Limits of the Market

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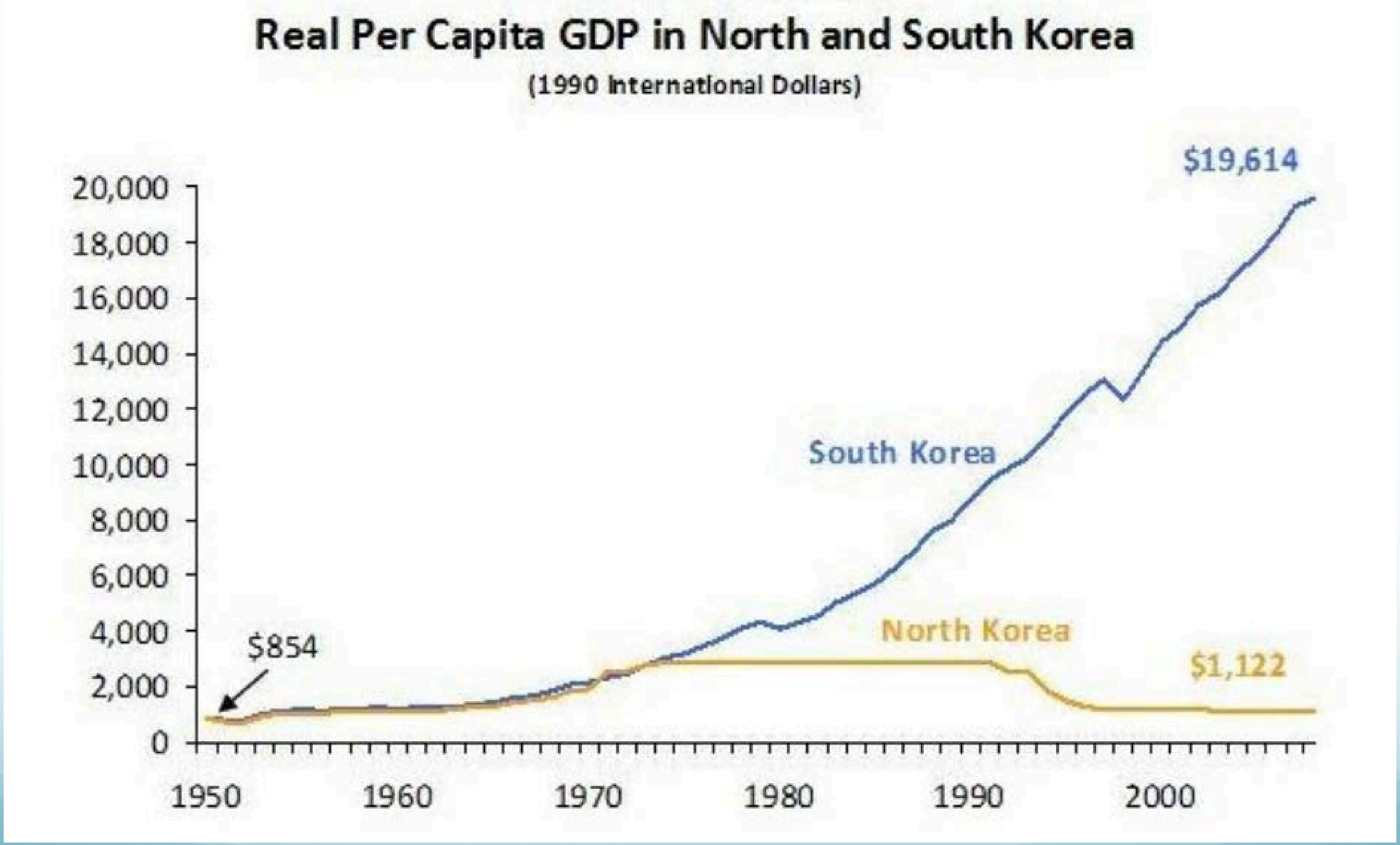
Wonders of Capitalism

- Capitalism (market system) only system that has been capable of providing increasing material welfare for large parts of population.
- Other systems have failed
- In particular Communism

