MARKETS, GOVERNMENTS, AND SOCIETY

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I would like to begin my remarks by expressing my deep appreciation to Dr. Garde Roca and the Institute of Fiscal Studies for undertaking and completing the Spanish edition of my book, "Markets or Governments: Choosing Between Imperfect Alternatives" (MIT Press, 1993). Spanish is the seventh language, besides English, in which the book appears--"seven" is considered to be a particularly lucky number, so I hope that the Spanish edition will have abundant success!

I would also like to express my appreciation to the Institute for Fiscal Studies and to the Treasury Journal for jointly organizing this symposium on "The State, the Market, and Society," and for their gracious invitation to me to make a few initial remarks on the subject.

In these remarks, I wish to cover four related subjects:

- First, the concepts and categories of market failure and non-market failure, in both a static and a dynamic context;

- Second, the relation between market and non-market failures and "society"--which is the third part of the seminar title: "The State, the Market, and Society;"

[1]Remarks prepared for delivery at a seminar on "The State, the Market, and Society," sponsored by the Institute of Fiscal Studies, of the Ministry of Economics and Treasury, of Spain, Madrid, October 24-26, 1995.

- Third, some questions concerning the appropriate "mix" between markets and governments in the economic and social system;

- Fourth, some personal, and non-expert observations about Spain's own macroeconomic conditions, and their possible implications for the mix between markets and governments.

1. Market Failures and Non-Market Failures

The fundamental premise underlying my book is that the market's flaws are both more widely known, and more elaborately dissected--in logical and analytic terms--than are the corresponding flaws of the "non-market"--that is, of government or "the State." To be sure, government receives ample criticism, especially in the political arena. In my own country, for example, it has been the mantra of the Republican party that government is "the problem" more often than the "solution," and this conviction is the guiding philosophy behind the "Contract with America" of the present Republican leadership in the United States Congress.

Nevertheless, although criticism of government is often severe, it typically lacks the logic and structure that undergird the accepted theory of the failures of the market. Consequently, my main goal in the book was to redress this imbalance by advancing the analysis of non-market flaws closer to the sophisticated level already reached in analyzing those of the market.

The existing, well-articulated theory of market failure derives three principal types of market failure from the conditions of supply and demand prevailing for certain goods in certain markets, and to these three I have added a fourth type of market failure. These market failures arise in the following four instances:

(1) production and consumption of public goods, whose characteristic is that they yield non-appropriable benefits (for example, national security, which is the classic example of a public good);

(2) production and consumption of private goods with large externalities that entail non-appropriable benefits or non-collectible costs by other than the producers or consumers of the private goods;

(3) production and consumption of increasing returns, that will, in a free market, result in monopoly, and hence in a market failure to reach Pareto optimality[2];

(4) the fourth type of market failure relates to distributional equity, in the sense that the distributional results of markets may depart substantially from socially-accepted standards of equity, or from society's preferences for reducing excessive disparities in the distribution of income and wealth.

In a similar manner, one can specify four different types of non-market failures, or government failures that result from the conditions under which government output of services and goods are produced and consumed. These four types of non-market failure are, respectively:

First, redundant and rising costs (resulting from the disjunction between the costs and the sources of revenues to finance these costs);

[2]Incidentally, implicit in all types of market failure is the criterion that, left to their own devices, free markets will result in a non-optimal outcome.

Second, internalities and organizational goals (which are the standards or proxy goals that apply within non-market organizations to guide, regulate, and evaluate the performance of these organizations and their personnel);

Third, derived externalities (that is, the unanticipated side-effects of non-market activities that are often not realized by the agency responsible for creating them, and hence don't affect the agency's calculations or behavior).

And, fourth, distributional inequities that, in the non-market context, are typically indexed on the exercise of bureaucratic power and authority over citizens who have limited ways of assuring accountability either by recourse to another producer than the government, or by refraining from acceptance (i.e. consumption) of the bureaucratic or admnistrative action.

