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# Preface

Giulio Ercolessi, European Liberal Forum

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Everyday politics is getting more and more short-sighted in our countries by the day. National political establishments are more and more absorbed in the task of winning decimal fractions of a point in opinion polls in their daily fight for survival in a more and more hostile and “liquid” social environment, infested by demagoguery and quackery. And, more and more, the first quality required of a would-be politician appears to be that of not caring too much about his/her reputation, as personal negative campaigning appears to have become one of the most usual tools of electioneering. The relative decline of Western liberal democracies is also a result of a consistent decline in the quality of political debate and political personnel.

Countering this trend, reconstructing the conditions for more far-sighted and reliable political establishments should be the duty of all those concerned with the lot of our democracies, with the place of Europe in the global world and with the very future of our civilization. We try to play our part and to fulfil our duty in this effort. The European Liberal Forum, the organisation reuniting European think-tanks and foundations connected to the ALDE party, has the task of promoting liberalism and liberal ideas and policies, hopefully to be implemented in our political systems. We contribute to the debate on European public policy issues and the process of European integration, through education, training, research and the promotion of active citizenship within the European Union, particularly with regard to young Europeans. And the schools of liberalism we promote with the contribution of our member organisations are of paramount importance in our effort to help the renewal of ever new generations of young liberals.

The 2013 ELF Southern European School of Liberalism held in Santiago de Compostela on September 27th and 28th was a very successful example of this effort. A very committed group of students gathered for two days of intensive discussions, lectures and debates, revealing the existence of a real school of thought in the local University, anything but limited to our two days

event, that can count on a committed and enthusiast group of distinguished academics. Speakers and lecturers from six European countries contributed to the success of the School, that was realised thanks to our Galician member organisation Galidem, with the contribution of Movimento Liberal Social, Forum for Greece and the Friedrich Naumann Stiftung.

Our friends from Galidem hosted us in the local Casa de Europa, in the middle of a luxuriant park, and gave us the opportunity to discover the capital city of Galicia, that many of us only knew as the final destination of traditional religious pilgrimages, as the enchanting and captivating medieval and modern city it is, with its intriguing past, its eminent historical heritage, its lively university life, and also its delicious cuisine. And to discover a European region struggling to find its peculiar place and identity in a democratic Europe.

# On Adam Smith

Eduardo L. Giménez, University of Vigo and GALIDEM

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This essay presents a brief sketch of Adam Smith's life and ideas. Three questions are answered in the text: who was Adam Smith?; what were the main academic debates of the 17<sup>th</sup> and 18<sup>th</sup> centuries that made Adam Smith's contributions relevant?; and what were his very contributions and answers to those debates?.

## Who was Adam Smith?

The popular view on Adam Smith is divided among those who consider him as the champion of the individual and market freedom and a sound supporter of free trade and *laissez faire* policies, and those who blame him as the philosopher that sanctified any outrage against social equality and humankind solidarity in the name of the free trade and individual freedom. But ,... who was Adam Smith?

Adam Smith was a Scottish philosopher and an archetype of university professor: absent-minded, and usually absorbed in his thoughts. He was born in Kilkardy, Scotland, in 1723 and all his academic life was around the University of Glasgow where he was student, eventually became professor and, when old, its Rector. He started his university studies in Glasgow at the age of 14, which was the normal age at this time. In Glasgow he was student of Francis Hutcheson, a relevant empiricist philosopher. From 1740 to 1746 he moved to the University of Oxford. But, at that time Oxford was not the present well-known institution of academic excellence. Professors in Oxford did not even pretend of teaching classes, so Smith spent his time reading books guided on his own interests. After leaving Oxford, he got back to Scotland at the University of Edinburgh, where he met David Hume, another empiricist philosopher. In 1750 he moved to Glasgow to become Professor of Logic at the, and in 1752 he also became Professor of Moral Philosophy at the University of Glasgow.

In 1759 he published *A Theory of Moral Sentiments*, a book on ethics that became a best-seller of the time, even overseas. In Germany, "Adam Smith's problem" (*Das Adam Smith Problem*) was a topic of debate. Smith became

a popular person. People stopped him at the street to wonder him about the content of the book and ask his opinion.

His fame reached to Charles Townshend, a person interested in philosophy and politics who eventually became the British Minister of Finance. Townshend got married in 1754 with the Duchess of Dalkeith, widow of the Duke of Buccleuch, and turned out to find a tutor to his son-in-law in a journey through continental Europe. Townsend thought that Smith would be the suitable companion for the young Duke, and offered Smith 500 pounds, plus the expenses of the journey and a life-time pension of 500 pounds to accompany the Duke. This was a proposal difficult to reject, since Smith earned 160 pounds a year as a professor in Glasgow.

In 1764 Smith gives up the university, and struck towards France with the young Duke. In France he visited Voltaire and met François Quesnay, a physician in the court of Louis XV and the leader of a group self-called “les économiques” (*the economists*). The journey was suddenly interrupted on 1766, when a younger brother of the Duke died, and Smith and his disciple had to return the British Islands. Smith return to Scotland, to live with his mother, and will spend the following ten years working in a book that has started in France.

On 1776 Smith published **The Wealth of Nations**, a monumental treaty of economics, politics and public finance while living in London. His popularity increased so much that, on 1778 he was appointed Commissioner of Customs for Edinburg, which being a supporter of free trade it brings with some contradiction, but this allowed him to return to Scotland, live with his mother and, after her dead, with a cousin.

Smith died on 1790 after requiring to burn 16 volumes of non-published works, probably on Jurisprudence.

**What were the main academic debates of the 17<sup>th</sup> and 18<sup>th</sup> centuries that made Adam Smith’s contributions relevant?**

The main social debates of the 17<sup>th</sup> and 18<sup>th</sup> centuries were centered around the following question: “who humans can live in society without someone

to rule them out”. Some authors, like Niccolò Machiavelli and Thomas Hobbes,<sup>1</sup> asserted that without an authority life in society was impossible. Thus, an absolutist State is need for human society survival and the social order. This idea entails that (i) authority, based on the monopoly of power, is justified without any further legitimacy; and, (ii) authority, based on violence, is justified without as a way to ensure obedience. The alternative faced by society is the social dismemberment and the law of the jungle.

A different answer was provided from the British and Scottish empiricists, like Francis Hutcheson (1694-1746) e David Hume (1711-1776). By assuming that there exists a “natural benevolence” —or *moral sentiments*— among humans, these authors supported the thesis that live in society is possible thanks that people is concern with other human beings. Not being selfish by nature, Individuals tend spontaneously to associate themselves. This is a “natural order,” so it is not needed any external intervention in society by the State.

However, There were two problems in this argument: i) it was not clear —in fact, it was an assumption- why human beings are benevolent, and ii) it was not clear why selfish interest promotes the social wellbeing.

### **What were Adam Smith’s contributions and answers to those debates?**

Adam Smith appears in scene tackling both problems in his two main contributions: *A Theory of Moral Sentiments*, published in 1759, and *The Wealth of Nations*, published in 1776.

The *Theory of Moral Sentiments* aims to explain why human beings are benevolent. The reason is humans are endowed by a sympathetic feature that allows them to understand other people’s own circumstances and feelings. That is, different from other animal species, humans display the ability to “put in other people shoes”, and benevolence stems from this ability. From the first paragraph of the book:

“How selfish soever man may be supposed, there are evidently some principles in his nature, which interest him in the fortune of others,

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<sup>1</sup> For instance, these ideas can be found in Machiavelli (1532)’s *The Prince* or Hobbes (1651)’s *The Leviathan*.

and render their happiness necessary to him, though he derives nothing from it except the pleasure of seeing it.” *Smith (1759, Part I, Chap.I, Sec. I)*

Yet, sometimes sympathy is not enough, since we cannot take at anytime an unbiased view of our personal actions, so some *moral rules* are required, i.e. a generalization of actions that are commonly accepted or not. Finally, in those cases that moral rules are not sufficient, it is required *positive laws*.

Once it was clear that there exists a benevolence that allows individuals to live together in society, Smith faced the challenge to answer the second issue: why selfish interest promotes social wellbeing. In this quest, he will spend ten years writing *An Inquiry into the Nature and Causes of the Wealth of Nations*, a five-part book with about 1282 pages. This is an academic book, wrote with the style of the time, with several digressions that apart the reader from the main argument. The book’s content has been nicely described by Alois Joseph Schumpeter:

“There are five Books. The fifth and longest—taking 28.6% of total space—is a nearly self-contained treatise on Public Finance and was to become and to remain the basis of all the nineteenth-century treatises on the subject until, mainly in Germany, the ‘social’ viewpoint—taxation as an instrument of reform—asserted itself. The length of the book is due to the masses of material it contains: its treatment of public expenditure, revenue, and debts is *primarily* historical. [...] The fourth Book, nearly as long, contains the famous indictment of the ‘commercial or mercantile system’—the patronizingly benevolent criticism of physiocrat doctrine in the ninth and last chapter does not call for comment—from the ashes of which rises, phoenix-like, Smith’s own political system. Again: the reader beholds masses of facts painstakingly marshalled, very little of very simple theory. [...]“Book III, which occupies less than 4.5% of total space, may be described as a prelude to Book IV, filling in general considerations of a primarily historical nature on the ‘natural progress of opulence,’ the rise and the commerce of towns as distorted—hampered or propelled—by the policies sponsored by various interests. This third Book did not attract the attention it seems to merit. In its somewhat dry and uninspired wisdom, it might have made an excellent starting point of

a historical sociology of economic life that was never written. Books I and II—respectively about 25% and 14% of the whole—also overflowing with illustrative fact, present the essentials of A.Smith’s analytic schema. They can indeed be perused by themselves. But the reader who, more interested in theory than in ‘application,’ refuses to go beyond them will miss much that is indispensable for a full understanding of the theory itself.” Schumpeter (1954, Parte II, Chap.3.4.(e))

The book aims to answer two issues:

- 1) How is it possible that a community, with its individuals each seeking their own interest, the results is not a chaos and it is not torn up? That is, how does a society accomplish to develop all the task necessary for survival without a central authority planning?; and,
- 2) What is the future of society?

Smith answers the first question posing the market laws. The first law is the *selfish interest* driven humans to undertake those tasks that are valued by the society. Since there are a human tendency towards commerce and exchange, a feature that does not exists in any other living species, each human might specialized in any particular task within society. As Smith states,

“It is not from the benevolence of the butcher the brewer, or the baker that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity, but to their self-love, and never talk to them of our own necessities, but of their advantages.” *Smith (1776 Bk.I Chap.II)*

This self-interest, however, may bring with excesses, so a second law is needed: *competition*. The existence of competition mitigates the self-interest behavior of human beings in society.

The result of the interaction of these laws is the “social harmony”, characterized by Smith with the *invisible hand*:

“[Each individual] by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain;

and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. [...] By pursuing his own interest, he frequently promotes that of the society more effectually than when he really intends to promote it.” *Smith (1776 Bk.VI Chap.II)*

Several comments are in order. First, the social harmony as a result from self-interest behavior is an unexpected result. The compulsory requirement of competition is crucial to achieve this result. Second, Adam Smith put self-interest at the center of the debate. Thus, Smith prevents us from those people, usually people in authority, who ask for supporting policies “in the public interest”. Cynically, Smith comments

“I have never known much good done by those who affected to trade for the public good.” *Smith (1776 Bk.VI Chap.II)*

Third, since we cannot trust in those people claiming for the public interest, should we trust in business people? Not at all, indicates Smith:

“People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices.” *Smith (1776 Bk.I Chap.X)*

Business people have their own self-interest, which does not need to coincide with the interest of the society. Then, if we cannot trust on the people in authority, nor in business people, whom can we trust on to promote social wellbeing? Smith displays a clear message: on the market laws. By guaranteeing that all members in a society can take free (selfish) decisions, and encouraging competition among (selfish) individuals, social welfare will be promoted.

The second issue addressed in the *Wealth of Nations* is “what is the future of society?” What can be expected from an economic organization that any member of the society is guided by his self-interest, and competition controls individual selfish excesses? Smith asserts clearly: towards a continuous economic growth that benefits all members of the society. He states,



“No society can surely be flourishing and happy, of which the far greater part of the members are poor and miserable.” *Smith (1776 Bk.I Chap.VIII)*

And which are the keys for this never ending economic growth? They are the division of labor and the capital accumulation. This is the virtuous circle: more division of labor expands the size of the markets, and this brings with an increase of labor productivity that encourage further division of labor. As Smith asserts at the very beginning of the book:

“The Greatest improvements in the productive powers of labour, and the greater part of the skill, dexterity, and judgement, with which it is anywhere directed, or applied, seem to have been the effects of the division of labour.” *Smith (1776 Bk.I Chap.I)*

So the division of labor triggers the economic growth, since it encourages exchange, which requires further division of labor in society and further economic growth.

### **Some final comments**

To conclude, Smith explained the working of the human organization system grounded on the individual freedom. He showed that this system can work better than other alternative organization systems, and he envisaged that this system of social organization will increase the welfare of all members of the society.

It is worth wondering whether that system detailed described and explained by Adam Smith really works. Does the society moves towards a greater wellbeing of all its members? At the light of the impressive improvement of the economies in the last two centuries, it is hard to avoid showing amaze about Adam Smith predictions.

Concerning Economics, the new science he found, the academic relevance of Adam Smith contributions on the economics research developments in understanding the system described by Adam Smith has being clearly summarized by Ronald Coase in his Nobel Prize Lecture:

“During the two centuries since the publication of *The Wealth of Nations* the main activity of economists, it seems to me, has been to fill the gaps in Adam Smith’s system, to correct his errors and to make his analysis vastly more exact.” Coase (1991)

If we realize that Coase is talking about a book written in 1776, more than two hundred years ago, this is a very significant statement.

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# Liberalism and definitions

Giulio Ercolessi, European Liberal Forum

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*«Every man has a property in his own person».*

If it were not for the total lack of gender neutrality in this sentence (but until a few decades ago nobody would care), one could think that we are dealing here with such biopolitical issues as abortion, gay rights or euthanasia.

These issues were far away from the interests of the man who first wrote this sentence, a man of the 17th century, who, as all the people of his time, would likely not be in tune with today's liberal positions on these issues. It was John Locke, in his Second treatise of government (1690), that probably set the birth of proto-liberalism as a political theory. What is telling is how this principle can still produce ever more profound effects on the ever changing problems of our time: the «property in his own person», that was first, at least de facto, meant for the male, adult, white, mostly well-to-do, protestant, heterosexual, able-bodied, native citizen, is in fact now the more and more obvious domain of universal rights.

Property itself was given by Locke the very political role of a defence against the king's absolute power. And that political – and not merely economic – role has proved to be as much important in the 20th century. The experience of communism has confirmed that a free society can only be a polyarchic society, in which the holder of political power does not also hold most of the economic power and power over the media. And the self-determination of what Locke called “every man” – i.e. every individual – is today, too, the centre of liberal concern.

To an extent, liberalism has so deeply shaped, more than any other ideology, the very fabric of the Western civilization in the contemporary age, that nowadays liberalism and Europe, liberalism and the Western political civilization, almost identify.

Hence, defining liberalism is more difficult than before.

Is a definition necessary?

I think it is in order to have a critical control on one's own language, but we cannot expect it to be a prescriptive definition: it can only be a proposal, not the prescription of a particular use.

