
LIBERAL NEOCLASSICISM AND THE CURRENT POLICY OF ‘NEOCLASSICAL SYNTHESIS’

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Abstract

The capitalism which ‘socializes the losses’ and ‘privatizes the gains’ – reflected through the measure of rescuing the American banking system by the ‘visible hand’ of the state and through the measure of transfer of the financial crisis costs (through the decline of budgetary wages) toward citizens – reset the problem of the current value of neo-classical liberal paradigm. The solution adopted in the context of global contagion of crisis, dissonant with the neo-classical philosophy of deregulation and with the canonical principle of the market automatic stabilizers, express the concern of political institutions for the macroeconomic stabilization and the social utility. The paper aims to examine the current models of the ‘balance of power’ between market forces and state structures (the ‘perennial theme’ of liberal debate), of the capability to manage the markets, to regulate the financial system vitiated by the overwhelming role of the speculation with virtual money, to obtain economic growth through competitive practices and both private and social utility.

Keywords: neo-liberalism, neo-classical liberalism, neo-classical synthesis, balance of power

1. Introduction

This study aims to outline the positions of the exponents of the main liberal paradigms which marked the US policy in the last decades – the neo-classical liberalism and the neo-classical synthesis – on the financial crisis solution, on its appropriateness in the current context of financial deregulation and on its effectiveness in draining the vices of the financial system and in obtaining competitive financial practices. It will seek to highlight that the positions on this issue reflect two different types of reporting to the thesis that the financial failure of U.S. and the widely interventionist measures irreparably undermined the ‘doctrine of free market’.

The assumption of this study is that the interventionist nature of the crisis solution seems to reflect the option of the current American policy-makers for the model of the neo-classical synthesis, but that this option, strongly contrasting with the prevailing policy of neo-classical inspiration followed before crisis,

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represents till now a contradictory mix of American policies still ineffective to generate social utility and general equilibrium.

As such, the study comprises two sections. The first one contains the theoretical framework of reporting, namely the outline of the ‘particular history’ and the specific theoretical differences of the neo-classical liberalism and the neo-classical synthesis. Their evolution is traced starting from the common core of neo-liberalism in post-war and then in counter-distinction with the neo-liberalism constituted as social liberalism or liberalism of social market economy. The second section contains the outline of the reasons under which the controversial solution of ‘bailout’ and of American banks recapitalization through the state intervention signifies not just a denial of the neo-classical logic of market economy, but also a truncated and distorted application of the neo-classical synthesis model, one that is economically inefficient and socially and moral vulnerable.

2. Theoretical specifications

2.1. The Neo-liberalism

One of the most spread denominative and conceptual confusions regarding the XXth century liberalism – probably overran by the ‘extremely deceiving’ description of neo-classical liberalism as libertarianism [1] – is the monolithic framing of the differently oriented liberals in the same current – neo-liberalism – which ‘would have kept burning the liberal flame in the public discourse’, ‘eternal truths’ or ‘moral and philosophical fundamentals of liberalism’ during the Second World War and two decades after, in a context of the socializing and communizing ‘interpretations’ ascent and of the classical liberal doctrine ‘decline’. The approach to ‘renew the liberalism’, to reform it and to counteract the anti-liberalisms and any type of collectivist doctrines aimed a new model of liberalism, non-conflicting with the classical tradition, but at the same time therapeutic-corrective as compared to ‘paleo-liberalism’ or classical liberal orthodoxy excess, with communism and bolshevism. As a matter of fact, the ambiguous and ‘large conceptual umbrella’ of neo-liberalism does not shelter over almost three decades a unitary paradigm of a ‘new’ liberalism, but different theoretical options. These options crystallized in distinct liberal perspectives or in ‘types of liberalism’: neo-classical liberalism, ordoliberalism, *welfare* liberalism, libertarianism. The most important theoretical dissensions and assuming of differences (‘neo-liberals separation’) issued after a joint participation in ‘renewing the post-war liberalism’ (especially in the *Mont Pelerin Society* meetings) were those between the liberal option for social market economy (‘*Sozialer Marktwirtschaft*’) and for ‘*Ordnungspolitik*’, on one hand, and the option for ‘reviving the old liberalism’, on the other hand. State interventionism, exemplary argued in 1932 by Alexander Rustow in ‘*Freie Wirtschaft, starker Staat*’ (Free Economy, Powerful State), was denominated as ‘neo-liberalism’ after Rustow recommendation in 1938, made in order to replace

