Capitalism and Society

Volume 4, *Issue* 3 2009 *Article* 1

THE FUTURE OF CAPITALISM

The Rationale of the Market Economy: A European Perspective

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The fall of the Berlin Wall in November 1989 was the defining economic event of our lifetime. It marked the end of the most extensive controlled experiment in the history of social sciences – the division of Germany into two economic zones, one centralised and planned, the other a market economy. After forty years, the gap in living standards between the two was so extreme that the experiment was terminated.

This outcome is counterintuitive. A striking formulation by Ken Arrow and Frank Hahn spells out the issues. The immediate 'common sense' answer to the question 'what will an economy motivated by individual greed and controlled by a very large number of different agents look like?' is probably: 'There will be chaos'.[1] Even in the 1960s, most countries – developed and developing – outside the United States believed that central planning should be at the centre of their economic management. The US itself was concerned that the Soviet Union might achieve technological superiority.[2]

So why did markets perform so well? A popular caricature of the market economy sees greed as the dominant human motivation, and economic progress best achieved by acknowledging that behaviour and imposing as few restrictions as possible on what these greedy people do. This is the economic environment of Nigeria and Haiti, and it does not work: it is the commercial environment of the Ik tribe described by the anthropologist Colin Turnbull and of Lehman described by the inmate Laurence McDonald, and it does not work there either.[3]

Greed must be constrained, but it is inadequate to describe that constraint simply as 'the rule of law'. The property rights that are critical to 'the rule of law' are not given by nature, but are socially constructed.[4] Information asymmetry is endemic in modern economies with complex products, and that asymmetry is handled mainly through the mechanisms of trust relationships and reputation. Market economies operate with far more coordination and cooperation than the model of unrestricted greed allows. The simplistic account of human motivation based on self interest comprehensively fails to recognise the real complexities of human behaviour.

So what are the real strengths of the market economy? There are three components. Prices act as signals; the operation of the price mechanism is a better guide to resource allocation than central planning. Markets function as a process of discovery – the chaotic process of experimentation through which a market

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[1] Arrow, K.O. & Kahn, F.E. *General Competitive Analysis*, Oliver & Boyd, 1971, p. vii.

[2] See, for example Mintzberg, H., *The Rise and Fall of Strategic Planning,* Hemel Hempstead, Prentice Hall, 1994.
Scott, J., *Seeing Like a State*, New Haven CT, Yale University Press, 1999.

[3] Turnbull, C.M., *The Mountain People*, Simon & Schuster 1972 Macdonald, L.G. and P. Robinson, *A Colossal Failure of Common Sense,* Crow Books, 2009.

[4] This is the essential insight that won Elinor Ostrom the 2009 Nobel Prize.

economy adapts to change. And markets yield benefits from the diffusion of political and economic power. Prosperity and growth require that entrepreneurial energy should be focussed on the creation of wealth rather than the appropriation of other people's wealth. Decentralisation of authority and deconcentration of activity limit rent seeking.

In what we teach, in what we say, in what we do, in our economic research and, most importantly, in the policies we adopt – we put too much emphasis on the first of these elements – prices as signals to guide resource allocation. We do this at the expense of the, possibly more important, second and third elements – markets as process of discovery, markets as mechanism for the diffusion of political and economic power. In consequence, both supporters and critics of the market economy often confuse policies that are pro-business with policies that are pro-market. This confusion has undermined the social and political legitimacy of the market economy. Serious policy errors have followed from mistaken, or at least incomplete, understanding of how a market economy really works.

One central theme runs through all three strands of argument: that of disciplined pluralism.[5] When prices act as signals, decentralised enterprises and decentralised information are brought together to create a coherent result. Markets as a process of discovery are based on freedom to experiment, combined with discipline: unsuccessful experiment is acknowledged and terminated. Markets as a means of decentralising power illustrate how political and economic pluralism are closely associated in the achievement of an open society.

The model of 'prices as signals' describes how self-interested agents – individuals or firms – might, through independent decisions, make consistent and efficient choices about how to organise production and distribution and the allocation of capital, labour and other resources. In a loose formulation, this idea has been around since the beginnings of economics. Many people interpret Adam Smith's famous remark about 'the invisible hand', and his observation that it was not the benevolence of the baker but his self-love, that furnished our table in this way.[6] In an astonishing demonstration of the power of spontaneous order, decentralised markets manage the process of coordinating complex production systems better than centralised direction.

Although it appears to be an empirical fact that markets do manage this process better, economists did not offer a comprehensive explanation of why until the 1950s. The explanation they gave then proved both that a competitive equilibrium might exist, and that, if it did exist, it could be efficient. That general equilibrium model was influential. It shaped the research agenda of the economic

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[5] In Kay, J.A. *The Truth about Markets,* Allen Lane, 2003 (US version, *Culture and Prosperity*, New York, HarperCollins, 2004).

