CHOOSING BETWEEN CLASSICAL LIBERALISM AND SOCIAL LIBERALISM

Social liberals support markets, but also government action to promote a firm safety net and equal opportunity, with more confidence in the role of government, writes **Fred Argy**

Classical liberals and social liberals share some common views. Contrary to state paternalists, they both see benefit in market reform, but are less radical than libertarians. Contrary to social conservatives, they often agree that the state should use a light hand when regulating personal morality. Yet there is still a lively debate between classical and social liberals on the scope of welfare, the scale of measures to promote substantive equality of opportunity, and on the degree of economic intervention consistent with economic liberalism.

These issues stir up deep passions when people with prior beliefs and values dominate the debate (ideologues). The discussion becomes more civilised when people have regard for a realistic 'set of political values' (academics and journalists). And when the war of words becomes central to government, ideology loses much of its sting—at least on the surface (politicians).

The ideological debate

At the ideological level, there is little room for sensible argument.

'Libertarians' reject any sort of state intervention apart from a minimal role that protects against force, theft and fraud. Under libertarian individualism, failing to help people in need does not restrict liberty. Economic freedom, as measured in the so-called 'index of economic freedom,' is calculated by reference to the security of property rights; the openness of the economy to external trade; levels of business and credit regulation (how easy it is for entrepreneurs to start and manage their business); the extent of deregulation of labour markets (how much freedom managers have in setting pay structures and in hiring and firing); and the size of government (scale of government expenditure). Libertarians also tend to have a laissez-faire attitude to the environment.[1]

Some people on the political Right (and some on the Left) also demonstrate elements of 'social conservatism' in areas such as homosexuality, drugs, obscene literature, abortion, or federal funding for human embryonic stem cell research. Libertarians generally divorce themselves from social conservatism as they believe people should be able to pursue whatever ideals they like.

Some people on the Left actively support **state paternalism**, a mix of democratic socialism and welfare 'rights.' The methods and instruments chosen include guaranteed social minima; trade barriers; exchange controls; a managed exchange

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rate; a rigid, inflexible wage structure; public ownership; and foreign investment regulation. Social liberals divorce themselves from these policies, which seem unnecessarily costly for productivity and flexibility. There are more effective ways of achieving good distribution effects through the social security, the tax system, and moderate wage regulation.

The doctrines of libertarianism, social conservatism, and state paternalism are held mostly by 'political outsiders.'[2] Most academics and political participants, while drawing heavily on prior ideology, lean toward a more realistic view of politics. This is what we call 'progressive liberalism'—a pragmatic mix of markets and government intervention to promote economic growth while promoting equality, opportunity, and a welfare safety net. Progressive liberalism is the governing orthodoxy of the day.

The academic debate

At the academic or journalistic level, there is an ongoing debate between organisations such as the Institute of Public Affairs, the Centre for Independent Studies, and the Australia Institute and between bloggers and individual writers. They contribute to, and scan through, learned articles—and use the ideas in them to pursue particular political ends. Two of the main exponents are classical liberals and social liberals.

How much economic freedom?

Classical liberals can be viewed as 'less extreme' than libertarians. For example, they adopt a more intellectually eclectic set of justifications instead of a simple assertion of rights. While favouring libertarian institutions, such as limited government, protection of personal freedoms, and free markets, they rely on rules of thumb derived from experience—for example, that governments tend to mess things up and individuals are the best judges of their own interests. They see the libertarian label as too narrow and as representing a too absolutist view of politics and policy.

Classical liberals like *Policy* editor Andrew Norton see 'an inherent, massive complexity' in income inequality, which is the result of 'billions of individual decisions, actions and transactions taken over a long period of time' and reflecting different talents, abilities, effort, and luck. When a classical liberal sees a need to redistribute income, it would be not to reduce inequality per se but instead address specific individual needs such as increasing incentives or assistance for the elderly. This explains why classical liberals are sceptical of the use of 'composite indexes designed to aggregate different liberties or inequalities'—such as the Gini coefficient or shares of income—and why they are more 'flexible' on the issue of tax cuts relative to expenditure.[3]

Like libertarians, classical liberals refuse to see themselves as 'moral conservatives'; instead, they generally oppose censorship and support improved legal recognition of gay relationships and abortion rights for women.[4]

Classical liberals are 'at least first cousins' to libertarians, with a similar stress on the role of government. However, classical liberals are more pragmatic, and their ideas are somewhat closer to political realities.

How much social liberalism?