And I think a definition is also necessary in order to avoid confusion. Otherwise, if we accepted to define as liberal whomsoever adopted the label, we should include in our family, for example, the antisemitic and anti-Western Russian party of Vladimir Zhirinovsky, the so-called "Russian liberal-democratic party". (And, to the shame of us Italian liberals, Berlusconi too, who sometimes describes himself as liberal – and his non-liberal opponents have let him do so for twenty years).

There are other difficulties.

1. Political definitions also carry very subjective, non-rational understandings. Think, for example, of the different resonance and understanding that the words that define the principal political ideologies have, depending on the personal opinions of different individuals. Norberto Bobbio quoted the example of the word "communism", synonymous with deprivation of all individual liberties and of generalised misery for most of us, and synonymous for earthly paradise for millions of committed communists decades ago.

National traditions also may bring about misunderstandings. European integration and globalisation itself would obviously require a joint vocabulary, but all political speech is rooted in different linguistic and historical traditions.

One year ago, I was at an ELF seminar in Prague. The audience was mostly composed of Central and Eastern Europeans from former communist countries; three of the speakers in one of the panels were Western Europeans – a Frenchman, a German and myself. When we used the word "federalism", we were naturally thinking of the US, of Switzerland, of the success story of the Federal Republic of Germany; but we realized that for the audience that word was linked to totally different historical experiences: the Soviet Union, former Yugoslavia, communist Czechoslovakia.

And another example of such misunderstandings is typical of this part of Europe: here the word “nationalism” bears today a very peculiar meaning, if compared to the rest of Western Europe. It is not a more moderate form of “chauvinism” or “jingoism”, but is related to the request of self-determination of parts of the Spanish state, traditionally deprived of their democratic rights by a centralistic and for centuries authoritarian power. Yet, if you asked an average learned and cultivated European what can be described as “nationalist” in the contemporary history of Spain, this person would quite obviously think of the Franco regime, rather than of any democratic movement.

2. The thing liberalism (unlike, for example, mainstream socialism) was born before its theory. The theory was formulated after a number of demands for political reform, economic reform, religious reform, social reform, produced a melting pot of new ideas and institutions during the “Great Rebellion” of XVII century England. The new form of government finally arisen from the “Glorious Revolution” towards the end of the century, despite all its contradictions, was the only relevant and real alternative to the opposite model of that time, the French “solar monarchy”, that had been a reference for all the major European countries.

3. Thing and theory were both born before the name was born. Perhaps surprisingly, the word “liberal”, as a way to qualify a political stance, was born in Spain, at the time of the Cortes de Cádiz, in 1810-12, when a parliamentary assembly was drafting the first Spanish constitution, protected by a British fleet; and when, very tellingly, a “servile party” – “partido servil” – was opposed to a “partido liberal”.

4. Liberalism (unlike socialism – at least at its beginning) does not coincide with one single philosophy: it has always been a philosophically polygamist (libertine in the trivial sense of the word), merely political theory, that married with empiricism, the Enlightenment, Kant’s criticism, idealism, positivism, instrumentalism, and with the most diverse “analytic and “continental” contemporary philosophies; and also with libertinism, rationalism, atheism, some very important Protestant theological currents since its birth – and even with some minority brands of Catholicism);

5. Liberalism largely coincides with a civilization, despite countless contradictions, and yet has a universalistic vocation. It is not the common fruit of the Western civilization as a whole, even though it grew on some typically Western cultural depositories.

Some of these depositories deserve to be mentioned. A) The Greek classical philosophical tradition and the political thought and “constitutionalism” of the Antiquity, as reassessed, re-appropriated by scholars and revitalized since the Renaissance. B) The heritage of Roman Law and Common Law: i.e. the rule of law, gradually led by liberal constitutionalism to cover even the production of new laws under the judicial review of ordinary or constitutional courts (this connection between liberalism and legal traditions, practices and theories is often underestimated by historians, political philosophers, and even political scientists, perhaps because outside their academic focus). C) Conflict among political and religious powers, that forced Western Europeans, throughout their history, to take side in political, religious and politico-religious struggles. Conflict entails differentiations. At a time when these differentiations were believed to involve individual salvation or perdition, the personal choice of the Western individual, whose loyalty was contended by Popes and Emperors, became crucial. D) Hence, also, arose the new Western idea of the individual, especially born in the Ancient Low Countries and in Northern and Central Italy in the late Middle Ages and well visible in the material culture and in the figurative arts and literature of both regions. E) The central role and the incoercibility of individual conscience, born with Christianity and empowered by the rift caused by the Reformation. F) The disenchantment of the medieval world – also an unintentionally joint result of both libertinism and the Reformation – (that forced to a smaller extent also the Catholic church of the Counterreformation to rationalise its doctrine and impose a sharp resizing to spontaneous and superstitious popular faith, at least in those areas where the Protestant challenge was most dangerous) and the birth of modern science. G) Tolerance, as a lesson taught to us by religious wars.

But liberalism – and tolerance as a value, and not as the consequence of the impotence of power to crush dissent – is basically a Dutch, English, American and French product, that proved capable in the last three centuries of being introduced, transplanted, copied, adapted, sometimes even improved, in very

different cultural and political environments. This historical expansion of liberalism beyond its original boundaries can be seen today as a promising precedent for regions where new totalitarian or fundamentalist threats seem to be on the rise.

This process is particularly evident in the history of the Italian Risorgimento, when both moderate and radical liberals mostly shared the idea that the civic backwardness of 19th century Italy was largely a consequence of the political predominance of the Roman Church: Italian patriotism at the time was largely nourished by the *leyenda negra* of Counterreformation Spain, that had ruled over a large part of Italy, especially in the 17th century, and by the positive opposite examples of British parliamentarianism, of the French secularist principles of '89, sometimes of Swiss federalism and – in the eyes of the most far-sighted – of the new-born and at the time far-off American democracy. But the British and later the American examples had been an extremely important reference even for French liberal-minded thinkers before and after the Revolution: just think of Montesquieu, of Voltaire's *Lettres anglaises*, of Constant, of Guizot and of Tocqueville. And in Spain, too, the British example played a major role (that was recently explored by Manuel Moreno Alonso in his book *La forja del liberalismo en España*).

In any case, liberalism is today almost synonymous with our political civilization, as opposed to others in the world. So much so, that almost no political force in our countries can survive today on a totally anti-liberal platform: at least, they have to pay lip service to some of our basic principles, even when their policies openly contradict them.

Hence, every definition of liberalism can only be what is called in social sciences an ideal type, i.e. an abstract intellectual construction, to which we can compare what exists in history and in societies, in order to be able to appreciate what is most liberal, what is least liberal, and, of course, what is most illiberal or anti-liberal.

We should therefore try to propose a definition. And this is my proposal: liberalism is a theory of the ends and a theory of the means: maximising individual freedom and self-determination, mainly through the instrument of the legal limitation of powers.

If we accept this definition, Liberalism is a perpetual work in progress.

First because, from the very beginning, it was connected with an ever more comprehensive and ever more consistent fight against authoritarian traditions and beliefs, and because of the natural inclination of every political, traditional, bureaucratic, social and economic power to confront and overrun its imposed limits.

Second, and as a consequence of that, because liberalism was never restricted to the limitation of political power: liberalism always aimed at imposing limits also on the ever possible tyranny of a democratic majority; on the abuse of economic power, through anti-trust legislation protecting free market and competition, and through a legal protection of workers from abuse, and defending consumers from fraud and adulteration; on the abuse of power even inside communities and families, advocating equal rights for women (since Locke's time, and his reduction of marriage basically to its merely legal framework) and protecting children from abuse and indoctrination.

Third, finally, because the economic means necessary to fulfil the goal of enhancing individual self-determination do change with the different challenges we have to face.

The brand of liberalism that was mostly recognized as such, after the end of World War II and until a couple of decades ago, the one that largely influenced most of the political spectrum in most Western democracies throughout the Cold War, not only required the guarantee and the implementation of the individual liberties that were trampled by communist and other totalitarian regimes, but also included a push towards an ever greater inclusion and empowerment of each individual in the actual exercise of his/her citizenship and liberal rights. That had originally been a typically liberal idea, born in the Victorian age in the same country, England, that had given birth to liberalism two centuries before. The idea was that public powers should actually put individuals in the condition of making real use of their liberal liberties. The Welfare state itself was first conceived and designed by liberals as Keynes and Beveridge, who were card-carrying members of the British Liberal Party, not by socialists or social democrats. And for years, not only communists,



but also a lot of mainstream socialists, had been accusing the wicked liberal economist John Maynard Keynes, for having rescued capitalism from its certain downfall, thus preventing the rise of a happy global socialist society.

It is a fact that almost all national political classes and state bureaucracies had long been squandering since, for their own advantage, much of the benefits they were supposed to make available to a majority of citizens.

A healthy liberal mistrust towards ever possible abuses committed by the holders of political power, and a less naive and more sober notion of democracy, should have suggested that “public” is by no means equivalent per se to “caring for public interest”. Moreover, the demographical and technological transformations of the last three decades nowadays impose deep reforms of the welfare systems in order to assure their financial sustainability. But, as it frequently happens in politics – and in social sciences – an overreaction took place since the late Seventies on both sides of the Atlantic, in the end substituting the liberal consensus that had been shared in most Western countries by the moderate left and the moderate right alike while we were containing and opposing Soviet communism, with what was – usually derogatively – called Washington consensus in the Nineties, that was more inclined to accept growing inequalities, and, especially, also decreasing equality in opportunities.

In some countries, namely in France, and elsewhere to a smaller extent, that essentially merely economic and very often caricaturized doctrine became synonymous with liberalism, to the point that the previous meaning – liberalism as synonymous for political freedom and freedom of conscience in the first place – has long been labelled as *vieilli* (outdated) by French dictionaries: so that even the Chilean Pinochet regime of the Seventies and Eighties can often be defined as *libéral* in the present French political debate.

Anyway, this new basically economic theory, not the comprehensive liberal political views that embodied the Western opposition to communism from the Forties more or less to the late Seventies, was the ideology upon which the globalised world was restructured after the fall of communism.

At the beginning it was a success, because of the enormous growth caused by

the more open societies in general and by the opening of totally new markets; and perhaps most of all by the simultaneous huge technological revolution; and, later, due to the practice of easy indebtedness. The subsequent global economic crisis still ongoing, and the consequent discredit that the most radical interpretations of the so called Washington consensus are undergoing, should not be allowed to drag liberalism into disrepute together with them.

A liberal society cannot survive without a free market economy, not only because private enterprise is an expression of individual freedom, and because the economic development, that it alone can make possible, is necessary in order to achieve a satisfactory degree of human development, but also because a liberal society must be polyarchic: political power, economic power and power over the media power should be as much separate as possible. Strong counter-powers to the political power are vital for a liberal society. And free trade is also the best guarantee for peace in a global world: thanks to globalisation, perhaps for the first time in history, the rise of a new global superpower like China is not leading to a war among the major powers, that today would be the global nuclear war that had been threatening all of us for forty years.

It is however not only a long overdue tribute to historical accuracy, but also a statement of fact, that different views on the extent of legitimate and suitable state intervention, and different ideas on the desirable level of equality of opportunities, have always been present in the history of contemporary liberalism. We should remember this while trying to find the way out of the present global crisis.

Rather than focusing on the traditional (and in my humble opinion largely arguable) distinction between the so-called “classical” and “social” brands of liberalism, I would express my personal preference for a third possible variety of liberalism, that has been recently identified and categorised as a distinct one in a very interesting lecture given by our ELF friend Patrick van Schie, *Bildungsliberalismus* (German translation for the original Dutch *ontplooiingsliberalisme*, difficult to translate into English or other languages): a current originating from the thought of Wilhelm von Humboldt and John Stuart Mill, for which the main role of public institutions is that of empowering

individuals to display all their personal potential, especially in the field of education, and of enabling them to free themselves from the straight-jacket of community and group coercion.

Both more Keynesians and more free-trader liberals or, if you wish, classical liberals, “social” liberals, and Bildungliberalen alike should find a common ground on the overriding importance they all attach to the freedom and free development of the personality of each single individual: personal freedom, freedom of speech, the right to a due process of law, protection from discrimination on the ground of ascribed identities (ethnicity, physical characters, age, disability, sex, gender, sexual orientation) or on the ground of political, cultural and religious choices; and equal social dignity.

Yes, the rule of law, human rights, liberal constitutional democracy are nowadays the joint heritage of all the democratic political families in Europe. But all these values and principles are the outcome of liberal initiative, liberal imprinting, liberal intellectual leadership in the past. We should be their most demanding interpreters today.

The ever impending risk of the “tyranny of the majority” is nowadays most notably visible in the debate concerning the rising and aggressive claims of religious fundamentalists (both Islamic and Christian), the new bioethical issues, prohibitionist policies and the controversies over multiculturalism.

On all these issues we should stick to the rule that basic constitutional principles – individual liberties, equal rights and dignity, the rule of law, democracy – are the only acceptable binding civic bonds of an open society despite the claims of populists and religious fundamentalists. This is what I proposed to call the “patriotism of the Liberal Grundnorm”, with an explicit reference to Jürgen Habermas’s idea of “constitutional patriotism” and to Hans Kelsen’s idea of Grundnorm: i.e. the only possible sort of inclusive patriotism, for Europe and for each of its traditional nations alike.

This implies that the state, or public powers, can never be entitled to forcefully protect adult and sane individuals from themselves (remember Locke: «every man has a property in his own person»); that individuals should always be treated as individuals, not as individual members of typified groups; that cultural

diversity can never justify a compression of individuals' rights within minority communities, or minority families, or those of minorities within minorities; that faith, ideas and practices of their elders should never be forcefully imposed on those minors that are «capable of forming their own views» (as stated by the New York 1989 Convention on the Rights of Children).

No better institutional framework could be provided, in order to protect these individual liberties and rights, than that provided by our great and successful liberal tradition of religious neutrality and separation – as large as practically feasible – between religion and political power.

This achievement was the converging result of the struggles both of deists, free-thinkers, libertines and immanentist or atheist philosophers, and that of religious minorities. In the new multireligious situation, when many claim that “interreligious (i.e. inter-communitarian) dialogue” is the key to any peaceful coexistence, we should never forget that the fight for religious freedom and freedom of conscience was from the start a fight against the religious supremacy of the established churches (at that time in the form of compulsory uniformity and intolerance), and only in the end a fight against the scourge of state atheism in communist counties or against Islamic fundamentalism. The «wall of separation between church and state» (Thomas Jefferson, 1802) is even today the most secure and effective tool to protect the freedom of conscience of each single individual and peaceful coexistence in our inherently and irreversibly plural societies.

On the contrary, today many religious leaders demand a “public recognition” on the part of our states and of the EU itself. That is almost wherever in Europe the demand of Muslim leaders. And other established religions, first of all the Roman Catholic Church hierarchy, are thus trying to seize the opportunity to ask for a renewed “public role” of all religions, that would inevitably confine non-believers and maverick believers (today's dissenters, as they were called in 16th century England) in the position of second class citizens, like the Dhimmis in the Ottoman Empire; and trying to impose on all of us, by law, personal behaviours only consistent with a faith many of us do not share, and even many more do not share in its official interpretation, as it is the case of tens of millions of Catholics in Europe.

An even more open threat to open societies comes from those populist politicians who want no “religious dialogue” at all, but use the autochthonous religion, or whatever other item they find in their country’s real or invented “tradition”, as tools to exclude people of other religion, and the autochthonous individualists alike, from their regressive dream of a society they would like to make more cohesive and intolerant through a renewed authoritarian imposition of some kind of anthropological uniformity. Christianity is for them nothing more than an ideological weapon to be brandished against minorities, and/or against immigrants.