It should be noted that, although there are four categories of "failures" on each side of the ledger--both market and non-market--this does not mean that the collective failures of markets and non-markets tend to be equal. Moreover, the non-market inadequacies are not the mirror images or "duals" of those associated with market activities. For example, "externalities" on the market side of the ledger are only obliquely related to "internalities" on the non-market side in the sense that each is a major source of shortcoming in the respective market and non-market contexts. "Externalities" in the market sector are conceptually much closer to "derived externalities" than to any other category in the non-market side of the balance sheet.

The foregoing remarks about market failure and non-market failure, and the different types and sources of both of them, principally apply in the static context of general equilibrium Pareto-efficiency. Comparisons between market and non-market regimes are further complicated when one invokes criteria of dynamic efficiency--that is, improvements in the performance of economic systems, sectors, or enterprises longitudinally. In this context of comparing the capacity of market and non-market regimes to generate and implement efficienty-enhancing changes over time, my book distinguishes among three principal ingredients contributing to such changes: dynamic (or Schumpeterian) efficiency; technological (or "best practice") efficiency; and X-efficiency.

I won't elaborate on these three different sources of efficiency enhancements over time, or the connections among them. These are dealt with in the book. However, I would add one comment that is somewhat different from what is stressed in the book. In comparing market and non-market modes of organizing economic activity, or various mixes between them (a subject to which I will return below), the relative capacities of these differing modes of economic organization to generate and sustain dynamic efficiencies are at least as important and significant as the relative extent to which market failures or non-market failures impede the achievement of Pareto-efficiency in the static context. The dynamic context is no less significant than the static one, though typically the literature devotes more time to the static context.

2. The Relation of "State" and "Market" to "Society"

The organizers of this conference have shown wisdom in adding societal considerations to the analysis of "markets" and "governments," which is the essential focus of my book. Thus, the statement of the seminar's purpose and perspective includes the following quotation:

> " . . . the existence of a vigorous civilian society and the developement of creative formulas of social value seems to be essential in order to manage the great challenges that we face today. Without the development of society, neither the market nor the State can reach their full potential of efficiency."

To the limited extent that my "Markets or Governments" book addresses these larger questions of the societal impacts of markets and governments, it does so through the fourth set of "failures" associated with market and non-market systems, respectively: namely, distributional inequity that, in the case of market regimes, is indexed on income and wealth, while in non-market regimes, distributional inequity is principally indexed on authority and power.

To cite two sharply contrasting examples: In the non-market setting of the former Soviet Union, the political power and privilege of the *nomenklatura* constituted an enormous inequality between them and the Soviet masses, yet income distribution in the Soviet Union was relatively equal on the other hand, in the United States, <u>political</u> power is <u>fairly widely dispersed</u>, yet the recent so-called "trial of the century" in Los Angeles demonstrated that wealth can go a long way toward buying <u>unequal</u> and <u>preferential</u> treatment in the U.S. criminal justice system!

Those who are most concerned about the distributional inequities of the market system focus on the social alienation and fragmentation that may result from excessive inequalities between the rich and the poor, the "haves" and the "have-nots." Those who are most concerned about the distributional inequities of non-market systems worry principally about the expansion of the bureaucratic state and its encroachments on the individual, the family, and other private groups and activities that should lie outside the purview of the State. Gunnar Myrdal, Oskar Lange, and the socialist legacy focused mainly on the first type of distributional inequity--inequities indexed on income and wealth. Friedrich Hayek, Milton Friedman, and the libertarian tradition concentrate their attention on the distributional inequities of non-market arrangements--inequities indexed on authority and power.

In the contemporary world, both types of inequities frequently occur. In the United States, for example, we are concerned about increases in income and wealth disparities, and their impact on social separation and alienation;. Yet, we are also concerned about the exercise of bureaucratic power that often seems arbitrary and that imposes heavy burdens on the public. Whether and how both types of inequities can be modulated in the interests of the healthy and "vigorous civilian society" referred to in the brochure describing this siminar, is surely one of the key questions to be resolved in achieving a durable and effective mix betwen the activities of the market and of the State.