One aspect of 'equity' that is widely accepted (by both sides of the fence) is that people in the same circumstances should be treated the same (i.e. ensuring processes are transparent and non-discriminatory on the basis of race, religion, sex, or sexual preference).

But social liberals (the principal topic of this paper) go further with their ideals of equity. They believe in a strong safety net, and they support substantive equality of opportunity. These two equity wings of social liberalism interact with a third—a strong belief in economic liberalism.

Strong safety net

Classical liberals and social liberals have much in common regarding the **existing** distribution of income, although they are likely to differ regarding individual needs and degree of opposition to further redistribution of incomes.

The social liberal insistence on a firm safety net can cause some differences with classical liberals, but three considerations pull them together. First, income distribution in Australia happens to fall mid-way in OECD circles, and appears to be roughly consistent with public opinion. Second, many social liberals share the classical liberal view that governments need to identify a specific individual instance of 'inequity' before intervening to alter income distribution. They differ from social democrats, who tend to be guided by particular points in income distribution. Third, social liberals also fear that the economic efficiency costs of a marked shift in distribution can often exceed the welfare benefits. In particular, those able and willing to work should have every incentive to gain employment or train.

However, differences emerge on proposed policy changes likely to affect income distribution. One route—the one chosen by classical liberals—is to simply look at the effects of new economic reform on GDP. If these effects are positive, it is assumed that winners will *potentially* be able to compensate losers and still remain better off. There is no need for *actual* compensation.

But social liberals start with the presumption that an *extra* dollar (the *incremental* benefit of policy-induced reform) is worth more to a poor person than a rich person, so the distribution effects of economic reform need to be considered in order to assess its aggregate welfare benefits. If the benefits are substantial and virtually all go to the rich, governments need to sympathetically consider alternative policy packages that deliver a more neutral outcome—one more consistent with Pareto optimisation, where no one can be made better off without someone being made worse off.[5] Other privately initiated reforms in product markets also have 'losers'—but the losers are not policy-initiated.

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A further economic justification for such redistribution is that it can smooth the path of economic reform. If people are unhappy about how the previous benefits of reform have been distributed, they are less likely to support policy-induced structural change.[6]

This leads social liberals to propose various policy initiatives. When a new tax, like the GST, is contemplated, it should be possible to offer direct compensation to families. And workers forced by a policy change into lower-paid jobs could be offered a special system of wage insurance. If such ideas fail (e.g. it might be hard to precisely identify the victims), government could invest in socially active yet productive programs.

It is worth noting that this kind of social liberalism, like libertarianism, is committed to individualism—but includes protecting individuals from acts of omission as well as commission.

Substantive equality of opportunity

Social liberals also attach much importance to the achievement of substantive equality of opportunity—the opportunity available to well-motivated, capable, and hard-working people to get ahead in life and achieve their maximum potential, no matter what their social background and starting opportunities. Equality of opportunity is not simply about money. Governments also have an obligation to ensure that sufficient assistance is available to directly address capability deprivation, e.g. in health, education, training, housing, and transport infrastructure.

We know that social mobility (the frequency with which people can move up the ladder in the course of their lives) is highly sensitive to the scale and mix of policy instruments used by governments. Countries enjoying relatively high levels of mobility tend to have governments that encourage free, competitive markets and *regulate* labour markets relatively lightly but also *engage* in active societal redistribution. The first two market-oriented policies alone will not deliver optimal equality of opportunity. They need to be supplemented by the third—redistribution to build capabilities.[7]

Compatibility with economic liberalism

How does all this link up with economic liberalism—the view that decisions on what is produced and how it is to be produced are generally best left to the market, unless there is clear evidence of market failure and governments are able to correct the problem with a reasonable level of effectiveness.

First, from a welfare point of view, social liberalism is more likely to ensure an economic efficient (Pareto-optimal) outcome in response to major reform initiatives. Second, it also facilitates structural change. Third, market income inequalities are only morally defensible and economically desirable if they reflect differences in talent, risk-taking, and hard work. Studies suggest that genes, pre-birth environment, and post-birth influences all play a substantial role in determining inter-generational transmission of socio-economic status,[8] and tend to distort the present distribution of market incomes. To 'level the playing field,' the observed market inequality must be made fairer, more economically rational, and more politically legitimate. A number of credible studies have found evidence of high national economic returns (in terms of real incomes per head) relative to government outlays.[9]

But all that is not enough to convince classical liberals, who argue that government subsidies should be relatively small, and that government cannot do things as well as the private sector.[10] Social liberals need to address these issues by focusing specifically on four key policy differences—size of government; privatisation of state enterprises; financial regulation and labour market deregulation.