Claims for national identities, or for a European identity, based upon a single religion, or indeed on one single culture or tradition, are never candid, innocent claims: what is claimed is an exegetic principle, a criterion to be implemented in the interpretation of the entire system of law, creating first and second class citizens. The biggest challenge of the present time is the paradoxical erosion of the most precious historical values typical of our common civic identity, largely part of a cultural *acquis communautaire*, by populist politicians, who pose as the keepers of our “real” identity and tradition, and would like to cage all of us into closed homogeneous and mutually hostile communitarian enclosures, the smaller and the more controlled the better.

I mentioned that modern liberalism was not built upon the vacuum, but upon some cultural depositories that were the heritage of previous periods of our history. In his celebrated Funeral Oration, Pericles praised «The freedom we enjoy in our government – in Athens, he meant – extends also to our ordinary life. There, far from exercising a jealous surveillance over each other, we do not feel called upon to be angry with our neighbour for doing what he likes...» And his unlucky successor Nicias mentioned «the unfettered discretion allowed [in Athens] to all to live as they pleased». Nicias’s Athens was defeated by the tyrants of Syracuse. It took more than 2000 years for individual freedom to reappear, after that brief ancient epiphany, in the Netherlands, in England, in America, in France, now supported by a new robust individualist anthropology and a much more developed system of law; but it took three more centuries to re-take roots, after the two attempted suicides of Europe in the 20th century, in our countries, and in our European Union.

The liberals' task is not only to defend, but to enhance and to expand those achievements. And to defend, strengthen and democratise and legitimise that European Union that is for us, in the global world, the only possible tool allowing us to have a say in a world where all our old individual nation states no longer have a voice strong enough to be remarked and taken into account, and strong enough to effectively stand for liberal principles, together with the like-minded voices in today's international community.

Remember: like-minded voices are really not numberless in today's global world.

# Perfectly competitive markets: Efficiency and distribution

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Free markets have been the main mechanism used to allocate resources by complex societies along History. But, why societies in different times of the human history have usually found free markets so attractive to solve their problem of resource allocation? If we wish to ask this question we need to understand how markets work because, in this way, we can realize their virtues.

Free markets, which we technically call perfectly competitive markets, allow individuals to take advantage of all profits of trade while these profits are spread among individuals according to their contribution to society. Moreover, perfectly competitive markets are informationally efficient, because prices transmit all relevant information that individuals need in order to take their decisions, while they also are incentive compatible because they also provide the individuals with incentives to transmit this information honestly.

From an ethical point of view characteristics of free markets are very interesting because respect free participation of all individuals and reward them according to their contribution to society while somebody cannot improve without somebody getting worse.

In order to understand how markets work, it is useful to develop a simple example.

## **A simple market**

Individuals interact in a market of a good. Some individuals own a unit of the good while other individuals don't own it. Individuals owning a unit of the good will be called potential sellers and individual without a unit of the good will be called potential buyers.

Each individual has a valuation of the good. Individuals differ in their valuations. Therefore, they will be willing to reach trade agreements. An

individual with a high valuation of the good and who don't own the good will wish to buy the good to an individual with a lower valuation, while an individual with a low valuation of the good owning the good will wish to sell the good to an individual with a higher valuation. It is assumed that each individual buy or sell only a unit of the good.

### **The profits of trade**

A free and voluntary agreement between a seller and a buyer necessarily implies a net profit. The buyer's valuation for the good must be higher than the seller's valuation. If this net profit doesn't exist then the agreement is not possible. The difference between the valuation of the buyer and the valuation of the seller is called the transaction surplus.

The transaction surplus will be shared between the buyer and the seller according to the set price. If the set price is comprised between the valuation of the seller and the valuation of the buyer then the transaction will be mutually beneficial. The surplus of the buyer is the difference between his valuation for the good and the price paid. The surplus of the seller is the difference between the price received and his valuation.

In a free market inhabited by rational individuals mutually advantageous transactions just will be carried out. A seller would never accept a price under his valuation and a buyer would never accept a price over his valuation. Therefore, the market prices will always be comprised between the valuations of the buyers and the valuations of the sellers, which implies that the surplus of any buyer or any seller is positive.

Social surplus is the sum of the surpluses of all participants –buyers and sellers- in a market. Therefore, social surplus means all profits of trade.

### **Efficiency**

All profits of trade will be achieved when social surplus is maximized. If a market removes all profits of trade –and maximizes the social surplus- then it is said that it works efficiently. Social surplus will be maximized when all mutually beneficial transactions are carried out. Therefore, when social surplus is maximized, somebody cannot improve without somebody getting worse.



### **Contribution to social surplus**

The contribution of an individual to social surplus is the difference between the maximum social surplus if this individual takes part in the market and the maximum social surplus if this individual doesn't participate in the market. If a buyer leaves the market he must be replaced by the potential buyer who has a highest valuation among those remaining out of the market in order to get the maximum surplus. Therefore, the contribution to social surplus of the buyer leaving the market is the difference between his valuation and the valuation of the buyer getting inside. If a seller leaves the market he must be replaced by the potential seller who has a lowest valuation among those remaining out of the market in order to get the maximum surplus. Therefore, the contribution to social surplus of the seller leaving the market is the difference between the valuation of the seller getting inside and the seller's valuation leaving the market.

### **Perfectly competitive markets**

A free market is characterized by free entry. It is said that there is free entry if any individual –buyer or seller- can decide to participate or not in trade without any impediment. In order to have a perfectly competitive market it is also necessary that at least the valuations of a potential buyer and a potential seller coincide, which is highly probable if there is a large number of potential participants in the market.

The buyers and sellers who have the same valuation are called marginal individuals (buyers or sellers). The valuation of marginal individuals is called the marginal valuation. The buyers who have a higher valuation than the marginal buyers are called intra-marginal buyers while the buyers who have a lower valuation than the marginal buyers are called extra-marginal buyers. The sellers who have a lower valuation than the marginal sellers are called intra-marginal sellers while the sellers who have a higher valuation than the marginal sellers are called extra-marginal sellers.

### **Competition and equilibrium price**

The equilibrium price of a perfectly competitive market must be between the valuation of the potential buyer who has a highest valuation among those

remaining out of the market and the valuation of the potential seller who has a lowest valuation among those remaining out of the market. These valuations will be equal because we have assumed that there are at least a potential seller and a potential buyer who have the same valuation. Therefore, the equilibrium price equals the marginal valuation

If a buyer pays a price lower than the valuation of the potential buyer who has a highest valuation among those remaining out of the market then such buyer will entry in the market offering a higher price. Competition between both buyers will raise the price just until to the valuation of the potential entering buyer.

If a seller receives a price higher than the valuation of the potential seller who has a lowest valuation among those remaining out of the market then such seller will entry in the market offering a lower price. Competition between both sellers will reduce the price just until to the valuation of the potential entering seller.

### **Efficiency and perfectly competitive markets**

At the equilibrium price, all potential buyers with higher valuations than the equilibrium price find advantageous to buy and all potential sellers with lower valuations than the equilibrium price find advantageous to sell. Therefore, at equilibrium, all intra-marginal buyers buy and all intra-marginal sellers sell, while marginal and extra-marginal individual don't take part in the market because at the equilibrium price they don't find beneficial to buy or to sell.

Consequently, in a perfectly competitive market all mutually beneficial transactions are accomplished and social surplus is maximum. Therefore, a perfectly competitive market works efficiently.

### **Distribution and perfectly competitive markets**

Moreover, an interesting property of perfectly competitive markets is that each individual earns exactly his contribution to social surplus because the equilibrium price equals the marginal valuation.

**The magic of prices: informational efficiency and incentive compatibility**

Perfectly competitive markets are highly efficient mechanisms of resource allocation from an informational point of view because the equilibrium price transmits all information needed as much by buyers as sellers to take decisions. When a potential buyer knows the equilibrium price he knows if he wish to buy or not, and a potential seller knows if he wish to sell or not.

Moreover, the equilibrium price makes compatible incentives of all individuals. If the individuals carry out transactions at the equilibrium price, nobody wishes to do other different action than what he is doing. Nobody buying or selling would wish to break the agreement and to go out of market, while nobody remaining out of market would wish to enter. The reason is that the equilibrium price remunerates each individual with his contribution to social surplus and it is not possible for him to find other better agreement.

**The failure of socialism**

The reasons of the failure of socialism become clear once the magic of prices is understood. Lack of markets in a socialist economy implies that prices cannot play their functions (to transmit information and to make compatible incentives). Therefore, socialist economies are very inefficient to process information and don't provide incentives to effort and accumulation. Moreover, since individuals are not reward for their contributions to society, they allocate their efforts to unproductive activities.

**Cooperation**

Free market implements the same result that voluntary cooperation between individuals. If individuals could freely make up coalitions to trade and share surplus then the only coalition which would be not blocked it is the coalition of individuals trading and sharing surplus in the same way as goods and surplus are traded and shared in the perfectly competitive equilibrium (a coalition would be blocked if some individual has a better option outside the coalition).

However, making up coalition could be an expensive process implying hard negotiations and disagreements. Free markets could implement the same results without incurring these costs. Cooperation can be very costly because

individuals must truthfully inform others of their preferences, endowments and technologies

### **Why markets exist?**

From an evolutionary point of view free markets have a great advantage: they allow to solve the problem of social cooperation in an easy and fair way. However, the threat comes from those wanting to get better results for them even at the cost of worsening the whole society. They will not hesitate to manipulate the rules to their advantage imposing barriers to free and voluntary agreements between individuals.

### **The ethics of free markets**

Any action can be judged according to two criterions: a procedural criterion –i.e. according to the respected rules- and a consequential criterion –according to its consequences-. Likely, when human beings judge any action, they combine both criterions in some personal way. Our intimate conception of justice takes into account as much the respected rules by an action as the consequences that it produces.

Having in mind both ethical criterions, we can try to find out the underlying ethics of the free markets. It is necessary to formulate and respond two questions

1. What are the rules of game respected by free markets? (Procedural criterion)
2. What are the characteristics of the distribution produced by free markets? (Consequential criterion).

The answer to the first question is that free markets respect voluntary and free participation of all individuals. There is not any impediment to enter in the market or to leave it. An individual can buy or sell if he wishes it and no individual or group of individuals can manipulate market in its favor imposing obstacles to other individuals or forcing them to make something that they don't wish.

The answer to the second question is that free markets reward each individual according to his contribution to social surplus while the generated social surplus is maximum, so that somebody cannot improve without somebody getting worse.

### **Conclusions**

A free and voluntary transaction yields profits for all participants. Profits of a transaction, which are called transaction surplus, are shared between the buyer and the seller according to the set price. The sum of all individual surpluses is the social surplus.

A market is perfectly competitive if nobody is impeded to participate and at least there are a buyer and seller with a common valuation. Perfectly competitive markets remove all profits of trade. Consequently, social surplus is maximized and somebody cannot improve without somebody getting worse. Moreover, each individual is rewarded according to his contribution to social surplus.

The equilibrium price of a perfectly competitive market transmits all information that individuals need to take their decisions. Therefore, a perfectly competitive market is very efficient from an informational point of view. Moreover, the equilibrium price remunerates individuals for their contributions to social surplus and, consequently, makes compatible incentives of all individuals because, at the equilibrium price, no individual wishes to modify his behavior.

If a perfectly competitive market is judged according to a procedural criterion (i.e. according to the rules of game) then it must be pointed out that it respects free and voluntary participation of all individuals. If a consequential criterion was applied to judge a perfectly competitive market (i.e. if it was judged according to its consequences) then it must be pointed out that in a perfectly competitive market each individual is rewarded according to his contribution to social surplus while the generated social surplus is maximum, so that somebody cannot improve without somebody getting worse.



# **We are not alone – Why Liberalism needs to be social**

Luís Humberto Teixeira, Movimento Liberal Social

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«Liberalism has a pretty thick skin. So thick that an absurd prefix devoid of any sense (neo) has turned a whole set of ideas on liberty into a prêt-à-porter insult for tinpot intellectuals. So thick that it shoulders all the responsibilities of the current crisis».

These sentences are part of an article called “O liberalismo e os seus descontentes” (Liberalism and its displeased), written by Pedro Norton, CEO of the Portuguese media group Impresa, and published by the newsmagazine *Visão* on June 27th, 2013. It’s only an ascertainment of how negative the popular perception and the public speech about liberalism has become.

It’s almost as if liberal is now a cursed word, used to mean all sorts of bad things related to the economic crisis. But it wasn’t always like this, and the shift that the use of the word “neoliberalism” has undergone is particularly striking, since «scholars once employed the term nearly the opposite of how it is commonly used today»<sup>1</sup>.

First coined by the Freiburg School of German economists, in the period between the two World Wars, it denoted a philosophy that was explicitly moderate in comparison to classical liberalism, both in its rejection of laissez-faire policies and its emphasis on humanistic values, which granted it a positive normative valence, since this new liberalism would improve upon its classical predecessor in many ways.

The original German neoliberals devoted extensive attention to the term’s meaning and applied it specifically to their economic philosophy, which had a moderate and pragmatic faith in the free market when compared to that of 19th-century liberals.

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1 Boas, Taylor C. & Jordan Gans-Morse (2009), “Neoliberalism: from new liberal philosophy to anti-liberal slogan” in *Studies in Comparative International Development*. vol. 44, no. 2, pp. 137-161

These economists argued that for the free market to function the state must play an active role in order to keep powerful private actors in check, preventing them from posing a threat to freedom of competition between individuals. Based on the fact that monopolies and cartels had decimated Germany's small businesses in the interwar years, they «sought to divorce liberalism – the freedom of individuals to compete in the marketplace – from laissez-faire – freedom from state intervention»<sup>2</sup>, arguing that a laissez-faire state policy stifles competition, as the strong devour the weak.

The “neo” qualifier was seen in such a positive light that there were debates on whose liberal theories deserved such label. These ideas were not kept in an ivory tower and they flowed from academic to political grounds. Germany's Economics minister Ludwig Erhard took a liking to them and successfully applied some “social market economy” policies proposed by neoliberal thinkers of the time, in order to achieve the so-called “German miracle”.

Given their success, these ideas travelled the world and found fertile ground in Latin America, namely with Chilean pro-market intellectuals. During the 1960s and the early 1970s, the meaning of neoliberalism was still the original one and even Marxist scholars who used it didn't do it pejoratively.

But then came the Pinochet dictatorship, with its political repression and radical economic reforms, clearly more inspired by the ideas of Milton Friedman and Hayek than by the Freiburg School economists. The reason for the wider influence of Friedmanian and Hayekian perspectives had its roots in a program launched in 1955 by the University of Chicago, which invited a select group of Chilean students to pursue postgraduate studies in Economics. These “Chicago Boys”, as they became known, worked directly under Friedman and were also exposed to Hayek, who was a professor at Chicago's Committee on Social Thought during that period.

On their return to Chile, in the 1960s, these economists began concerted efforts to spread the philosophy and policy recommendations of the Chicago and Austrian schools, and they set up think tanks and media outlets sympathetic to their ideology, making it one of the dominant orientations among the Chilean right by the time of the 1973 coup.

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<sup>2</sup> *Idem*



With Pinochet, in the late 1970s they emerged as the architects of a reform program that consisted of rapid and extensive privatization, deregulation and reductions in trade barriers. And, at the height of the dictatorship, neoliberalism acquired a new meaning, as opposition scholars began using it to describe the market fundamentalism of these policies and imbued the term with pejorative connotation.