3. The "Mix" Between Markets and Governments

The choice between markets and governments, and the relative scope of the market and "the State," is complex, and it is usually not binary. Rather than being a pure choice between markets *or* governments, it is usually a choice between different combinations or "mixes" of the two, and different degrees of one or another mode of decisionmaking and resource allocation .

While the choice between markets and governments is thus a matter of emphasis and degree, these differences matter enormously in their effects on the performance, as well as the fairness, of economic and social systems.

As a general allocative mechanism, markets typically do a better job than governments, from the standpoint of both allocative (or static) efficiency (that is, realizing a higher ratio between outputs or product on the one hand, and inputs or costs, on the other), and dynamic efficienty (that is, sustaining a high rate of economic growth over time). Market systems tend to be more efficient in the use of resources at a given point in time, and more innovative, dynamic, and expansive in generating new products and new technologies, over time.

Several qualifications should be added to this conclusion, most of which are dealt with at length in my book.

First, the previously stated judgment assumes that the production of pure public goods--such as defense and public order--is maintained by government. Under a market regime, market failures would inevitably result in insufficient output of such public goods because of their inherent "publicness."

Second, there is no formula for establishing the essential minimum threshold of government activities and outputs beyond which the prevous proposition about the relative merits of the market over the "non-market" applies. For example, the proposition does not imply that if government attains a level of 30 percent of a nation's gross domestic product, the economy as a whole will be less efficient--both allocatively and dynamically--than if the government sector is only 28 percent. However, there is some empirical work summarized in my book which suggests that, as the size of the government sector expands, the sustained annual rate of growth in GDP decreases.

I might mention in passing that this empirical work covered the 1970s and mid-1980s. It would be useful to have this work extended into the late 1980s and at least the first half of the 1990s.

When one moves from considerations of efficiency to considerations of equity or fairness, both market and non-marlet systems have serious flaws. Market systems do not assure equity (in the sense of reasonable equality of opportunity). On the one hand, the market's impersonal and relatively objective process of evaluating individual performance by people as well as firms, makes an important contribution to fairness in outcome, especially when compared with other imperfect institutional inventions for performing these functions. On the other hand, serious inequities arise in market systems because of the different starting points that differently situated people bring to the market's relatively impersonal filtering process. For example, it helps to have wealthy parents and a happy and stable homelife; to have a challenging and effective education and to attend prestigious schools; to have talented and influential friends; to benefit from healthy and balanced nutrition; and so on. The market does not assure that such endowments will be either equal or randomly distributed.

Yet, as implied earlier, non-market systems are also flawed with respect to the equity criterion. Arbitrariness, pettiness, favoritism, and delay in bureaucratic decisionmaking are more characteristic of non-market than of market systems. Consequently, the more extensive is the role of non-market organization--as in centrally-planned economic systems--the more pervasive are these characteristics. The catch-22 syndrome of irrationality and rigidity tends to be more frequently encountered in non-market than in market organizations.

Where do these competitng and complicating considerations leave us with respect to the preferred mix between the market and the State in the social system as a whole? Frankly, I don't have an answer to this question, but I would suggest two principles to guide the process by which each country should seek to arrive at preferred answers: first, governments should systematically search for ways to improve and extend the functioning of markets. And second, the use of market forces and mechanisms should be systematically considered in efforts to improve the functioning of governments.

Let me suggest a few examples of each of these guiding principles.

Antitrust efforts by government can be useful in reducing, if not entirely precluding, the occurrence of market failure due to increasing returns and monopolistic practices. Thus, in the United States we have the Sherman Antitrust Act of 1890, and the Clayton Act of 1914 which, respectively, make it illegal to fix prices in restraint of trade, and prohibit mergers and acquisitions that "may reduce competition" or "may tend to create a monopoly." However, to make markets function efficiently in a world economy that is increasingly interconnected, it may be less important to concentrate on breaking up domestic mergers and acquisitions, or large concentrations of output in one or a few domestic firms, than to assure that domestic markets are fully open to competition from large scale <u>foreign</u> producers. In other words, the aim of government action should be to improve the functioning of competitive markets by liberal and open foreign economic policy, no less (and perhaps more) than through vigorous domestic antitrust litigation.

