

# Markets under siege. Towards a fair economy

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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.
- Why?
  - Freedom to produce and consume
  - Markets with competition
  - Free trade (globalisation)
- These three factors are responsible for innovation and technical progress
- Lifting material welfare to unseen levels.

# Other systems have failed

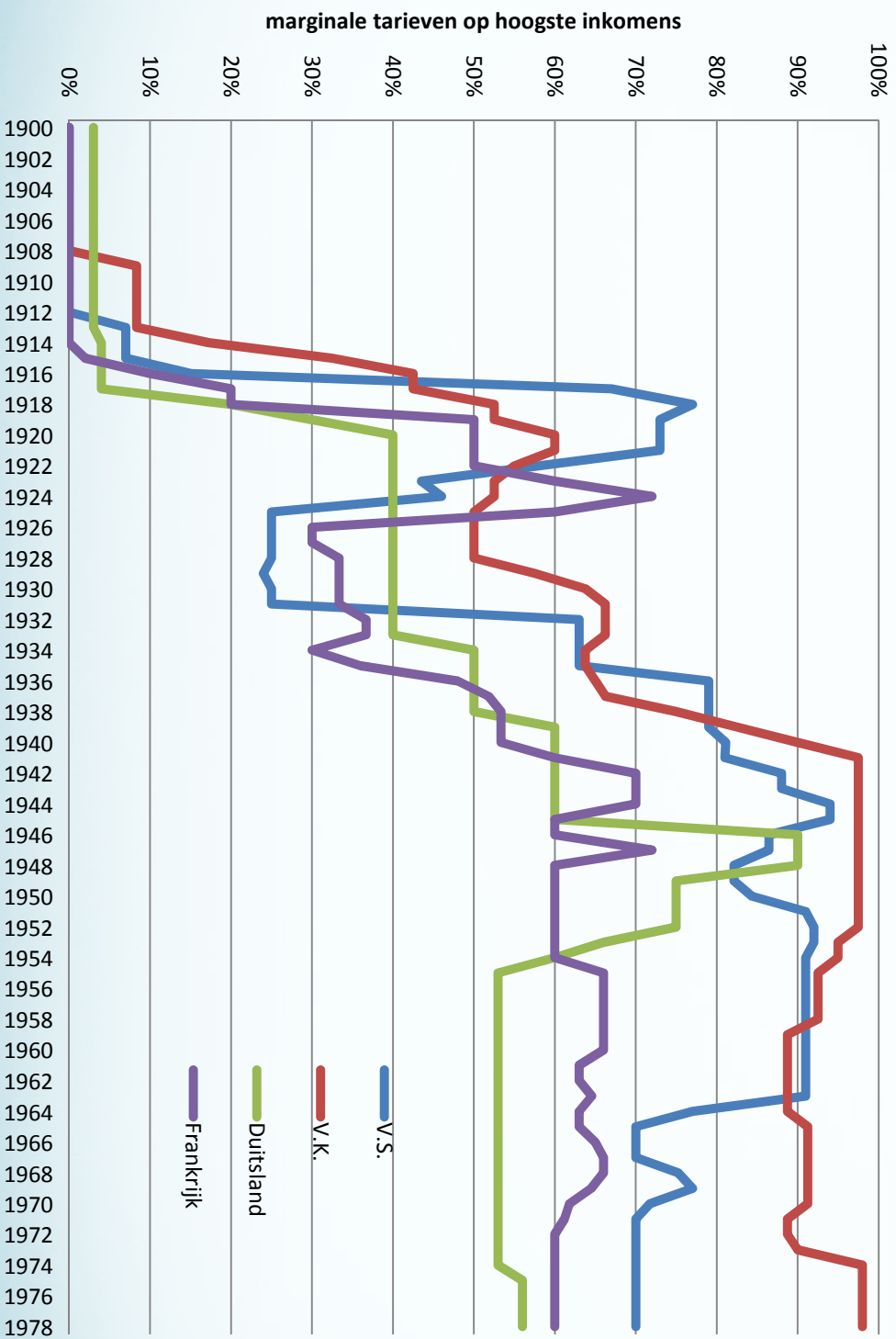
- In particular communism has failed
- Why?
- Centralisation of all economic decisions led to two problems:
  - Intractable information problems
  - Absence of incentives to work hard and to innovate
  - Very little technological changes
  - Stagnation.

