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Will We Have to Redraw the Boundaries between Government and Markets?

The question as to whether the boundaries between the state and markets should be shifted can be approached at different levels. At the more fundamental level, the question might be: What is the right economic system? At a more pragmatic level, we have to ask: Should or will government involvement increase in view of the current crisis (whether we like it or not)?

In accordance with the different levels of the question posed in the title, my answer is threefold. First: No, there is no need to redraw the boundaries. Second: Yes, the boundaries will shift. Third: The changes required go beyond the boundaries between government and markets.

Part A: No Need to Redraw the Boundaries between Government and Markets

The fact that certain people have adhered to a naïve market ideology is no reason to now shift to a blind state ideology. Slogans such as *markets are efficient, state intervention is bad; managers are competent, politicians are corrupt* are as unfounded as their counterparts, *markets are chaotic, central coordination is better; managers are greedy, politicians serve the common cause.* The challenge is to remove the ideological boundaries instead of shifting between ideologies.

The view that market economies work well if they are not disturbed by state activity has always been wrong (and will be wrong in the future, of course) – both empirically and from the point of view of economic theory.

Empirically, any discussion about the boundaries between state and markets should bear two facts in mind. First, the government share is substantial in all advanced market economies. Second, it ranges between roughly 30% and 60% of GDP. This tells us two things: (i) strong government activity is a regular feature of market economies; (ii) there is no single, quasi-natural boundary between government and markets.

Theoretically, the foundation of market economies is given by the two fundamental theorems of welfare economics. They define the boundaries between government and markets in a rigorous and correct way by telling us that under the assumption of (i) "rational economic agents", (ii) "complete markets" and (iii) "perfect competition", we can draw two conclusions. First, in equilibrium, market outcomes will be efficient. Second, given appropriate redistribution, any efficient outcome can be realized through markets. In principle, this provides us with clear guidelines for the allocation, stabilization and distribution functions of the state. Obviously, the meaning of theory is in the premises as well as in the conclusions. If we remember this, then – from a theoretical point of view – I see no need to redraw the boundaries between government and markets.

The problem is that these guidelines have become blurred over the last 15 years or so. In my view, this is closely related to the emergence of new markets (including, in particular, new financial markets in advanced economies) and to the blossoming of some young scientific industries. I see two main errors behind the current crisis: an almost universal shift in the focus of attention from real economics to fi-

nance;[1] and a broad neglect of *underlyings*, including the assumptions underlying the efficiency of a market economy. Asset prices in the news and the *bankers' view* being presented as economic expertise in the media are prominent examples of the shift in attention. But the

shift also occurred in the scientific community. In certain environments, it seemed that *the causes and the sources of the wealth of nations* had changed from production of goods or services and the employment of human as well as non-human resources to financial wealth and its management. In order to illustrate the recent neglect of the assumptions underlying the theoretical foundation of the market economy, I would like to give three examples.

Example 1: Naive Belief in Rationality and Equilibrium

Many conclusions in monetary macroeconomics and financial modelling seem to be based on the following reasoning: Whatever happens is the outcome of a rational expectations equilibrium so there is no need to bother about drastic changes in income distribution or fundamental imbalances reflected in basic macroeconomic variables like saving rates, debt ratios or current accounts. This is not what economic theory tells us. It is instead an aberration of certain very specific though widely used models in which the role of heterogeneity of economic roles and interests is neglected and important imperfections are ignored. At the level of economic policy, this neglect is reflected by the fact that *magical polygons* have lost their appeal – in particular, the dimensions of *external equilibrium* and *fair distribution*.

Example 2: Uncritical Belief in Complete Financial Markets

Not every economic interaction is captured by the markets. This is well understood in the theory of public goods and external effects, in contract theory and the foundations of financial economics. Obviously, the problem of incomplete market interaction will be particularly severe if we have to deal with the future. This suggests a cautious approach to financial markets. Unfortunately, the opposite seems to be the case. On the one side, there was the euphoric conviction that any incompleteness could be cured by financial innovations. On the other side, ample financial marketing activities promoted the confused belief that any new financial product is a financial innovation satisfying a missing market.

