

Masters of the Universe

*

HAYEK, FRIEDMAN, AND THE BIRTH OF NEOLIBERAL POLITICS

Daniel Stedman Jones



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To my parents,

Sally Alexander and Gareth Stedman Jones

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Daniel Stedman Jones

March 2011

Timeline

Decade	United States	Britain
1900s	1900–1930 High tide of American Progressivism	1906–14 New Liberal government of Herbert Henry Asquith enacts welfare reforms
1910s	1917–18 United States joins the war	1914–18 World War I
1920s	1929 Wall Street crash	1926 The General Strike
1930s	1932 FDR elected and New Deal begins 1933–1945 Democrat Roosevelt administration	September 1939 Outbreak of World War II
1940s	April 1945 FDR dies, replaced by Harry Truman 1945–53 Democratic Truman administration 1945 World War II ends	May 1945 Clement Attlee prime minister 1945–51 Labour government 1948 National Health Service founded by Nye Bevan
1950s	1950–53 Korean War 1953–61 Republican Eisenhower administration 1955–75 Vietnam War	1951–64 Conservative government 1951–55 Winston Churchill prime minister 1955–57 Anthony Eden prime minister 1956–57 Suez Crisis 1957–63 Harold Macmillan prime minister
1960s	1960 JFK elected 1961–63 Democratic Kennedy administration 1963 JFK assassinated 1963–69 Democratic Johnson administration 1968 Richard Nixon elected 1969–74 Republican Nixon administration	1963–64 Alec Douglas-Home prime minister 1964–70 Labour government Harold Wilson prime minister

XII TIMELINE

Decade	United States	Britain
1970s		1970–74
	1974	Conservative government
	Watergate scandal; Nixon resigns	Edward Heath prime minister
	1974–77	1974–79
	Republican Ford administration	Labour government
	1976	1974–76
	Jimmy Carter elected	Harold Wilson prime minister
	1977–81	1976–79
	Democratic Carter administration	James Callaghan prime minister
		Margaret Thatcher elected
		1979–1997
		Conservative government
1980s	1980	
	Ronald Reagan elected	1982
	November 1988	Falklands War
	Republican Reagan administration	
	1981–89	
	George H. W. Bush elected	
	1989–93	
	Republican Bush administration	
	Fall of the Berlin Wall	
	October 1989	

Abbreviations



AEA—American Economic Association
AEF—American Economic Foundation
AEI—American Enterprise Institute
ASI—Adam Smith Institute
CPS—Centre for Policy Studies
FEE—Foundation for Economic Education
FHA—U.S. Federal Housing Administration
HIPs—UK Housing Investment Programmes
HUD—U.S. Department of Housing and Urban Development
IEA—Institute of Economic Affairs
IHS—Institute for Humane Studies
USPHA—U.S. Public Housing Administration
WVF—William Volker Fund

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Introduction

The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back. I am sure that the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas. Not, indeed, immediately, but after a certain interval; for in the field of economic and political philosophy there are not many who are influenced by new theories after they are twenty-five or thirty years of age, so that the ideas which civil servants and politicians and even agitators apply to current events are not likely to be the newest. But, soon or late, it is ideas, not vested interests, which are dangerous for good or evil.

JOHN MAYNARD KEYNES, The General Theory of Unemployment, 1936

Neoliberal ideas—monetarism, deregulation, and market-based reforms—were not new in the 1970s. But as Keynes suggested, they were the ideas to which politicians and civil servants turned to address the biggest economic crisis since the Great Depression. This book is about why this happened, and how the neoliberal faith in markets came to dominate politics in Britain and the United States in the last quarter of the twentieth century up to the financial crisis of 2008.

The demise of the postwar economic settlement had been hastened by a series of catastrophic events: the Vietnam War, the first oil shock of 1973, and the near collapse of industrial relations in Britain. The Keynes-inspired policies that governments had relied on to deliver a golden age of prosperity and rising incomes for the generation after 1945 seemed exhausted. The

collapse of the Bretton Woods international monetary system in 1971 indicated the end of the experiment with fixed exchange rates. The assumption that there was a relatively simple and manipulable trade-off between inflation and employment, the famous Phillips Curve (named after the New Zealand Keynesian economist William Phillips), proved to be a dangerous illusion. Repeated balance-of-payments crises were the most prominent symptom of the so-called "British disease" of industrial decline. In both Britain and the United States, the appearance of stagflation—simultaneous stagnant growth and inflation—meant that governments felt forced to change course.

