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Market Versus State: in Theory and in Practice

Thoughts on the "Keynes and Hayek" Book Review of Katalin Botos

SUMMARY: In her review on *Nicholas Wapshott's* book *Keynes and Hayek* (see *Botos,* 2016), Katalin Botos elaborates on her thoughts regarding the two economists as the subject of Wapshott's work and discusses one of the key economic policy issues associated with their conceptual framework (*Botos,* 2016). In this article I propose a few clarifications and may even challenge certain issues, while also taking a stand on the fundamental issue. I attempt to argue that the market versus state debate has long been resolved in practice, that is, with respect to economic policy; indeed, the issue may never even have been on the agenda. At the same time, I also try to argue that economists wary of government intervention will always be present in economic thinking. The reasons behind this should be sought quite simply in the development of economics, although they are not entirely independent of the Mont Pelerin Society either.

KEYWORDS: Hayek, Buchanan, Mont Pelerin Society, state intervention
JEL CODES: A11, B20, B31, P16, Y3

Obviously, this article is not meant to discuss either the full topic or any of its sub-areas in detail as this would far exceed the scope of this study. Nonetheless, I trust that the essence of my message will be clear to any reader with a modicum of competence in community decision making and rent-seeking. It is a sensible choice to focus the economic analyses laying the groundwork for economic policy decisions on well-defined (smaller) topics and on a given market while also striving to be as thorough as possible. It is also expedient to draw conclusions from such market analyses with respect to the specific market and, insofar as it is the intention, to base economic policy recommendations or decisions on them.

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THE CURRENT ISSUE(S)

One of the big questions Botos considers topical is posed at the very beginning of the book review: is government intervention necessary for the viability of the market and can this view be adequately supported? I am not sure what Botos meant exactly by this question but I think that such general questions do not usually have a (good) answer; indeed, searching for an answer may only divert our attention and energy. Instead, whenever this question arises I always recommend that it is posed more precisely in relation to a specific product market. Specific, well-defined questions are far more likely to yield fairly straightforward answers. Moreover, the clarification of the question also implies that the normative question ("Is it necessary?") should define the person from whose perspective the intervention is to be evaluated, and in the answer the inquirer should also try to assess the impact of the intervention on others.

In my experience, market analyses can only serve their purpose if, instead of the aforementioned general question, the answer is sought in a specific market. Likewise, even in relation to the given market our questions should not be independent of the time and place and the specific intervention; we should strive to ensure just the opposite.

I believe that economists are not merely interested in the viability of the market (whatever this might mean), but more importantly, in the (comparatively) efficient or inefficient nature of the free market and/or any other institutional arrangement, for instance, a government intervention. This is simply a consequence of a way of thinking that considers alternatives. As a matter of fact, the generalised question at hand can be better formulated today as follows: "Is government intervention capable of improving the outcomes of the free market (i.e. a state free from any intervention by the government)?". Another increasingly frequently posed question is whether the free market (a state free from any intervention by the government) produces desirable outcomes.

If the results of a multitude of market analyses were known and they were fairly consistent, we might be in a better position to answer the generalised question in general terms. Even so, presumably, the opinion derived from such generalisation will be, due to the nature of generalisations, too uncompromising. And it can be safely assumed that the answer to the generalised question will most likely be: "it depends".

THE NIRVANA APPROACH

Market analyses or, in more general terms, the conclusions drawn from economic or social analyses alone may not provide a sound basis for any government intervention. It should be borne in mind that even in relation to a specific market (social) problem an additional question arises, namely, whether the existing theoretical or practical possibility can be implemented in the given environment. Unfortunately, there is no guarantee that it can be; indeed, more often than not, the opposite is true.

This is because at this point, analysts often fall into the trap of the so-called Nirvana fallacy. *Demsetz* (1969) warned that from a practical (economic policy) perspective, it is a mistake to compare an unrealistic, ideal norm (alternative) and its hypothetical outcome to the real institutional arrangement/outcome under analysis. From a practical (economic or social policy) perspective it has no use or significance to compare a theoretical possibility to a real situation. The right course of action is to compare real alternatives and real expected outcomes as they are the only ones relevant to reality and this is the only way to draw sensible, useful and correct conclusions from a practical perspective.

In my opinion, even though economics principally means institutional analysis, caution is called for whenever we wish to make a leap from the realm of theory to the realm of practice.[1] If we deduce that a real institutional arrangement is inefficient based on discrepancies between a theoretical situation and an institutional alternative, we are already stuck in the quagmire of the Nirvana fallacy. It is fine to assert that something is inefficient but we also need to ask ourselves specifically what (which alternative institutional arrangement) could be a more efficient solution.