Contrast between 2 systems

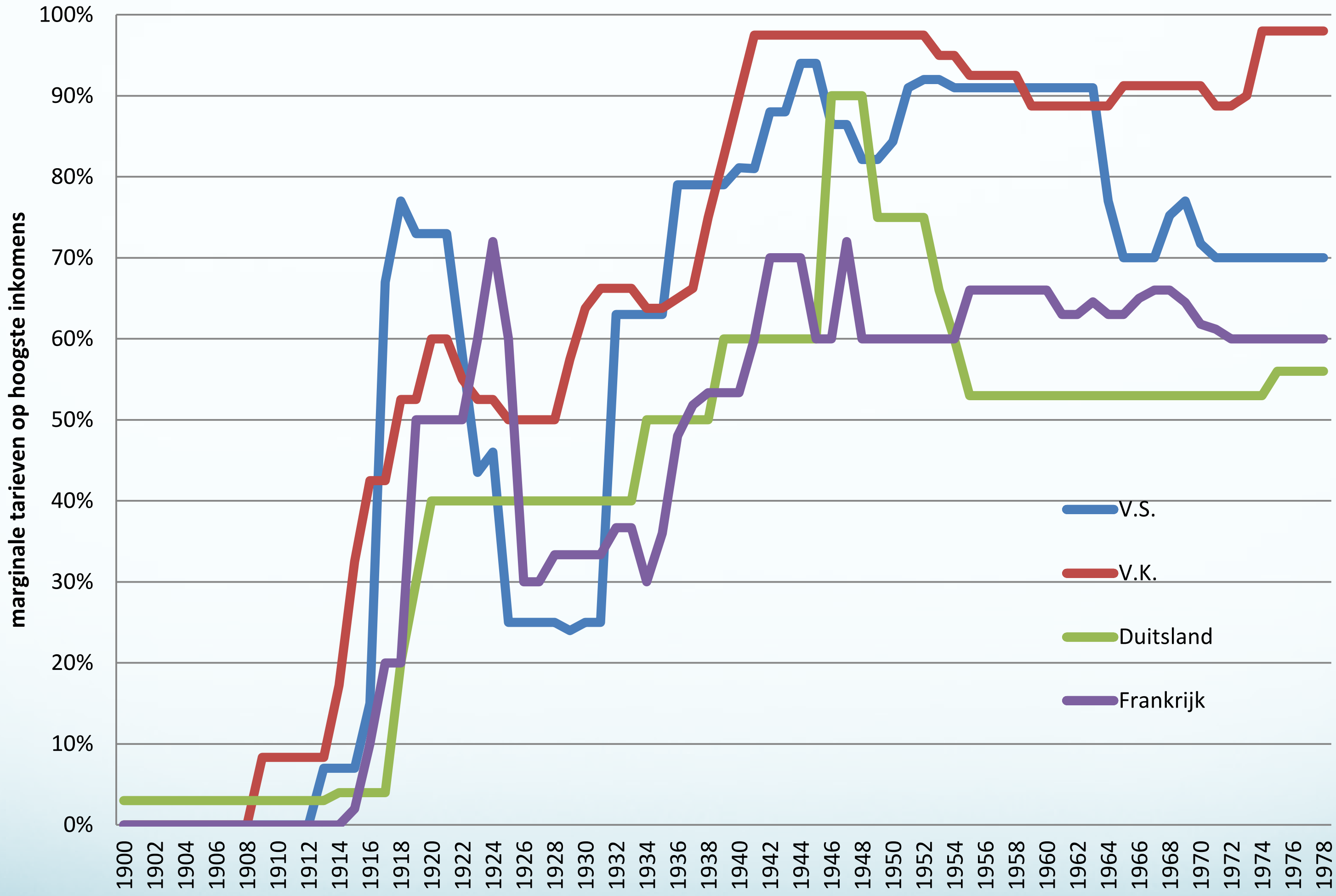


Cyclical movements capitalism

- If all is so well with capitalism why has it regularly been rejected, to be reinstated later?
- History of capitalism is one of cyclical movements.
- Periods of strong growth of capitalism:
  - Second half 19th century
  - 1980-2008.

- But capitalism becomes victim of its own success and hits its limits.
- Governments take over.
- This happened in the early 20th Century and especially after Great Depression:
  - Large parts of the world turned to Communism,
  - Elsewhere governments took over command of economy.