[6] It is unlikely that this is a correct interpretation of Smith's comment: see Rothschild, E., *Economic Sentiments*, Harvard University Press, 2001, Chapter 5.

DOI: 10.2202/1932-0213.1063

profession and has provided an intellectual basis for economic policy even among people who may know nothing of the underlying arguments. The inference commonly made was that profitable transactions are socially beneficial: even that their social benefit is demonstrated by their profitability.

These models also provide a rationale for a certain kind of market fundamentalism. Not only is interference with market forces usually inappropriate, but market outcomes are efficient, even morally justifiable, simply by virtue of being market outcomes. Not only are markets good, but more markets are better than fewer markets. The emergence of new markets for financial products, for example, is presumptively beneficial.

Among economists, the popularity of this approach is in part the result of physics envy. General equilibrium models provide a universal explanation of economic affairs that resembles in many ways the kinds of equilibrium and optimisation models that have proved so powerful in the natural sciences.[7] Rigour, which often means the demonstrated logical consistency that arises from mathematical formulation, has become the measure of the quality of a theoretical economic argument.

Among practical people, the simple message that government should go away and leave business alone has wide appeal in the business sector, and the message that greed can serve a constructive social role likewise has wide appeal among greedy people. The claim that profitability demonstrates – or is even the measure of – public benefit relieves any worries traders might have harboured about the utility of their profitable activities. In the financial sector, particularly, I have rarely detected such moves.

These claims found a wide constituency in the United States; in Europe, however, they found a less receptive audience. Acceptance of the market has been grudging at best. These messages are resisted by a broader intellectual community which finds the assumed motivation and the conclusions reached unappealing. They are also resisted by the population at large, which does not run business, benefits only indirectly from the activities of business, and is not necessarily enamoured of greed. And so we have the European political world as it is today, in which both parties and voters acknowledge the empirical success of the market, but dislike almost every aspect of it. ‘The market’ and ‘market forces’ are the acknowledged source of European prosperity, but also terms of abuse.

And yet the story of the market described above is inadequate, and a better description is not only more accurate but more palatable. The model of competitive equilibrium probably contributes something to our understanding of how markets work. But that contribution is largely misunderstood and grossly over-emphasised. One problem is that there is no real acknowledgement of

[7] See especially, Mirowski, P., *More than the Light*, Cambridge University Press, 1989. The phrase is popularised by Andrew Lo.

uncertainty in the model, or, to be more precise, uncertainty is acknowledged only in essentially formal ways.

This omission is of fundamental importance when the model is used to describe financial markets, in which trading in risk is the essence of the transaction. In such markets, the mechanism for incorporating uncertainty into the model requires, in effect, that there is some true underlying value of an asset which is independent of beliefs about that value, and that market transactions involve a process of convergence towards that one value.

But recent events have demonstrated not only that this claim is false, but that trade in financial results is often the result of uncertainty about the nature of the traded product itself. There were always two broad accounts of the explosion of trade in complex structured products in the financial sector over the last decade. In one, these developments represented a more sophisticated form of risk sharing and risk transfer, an exemplification of the benefit of the creation of new markets. In another, the trade was mainly driven by information asymmetry: the products were bought by people who overestimated their value.

The difference in the consequences is important: in the first case, the private profitability is mirrored by public benefits in the form of lower costs of risk: in the second case, the private profitability is illusory and disappears when asset values correct themselves. In retrospect, it is evident that this latter explanation – that trade was driven by differences of information and interpretation and the profits from it evaporated when these mistakes were revealed – is closer to the truth.[8]

The world is uncertain: not just risky, but uncertain, in the sense used by Keynes and Knight.[9] Not only are we unaware of future outcomes: we are unable to specify at all fully what these possible outcomes will be. If we could predict or anticipate the invention of the wheel, we would already have invented it. Market economies do not predict the future, they explore it.

Hayek is the most eloquent expositor of the concept of the market as a process of discovery.[10] While his argument was *a priori*, the failures of the eastern bloc in the post-war era provide clear evidence for his hypothesis. These planned economies failed in the development not just of consumer products, but of business methods and in almost all areas of applied technology not related to

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[8] Greenspan, A., 2002, Speech to the Federal Reserve Bank of Kansas City Conference at Jackson Hole, August 30. 2008, Testimony to the Congressional Committee on Government Oversight, October 23.

[9] Keynes, J.M. *A Treatise on Probability*, Macmillan. Knight, F.H., *Risk, Uncertainty and Profit*, Houghton Mifflin.

