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Micro-Economics and Rational Choice

The axiomatic economics that emerged in the late 19th century has gradually broadened its sweep across the social sciences as Rational Choice theory. Its principles were well spelt out when Finn Kydland and Edward Prescott were awarded the 2004 the Swedish Central Bank's 'Nobel Prize' for economics for their work on business cycles. The *Financial Times* (12 October, 2004, emphasis added) summed up their contribution as follows:

> The two professors were the first to ground the theories of business cycles in *rigorous microeconomic theory*. This led to a body of work called "*real* business cycle" theory. They explained a business cycle as the equilibrium outcome of *rational decisions made by millions of perfectly informed individuals*. Though the *predictive power of the model was weak*, it encouraged the economics profession to ensure that subsequent theories of business cycles also had strong theoretical foundations.

The terms emphasised here—'rigorous'; 'real'; 'equilibrium outcome'; 'rational decisions'; and 'perfectly informed individuals' all point to the strand of thought we are looking at in this chapter, *micro-economics*, the economics of subjects (individuals, households, corporations, states) choosing to consume, save, or invest. True, 'the *predictive power* of the model was weak' (that is, things usually don't happen this way). But since the *prescriptive power* of neoclassical economics is momentous—market freedom must not be interfered with and its scope must be widened wherever possible—no one can afford to ignore it. Of course, some of the shine of this tradition has evaporated in the financial crisis that exploded in 2008, but its hold on economic common sense endures.

We first look at the marginal revolution in economics. In section 2, we turn to Keynes, who in the 1930s argued that the subjective turn had in fact been incomplete because it left in place the classical suggestion that a market economy is self-equilibrating (by the 'invisible hand', the law of value, supply and demand)—which it isn't. Therefore the state must step in, on the one hand to ensure full employment; and on the other, to suppress the role of the private investor, whose 'prudence' had led the economy into the Great Depression. This provoked a virulent response from a neoliberal strand of thought resisting the idea of a protective state role in the economy on the grounds that this would bury 'freedom'. The axiom of the freedom to choose then generated the broader notion of Rational Choice. In section 3 we look at how Rational Choice accounts for social interaction by its mathematical representation as *games* between utility-maximising subjects.

1. THE MARGINAL REVOLUTION IN ECONOMICS

The 'marginal revolution' occurred in the 1870s. It is associated with the names of Stanley JEVONS (mentioned already), Carl Menger (1840-1921) and Léon Walras (1834-1910). True, as Meek reminds us (1972: 83-4), it was not as revolutionary as its authors and many after them assumed. Mill's prior reformulation of value predated it by several decades. But there is no doubt that the marginalists sealed, and lent academic respectability to, the subjective turn in economics and beyond.

From comprehensive political economy, economics thus became *micro-economics*, the action of individual, self-interested subjects in various markets. Value is no longer understood in terms of labour time, but as *utility*, a subjective, psychological category (cf. Jevons on 'pleasure and pain' as the drivers of economic processes). Thus the focus moved from the sphere of production to the sphere of exchange; it envisioned a theory of distribution (of income) 'entirely within the circle of market relations', by seeing income as remuneration of what Walras called the productive services or *factors of production*, without relying on any sociological datum (Dobb, 1972a: 205-6).

The marginalists as we saw were concerned with the advancing labour movement and Marxism, the critique and culminating result of classical political economy. But it will be remembered that they also specifically adopted the perspective of the stock-owning financier, whose vantage point they generalised as theory. As absentee owners and title holders not directly involved in production, the rentiers welcomed a vision of economics which concentrates on maximising returns, without any concern about how these are generated. There were other forces at work when marginalism emerged, such as a slowdown in the 1870s which placed *scarcity* at the centre of attention. Meek (1972: 89) therefore rejects Bukharin's (1972) association of marginalism with the rentier perspective. But the slowdown was overcome in the 20th century, whilst the perspective of the inactive owner has proved an enduring characteristic of capitalism. Specifically, the rentiers welcomed the idea that their incomes should be considered as an equally honourable source of revenue as that gained by work. 'The essence of interest is not exploitation', Böhm-Bawerk wrote; it is 'an entirely normal phenomenon', an 'economic necessity' that even a socialist society would have to respect (quoted in Dobb, 1972b: 60).

Marginal Utility Theory

The notion of 'utility' predates marginalism but it was also a product of the disenchantment that followed the Enlightenment optimism of the earlier liberals. The 'Utilitarians' led by Jeremy Bentham (1748-1832) made their name by arguing that if one starts from the quest for utility, the harmony of interests postulated by the liberals could not be expected to apply to everybody in the end. It is enough that society ensures 'the greatest happiness for the greatest number'. The state must assume an active role in achieving that outcome, whilst ensuring, for instance by building prisons, that those outside the circle of prosperity and happiness will not interfere with the lives of those within it. *Discipline*, socially and on the factory floor, was a key concern of the Utilitarians.

Marginal utility was already coined by Hermann Gossen (1810-1858—Dobb claims the concept is borrowed from differential calculus, 1972b: 50). Gossen's original argument was that in working the land, each added labourer adds to overall productivity but after a certain point, they begin to walk into each other's way and the added value becomes less. Lipsey in his textbook (1982: 213) calls this a 'hypothesis' although it is meant as an axiom; he claims that 'empirical evidence in favour of the hypothesis of diminishing returns is strong in many fields', pointing at working the land as an example (never mind that this is a marginal form of labour today and that by the criterion of positivism, a hypothesis only holds if it is *always* true).

From the angle of consumption, Gossen's *law of saturation* captures the same idea. It claims that the enjoyment of something, say, plates of brown beans, increases with each added quantity but at some point begins to decrease to the point of saturation. It is the last added increment which still provides enhanced enjoyment, which determines the *subjectively experienced value* of a good or service. At some point, the marginal substitution rates of two different goods or services intersect, and for his last penny, the subject prefers an apple instead of more beans. Jevons' 'indifference principle' is based on intersecting utility curves of rival goods, where marginal preferences, choices 'concerning a little more or a little less', decide (Lipsey, 1982: 159; on the indifference principle or 'diminishing marginal rate of substitution', Ibid.: 170).