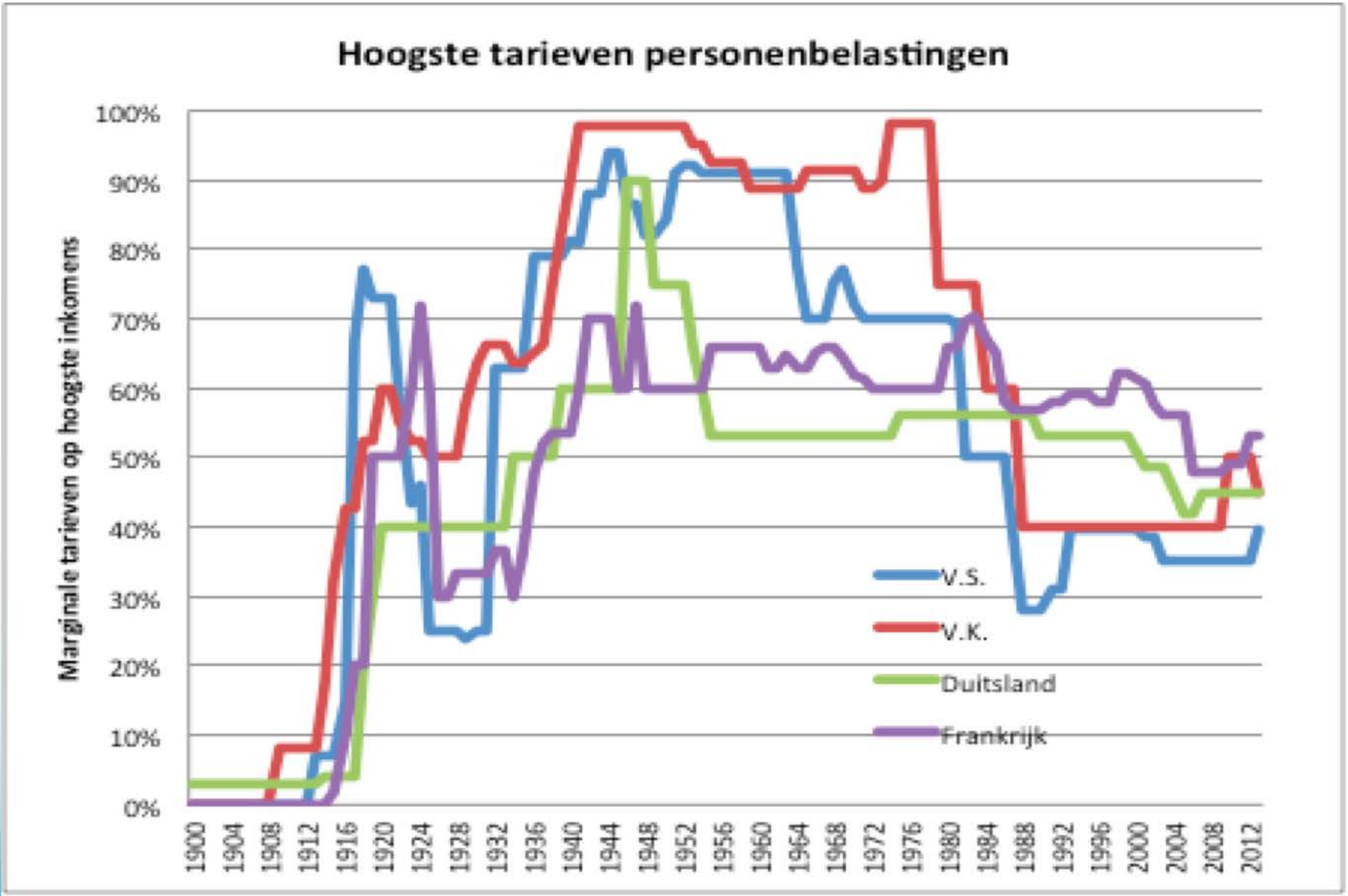
Hoogste tarieven personenbelastingen



Bron: Piketty, Capital in the 21st Century

Cyclical movements

- Cyclical movements do not end when governments take over.
- These governments in turn hit their limits as during the 1970s
- From 1980s triumphant return of markets



Hoogste tarieven personenbelastingen
Marginale tarieven op hoogste inkomens
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V.S.
V.K.
Duitsland
Frankrijk

- Markets and governments seem to permanently circle around each other,
  - Ready to take over when the other fails
  - to be pushed away by the other again.

Questions I want to raise

- What are the limits that constrain the evolution of the market and that make its success temporary?
- And what are the limits of the state that each time lead governments to retrench from the economy?
- Are we condemned to repeat these cyclical movements in the expansion and contractions of markets and governments?
- Is there a magic equilibrium possible between these two systems?