Pro-market scholars went along, not opposing the more radical meaning given to “neoliberalism” and reconceptualizing “liberalism” as more moderate. For instance, Miguel Sang Ben and Andrés Van der Horst argued that «the neoliberals should be labeled antiliberal because they prefer to sacrifice social welfare in the name of their “economy-first” proposals»<sup>3</sup>.

However, the antiliberal label for these proposals didn’t catch on and, simultaneously, the pejorative connotation of neoliberal began to spread like wildfire among those critical of market freedom.

In Chile, the propaganda of the Pinochet regime didn’t tag along with the critics; it simply abandoned the term and called its economic model a “social market economy”. Featuring the word “social” so prominently, Pinochet and his entourage sought to suggest that the radical economical reforms that were being put to practice would not have harmful social consequences.

Thus, left to its own devices and with pro-market champions more interested in finding other words to describe their policies, “neoliberalism” became a vague term used by free market opponents and that can mean virtually anything, as long as it refers to normatively negative phenomena associated with free markets.

Worldwide result? Currently, virtually no one self-identifies as a neoliberal, but many are labelled as such by others who wish to attack individuals and organizations with pro-market views.

Can this pose a problem to those with sympathy toward the free market and who also have the humanistic concerns of the original neoliberals? Definitely,

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3 Sang Ben, Miguel & Andrés Van Der Horst (1992), “Ideales de antaño, necesidades presentes: el liberalismo dominicano como filosofía emergente” in Levine, Barry B. (editor), *El Desafío Neoliberal: El Fin del Tercermundismo en América Latina*, Bogotá, Colombia, Editorial Norma.

because as Sang Ben and Van der Horst say in the article where they propose the label “antiliberal” for those who put the economy ahead of social welfare, people often confuse liberals and neoliberals.

This happens because the prefix “neo” is usually placed to define something that is a modern version of an old one, thus contagion the other way around is quite probable among the masses. Soviets, for example, were well aware of the importance of terminology and it is said that the term national-socialist – used by most to describe Adolf Hitler and his followers – was forbidden in the USSR after the country began waging war against the Third Reich, presumably to avoid tainting the good word “socialist”.

So how can liberals with humanistic values who argue for a state with an active role in preventing the strong from devouring the weak get their message through?

### **It shouldn't be a jungle out there**

Choosing words to refer concepts is never neutral, because one's use of language invariably expresses a position towards an issue.

When Freiburg School economists coined the term “neoliberalism” to define their ideas, they were trying to revise classical liberalism in order to save the markets from the rising threat of socialism in Germany. That's why they advanced “social market economy” policies inspired by their type of liberalism. It was an attempt to enter the lexical arena of the socialists by combining the words “social” and “market” under the guidance of a new liberal line of thought.

The same terminology was used by Pinochet to stifle the speech of his opponents in a more polarized ideological debate and under the real threat of a shift back to socialism (despite his authoritarian rule), but in the process the word “neoliberalism” was abandoned to the opponents of liberalism and became normatively negative, clearly associated with radicalism.

Today, changing this negative connotation would be neither easy nor necessarily desirable, but there has to be some damage control regarding what this public image does to the image of liberalism and its many currents.

Not all liberals believe that the state has to be as minimal as possible, nor that economic efficiency is what matters the most in the world, and many argue that individuals should have an equal opportunity of success and favour a certain degree of state intervention in social, economic and cultural life.

I belong to one such association in Portugal, the Social Liberal Movement (Movimento Liberal Social – MLS), where we try to balance individual liberty and social justice, understanding that the lack of opportunities to get a job, education or health, for instance, can be as harmful to liberty as compulsion and coercion.

For most of us (in the best liberal tradition we have members that stand for other currents and that are paramount to the vitality of our organization, because of the debate opportunities they provide), the state must act as a referee in some instances, making sure that the game is played with fairness and that humanistic and social values are on par with economic efficiency.

We stand for a mixed market economy, mainly made up of private companies but where there are state programmes or subsidies that deliver education, health and child care to all; free trade; a basic social security system; moderate taxation levels; regulatory bodies; openness to multiple cultures and life choices; social and civil rights; decentralized decision-making; environment protection laws; and a foreign policy that promotes democracy and human rights, just to name a few.

We're inspired by notable thinkers as "old" as Jeremy Bentham – founder of utilitarianism and who was in favour of the abolition of slavery, the abolition of death penalty, the decriminalising of homosexual acts, equal rights to women and also an early advocate of animal rights –, or as "new" as Amartya Sen – for whom societies should make a list of the minimum capabilities that should be guaranteed to citizens, so that one can truly say that every single person is acting out of personal choice, and who developed ways to evaluate economic policies in terms of their effects on the well-being of the community.

In between, we find, for example, Leonard Hobhouse, an English New Liberal from the early 20th century who said that property is acquired not only by individual effort but by societal organization. Therefore, wealth has a social

dimension – it's a collective product, meaning that those who have property owe some of their success to society and thus have some obligation to others. This justifies a certain level of redistribution.

Personally, I believe that focusing on ideas that promote the feeling of belonging to a community without losing one's individuality and liberty to act, as well as having some notion of responsibility and concern towards others because their welfare is important for our own, may be the key to building a more positive image for liberalism, one that moves away from the "toxic" influence of neoliberalism and the negative connotation it now holds. After all, we are not alone in society.

# **Social Market Economy in Germany – From Triumph to Reform**

Gérard Bökenkamp, Liberal Institute, Friedrich Naumann Foundation,

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During the last sixty years the German economy experienced boom and bust like every modern economy, but by and large this was a success story in particular in the first stage of the Federal Republic of Germany. The Social Market Economy is a special form of free market economy, combined with social policy. It was not sure, that free market policy could implemented in the new State, it was even unlikely, that it would happen. After the end of the war, capitalism was very unpopular and socialism seemed to be the idea of the time. It was not only the Social Democratic Party, which supported an economic agenda of nationalization of the heavy industry, the continuing of price controls and economic planning, but also the new established Christian Democratic Party (CDU) passed a program of “Christian Socialism.” Only the smaller Free Democratic Party (FDP) had some sympathies for the idea of freeing business from restrain. Neither the allied administration was convinced, that a liberalization of the West-Germany economy would be the best way to rebuild their occupied territories in the West. Britain and France enforced at home a policy of economic planning and the Americans mistrusted the German Business for its involvement in the War-Economy. Many American officials were socialist in a new deal tradition of F. D. Roosevelt.

It was a relatively small group of liberal academics and politicians, which took the chance to enforce a special form of economic liberalism, the Social Market Economy. They declared it as a Form of “Third Way” between the old time laissez faire capitalism and socialism. These Ideas had been worked out during the time of the Nazi tyranny from liberal Economists within Germany and in exile. They called themselves Neoliberals or Ordoliberals. The most important goal for them was a revival and renewal of liberal ideas. They thought the old laissez faire liberalism as a failure, because the old liberals had ignored the tendency of big business to grip after political influence and use it to create monopolies. They thought, big business had cartelized

the economy and restrained the free competition. As a matter of fact over 300 cartels had existed before the war. That's why the Ordoliberales believed in the responsibility of the state to guarantee free access to the markets and free competition. Many of them emphasized, that the market Economy isn't enough to ensure the existence of a free society. The Role of Christian Culture, Family values and personal responsibility would be necessary to secure the society against socialism and totalitarianism. Ideas of Christian Social Ethics, especially the Idea of subsidiarity influenced the concept of Social Market Economy as well.

But there was strong resistance against free market policy. A famous Journalist, the Countess Dönhoff, wrote in the spring of 1948 in the "Zeit" about Ludwig Erhard, the political strongest figure among the Ordoliberals: "If Germany were not already ruined, this man, with his absurd plan to abolish all controls, would certainly bring that ruin about. God protect us from him ever becoming minister for economic affairs. That would be the third catastrophe after Hitler and the dismemberment of Germany." The Social Democrats believed the abolishing of price controls would lead to a big famine and hundred thousand victims. That the Concept of Social Market Economy could although be realized had several reasons:

1. The First one is the fact, that the Ordoliberals reached key positions in the new West-German postwar Administration. The free market economist Ludwig Erhard became director of the Bizone-administration and it had much to do with his personality, that the free Market position prevailed.
2. The second reason is that the practice of overpowering bureaucracy and planning was seen as harassment for more and more Germans und was becoming unpopular.
3. The third reason is, that the free market protagonists had a very clear program, how to implement the free market system. The protagonist of socialism agreed about the implementation of central planning, but not how central planning should be organized. There didn't know how to overcome the current economic and humanitarian misery in the first years after the war.

4. The fourth reason is: that the violent communist rule over East-Germany and its state-terrorism discredited the whole Marxist idea. Everything, what seemed to have similarities with Marxism was mistrusted. The polarization in the first years of the beginning cold war gave liberal economists a better stand in the public and made them trustworthy for the Americans.
5. The head of the new established Christian Democratic Union (CDU) Konrad Adenauer invited Erhard to become member in his party and enabled him to implement his ideas in the agenda of the Christian Democrats. This suited well to Adenauer's plan to form a strong anti-socialistic conservative profile.

What happened in Germany after the war was very different from the policy that was implemented in France or Great Britain. The so called "Economy Miracle", which means the fast rebuilding of the German Economy after the war and the strong economic growth, which leads West-Germany in the second position of economic powers behind the USA, based on several aspects:

1. A new currency, the German Mark, was introduced 1948 and replaced the old currency – the Reichsmark. With one step the glut of money in the marked was annihilated.
2. The price controls were abolished with one step. From one day to the other the shops were filled with goods and services were available
3. The new government avoided the nationalization of key industries, what France and the United Kingdom did.
4. The guarantee of property rights and the anti-socialist profile of the government convinced the entrepreneur to rebuild the business and to invest in the production.
5. The national budget was strictly limited. Instead of increasing debts, the state accumulated a surplus in the budget.
6. The unions accepted high numbers of weakly working hours and moderate wage increases.

7. The exchange rate between D-Mark and Dollar promoted German Exports.
8. An antitrust legislation was introduced to promote free competition.

What we can learn from this development is the fact that it is possible to rebuild a country and to promote economic success with a relatively small government. It is often argued, that prosperity would be the consequence of growing public expenditures. But in West-Germany the ratio of government expenditure to the gross national product was between 25 and 30 percent in the 50ties and sixties. With this level of government expenditure, the Federal Republic could rebuild the destroyed infrastructure, integrate 12 million refugees. It was enough money to pay the redemption to the victims of the Nazi-Dictatorships, to provide the widows, orphans and invalids. Today the level of government expenditure is more than half of the gross national product. Even so the complaints that the state has not enough money to do his work to provide good education and implement social justice are strong. The question rises, why was it possible to rebuild a country and its whole infrastructure and manage the social problems after the most terrible war in history and why it isn't possible to solve our problems now with a higher degree of expenditure and wealth, which was not available fifty years before? And this does not only apply to Germany but to almost every western country. The answer is, that it is an illusion to believe, that higher state expenditure leads to higher growth, better social and educational provisions and happier citizen. The opposite is the case.

In the sixties the framework of the Social Market Economy changed. New Keynesian ideas replaced the ordoliberal concepts. The success of the Keynesians was paradoxically a result of the success of the Liberals. The Social Democrats couldn't deny any longer, that the Social Market Economy was a success and Marxism was not. Therefore the Social Democratic Party (SPD) abolished Marxism in its program and was looking for something new. Keynes ideas offered the possibility to modernize the left agenda. The most important figure in this process was Karl Schiller, a very smart economist, who was also respected by voters from the center, conservatives and liberals. He became Minister for economic affairs in the first Grand Coalition (1966-1969), formed by the Christian Democrats and the Social Democrats. In this



position he convinced the government to pass the first stimulus package to fight the recession of 1967. The end of this relatively small recession seemed to prove the success of this concept. Karl Schiller became a very popular politician like Erhard was before.

After the election 1969 when Willy Brandt became the first SPD-Chancellor after the war, Schiller got the position of minister for economic affairs again. Later he became also minister of finance. So he had a more powerful position than even Ludwig Erhard had under Chancellor Adenauer. But Schiller became the victim of his own success. His colleagues in the cabinet and the public opinion believed that time had come to spend more money for public services, education, the pension system, the health system and traffic and environment. The public expenditures increased rapidly and the inflation reached almost 10 percent, the unions fought successfully for wage increases and the national budget ran out of control. Schiller knew that the second part of the Keynesian program was saving money after a period of spending. But spending was very popular, saving was not. Thus the conflicts between Schiller and his own party reached the point, when compromise was no longer possible. Schiller resigned in the year 1972, even left the SPD and campaigned together with Ludwig Erhard against his own party because he believed that the policy of increasing expenditures, wages and public services so rapidly would lead to a national disaster.

Schiller was right. Since the oil crisis in the year 1972 it was obvious that the government and the unions were overoptimistic. The new SPD-Chancellor and former student of Karl Schiller Helmut Schmidt tried to fight the unemployment with even more public spending. Many stimulus packages were passed, but nothing of them were successful. The deficit increased and the unemployment figures grew up. At the Beginning of the 70<sup>th</sup> there was almost no public deficit and more jobs were offered than workers were available, therefore millions of immigrants were invited to Germany to fill the gap. At the end of the 70<sup>th</sup> the deficit was 30 billion D-Mark and more than two million people were unemployed. Full employment was never reached again. Under these circumstances the liberal coalition partner FDP decided to swing from the coalition with the Social Democrats to the Christian Democrats. The liberal Minister for economic affairs and FDP politician Otto Graf Lambsdorff

wrote in the year 1982 a concept to a radical reform of the unemployment market, the public budgets and the social insurance system. This so called "Lambsdorff-Paper" took the SPD-chancellor Helmut Schmidt as a cause to end the coalition with the liberals. In this moment it was obvious, that the social-liberal coalition had no longer a common agenda and the swing of the liberals would be only a matter of time. Helmut Schmidt thought it would be better for his reputation to end the coalition himself.

In the year 1982 the Christian Democrats and the liberal FDP formed a new government, which lasted for 16 years. In the first eight years the new government lowered the budget deficit and passed a tax reform. Taxes were lowered about 30 billion D-Mark. But the social insurance system, the pension system and the employment market weren't reformed. The left wing of the Christian Democratic Union (CDU) refused any reform. The most important figure among the left wing of the Christian Democrats was Norbert Blüm. He was minister for employment and invented the slogan: "pensions are safe". But this was wrong. Since the beginning of the 70<sup>th</sup> the birth rate was very low. In the German pension system the younger generations have to pay for the older generation directly by monthly contributions. The German system is not capital covered and there are no money reserves in the system. The German pension system has the obligation to pay the pensions for the old people, but will have fewer members to pay contributions for reasons of demographic development in the future. The results of the first part of the coalition of Christian Democrats and Liberals were mixed. On the one side there was progress in the financial policy and on the other side there were stagnation in the social- und employment policy. The figures of unemployed remained high.