Marginal utility curves are also used to determine the price of a good or service. It is established at the point where marginal utility curves of buyer and seller, that is, their subjective valuation of what the item is worth, intersect. The marginal utility ('efficiency') of capital is the last piece of equipment that still adds to profitability, given the prices of all factors of production (Fabiunke, 1975: 263, 268). *Thus the original notion of added labourers on the land and the law of saturation, generalised as marginal utility, becomes the cornerstone of axiomatic micro-economics.*

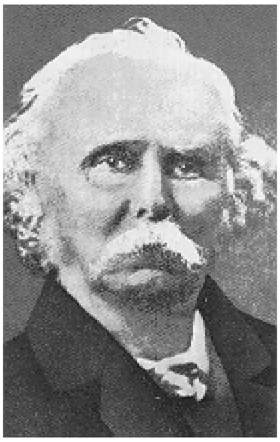
The core axiom is that there exists an individual (unit) who/which is free to choose, unencumbered by any market constraints or social circumstances (Dobb, 1972b: 63-4). Liberalism is therefore the essential condition; only then subjective choices can be made freely by all parties. Any impediments to the free exchange of commodities must be guarded against—trade unions in this respect are a market distortion as much as are business cartels and monopolies.

Free trade (internationally as well as internally), dear to British factory owners and those who thought and spoke for them, was considerably less popular in countries seeking to industrialise in the face of UK competition, and landowners everywhere rejected it outright. Both in the US and Germany, conceptions articulating the perspective of late industrialisation circulated throughout the 19th century. Friedrich List (1789-1846), the intellectual founding father of German protectionism and author of *The National System of Political Economy* in 1841, actually developed his ideas as a political refugee in the US in the 1820s as the guest of Matthew Carey, an Irish immigrant, who argued for a protective tariff. Advocates of national economic development (including Matthew's son, Henry Carey) typically claimed that the British policy of free trade forced countries to over-specialise, producing colonial poverty and a lack of capital formation outside Britain.

Once Marxism took hold, however, the alternatives to liberalism became more muted. In Germany, a *Historical School* (Wilhelm Roscher, 1817-1894, Gustav Schmoller, 1838-1917, and others) rejected theory altogether. The historical economists were conservatives who shared the outlook of the agrarian land-owning classes with whom they agreed on the need for a protective tariff. The US after the Civil War adopted protective tariffs to allow its manufacturing sector to develop (the 'infant industry argument'), but American economists early on claimed that mechanised production in due course required large markets again and hence, the elimination of trade barriers. 'They argued for long-term benefit against manufacturing interests who had succeeded during the Civil War in erecting a protective tariff' (Ross, 1991: 77). In addition, 'Free laws of the market stood sentinel … against greenbackers, labour reformers, and after 1879 … proponents of a single tax to expropriate the unearned increment on land'. (Greenbackers were the advocates of easy money growth).

There were initially many radicals among US economists (e.g., the institutionalists discussed in Chapter 5), but growing labour unrest in the 1880s led to a mass conversion to marginalism. John Bates Clark (1847-1937), who had earlier signalled an interest in socialism, was prominent in the shift. 'The desire to legitimate the capitalist market in the face of radical challenge was the major element in Clark's thinking' (Ross, 1991: 118). This was evident in his marginal productivity theory of income distribution, which given that everybody is rewarded in direct proportion to what they contribute, 'there was no possibility of exploitation and no economic grounds for conflict' (Perry, 2009: 95). 'What a social class gets is, *under natural law*, what it contributes to the general output of industry', Clark wrote in 1891 (quoted in Hunt and Schwartz, 1972: 16, emphasis added).

The establishment of the American Economic Association in 1885 only consolidated marginalist hegemony. Once a discipline establishes itself in this way, it must gain the respect of the outside world by 'moderation' and a visible concern for 'objectivity'. The high level of abstraction and the promise of mathematical deduction exerted its own attraction on academics, but 'marginalism had its origins and gained its force not simply as an analytical tool, but as a liberal world view' (Ross, 1991: 173; cf. 179).



The doyen of US and subsequently, all mainstream economics, was Alfred MARSHALL (1842-1924). Marshall in the 1890s sealed the continuity with the classical tradition by claiming that Ricardo's theory already prefigured the marginal revolution. Thus the labour theory of value that had served as the basis for Marx's theory of surplus value, was written out of the script. Keynes in this respect duly follows the mainstream; he qualifies as 'classical' economists not just Ricardo and his predecessors, but also 'J.S. Mill, Marshall, Edgeworth and Prof. Pigou' (Keynes, 1970:

3n).

Marshall was cast as the founding father of the economics discipline because he softened the extremes and packaged the history of economic thought into a comprehensive, supposedly continuous line of development ('It's all in Marshall'), that would make economics respectable. In his *Principles of Economics* of 1890, Marshall combines marginalism with the claim that the price mechanism ensures long-term *equilibrium of supply and demand*, which harked back to the law of value of classical political economy (Ross, 1991: 174). But as Meek points out (1972: 93), the terms of Marshall's analysis 'were essentially subjective and therefore very different from Ricardo's.' Nevertheless economics owes its prestige at least partly by claiming it is the product of all thinking on the subject, from Smith to Hayek—the *neoclassical synthesis*. Never mind that its 'predictive power is weak'—it is an axiomatic, deductive system rich in mathematical applications.

