Churchillian. Those with a propensity to write "We live in an Orwellian dystopia" would not be able to do so in truly totalitarian states. While government surveillance is a serious concern, we're not anywhere close to living in Orwell's Oceania.

A glance at the current crop of political leaders uncovers no one with Churchill's rhetorical skills. That is a shame, especially given that Ricks's book leaves one feeling that a stubborn political orator with a penchant for drinking, the written word, and human freedom would be very welcome right now. So too would a journalist with Orwell's writing style, combat experience, skepticism of authority, and imagination.

Aside from exhibiting his subjects' talents and flaws, all of which have been discussed for decades, Ricks provides some valuable insights to anyone concerned with the state of liberalism. When it comes to the defense of freedom, allies can come from any wing of the political spectrum, but mounting a defense of liberalism still can be a lonely—though ultimately worthwhile—endeavor.

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The Limits of the Market: The Pendulum between Government and Market
Paul De Grauwe
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In the preface to *The Limits of the Market,* Paul De Grauwe, an economics professor at the London School of Economics, begins with two basic premises: first, that a centrally planned economy does not work; second, that pure market systems do not exist anywhere. According to De Grauwe, "The only relevant question, then, is how precisely that mixture should look"—that is, the correct mix of market freedom and public policy oversight.

He writes of a "Great Economic Pendulum"—that swings between greater and lesser government intervention—"cyclical movements" in economic history. To illustrate this, he describes a general decline in government involvement in the world economy during the first part of the 20th century. Then the Great Depression ushered in greater government involvement that continued through the middle decades of the century. That gave way to renewed

market liberalization in the 1980s, which ended with the Great Recession. With this brief overview of modern economic history as his departure point, he begins to explain what he sees as the limits of capitalism.

"The limits of a market system relate to the fact that the connection between individual and collective rationality can be severed," De Grauwe writes. He identifies two types of situations in which large numbers of people do not believe that their own interests are being met satisfactorily by markets. The first type, which he labels "external limits," and others commonly call "externalities," involves individual decisions that have a positive or negative effect on others. The second category, "internal limits," involves the conflict between individuals' "System I" decisionmaking—relying on intuition and emotion—and "System II" decisionmaking—relying on reason. These two systems are connected and require a satisfying balance between emotional and rational demands in order for the market system to work effectively. Often, however, this balance of individual and collective rationality is not maintained.

DeGrauwe argues that individuals do not take into account the external effects of their individual decisions. He offers three examples of this: climate change and global warming ("carbon dioxide as a harmful gas generating external costs across geographic borders"); financial markets ("a banking crisis where the system reaches its limits before collapsing and requiring a government bail-out"); and public goods and the free-rider problem ("the market system has no mechanism for creating public goods").

He discusses how the expansion of the market system brings it to its "internal limits." He identifies three mechanisms that lead to the discrepancy between individual and collective well-being.

The first mechanism has to do with markets and distribution, whereby the price system leads to an inequality of income and wealth, a sense of injustice, and a desire for individual charity on the part of those able to purchase a good ("sharing with those not able to pay for a product"), as well as a possible revolt by those individuals in the lowest income groups ("protests and violent revolutions").

The second mechanism has to do with intrinsic and extrinsic motivation. Intrinsic motivation means "that people are motivated to put their effort into their work or other activities because they are fulfilled by the work or activity itself." Extrinsic motivation means "that people make an effort for the sake of the financial reward for a

particular activity." Reconciling these two diametrically opposed motivations is inherently challenging, as managers find it easier to focus on extrinsic motivations involving financial bonuses (which are easily eliminated when managers are confronted by company financial duress).

The third mechanism has to do with competition and cooperation in the market environment. Though both can encourage good market behavior, competition and cooperation can conflict with each other on both emotional and rational levels, resulting in an internal tension between individual and collective well-being.

