

Robust Political Economy. Classical Liberalism and the Future of Public Policy

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The classical liberalism approach in political economy has undergone detailed scrutiny in the last few decades. Even after the collapse of socialism, which reinstalled the belief in markets, the cyclical nature of the economy creates new challenges and fosters debate on the efficiency of the market system and the fairness of capitalism.

Even though classical liberalism has been deemed triumphant after the fall of socialism and has according to some regained momentum as the dominant doctrine, many areas of public policy failed to follow in these steps. In fact, one can rightfully question the dominance of the classical liberalism approach as there is hardly any country that has recently followed its trajectory.

In Europe, the social democratic approach and the rise of the welfare state became the mainstream in political economy. The US is moving in a similar direction as many of its public policy areas have been dominated by state intervention. These include health care, education, environmental protection, agricultural protectionism or even large interventions in the economy during the latest financial crisis. So one can arguably claim that the triumphant doctrine following the fall of socialism has been an attempt to organize a mixed economy where the state has an active role in ensuring the economic well-being of its inhabitants. In fact, the soundness of the classical liberal approach is being hotly debated from both an economic and an ethical perspective, with the underlying aim being to strengthen the dominant position of social democracy and the welfare state approach.

This book is an attempt to provide a theoretical framework to defend classical liberalism from political, economical and ethical challenges. The author, Mark Pennington, defines the challenges in three categories: market failure arguments, challenge of communitarianism and the challenge of egalitarianism. He aims to link economic arguments for limited government and open markets with moral and political arguments for strong institutions. This is done through the framework of robust political economy.

The term robust refers to the persistence and strength of the institutional environment surrounding human action. It should act as a guarantee to correct human imperfections which arise from limited human rationality, also referred to as the knowledge problem (human beings are not rational agents and operate within uncertainty) and self-interest or the incentive problem (when people act opportunistically, institutions should discipline and punish this behaviour). The concept of robustness aims to find which institutions yield the best possible outcomes with respect to existing human imperfections that threaten to destabilize the system and lead to unfavourable results.

Robust institutions can correct for these imperfections by allowing a competitive trial and error learning process, allowing freedom of entry and exit, and by chan-

nelling egoistic motives of individuals into what is beneficial to society. The main point is to develop democratic institutions that will guide self-interest and selfish behaviour into a profit-making motive instead of theft, without there being any form of coercion from a central authority. The requirements for classical liberalism to achieve such institutional robustness are private property ownership, a market economy and limited government constrained only to a resolution of disputes (i.e. to maintain the rule of law). The main argument of the book is that classical liberalism can withstand all the given criteria, and is thus to be considered robust.

After defining classical liberalism through the principles of freedom of association and disassociation, the triumph of dispersed private property ownership and the Hayekian concept of spontaneous order, the book is divided into two parts; the first dismantling the theoretical challenges to classical liberalism, the second applying the framework of classical liberalism robustness to real public policy issues. The author does a good job in summarizing and precisely outlining the main points of the challenges to classical liberalism, particularly the market failure argument. This makes it easier for the reader to draw his or her own conclusions and to verify whether the author has succeeded in overcoming the challenge to the robustness of liberalism. By acknowledging the robustness criterion, the reader can also use it as a comparative benchmark to evaluate the performance of real world institutions.

In the first part, the theoretical challenges to classical liberalism are depicted through an economic, collectivistic and egalitarian perspective. The economic, market failure, challenge presented in chapter 2 comes on one hand from neoclassical economic theory in its underpinnings of perfect information and perfect competition, and on the other hand from the old and new market failure theories (the socialist calculation debate and the information asymmetry argument). In a world with imperfect knowledge and imperfect rationality, the production process is not evenly distributed – this is why markets act as an evolutionary discovery mechanism that is best suited to overcome the knowledge problem. The neoclassical approach fails to realize this simple principle. On the other hand, the new market failure argument that stresses the Stiglitzian importance of imperfect information and advocates a regulatory state, fails to apply the same framework of analysis to the failure of government regulators as it does to the failure of markets. The author points out how it is unclear from this argument why government regulators would have better foresight than market actors.

The communitarian challenge to selfish behaviour is addressed by applying the rational principle of exit as opposed to democratic voice, and the decentralised evolution argument. It fails on the principle of providing incentives to people to adopt different norms of cooperation. After outlining the communitarian theory, chapters 3 and 4 get down to explaining how the concept of exit does not refer to

self-interest, but to a knowledge enhancing property of the spontaneous order. The democratic process itself is questioned in its desire to overcome the problem of aggregating preferences. It can only offer the opportunity for “voice” (change an institution from within) instead of “exit” (leave the institution). An exit mechanism is an expression of the process of learning based on experimentation and gradual, evolutionary change. Furthermore, decision-making based on majority rule should imply that bad preferences are eliminated. Historical experience tells us that this does not always hold. In a majoritarian system, a minority well organized within a special interest group can often prevail over the policy outcomes preferred by the majority (as found by Olson, 1965).

The egalitarian challenge in chapter 5 is also examined from the knowledge and incentive problem. Since agents operate in a world of uncertainty where knowledge tends to be limited, there should be no attempt to design and implement centralized policies that assume an equal society. Rather, this must be achieved by voluntary action and association, which would discover the optimal amount of social justice. The role of institutions is to facilitate this discovery, not enforce it. The process of ethical learning with competing norms and a clearly defined link between ownership (of both talent and assets) and incentives are the fundamentals of a liberal environment which, opposed to egalitarian political theory, does achieve institutional robustness in this case.