proposals as 'left-orientated liberalism', 'positive liberalism' or 'social liberalism'. Against this 'new' liberalism, 'interventionist' or 'positive', interpreted following the rules of 'old liberalism' as 'forcing liberty limits', and consequently, in Ludwig von Mises expression, as a mark of 'separation from classic liberalism', was counterposed a restructured type of classic 'negative policy' or as Hayek named it "a liberal conception about liberty" [2]. As such, reorganizing of a *thinking in individuals* in classic manner, following the individualism's principles, *invisible hand* of the market and the *minimal state*, has developed alongside and by confronting a *thinking in communities*, the latter, maintaining the role of the state regulatory intervention in supporting the collective interests, conferred it a 'kind of theoretic personality'. The state became thus "the guaranty of the chances equality and promoter of the fight against economic and social inequalities" [3].

From my view point is important to underline that, beyond the common motivation to reject the model of collectivist, communist and Bolshevik anti-liberal orders, the two major liberal options, neo-classic liberalism and neo-liberalism and had different resorts in restructuring the post-war liberalism. The neo-classicists (traditionalists) had as a purpose stopping 'the decadence of old liberalism' provoked by the interventionist hegemonic model of Keynesian inspiration, found in time's theoretical and political *mainstream*, while the neo-liberals (progressive liberals or revisionists) wanted to correct 'the paleo-liberalism' or 'the classical liberal orthodoxy' because it was not able to prevent and avoid inter-war economic crisis. The illicit extension of the term 'neoliberalism' – which in Germany was initially synonymous both with ordoliberalism and with 'social market economy', and which gradually disappeared – is more obvious as, of all reorganized 'liberalisms' in the post-war period, 'neo-classical' liberalism become the most influent economical and political philosophy of the past decades and, especially through Hayek's works, the 'ideological basis' of the present-day liberal order.

2.2. Neo-classical liberalism

The XXth century posterity of the 'apostolic' succession of *laissez-faire* 'smithian' doctrine, namely the posterity of the radical liberalism of the classical Ricardian School, became a fact through the Austrian School of Economy and especially through von Hayek.

The 'rebirth of *laissez-faire*' or systematic reconfirmation of classical liberalism was achieved around 1970 through Hayekien evolutionary perspective that used the methodological principle of empiricist consequentialism, that of 'unintended consequences and mechanisms of spontaneous balancing' of the market and, also, that of 'subjectivism' or 'marginalism' (developed by Carl Menger) in forming the value of goods. Hayek's neo-classical economic theory represents the methodological foundation of an 'atomist' discipline which surveys the individual components of market behaviour. At the same time, it represents the methodological foundation of the study of human subjectivity and