De Grauwe next addresses what he refers to as the "utopia of market self-regulation." While so-called market fundamentalists argue that problems concerning the environment and public goods are grounded in a lack of property rights and solutions lie in somehow creating those rights, De Grauwe questions how such rights are possible. For instance, how can government establish ownership rights when people all over the world are negatively affected by air pollution? How does one identify billions of harmed people who will seek legal compensation from billions of other people who are responsible for their injuries, and in what court of law (De Grauwe calls this a "complicated information problem")? But, as he notes, even if one were able to solve this information problem—that is, through the highly unlikely scenario of negotiating voluntary agreements with billions of people—the legislative branch will have to assign property rights in law (or negotiate those voluntary agreements), and the courts and police will have to enforce those rights—thus inevitably involving government institutions.

Given this need for government to ultimately save the market from its own destruction, De Grauwe discusses three domains where government policy and normative theory have a role in managing the market: externalities (by levying taxes on those engaging in undesirable behavior), supplying public goods (and eliminating the free-rider problem in market responses), and redistribution (of income and wealth on the highest incomes, thus providing the socially and politically stabilizing effects of greater equality). However, he recognizes that, while the government may know what it must do, that does not always mean that it will implement such policies. Why? Because government is also subject to limitations.

According to De Grauwe, politicians are prevented from following the normative prescriptions of economic theory. The external

limits of government, he writes, involve externalities related to the collective interest, say for environmental protection. This is a similar discrepancy that exists with the external limits of markets, but, unlike the market where individuals resist the efforts of governments to harm private interests in favor of the collective, the discrepancy works in the opposite direction: individuals make decisions that harm the collective good. In this case, the challenge for government (especially in democratic societies) is to close the difference between individual and collective rationality, thus gaining broader support from their citizens for the government's decisions.

As De Grauwe points out, the free market appeals to the individual's rational, calculating side at the expense of his or her emotional side. Thus, government appeals to the emotional side—or the dissatisfaction gap left by the free market—and is the mechanism through which emotions are expressed. To this end, government focuses its efforts on distribution problems, motivated by a universal sense of fairness. Emotional appeals to "fairness" win out over rational appeals to profit and efficiency.

Government, however, faces two limits. The first—redistribution at the expense of efficiency—holds that neither excessive equality nor excessive inequality is good for efficiency. Most capitalist regimes tend to reflect this principle. The second—a balance between emotion and reason—recognizes that the more governments work on redistribution the more they tax individuals and limit individual freedom. An example of this is embodied in a public-pension system, where, if government does not keep moral hazard under control, the citizen's sense of fairness is overwhelmed by too many "free-riders" exploiting the system.

De Grauwe notes that discussions on the role of markets and government have been ongoing for centuries "between people who believed that the market system was the foundation of economic organization (and creates the economic value that makes it possible to maintain the public sector) or that the task was reserved for government (as it establishes and enforces property rights)." That traditional view is espoused by both market fundamentalists and government fundamentalists, and is often portrayed as a pyramid hierarchy, with either the market or government at the top. So who is in charge?

De Grauwe argues that such hierarchical thinking is wrong, as both the private and public sectors are necessary and it is equally important for both sectors to operate effectively. To that end he

offers a nonhierarchal, elliptical portrayal of the relationship of market and government. As he explains:

> If the government does not succeed in making those who generate external costs from market activities pay for them, then at some point the market system will come to an end. In the same way we can conclude that a government which does not succeed in providing essential public goods such as infrastructure, law and order, public safety, and education will lead the way to the downfall of the market system

The only relevant question worth asking, he writes, is how the division of labor between markets and government can best be - organized.

De Grauwe next reviews theories of the linear historical demise of capitalism proposed by Karl Marx, Rosa Luxemburg, Vladimir Lenin, Joseph Schumpter, and Karl Polanyi. In response to their critiques, he explains that the empirical data of the last 200 years have shown a cyclical—not linear—movement. The market system hits its limit, wanes temporarily, and is replaced by a state system that is full of internal contradictions that will lead to its demise, eventually to be replaced by a resurrection of the market system.

De Grauwe also views the creation of the eurozone (and by extension, the euro) as a threat to national governments. He explains how a eurozone government issues debt in a currency over which it has no control. Thus, the national government cannot offer any guarantee to bondholders that the euros will be available to pay them on the maturity date. Thus, without a national guarantee, the implication is that the financial markets can force national governments into insolvency against their will, which will lead to a dangerous supremacy of the markets. De Grauwe believes that the market has forced many eurozone countries (such as Greece, Portugal, and Spain) to adopt excessive austerity budgets that have led to increasing unemployment and the collapse of parts of the public pension system.