Small government

There is no such thing as an 'optimal' size of government from an economic point of view: It is hard to find a statistical correlation between size of government (levels of government spending and taxation) and economic performance.[11]

Tax increases can have significant incentive costs (although there is controversy even here[12]), with the so-called 'deadweight' (choice distorting, welfare-reducing) costs of higher taxes possibly as high as 20 cents in the dollar. But the net economic costs of tax increases depend on:

- the initial tax levels (efficiency costs increase approximately with the square of the tax rate);
- how the revenue is raised (how much it influences work incentives and capital movements and how much it distorts choice);
- how productively the money is spent (spending needs to be assessed, program by program, to see whether it is justified).

Spending programs need to be evaluated without any presumption in favour or against. In particular, if the economy is facing the prospect of a severe recession, the case for contra-cyclical spending is very strong.

Privatisation

Because of some ambiguities in the meaning of 'market failure,' an element of ideology may have entered the debate.

Thus, classical liberals insist that private ownership will generally create incentives for efficiency—except where there are natural monopolies (where regulation is required) or where commercial incentives would not be enough to meet social goals, such as service provision in low population areas.

Social liberals have a rather broader definition of market failure. As understood by most economists, it refers to a situation in which a market left on its own fails to allocate resources efficiently. It allows for externalities, market power, and information asymmetries. It also assigns to government an important role in the delivery of the services, such as in the case of Telstra.[13]

Assigning infrastructure ownership risks predominantly to the private sector can also lead to a misallocation of capital resources. For example, it tends to encourage infrastructure with good 'commercial potential' and discourage infrastructure with high 'social returns.' Classical liberals also allow for such situations, but on a smaller scale than social liberals.

Financial regulation

The global financial crisis, its causes, and remedies have an ideological dimension that touches on the differences between and classical liberals.

- Some people look for 'external' factors; for example, blaming it all on the US Federal Reserve's monetary policy, untruthful homeowners, and the role of global imbalances, such as the huge current account surpluses run by countries like China (libertarians and, to a more moderate extent, classical liberals)
- Some people want somewhat tighter regulation, such as higher capital ratios for banks and a wider prosecution of fraud, but with 'warnings against micromanagement' (Greenspan)
- Some go further. They argue that bad incentives (such as those of commission-based mortgage brokers and the biased role of rating agencies) are partly to blame. And

> they also view regulation as a failure by permitting very close 'pathways' between the banking and non-traditional banking sector. They want the regulatory authorities to either ensure that traditional banks do not take on excessive risks through their relationship with lightly regulated entities—leaving it to the markets to investigate and monitor the hedge funds or investment companies or their use of derivatives; or else the same regulatory framework could apply to the shadow banking sector as to the banking sector (Ben Bernanke and, in a more extreme form, Paul Krugman).

Social liberals lean more strongly to the third option. In particular, they want to see the system of regulation address the problems of panics, crashes and bubbles—which occur because of irrationality, asymmetries of information (imperfect knowledge), and market psychology.

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Labour market freedom

The gap between libertarians and classical liberals is starkly evident in the debate over labour market freedom.

Classical liberals dislike unions and advocate labour market deregulation because it widens individual choices. On the other hand, social liberals support deregulation of the labour market only where it is expected to produce significant social or economic benefits.[14]

They know that freeing up the constraints on labour markets makes sense when the economy suffers from high unemployment benefits (relative to median earnings); extensive state involvement in wage determination; stringent employment protection; and exposure to militant trade unions. But this can easily go too far. Some back-pedalling is needed to ensure that labour has a reasonable balance of power. For example, while labour markets clearly need to be sensitive to international pressures, trade unions have a role to play in protecting low-paid employment.

There is also the wider issue of perceived 'fairness'—getting a fair share of the benefits of economic growth without having to depend on a social security system that is already under threat as it gets larger.

This would require that more workers have to be retrained or are made more job-ready for other activities. Ultimately a value judgment is needed.

