

# REASSESSING THE PARADIGM OF ECONOMICS

BRINGING POSITIVE  
ECONOMICS BACK INTO THE  
NORMATIVE FRAMEWORK

**Valeria Mosini**



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into the normative framework

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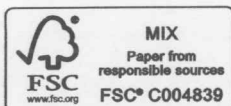
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'Valeria Mosini not only drives another, solid nail in the coffin of neoliberal economics as the dominant, mechanically repeated prescription for progress, development and welfare that in actual fact does more harm than good; more importantly yet, she skilfully dissects and convincingly demolishes the empty claim to scientific status that its ideological protagonists and political advocates in the global north and south have managed to sustain for decades.'

Eberhard Kienle, *Political Sciences, CNRS, Paris and Grenoble, France.*

'This extremely timely contribution by Valeria Mosini is an excellent read, relevant not just to economists and philosophers, but to anyone interested in both why we are where we are, and in what might be done about it. It focuses on the philosophical and political economy under-pinnings of neo-liberal doctrine as formulated in particular by Milton Friedman. Mosini skilfully demonstrates the untenability of Friedman's contribution, whilst arguing convincingly for the need to reformulate modern economics within an explicitly recognised ethically driven normative framework.'

Tony Lawson, *Economics, University of Cambridge, UK.*

'In this well written and well argued book, Valeria Mosini indicts Milton Friedman for devising positive economics, the analytical method he used to smuggle in ideology disguised as theory and so provide an intellectual foundation to the neoliberal counterrevolution which has changed the world in the last 40 years. She exposes the whole process as fake science. After reading her closely argued strictures, it is hard to disagree with her.'

Marcello De Cecco, *Economic Theory and Finance, Scuola Normale Superiore di Pisa, Italy.*

'The monetarism of Milton Friedman has been much discussed over the years, but his methodology and philosophical attitude to economics have been less explored. Valeria Mosini has thus offered us an invaluable book. Wide-ranging, well-informed and balanced in its judgements, her work casts light onto Friedman's instrumentalist and contradictory approach to economics. A particular strength of the book is the author's command over the history of economic thought. Mosini has produced a penetrating critique of neoliberalism at a particularly opportune moment following the crisis of 2007-9.'

Costas Lapavistas, *Economics, School of Oriental and African Studies, University of London, UK.*

# Reassessing the Paradigm of Economics

When President Reagan and Prime Minister Thatcher adopted the neoliberal doctrine as the paradigm of economics, there was no evidence that the move would be successful. Thirty years on, the recurrent crises that culminated in 2008 suggest a serious mismatch between expectations and outcomes: a re-examination of the paradigm is in order. This book focuses on Milton Friedman's formulation of the neoliberal doctrine, and analyses two aspects that were essential to turning it into a fully fledged paradigm: the attribution of scientific status to positive economics, which led to informing public policies on the requirements of the market and the characterisation of economic freedom as capable of promoting political freedom, which led to identifying free market with democracy.

The book exposes Friedman's methodological argument for attributing positive economics scientific status as a failure, and his characterisation of economic freedom as a delusion; it identifies in the emergence as the mainstream in economics of the neoclassical synthesis, which borrowed from Walras' economics the mathematical treatment of equilibrium but not the ethical and social framework in which it was inscribed, a development that facilitated the transition from the Keynesian to the neoliberal paradigm.

Dr Mosini shows that the gigantic bail-outs carried out courtesy of the public purse, which institutionalised the practice of collectivising losses while keeping profits private, were no accident, but the consequence of the rethinking of the function of lender of last resort according to Friedman's conception of rationality in relation to risk, combined with his interpretation of the 1930s recession. The book concludes that the neoliberal paradigm has served the interests of the economically powerful social strata it was designed to benefit extremely well, but that the deep, and deepening, injustice it has brought about calls for a complete rethinking of the paradigm of economics according to ethical principles respectful of human values. This book should be of interest to students and researchers of Political Economy, Economic Methodology, History of Economic Thought and Philosophy.

**Valeria Mosini** is a staff member of the Science Faculty of the University of Roma 'La Sapienza', Italy and associate of the Department of International Development of the London School of Economics, UK.

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**To S. T. and C. B. for what they mean to me**

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# Introduction

## Reasons for the book

Over the past thirty years, the economic and financial systems have operated under the neoliberal paradigm conceived and designed over decades by, among others, F. Hayek and M. Friedman.<sup>1</sup>

The paradigm consists in the technical apparatus of neoclassical economics, framed within the tenets of the neoliberal doctrine: that markets are equilibrating, that a flourishing private enterprise provides the most efficient incentive to the functioning of the economic system, that economic freedom (of production, trade, capital mobility) is a primary goal for the society as a whole, and that, consequently, government intervention should revolve around safeguarding it (Harvey: 2005).