Origin of the limits of the market

- Limits arise **because individual rationality and collective rationality are not in tune**.
- In contrast with the “invisible hand” of Adam Smith
- I will make a distinction between
  - External limits
  - Internal limits

External limits

- Very generally: individuals do not take into account the external effects of their decisions
- Example of polluting firm
  - Creates costs outside the firm (external costs)
  - And does not take these external costs into account in calculating the cost of what it produces

- Nothing in market system forces firms to take these external costs into account
- These costs are not “internalized”
- Effect:
  - Social cost of production exceeds costs imputed by the firm
  - Too much is produced of goods with external costs
- Environment deteriorates
- As the market expands this gets worse
- Globalisation enhances this

Old and new globalisation

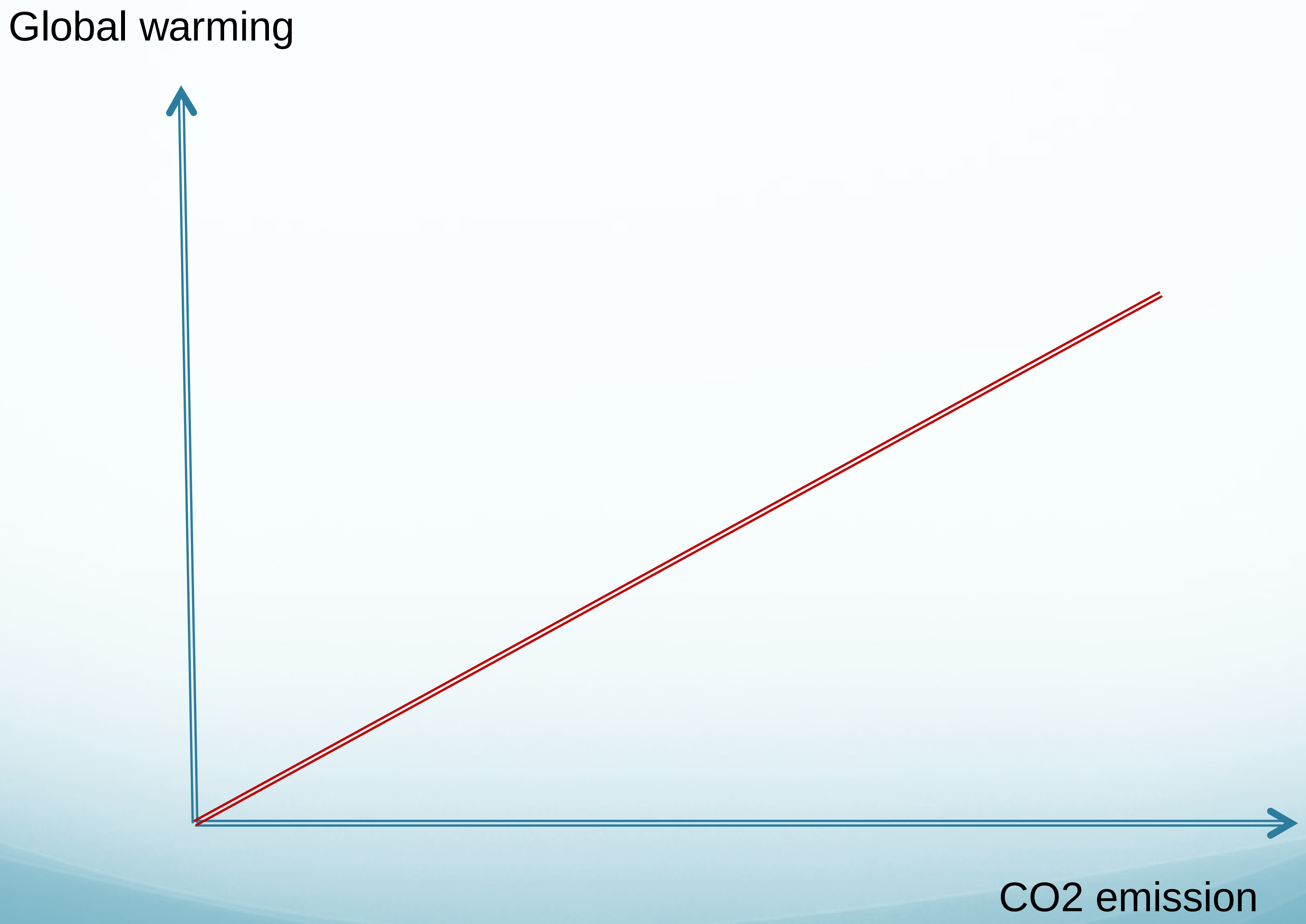
- “New globalisation” is very different from “old globalisation” (Richard Baldwin)
- Old globalisation was based on strong reduction of the cost of moving goods, while the cost of moving ideas and people did not decline at the same rate.
- The ICT revolution has changed this
- It has made it possible to substantially reduce the cost of moving ideas.