The political debate

Academic and journalistic contributions soften the role of self-interest, but they still retain many of the vestiges of ideology. The third group—the politicians—are normally the least ideological of the three. Their own interest lies in accurately reading the electorate's beliefs and stated views. Prior ideology continues to influence ideas but its role is more camouflaged. Former Prime Minister John Howard often pointed to 'the hard edges of the American approach,' and argued that the Liberal Party is 'not a party of the hard right—it is a party of the centre right, a party which rejects extremes.'[15]

But he still managed to cautiously push his own agenda. He neglected lower-income families without kids, and used tax policy to disproportionately benefit the rich (such as halving capital gains tax, abandoning measures to reduce tax avoidance through trusts and companies, and weighing superannuation towards the better off—all of which affected wealth distribution rather than income distribution). On the danger of 'welfare dependence,' Howard tended to go further than the ALP was prepared to live with. He took a firm stance on issues such as waterfront reform, the GST (prior to its resolution in the Parliament), and the privatisation of Telstra. The government's final assault was on labour market deregulation. Here, he went too far and may have brought about the Liberal government's demise. But in general the attack was fairly effective.

On the other side of the fence, we find Kevin Rudd warning about executive greed, distributive inequity, the need for opportunity-levelling new investment, the potential valuable role of unions in the new IR system, the limits of privatisation, and the role of big government in times of global crisis.

More recently, in the February edition of the

Monthly, Rudd discussed the excesses of capitalism. While his rhetoric may at times seem excessive, Rudd is a long way from being a socialist or anti-liberal.

For example, Rudd is still a free trader (leaving aside his support for motor vehicle protection);[16] his position on foreign investment is mostly liberal; he seems willing to commit the government to zero net borrowing over the economic cycle—which implies starting with a presumption in favour of private sector infrastructure investment over the long term; he wants to expose Australia to competitive forces in education (e.g. making education conditional on school-level reporting and rewarding excellence in teaching); he is mostly hated by militant trade unions; he is very sympathetic to moderate Aboriginal intervention (e.g. adopting and preserving most of the Howard government's 99-year lease scheme); he insists on future reductions in public sector size; and (until now) he has refused to consider a rise in New Start (unemployment) benefits.

With electoral opinion centred in the middle, the public debate on politics continues around the edges. Based on my understanding of opinion polls, a high proportion of Australians seem to believe that we already have equality of opportunity; for example, there is a fairly widespread view that able-bodied working age Australians who are in poverty 'are to blame for their situation to some degree,' while only 15–20% disagree with the proposition that 'people are rewarded for their skills and effort.'[17] Yet there is strong sense of 'what is fair': People feel uneasy about the treatment of pensioners and the inequality of access to public services. Only a minority want governments to embrace labour market deregulation (as we saw in the reactions to WorkChoices).

Malcolm Turnbull's economic agenda may have recently moved to the right. For example, we note his strong stance on 'small' versus 'big' government, and his advocacy of 'general tax cuts' in preference to the government's policy of upfront cash grants. Turnbull is asking 'why do we assume the government will invest that money more wisely than the people who earned it'?

His new stance on 'small government' could prove a difficult act to apply in practice—not just because of conflicting goals (more spending on pensioners, carers and welfare recipients versus lower taxes) but also because Turnbull's contra-cyclical debt aversion thesis does not have the backing of the Reserve Bank, Treasury, the IMF, the OECD, and 90% of economists (according to Greg Mankiw[18]). Without any government intervention, the economy would be much weaker and public debt could be even larger than it is. The 'permanent income hypothesis' is only relevant as a long-run supply-side response: It does not apply to short term periods of 'liquidity constraint.'[19]

Nonetheless, if Turnbull persists with his classical liberal stance, the next election will test the public reaction to Labor's big Keynesian ideas.

Conclusions

Classical and social liberals have much in common—they share a common stance on issues such as free trade, limited welfare for people able to work, and the need to balance the budget over the economic cycle.

But they are often at variance on the degree of government involvement—such as on social welfare, the promotion of equality of opportunity, and government intervention in the economy. The extent of these differences is most acute at the firmly ideological level but becomes more moderate as people start to have regard for political sensibilities.

In the recent survey by Andrew Norton of Australian political identity, I described myself as someone with social liberal views.[20] This has several features:

- It has a broader safety net—one that broadly accepts the existing distribution of incomes, apart from addressing specific individual needs that seem anomalous, but which allows governments to manage the distribution effects of new economic reform;
- It includes a commitment to substantive equality of opportunity; and
- It has a greater (ideological) faith in government's ability to effectively address market failure; this contrasts with the classical liberal view (again ideological) that governments tend to mess things up, fail to independently assess and address market failure, and individuals are the best judges of their own interests.

My social liberal leanings lead me into a more neutral policy position. For example, I prefer government spending programs and privatisation of government assets to be judged on their merit—without any presumption for or against. It also leans me towards greater financial regulation. And, while favouring a relatively free labour market, I would inject enough restrictions on the free play of demand and supply (e.g. on minimum wages and unfair dismissals) to ensure a level playing field and 'fairness' goals.