The problems became more dramatic after the reunification of Germany in the year 1990. In the year 1989 the communism in East Europe and the German Democratic Republic (GDR) collapsed. The former GDR became part of the West German Federal Republic of Germany. Of course it was one of the happiest events in the German history of the 20<sup>th</sup> century. It was a historical success of the Christian-liberal government. But many mistakes were made in the process of unification of West Germany and East Germany, which harmed the economy and the employment market. The Unions of West Germany were afraid, that in East Germany could be produced cheaper as in West Germany,

because of the lower wages in the eastern part. That would have damaged the strong position of the Unions in negotiations with the employers. That's why they used all their influence to increase the wages rapidly in the eastern part of Germany. They put pressure on the employers in East Germany, who had no organization. The big majority of the enterprises was state property and not privatized yet. Therefore there was little resistance against the claims of the unions. The East German industry had even without these unfair wage negotiations big problems to be competitive. After 40 years of socialism the economic basis of East Germany was rotten. The mixture of a rotten factories, hard currency and high wage policy destroyed the competitiveness of East Germany permanently. Thus millions of people in East Germany lost their jobs and the West German tax payer had to pay for the social expenditures. The government had to subsidize the East German economy. The annual expenses for the national budget were more than 100 billion D-Mark. Therefore the Federal Republic doubled its national debts within ten years after the reunification. The high taxes and social insurance costs lead to the loss of international competitiveness. More than 5 Million people were finally unemployed. The Social Market Economy was in its most terrible crisis.

Ironically it was a left government, formed by the Social Democrats and the Greens, which implemented hard reforms. Although they promised more "social justice" during their election campaign in the year 1998, they passed the so called Agenda-2010-Reforms in the year 2003. They lowered the taxes, passed cuts in the budget and accomplished more flexibility on the employment market. The new flexibility on the employment market was reached by lowering the social welfare benefits, to create more temporary work and more low wages jobs. They did it, because of the pressure of the opposition in the second chamber and the change in the public opinion. More and more people believed that the status quo was no longer acceptable and reforms were necessary. In the meanwhile the pension system is reformed as well. The pensionable age today is 67 years for the generation born after 1964. All these reforms lead to a rapid recovery of the German economy since 2005. The unemployment went down to less than 3 million. But these reforms weren't very popular. There are many critics in particular within the Social Democratic Party. Therefore it is very likely, that the new Grand Coalition

will introduce minimum wages, tax increases and more regulation. If the good development on the employment market and the competitiveness will be sustainable is very uncertain in this moment.

# The political and social thought of Murray N. Rothbard

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This conference is intended to make an introduction to political, social and economic thought of the professor Murray N. Rothbard , founder of the modern theory of anarcocapitalism .

Rothbard was born in New York in 1925, into a Jewish family from Poland . From youth had an great interest in political and economic phenomena around him, showing great independence of mind soon , even in front of his family that defended leftist postulates about social issues , and indeed he do not fundamentally changed his ideological positions along his life. In college he became an anarchist free market and remain in this position along his life. He was too an activist in numerous cases , seemingly contradictory in his political filiations , but always consistent in his total and unequivocal rejection of the modern state. He qualified himself as a radical reactionary, because his ideal was a world like the United States before 1910, in which the state has played a residual role in social life. He lectured as an university professor in New York and Las Vegas, and gave us an abundant work in all fields of social sciences . We purpose of this conference is divided in his work as a political theorist, his work as a historian and his work as an economist.

## **Rothbard 's political theory**

Rothbard was an anarchist individualist throughout his academic life. His political theory fits this vision and formulated in two of his books *The Ethics of Liberty* and *For a New Liberty* and many pamphlets and scholarly articles as an elaborate perspective of like should be living in a stateless society. His influences stem from three major intellectual traditions, the main of which is the American individualist anarchism, with authors like Lysander Spooner or Josiah Warren Tucker like principal references. Another American tradition of reference for Rothbard was i that of the so-called American Old Right that opposite to the nascent welfare state advocated by the New Deal and kindred

turn the American isolationist tradition, opposed to U.S. imperialism and war and intervention in internal affairs from other countries, especially in South America.

The central place of Rothbard 's thought is its radical opposition to intervention in wars beyond America's borders , as Rothbard believed that war is the apotheosis of the state. According to the author argues, in wars all social activities are subordinated to the state under the guise of obtaining military victory, and thus avoid wars would avoid the increased power of the state, since the state is born and lives in the war. In wars suspending rights and freedoms, in war and taxes are rising currency devaluation and war the population learns to submit and subordinate to higher powers. War is the health of the state as would another influence Rothbard, journalist Randolph Bourne, wrote at the beginning of the twenty century.

No wonder, therefore, that Rothbard 's vision about the state is so radically pessimistic . He advocated a kind of predatory theory of the state, according to which the state is a vast organization of extortion and robbery. In his view the political power, and modern state like its realization is a specialized mafia luck in getting taxes and adapt rents of his subjects, basing their power in the monopoly of physical force. The state would thus supremely organized predation and extortion.

### **Rothbard like an historian**

Rothbard has two main directions like an historian. The first like and historian of ideas, both political and economic, and the second as historian of economic facts, in special depression and business cycles. In its first dimension Rothbard writes a monumental History of Economic Thought in key libertarian and from the perspective of the Austrian School of economics, unfortunately unfinished because he died suddenly before he had been unable to complete. In the two volumes of Rothbard book challenges many of the myths of economic historiography, especially the myth that modern economics begins with the work of Adam Smith. Rothbard cites dozens of authors before to the apparently seminal works Adam Smith, many of them as Turgot or Cantillon with contributions well above those of Smith himself. Mainstream currents

of history of economic thought, excepting perhaps Schumpeter's *History of Economic Analysis* usually ignore that many contributions to economic science had been written centuries before by the scholastics, especially those gathered in the Spanish School of Salamanca, only to have been written in Latin, are not easily accessible to the contemporary reader. Rothbard do not forget them. It's not just Smith is not particularly innovative but retracts the economy in areas that had already been surpassed by the scholastics as all the reference to the theory of value. Smith advocated a kind of theory of value at work and the consequence, in Rothbard's opinion was the Marxist theory of exploitation and the Marxist radical critique of capitalism. Rothbard 's mains contributions in this book are out of oblivion to the old escolásticos, are indeed demystify Adam Smith and Marxism and rediscover dozens of forgotten authors in the history of economic thought.

As an economic historian his main work was his book about the great American depression, *America's Great Depression*, showing that the crash of '29 was caused by massive injections of liquidity by the Federal Reserve during the 20s, completely distorting the structure of production of the American economy and subsequent policies implemented to address it were only a source of even greater evils.

As a historian of political ideas could highlight his essay on the history of contemporary American right, *The Betrayal of the American Right*, which recounts the evolution of the American right, from anti-statist and isolationist attitudes to contemporary neoconservative statist right. In another briefs writings about history Rothbard narrates the buiding of the modern progressive state and the events that led the United States to be involved in wars of all kinds, and describes too the ideas that shaped the modern progressive state , with particular attention to the role that state control education had on shaping the minds of most citizens .

### **Rothbard economist**

The Rothbard economist configured as the main driver of the Austrian school of economics since the Second World War. A student of Ludwig von Mises at New York University, Rothbard soon assimilated and improved intellectual

legacy of the then languid school I, almost defeated at that time by the rampant Keynesianism. Rothbard wrote a great economic treatise, *Man, Economy and State* in what he established the fundamental theoretical basis of economic science an elaborate a systematic typology of forms of intervention, that he defined like violent, of the state in economic life, and especially of the impact the intervention has on the smooth running of the economy. We may emphasize here his contributions to the classic debate about the impossibility of economic calculation in a socialist economy, expanding the argument of the impossibility to another areas as may be to large organizations. Economic calculation is in his opinion also impossible in the organizations that exceed certain dimensions, and hence that there never can exist the legendary Marxist megatrust able to control in a single organization all existing enterprises. As there can be nor centrally planned economy nor its counterpart in the capitalist big enterprise could ever exist for long time. Small businesses usually defeats large, then in turn be eaten by another company still small. Rothbard also developed theoretical proposals to address the transition from socialism to capitalism.

The other major contribution to Rothbard's economic science was his study of the functioning of the Western banking system, especially those runned by central banks. For Rothbard modern central banks are part of the power apparatus of modern states and operate in collusion with commercial banks operating under government license. Central banks and their allies would thus be responsible for financing the government's activities, the most painless way possible, and diverting attention from the negative consequences of such interventions out political system. No one now can know well as crises, speculative bubbles and inflationary phenomena arise and thus avoid political responsibilities. The government according to their theories will manipulate the currency and credit and have socialized in fact the world of production and distribution of money.

Rothbard also makes interesting contributions in the theoretical critique of Keynesianism and the theory of advertising and consumption, denying the widespread view that advertising has the power to condition the behavior of consumers.



As we can see Rothbard was complete social scientist. Cultivated all the social sciences still taking time to write a play, and be a fertile literary and even film critic. His legacy has shaped a new understanding of liberalism and has been the source of the awakening of new theoretical insights within the liberal world. His legacy remains with us.



# Positive Changes in Greece: An overview of the Start-up and Social Enterprise Ecosystem in Greece

Maria C. Choupres, Forum for Greece

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Although the economic slowdown is proving to be a global phenomenon, its effects have had a very negative impact in southern Europe and especially in Greece. Neither politics as usual nor business as usual has proven its mettle or worth in resolving the economic fallout—or the equally devastating social fallout.

This is certainly not lost on voters. While there is much to despair about, there are also glimmers of hope; one very important and potentially game-changing consequence is a more aware and engaged electorate. Greater demands for transparency and accountability on both the local and European levels, implementation of policies and laws that serve the greater good and not simply special interests groups, and innovative solutions to approaching economic structures are forcing political and other change.

The “social economy” is one area where change is evident—both at the civil society and government levels. While Greece has always had its share of entrepreneurs, there is something decidedly different about today’s group. The start-up scene, and particularly those engaged in social entrepreneurship, a nascent but growing field in Greece, are leading the way forward as early adopters of an economic concept that has the potential to not only change the way citizens do business, but also to change the way that citizens relate to politics.

This is a group to engage, as they will undoubtedly prove to be multipliers of the concepts and policies that work—and by extension, supporters of those in the political field that mirror the creativity and energy—and guts—that are necessary to take Greece forward.

### **The Start-up Scene in Greece: What it looks like, where things stand**

Starting a business in Greece has its challenges. According to OECD rankings (2011), Greece was ranked 101 from 183 countries in the category “ease of starting a new business.” These rankings took into consideration aspects such as construction permits, getting credit and dealing with insolvency, among others. And yet, despite the ranking, Greece—a country of about 11 million—has, and has had, one of the highest rates of entrepreneurship and indeed a very high percentage of SME’s (small and medium sized enterprises). Since the onset of the economic crisis, many businesses, especially SME’s, have closed or relocated outside of the country

However, the news is not all bad: during the last several years young (and young at heart) entrepreneurs are leading the charge to innovate and re-energize the start-up scene in Greece, and are indeed, helping to buck the trend. These entrepreneurs are taking a more business-minded approach and focusing on new sectors, as well as on social entrepreneurship, where the primary objective is addressing social needs rather than profit. Social entrepreneurship has been buoyed by the global growth trend in socially responsible investment (SRI).

The Greek government, with assistance from the EU, has been making considerable efforts to create a favorable environment—in terms of legal procedures and frameworks—to boost entrepreneurship and in particular, social entrepreneurship and the social economy. Navigating the less than stable economic, political and social situation in Greece has made it difficult to assess what the actual needs of social enterprises are and what types of development opportunities would be best, thus making it equally complex to initiate the most responsive types of structural reforms.

One thing is certain, and that is that entrepreneurs need resources, namely capital and mentoring. As the government struggles to act fast enough, the start-up community is—not surprisingly—taking matters into its own hands. With real estate prices at an all time low, entrepreneurs are setting up spaces for like-minded individuals: co-working spaces—something that was virtually unheard of in Greece a few years ago—have been springing up in Athens, Greece’s capital city, and Thessaloniki, the second largest, among other cities, as well.

Through co-working spaces, entrepreneurs are helping others who are also interested in start-ups, providing networking, mentoring and funding opportunities.

Many with experience from abroad and ties to venture capital and liquid capital markets—two important keys to Silicon Valley’s success—as well as ties to Silicon Valley itself, are sharing their knowledge and resources, plainly making up for what the government is not able to provide in as timely a manner.

After all, the government itself is attempting to innovate its own internal processes, in addition to responding to the multitude of concerns, economic and social, created by the crisis. Recognizing that start-ups are a bright spot in the dark economy, foundations, companies and experts from Greece and abroad, are helping energize the start-up scene, through mentoring and seed money, and members of the Greek diaspora are also finding ways to contribute.

The Greek diaspora is finding creative and powerful ways to weigh in and affect change. This can be seen by the efforts of “**The Hellenic Initiative**” (THI), which is a non-profit, non-government organization. Formed in 2012 by prominent members of the global Greek diaspora, THI united numerous diaspora initiatives regarding job-creation and philanthropy. The core beliefs include a commitment to Greece (“faults, and all”), maximizing investment with a focus on impact not just effort, and the positive potential of collectively applying everyone’s strengths to build a better a Greece.

THI seeks to support non-profits with high-impact value as part of the investment scheme; this is not about providing charity. Areas such as crisis relief, entrepreneurship and investment in Greece are all focus points for THI—and are supported by ambitious programs, such as the Hellenic Entrepreneurship Award, which is backed with a €5 million commitment. Awardees must be based in Greece and they and/or the company and their employees must be domiciled within the country. Expert mentoring, business support services and funding of up to €500,000 are part of the prize. According to Andrew Liveris, chairman and founder of the Hellenic Initiative and CEO of Dow Chemical Co., “Greece is, and always has been, a crucible of innovation and creativity;

however, economic strife can create a cycle of disadvantage that can make it difficult or impossible to launch a new business.”

Two other very notable examples are The Openfund and PJ Tech Catalyst Fund. Between them, they have ties to many of Greece’s successful start-ups.

#### PJ Tech Catalyst Fund

PJ Tech Catalyst Fund is a venture capital fund that invests in seed stage start-up companies in Greece and supports the development of entrepreneurship in Greece.

#### The Openfund

The Openfund provides support to technology start-ups that are registered in Greece, including advice, seed money ranging from 50K-500K and introductions to investors. Eligible companies in software, mobile, and web-based fields are required to operate domestically but be globally oriented.

The Openfund looks for innovation in either the product, service or business model, and for value creation, overall, and supports start-ups that are either in pre-seed or seed state. The application process is extremely structured, and the response turn around time is approximately 30 days. If selected, The Openfund works closely with the start-up, helping to ensure goals are met and guidance is on point. Capital is also distributed in a structured manner, tied to specific targets being met. If this occurs, and there is demonstrable proof of a positive market reaction, a similar amount of capital (to the initial investment) is reinvested.

Clearly The Openfund is making a difference in the start-up community and consumers: BugSense, Taxibeat, Hellas Direct, Incrediblue and Workable are part of The Openfund’s portfolio, and are successful Greek startups—all founded during the crisis.

#### Taxibeat

One of the best-known Greek start-ups is Taxibeat. Started in Greece, this mobile app has gone international, and has changed the way you hail a cab: in two taps. Rather than hailing a random cab, you choose from a network of trusted drivers

that have been rated by other users. The app locates you on the map, and then shows you the available drivers. You can then choose the cab you'd like, based on location (which driver is closest), type of vehicle or best rating. Also listed are the languages the driver speaks and whether the cab is pet-friendly.

### Incrediblue

Incrediblue connects those seeking to rent a boat, with the boat of their choice, and of course, a captain and/or crew. Boat rentals are global—they're not simply confined to Greece, and the entire process of transacting is easy and transparent, including reviews and real images of the boats for rent. Excellent customer service, a secure payment system through Europe's leading online payment system and the fact that hosts (boat owners) are verified are all leading to Incrediblue's expansion.

