither. Even in macroeconomics, when a new 'consensus' began to emerge by the 1990s, though Lucas's ideas had been highly influential, it was not based on his work alone, but on a more eclectic theory that also reflected ideas developed by his 'New Keynesian' critics. There is thus a very real sense in which those economists whose politics can be described as neo-liberal have worked as part of an academic community encompassing many economists who did not share their political views.

The main reason why the ideas of the neo-liberal minority were taken seriously is that they were seen as doing rigorous work tackling important problems: for example, even a committed Keynesian, Yale's James Tobin, took Lucas seriously before his ideas became fashionable. Even for economists who rejected his policy conclusions, Lucas opened up new ways of modelling the economy. Yet taking seriously these models, in which there was no place for 'involuntary' unemployment, meant accepting the assumptions of rationality and perfectly competitive markets on which they were based.

In part, the reason they were accepted is that they were simple to work with. Take as an example the theories that Joseph Stiglitz used to offer a critique of the International Monetary Fund's response to the Asian financial crisis of 1998 (Stiglitz, 2002). These theories about markets in which some traders had more information than others were widely seen as very important, and many economists, especially after Europe's experience in the 1980s, used such ideas to explain unemployment. However, they were too complicated to provide the basis for a new general theory of macroeconomics.

That, however, begs the question of why academic economists were not more cautious in accepting Lucas's assumptions, which were central to the whole theory, especially given that the theoretical coherence of the theory of general competitive equilibrium had been challenged during the 1960s and the empirical support for the new theories was not decisive. No definite answer is possible, though it is hard to avoid concluding that the shock of conventional theories having apparently failed; the urgent need for policy guidance; and the changed political climate were all factors, as well as the appeal of new theories to young economists searching for ways to demonstrate their technical skills.

Conclusions

What, then, is the relationship between changes in academic economics and the rise of neo-liberalism? As the list of Nobel Memorial Prize winners indicates, a significant number of the economists who became influential in the 1970s and after, many of whom had links with Chicago, were committed to free-markets. It is also true that many of the economic theories developed during the 1970s, from new macroeconomic theories to theories of government failure, added to the arguments that could be used to criticise government intervention in the economy.

However, there remained many academic economists who did not jump to the conclusion that government intervention should be abandoned (witness the letter opposing the Thatcher government's economic strategy by 364 economists to *The Times* in March 1981). There were many economists who, whilst finding many valuable insights in the new theories, continued to adopt a much more pragmatic approach to policy: new theories of government failure might make some recommendations about intervention seem naïve, but earlier theories of market failure retained their validity.

Why, then, were more extreme views on policy so influential and why did the climate of opinion shift so markedly against the idea of government intervention? One factor is the new breed of free-market think tanks. Mrs Thatcher, for example, disliked academic economists, but had close links with the IEA and admired the work of Hayek, someone who, within academic economics, was not even considered an economist, let alone one whose ideas should be taken seriously (14). The changed political climate since the 1980s would seem to have created a situation that is the opposite of the one discerned by Hayek in 1949, in that the fashionable conventional wisdom has been to be sceptical about government and to overlook the potential problems with markets.

Hayek may have been right about the importance of 'intellectuals', but rather than adopt his social psychology, it is more plausible to adduce factors such as the media's preference for simple, clear-cut solutions, creating a bias against the pragmatic balancing of government failure against market failure on which the case for government intervention nowadays rests. Like anyone else, academic economists will not have been immune to changes in the climate of opinion, but, as the previous section argues, this is no more than part of a more complex story.

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Notes

1. The question of whether neo-liberal ideology is consistent with practice is another matter, not considered here.
2. I leave aside the question of who counts as an economist.
3. This section is an edited version of passages from section 4 of Backhouse (2005) where a more comprehensive list of sources can be found.
4. Its website (http://www.fee.org) claims that it is 'America's oldest free-market organization.'
5. Both quotations are taken from http://www.atlasusa.org/aboutatlas/index.php?refer=aboutatlas.
6. For broader international surveys of think tanks, see Stone *et al.* (1998) and McGann and Weaver (2002).
7. See the excellent discussion in Goodwin (1998). See also Crowther-Heyck (2006) on social science funding. He also discusses the pressures operating through university administrators.
8. See Backhouse (2008) and Backhouse and Fontaine (2010).
9. This account of the GSIA draws on Khurana (2007).
10. See Backhouse (1998).
11. On the centrality of psychology to the post-war social sciences, see Backhouse and Fontaine (2010, chapter 8).
12. The slow acceptance of this definition of economics, due to Robbins (1932), is discussed in Backhouse and Medema (2009).
13. For an excellent overview of attitudes towards government and the market, see Medema (2009).
14. Few students of economics will have even encountered his name. The minority familiar with the history of their discipline will have been aware that, from the 1940s, he had moved out of economics into psychology and political philosophy.