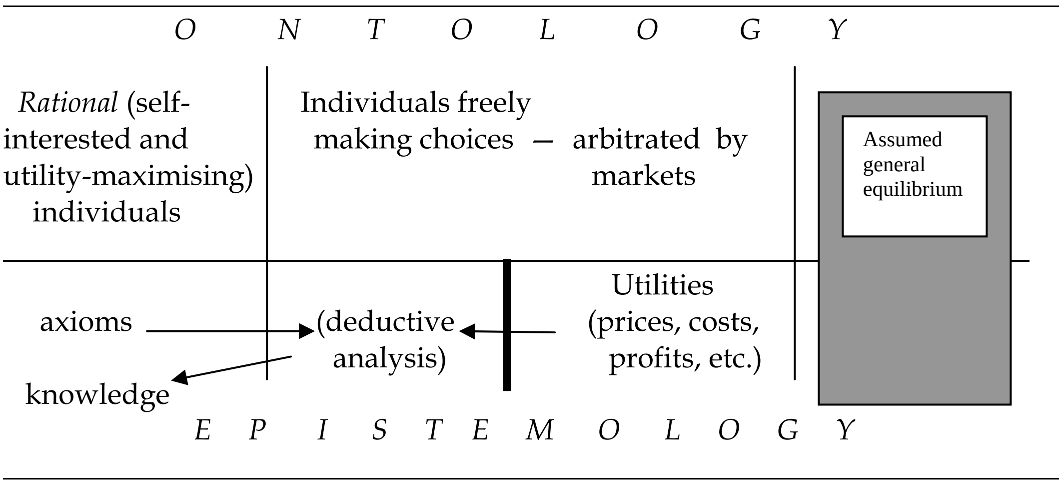
Anchoring Subjective Rationality

The significance of the *subjective* theory of value is that the aspect of production, and hence, labour (time), is eclipsed for reasons indicated above—to articulate the perspective of the property owner, and to sideline the Marxist critique of economics by derailing the entire tradition based on the labour theory of value. 'Utility' or use value was always an aspect of value (what is the point of spending labour time on something nobody wants). But in the concept of utility as used by the utilitarians, Mill, and the marginalists, it becomes the angle point of the analysis. There was never any doubt that this was explicitly aimed at Marxism. Eugen BÖHM-BAWERK's (1851-1914) chief work was entitled *Marx and the Close of His System* (originally of 1896).

The change from the (overt or implicit) materialist perspective of classical political economy to a subjective idealism (rationalism), affects both ontology and its epistemology. It suggests that the only thing an economic subject (a worker, capitalist, a land owner) can rationally do, is to try and get the highest price of his/her economic asset (capital, land, labour). This price is set by the last increment added by the 'marginal' unit before its return decreases—before utility turns into disutility.

Importantly, *the economy (the market) is an anonymous arbitrator of individual decisions; it is an impenetrable world into which one inserts one's assets as long as the last item thrown in, still brings a return.* Hence, epistemologically speaking we do not really know what happens there (nor do we care to know). This is depicted in Figure 2.1., following Figure 1.2 in Chapter 1.

Figure 2.1. Neoclassical Micro-Economics as a Subjectivist Approach



The market economy, then, is 'not an order of collective action, for the market is the negation of collective action… it is a spontaneous order arising among… purely self-regarding actors' (Taylor, 2004: 79). Hence there is no rationality to the market except this lingering idea of a naturalised, self-equilibrating function (eventually thrown out by Keynes); the rationality at work is entirely subjective. Epistemologically, the inner nature of the objective economy is a black box; since subjective behaviour is given, knowledge results from deduction. Marginalism does not reject empirical analysis, but it does '[emphasise] the *higher importance of scientific law* in understanding change' (Ross, 1991: 175, emphasis added; cf. 'Notes on the Fifth Edition', Lipsey, 1982: xix-xxii). As we will see, Rational Choice takes this schema as the general model for all human behaviour.

The German and Austrian marginalists were more literate about the philosophical and methodological implications than their English-speaking colleagues (who more readily referred to 'nature' to legitimate their views). Menger claimed that he 'endeavoured to reduce the complex phenomena of human economic activity to the simplest elements that *can still be subjected to accurate observation*' (quoted in Ross, 1991: 332, emphasis added). But this 'observation' is not meant to yield unexpected insights; it is merely the level at which the rational subject is claimed to operate. Böhm-Bawerk (in a review of Menger) highlights that their aspiration is nothing less than 'the elimination of the historical and organic methods as the dominant methods of theoretical investigation in the social sciences … and the restoration of … *the precise atomistic tendency*' (quoted in Bukharin, 1972: 40, emphasis added).

However, as Maurice Dobb argues (1972a: 206), 'the linchpin of this whole conception is of course the notion of the marginal productivity of a factor (as governing the pricing of the latter)'. In the 1960s, this gave rise to the *capital controversy*.

'Capital' in neoclassical theory consists of 'existing machines, plant, equipment, etc.' (Lipsey, 1982: 356; *money* is merely a claim on resources —ibid.: 359). Now people will invest in machines etc. only if the *marginal efficiency*, the return on the last unit of capital added, is higher than the rate of interest. If not, they will put their money in the bank (Lipsey, 1982: 398). But to establish this marginal efficiency, one must know the price of capital, which depends on the contribution to future profits it will make. This in turn is dependent also on future wages and other costs, all of which also depend on the overall price level. In other words, a whole range of prices must be known if the crucial decision to invest or not, can be made. The decision(s) that will determine the future price level, is /are determined by … the future price level. 'The one way out of this tautology,' writes James Perry, 'would be if neoclassical economists had found a way of quantifying capital inputs independently of price, and hence *prior* to the calculation of profit. They have not' (Perry, 2009: 97-8).

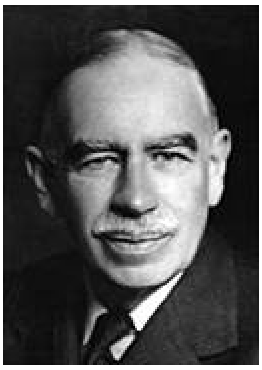
The impossibility to quantify capital goes to the heart of the original reformulation of a separate, subjective economics—it invalidates the notion that the moral title to income of a capitalist (in particular, an inactive *rentier*) is the same as that of somebody who works. But if the 'dogma that the rate of profit that the owners of capital enjoy is equal to the productivity of capital equipment' (Robinson, 1972a: 239), turns out to be fiction, this identity too evaporates. Clark's 'natural law' of income distribution based on marginal productivities, goes down along with the entire edifice of neoclassical economics and its claims of 'accurate observation', 'the precise atomistic tendency', etc.

The advocates of neoclassical economics in the end could not but concede. Paul Samuelson in 1966 wrote that the efficiency of capital can only be measured in an 'ex post tautological sense' (quoted in Perry, 2009: 98). Lipsey also concedes the circular argument invalidating any real claim about the marginal productivity of capital; however, he claims that this is not a problem *if one sticks to a micro-economic perspective, i.e., the level of the single economic agent*, who is not concerned with aggregate price levels but only with those he has to deal with himself (as costs, income, profit) (Lipsey, 1982: 412-3). This takes us back to Figure 2.1: for an economic subject, the *market* is a dark enigma, except for the lingering equilibrium assumption that Keynes would demolish—but which is usually resurrected after a crisis. The market is what lies beyond the point where 'factor' inputs are thrown in, and from which the income they generate, is returned (or not). The *macro*-economy (the economy as a totality, a system of inputs and outputs with its own inherent logic) cannot be understood in terms of marginalist theory; *only the (micro-economic) actions and motivations of the agents can*, but only in hindsight.