### Workable

With the tag line, "Your hiring, made Workable", Workable offers beautifully designed and innovative recruiting software that lets recruiters post jobs, manage candidates and hire the person that's the best fit. Recruiters can browse through candidates in a similar way that social networks are set up. The software is linked with major jobs sites, such as Simply Hired, LinkedIn and Monster, as well as other candidate sources, and offers historical timelines of shortlisted candidates in addition to other intuitive controls. Workable helps companies that don't have an HR department or the resources to outsource to set up a holistic recruiting process in less than a day.

### BugSense

Founded in March 2011, BugSense is a tool that collects and analyzes crash reports from all major mobile app platforms; it supports Android, iOS, HTML5, WP and Windows. BugSense was created by developers for developers, to be able to monitor and test the stability of created apps.

### Hellas Direct

Founded in 2011, Hellas Direct is a car insurance company seeking to innovate the Greek insurance market. Advocating transparency and customer

experience, Hellas Direct seeks to redefine car insurance, “one policy at a time.” The company has an impressive line-up of Greek and international backers and a highly qualified staff with global experience. Quotes are offered via web and phone and are custom-tailored, taking into account a number of factors about the customer and their driving habits.

While there is an intense focus on tech-related ventures—not only in Greece, but internationally—the start-up scene in Greece is varied, with a number of different sectors being represented, including agricultural, urban development and construction, fashion, art and culture and tourism.

Noting the trend in educated professionals leaving the cities to pursue agricultural ventures, some analysts have voiced concerns that these start-ups will not be able to compete against global food companies and that Greece runs the risk of converging towards lower labor cost Mediterranean countries instead of EU averages; therefore the focus should be on creating high value added companies, like those of Silicon Valley. While this may be a concern, it is important to point out that many agricultural ventures are catering to niche markets (high-end olive oils/snails), and while they may not be creating the number of jobs that a large firm might create, they are generating strong profits and revitalizing the communities they’re in.

Another concern is the lack of women in the start-up community—and this is one concern that must be resolved. While this issue is not confined to only the Greek start-up community, it is an especially pressing issue in Greece: gender inequality is a long-standing problem and must be innovated if the country is truly able to live a rebirth, economic and otherwise. To put this in context, the gender pay gap in Greece is the second largest in the EU, measuring 23%, both in terms of salaries and payable services to self-employed people.

Women make up approximately 20% of the total of entrepreneurs, with the breakdown within the start-up community being reported to be about the same percentage. How to engage more women in the start-up community and the tech sector, is a question that’s being asked across the board, from Silicon Valley to Athens, with a number of big names weighing in. In Greece, this issue has captured the attention of the government, civil society organizations and



female entrepreneurship associations. There is overall cognizance that special attention and initiatives are required to help promote and develop women's entrepreneurial efforts. Currently, there are certain initiatives and support programs offering capital specifically in support of women's entrepreneurship, but their impact has not yet been assessed or measured; it is too soon.

One example of such an initiative is the creation of a Europe-wide mentor network of established entrepreneurs that is supported and financed in part by the European Commission. The local (Greek) network of this initiative is called, "Business Mentors," and is being implemented by four diverse partners, which include Militos Emerging Technologies & Services, Federation of Industries of Northern Greece, Hellenic Association of Young Entrepreneurs and OLN Learning.

Started in 2011, the Business Mentors program aims to connect women entrepreneurs who have recently started businesses with established entrepreneurs who can provide know-how, tools and synergies; the mentors help women of all ages develop and sustainably grow their businesses, especially in the first few years where difficulties abound.

The program is run in 12-month intervals. During this cycle, the mentors and mentees meet regularly to facilitate the flow of ideas and experiences; by providing female entrepreneurs with the knowledge and skills necessary, as well as with role models who have tackled and overcome challenges, the Business Mentors program hopes to make an impact.

Another mentoring service for women is from the organization, Women on Top (WOT). This group, which is also a start-up, provides help to women by women. Started in 2012, WOT offers mentoring, seminars and advice for navigating the Greek work environment; although the services are not strictly meant for start-ups, start-up advice can be found in this diverse community.

### **Government: Local and EU-Level Interest**

The social economy is in the nascent stages of development. Its development is considered a viable path toward reducing Greece's high poverty and unemployment rates, especially among the young and other vulnerable

groups. Its also seen as an integral part of the structural reform strategy that will be able to create sustainable employment and help reshape the economic and social fabric of Greece.

The legal and policy changes that are occurring are both indicative of the interest in this sector and of a greater understanding that with focus and strategic support, a diffusion of social enterprises will occur.

Key to these efforts on the legal and policy end is the government, which is trying to do its part to help start-ups and further social entrepreneurship. Law 4019/2011 on “Social Economy and Social Entrepreneurship” is one example, and the other is the “Strategic Action Plan for the Development of Social Economy,” which is the result of the joint efforts and vision of both the (Greek) Ministry of Labor and Social Security and the Employment, Social Affairs and Inclusion General Directorate of the European Commission.

#### **Legal Changes making a difference: Law 4019/2011**

One very important—perhaps the most important—legal change to date that has proven very useful to those wishing to take their first steps toward creating something of their own is the Law 4019/2011; it provides a framework for “Social Economy and Social Entrepreneurship,” and specifically, the Social Cooperative Enterprise. The law allows for a civil cooperative with a social purpose, or in other words, having a statutory purpose of social benefit but with a twist: entrepreneurial capacity, i.e. for profit activities, is allowed. A minimum of 5 individuals or entities (legal bodies) is required for the formation of the cooperative, each having one vote regardless of the number of shares that they possess. Currently, there are about 240 registered Social Cooperative Enterprises in Greece.

#### **“Strategic Action Plan for the Development of Social Economy”**

The “Strategic Action Plan for the Development of Social Economy” seeks to provide both general and financial support to start-ups within the social economy, as well as financial instruments that are tailored to the needs of the social cooperatives mandated by Law 4019/2011. This plan was developed under the auspices of the National Strategic Reference Framework (NSRF) 2007-2013.

The NSRF 2007–2013 outlines how EU funds will be used at the national level for the 2007–2013 period, and “...ensures that the assistance from the Funds is consistent with the Community strategic guidelines on cohesion and identifies the link between Community priorities, on the one hand, and the national reform programme, on the other.” The framework calls for the promotion of the social economy through capacity building and coaching/mentoring, as well as through the increased availability of capital to social enterprises.

The “Strategic Action Plan for the Development of Social Economy” is the product of an independent committee of Greek and European experts. Initially proposed by Commissioner Ander (Employment, Social Affairs and Inclusion General Directorate of the European Commission), the committee has been jointly appointed by the Greek Ministry of Labor, and the Employment, Social Affairs and Inclusion General Directorate of the European Commission. While the Committee has no operational responsibilities, it is responsible for providing strategic guidance and expert advice to the authorities in charge of the implementation of the social economy agenda in Greece. As such, the social business best practices from other European countries will be incorporated into the Committee’s plan.

Specifically, the committee is charged with helping to develop an overarching vision for the promotion of the social economy and social enterprises, and to then distill this strategic vision into specific actions to be implemented. Central to this vision is fostering a network of interested stakeholders—such as social entrepreneurs, experts, social investors, and social economy organizations, both in Greece and in other European countries, and providing capital and access to capital for social enterprises, both in the start-up and development phases.

Implementation is of course extremely important, and where ambitious projects and good intentions very often hit a snag. Therefore, the committee will also oversee the implementation phase, making suggestions as needed to address or correct the course of the recommended actions. Assisting the committee in its work, are 3 sub-committees each working on a specific task: financial access for social businesses, grants awarding and social enterprises.

Work has already begun: the Ministry first submitted its own plan in late 2012 to the committee, effectively beginning the process. In early 2013, the committee issued its report. The committee noted the increased interest in social entrepreneurship, but found that where matters currently stand is in part due to the low level of capacity development of interested actors and stakeholders on the national, regional and local levels. For measureable progress to occur in this sector, a restructuring of the types of support currently available would be necessary at all levels, including administrative and legal frameworks, public support schemes, provision of support services, and social finance.

The committee further highlighted the strategic importance of developing the social economy in Greece, and the important role that civil society organizations and other stakeholders would need to play in order for social entrepreneurship to truly take root and yield the types of systemic changes that can revitalize the Greek economy and address the devastating social ills that have resulted from the crisis. First and foremost is an assessment of the needs and types of support that social enterprises require and the impact of the support. The taking stock of, analysis and correction of existing legal and policy infrastructures, as well as a review of the implementation practices was also another important area highlighted by the committee.

A shift in cultural dynamics was seen as equally important; greater emphasis needs to be put on values such as cooperation, sustainability and community development. Structural and economic changes are also called for; independence from political and other special interests must be maintained, while new cooperation must be encouraged between social and mainstream enterprises. These changes—cultural, structural and economic—are necessary to “disrupt political patronage, improper use of profits and illegitimate access to public funding.”

Lastly, the committee noted that engaging the public and earning its support would affect the impact on sustainability of the social economy and social enterprises; without public support, the committee saw barriers such as “fragmentation of efforts and lack of critical mass, low levels of skills and capacity, the absence of

role models and champions, and the difficult access to finance” as being forces that could derail the development of the social economy.

### **Who else is helping this sector? Great synergies**

The synergies that are present in the start-up community are a source of inspiration. Examples of great synergies include a workshop series administered by the British Council, called, “Think Social. Act Business,” which helps draw attention to social entrepreneurship in Greece, as well as to facilitate the exchange of ideas. The pilot was held during the summer of 2012, and in 2013, it scaled up in partnership with the EUNIC network (European Union Institutes for Culture) and with the social enterprise 180 degrees, to intensify the capacity building aspects.

While the British Council and EUNIC are familiar names, those of the other supporting partners may not be. Below is a list, along with information about the other key supporters of, “Think Social. Act Business”:

Impact Hub Athens is a well-known co-working space in Athens that provides fully equipped office facilities, in addition to workshops, seminars and networking opportunities to start-ups and others.

Omikron Project is a volunteer grassroots initiative that aims to confront and address people’s negative perceptions about Greece.

Sandbox is a diverse global community of 800 young change makers in 25 cities worldwide committed to changing the world for the better. Members connect online and through more than 150 yearly events.

The Global Shapers Community, part of the World Economic Forum, is a network of city-based Hubs where young leaders committed to building a more peaceful and inclusive world by undertake local projects to improve their communities.

StartUp Greece is a digital information and networking space serving entrepreneurs in Greece, bringing together people and ideas and changing the country’s perception of doing business

and entrepreneurship. The site includes information on public and private funding initiatives; legal information complete with explanations; a listing of entrepreneurship events and competitions; topical articles, data and trends; and, success and failure stories, as both offer learning opportunities.

180 degrees applies design processes to solve social problems through a co-design approach. 180 degrees consider themselves “a combination of Design + Social Innovation, with the goal of playing an active part in everyday lives through new ways of thinking and doing.” One of 180 degrees’ projects is an alternative health care access system for no-income and low-income groups, based on the idea of service marketplace. The pilot will start 2014.

The “Think Social. Act Business,” workshop series is an ongoing project with the aim of increasing awareness about the social economy on the local and global levels; sharing social enterprise best practices from the UK and elsewhere; supporting research; and spurring partnerships and collaborations between social enterprises, government institutions and communities in the UK with their counterparts in Greece.

### Startup Live Athens

Startup Live Athens is a non-profit initiative supported by the, “Think Social. Act Business” series, and another great example of synergies with an impact. This three-day entrepreneurial event that was established in Athens in 2011 happens yearly. Startup Live offers aspiring entrepreneurs the opportunity to deliver a 3-minute pitch of their social enterprise ideas—whether they are in the early or more advanced stages of development implementation stage—to a panel of judges and the audience. What’s more, Startup Live enables participants to take their idea and be ready to launch in in the course of essentially, a weekend.

### **Foundations**

Foundations have been playing an important role in offering assistance and being responsive to the needs of the greater community. Inclusive in their

philanthropy has been a renewed commitment and additional support to start-ups, recognizing their job creation potential, as well as the potential for the empowerment of those involved and the impact that start-ups, and especially social enterprises, can have on their surrounding communities.

The Stavros Niarchos Foundation, one of the largest in Greece, recently held a conference on, “The Role of Philanthropy within a Social Welfare Society.” The two-day event included sessions on Social Entrepreneurship Development and the Third Sector’s Capacity Building, in recognition of the important role that social enterprises will play in Greece as the social economy continues to develop. Additionally, the Stavros Niarchos Foundation is administering a grant that is part of a 3-year, €100 million initiative to counter the socioeconomic crisis. One of the grant awardees is Metavallon, an Athens-based start-up founded in 2012.

Metavallon offers education and support to aspiring entrepreneurs through “The Startup Series,” a proprietary program that imparts to the participants the requisite skills and advice to take their idea and turn it into a business launch. Key to the process is practical learning, visits to major start-up centers and the guidance of experts. The goal is to help the participants spur new economic activity across Greece.

Alexandra Choli, Metavallon’s Founder and Executive Director, states: “We strongly regard entrepreneurship as a source of value both for its driving force, the entrepreneur, and the society at large.” She continues, “We look forward to ... propel our organization to sustainability and bring about a cohort of dynamic, social-minded entrepreneurs in our struggling country.”

Another of the Stavros Niarchos Foundation’s grantees is the start-up Future Library, of which it is the exclusive donor.

Established in 2011 in Veria (northern Greece) Future Library’s goal is to create a sustainable network of public and municipal libraries across Greece, which will all be linked to the National Library of Greece; the National Library of Greece will be housed at the Stavros Niarchos Foundation Cultural Center in the near future. Helping people rediscover libraries, and making libraries into innovative hubs that promote interaction, learning and creativity

are the goals of Future Library and the Stavros Niarchos Foundation. The Bill & Melinda Gates Foundation, also have recognized the importance of innovating libraries, awarding the Veria Central Public Library the “Access to Learning” Award in 2010. Future Library spun out of the Veria Central Public Library.

Many start-ups are often volunteer-driven, and have been making a tremendous impact through innovating how to solve some of the toughest problems in Greece: hunger, poverty, drug addiction and homelessness—all unfortunately on the rise since the inception of the crisis.

BOROUME (translation: We can) is a non-profit organization that addresses the issue of rising hunger and poverty. BOROUME deals with difficult facts: 27.7% of Greeks live below the poverty line or are socially excluded, and 1 in 11 people in the greater Athens urban area occasionally visits a soup kitchen. BOROUME helps those in need by organizing the distribution of surplus food all over Greece, including fresh fruit, vegetables, bread and cooked food that would otherwise simply end up being thrown away; as such, food waste is also minimized. Founded in January 2012, BOROUME works with restaurants, hotels, bakeries, fruit and vegetable markets, and other companies and people across Greece and tracks and connects those in need (either people or institutions, such as soup kitchens) with fresh and packaged food. Donations and needs are arranged by geographic proximity, and the delivery of the donations goes directly to the institutions.

### Red Kitchen

Red Kitchen is a new soup kitchen located in Athens. It offers healthy, organic meals with ingredients that are sourced directly from small farms. Customers do not have to pay for their food; they can either provide a “donation”, even if it’s a few coins or they can volunteer at Red Kitchen to “pay” for their meals. Red Kitchen also sells coupons, in the amount of 5 euros, as a means to support their efforts, which is good for one meal. In addition to providing food to those in need, Red Kitchen also helps build solidarity and good community relations, offering a space where people in the neighborhood or from other parts of the city can come together and find and give moral support and encouragement. While



Red Kitchen is a social cooperative meant to address poverty, it also is set up to function as a restaurant, where, “youngsters, students, hardworking individuals, families or just persons in need, all are welcome to share a good meal.”