Example 3: Presumption of Competitive Financial Markets

Industrial economics, including new empirical industrial economics in more recent years, has been one of the most dynamic research fields since the 1980s. The dynamic was driven by the

[1] *The shift in attention to financial business may have been fostered by the almost global wave of privatization, but shifts of boundaries between the real and the financial world are still a different thing to a shift between the public and the private sector.*

fact that market power and imperfect information are important features of real markets. Given the growing importance of the financial industry and the rise of finance as an academic field, one could expect financial industrial economics to be a core topic in the finance literature and in the finance curricula – examining, for instance, excessive returns and fees or the dead weight loss from tax avoidance and subsidies. To my knowledge, this has not been the case so far. This is reflected by another observation. In almost all fields of real economics it has become quasi a required standard to account for some market imperfections. For instance, new trade or new growth theory have created a healthy niche for themselves by considering fixed costs, oligopolistic and monopolistic competition, and so forth. Another even more striking example is macroeconomics. Distortions through search costs or union power in the labour market are a must of modern theoretical and empirical research and teaching. By contrast, frictions and rents in the financial market are more or less missing from the analysis.

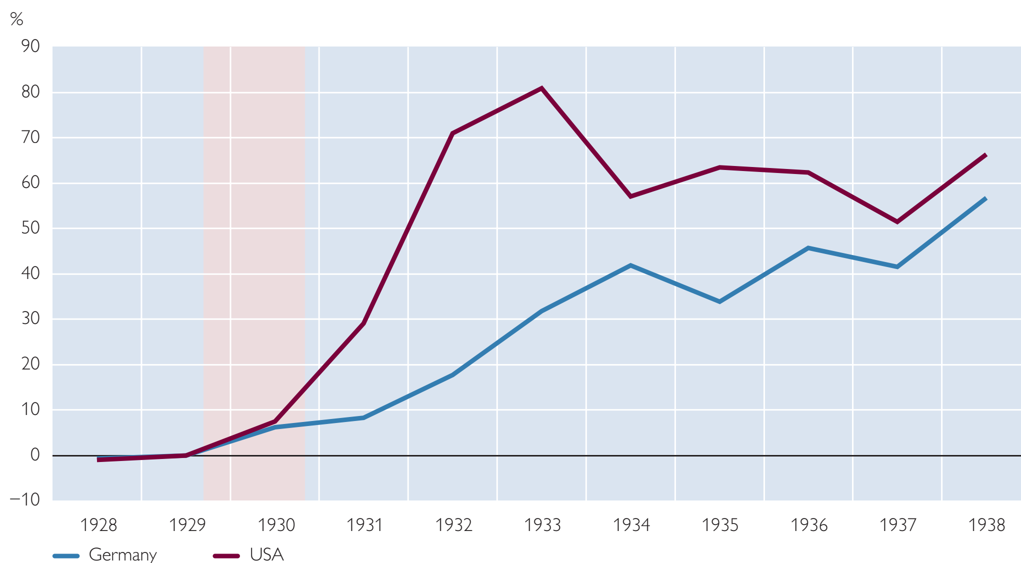
Part B: Yes, the Boundaries Will Shift

In short, the first answer was that ideologies and shifts between ideologies are unhelpful. The boundaries between government and markets are correctly defined by the theoretical foundations of the market economy provided by economic theory. Rather than redrawing boundaries, we should remember basic economics and fix some holes in the business and policy domain as well as in the area of academic research and teaching. In particular, this applies to management and regulation in the financial industry, as far as business and policy is concerned, and to finance and monetary macroeconomics, as far as scientific work is concerned.

While the first answer addressed the principal normative aspect of the question posed, my second answer is

Chart 1

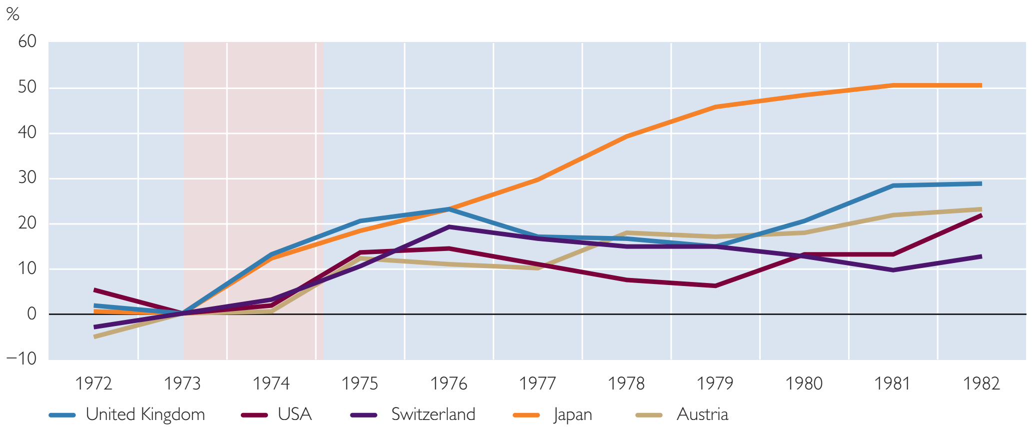
Great Depression 1929 – Percental Change of Share of Public Expenditures in GDP Relative to 1929