The subjectivist interpretation of economics thus coincides with the naturalisation of income differentials. We no longer know *why* things happen in the objective world (in the sense of an integral rationality independent of our will), but we trust that subjective rationality is 'natural', autonomous, and not determined by structured, knowable processes of historical change. 'The social laws,' writes Böhm-Bawerk, 'whose investigation is the task of political economy, depend on coinciding transactions of individuals. Such uniformity of action is in turn a consequence of the operation of like motives determining action' (quoted in Bukharin, 1972: 38). Note 'the operation of like motives determining action', which highlights the subjective valuation which comes in the place of an objective value standard whilst shifting the commonality ('like motives') to the quest for remuneration independent of the issue *for what* this remuneration is obtained.

Thus academic economics at the end of the 19th century completed the subjectivist turn begun by Mill. The aim of discovering the inner workings of the economy which Adam Smith still had done on the assumption that the subjective self-interest was fully compatible with the common good; and which Marx and the utilitarians had claimed was unattainable, was abandoned. Marshallian neoclassical economics instead revolves around a series of assumptions beginning with (a) choices by consumers, (b) production decisions based on these choices, by producers concerned about profit; and (c) the market as the sphere in which these choices and preoccupations are totalised into optimum outcomes (Hunt, 1972: 188). However, as with all theory, at some point real developments makes it obsolete. In the 1930s, a massive economic Depression hit the West to which this type of economics had no answer.

2. THE KEYNESIAN CHALLENGE AND THE NEOLIBERAL RESPONSE



John Maynard KEYNES (1883-1946) was a dissenter within the community of mainstream economists. As a youthful assistant to the British delegation at the Versailles peace talks in 1918, Keynes made his name by walking out in protest over the war indemnities imposed on Germany. In *The Economic Consequences of the Peace* of 1922 he predicted that by creating huge financial imbalances in the post-war economy and by preventing Germany to produce, the peace would merely be a prelude to the next round of fighting. All through his career, he would challenge orthodox liberalism, the rentier mentality of short-term gain and failure to see longer-term consequences.

The Great Depression broke out in the aftermath of the stock market crisis of 1929 and the 1931 bank crisis (triggered by Franco-German rivalries). Keynes attempted a systematic exposition of how full employment could be restored, an exposé which recommended *eliminating the rentier from the operation of the economy*. The individual rational subject of micro-economics in the process was transformed into the collective rational subject that is *the state*. The other subjects are seen as aggregate entities, which display what Keynes terms 'propensities' (the propensity to consume, save, invest). *The General Theory of Employment, Interest and Money* of 1936 was not therefore a radical alternative to mainstream economics. It was a modification that recognised market failure and the need for state intervention, with an eye to avoiding a radicalisation of the working class in the Depression.

Keynes never abandons the marginalist perspective; and occasional remarks on labour apart (cf. Chapter 1), he certainly does not return to the labour theory of value. He rather *seeks to remove the last vestige of classical political economy from the neoclassical synthesis, the notion of a self-regulating market equilibrium.* 'When my new theory has been duly assimilated and mixed with politics and feelings and passions,' he ventured in a 1935 letter to the playwright, Bernard Shaw, 'There will be a great change, and, in particular, the Ricardian foundations of Marxism will be knocked away' (reprinted on the cover of the 1970 edition). Shaw was a prominent figure in the Fabian Society, the most timid reformists in the Labour Party. The Fabians rejected not so much capitalism per se, as the individualist and rentier aspects of it; Shaw thought this could be based on …Jevons (Brick, 2006: 26-7). Keynes took the argument further by applying marginalism to the macro-level.

What Keynes rejects in Ricardo is the focus on income distribution (1970: 4n). He wants to return to the idea of how *total wealth* can be maximised, which Thomas Malthus (the vicar concerned with population growth, 1766-1834) still thought was the purpose of political economy. Obviously in the Depression of the 1930s, with millions out of work and capital lying idle, this was a highly topical issue. Keynes diagnosed the shortfall in the overall level of output as the intersection of three key variables (all formulated as *aggregate* subjective choices, propensities).

1) The propensity to consume (based on real wages, and part of effective demand);
2) the propensity to save (based on the rate of interest), and
3) to propensity to invest (based on profit expectation, 'the marginal efficiency of capital').

The central claim made by Keynes was that 2) and 3), *if left in the hands of the rentiers*, undermine 1), thus crippling total production. Therefore government money must be injected into the economy to cover the investment shortfall. Output can then be raised, and with it, employment; all incomes will increase by what he calls the *multiplier*. The multiplier effect can be calculated, if not empirically (that would require we open up the black box that is the actual economy), at least as a numerical example on the assumption of a closed economy (cf. Lipsey, 1982: 505).

The State Versus the Rentier

Keynes squarely adopts the perspective of the real economy as against the interests of the rentiers, who had been so well served by the arguments of the original marginalists. The economy, he claims, is about satisfying the needs of society. 'Capital is not a self-subsistent entity existing apart from consumption. On the contrary, every weakening in the propensity to consume regarded as a permanent habit must weaken the demand for capital as well as the demand for consumption' (Keynes, 1970: 106). The real driver of the level of economic activity is effective demand, which 'is simply the aggregate income (or proceeds) which the entrepreneurs expect to receive… from the amount of current employment which they decide to give' (Ibid.: 55).

Keynesian economics, then, is about 1) consumption, which highlights the crucial role of mass demand and by implication, the wage level; and 2) the monitoring role of the state in the economy (which also brings in, via parliament, the mass of the population). These two aspects bring Keynes close to the managerial perspective of the large corporation, the administrative cadre in the state, and the trade unions. But what really caused fury among the propertied classes and their spokesmen was the third aspect, his attack on the rentier.

In early capitalism, investment is a decision of which the social aspect is not different from the individual. But 'with the separation between ownership and management which prevails to-day and with the development of organised investment markets, a new factor of great importance has entered in' (Keynes, 1970: 150). That factor is the rentier, what he calls the *functionless investor*, who draws an income from stock market assets and savings.