An alternative policy agenda was ready to replace New Deal and Great Society liberalism, British social democracy and Keynesian economic policy. New approaches to macroeconomic management, the deregulation of industry and financial markets, the "problem" of trade union power, urban deprivation, and the lack of affordable rents or housing appeared to Keynes's "practical men" in power as both appealing and available responses to the economic and political crises of the 1970s. Politicians on the right and, just as important, on the left turned to the proposals of figures like Friedrich Hayek, Ludwig von Mises, Milton Friedman, George Stigler, and James Buchanan (all of whom, except Mises, were Nobel Prize winners) when the chimera of stability based on the Bretton Woods Agreement was dispelled. These thinkers were representative of what has become known as neoliberalism. It is hard to gain historical perspective on neoliberalism. The term has become divorced from its complicated and varied origins. It is too often used as a catch-all shorthand for the horrors associated with globalization and recurring financial crises. But transatlantic neoliberalism, as used in this book, is the free market ideology based on individual liberty and limited government that connected human freedom to the actions of the rational, self-interested actor in the competitive marketplace.

Neoliberal ideas had been generated slowly over fifty years or so by "academic scribblers" in Europe and the United States. In the interwar years, neoliberalism emerged from debates among liberals responding to the rise of trade unions, universal suffrage, and wartime administrations that had consolidated late nineteenth-century and early twentieth-century trends toward growth in government and bureaucracy. New political movements, such as the New Liberalism of H. H. Asquith and David Lloyd George in Britain, saw the state not as an obstacle to freedom but as a way to expand it for more citi-

zens through the introduction of new forms of social insurance and pensions. In the United States, progressive reformers drew on new scientific approaches to social problems in Europe. The specter of communist revolution was ever present after the overthrow of tsarist Russia by the Bolsheviks in 1917. A worrying political phenomenon appeared in the form of Mussolini's Black-shirts. In all these trends, many liberals saw threats to existing freedoms.

The appeal of socialism and the prospect of revolution gave added urgency to the debate among economists over the viability of economic planning. In Cambridge during the 1920s, John Maynard Keynes attempted to solve the problem of economic downturns by developing proposals for countercyclical public spending. In Vienna in 1920, meanwhile, leading Austrian school economist Ludwig von Mises elaborated the socialist calculation problem: whether economic resources can be allocated efficiently in a planned economy. This question was later refined by Hayek, Mises' student and Keynes's friend and adversary, who argued that the price mechanism operated as an information processor that sent unique, comprehensible signals to producers and consumers that were impossible for planners to replicate. After the Wall Street crash of 1929, capitalism seemed in apocalyptic crisis. Hayek debated with Keynes his proposal to use fiscal policy to tackle the fluctuations of the business cycle. The argument culminated in the publication of Keynes's General Theory of Employment, Interest and Money (1936), which transformed economic policymaking by seeming to offer a solution to recessions.¹

The Great Depression made many early neoliberals of the Austrian school, the Freiburg school, and the London School of Economics (LSE) accept the need for forms of intervention and social provision to complement the state's primary role as sustainer of the market order. This was true of Hayek, his friend and later colleague at the LSE Karl Popper, and also Henry Simons, a leader of the first Chicago school of economics. In Germany the Freiburg school, who became known as the ordoliberals (after the journal *Ordo*, the movement's leading organ after 1948), sought to harness state power to maintain a market order. In this they departed from laissez-faire doctrines of the nineteenth century and the modern activist liberalism of Lloyd George and Franklin Delano Roosevelt and aimed to reconstruct a *neo*-liberalism that remained true to the classical liberal commitment to individual liberty. Neo-liberalism therefore emerged in the interwar period as a nuanced response to a very different set of conditions—the experience of war and depression,

and the onset of fascist, Nazi, and communist totalitarianism—from those obtaining in the late twentieth century, when the word became a byword for market liberalization and globalization.

After 1945, Hayek and Friedman first helped to create, and then to synthesize, a neoliberal policy program and political strategy. In 1947, Hayek brought a disparate group of intellectuals together in Switzerland to discuss how liberalism could be defended in the face of the challenge of "collectivism"—an all-encompassing term that included Nazi and Soviet totalitarianism, New Deal liberalism, and British social democracy. The group adopted the name the Mont Pelerin Society. Then, in his 1949 article, "The Intellectuals and Socialism," Hayek drew on the successes of the British Fabian Left to argue that individual liberty within the framework of free markets could only be protected by an elite-driven and elite-directed strategy of opinion formation. Like Keynes, Hayek believed that ideas seeped into policy only very slowly. Therefore, the way to ensure that free markets triumphed was to focus on changing the minds of the "second-hand dealers in ideas," the intellectuals. The strategy was clear: neoliberal thinkers needed to target the wider intelligentsia, journalists, experts, politicians, and policymakers. This was done through a transatlantic network of sympathetic business funders and ideological entrepreneurs who ran think tanks, and through the popularization of neoliberal ideas by journalists and politicians.

