The success of market failure?

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The boundaries between state and market are the most contested in the political economy. After the Second World War the consensus centred on a belief in the mixed economy managed by an activist state using a panoply of tools – monetary and fiscal activism, planning, industrial policy, prices and incomes policies – to achieve its ends. But the stagflation of the 1970s called into question the viability of the mixed economy model and state activism. Free-market critics argued passionately that inflation, low growth and poor productivity alike were the consequence of too much state and too little market, creating a new, so-called 'neoliberal' consensus and a push for deregulation that held right up until the extraordinary events in the financial markets in the early autumn of 2008. The presumption has been that in general markets work and states do not. Only in exceptional circumstances – where a particular market is proven to fail – is there any case for government action, which should, in any case, be temporary.

Economic actors must freely follow market incentives and maximise profits, and in so doing, economically rational individuals and firms generate innovation, growth and wealth. Markets will regulate themselves, problem-solve themselves and balance themselves. This set of propositions reached its apotheosis in the celebrated 'first fundamental theorem of welfare economics', a mathematical proof which was always a limited and denuded conceptualisation of markets but which showed that as long as there are many participants freely entering any market, with everyone having access to the same information, unfettered competition produced the best, most efficient allocation of resources. The state is unlikely to improve upon these processes, and even if it did, the compulsion and enforcement that would be involved contrasted illegitimately with the voluntarism of markets. It is more likely that the state will both make matters worse and constrain freedoms.

However, the intervention of western governments into their financial systems has called into question the whole thesis. In particular, the massive recapitalisation of the UK banking

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system – with £37 billion of taxpayers' funds, provision of £200 billion liquidity, and guarantees of £250 billion of interbank lending – along with universal acceptance of the need for more effective regulation, has dealt a major blow to the free-market consensus. Markets – even the financial markets that come closest to the theoretical ideal, with many well-informed participants – are capable of making incredible, systemic mistakes that threaten the entire economic fabric.
At the same time, our growing understanding of key economic processes like innovation are widening the categories of activity in which markets are continually prone to failure.

It is thus timely to reappraise the case for markets, together with identifying the limits of traditional market failure analysis. The proposition is simple. The genius of markets is that they encourage the experimentation and variety necessary to cope with the indeterminacy of the future, not just that they are efficient allocators of resources, a machine that can be precisely manipulated. Markets, however, have systemic weaknesses. They are unstable, unfair and vulnerable to manipulation – and no amount of intellectual theorizing can surmount these realities. But the free-market fundamentalists have been so successful in creating an intellectual hegemony that they have managed to steer the debate about the shortcomings of markets away from a discussion about the market's weak properties as a system, and into a debate about the scope of particular market failures. The presumption has been that the market paradigm works, even if they admit deviations from the general rule.

But if markets are prone to system-wide breakdowns, market failure thinking needs to be radically overhauled. Government action is not just about fixing temporary malfunctions in an otherwise smooth running machine; it is about continually designing and redesigning the machine itself. Government action in the financial markets recently is thus not an exceptional case in response to a very acute and unexpected market failure. It is the rule. This calls for a wholesale reappraisal of our approach to policy – not suddenly to become distrustful of markets and move to statism, but to become a lot more savvy and less ideological about what can be expected from any particular market and markets as a system.

Escaping conceptual economic jails for business-oriented courses requires an education that examines the historical and philosophical development of capitalism. If the current crisis deepens and the systemic failures are unresponsive to government actions it is conceivable that more radical approaches that regard capitalism as exploitative rather than productive/distributive may appear on the agenda.