Investment through the stock exchange induces short term behaviour, speculation, which separates the social aspect of investment (factories, mines, infrastructure—all long-term ventures) from the liquid holdings of investors. These investors may shift their assets from one sector to another on a daily basis. It is as if a farmer who wakes up to find the weather bad, can decide to leave farming on the spot. This however has a disruptive effect on the system as a whole to the degree the rentier aspect grows out of proportion.

> Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done (Keynes, 1970: 159).

The problem is that the rate of interest sets the standard which the return on investment must meet if there is to be investment at all (otherwise owners can put their money in the bank at little risk). In the classical equation, the volume of saving is always equal to the volume of investment, because rates self-adjust to equilibrium (Lipsey, 1982: 532-3). But as Keynes argues, the rate of interest is a psychological, conventional phenomenon, and when people also think that the rate of interest is self-adjusting (as part of the lingering classical notion of a general market equilibrium), they accept a given interest rate level even if it generates mass unemployment (Keynes, 1970: 204).

As long, then, as the decision whether to invest or not is left in the hands of the rentier, the economy will be hostage to fortune. *It must therefore be made impossible to make money on inactive holdings*. Interest in Keynes' view is no longer a reward for a genuine sacrifice, and it is therefore better to organise communal saving via the state. Lipsey calls this the 'extreme version of the Keynesian theory' (1982: 533), but it was *the core* of Keynes' programme to eliminate the rentier and pass the savings and investment roles to the state. 'I expect to see the State, which is in a position *to calculate the marginal efficiency of capital-goods on long views and on the basis of the general social advantage,* taking an ever greater responsibility for directly organising investment' (Keynes, 1970: 164, emphasis added).

The state role in sustaining effective demand may include loan expenditure (public expenditure based on borrowing) that is 'wasteful', i.e., for apparently useless purposes (pyramid building etc.). Even that would benefit the community on balance. It would generate economic activity and employment by keeping up effective demand. Such activity by itself would already reduce the role of the rentiers. Since their income is fixed in money terms, inflation accompanying the booming economy will 're-distribute incomes to the advantage of the entrepreneur and to the disadvantage of the rentier' (Keynes, 1970: 290. cf. 128-9).

Shifting the savings function to the state will not eliminate entrepreneurship—only *'the rentier would disappear'* (Ibid.: 221, emphasis added). 'I see, therefore, the rentier aspect of capitalism as a transitional phase which will disappear when it has done its work… the euthanasia of the rentier, of the functionless investor, will be nothing sudden… and will need no revolution.' Instead of the private investor, 'a scheme of direct taxation' would allow the skills of the financier 'to be harnessed to the service of the community on reasonable terms of reward' (1970: 376). For an assessment of Keynes in context, cf. Robinson, 1972b.

The Revenge of the Rentier: Hayek's Neoliberalism

In his *General Theory*, Keynes provides the classic statement of a countercyclical state intervention policy intended to steer clear of the extremes of business fluctuations that result from the herd instinct of private investors. His recommendation that the rentier class should be subjected to a 'euthanasia', however, did not fail to raise profound concern on the part of the propertied classes. The spectre of a democratic state taking an active role in managing the economy was never accepted, even though the voices of dissent were briefly muted when it seemed social revolution was around the corner.

Once the Second World War and a series of adjustments to the original New Deal in the United States (which business had responded to by an investment strike) had removed the immediate danger of socialism, the long rollback began. Theoretically, the revolt against Keynesianism was not just a repeat of the marginalist attack on Marxism though. This time the issue for the rentier class was one, literally, of life and death. *The position of the private property owner was now articulated as a struggle for freedom and against dictatorship*—indeed for the private investor, there was little difference in principle between Keynes' 'euthanasia' and outright socialism.

Marginalism already is premised on liberalism, rejecting state intervention. As J.B. Clark put it, neoclassical theory serves to reveal when government is 'violating economic law' (quoted in Ross, 1991: 415). But in the perspective of the anti-Keynesians and opponents of the New Deal and the class compromise with organised labour, *it is not enough to return to the old liberalism*.

Walter Lippmann (1889-1974), the journalist and trustee of the Atlantic ruling class, in *The Method of Freedom* of 1934 claimed that it would be impossible 'to go back to laissez-faire and the neutral state'. Lippmann was an early radical who had studied with the Fabian, Graham Wallas, as well as with the pragmatists, James and Dewey (cf. Brick, 2006: 50-1). In *The Good Society* of 1937 he argued that 19th-century laissez-faire individualism should be rejected along with fascism, communism, and state socialism (including the New Deal). *Neoliberalism* emerged from meetings in the late 1930s among the adherents of the idea that a new social philosophy based on generalised self-interest had to be developed, although it would take until the crisis of Keynesianism in the 1970s before it became hegemonic.

Importantly, the neoliberals no longer confine their prescriptions to the economy. They want economic rationality to be applied to all aspects of society; *no organ of the social body may be allowed to function according to other principles than that of free choice by rational, self-interested individuals.* Wilhelm Röpke (1899-1966), one of the early neoliberal philosophers, in fact saw the advance of 'totalitarianism' (their term for the increased role of the state) as a feature of the loss of discipline in society, to which narrowly conceived social science disciplines paradoxically had no answer. As he put it in a paper with his co-author, A. Rüstow (quoted in Walpen, 2004: 58, emphasis added),

> The real cause of this deficiency of [the] social sciences seems to be found exactly in the narrow economic conception and the lack of courage and ability to develop a *really synthetic interpretation which is connecting up the economic phenomena with the wider aspect of society.*

The problem, Röpke and Rüstow claim, is in fact not economic. There is 'a deeper organic disease' at work. This is the loss of purpose felt by the working classes, which in their view cannot be met by 'bigger wages and better cinemas' (the Fordist recipe of the mass consumption society, in a word). What is necessary is a re-vitalisation of society. 'A re-integrated society of freely cooperating and vitally satisfied men is the only alternative to laissez-faire and to totalitarianism'.

The key figure in the neoliberal movement was Friedrich von HAYEK (1899-1992). Hayek in the 1930s left his native Austria to begin teaching at LSE. Keynes at the time noted Hayek's concern for the private investor and made some mildly disparaging remarks about its author in the *General Theory* (1970: 60, 79-80). Hayek shared Röpke's ideas about the need to fundamentally rethink the social sciences. At LSE, he studied the positivism of Comte and Saint-Simon, in which he detected the beginning of the decline of freedom (cf. Hayek, 1958). As noted in Chapter 1, positivist sociology indeed emerged as an empirical alternative to axiomatic economics, an approach closer to the managerial perspective on the economy and society.