To better understand the limits of capitalism, he refers to the results of Thomas Piketty's *Capital in the Twenty-First Century*. Piketty begins his analysis by evaluating the long-term development of the quantity of (net) capital in the economies of the western world, focusing his historical analysis on France and Great Britain (although referencing the United States). He finds that, in the very long term,

capital income is higher than the growth of the economy, thus the return on capital is greater than the growth of gross domestic product. De Grauwe believes the implications of Piketty's research are reflected by the increasingly large proportion of top incomes in capitalist societies that go to the *rentiers*—the investors in capital. To save both democracy and capital, Piketty's solution is to offset the great inequality in *rentier* assets by instituting a progressive wealth tax, thereby saving capitalism from the capitalists.

In his concluding chapter, De Grauwe acknowledges there will always be pendulum swings between market and government. In the 21st century, he views the natural environment as an external limit toward which the market system is rapidly headed, and the tendency for greater income inequality as an internal limit of the market system. A reformist scenario, however, has governments raising taxes on high incomes and wealth, thus making inequality less extreme and more acceptable to society in the 21st century. By instituting this policy, governments would allow the market system to softly come up against its internal limits. Likewise, citizenry would apply democratic pressure on governments to combat pollution (such as carbon dioxide) by using taxes and regulations, and to provide subsidies for alternative energy sources. Therefore, this policy response halts environmental degradation and allows the market to more gently approach its external limits.

De Grauwe's basic framework offers a plausible explaination for how the pendulum swings between a mix of market freedom and government oversight and intervention. Modern economic history, with the cyclic swings in western democracies embracing capitalism bears this out. What that "mix" should be, however, is less convincing. He admits that he has evolved into less of a supporter of market forces, which is reflected in the title of his book. His argument is based on his belief that "neither market nor government is more important," yet he emphasizes examples of market failure far more than examples of government failure, though the latter includes such drastic examples as failed communist regimes or the potential for eurozone failure to back sovereign-issued debt. This book would have been improved if De Grauwe had dealt in finer detail with the true limits of government, for example by including the theory on nonmarket failure in democratic and capitalist societies as developed by Ronald Coase and Charles J. Wolfe, among others.

For example, De Grauwe uses the economic recession of 2008, specifically the financial services sector, as an example of market failure. The Financial Crisis Inquiry Commission, a U.S. commission charged with investigating the causes of the financial crisis, reported in 2011 that, while the modern financial system was evolving, government regulation did not keep pace with the rising risks in the U.S. economy. As the report states, "We had a 21st century financial system with 19th century safeguards." That was not a market failure, but a government one—specifically, an egregious example of how the federal government performed inadequately and did not sufficiently intervene. This form of nonmarket failure is characterized as regulatory arbitrage, where financial institutions take advantage of the differences between economic risk and the existing regulatory position.

On the market side, De Grauwe discusses market failures in self-regulation but does little to explore rich examples of successful private ordering. Recent work by economist Edward Stringham (*Private Governance: Creating Order in Economic and Social Life*) offers a rational approach to addressing when government or markets are warranted to solve societal problems. Private governance is practiced by clubs and voluntary associations in the marketplace, through electronic payment processing, for example. Other examples include best industry practices, as well as codified industry standards, which are developed in the United States by associations without direct government involvement. (Such standards are often later incorporated by reference in administrative rules.) While often requiring a certain level of government intervention, for example, to adjudicate and enforce contracts, such private ordering is an example of how markets can operate creatively and effectively with limited government intervention and oversight.

In conclusion, De Grauwe offers the reader a thought-provoking book and a basic theoretical and empirical departure point for further work on an important topic relevant to the future of democratic capitalism. Public policy issues of income inequality (especially a stagnant or declining economic middle class), crushing national debt, public pension and health insurance funding shortfalls, and the ever intrusive and coercive regulatory state (and loss of liberty) are coming due. The important question still remains: What is the right mix of market and state?

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