of economic categories relevant from this point of view: self-interest, utility maximization, desires and subjective evaluations that constitute the basis of the productive activities. As in Menger, the basic principle of the Hayekian economic analysis is the individual and the satisfaction of his needs – since “the man is the beginning and the end of any economic theory”, and “our [economic] science is the theory of the human beings’ capacity to face their needs” [4]. The fundamental ontological assumptions of his discourse are: that “the understanding of the social *reality*, from a scientific or ethical point of view, requires a complete individualist orientation” and that “the concept of man as autonomous individual, whose actions are the purpose and the result of the choice, is that on which the philosophy of the free society is based upon” [1, p. 4]. The classical Hayekian methodological arsenal contains the thesis that the epistemological foundation of the society and of the market economy is ‘the decentralized nature of knowledge’: the dispersed, separate, partial and often conflictual knowledge or the knowledge that represents nowhere and never an integrated whole. Consequently, by admitting the ‘inevitable ignorance’ or the limits of individual knowledge and the role of the individual habits and opportunities for attaining the own objectives, Hayek builds the basis for justifying the individual freedom, the human action in uncertainty circumstances, the decentralized use of information in the free market relations and the logical impossibility of planning and of centralized economic management. On this basis, the articulation of the social and economic order results as the mutual adaptation of the individual spontaneous actions according to the delimitation of each private control sphere and to the correct forecast of the collaboration with the persons that one can count on. In this logic, the order of ‘a society of the free men’, which Adam Smith called ‘*the Great Society*’ and which Karl Popper named ‘*the Open Society*’, ‘the right order in a state or a community’ that the Greeks designated as *kosmos*, is necessarily the *spontaneous order*, ‘the grown’, self-generating, endogenous order. For Hayek, this is opposed to ‘the made’, artificial, exogenous or directed social order, which the Greeks designated as *taxis* [5]. In the economic field, this order, that is not created deliberately by someone, signifies the mechanism through which man is led “to promote an end which was no part of his intentions”, that is the order for which Adam Smith used the long ridiculized expression *invisible hand* [5], an ‘abstract and not concrete order’, an order that cannot be perceived intuitively, ‘but has to be traced by our intellect’ through the relations that exist between its elements. What is absolutely defining for the neo-classical character of the Hayekian liberalism is the thesis that ‘the market order’ – *catallaxy*, from the Greek *katallaxia* – represents ‘a wealth-creating game’ and not what game theory calls a ‘zero-sum game’, a game that is a ‘mixture of skill and chance’, a game of the economic connections – ‘*cash-nexus*’ – ‘which holds the Great Society together’, a game in which “the relations between the parts are governed by the striving for the better satisfaction of their material needs” [5, vol. II, p. 112]. It should also be mentioned that in the neo-classical Hayekian logic any intervention in the spontaneous order – except for the mechanisms that facilitate

the easy and efficient functioning of the market –, any imposed policy, including the economic policy of redistribution of incomes and of *dirigisme*, represents forms of approaching the system of command economy, unequal treatments applied to the individuals, 'discriminatory and discretionary actions' that replace the principles of the state of law. The only purpose for which is accepted the governmental action is the "economic stability and the avoidance of the major depressions" [6], only in the context of the antimonopol policy and only when granting subventions for the monetary policies, workplaces, dwellings, agriculture and education respects a single general principle: "they can never be justified in the terms of the immediate beneficiary interest (either supplier or target of the subsidised service), but only in terms of the immediate benefits that all the citizens can take advantage of – this means the general wealth, in its true meaning" [6, p. 278]. Finally, it is worth mentioning the fact that the neo-classical Hayekian liberalism inspired two of the most important economic policies of the seventh and eighth decades of the past century, the American one of the Reagan administration and the British one of the Margaret Thatcher Cabinet.

2.3. The Neo-classical synthesis

The conception of Hayek and of the masters of the Austrian School of Economy (Menger, von Böhm-Bawerk, von Wieser, von Mises) is relevant for the paradigm of the *subjective value*. Besides, the 'neo-classical' or 'marginalist revolution' in Economics produced other two paradigms: that of the *objective cost*, developed by the Neoricardian Alfred Marshall on the basis of the 'final' (marginal) utility theory of value of William Stanley Jevons, and that of the *general equilibrium*, developed by the second generation ('Italian') of the 'Walrasian' neo-classical 'marginalists': Vilfredo Pareto, Enrico Barone and Giovanni Antonelli. Their theoretical fundaments, involving the distinct solutions for the 'value paradox', were thus: 'subjectivity', 'objective' evaluation and evaluation of the relations at the 'microeconomic' level (or of the 'microfundaments'). They have been developed in a context in which strongly grew other two theoretical directions originated in Jevons' theory: Keynesian theory of macroeconomics, which included also a central role for intervention in the management of the macroeconomy, and *Welfare Economics* of Arthur Cecil Pigou. If Keynesian British 'revolution' in the field of economic theory and practice represented the strongest counter-weight of the Austrian neo-classical liberalism culminated with Hayek and consequently contributed to a powerful dichotomic structure of the economic and political thinking of the XX century, 'The School of Mathematical Economy' or the 'pure economy' represented by the Neowalrasian Pareto inspired a synthesis or a theoretical fusion of the two paradigms: neo-classical and interventionist–neoliberal. It should be mentioned in this context that the School of the Italian Neowalrasians studied the feasibility for the market equilibrium of the 'movement: trial-and-error', the problem of the relationship between consumption and consumption preferences, between