In the 1940s, Hayek's overriding concern was to seek to undermine the notion that a managerial approach to the economy as Keynes and others had recommended, with the state replacing the rentier, ran upon insurmountable obstacles. Key among these was the inability to centralise the information necessary to plan an economy; to entrust a managerial cadre with such a task would lead to slavery under a totalitarian state. The need to uphold free choice at all costs is paramount in Hayek's thinking. In *The Road to Serfdom* of 1944 he denounces the planning trend of the period, the myopic arrogance of the cadre, and the welfare state with its promise of redistribution and comprehensive public services. From the 'Points from the Book' which he sent to his publisher in 1943, note the following ((both quoted from Cockett, 1994: 81, emphasis added)

- *Economic freedom which is the prerequisite of any other freedom* cannot be the freedom from economic care which the socialists promise us and which can be obtained only by relieving the individual at the same time of the necessity and the *power of choice*: it must be the freedom of economic activity which, with *the right of choice,* inevitably also carries the *risk* and the responsibility of that right;

- What our generation has forgotten is that the system of *private property is the most important guarantee of freedom*, not only for those who own property, but scarcely less for those who do not.

In the Hayek formula, the individual pursuit of *freedom* (anchored in the system of private property) is therefore the main plank of the Hayek programme: everybody must be *free* to enter/exit the field of operations that is the economy. Although it is called 'market economy', in fact the market is only the entry/exit point into an otherwise intractable process (if it weren't, planners could ultimately obtain the information to plan).

The market therefore does not guarantee freedom from economic want, indeed it cannot guarantee anything—how would we know. *Choice* (the choice where to invest, the decision to freely dispose of one's possessions otherwise, consumer choice) is the expression of freedom. How those who have no property (and hence little choice), will enjoy the general freedom that Hayek claims follows from the freedom granted to those with property, is left unclear. This of course takes up the old idea of the marginalists which had remained central for mainstream economists throughout. Indeed as the Italian Vilfredo Pareto (1848-1923, whom we will encounter again as one of the neo-Machiavellian elitists in Chapter 9) put it, 'the theory of choice… gives more rigour and more clarity to the whole theory of economic equilibrium' (quoted in Meek, 1972: 95).

'Market' for Hayek therefore is merely a code word for the free disposal of assets. Since only the individuals themselves have the knowledge about what they want, and the state (or any other embodiment of the collective that is society) is a priori disqualified as the organiser of social life, the process of totalising individual preferences must be left to a sphere of exchange where these preferences cancel each other out, or are otherwise mediated. Although we do not (want to) know what lies behind this exchange process, we do know that this is the sphere in which subjective choices are totalised one way or another—the market.

The core concept of neoliberalism is the notion of 'competitively determined freedom'. This concept of freedom is defined from the principle of privately disposable property of the means of production, secured by political institutions ensuring 'law and order'. Hayek later specified law and order as the foundations of private property as such, as freedom of contract and the coercive upholding of contracts (quoted in Walpen, 2004: 114-5).

Competitive freedom is not only totalised economically by the market (in the aforementioned sense). It is also realised in politics by elections. But then in the neoliberal perspective, one might as well call the market an ongoing 'election' by investors and consumers, or the political process a 'market' for candidates and votes. As long as there is freedom to choose.

In April 1947, a meeting in a hotel in the village of Mont Pèlerin in Switzerland established the Mont Pèlerin Society, which still today is the key network of the neoliberals. Thirty-nine, mostly economists, attended:

Walter Eucken, Milton Friedman, Hayek, F. Machlup, and Röpke were among the participants. Also present was Karl Popper, with whom Hayek corresponded whilst writing *The Road…*, and whose *The Open Society and its Enemies* of 1945 was the philosophical counterpart of the attack on 'collectivism'. Popper's neo-positivism, however, as we will see in Chapter 3, is incompatible with the axiomatic notion of 'rational choice'. On the first day of the founding MPS meeting, Hayek already indicated that the question how to restrict, in law and in practice, the power of the trade unions, would be one of their most important tasks. Yet at the time, the Keynesian approach of economic management by the state and class compromise with organised labour still held the high ground.

The hour of neoliberalism finally struck when Keynesianism landed in a deep crisis in the mid-1970s and the rentier class and associated players (investment banks, mutual funds etc.) rose from the grave to which Keynes had supposedly assigned them. 'Nobel prizes' for the proponents of neoliberalism mark its ascendancy beyond economics as a general hegemonic concept for society, and the rise of finance and the rentier element in the distribution of incomes, through privatisation and marketisation, can be easily documented. The theory of New Public Management is one way in which this has been articulated. Ideally, under NPM rules, the state is stripped of any preferential access to society and the economy, and becomes a bidder for tasks to be undertaken along with private bidders (Lane, 2000: 37).

3. RATIONAL CHOICE AND GAME THEORY

Among those advancing the idea of generalising from micro-economic choice to social action at large a prominent role was played by the US economist, Frank H. Knight (1885-1972). Neoclassical economics according to Knight is an exact science that produces laws as universally valid as those of mathematics and mechanics. Through its high level of abstraction, economic science had achieved '*the form of all rational activity*' (quoted in Ross, 1991: 426, emphasis added; Rational Choice, the approach seeking to apply the logic of micro-economics across the social sciences, here has its origin. Cf. Simon, 1955).

Against the idea of a descriptive approach to economic behaviour as argued by the institutionalists (cf. our Chapter 5), Knight emphasises that the axioms of economic rationality should be applied to social reality at large. There had been occasional references to economics as the model for social and political behaviour, but it was only with Knight that politics and economics were both systematically reduced to individual choice (Ross, 1991: 427).

Now as Dobb noted in 1940 in a comment on the neoliberal writers (1972b: 71-2),

> If all that is postulated is simply that men *choose*, without anything being stated even as to how they choose or what governs their choice, it would seem impossible for economics to provide us with any more than a sort of algebra of human choice, indicating certain rather obvious forms of interrelationship between choices, but telling us little as to the way in which any actual situation will behave.