- As a result, it became possible to “unbundle” production stages
- and transfer many of these to other countries
- This has created long “global value chains” that encompass many borders
- leading goods to frequently cross the same borders
- while with each border crossing new components have been added
- New globalisation amplifies external costs because it multiplies transportation

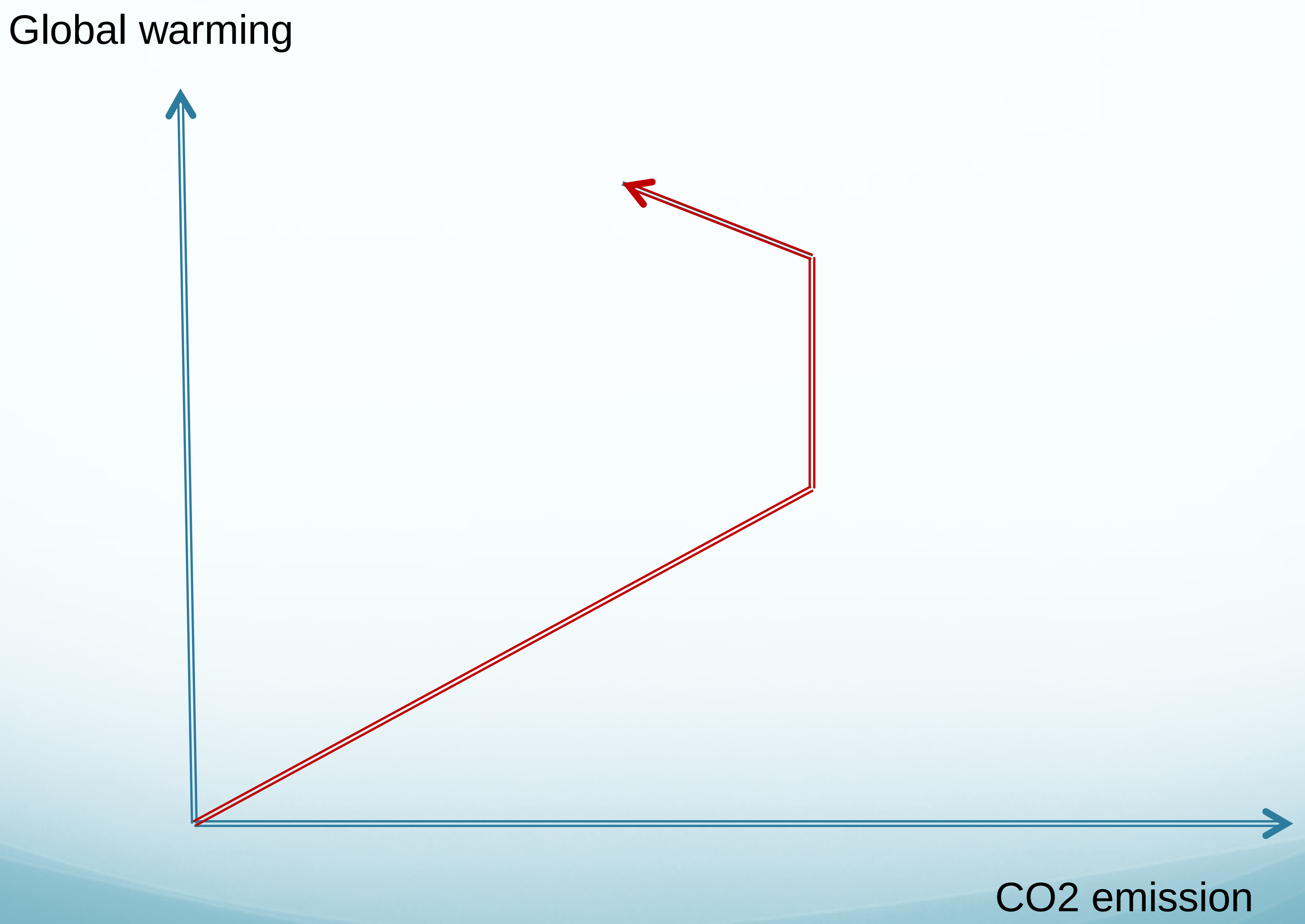
Climate change

- Extreme example of this problem
- Because most of the external costs cross the borders making it impossible to allocate the costs to all those who are responsible for them.
- CO_2 emission uncontrollable.
- Two views: linear and non-linear

Optimistic view: the world is linear



Pessimistic view: the world is non-linear



- If non-linear model prevails it will lead to catastrophe if not stopped
- Collateral damage will be imposed on market system: it will be rejected and authoritarian systems will take over.
- This is also what happens during wars.