When the neoliberal paradigm was implemented, in the early 1980s, no evidence was available showing that it would be conducive to the efficient functioning of the economic and financial systems; the forward-looking, predictions-based, methodological approach introduced by Friedman (1953) in his *Essays in Positive Economics* made the lack of supporting evidence in its favour appear not to be a problem in the face of the difficulties that burdened the previously dominating Keynesian paradigm. Thirty years on, a large body of evidence has accumulated, which, covering the crises of the 1990s and early 2000s – followed by the global crisis of 2008, in turn followed by further localised, but intense, tremors (Iceland, Greece, Ireland) – provides strong indication that the prediction that the economic and financial systems under the neoliberal paradigm would perform efficiently was incorrect.

The implementation of the neoliberal paradigm led to a substantive rewriting of public policies, which, giving the individual primacy over the collective and market forces free rein, performed a U-turn with respect to

<sup>1</sup> For differences between Hayek's and Friedman's conceptions of neoliberalism, see Prebish (1981) and Hayes (2008).

## 2 Introduction: reasons for the book

the direction previously followed in which welfare and high employment were paramount. The new trend imparted on public policies impacted heavily on the conception and organisation of society; the drastic changes that have come about, which may be broadly described as having reduced the expectation of security (job, pension, housing, education, etc.) for the majority of people, were justified on the *presumption* that economics had reached scientific status:

The modern prominence of economics in the development of public policy has been founded upon the *generally accepted presumption* that the investigatory techniques used successfully for centuries in the physical sciences are readily and with only minor modification applicable to the study of human interaction in the marketplace and elsewhere.

(McKenzie: 1981, pp. 3–4, my emphasis)

Such a *presumption* represented a further step from the simple attribution of scientific status to economics, which had been a recurrent theme in the discipline ever since its establishment in the modern era with emphasis shifting back and forth between the epistemological plane – affirming similarities between the laws of economics and those of the natural sciences – and the ontological plane – affirming similarities between natural and economic phenomena:

From Smith's pursuit of Newtonian laws of economic motion, to Ricardo's exposition of the natural laws of distribution, Jevon's mechanical analogies, Marshall's extensive use of biological metaphors and, finally, to Samuelson's use of the techniques of optimization and dynamics borrowed from physics, economic phenomena have been represented as natural, subject to natural laws.

(Milberg: 1998, p. 243)

Prior to the implementation of the neoliberal paradigm, the attribution of scientific status to economics was controversial, and the arguments on which it was based – the ontological one (Quesnay: 1756, Smith: 1776), and the mathematical one (Edgeworth: 1881, Jevons: 1879, Pareto: 1896, 1911) – met with strong criticism (Sidgwick: 1883, Keynes: 1890, Robbins: 1938). But, most importantly, neither of those arguments (which I discuss later) commanded the authority/persuasive power necessary to turn the attribution of scientific status to economics into a *presumption*.

As I discuss in Chapter 3, it was Friedman's methodological argument, in association with developments in economic theorising related to the

neoclassical synthesis, which prepared the ground for the implementation of the neoliberal paradigm on the *presumption* that the theoretical body of economics had reached the same degree of objectivity as that of the natural sciences, which sanctioned the primacy of positive economics over normative economics.

While the reasons why Friedman's role in turning the neoliberal doctrine into the paradigm of economics proved to be even greater than Hayek's, who was acknowledged as the intellectual leader of the neoliberal movement, have been discussed (Cockett: 1994), the importance of Friedman's (1953) methodological argument in that process has not received much attention.

### Friedman's methodological argument

When Friedman's paper 'The Methodology of Positive Economics' was published in his *Essays* (Friedman: 1953), discussion of method in economics had a long-standing tradition in association with discussion of scope; the received view was that, whatever the methods employed in positive analysis – inductive or deductive – and whatever the techniques – historical and mathematical – the positive-normative distinction was not clear-cut and the interrelation between the two elements was such that positive economics was *subordinated* to normative economics. (See Chapter 2 for discussion and illustration.)

The main contentions in Friedman's methodological paper were that, if positive economics followed the method presented, its theories would acquire the same degree of objectivity as the theories of the natural sciences, its scope could be sharply separated from that of normative economics, and its conclusions should be implemented irrespective of social and moral concerns about their possible consequences or side effects.