production and the behaviour of maximization the benefits of economic agents and formalized in a system of differential calculation the efficiency and the social optimum of the general equilibrium. It is interesting to mention that the Paretian direction concerned with the study of the efficiency was prolonged into *New Welfare Economics*, while a prominent direction, sustained by Irving Fischer, Henry Schultz, John Hicks, Oskar Lange, Maurice Allais, Paul A. Samuelson and so on, developed the Paretian system of the general equilibrium. ‘The history irony’ makes that the basis for an approach of the Keynesian interventionist model should be elaborated within a model of the free competition presented in a formal system of general equilibrium [7]. Samuelson, sustained by a Paretian *background*, carried out a ‘synthesis’ between the Keynesian fundament of the macroeconomics and the neo-classical fundament of the microeconomics or of the ‘equilibrium’. He argued that “economy is a self-regulating free market system over the long term, but is subject to market failures requiring corrective action over the cycle” [7]. In this model of ‘synthesis’, ‘the proper use of monetary and fiscal policy’, in the context of an excess of supply in both goods and labour markets, represents the instrument able to ‘jump start’ the lingering demand for goods and pull the economy out of unemployment. The mode of thinking that ‘the synthesis’ imposed was put in terms of tâtonnement with prices adjusting to excess of supply or demand. By studying the microeconomic fundaments of the behavioural components, the Neoparetians, Modigliani in principal, succeeded to develop the four great chapters of the Keynesian system: the consumption function, the investment function, the demand and the supply of money and the mechanisms determining prices and wages. All these, together with the results of *the growth theory*, have been combined in macro-econometric models. What is important to stress in the context of the current anti-crisis policies is the fact that the main concern of Samuelson’s generation was to formulate the principles of the active countercyclical policy intended to keep a small unemployment in economy under a too slow adjustment of prices and wages. Especially Modigliani’s model has been considered relevant for reflecting the multiple channels through which shocks and policy could affect the economy, to indicate the effects of structural changes in financial markets and to derive optimal policy. Obviously, these principles of the countercyclical policy have been thought as complementary with the ground rules for cyclical fiscal policy and with the microeconomic principles of fiscal policy, useful to choose the mix of fiscal measures in the context of maintaining the constant rhythm of economic growth.

The ‘strange alliance between Keynesian and neoclassical theory’ which Joseph Stiglitz has termed the “neo-classical synthesis” [8] and which he has considered under the aspect of the epistemological basis rather ‘a dogma, an article of faith’ than a ‘deductive position’ formulated in a general theory which explained unemployment and from which it followed that the elimination of unemployment would lead to efficiency of economic allocation, dominated for 20 years the Western debate. The greatest challenges for the ’70 policies that followed the ‘synthesis’ model were to maintain steady growth and low

inflation, to provide adjusting wages and prices to their appropriate levels, to solve the macroeconomic equilibrium under non-market clearing. The 'new neo-classical synthesis' at the mid '90, also called the 'new Keynesian synthesis', aims not only at optimizing the behaviour of the corporations, consumers and workers, but also at introducing explicitly the distortions or nominal rigidities: price and wage behaviour is derived from optimizing behaviour by price and wage setters. Unlike the models of the '50-'70, the 'new synthesis' model of the '90 is closer to the microeconomic explanation, so that the utility maximization by consumers and profit maximization by firms is derived from assumptions about underlying technological parameters and the dynamics of utility. Obviously, this model preserves a major role for the monetary and fiscal policy and allows a closer analysis of the policy implications on wealth.

3. American crisis policy between neo-classicism and neo-classical synthesis

Hayek's economic neo-classical theory has prominently inspired for decades the U.S. economic policy and maintained an intense debate with the representatives of the neo-classical synthesis theory on U.S. economy dysfunctions, such as unemployment, inflation, economic stagnation, economic imbalance, implications of structural deficits.

Serious financial crisis of the U.S., propagated worldwide through the liberalized capital and financial markets, but especially in Western Europe, was followed by a government spending that sum by far the largest nominal deficit ever incurred by a nation and, as a consequence, a substantial decrease in the population income. The crisis and the controversial solution of 'bailout' and of American banks recapitalization through the *visible hand* of the state express not only the concern of political institutions and theorists for the macroeconomic stabilization and social utility, but reset the problem of the current value of neo-classical liberal paradigm. The government intervention was accompanied by the thesis that free market model, i.e. that which fully marked the U.S economic and political development and significantly supported the dismantling of socialist system, was irreparably eroded.