#### KETHEA

KETHEA addresses the very serious issue of drug rehabilitation and other forms of addiction, all of which have seen a sharp rise since the outset of the economic crisis. Active since the early 1980’s, KETHEA has become the largest rehabilitation and social reintegration network in Greece, offering services free of charge on the street and in prisons and rehabilitation units around Greece, including drug treatment, healthcare, counseling and training, and assistance re-entering the work force. KETHEA looks to help people make long-term changes in their behaviors, and as such, addresses the psychosocial factors that contribute to addiction rather than relying on pharmaceutical substances or substitutes.

#### Shedia Magazine

Shedia is a Greek magazine that is sold on the street by persons that come from socially vulnerable populations, such as the homeless, unemployed or those living below the poverty line. The sellers are given 10 free copes to sell, and with that “capital” can then purchase the magazine for 1.50 euros; they then sell the magazine for 3 euros, which offers a minimum but honest income, a way to engage with others and an incentive to help rebuild their lives. The sellers do not beg and this is not charity; the buyer purchases a very good product.

Shedia is a member of the International Network of Street Newspapers (International Network of Street Papers-INSP), which lists 122 street magazines in 41 countries, with 14,000 homeless, unemployed sellers and 6,000,000 readers worldwide.

#### **What’s Next: Working with Entrepreneurs**

The individuals involved in the ventures profiled in this text—and the many more that exist—make up a community of inspirers and early adopters, willing

to take risks while showing solidarity with each other. These individuals are showcasing that Greece has the capacity to change economically and socially. Engaging this reform-minded group may be a way to tap into Greece's ability to change politically, as well; entrepreneurs have the potential to disrupt and innovate political processes, much in the same way that they've done with business.

The start-up community's impact in Greece is clear—and positive. The final question remains, what do politicians have to offer this diverse community?

# Market Failures. Myth or Reality?

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For many people, Neoclassical Economics support the idea that markets “fail” in many instances. This is the usual way to describe things in many well known textbooks.

Most of these textbooks also claim that the development of the “Economics of Information” (a branch of Microeconomics, initiated during the 70’s, that studies allocation problems in which the agents involved hold different information) has provided new arguments favouring this view. Not only because the Economics of Information has made clear that asymmetric information is the source of some previously unknown phenomena such as adverse selection or moral hazard, but also because information issues seem to be an important source of transaction costs in those environments in which classical market failures (externalities, public goods or increasing returns) may arise.

In this lecture, I challenge this view and claim that information asymmetries and other information costs provide arguments against, not in favor of, the idea that markets fail.

## **What do Neoclassical Economists mean by market failure?**

To make this claim clearer, some observations on the meaning of the expression “market failure”, first proposed by the economist Francis Bator in 1972, are in order. When neoclassical economists speak of market failures, they do not mean that markets fail to deliver “just” or “equitable” allocations, nor to the fact that, with freedom to choose, people may behave irrationally and are unable to pursue their own interests or to hold reasonable predictions about the future. By “market failure”, neoclassical economists refer to those instances in which free markets deliver Pareto inefficient allocations, even when the participants are fully rational and behave according to the predictions of Game Theory. That is, to instances in which, starting from the allocation arising with free markets, it is possible to reallocate resources in such a way nobody is worse

off and some people are (strictly) better off. Since Pareto inefficiencies imply that there are potential welfare improvements for all agents involved in an economic problem, claiming that delivering inefficient outcomes constitutes a failure of markets seems to be reasonable.

According to Neoclassical Economists, free markets (that is, free trade from an initial allocation of property rights) allocate resources efficiently in two -rather special- circumstances, or environments:

- The first of these environments corresponds to what modern game theorists refer to as an environment of complete information. Here, according to the Edgeworth-Coase tradition, free markets deliver inefficient outcomes only in problems in which trading is, for some reason, costly. Put it in other words, if preferences and technologies of all agents involved in a problem were common knowledge, then a simple way to allocate resources efficiently would consist in i) distributing property rights on all available resources and b) allowing people to freely trade on their property rights. Since any inefficient allocation of resources necessarily brings with it potential gains from trade to all agents involved in a problem, allowing the agents to trade the resources they own should exhaust these potential gains from trade. Of course, efficiency might not be achieved if information on subjective costs and benefits of trade are privately known (that each, individuals know only their own preferences and technologies) or there are other transaction costs that make it impossible that people exploit these commonly known gains from trade.
- A second environment in which free markets deliver efficient outcomes corresponds to what neoclassical economists refer to as a perfectly competitive environment. Here, according to the Walras-Arrow-Debreu tradition represented by the First Welfare Theorem, free markets deliver efficient outcomes even when information is private, that is even when the agents involved in a problem are aware exclusively on their own preferences and production possibilities. Unfortunately, and in addition to strong rationality assumptions, the First Welfare Theorem works only under very special circumstances, among which I should mention the following:

1. All commodities, that is, goods and services distinguished by their physical attributes as well as by the place, date and “state of nature” in which they are delivered, to be allocated are rival, (that is, the fact that one agent consumes a given amount of a commodity prevents that any other agent consumes the same amount of that commodity). As a particular case, there are no external effects in consumption or production activities, that is, consumption or production activities taken by any agent do not directly affect any other agent’s preferences or production technologies.
2. There exists a large number of agents trading at every market.
3. There exists a finite number of commodities.
4. There exists a complete set of markets operating at every date, so that all agents are able to trade, directly or indirectly, any two commodities any point in time.
5. The agents have Symmetric Information on the characteristics of every commodity, such as its quality, the future contingencies under which the commodity should be delivered, etc.... .

Since the assumption of complete information -and, hence, Edgeworth Coase argument- is rarely applicable, most sources of market failure correspond to departures of the assumptions under which the First Welfare Theorem holds. Before the works by Vickrey (1960) and Harsanyi (1966) provided the economists with the tools needed to understand games with incomplete information, three sources of market failure were identified: the classical problems of 1) *Externalities and Public goods*, the problems originated by agents with 2) *Market Power* with or without *Increasing Returns* and 3) *Long Run inefficiencies* arising in infinite horizon economies, a type of potential market failure discovered by Allais (1948).. With the development of the economics of information initiated after Vickrey’s and Harsanyi’s works, new sources of market failure were “discovered” (at least, in the context of formal models): Arrow (1963,65) highlighted some of the allocative inefficiencies originated when one the agents involved in a trade relationship can undertake actions that are not observable to the other part, a problem referred to as 4) *Moral*

*Hazard*. Radner (1969) was the first to study the allocative consequences of the fact that some markets (particular, markets for future commodities) might be 5) *Missing Markets*. Akerloff (1970) showed that if the information on the quality -or some other relevant characteristic-of a commodity is distributed asymmetrically, a phenomenon referred to as 6) *Adverse Selection* might arise in free markets. The work initiated by Akerloff on Adverse Selection was continued by Spence (1972), who showed that when markets allow the agents with private information to signal their unobservable characteristics, a phenomenon referred to as 6) *Market Signalling*, inefficiencies are not eliminated. Finally, Rothschild and Stiglitz (1976) showed that inefficiencies arising with adverse selection do not disappear either when the markets' response to Adverse selection takes the form of *Market Screening*.

Thus, the early works of Economics of Information initiated in the 70's seemed to support the idea that market failures were more important than most economists were aware of. Yet, a question remained open. Can governments "correct" market failures arising in contexts of asymmetric information? According to "Mechanism Design", a branch of the Economics of information also initiated in the 70's, there are many instances in which they cannot.

### **Can governments correct market failures? The lessons from Mechanism Design**

Mechanism Design studies how a central -non necessarily public- authority should "design" the "rules of the game" to allocate resources in order to satisfy certain objectives -such as efficiency-, in contexts in which information is private (or asymmetric) and costly to obtain and process. This branch of the Economics of Information was initiated by the russian-american economist Leonid Hurwicz, who, together with the American Mechanism Design researchers Eric Maskin and Roger Myerson, would won the 2007 Nobel Prize in Economics.

### **An example: designing auction rules to allocate a single object**

To understand Mechanism Design (hereafter, MD), I shall describe its main findings in the context of a simple economic problem in which:

- The owner of a single, perishable, and indivisible object wants to sell it to one individual among a group of buyers.
- Each individual's valuation (including the seller's) of the object in terms of another commodity -that I shall refer to as "money"- is independent of the amount that the individual owns of such other commodity. In the jargon, utility functions representing the agents' preferences are linear.
- The agents might have common beliefs on other agents' valuations (In the jargon, the individuals live in a Bayesian setting).

In this context, achieving efficiency means that the object should be given to the individual who values it most, for otherwise the individual who gets the object and the individual with the highest valuation would get involved in a mutually beneficial trade. If the owner of the object knew the buyers' valuations and one of these valuations were higher than her's, then she would try to sell the object to this buyer at a price close to this valuation, and the buyer would accept the seller's offer. .

However, when the agents are uncertain about other agents' valuations, free markets might deliver inefficient outcomes. To see this, assume that, in a free market system, the seller would use her property rights to run a standard English, ascending Auction with a given reservation price and a discrete but large set of possible bids available to each buyer. Using standard game theory, it is straightforward to see that all buyers participating in an English auction have a dominant strategy, that is, a strategy that is best to a player irrespective of the strategy played by the player's rivals. To be more precise, in an English auction, each buyer will stay bidding in the auction until the current bidding price reaches her valuation, so that the buyer with the highest valuation ends up winning the object at a price approximately equal to the maximum of the reservation price chosen and the buyers' second highest valuation.

Taking this into account, an English auction would always deliver efficient outcomes if the starting reservation price equals the seller's valuation. Unfortunately, if the seller is allowed to select the initial reservation price, she will maximize her expected utility by setting a starting reservation price above her valuation. By doing this, the seller faces a risk of not selling the

object (an event that will actually happen if the buyers' highest valuation is below the reservation price), but this risk may be compensated by the fact that, if sold, the object will be sold at a higher price. Therefore, if the seller makes use of her property rights and runs an English auction with the reservation price that maximizes her expected utility -as she would probably do in a free market system- there is a positive probability that the outcome of free markets is inefficient.

Observe that, in this example, the ultimate cause of market failure (i.e., of inefficiency) is asymmetric information, not market power. Taking this into account, a natural question arises:

I) Can any regulatory mechanism achieve efficiency if regulators face the same informational constraints as those faced by private agents and, hence, do not know other agents' preferences?

The reader may be surprised to find out that the answer to question I) is ..YES. In order to achieve efficiency, a regulator may expropriate the object to be allocated from its original owner and run a standard English auction (in which the former seller is allowed to participate as a buyer) with a starting reservation price equal to zero. As explained above, the agent with the highest valuation will get the object at a price approximately equal to the second highest valuation among all participants, which implies that the allocation arising from such English Auction is always efficient -that is, it is efficient for every possible specification of the agents' preferences-.

But, of course, this is tricky. The problem with such procedure is that it violates the former seller's rights. That might be fine to utilitarians or old fashioned practitioners of cost-benefit analysis; but for everyone else efficiency cannot be the only criterion to evaluate allocations from a normative point of view. As argued above, efficiency seems a reasonable social objective because staying in an inefficient allocation leaves some unanimous welfare gains unexplored, but moving from an inefficient allocation to an efficient one might not bring with it such unanimous welfare gains, and therefore it might not be desirable from a social point of view. In a world in which the agents have complete information about other agents' characteristics and an external impartial designer of the rules of the game does not have this information, giving property rights to the



people and let them trade on these property rights is precisely the means by which the designer can conceal her concerns for efficiency with her concerns for equity or justice. But distributing these rights on the grounds of efficiency does not make sense.

Taking this into account, researchers on Mechanism Design usually complete question I) as follows:

II) Can any regulatory mechanism can always achieve efficiency if regulators face the same informational constraints as those faced by private agents and, hence, do not know other agents' preferences? Can it do it without violating individual rights?

In the auction problem described above, respecting individual rights means that the seller cannot be enforced to sell if she does not want to and, analogously, that buyers cannot be enforced to buy if they don't want to. If regulators are restricted to respect these rights, achieving efficiency seems subtler. As explained above, English auctions will not achieve efficient outcomes and respect individual rights unless the starting reservation price equals the seller's true valuation, which is her private information. One might wonder whether a mechanism in which a regulator sets the starting reservation price after asking the seller what her true valuation is would do the job, but unfortunately the answer to this question is... negative. If a regulator asked the seller to report her true valuation, she would probably lie and report a valuation -which is the seller opportunity cost of delivering the object- equal to the reservation price that she would have selected to maximize her expected utility if she was allowed to do so.

### **The Revelation Principle**

Although designing mechanisms that always achieve efficiency and respect individual rights seems hard if we restrict to English auctions (with different rules to determine the minimum, starting prize), it might still be possible and other auction formats do the job.

But other auction formats do not work either. For example, consider a Dutch auction with a minimum reservation price, a procedure in which an auctioneer

starts from a high price which is lowered until it reaches its minimum value or one of the buyers stops the auction, in which case such buyer gets the object at that price. Dutch auctions are harder to predict than English auctions, because the individuals don't have dominant strategies. Still, Game Theory predicts that, as in any other game with incomplete information, an individual with private information will choose a Bayesian Equilibrium Strategy, that is, she will choose the action that maximizes the expected utility that she would obtain under the assumption that all other agents behave following the same principle. In a Dutch auction with a given reservation price, the Bayesian equilibrium strategy of a buyer whose valuation is above the reservation price consists in stopping the auction when its current price is below such valuation. Since any two buyers with the same valuations and beliefs will face the same strategy, Dutch auctions give the object to the buyer with the highest valuation above the reservation price, at a price that, however, is below the winner's valuation. It follows that, as for English auctions, Dutch auctions allocates the object efficiently if the reservation price coincides with the seller's valuation, an information that is hard to get for a regulator.

Thus, since neither Dutch Auctions or English Auctions achieve efficiency and respect individual rights, we should look for some other procedure. However, since the class of procedures (or mechanisms, or rules of the game) to allocate resources is potentially infinite, the search of mechanisms satisfying these two properties might be a never ending search. A key theorem in Mechanism Design, referred to as the Revelation Principle, allows one to reduce the class of mechanisms available to the designer to a much smaller class of mechanisms, referred to as Revelation Mechanisms, by which

- i) The participants report their private information to a mediator.
- ii) The dealer uses this information to select, with a pre-specified rule, a feasible allocation

The Revelation Principle can be stated as follows:

**The Revelation Principle:** *If the behavior of the agents in any mechanism is predictable using game theory, then such mechanism is equivalent (i.e., it yields the same outcome) to a Direct Revelation Mechanism that provides*

*the participants with incentives to report their true (privately known) characteristics*

*More precisely:*

*- If, for a given mechanism, every participant has a dominant strategy (that is an optimal choice depending only on the participant's private information), then the outcome of such mechanism can be equivalently implemented by a revelation mechanism for which reporting the truth is a dominant strategy (Hurwicz, 1973). Such mechanisms are called strongly incentive compatible mechanisms.*

*- If, for a given mechanism, every participant has a Bayes-Nash equilibrium strategy (that is, an optimal choice given their private information and their beliefs about the other participants' characteristics), then such mechanism can be equivalently implemented by a revelation mechanism for which reporting the truth is a Bayes-Nash equilibrium strategy (Myerson, 1979). Such mechanisms are called weakly -or Bayesian- incentive compatible mechanisms*

Although I shall not give here the mathematical details of the revelation principle, it's proof is quite simple. Observe that any mechanism can be described as a function mapping an abstract set of individual possible actions (or action plans) to the set of feasible allocations. Also, a game theoretical prediction of the behavior of the individuals in a mechanism must specify the action  $e_i(v)$  chosen by any individual participating in the mechanism as a function of the individual's private information. Thus, if a mechanism  $m$  is predictable to an outside observer (i.e., the designer), such observer can easily construct an equivalent revelation mechanism  $m'$  whose decision rule selects, for each profile of reported valuations  $v=(v_1, \dots, v_N)$ , the allocation that would result with the rules of the original mechanism if each individual played the predicted strategy  $e_i(v)$ . Then, if the original strategy of an individual was the individual's best response to other players' strategies, then telling the truth must be a best response to other agents doing the same in the revelation mechanism constructed as explained above.