[10] Notably in Hayek, F. von, 'The Use of Knowledge in Society', *American Economic Review*, XXV, No 4, September 1945, pp 519-30. See also Baumol, W.J., *The Free Market Innovation Machine*, Princeton University Press, 2002 and Landes, D.S., *The Wealth and Poverty of Nations*, Little Brown, 1998.

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military hardware. Centralised systems experiment too little. They find reasons why new proposals will fail – and mostly they are right in their suspicions, because most experiments do fail. But market economies thrive on a continued supply of unreasonable optimism.

If market economies are better than planned societies at the origination and diffusion of new ideas, they are also better at disposing of failed ideas. Honest feedback is not welcome in large bureaucracies. In authoritarian regimes, such feedback can be fatal to the person who delivers it. In less draconian contexts, unwanted messages can be fatal to careers.

Large bureaucracies here include private bureaucracies as well as public ones. Disruptive innovations most often come to market through new entrants. Incumbents have good reason to be suspicious of novelty and protective of their established markets and activities. The health of the market economy depends, therefore, on constant replenishment from new entry. But planners and governments of a market economy see industries through the eyes of established firms already in the industry. In doing so, they miss the pluralism that is the market economy's central dynamic.

That leads directly to the third group of reasons for the superior performance of market economies. A one sentence description of why some countries are poor and others rich is that the politics and economics of poor countries are dominated by rent-seeking and the politics and economics of rich countries are not. Rent seeking is the process by which the ambitious find it more rewarding to batten on the wealth created by other people than to create it themselves.[11]

Rent seeking takes many forms – castles on the Rhine; the Wars of the Roses; ten per cent on arms sales, or seven per cent on new issues; awarding yourself control over former state assets; stealing the revenues from your country's resources deposits; seeking protection from foreign competition; blocking market access by new entrants; winning sinecures or overpaid positions by ingratiating oneself with public servants or corporate employees. The mechanisms of rent-seeking range from armed force to victory in democratic election, the methods pursued range from lobbying on Capitol Hill and in the restaurants of Brussels, through access to the King or the Chief Executive.

But while rent seeking cannot be eradicated, we can have more or less of it. Politics everywhere used to be dominated by rent seeking; factions would

[11] The concept is due to Tullock, G., 'The Welfare Costs of Tariffs, Monopolies and Theft, *Wales Economic Journal,* 5, no. 3, 1967, pp 224-32, and was first defined in Kreuger, A., 'The Political Economy of the Rent-Seeking Society', *American Economic Review*, 64, no. 3, 1974, pp 291-303. See Buchanan *et al, Towards a Theory of the Rent Seeking Society*, Texas A&M University Economics Series, 1980.

battle for control of the state and when they won such control would use it to steal as much as they could get their hands on. In much of the world, it is like that still.

The ability of a political or economic system to resist rent seeking depends on the degree of decentralisation of economic power. Where such power is concentrated, whether in the public sector, private businesses, or groups of private business, individuals will try to get their hands on the rents such concentrations of power attract. The wider the extent of these opportunities, the greater the tendency for individuals to gain wealth and influence for themselves by attaching themselves to existing sources of power rather than exploiting their own individual talents and creating rents by developing distinctive capabilities in their own economic activities.

There is a strong tendency for private economic power to be self-reinforcing, as is widely recognized in the case of America's 'gilded age' at the end of the nineteenth century. The well-founded fear was that the new mega-rich – the Rockefellers, the Carnegies, the Vanderbilts – would use their wealth to enhance their political influence and hence enhance their economic power still further, subverting both the market economy and the democratic process. As a result of these concerns anti-trust legislation came into being.[12] The process that concerned Americans then is the problem we see in Russia – and elsewhere in the world – today.

The political economic nexus was not an issue of comparable importance in Britain or elsewhere in Europe because although there were many newly rich entrepreneurs and industrialists, their access to political power was limited by the persistence of aristocracy and class systems. This is no longer true. The creation of anti trust laws followed the decline of the aristocracy.

Such legislation was introduced after the Second World War, in Britain as part of the Labour government's reforms in the 1940s, and in Germany, as a conscious attack on the concentrations of industrial power which were seen as having contributed to the rise of Nazism. Today they are largely administered at the European level and are somewhat more rigorous than their US equivalents.

The ability of a market economy to channel the desire for acquisition into channels that create wealth rather than extract it depends on a range of steps that both prevent the concentration of economic power and limit the terms of access to such concentration. Required are constraints on the economic power of the state, constraints on the concentration of economic power in large businesses, constant vigilance at the boundaries between the state and business, and a mixture of

[12] 'If the concentrated powers of a trust are entrusted to a single man, it is a kingly prerogative, inconsistent with our form of government…. If we will not endure a king as a political power we should not endure a king over the production, transportation and sale of any of the necessaries of life'. Senator Sherman, introducing the legislation which bears his name. See also Madison in Federalist Paper 10. *Congressional Record*, vol. 21, 1990, p. 2457

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external supervision and internal restraint which prevents individuals who pull levers of economic power from using these levers to direct the revenues that arise to themselves.