Source: Federal Ministry of Finance Germany and from www.usgovernmentspending.com, *author's calculations.*

Chart 2

Oil Crisis 1973/74 – Percental Change of Share of Public Expenditures in GDP Relative to 1973

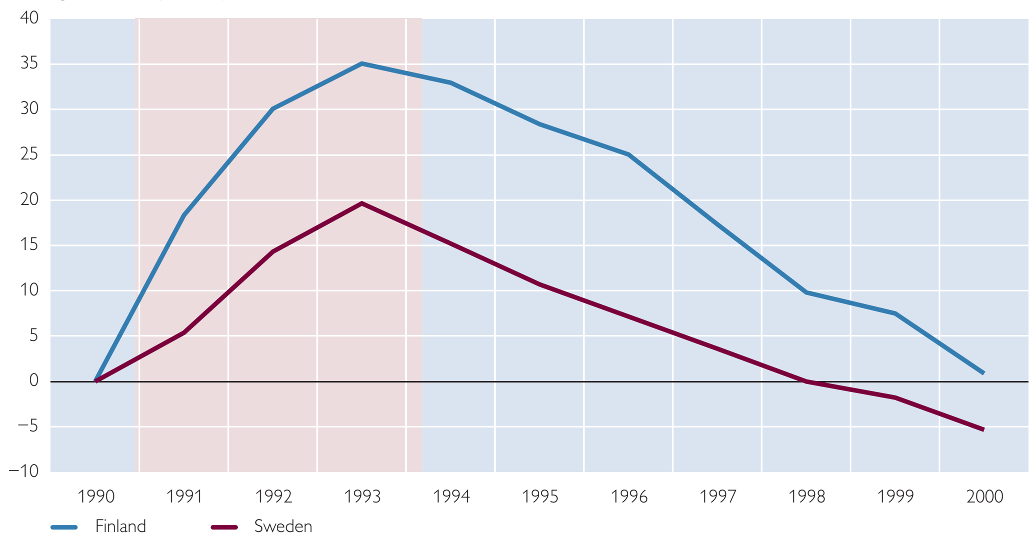


Source: Data from UK National Statistics, www.usgovernmentspending.com; IMF (JPN, AUT); Public Finances of Switzerland; author's calculations.

Chart 3

Scandinavia Crisis 1990 to 1993

% change of share of public expenditures in GDP relative to 1990



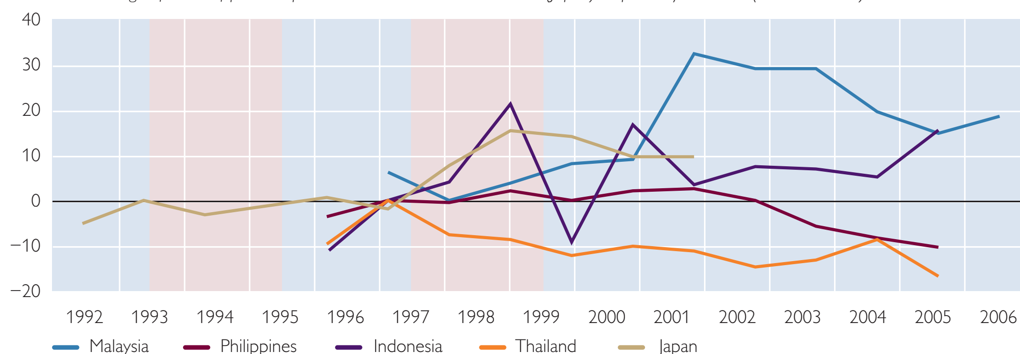
Source: Data from OECD (Sweden), Statistics Finland; own presentation.

more pragmatic and refers to the level of positive analysis. Of course, the crisis will raise government shares for quite a while. Even if ex ante a larger state is not needed to avoid a crisis, increased involvement of the state will be inevitable ex post so as to stabilize both the financial system and the real economy. A look back into past crises sheds light on this fact. The figures show for four prominent episodes of crises – the Great Depression, the Oil Crisis, the Scandinavia Crisis and the Asia Crises including Japan – the dynamics of the government share in the aftermath of the crisis. For the sake of comparability, the presentation focuses on the percentage changes of public expendi-

Chart 4

Japan Crisis 1993/94 and Asia Crisis 1997/98

% Percental change of share of public expenditures in GDP relative to 1993 (Japan) respectively to 1997 (other countries)



Source: United Nations Economic and Social Comission for Asia and the Pacific (UNESCAP), author's calculations.

tures shares relative to the government share at the beginning of the respective crisis.[2]

The only controversial question is to what extent the increased share of public expenditure in GDP will be accompanied by a rise in state ownership. Should the state acquire equity capital when rescuing insurance companies, banks or other firms? In principle, acquiring ownership in exchange for financial means is a standard deal in a market economy. Obviously, if the state is involved, this should only happen in exceptional situations. The goal cannot be the nationalization in the long run. However, in difficult phases, history has seen quite some variation of state ownership in real market economies without these markets being destroyed. An example are the difficult but successful decades following the Second World War.