This reminds us of the deductive character of any axiomatic approach. Dobb too argues that choice can never be confined to economic choices, given that there is nothing inherently economic in 'choosing'. Lionel Robbins (1898-1984), one of Hayek's fellow neoliberals at LSE, on the other hand argues that 'every act which involves time and scarce means for the achievement of one end involves the relinquishment of their use for the achievement of another (and) has an economic aspect' (quoted in Ibid.) Or as Ludwig von Mises (1881-1973) puts it,

> It is illegitimate to regard the "economic" as a definite sphere of human action which can be sharply delimited from other spheres of activity. Economic activity is rational activity… *The sphere of economic activity is coterminous with the sphere of rational action* (quoted in Dobb, 1972b: 73, emphasis added).

If the circumstances under which people make choices, are left unspecified, the implication that they choose *freely* is a false statement, Dobb concludes from this discussion. Yet is precisely this freedom, not choice a such (and even less, the market) that Hayek was concerned to restore in the face of the advancing Keynesian state and the managerial revolution of the cadre.

In the spread of the principles of micro-economics across the social sciences as Rational Choice theory, Frank Knight's students, James M. Buchanan and Gary Becker, led the way. Two main strands may be distinguished.

- The *Public Choice* school of Buchanan and Warren Nutter took ideas from Kenneth Arrow, Duncan Black, and Anthony Downs, to argue the application of the market mechanism to politics. This would bring about a more efficient allocation of individual preferences. To counter the thesis of 'market failure' (the claim that a capitalist economy fails to deliver the goods), Buchanan and Gordon Tullock in 1962 wrote *The Calculus of Consent* which claimed instead that 'governmental failure' was the cause of social problems (Walpen, 2004: 152). Public Choice theory identifies the interventionist state as the cause of social malfunction. In particular, its redistributive role (taxing the rich, helping the poor) creates the problem of the *free rider*, the idea that anybody, any institution, is enjoying advantages for which he/she/it has not paid. This has worked in practice as a limiting principle on making rights-based claims on the part of those without sufficient means.

- In the same period (late 1950s, early 1960s), Gary Becker developed the 'human capital' theory (not to be confused with this concept as developed in institutionalism, cf. Chapter 5). In a series of works inspired by Knight, Hayek, and Friedman, Becker applies micro-economics (consumer choice, utility maximising) to all areas of human action and interaction. Whilst Buchanan led the way in developing market economy as a general science, Becker applies micro-economic choice thinking to a range of other areas, by assuming that an individual acts on the basis of an instinctive cost/benefit calculus in every act of choice—altruism, delinquency, discrimination, family, household, punishment—everything. (Walpen, 2004: 153-4; cf. Becker, 1962).

These approaches aim to overcome the separation of economics from politics, from sociology, law etc., *by taking the economic definition of man/woman as the starting point for an integral social science.* One source of the re-emergence of the term 'Political Economy' was to denote this new neoliberal social science.

The Shadow of Society: Games Between Rational Subjects

The influence of Rational Choice theory and its offshoots today is such that we tend to forget that its emergence passed through several stages, crucially the reformulation of value theory as a theory of subjective value. This removes *society as an objective reality* from view. In Dobb's words (1972b: 81), it

> creates for us a realm where disembodied minds hold communion with etherealized objects of choice and then, unmindful of the distance between this abstract world and reality, seeks to represent the relations which it finds in this realm as governing the relations which hold in actual economic society and as controlling the shape which events must have under any and every system of social institutions.

Indeed, if we assume,

1) that all social action ultimately refers to free choices made by interest-maximising, rational individuals, and

2) we reject any notion of 'society' as an objective configuration of forces which can be analysed in its own right,—

then the possibility of an empirical approach to society is removed too.

Hence to represent social relations, we must resort to a highly abstract, indeed the most abstract level of representation, mathematics—concretely, *game theory*. In game theory, it is assumed that a rational subject goes about life making choices, but there are other rational individuals doing the same. Since we also have given up the idea of a market equilibrium in the classical political economy sense, and hence, the notion that society processes subjective rationality into collective rationality, we are left with rational subjects at cross-purposes. Not the Enlightenment notion of harmony, but the utilitarian principle of *optimisation* is at work here, except that we do not/cannot/do not want to, know *how*.

Under these circumstances, how are outcomes which meet the criterion of subjective rationality to all sides, for all 'players' that is, actually achieved? Note that we are dealing here with epistemology and ontology alike: our view of how scientists act, and how people in the real world act, is structurally identical (as we will see, in structuralist theories, this is usually not the case; hence the inherent elegance and attractiveness of subjectivist theories in a liberal society). In both theory of action and theory of knowledge, the world is unknown/unknowable/insufficiently known, an area of uncertainty and risk; while the subject is rational, indeed the *source* of rationality.

Games describe encounters between rational, interest-maximising individuals under varying circumstances. The form of describing the encounter is mathematical, because we can only denote the relations between subjective actors abstractly, deductively, without reference to a social structure which cannot as such be described except as 'positions' in a space—not on grounds of objective, substantive reality.

Rapoport (1966) defines game theory as a subjectivist, actor-oriented theory when he contrasts *strategic* and *systemic* conflict theory. In systemic theories such as Lewis Richardson's arms race studies, the system of international relations moves by its own accord; people and nations are drawn along into its flow. The system operates on the bases of objective laws, as do atoms or planets. This is objectivist, structuralist theory.

Strategic conflict analysis on the other hand, of which game theory represents the most sophisticated version, is exclusively based on subjective preferences. The theory is merely a device to determine outcomes. Two players each assign values to certain outcomes (utilities) which they necessarily (given the assumption of rational interest maximising) seek to achieve but which others may interfere with because the other (who is a competitor) may have other preferences.

Basically the game results in an n^{th} -best outcome for all. The central principle of strategy was always that competence in politics is the *rational* use of power, writes Rapoport. He highlights the connection with political economy when he writes that the original work of J. von Neumann and O.

Morgenstern on game theory was mathematical, and then applied to 'economic behaviour, i.e., to a context in which economic units compete with each other.' 'It seems, however, that the keen interest and enthusiasm with which the theory was received stems not from its possible applications to economics and business but from the realization that here at last was a rigorous and general theory of *rational conflict*' (Rapoport, 1966: 267, emphasis added).

The origins of the model of Rational Choice and game theory in micro-economics are obvious. Indeed as Rapoport writes (1966: 280), 'the ultimate reference point remains the smallest acting unit—the player who must rationalize his actions in terms of his self-interest immediate or ultimate. This outlook has a long tradition.