In the following decades, the neoliberal center of gravity shifted from Europe to the United States, especially the University of Chicago. Hayek's status as a founding thinker was unchallenged, but it was Milton Friedman, a tireless public intellectual and campaigner for free markets, who showed the most talent as a proselytizer of neoliberalism. Other Chicago economists, among them George Stigler, Aaron Director, Ronald Coase, and Gary Becker, opened up new areas to free market analysis. Hayek was also based in Chicago during the 1950s in the Committee on Social Thought (his Austrian economics not being entirely welcome in the Economics Department). He, too, was relentless in his policy activism. Allied to Chicago economics was Buchanan's and Tullock's Virginia school of public choice. Rational choice theory, inspired by Willliam Riker at the University of Rochester, like the Chicago and Virginia approaches, also used utility-maximizing and rationally based economic models to explain politics, government, and other areas of social and political life. These U.S.-based neoliberals formed the intellectual nodes at the heart of a transatlantic network of think tanks, businessmen, journalists, and politicians, who spread an increasingly honed political message of the superiority of free markets.

The sharpened neoliberal philosophy that resulted from these developments should be separated from the academic contributions made by Austrian, Chicago, and Virginia school economists. Friedman himself insisted that his technical and empirical work as an economist was distinct from his political philosophy and activism. His research was supposed to be open to rigorous empirical testing and was therefore theoretically open to change; his advocacy of the virtues of markets, by contrast, was a product of his strongly held political beliefs. But undoubtedly, Hayek's, Friedman's, Stigler's, Buchanan's, and Tullock's free market views were lent credence by their academic achievements. Their scholarly success meant that politicians, public officials, and civil servants were much more likely to take neoliberal ideas seriously when they resonated with a new set of problems, just as Keynes's ideas had during the Great Depression.

In the mid-1970s, neoliberal insights into macroeconomic management and regulation first took hold in the administrations of Democratic president Jimmy Carter and Labour prime ministers Harold Wilson and James Callaghan. Carter began to deregulate the transportation and banking sectors, and appointed Paul Volcker chairman of the Federal Reserve. After 1975, Wilson, his successor Callaghan, and Chancellor Denis Healey oversaw deep spending cuts and the abandonment of the long-cherished postwar goal of full employment in favor of targeting inflation. These neoliberal-influenced policies broke through on the left because liberalism, social democracy, and Keynesianism seemed toothless in the face of stagflation. But even in the 1960s there was evidence of a change in approach among British and American policymakers across a range of fields, especially with regard to trade unions, welfare, housing, and urban development. There was a greater willingness to look at market-based solutions in areas of perceived policy failure, such as affordable housing and urban renewal.

Despite this evidence of incremental policy change, the neoliberal legacy would not simply be the instigation of a gradual shift away from reliance on state provision to experimentation with markets. Instead, the initial appeal of neoliberal proposals led ultimately to a widespread acceptance, by the 1980s, of an overarching philosophy of free markets. This was unnecessary. That certain neoliberal proposals spoke to the problems of the 1970s—stagflation,

worsening industrial relations, the breakdown of antipoverty and welfare strategies, and the collapse of economic competitiveness—did not make the larger faith in markets an essential accompaniment. Indeed, it was the boundless belief in markets and deregulation that, a generation later, led to the collapse of the international financial system in 2007–8. Moreover, the philosophy of markets contrasted with the more compromising positions of the early neoliberals themselves. This leap was made by an energized political Right after the elections of Margaret Thatcher in 1979 and Ronald Reagan in 1980. The way in which neoliberal ideas—about individual liberty, free markets, and deregulation—translated into electorally successful programs in Britain and the United States between the 1940s and the 1980s is the story of this book.

The Three Phases of Neoliberalism

The history of neoliberalism has at least three distinct phases. The first lasted from the 1920s until about 1950. The term began to acquire meaning in interwar Europe as the Austrian school economists and the German ordoliberals sought to define the contours of a market-based society, which they believed was the best way to organize an economy and guarantee individual liberty. "Neoliberal" was embraced by participants at the famous Colloque Walter Lippmann, organized in Paris in 1938 by the French philosopher Louis Rougier to consider the implications of Walter Lippmann's book, *The Good Society* (1937). The term was chosen because it suggested more than a simple return to laissez-faire economics. Instead, neoliberalism would reformulate liberalism to address the concerns of the 1930s. Present, among others, were Hayek, Alexander Rüstow, Wilhelm Röpke, and Mises, as well as the French economist Jacques Rueff and the Hungarian British polymath Michael Polanyi. These men, along with others from Europe and America, would later form the Mont Pelerin Society with Hayek, Röpke, and Albert Hunold in 1947.

The influence of Mont Pelerin liberalism was apparent in Milton Friedman's essay, "Neo-liberalism and Its Prospects," published in 1951.² Though little noticed and in many ways oddly unrepresentative of his thought, Friedman's article can be seen in retrospect as an important bridge between the first and second phases of neoliberalism, between the concerns of the pre-