TIGER

TRANSFORMATION, INTEGRATION and GLOBALIZATION ECONOMIC RESEARCH

CENTRUM BADAWCZE TRANSFORMACJI, INTEGRACJI I GLOBALIZACJI

TIGER **Working Paper Series**

No. 142

Perfect Markets, Perfect Democracies and Pandemics

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Warsaw, January 2021

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ESSEY

There are some largely theoretical roles that economists and political scientists admire and prescribe. One is the role of perfect markets. With some exceptions, these roles have been welcomed and promoted by mainstream economists. When economies and governments have diverged from these roles, they have been criticized by economists.

The main point that this article will make is that, as it is true in various walks of life, perfection may come at a high cost. What may seen to be imperfections might have merits, and might play some positive and desirable roles. Both the concept of progress and that of evolution, that are so important in economics, are not consistent with perfection. By definition, perfection cannot be a dynamic process. It is essentially a static concept. Once it is reached, there is no incentive to change it. You cannot make something that is perfect, even more perfect. Perfection does not allow change, or progress. While perfection reflects essentially a static state, progress and evolution are dynamic processes that require some imperfection to keep evolving.

Rita Levi Montalcini, an Italian biologist who, in 1986, won the Nobel Prize in medicine and died recently at the age of 103, in 1988 published an important book called In Praise of Imperfections (Basic books). As she put it in that book:

"It is imperfections –not perfection—that is the end result of the program written into the formidably complex engine that is the human brain, and of the influences exerted upon us by the environment and whoever takes care of us during long years of our physical, psychological and intellectual development". She added: "…don't fear difficult moments, [because] the best comes from them". As the Chinese are found of affirming, crises bring opportunities, and possibilities for changing things for the better. Perfect states do not. The above quote from Levi Montalcini suggests a particular way of looking at the world, and also at popular economic and political models that depend on equilibrium and on perfect behavior.

These models have dominated economic and political thinking over many decades. Let us start with the economic side of the issue. Theoretical economics, especially price or micro theory, as was developed by great economistsm such as Alfred Marshall, Milton Friedman, George Stigler and others, told us that what we should aim for, and should promote with policies and behavior, is "perfect" competition, competition that will lead to, and will be consistent with, a market equilibrium. Perfect competition implies that the forces of the market will drive companies' profits toward zero, and will deliver the lowest prices for goods and services at which consumers can buy what they need. Therefore, it will leave companies with no space to accommodate random shocks, such as for example pandemics and recessions. The theory argues that the equilibrium created by perfect competition is consistent with what economists call a Pareto optimum, and with the maximum, achievable, social welfare. You could not do better than that.

The implication of this equilibrium is that, once achieved, enterprises will have no buffer to deal with unexpected, negative shocks. They will also have a strong incentive to keep their inventories very low, and their labor force at a minimum, and wages as low paid as possible, This will allow them to keep costs down and to remain competitive. They will also exploit low cost foreign suppliers of needed parts, and to rely on "just in time" deliveries of inputs, to keep the costs of inventories down. They also will push for policies that make it easy for them to dismiss workers, in case the need for then falls as it normally does during recessions.

In this equilibrium, workers will receive, low, "competitive" wages which will determine their standards of living. Flexible labor markets and easy access to credit, facilitated by central banks policies, imply that the workers will not have much of an incentive to save, and the companies an incentive to retain some profits, for "rainy days". The profits that the enterprises make will be mostly distributed to shareholders, as Milton Friedman had recommended in a famous article, published in 1970, in the New York Times Sunday Review. He argued that private enterprises have no social responsibilities, and their main objective should be that of maximizing financial returns for the holders of corporate shares. Therefore, there will not be any holding of resources by enterprises to provide some buffer to cope with unexpected economic or other shocks.

In many advanced countries, over recent decades, rather than accumulating assets, workers and enterprises have accumulated debts, which are now at historically high levels. These debts, and also rising government debts, started to be accumulated, especially since the 1980s, during a period, when "market fundamentalism" became the guiding economic philosophy in several important countris, including the USA and the UK. It stated that the market is always right.