Because the last decades have confused a pro-business stance with a pro-market stance, we have emphasised some of these conditions at the expense of others. Most European countries have constrained the economic role of the state, largely with an eye to an attack on one focus of rent-seeking, that by organised groups of public employees.

Large businesses, or groups of large businesses, use the leverage that power gives to strengthen established positions and enhance the economic and political power still further. Financial services and intellectual property are the most important battlegrounds today. Common to both is the malign consequence of viewing the industry through the eyes of established firms.

The current problems of the financial services sector are too familiar to require much elaboration. Governments of the world have pumped unimaginably large amounts of money into the system. Directly through recapitalisation and purchase or underwriting of so-called toxic assets, and more substantially if indirectly through wide-ranging implicit and explicit guarantees of liabilities. Even if these explicit guarantees expire, a ‘too big to fail’ doctrine has been established which means that implicit guarantees persist indefinitely. The criteria needed to qualify for these guarantees are, essentially, that the firm is large, well established, and unsuccessful commercially. It is difficult to think of a policy more directly contradictory to the central dynamic of the market economy.

Behind that policy lies the central fact of modern political life – that the financial services industry, and particularly its investment banking arm, has become the most powerful political force in the United States and other countries. The reasons are clear enough: the rents available in the financial sector have attracted much of the ablest talent in the two countries and created a generation of financiers who are both smart and wealthy.[13]

Digitisation is transforming *all* media industries. The change was most immediate in music. The music industry is thriving. The demand for live performances is growing rapidly. As with so many leisure activities, people will pay much more than had traditionally been imagined. Recorded music can be distributed much more cheaply and at higher quality than before. Overall expenditure on music has been increasing, and so has the share of revenue going to artists.[14]

New technology isn’t a problem for the music industry, but an opportunity. New technology *is* a problem for some established firms in the music industry. Music publishers attempted to use legal restrictions to prevent

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[13] Johnson, S. ‘The Coup’, *The Atlantic*, May 2009.

[14] Page, W., ‘Adding up the music industry for 2008, *Economic Insight*, Issue 15, 20 July 2009.

internet distribution in order to preserve their established business model, and failed. Piracy took off, not as an alternative to legal downloading, but as an alternative to no downloading.

The result of this organised resistance to inevitable change was that these businesses marginalised themselves. They ceded market dominance to, bizarrely – Apple. But probably such marginalisation would have happened anyway. It is rare for established firms to migrate successfully to new business models in the face of disruptive technologies.

We can already see the beginnings of the same problem in books. The idea of a universal digital library may be the most exciting development in the book business since printing.[15] The issue is presented as a problem for authors. It isn't. Not only will authors have expanded opportunities to make their work available, but prospect of a digital library potentially solves the problem that has dogged authors and limited their economic opportunities for centuries: the absence of a trail of record between author and reader. The problem is, once more, what is the role for established publishers in the new era? Their ability to insist that policy makers find one is capable of delaying the application of new technologies for decades.

Determining the future of any industry is a matter of perpetual small scale experiment, mostly unsuccessful, and we will all be surprised to discover which developments turn out to be seminal. It is almost axiomatic that committees of wise people from the industry, and consultations dominated by vested interests and their acolytes, will not include those who are likely to be the important players in the development of a rapidly changing industry. The job of government should not be to offer monopolies to encourage very large firms to invest, or to attempt to shape the industry, but to give maximum opportunity for the industry to shape itself.

There are clear common elements in what is happening, and what should be happening, in both financial services and media. There is a need for policy, but policy aimed at supporting the market, not supporting the industry: policy towards breaking up the industry, not promoting concentration: policy towards facilitating entry, not conferring artificial advantages on established firms: policy towards removing distortions of competition, not creating them.

What we too often miss in policy making is the wider dimensions of the power of markets. By focussing on the first pillar – prices as signals – competition policy underestimates the strength of markets as a process of discovery, and the vital political and economic role of markets in restraining concentrations of economic power. Markets are not a well-oiled machine: they more closely resemble a constantly changing, adaptive biological system. Pluralism is their

[15] The Google proposal continues to be disputed in the US Courts. Plainly, whatever its resolution, this is not an appropriate form for decisions most of whose implications lie outside the US.

DOI: 10.2202/1932-0213.1063

motive force, their essence is chaotic, their development inherently uncertain. If we could predict the evolution of markets, we would not need markets in the first place.

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