External costs in financial markets

- Bankers do not take into account the risks they create outside their own banks (external risks)
- These are important because banks form a network of borrowing and lending with other banks
- Domino effect when one bank gets into trouble
- Banks take too many risks because they do not take these systemic risks into account
- Great instability of financial system

Internal limits

- Kahneman:
  - System I: emotional dimension
    - Love, hatred, fear, sense of justice (fairness)
  - System II: calculating and rational
    - Computes costs and benefits of individual decisions
  - System I is fast; system II slow and “lazy”
  - Interaction between two systems (Damasio)
  - Balance between two systems necessary to make us happy.

- Market system calls upon rational and calculating capacity of individuals (system II).
  - These react to financial incentives and competition.
- When market system expands rational capacities gain in importance.
- They become the sole criterion of individual success.

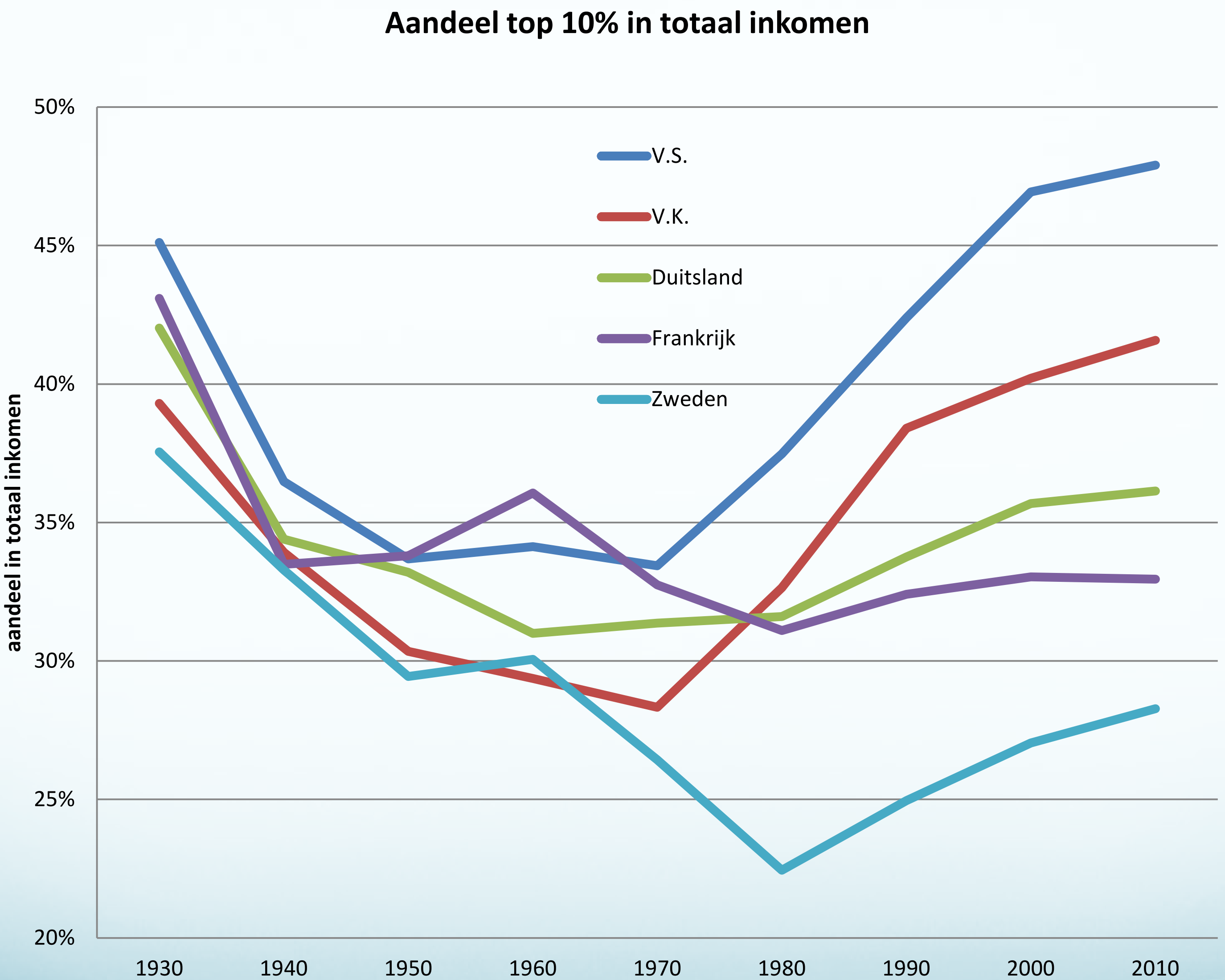
- Other individual characteristics of the emotional System 1 are repressed.
  - Many people who care about fairness in income and wealth distribution, who have intrinsic rather extrinsic motivations and for whom cooperation matters
  - are dissastified by a system that does not attach importance to these motivations..
- Market system produces a lot of material welfare,
- but represses feelings that matter to make individuals happy