# 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.

- Each time 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

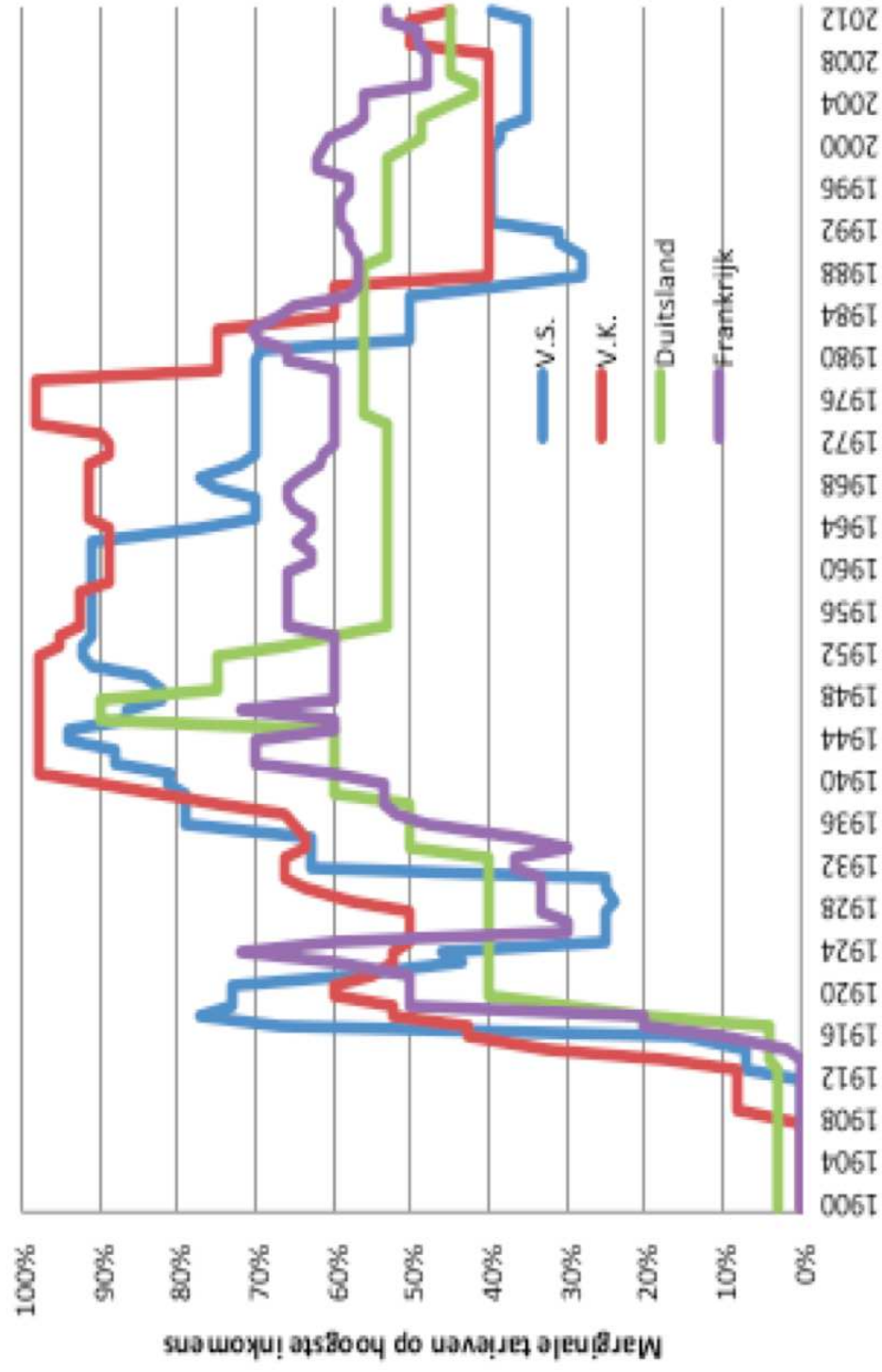


Bron: Piketty, Capital in the 21<sup>st</sup> Century

# 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





- 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?