Friedman's attitude to his own method was rather peculiar: while, describing it, he stated that the empirical corroboration of predictions was the only way to assess the validity of scientific theories, in the illustration of the method he left the boundary conditions and the timescale of his predictions so ill-defined that their corroboration became impossible, or was shifted indefinitely forward ('long-runism'), nullifying any chance of theory testing. (See Chapter 4 for discussion.)

The forward-looking, prediction-based, character of Friedman's method had a major advantage, from the point of view of the neoliberal movement, with respect to the inductive and deductive methods, both based on past occurrences. This is because it enabled the neoliberal doctrine to be turned into a paradigm and its implementation urged even in the absence of evidence in its favour, and any piece of counter-evidence

#### 4 *Introduction: reasons for the book*

that may become available against the prediction that the economic and financial systems would perform efficiently under it to be effectively neutralised.

In this way, Friedman's methodological argument provided the neoliberal doctrine with the extra-bit that was required to turn it into a fully fledged paradigm awaiting implementation.

How this came about is summarised in the next section.

### **M. Friedman: academic and policy maker**

It is well known that Friedman accompanied his duties at the University of Chicago with a deep involvement in extra-academic activities run under the auspices of influential neoliberal power groups, such as the Mount Pelerin Society, the Philadelphia Society, the Heritage Foundation, and the Institute of Economic Ideas,<sup>2</sup> which actively promoted free market values against the Keynesian-inspired trend borne out of the 1930s depression.

Those think tanks managed to bring together the stars of the neoliberal doctrine; however, what the business community was looking for was an individual capable of creating a pressure group and imposing it at the political level (Cockett: 1994). That individual was Friedman whose role, not just in the formulation of the neoliberal doctrine, but in turning it into a fully fledged paradigm, is widely acknowledged (see, for instance, Thygesen: 1976, Sufrin: 1980, Frazer: 1982, Hammond: 1995, Krugman: 2007).<sup>3</sup> In the early 1960s, he became economic advisor to Barry Goldwater assisting in the presidential campaign of 1964, which, although unsuccessful, managed to bring the neoliberal agenda under the spotlight especially with respect to fiscal policies and the limitations imposed on governments' action. In fact, success greeted presidential candidate Richard Nixon in 1968, to whom Friedman served as economic advisor; international recognition for Friedman's academic contributions followed: in 1976 he was awarded the Nobel Prize, which had gone to Hayek in 1974.

In the meantime, neoliberal think tanks had proliferated in the United States and elsewhere, with the Centre for Policy Studies, the Adam Smith Institute, and the Social Affairs Unit becoming established in the United Kingdom, respectively, in 1974, 1977, and 1980, while the Canadian Fraser Institute opened in 1975; their coming together provided an effective task force against the hopes of socialism that were spreading worldwide.

2 For discussion of neoliberal think tanks, and of Friedman's personal involvement in them, see, for instance, Cockett (1994), Hartwell (1995), Frazer (1997), and Backhouse (1998).

3 See also the interview with G. Lucas in Snowdon and Vane (1999).

The time was getting right for the neoliberal doctrine to be turned into the paradigm of economics.

### **The crucial years: 1971, 1979, 1980**

If Goldwater's presidential campaign of 1964 represented the rehearsal for neoliberal ideas resonating in the real world, they positively did so in August 1971, when, on Friedman's advice, President Richard Nixon, allowing the floatation of the dollar, in actual fact withdrew the United States from the Bretton Woods system of regulations that had been in operation since July 1944. The move resulted in the depreciation of the dollar, which, among other consequences, led to a decrease in the revenues of the oil-producing countries; the Organisation of the Petroleum Exporting Countries (OPEC) responded with protective measures that inflated prices, followed by further increases in 1973 and 1974 (Braithwaite and Drahos: 2000), in stark contrast with the Bretton Woods era in which oil prices had remained relatively stable.

Higher oil prices brought higher revenues for the oil-producing countries, which accumulated large sums of dollars in their central banks; meanwhile, the abandonment of the requirement of convertibility of dollars into gold opened up the possibility for the United States to finance with Treasury bills or other similar instruments, and practically without supply-side limits, an already large deficit (partly to do with the Vietnam war expenses). In the absence of effective price control mechanisms, or adequate income policies, the resulting liquidity surge was addressed in the United States with the tightening of monetary and fiscal measures that caused unemployment figures to skyrocket between 1973 and 1975. The liquidity surge sent shock waves through the international banking system, and, in some cases, brought about all-out crises.<sup>4</sup>