3.1. The American crisis and the visible hand of the state

American administration's decision to allocate 500 billion \$ or more toward the ailing banks was widely considered as a violation of the rules of market economy. The decision had vexed the more so as it occurred at the end of an administration which pursued a liberal economic policy in classical tradition, which took over the 'philosophy of deregulation', mainly the abandonment of the provisions that limited commercial bank securities activities and affiliations between commercial banks and securities firms; took over the 'opened monetary policy', not even using the regulatory tools of the Federal Reserve; lowered the taxes for the biggest contributors; expanded the consumer credit that has allowed middle class and poor Americans to live beyond their means by

increasing their debt. And, perhaps most seriously, through the measures of deregulation and by promoting a maximal model in the financial sector, allowed to proliferate to an overwhelming extent the speculation with virtual money, the 'toxic bubble' with serious and lasting implications for the global capital market.

Although the diagnosis of the U. S. banking system and economy realized by theorists from various liberal orientations indicate diseases with varying degrees of gravity, and although their solutions are different, they massively rejected the government involvement in the saving of a part of banking sector and, altogether, rejected the formal justification that the 'bailout' is the only measure capable of engendering the economic recovery.

If we analyse the government intervention in terms of the neo-classical non-interventionist logic, expressly in those of Hayekian principle (cited above) of accepting the state intervention (as an exception) just in order to avoid major depressions, the actual 'bailout' proves to be an invalid or an incorrect decision since: affects in a discriminatory way the individuals who did not contribute to the causes the crisis, does not cover an antitrust policy, concerns a destination for private investors and not for general welfare, serves to achieve certain immediate benefits of private banking segments (even if they are to avoid bankruptcy).

The liberals themselves, those representing the Hayekian, neo-classical lineage, argued that the best solution would have been to let the market to solve the problem and to respect the canonical principle of the market automatic stabilizers. For the neo-classical liberals, the austerity could be made by leaving to bankrupt those who invested poorly and who lost. The state intervention appears as not being in this case, as in neither another case, a viable project because it could be followed by a capital market increased control and by a change in the level of capitalization tax. The prevalent lending standards in the foreseeable future could become more stringent and new patterns loan could be, also, subject to stringent and detailed regulations. This would entail a greater distortion of an important automatic stabilizer and this can be particularly damaging in the current conditions of globalization because could contribute to a global market plunge.

The main concern of the neo-classicists is to strengthen the argument that the crisis is prolonged in part because of the 'unusual nature of this financial downward spiral' and that the recovery tools used in these circumstances by the U.S. government and by some European governments have reached at a level that 'contradicts the principles of the modern capitalism'. The argument that only the free circulation of capital and the free market ensure the competitive, emulative and creative environment that can lead to increased productivity, essentially the constant argument of 'non-regulation' and of 'de-regulation', is meant to diminish the impact of the bitter conclusions, as that uttered by President Sarkozy in early 2009: '*le laissez-faire, c'est fini*', or as that summarized in 1991 by Joseph Stiglitz and that represents the position of those who theorized the 'classes of market failure': "Adam Smith's invisible hand may be invisible because, like the Emperor's new clothes, it simply isn't there;

or if it is there, it is too palsied to be relied upon" [8, p. 5]. The neo-classicists crucial argument, one by that largely depends the changing of perception on the 'pathetic situation of American model of free market capitalism', is that of the 'failure of regulation': the crisis as a result of 'the greatest regulatory failure in the modern history', a failure that extends from the banking supervision to the supervision of lending rates, and which will worsen the Western financial institutions for years. As such, it can be remarked that the American neo-classical liberals' argument keeps, almost without shades even with respect to the tools of financial and economic recovery in post-crisis, the foundation of Hayekian argument, even under the unprecedented pressure due to the 'huge deficit', as has been said often in recent years, by far the largest nominal deficit ever incurred by a nation.

3.2. Another 'balance of power'

The liberals belonging to different currents of the 'neo-classical synthesis' considered that the American administration's decision is a questionable solution because it does not solve the problems of the 'real economy' or of the state of 'wrenching transition' within which the economy remained for decades.

