

# ECON 409

October 3, 2012

Liberal Political Economy

# Introduction

- Why did political economy emerge at the end of the 18th Century?
- How did the economy work?
  - Tradition and customs
  - Authority
- Economic relations are embedded in a broader social context
  - The main motivation was the survival and reproduction of the social structure, not the personal gain.
- Market system
  - Traditional markets
  - New markets (land, labor and capital)

# Liberal Political Economy

- Adam Smith "Wealth of Nations" 1776
  - Self-regulating markets
  - Politics vs. nonpolitics
    - What is the basis of this new mechanism?
      - Exchange contract
    - What is the motivation for exchange?
      - Self-interest
    - How to coordinate different individuals' actions?
      - What happens if I cannot find a job?
      - What happens if I cannot sell my product?

# Liberal Political Economy

- Is it possible to have a systematic failure?
  - Say's law
- If everyone acts according to his/her self interest then that will lead the society to its best position
  - "The individual intends only his own gain, and he is in this, as in many other cases, led by an *invisible hand* to promote an end which was no part of his intention (Smith, Wealth of Nations)

# Liberal Political Economy

- How to reconcile private interest and public good?
  - Profit is the main concern, and accordingly we'll have the best allocation of investment (income for everyone, jobs for everyone, full capacity utilization)
  - "It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interests" (Smith)
- What about the role of the state?
  - National defense
  - Law and order (private property)
  - Public investment

# Liberal Political Economy

- Question:
  - Is acting on self interest enough to satisfy needs and wants of individuals?
    - What about the initial distribution of property?

How to distribute the social output?

Wage is what is left out from total output after deducting the profit.

How can we determine the level of wages?

Subsistence wage that is to be determined socially (i.e. the social needs of workers)

# Neoclassical Political Economy

## (late 19th Century)

- What is self-interest?
- Economics is all about optimization
  - How to maximize the objective function (utility or profit)
- "constrained choice"
  - The individual is a choosing agent
  - Ends
    - preferences are ranked in a consistent manner
    - They must satisfy the same desire
  - Scarce resources
    - Scarcity depends both on our desires (subjective) and availability of resources (objective)
  - Scarcity requires choice among competing ends

- Distribution of income:
  - Each factor of production deserves what it contributes to the production
  - Wage, rent, profit etc.
  - Different from classical liberal political economy
  - What about initial distribution of resources?
- What about social welfare?
  - We cannot impose any preference on the group as a whole
  - If exchange makes some individuals better-off without making someone else worse-off, then this exchange will improve social welfare (Pareto)
  - But initial distribution of resources is a given