Competition and cooperation

- Many individuals find a lot of satisfaction and happiness in cooperation.
- At the same time many individuals find satisfaction in competition.
- The firm is marvelous invention that combines cooperation (internally) with competition (externally)
- But when the market system expands it breaks the balance, when inside the firm competition takes over from cooperation.
- This is often the result of financial markets with their short-termism

Individual and collective welfare (again)

- All this can be summed up as follows: expansion of market leads to widening gap between individual and collective welfare
- Result: system is rejected; it is perceived as unfair, cold and brutish.
- Social consensus that free market system needs for its survival is undermined.
- Increasing income and wealth inequality makes this outcome increasingly likely..

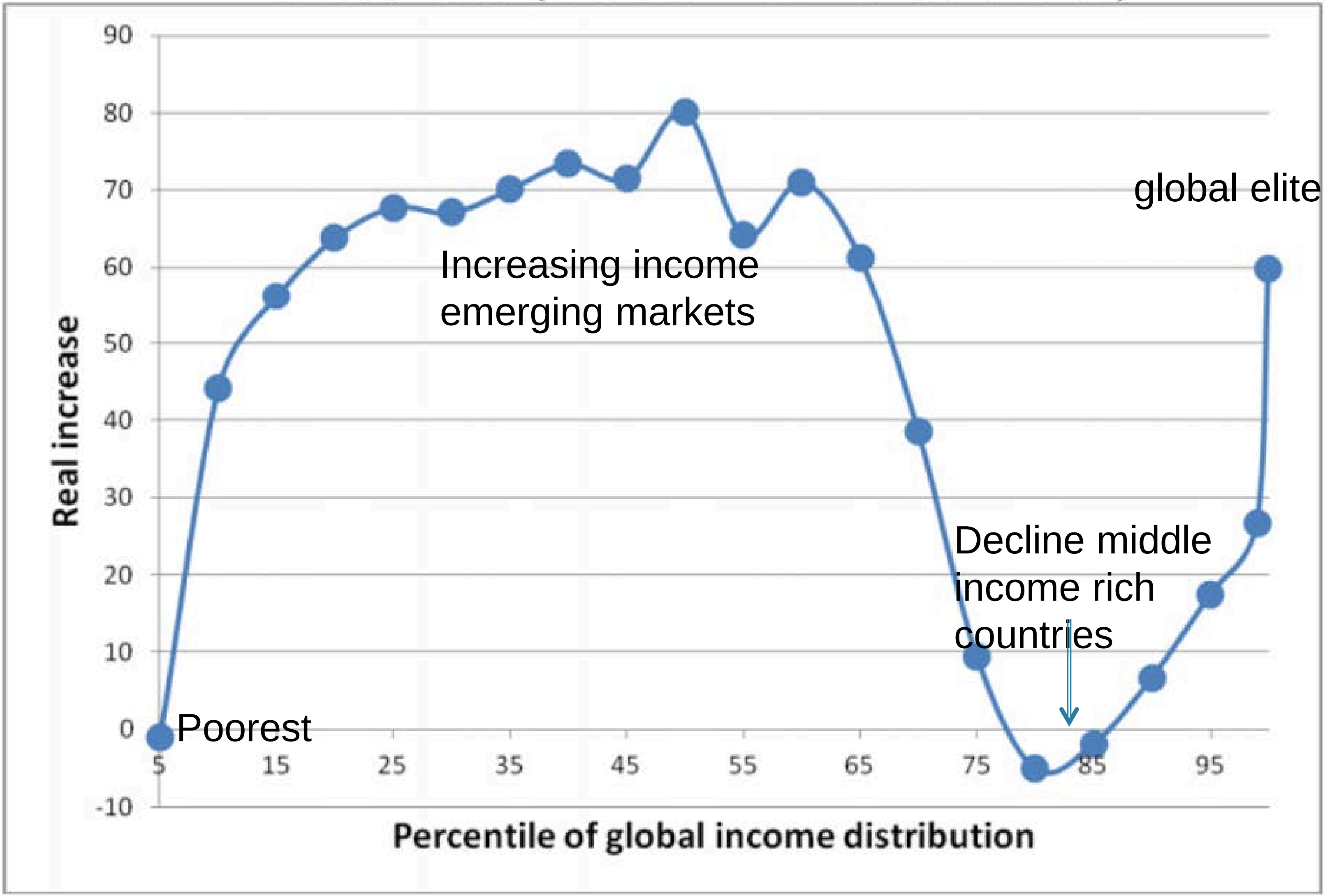


Bron: Piketty, Capital in 21st Century

- Free market system (globalisation) leads to winners and losers
- Lots of winners of globalisation.
- The most important winners are the hundreds of million people (mostly in Asia) who were pulled out of extreme poverty thanks to globalisation.
- Also winners in industrial countries,
  - People working in export industries
  - Shareholders of Facebook, Google, Apple, etc.
  - Top football players

- The losers are the million of workers in industrial countries
  - Who lost their jobs
  - or experienced deep cuts in their wages

Figure 4. Change in real income between 1988 and 2008 at various percentiles of global income distribution (calculated in 2005 international dollars)



Note: The vertical axis shows the percentage change in real income, measured in constant international dollars. The horizontal axis shows the percentile position in the global income distribution. The percentile positions run from 5 to 95, in increments of five, while the top 5% are divided into two groups: the top 1%, and those between 95th and 99th percentiles.

Self-destroying success

- When market system hits its limits the state is strengthened.
- Dynamics is created that shrinks the market,
  - when market system leads to destruction of environment
  - when inequality becomes unacceptable.
- There is something self-defeating in market system.

Absence of self-regulations

- Capitalism is not capable of self-regulation that will prevent hitting its limits.
- These regulatory systems can only be created and maintained by governments. .

How to marry individual and collective rationality?