Endnotes

1 Harry Clarke is an exception: He is an inveterate supporter of labour market deregulation and small government—yet he is a source of support for the environment and distribution.

2 Harry Clarke, 'The end of free market fundamentalism, not of the mixed economy,' *On Line Opinion*, 5 December 2008.

3 Andrew Norton puts his point of view as follows: 'I say there should be less tax' but 'I never say exactly how much tax I think should be levied, or what tax rates I would be happy with' ('The intellectual uses of liberty and equality,' Andrew Norton's blog, 6 April 2008, http://andrewnorton.info/2008/04/the-intellectual-uses-of-liberty-and-equality/.)

4 See Andrew Norton's analysis of the Survey of Australian Political Identity on his blog, 'Are classical liberals and libertarians the same?' 12 April 2009, http://andrewnorton.info/2009/04/are-classical-liberals-and-conservatives-the-same/.

5 As one of the fathers of modern welfare economics (Ian Little) put it, 'scarcely anyone would want to say that all changes such that the gainers could over-compensate the losers must be good. For most people it would depend on who the uncompensated losers were,' IMD Little, *A Critique of Welfare Economics* (OUP: London, 1950), 93. See also Fred Argy, 'Distribution effects of labour deregulation,' *Agenda* 14:2 (2007).

6 The risks of protectionism are markedly lessened when governments try hard to 'share the pains and gains' of such reform. See AM Mayda and KH O'Rourke, 'Big governments and globalisation are complementary,' VO.EU, 12 November 2007, www.voxeu.org/index.php?q=node/705.

7 Fred Argy, 'Equality of opportunity in Australia: Myth and reality,' Australia Institute Discussion Paper No. 85, April 2006. See Andrew Leigh's revised paper on 'international elasticity of earnings,' which suggested that Australia had a lower mobility than Scandinavia, 'Intergenerational mobility in Australia,' *The B.E. Journal of Economic Analysis and Policy* 7:2 (2007), and 'Social mobility and statistical immobility,' Andrew Leigh's blog, 9 April 2009, http://andrewleigh.com/?p=2028.

8 Sources include James R Flynn, *What is Intelligence: Beyond the Flynn Effect* (Cambridge: Cambridge University Press, 2007); and 'Nature v/s nurture, poverty matters,' *Economist* 23 July 2006.

9 The national returns come in the form of a better educated and skilled workforce and citizenry; greater geographic and occupational mobility of labour; less waste of potentially successful entrepreneurs; higher employment participation rates; diminished health costs; lower imprisonment rates; less spending on welfare and juvenile delinquency; savings in commuting time; and fewer accidents and reduced pollution.

10 Andrew Norton, 'Slipping social mobility,' Catallaxy blog, 18 April 2006, www.catallaxyfiles.com/blog/?p=1707.

11 Fred Argy, 'Australia's fiscal straightjacket,' John Butcher (ed.) *Australia Under Construction* (ANU, 2006), 71–82.

Fred Argy, 'Fiscal policy for the future,' State of the States, Evatt Foundation, 2006, 62–73.

12 Michael Keating, in his recent book *Who Rules* (Federation Press, 2004), points to literature that finds that 'there is not much empirical evidence of taxation affecting the supply of labour or saving,' 29.

13 John Quiggin, 'The Australian case for nationalisation,' blog, 25 January 2009, http://johnquiggin.com/index.php/archives/2009/01/25/the-australian-case-for-nationalisation/.

14 See further discussion in Fred Argy, 'Economic freedom: The good, the bad and the ugly,' *AQ: Journal of Contemporary Analysis* (September–October 2007), 36–38.

15 John Howard, 'Turnbull is on track,' *The Australian*, 20 February 2009.

16 Kevin Rudd said on 31 January 2009 at a press conference (which hit the newsstands a few days before *The Monthly*) that 'The Australian Government position has never changed. It is a position informed by history and the appalling history of the Smooth-Hawley tariff of the 1930s' and stressing the 'need not to throw the baby out of with the bathwater.'

17 Fred Argy, 'Equality of opportunity in Australia: Myth and reality,' as above, 51–56.

18 Greg Mankiw's blog, 'News flash: Economists agree,' 14 February 2009, http://gregmankiw.blogspot.com/2009/02/news-flash-economists-agree.html.

19 Fred Argy, 'Fiscal policy: The ideological war,' *On Line Opinion*, 4 March 2009, www.onlineopinion.com.au/view.asp?article=8568.

20 Results available at http://andrewnorton.info/category/political-identity-survey/.