The second part of the book looks at real policy issues (the welfare state, international development and environmental policy) in which the author successfully adapts his worked-out arguments to verify whether the challenges to classical liberalism on each of the issues satisfy the robustness criterion. Each issue is presented firstly through the lens of classical liberalism and then analyzed through three dominant challenges in their assumptions and conclusions. They all seem to fail with respect to the knowledge and the incentive problem, which is the dominant position developed in the book. They assume a given set of knowledge within a society, while the classical liberalism approach argues that “knowledge needs to be achieved and created via the process of evolutionary growth” (pp. 193).

The crucial insight from chapter 6 on poverty relief and public services (health and education) is that these services tend to be more inefficient when provided by governments. The argument is based on historical examples and empirical evidence of mutual aid and provision of poverty relief by voluntary actions (and private education or private health care) and stresses the importance of combining private solutions with a rise in prosperity for the society that will enable a bigger creation of wealth. The focus is on the process of cognitive learning and discovery of different principles and norms that may provide much more efficient answers than a state-led redistribution and allocation. It is based on offering a signalling mechanism to people on the amount of education or health care desired, just like the price signal in the market. The egalitarian and the communitarian approach on

the other hand fail to explain on what ground a welfare state institution would be superior to an institution founded on the concept of competition. They both assume that social justice is achievable within the remit of a central authority, while failing to explain the knowledge needed for its functioning.

The following chapter 7 addresses the development issue and the problem of inter-country inequality explained by dependency theories. The chapter begins by defining the classical liberalism approach based on the principle of institutional robustness. It argues that the best way for a country to exit its poverty trap and achieve prosperity is by developing a set of robust formal institutions followed simultaneously by a gradual process of evolution of social norms and conventions (the so-called informal institutions). It is the consolidation of institutions of classical liberalism (private property, open markets, rule of law) that will determine whether a developing society may overcome its knowledge problem and its incentive problem. An excellent insight in the role of institutions in the development and consolidation of nations is offered by Acemoglu, Johnson and Robinson (2001) where they devise a detailed, clear-cut (one can arguably say robust) case for the positive relationship between institutional robustness and economic growth and development. The chapter furthermore questions the rationality of the foreign aid approach combined with domestic protectionism of certain industries that undermine the competitiveness of developing nations. Centralized aid agencies fail to acquire the knowledge or the incentives to select an appropriate development path for low-income countries.

In the final chapter 8 on environmental policy, centrally directed regulation of environmental issues is challenged by an argument on property rights and social capital in solving the collective action problem with respect to the common good. The knowledge problem and the process of cognitive learning are evident once more when private actors are able to solve their second-order dilemmas without the need of external enforcement, as is shown by the classical work of Elinor Ostrom (1990). The Coase (1960) argument of property rights and institutional entrepreneurship is used to dismiss problems of externalities in environmental issues. The process of competitive experimentation between the owners of the resources and institutional design can be used to solve the failure of externalities. He does accept that classical liberalism cannot answer all the environmental problems but it can provide a crucial insight into the practice of decentralized decision-making and the enforcement of property rights, instead of a top-down regulation approach which is again dismissed on the principles of the knowledge and incentive problem.

In the lasting battle of ideas between collectivist intervention and individual liberty, the book serves its purpose as a defence of classical liberalism. It provides a framework to challenge the currently dominant intellectual climate focused on the failure of markets in the domains of inequality, injustice and economic reasoning.

The attacks against classical liberalism are often wrongly centred on the efficient market hypothesis of neo-classical economics, the informational market failure argument, the asocial conception of individualism and the problems of social injustice and an unequal distribution of income. The book shows how all these arguments fail, in principle, to explain how a coercive alternative can provide a better policy outcome. The author rightly recognizes that in an uncertain environment with limited and imperfect knowledge a centralised authority may only increase the systemic risk in a society. On the other hand individual interactions are more likely to be able to respond to organizational and collectivistic problems of coordination.

The book is a combination of economic, political and philosophical arguments in favour of classical liberalism. It tries to look at these arguments from a contemporary point of view and as applied to the most challenging public policy issues facing classical liberalism. The author is realistic in stating that liberal institutions do not always or completely solve the knowledge problem, but compared to the alternatives in a system of realistic imperfections it is the only approach robust enough to offer an efficient outcome. The book is a good read for anyone interested in the classical liberal arguments in public policy and for any critic of classical liberalism as well, for he or she may engage in a challenging debate on the insights of the free market approach. It is also a recommended read to any reformist policymaker aiming at reforming the welfare state not by setting any particular policy guidance, but rather by establishing a favourable institutional environment capable of satisfying the elementary robustness criterion.

The applicability of the findings in the book could be extended to Croatia as well. In Croatia and the whole of the Balkans, the fall of socialism was followed by the rise of state “crony” capitalism, while simultaneously the doctrine of neo-liberalism, or in this sense classical liberalism, took the blame for poorly managed privatisation, rising inequality and a declining living standard. However, as this book shows, classical liberalism in public policy did not exist in the Western world, nor did it arise as a response to socialism in Eastern Europe. The dominant approach was that of the welfare state which was fully embraced in Croatia and the Balkans, but unlike the West, the area operated under a set of weak, corrupt and newly founded democratic institutions that could not satisfy the consolidation criteria. Therefore, the consequences of this approach were worse for the Balkan countries, where political populism and state redistribution were used to acquire votes and thus led to a misallocation of resources. In this case, the book can be used to introduce the classical liberal argument into the Balkans and shed some light on the current debates over the dominant doctrines of statism vs. Keynesianism, from an economic as well as from a social, political and ethical perspective. This is, after all, the aim of the book.

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