Liberals from a more pronounced Keynesian orientation, such as Joseph Stiglitz, classified it as an error which allowed huge transfers of wealth toward the financial markets. In one of his already famous formulations, that accurately and maliciously summarizes the implications of governmental decision, Stiglitz affirmed: "What the Obama administration is doing is far worse than nationalization: it is *ersatz* capitalism, the privatizing of gains and the socializing of losses. It is a 'partnership' in which one partner robs the other" [9].

As such, the crisis and 'the bailout' evaluation constitute to the exponents of the neo-classical synthesis and to those, more radical, of neo-keynesian orientation, as well as to a broader category of financial experts and economists – not a problem of legitimating or delegitimizing a theoretical model – but a issue which impose the evaluation of the efficiency and desirability of the current direction of free markets. To them, the current context of the strong imperfections of capital markets and of unfettered free market evolution requires a deeper debate on the desirable direction of evolution of the contemporary globalized capitalism and human capital structure. Their main concerns are the nature of 'the intervention' in markets that could shape a development with beneficial results and the nature of the most suitable configuration of power in the sphere of economic decision, so that the result of 'the intervention' to cover not immediate benefits, but 'the recovery' of the economy, namely the structural changes in the real economy.

The problem of the nature of state intervention involves as most important theses: the *regulation* of market rules and of market management mechanisms and the *control* of the compliance with the regulation, i.e. the control of competitive market behaviour. The most important requirement in this regard is, in my view, the intention to transfer a part of the regulatory task on those who

are directly concerned and on those who suffer the effects of ‘market failure’. What takes in this respect a particular focus is the effort to appropriate the regulatory framework in order to prevent the systemic risk in economy, to align properly the private costs, benefits and incentives, to curb the ‘abuses and widespread corruption’, especially in the banking sector, to prevent ‘harmful behaviour’ and to reduce the existence of the key externalities. What seems to me remarkable in this respect are the efforts to use the research on systemic effects of correlated behaviour on the part of individual institutions and of correlated behaviour of a large number of institutions in order to increase the opportunities (regulation) of supervision of the various parties involved in the big business corporations (as individual institutions): owners, managers, shareholders, customers, etc. and to protect the individual investor from abusive practices.

The problem of a new and efficient balance of power involves the problem of widening the economic decision-making framework: market or corporations (the corporate government), government and civil society, including here broader institutional infrastructure. The widening of the balance of decision power is to expand the sphere of alternatives under consideration and, by default, to ensure a large representation of the stakeholders. What seems particularly important to add in this regard is that an enlarged balance in economic decision increases the opportunities to correct the important imperfections and asymmetries of information, what Stiglitz called the deficit of information, and thus to increase the possibilities of assessment the risk and to diminish the sphere of economic uncertainty at institutional and individual level. This new configuration of the balance of decision power is, also, considered important for the prevention of the lack of institutional transparency, the crisis of confidence at inter-institutional level, the toxic *aggregates* of disparate and limited information and, also, the ‘manipulation’ of information and of individual or collective expectations.

4. Conclusions

The solutions outlined in the American liberal debate *mainstream* of the recent years, especially those with a large impact from the sphere of what I considered to be liberal neo-classical synthesis, bring some nuances which reflect a high degree of adequacy to the real situation of the economy and to the American dominant mentality.

I would notice first the argument of the necessity to exit in the near time from the simplifying logic of the rigid economic models and to adopt the behavioural logic of various economic and social spheres and under-spheres.

I also think that it should be remarked the propensity towards a ‘good’, realistic, non-ideological, evaluation of the private and public economic mechanisms that could increase the social utility, to ensure the efficiency by eliminating unethical benefits and by preventing the abusive practices and corruptive ‘hidden leverages’.

Particularly important seems to me the requirement to specialize the tools used to support the economy recovery and growth by focusing 'the intervention' on areas where the market failure is most pronounced.

Finally, I would emphasize the careful effort to circumscribe as essential functions of the government to manage the risk and to allocate well the capital and as goal of equal importance to avoid, in theoretical and practical perspective, the socialism in all its variants, including 'the socialism in American style'.

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