- Essence of the theory
  - Tax those who generate external costs; this forces them to internalize these costs.
  - Redistribution of income and wealth
  - Social security
- This is necessary to save capitalism
- Paradoxically those who oppose these policies are the real enemies of capitalism.

Knowledge insufficient for action

- We know what should be done
- But will it be done?
- Not necessarily, because governments also hit their own limits
  - These make it difficult to impose the collective good on individuals who only care about their private welfare.
- Also in politics there is wide gap between collective and individual rationality.

Limits to political system

- Individual interests fight governments that want to promote collective welfare.
- This reduces the capacity of governments to act.
- And creates danger that governments are instruments of individual interests.
- Key issue: what type of governance gives best guarantees that those in power will pursue the common interest?

Democracy: least bad system

- Challenge: bridge the gap between individual and collective rationality.
- Difficult but chances of succes greatest in democratic systems.
  - In these systems consensus building about what should be done easiest.
  - Allows for bottom-up pressure from the people towards the politicians so as to force them to do something about environment and inequality

- Autoritarian systems fail dismally
  - Private interests infiltrate these political systems much more than democratic systems.
  - Result: discrepancy between private and collective interests is much larger than in democratic systems.
  - Weak bottom-up pressure

Cyclical movements between market and state

- History of last 200 years: cyclical movements in power of markets versus governments.
- Question is: will this history repeat itself?
- If so: will the recent expansion of the market be temporary and lead to a return of the state as the leading force in the economy?

Is this likely to happen?

- I would say yes,
  - It will be very difficult to control the environmental effects of economic growth.
  - Negative environmental effects threaten to become so overwhelming that they will destabilize societies.
  - Authoritarian political systems are likely to take over the commands of the economy.
- Similarly the pressure to deal with inequality may be too weak to avoid political upheaval

Conclusion

- Future looks somber
- But this should not be reason for despair.
- Le mythe de Sisyphe
- We are condemned to act.
- “Il faut s’imaginer Sisyphe heureux”