> It stems from classical economics, where the individual producer or consumer has been put at the foundation of the conceptual system. These competing, bartering, bargaining "atoms" constituted the economic system. It is noteworthy that nineteenth-century economics earned the epithet of "the Dismal Science" because of its inexorable conclusions that the poor must forever stay poor—a conclusion rationalized by a vulgarized version of the Darwinian notion of the struggle for existence and survival of the fittest.

Rapoport adds that 'in our days the epithet "dismal" can be appropriately transferred to political science, at least that portion of it which is profuse with neo-Hobbesian ideas' (that is, IR realism).

In this perspective, too, the rational subject (the state) faces a dark, impenetrable, ultimately unknowable world. This world cannot, by the same logic, be ever controlled by the subject(s). Game theory, in which such subjects confront each other across space (abstracted into mathematical space), here finds another area of application. The subjects are rational; the arena of their interactions is not; but there is a deductive, mathematical way of calculating their relations by identifying certain patterns and configurations of the cross-purposes of players, each of which carries a value, measured in utilities, for the subject(s).

What theories in IR and GPE seek to achieve in this manner, is to develop an argument *why and how, in an anarchic setting, co-operation or co-*

ordination can develop at all—even if we deny their mutual relations the status of being 'social', that is, composed of substantive, objective patterns of interaction which contain elements of hierarchy, dominance, or whatever quality we ascribe to them and which on those grounds, would be intelligible in themselves. Even when this is denied, and only anarchic empty space remains, the relations among rational subjects can produce co-ordination and co-operation.

'Co-ordination games,' Hollis and Smith write, 'rationally should result in stable equilibria or… *consensual norms*, from which no one has any reason to depart' (Hollis and Smith, 1991: 123). From this angle we can conceive that patterns of coordination and cooperation ('international regimes') emerge. *Hegemonic stability theory* assumes that such regimes (free trade) are put in place by a hegemonic state. Regimes thus can be argued to come about as a result of a rational choice on the part of that state; public choice theory then suggests that there will be free riders who profit from the regime but who do not pay for it or otherwise share the burden (Cf. Hausken and Plümper, 1997).

As we will see in Chapter 6, regimes can also be theorised as a weak system theory, a strand of objectivist/structural theory.

Applying the Method

How are we to proceed if we want to pursue a research project in this strand of thought?

The problem with the Rational Choice tradition is that it is not really a mode of investigation but a deductive, prescriptive approach, meant to organise one's thought before acting rationally in a competitive situation, *strategically*. In Milton Friedman's words (quoted in Hunt, 1972: 188), there is 'a common core' valid for 'almost all professional economists' to which they 'devote little professional research and writing—except in textbooks.' In other words, the axiomatic nature of economics is simply given and no longer up for discussion in light of facts.

The value of economics and Rational Choice is therefore primarily 'heuristic', that is, it serves to generate ideas about why people or firms or states may have acted in a particular way, or which course of action is the least costly given the assignment of different values to different courses. As Lipsey puts it in the notes prefacing the 5th edition of his textbook, he initially had tried to follow a positivist, Popperian approach (cf. our Chapter 3) but ultimately came to accept that the methodology of marginalist economics is 'Euclidean', i.e., axiomatic, not open to empirical verification or falsification (Lipsey, 1982: xxi). Logical positivism (or neo-positivism), with its claim that 'every single statement in the theory ha[s] to be positive and testable', has 'proved to be a harmful and unnecessary straitjacket.' Hence, 'all that the positive economist asks is that something that is positive and testable should emerge from his theories somewhere…' (Lipsey, 1982: 7).

Reuten defines the method of mainstream economics as 'axiomatic positivism'. Axiomatic, because it approaches economics as applied mathematics (the 'Euclidean' aspect); positivist, because it pays lip-service to the epistemology of empirical testing (Reuten, 1993: 64). The problem is that (neo-) positivists, as we will see in the next chapter, reject axioms such as the rationality of the subject as a basis for scientifically meaningful statements. And as we saw, Hayek explicitly rejected the original positivist philosophy. On the other hand, he worked closely with Popper, one of the neo-positivists sharing his anti-socialist convictions. Hence we are looking at an affinity but one with serious contradictions.

As Reuten sees it, a project undertaken in the Rational Choice strand would have to conform to the following requirements (these are also broadly the positivist requirements).

1) *consistency* (statements do not contradict each other);

Since mathematics and formal logic, which account for the axiomatic aspect of this approach, are in themselves consistent, this criterion is met without difficulty. However, since economics is also a social science, it will tend to drift away from this consistency as soon as it takes social data on board that contradict the axioms which usually are in fact assumptions. For instance, the claim that rational individuals are fully informed, is such an axiomatic assumption.

Let us retain though that consistency of one's abstract claims about the world, is a first step that is required in the methodology of this approach.

2) *plausibility* in light of the literature (claims are broadly in line with what others claim);

This is the second step, which is much more problematic. Basically, theory is expected to remain within the broad parameters of existing theories: hence there is a premium on selecting small areas not yet covered in previous research, or updating older research within an identical theoretical framework. As was argued by Thomas Kuhn's *Structure of Scientific Revolutions* of 1962, however, breakthroughs have always been achieved by rejecting the 'plausible', not by small steps building on it. We will see in the next chapter that this is the hot issue in positivism.

3) *empirical application* (some form of testing of statements against indicators/ data)

This is the weakest aspect of this approach because Rational Choice breaks the fundamental rule of positivism, i.e. that it posits first principles (axioms) One may also say, it sacrifices the problems of open-minded fact-finding to the construction of a constituent deductive model from the first principles (cf. 'the predictive power of the model was weak'). Therefore neoclassical economic theory has produced little research: historical/empirical analysis of economic process within economics has been evacuated mainly to business economics, history of economic thought, economic sociology, or political economy (Reuten, 1993: 67-9).

With the above limitations in mind we may agree that a Rational Choice research strategy would consist of

- identifying the actors and their interests;

- listing actor preferences and adding a putative quantitative value to them;

- identifying the particular game and which may be argued captures the nature of their competitive engagements (the best known is Prisoners' Dilemma which condemns actors to costly outcomes because of lack of communication and trust and the risk of even greater harm) and

- performing a calculation following the rules of that game to determine the outcome.