On their side, governments were urged to keep taxes low, not to discourage incentives, and, in recent years, even to finance spending with debt, rather than taxes. Furthermore, their spending has been generally directed to satisfy short run or immediate needs of the citizens, especially of those who vote.. The election cycle in democratic countries has had much influence on what public money is spent on, because the time horizon of the average voter, the horizon that also determines that of the government, is short. The interests of future generations receive little, if any, attention. It is the living who vote and count. As a consequence, public spending is often behind, in meeting long run and infrastructure needs. "Peak load" problems, in the use of infrastructures, continue to be serious in several areas. "Congestions" are often major problems. There is little spending that deals with the long run or with unexpected needs, such as those created by major disasters and by other shocks, including pandemics. For example, some spare capacity in hospitals was not created for possible emergencies, such as pandemics, and not enough assets were set aside to deal with future pensions needs.

Within the above framework, which is the one that was promoted by the prevailing economic theory, a government that decided to spend more money to meet potential future needs ((by, for example, building sufficient and long lasting infrastructure, by accumulating assets for future pension payments, by creating some spare capacity in some areas, such as health sectors, and by using resources for prevention against future, possible but uncertain natural disasters would risk losing the next election.

Long term problems, especially, for example, dealing with problems created by "climate change", or with possible, future disasters, including pandemics, receive no, or very little, attention. The expenses of public health systems will be directed at meeting today's needs, needs that are certain, such as chronic diseases, ignoring tomorrow's needs, that may be uncertain as to time and scope. Given the current paradigm, governments find it difficult to justify the creation of excess capacity, which may conflict with the immediate or short run needs, Preparation to meet potential future disasters, that are uncertain in both time and scope, will play no role.

Short termism and myopia have prevailed in both market and government operations and has been largely justified by the prevailing theoretical, economic models. Short termism is consistent with the equilibrium view of efficiency, a view that stresses the immediate needs of economies and citizens, and ignores the needs of future generations. This is the essential nature of a market economy, and of a democratic system of government that depends on frequent elections. The first worries about short run economic costs, and the second worries about the votes in the next election.

In recent years, governments have been encouraged, by some influential economists, with easy access to the media, to cover some of their spending not with taxes but with public debt. They have advised governments to abandon what they have called "austerity", while some of them have advanced a new, strange, theory called "New Monetary Theory". This theory essentially argues that much government spending could and should be financed with public debt, or even better with central banks' money creation, They have argued that this would not have serious, negative economic consequences. Adherence to these advices has made it more difficult for countries to face future, large and unexpected spending needs, such as those associated with disasters including the present pandemics. The existence of a possibility of budgeting for such future spending in past, traditional ways, should have justified keeping available some genuine "fiscal space" to meet potential, future spending needs. Since the decade of the 1970s the level of public debt has increased sharply in many countries. The world's total debt, for both the public and the private sectors, now significantly exceeds that of the world's GDP. Clearly this does not help countries that are facing the needs created by the pandemics.

It should be realized that the above situation is partly a consequence of the political and economic models that have been popular in advanced countries. One of the greatest philosophers of all times, Plato, in his Republic had been highly skeptical about a government based on the views of less informed and often emotional citizens. He would have preferred a government in which highly trained and educated individuals ,individuals that he called "philosophers", made the important decisions. It is uncertain how such philosophers would be selected today. Some countries, especially China, have adopted systems in which some individuals survive a filtering process provided by leading parties, to assume, presumably time-limited, leadership. Some countries, such as Singapore, have managed to adopt a system that gives a lot of power to those who make policy decisions. In some countries, public enterprises have been created so that, by being "public", they may have less need to follow the strict financial requirements of private enterprises.

The conclusion of this short article is that the ongoing pandemic has exposed some major weaknesses that may exist in the competitive, democratic system that we as economists have admired and have promoted, over the years. It is not easy to think of satisfactory alternatives to that system. However, it is easier to argue that, in a world in which major disasters and pandemics exist, and may become more frequent, because of climate change and other developments, we will need some new thinking, that might suggest some desirable ways to change the modus operandi that we have admired up to now. That thinking should suggest ways to still promote efficiency, an objective that cannot be abandoned, and democracy. But the new ways should do a better job in dealing with major shocks, including pandemics, and with equity consideration of economic policies, that often receive little attention in mainstream economics. As Rita Levi Montalcini wrote four decades ago, let us hope that some good may come from the difficult moment that we are experiencing.