# 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
- Distinction between
  - External limits (environmental)
  - Internal limits
- I will only deal with the internal limits

# 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 dissatisfied 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

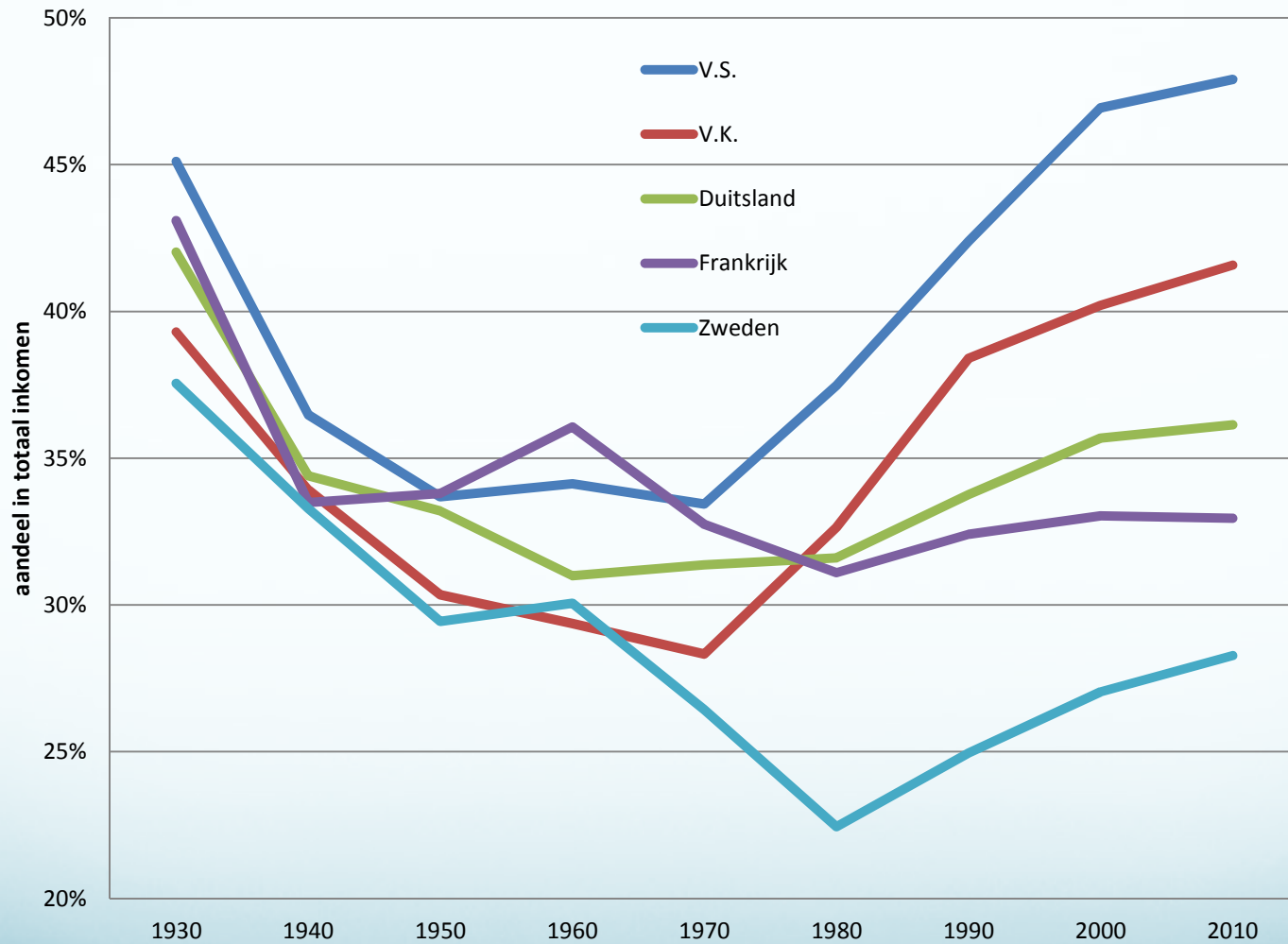
- Many individuals find a lot of satisfaction and happiness in cooperation.
- At the same time many individuals find satisfaction in competition.
- The firm is marvelous invention that combines cooperation (internally) with competition (externally)
- But when the market system expands it breaks the balance, 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

- **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..



## Aandeel top 10% in totaal inkomen



Bron: Piketty, Capital in 21<sup>st</sup> Century

# 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
  - Strengthen 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.

# Democracy: least bad system

- Challenge: bridge the gap between individual and collective rationality.
- Difficult but chances of success 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

- Authoritarian 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
- We must resist authoritarian systems
- The will lead to destruction of free markets