A second example of how government can contribute to the improved functioning of markets is by having a Central Bank that is charged with the function of assuring relative price stability, and a predictable and restrained monetary policy. In general, these conditions are more likely to be advanced through a Central Bank that is relatively independent of the fiscal authorities.

Other examples are mentioned in my book concerning ways that government can act to improve and extend the functioning of markets in the case of the mutual fund industry, the health care industry, and the market for pension funds.[3]

Just as goverment policies may contribute to improving the functioning of markets, so may market processes and incentives contribute to improving the functioning of government. In other words, non-market failures may be diminished by injecting some elements of market forces into government operations. There are many examples that can be cited of this second guiding principle. For example, the use of educational vouchers <u>within</u> the public school

[3]See "Markets or Governments" ibid. pp 162-168.

system, or the setting up of so-called "charter schools"--still within the public school system--are instances of how quasi-market devices might inject a healthy degree of competition into public, governmental functions. Opportunities along similar lines can be found in "out-sourcing" and privatizing (and thereby subjecting to competition) many activities that are performed within the Defense Department, including logistic functions, data management, and various base operations and maintenance functions. Other examples can be cited from such widely different fields as auction bidding for allocation of radio frequencies and television transmission channels, and even for highway construction. Instead of building a highway from the Washington, D. C. airport to Reston, Virginia, the highway authority in the state of Virginia recently awarded an openly-bid contract to a private construction group to finance and build this additional facility in return for the right to operate the highway as a toll road for several decades!

In sum, there are many opportunities for creative thinking about how to "mix" government and market responsibilities, how to invoke market mechanisms to improve the functioning of government, and how to invoke government action to improve the functioning of markets.

4. <u>The Economy of Spain: Implications for the Market vs. Government "Mix" Issue</u>

Finally, let me make a few concluding comments about the Spanish economy in the light of the broad subject of this conference--"The State, the Market, and Society." I should emphasize that I approach this subject with trepidation and humility. I have not studied the economy of Spain. I am not in any sense an expert on the subject, and don't pretend to any deep insight about it. So, please treat my observations as musings, reflections, and "thinking out loud" about the Spanish economy in the light of the foregoing discussion of markets and governments, and in anticipation of other subjects that will be brought up in later sessions of this seminar.

According to the Dresdner Bank, Spain is expected to have a 1995 budget deficit of 6.3 percent of its gross domestic product, which represents the largest excess of government spending over revenues of any country in Europe except for Greece (11.4 percent), Sweden (9.0 percent), and Italy (7.8 percent).

Goverment spending in Spain represents about 45 percent of Spain's GDP.

Spain's unemployment rate is estimated at 22 percent --a staggeringly high figure. No doubt this is a major factor underlying the large budget deficit.

Also, the rate of increase in the money supply from a year ago is high (10.5 percent at an annual rate in August), and both nominal interest rates and real interest rates are high: 9.75 percent is the bank prime rate, and consumer prices rose by 4.3 percent at an annual rate in August.

Finally, in this very superficial review of macroeconomic statistics, government employment in 1994 is about 16 percent of the total work force, compared with only 5 percent in 1970. This is the highest rate of increase in the proportion of labor force employed by government of any country in Europe during that period!

My initial and tentative judgment, based on this brief and cursory review of these salient and striking statistics--, and recalling all of the earlier cautionary remarks about my limited knowledge in this field--is that there may be strong reasons for policymakers in Spain to consider expanding the relative scope of market activities while limiting those of government. It sounds to me--although I may be wrong--that government spending and government employment may be relatively too large for what one would expect to characterize a healthy and vigorous economic system. Reductions of government spending, privatizing State-Owned Enterprises and/or eliminating subsidies to them, may be the direction in which public policy should proceed.

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Thank you again for giving me this opportunity to address you, for convening this very timely seminar, and for the impending publication of the Spanish edition of my book.