As certain as rising government shares are my concerns about them. First, a larger government share does not necessarily mean a stronger government. States may be overloaded or even fail. The loss of confidence in markets might be followed by a loss of confidence in democratic governments. Second, the pro-state mood risks being abused by all kinds of lobbies – from companies to industries, unions and political organizations – seeking to secure benefits for themselves. This further increases the burden on the state and keeps inefficient structures alive. Third, the global character of the current crisis requires supranational measures rather than nationalistic reactions. The history of the periods before and after the First World War showed us the road from nationalistic protectionism to catastrophe. Finally, the rise in government shares may have undesirable distribution effects. One inequity is almost unavoidable in the short run: Due to the key role of the financial sector, the players responsible for the current crisis will also have to be saved – at least partly. In the long run, either the taxpayers will pay for the incurred public debt or, if inflation returns, gov-

[2] *The figures are based on government shares reported in the following data sources:* Great Depression 1929: *Federal Ministry of Finance Germany; www.usgovermentspending.com;* Oil Crisis 1973/74: *UK National Statistics; www.usgovermentspending.com; IMF (JPN, AUT) Public Finances of Switzerland;* Asia Crisis 1997/98 and Japan 1993/94: *United Nations Economic and Social Commission for Asia and the Pacific (UNESCAP);* Scandinavia Crisis 1990-93: *OECD (Sweden); Statistics Finland.*

ernment bond owners will lose part of their savings. In view of this fact and the current risk of deflation, the options of financing public debt by the central banks should be discussed in full transparency. For an open discussion of options, the long-run distributional aspects should also be considered when evaluating the pros and cons of stocks for the government in exchange for financial help. Public property acquired now can generate important privatization revenues in the future.

These worries should not be taken as the bleak prophecies of a gloomy scientist. I do not think that history will repeat itself in the form of another political catastrophe following a great depression. My hopes are based on three facts. First, despite the many aberrations I criticized in Part A, scientific progress in economics has improved

macroeconomic crisis management enormously. Second, Europe is a more stable democracy than in the 1920s and, third, there is much more global political will for economic stabilization.

Part C: Beyond the Boundaries between Government and Market

Government (or state) versus markets is only one dimension along which causes and cures for the current crisis should be traced. A society relies on more than these two institutions. In particular, government (or state) must not be set on a par with critical thinking, long-term orientation, pro-social attitudes, social norms, public sphere or other things one may have missed in the recent past and now wish to promote in the aftermath of the current crisis. I will illustrate this using three examples.

Example 1: Bounded rationality, herding, overconfidence, irrational exuberance, etc. are not bound to (financial) markets. They are also present in public opinion formation, attention allocation in the media and economic thinking. The cure lies not in more government activity but in critical minds; long-term memory; robust thinking; and focusing on fundamentals (of theory and reality). The challenge is to design institutions that reward such behavior and make it effective at the collective level.

Example 2: Greediness, free-riding and other forms of bad behavior are not bound to the private sector. As Adam Smith emphasized, self-interest is a central motivational source of growing economic wealth if adequately checked by competition and by laws. But these checks have to be complemented by values and social norms (such as Smith's "fellow feeling", "sympathy" or "sense of duty").

Example 3: Incomplete and imperfect competition are not the sole privilege of markets and economics. Star contests, selection of elites, propagation of information, election campaigns and promotion of ideas all suffer from similar flaws. Again, the cure lies not so much in an expansion of government

activity. What is required instead are critical public discussion of success stories, promotion filters and remuneration systems in all areas of society, as well as a critical reflection of the fact that prices may be wrong also in the space of public recognition.

Conclusions

1. Remember basic economics, in particular the boundaries reflected in the two fundamental theorems of welfare economics. Account for them more carefully in the financial sector.
2. Save the system through globally coordinated stabilization policy even though this will raise government shares substantially.
3. Raise attention for fundamentals and real economics in the financial sector, in the media and in the scientific community. In particular, bring macroeconomic accounting and policy polygons back to mind. Extend them by aggregate financial indicators to develop a warning system.
4. Reactivate society.