In the context of the simple example described here, revelation mechanisms

are called Sealed Bid Auctions, and can be described as auctions in which the participants, without communicating with one another, secretly transmit their valuations to a mediator, who uses this information to select, with a previously specified rule, the individual who gets the object and the amount of money paid or received by every individual. For example, a First Price, Sealed Bid Auction with a minimum reservation price gives the object to the buyer reporting the highest valuation over the reservation price at a price equal to the buyer's reported valuation, while a Second Price, sealed bid auction with a given reservation price gives the object to the individual reporting the highest valuation over the reservation price at a price equal to the maximum of the reservation price and the second highest valuation reported by buyers.

To illustrate the strong version of the revelation principle, think of an English Auction with an exogenously given reservation price. As explained above, the dominant strategy of a participant consists in staying in the auction until the current price exceeds the participant's valuation. Thus, an English Auction gives the good to the buyer with the highest valuation over the reservation price at a price approximately equal to the maximum of the reservation price and the second highest valuation among buyers. But this is exactly what a Second Price, Sealed Bid Auction does, since, for such second price, sealed Bid auction, reporting the true valuation is a dominant strategy for every buyer. Thus, as stated in the strong version of the revelation Principle, English auctions are equivalently implemented by a revelation mechanism for which reporting the truth is a dominant strategies.

To illustrate the weak version of the revelation principle, a similar argument applies. Consider a dutch auction with a given reservation price, and let  $e_i(v_i)$  be the value of the current price at which buyer  $i$  would stop the auction if such buyer was playing a Bayesian equilibrium strategy, which must be a strictly increasing function of the buyer's valuation  $v_i$ . Then consider the revelation mechanisms whose provision rule gives the object to the buyer  $h$  with the highest valuation -over the reservation price- among all buyers, at a price equal to  $e_h(v_h)$ . If  $e_i(v_i)$  was a best response to other players' bayesian equilibrium strategies, then reporting the true valuation must be a bayesian equilibrium strategy of every buyer participating in such revelation mechanism, which is therefore equivalent to a Dutch auction.

In the context of the example analyzed above, revelation mechanisms -sealed bid auctions- are functions of the form

$$(x, p) : \mathcal{R}_+^{N+1} \rightarrow \mathcal{A} \subseteq (\{0, 1\}^{N+1} \times \mathcal{R}_+^{N+1}),$$

such that, for every profile of valuations  $v=(v_0, \dots, v_N)$ , and every individual  $i \in \{0, 1, \dots, N\}$  (where the individual indexed by  $i=0$  represents the owner of the good), the mechanism determines

- a decision  $x_i(v) \in \{0, 1\}$  representing whether individual  $i$  obtains -or keeps if  $i=0$ - the object (in which case  $x_i(v)=1$ ) or not (in which case  $x_i(v)=0$ );
- a decision  $p_i(v)$  represents the amount of money paid (or received if  $p_i(v)<0$ ) by individual  $i$ .

Note that, since the mechanism selects feasible allocations and there is a single object to be allocated among the individuals one must have, for every profile  $v$  of reported valuations,

$$\sum_{i=0}^N x_i(v) = 1 \text{ and } \sum_{i=0}^N p_i(v) = 0.$$

Thus, the set of all possible rules of the game become a tractable mathematical object, namely, the set of all functions satisfying both feasibility as well as incentive compatibility constraints.

### **Vickrey Mechanisms and the impossibility of designing (classically) efficient, strongly incentive compatible auctions**

With the Revelation principle in hand, proving that designing a mechanism that always achieves efficient outcomes and respects individual rights is impossible. Why? In an auction problem, a strongly incentive compatible mechanism that achieves efficient outcomes can be characterized as a mechanism working as follows (Vickrey, 1960):

- All participants pay a participation fee that is lump sum (i.e. independent of their own valuations);

- The object is allocated efficiently, that is, the single object is given to the buyer reporting the highest valuation;
- In addition to the participation fee, the buyer who gets the object pays a price equal to the second highest valuation (that might coincide with that of the seller's); while the seller receives a revenue equal to the highest valuation.

Thus, providing the participants with incentives to report their true valuations requires an unbalanced budget. Moreover, balancing the budget with participation fees violates individual property rights. Therefore:

Designing strongly incentive compatible auction rules that simultaneously i) respect individual rights and ii) yield efficient outcomes for every profile of individual valuations is impossible.

The same Impossibility affects weakly incentive compatible mechanisms. Why? Here, the answer comes from Myerson's Revenue Equivalence Theorem, that can be stated as follows:

**The Revenue Equivalence Theorem** (Myerson, 79) *Consider an auction problem in which the participants' valuations are independent random variables. If any two incentive compatible auction rules have the same rule to allocate a single object, the expected price paid by any buyer with a given valuation must be the same (except for lump sum terms).*

**Corollary 1** *With independent valuations, an English Auction and a Dutch Auction (with the same reservation price) yield the same expected revenue to the seller.*

**Corollary 2** *With independent valuations, a weakly incentive compatible mechanism that allocated goods efficiently must be equivalent to a Vickrey Mechanism. Therefore, designing weakly incentive compatible auction rules that simultaneously i) respect individual rights and ii) yield efficient outcomes for every profile of individual valuations is impossible.*

Therefore, even in the simple environment analyzed in previous section, the apparent market failure originated by a combination of Market Power and Asymmetric Information cannot be corrected by any regulatory mechanism.

But similar Impossibility Theorems have been obtained by other MD Researchers. The Best known impossibility results are the following:

- 1) **Hurwicz Impossibility Theorem** (Hurwicz 72): In classical exchange environments with private goods and a finite set of participants, designing strongly incentive compatible mechanisms that simultaneously i) respect individual rights and ii) yield efficient outcomes for every profile of individual preferences is impossible
- 2) **Gibbard-Satterthwaite Theorem** (Gibbard 72-Satterthwaite73): In a Social Choice Environment with unrestricted domain of preferences, the only Social Choice Functions that are Strategy-Proof (Strongly Incentive compatible) are Dictatorships.

There are many others, among which we should mention those by Groves and Ledyard (77) (Similar to that of Hurwicz's without even imposing respect to individual rights), Green and Laffont (79) (Public goods, quasilinear environments), Myerson and Satterthwaite (83) (Bilateral trading, quasilinear environments), or Mailath and Postlewaite (1989) (In pure, non excludable public goods, requiring incentive compatibility and respect for individual rights rules out not only efficient mechanisms, but also most mechanisms). Indeed, arriving to an impossibility result has become so common that many Impossibility Results are "Folk Theorems". In particular, achieving efficiency in environments with externalities, market power, moral hazard or adverse selection is usually impossible, specially if one cares about individual rights (See, e.g., Mas Colell et alii, 2005).

Furthermore, whenever positive results arise (environments with many participants and only private goods), Makovski and Ostroy (2000) have shown that:

- Incentive compatible mechanisms that achieve efficiency and respect individual rights closely resemble free market mechanisms.
- Conversely, mechanisms currently functioning in real trading problems closely resemble the outcomes of incentive compatible, efficient revelation mechanisms.

To get this idea, consider an environment similar to the auction environment analyzed above but that differs from a standard auction problem in that there might be many buyers and sellers willing to buy or sell one unit of a consumption commodity. In this setting, consider a revelation mechanism by which

- A mediator, using information of a profile  $v$  of reported valuations -or reservation prices-, selects a price  $p(v)$  in such a way that the number of buyers reporting a valuation above  $p(v)$  equals the number or sellers reporting a valuation below  $p(v)$ .
- Then, the mediator a) takes one unit of the commodity from every seller who previously reported a reservation price below  $p(v)$ ; and b) gives one unit of the commodity to each buyer previously reporting a valuation above  $p(v)$ .

For non expert readers, observe that the mechanism resembles the outcomes arising from free markets, except that, with free markets, there is no need for such a mediator. The competition among buyers and sellers to trade goods in the most favorable terms forces everyone to set a unique price, the price at which Demand Equates supply. Being strict this simple, market mechanism is not incentive compatible (that is, the agents may report a reservation price  $v_i$  different from their true valuation). However, the incentives to misreport vanish as the number of traders increases.

### **Conclusions**

To summarize, when one looks at the problem of market failures from a MD perspective, one learns the following:

- In spite of private information, free markets may allocate resources efficiently in some environments (Trading private goods).
- When they cannot, governments cannot either.

So, why do we refer to those circumstances as market failures and not as regulation failures? For MD researchers, it is not that institutions fail. Rather, they claim that focusing on outcome Pareto efficiency is not the proper way to evaluate allocation mechanisms when information is asymmetric. The



classical notion of efficiency uses information that is not freely available to any particular individual involved in an economic problem and, as we have seen, there are problems in which the only way to obtain that information is by committing ourselves not to use it.

In view of this, Holmstrom and Myerson (1981) proposed an alternative way a) to evaluate mechanisms and b) to determine whether a mechanism is optimal. Both a) and b) are also based on the Pareto criterion, but, differently from the classical notion of efficiency, use it to evaluate allocation mechanisms rather than allocations. More precisely

a) A feasible allocation mechanism (i.e., equivalent to an incentive compatible ) A is (Pareto) better than a feasible allocation mechanism B if, with the information available before any of these mechanisms is applied, the allocation A provides all participants with higher utility, independently of their private information

b) A feasible mechanism A is optimal (in the jargon, incentive constrained efficiency) if there does not exist an alternative feasible mechanism B that is better (in the sense given in a) ) than the mechanism A.

Indeed, Myerson and other MD researches have explores the properties of optimal to show that many mechanisms arising in free markets systems can be viewed as optimal. But that is a different story.

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# The organizations

## **The European Liberal Forum**

Founded in the fall of 2007, the European Liberal Forum, asbl (ELF) is the non-profit European political foundation of the liberal family. ELF brings together liberal think tanks, political foundations and institutes from around Europe to observe, analyse and contribute to the debate on European public policy issues and the process of European integration, through education, training, research and the promotion of active citizenship within the EU.

The role of the European Liberal Forum is to:

Serve as a framework for think tanks, national political foundations, institutes, academics and leading liberal personalities to work together at European level.

Develop close working relationships with and among its member organisations, the national parliamentary groups, the ALDE Party in the European Parliament, Liberal International (LI), the world federation of liberal political parties, and the European liberal youth (LYMEC), the youth organisation of the ALDE Party.

Observe, analyse and contribute to the debate on European public policy issues and the process of European integration, through education, training, research and the promotion of active citizenship within the European Union, particularly with regard to young Europeans.

Strengthen the liberal, democrat and reform movement in the European Union and throughout Europe.

Seek a common position, as a transfer of experience gained from the contracting Members, on all important matters affecting the European Union.

Support liberal democracy throughout Europe and its neighbourhood.

Inform the public and involve it in the construction of a united European democracy.

Support and cosponsor European seminars, conferences and studies on such issues between the aforementioned stakeholders.

How does the European Liberal Forum work?

The ELF General Assembly is the supreme decision-making body. It elects the members of the Board and approves the common annual activity programme, upon proposal by the Board of Directors. It also approves the annual accounts, the annual report, the budget and any other form of financing.

The ELF Board of Directors provides the foundation with day-to-day guidance. Currently, the Board is composed of: Felicita Medved, President, State Minister Dr. Jürgen Martens, Vice-President, Roel Martens, Treasurer, Andreas Bergström, Board member and Giulio Ercolessi, Board member.

### **Movimento Liberal Social**

The Social Liberal Movement ( abbreviated as MLS ) was founded in 2005 and aims to promote the Social Liberalism in Portugal . The movement is a platform joining individuals who believe that the old dichotomy Left / Right now makes little sense and it is possible to make policy in Portugal in a different and constructive way.

The MLS is not connected to any political party in Portugal , and yet the majority of its members sit ideologically very close to the European Liberal Democrats, the third largest political force in the European Parliament (which currently does not have any representative in Portugal).

In summary, one can say that the MLS defends:

The sovereignty of the individual over himself, the inalienable right to live his life and to seek his happiness at his discretion.

A fairer society , governed by merit where everyone can freely exercise their talents and develop their potential , free from any control or pressure in a supportive environment and respect between individuals.

Equality before the law, but always with respect for the right to be different.



Reduced to a bare minimum state, but ensures a sustainable manner and in accordance with the principle of subsidiarity , the defense of the individual and society, private property, the court, the existence of basic health services and social security, education quality, and protection of cultural and environmental heritage .

The Market Economy as a form of economic organization , but always under the control of the State, as its inevitable correction of imbalances element.

The existence of organizations that promote the free movement of people and goods, and collaboration at international level as well as the right of every people to self -determination .

### **Forum for Greece**

The Forum for Greece is an independent think tank based in Athens, Greece that engages in policy and lobbying, as well as events and initiatives across the globe. Through our partnerships and positive activism we impact political and civil discourse and encourage non-traditional collaborations, both within Greece and beyond its borders.

Founded in November of 2010, the Forum for Greece serves as a resource for government officials, business executives, journalists, educators and students, civic and religious leaders, and other interested citizens. Our goal is to develop concrete policy recommendations and to help in their implementation.

### **Asociación Galega para a Liberdade e a Democracia**

The Asociación Galega para a Liberdade e a Democracia (GALIDEM) was founded in 2009 and aims to promote Liberalism in Galicia. The GALIDEM is connected to the Galician party Convergencia 21, yet the members of GALIDEM are not necessarily affiliated to any political party and the actions and opinions of GALIDEM are independent.

The main objectives of GALIDEM is to spread the liberal values throughout the Galician society and to serve as a framework to observe, analyse and contribute to the debate on public policy issues, through education, training, research and the promotion of active citizenship.

### **Friedrich Naumann Foundation for Freedom**

The Friedrich Naumann Foundation for Freedom is the foundation for liberal politics in the Federal Republic of Germany. It aims to promote the goal of making the principle of freedom valid for the dignity of all people and in all areas of society, both in Germany and abroad. With the safeguarding and the development of its statutory projects (civic education and dialogue, sponsorship of the talented, research and political consultation, archive-work), the Friedrich Naumann Foundation wants to contribute to shaping the future.

In Germany the Foundation offers diverse forums, mostly for young and talented people, to exchange of information and experience in present-day contexts. Its main focus is to promote a greater understanding of politics and to inspire citizens to take part in political processes.

Abroad, the support of human rights, rule of law and democracy in more than 60 countries form the core of the work of the regional offices in Europe, Africa, Asia, and Central America; various forms of international dialogue and transatlantic dialogue programme are used to promote these three values around the world. The foundation supports local, regional, and national initiatives to advance the rights of minorities, the democratic control of security forces and for strengthening international human rights coalitions.

Furthermore, we assist the development of democratic and constitutional structures by supporting liberal parties and groups. A strong network of associations of democratic parties, of human rights organisations and of academic establishments forms the basis of the foundation's activity abroad. The foundation's central idea, both at home and abroad, is the realisation of freedom and responsibility.



