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Moving Beyond Market Fundamentalism to a More Balanced Economy

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Market Fundamentalism

- For a quarter century, the prevailing "religion" in the West has been market fundamentalism
  - Based on Adam Smith's notion of the invisible hand
  - Advocating a particular form of economic organization—profit maximizing firms, without government regulation

Rebirth after Great Depression

- Great Depression showed that markets do not necessarily work well
  - And that economies do not necessarily self-correct
  - At least in the relevant time frame
- But Keynesian economics rescued the market
- Government *macro interventions* could sustain the economy

Neo-classical synthesis

- Notion that once the economy is restored to full employment, market forces could be relied upon to allocate resources
- Not based on any economic theory
- More plausible that macro problems are the tip of the iceberg of much more pervasive *market failures*

Information Economics

- Conventional economics based on hypothesis of perfect markets/perfect information/perfect competition
- Hope was that a world in which there were not too many imperfections would look approximately like the perfect world
- New information economics showed that that hope was wrong
- Showed that whenever information was imperfect—that is, always—the reason that the invisible hand seemed invisible was that it was not there

Implication

- There were always government interventions that could make *everyone* in society better off
- One needed to find a balance between markets, government, and other institutions—including not-for-profits, cooperatives, etc.
- Successful countries were those that found that balance
- Market fundamentalism, neo-liberalism was simply wrong

Historical experiences confirmed this perspective

- Washington Consensus policies based on market fundamentalism failed
- Success in East Asia was based on a much greater array of institutional arrangements
  - Critical role played in China by Township and Village enterprises, cooperatives
  - Critical role played by government

- But so was success in US and Europe
- Role of government
  - In education
  - In financial sector
    - regulation (before deregulation!)
    - And in providing finance
  - In technology and science
    - In agriculture
    - From the telegraph to the internet
    - Modern advances in bio-technology
  - In infrastructure
- The role of cooperatives
  - In finance/insurance
  - In agriculture
  - In housing

New perspectives on growth

- A fairer society (better distribution of income) can have more sustainable growth
  - People are a country's most important asset
    - Important to make sure that every person can perform up to their potential
  - Excessive inequality can give rise to macro-economic problems
- Important role for government in providing essential investments—education, infrastructure, technology
- Important role for government in making markets work
  - Bank regulation

America is now facing massive micro-economic failure

- On par with the macro-economic failure of the Great Depression
- Problems were predictable—and predicted
- Result of lack of adequate regulation—belief in market fundamentalism by Fed and Bush Administration
- Firms were maximizing profits—in the short run
- Or more accurately, CEO's and other managers were maximizing bonuses and income

Central Point

- Once again, we have a dramatic illustration of the failure of Smith's invisible hand
- The pursuit of self-interest, profits (old-fashioned greed) did not lead to societal well-being
- Lack of alignment of private rewards and social returns
  - Partly related to incentive systems
  - Based on stock options—designed to obfuscate costs
  - Focused on stock market prices—encouraging distorted information (easier to get stock price up by distorting information than coming up with good products)
  - Without good information, markets cannot work well
  - Incentives designed to encourage *excessive* risk taking
    - Bonuses in good years—but shareholders bear total costs of bad years

Gap between Private Rewards and Social Returns

- While they were supposed to be rewarded for managing risk and allocating capital, they created risks and misallocated capital
  - Even they could not appraise the risk of the non-transparent products that they created
  - Real investment in housing beyond people's ability to afford
- And they failed to create the risk products that people needed—that would have allowed them to manage the risks they face

Disastrous consequences

- 3 million Americans have already lost their home, 2 million more in next year
  - Many will lose their life savings
  - A social disaster as well as an economic disaster
- The economy is going into a downturn
  - Loss in output in U.S. alone will exceed $1.5 trillion

Others are bearing the cost

- Not just homeowners who are losing their homes
- Not just workers who are losing their jobs
- Taxpayers are being asked to bail-out Fannie Mae, Freddie Mac, Bear Stearns
  - We still don't know how much we may have to pay
    - bail-outs totally non-transparent
  - In billions….
  - National debt has now soared from $5.7 trillion when Bush went into office to $15 Trillion
- While executives walk away with generous severance packages, and investors and creditors who enabled all of this to happen are also being protected
- Contrast with what happened in East Asia a decade ago highlights hypocrisy

Beyond these standard notions of efficiency

- Markets by themselves often do not produce socially desirable outcomes
  - Quality of the workplace
  - Great inequalities

Success requires a more balanced economy

A plural economic system, with

1. Traditional private economy
2. Public sector
3. Social/cooperative economy (including mutual societies, not-for-profits)

Not-for-profits/cooperatives/mutual societies

- Are among the most successful part of the American economy
  - Universities
  - Source of innovation that underlies the strength of the rest of the economy
  - Include key enterprises in publishing, agriculture, education, health and large fraction of New York housing

Reasons for success

- Democracy is a value in itself
- Less inclined to exploit those with whom they interact
  - Especially important when competition is limited
  - Or when there are information asymmetries
  - Or asymmetries in bargaining powers

- Greater internal democracy can foster not only a better workplace, but a more innovative workplace—and a more innovative society
  - More participation/openness/transparent management
  - Spreading entrepreneurial culture
  - Job satisfaction an important part of quality of life
  - Higher quality of workplace leads to greater job satisfaction even for low wage jobs
  - Higher quality workplace not only improves quality of life, but also productivity
    - Participation leads to better flows of information
    - Better information leads to better decisions
    - Greater performance from intrinsic rewards/sense of satisfaction than extrinsic rewards
      - For profit sector relies more extensively on extrinsic rewards
    - Virtuous circle

Principles are playing out in New Economy

- Success of open source software
- Spreading to other areas of innovation
- Greater participation/better motivation

Implication

- We need to encourage alternative forms of economic organization
- And we need to do more to identify the contribution they are making to our society
  - Measures of GDP/economic performance do not reflect broader set of values/concerns
    - Including job satisfaction and sense of well-being
    - Developing broader measures key objective of Commission on the Measurement of Economic Performance and Social Progress

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