Influential academic figures blamed the dim economic performance of the 1970s on the constraints created by the Keynesian paradigm; R. Lucas went as far as calling the predictions of Keynesian economics 'wildly incorrect' and the theory generating them 'fundamentally flawed' (Lucas and Sargent: 1981, pp. 295–96); following Friedman's 'natural rate of unemployment' hypothesis, he maintained that 'involuntary unemployment is not a fact or a phenomenon which it is the task of theorists to explain. It is, on the contrary, a theoretical construct which Keynes introduced' (Lucas: 1981, p. 243).<sup>5</sup>

4 As in the case of the 1973–75 crisis in the United Kingdom (Reid: 1982).

5 For the connections between Friedman's and Lucas's positions, see Hahn (1980, 1982).

The emerging trend in the discipline was one that blamed a wide and diversified set of economic difficulties on Keynesian economics; consensus was reached that the events of the early 1970s had verified Friedman's (1968), Phelps's (1967, 1970) and Lucas and Rapping's (1970) predictions, which recommended the abandonment of the Keynesian paradigm. The consensus among economists, though reached on the basis of highly contested claims (Backhouse: 1998), influenced public opinion and contributed to creating the conditions for the coming to power of Margaret Thatcher in the United Kingdom in 1979,<sup>6</sup> and of Ronald Reagan in the United States a year later.<sup>7</sup>

Thatcher and Reagan took upon themselves the task of implementing the neoliberal paradigm in the world of actual economic and financial affairs, opening the door to a series of liberalisations, which started with the capital accounts and financial deregulations (Wilson: 1981).<sup>8</sup>

## Unspoken words of caution

When the United States broke the Bretton Woods agreements and allowed the dollar to float, there was no *evidence* that the move would result in the solution of the many problems affecting the country, such as rising inflation and the increased deficit in the balance of payments, which, to a large extent, resulted from adverse trade competition with Germany and Japan.

When neoliberal reforms were properly implemented in the early 1980s, and Keynesian-inspired economic policies were abandoned altogether, the reason for the change in direction could not reasonably be claimed to have been the economic performance of the 1970s, which came about against a background characterised by elements – such as floating exchange rates and the removal of capital controls – which were not part of the picture relative to which Keynes had formulated his theories, while others – such as the oil embargo – depended on political and strategic factors external to economics.

Given that each scientific theory is defined within given boundaries and is expected to be valid only within those boundaries, its failing when applied outside should not be regarded as a deficiency of the theory but as *the consequence of its misuse*.

6 Who greatly admired Hayek.

7 For Friedman's and other liberal economists' influence on Reagan's policies, see Cannon (1991).

8 In the United States financial deregulation was introduced through the Depository Institutions Deregulation and Monetary Control Act of 1980, followed by the Garn-St Germain Depository Institutions Act of 1982.

If anything, a piece of *counter*-evidence about the performance of the economic and financial systems under the neoliberal paradigm was available: the 'Chilean experiment' (1973–83) carried out under A. Pinochet's military junta. Yet, Thatcher and Reagan ignored it and resolutely embarked on paradigm change, without making any attempt at rectifying the situation from within the existing (Keynesian) paradigm, for instance, increasing capital controls to calm financial markets and stabilise exchange rates, introducing a Tobin Tax imposing charges on financial transactions, pursuing a policy of management–labour cooperation to ease industrial relations (Howell: 1994).

The transition to the neoliberal paradigm *was not* determined by events:

Neoliberalism was a deliberate political and economic *choice* made in the later 1970s and early 1980s by economic elites around the globe in pursuit not of the general welfare, but of their narrow individual and class interests. To date ... their choice has been a great success for them, but something between a disappointment and a disaster for the majority of the world's people.

(Crotty: 2002, p. 22)<sup>9</sup>

## All is far from well on the stage

Despite all the good promises that the implementation of the neoliberal paradigm would be a panacea for the economy,<sup>10</sup> and prove beneficial in other ways,<sup>11</sup> things have not gone according to plan.

After an initial period in which booms and busts alternated (see Chapter 6 for discussion), a reduction in the rate of profit became widely established; to try and compensate for it, many firms joined the financial investors in speculative enterprises, which created a surge in liquidity and an imbalance in favour of the financial assets against the real assets so substantial that it 'changed the face of the world economy' (Wade: 2006, p. 117). The financialisation of the economy had a destabilising impact on the currency and financial markets, increasing the frequency of crises

9 See also Gowan (1999).

10 'The more you let market forces rule and the more you open your economy to more free trade and competition, the more efficient and flourishing your economy will be' (T. Friedman: 1999, p. 8).

11 'The liberal market economy ... encourages valuable moral virtues, it makes people richer and more concerned about environmental damage, pain and injustice. It makes the welfare state possible' (Wolf: 2004, pp. 4 and 57).