Based on this, the statement that societies in reality operate efficiently should not be surprising. It is the institutions that need to be changed in order to improve efficiency. This is because even though people always take advantage, under a specific institutional arrangement, of efficiency benefits or any other possibilities that may be used to improve resource allocation, some institutional arrangements are more efficient than others. The efficiency of resource utilisation may be improved further by transitioning to a more efficient institutional arrangement. This can be, for example, the objective of institutional reforms.

Even during the implementation, a multitude of institutional arrangements are generally available. I believe that plenty of choices are available in practice even if at first glance this seems impossible or the room for manoeuvre is seemingly limited. I have provided an example for this in relation to a sub-segment of competition law and practice: competition law enforcement in cases of abuse of a dominant position (*Szakadát,* 2011).

INSTEAD OF ONE BIG QUESTION: SEVERAL SMALLER QUESTIONS

I think that the wise answer to the big question at hand may be something like this: there might be some areas of the economy where the free market engenders such a steady state that is (perhaps) undesirable from a certain perspective. Or, there might be some areas of the economy where government intervention is capable of improving the efficiency of free market outcomes whereas some other segments of the economy essentially do not need any intervention by the government. At the same time, I wish to state well in advance that such answers typically derive from normative analyses.

Although theoretical it may be an option, whether the government intervention effectively improves or worsens a given situation is an answer to a different type of question. There might be some who may criticise this intention (objective) in the first place. Others may have misgivings about the decisions made and their actual consequences. Both those who call into question government intervention even on a theoretical basis and those who oppose the state's active involvement in economic policy based on empirical evidence tend to resort to concepts, arguments and thoughts associated with the theory of community decision making.

However, as mentioned above, I prefer to seek an answer in the context of specific markets rather than in general terms.

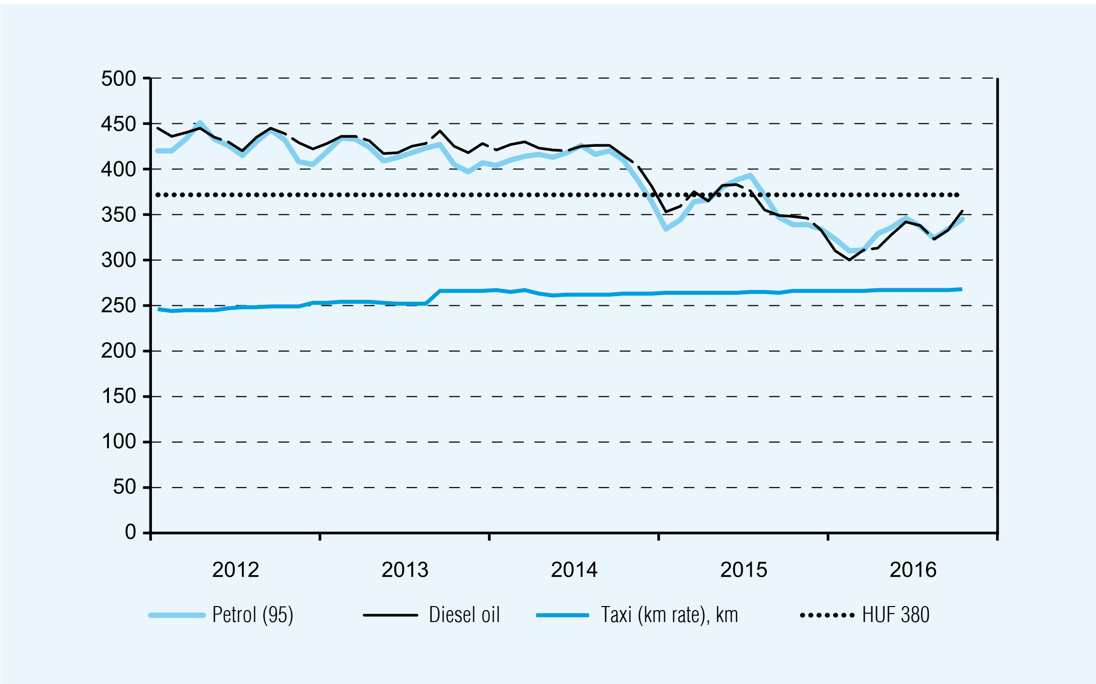
As an illustration – rather than a confirmation – let us look at the example of the Hungarian taxi market, more specifically, its price setting practice. Is it necessary to cap the prices in this market today (in the form of a government intervention) to ensure/improve its viability?[2] The question has been decided. I still believe, however, that it is easy to demonstrate – both in theory and practice – that the specific form of administrative price fixing benefits either taxi users or taxi drivers, depending on changes in petrol prices.[3] Calculations preceding the price fixing obviously considered (perhaps) petrol prices. According to a contemporary background material, the price calculation was based on an average fuel price of HUF 380 per litre (see the detailed calculations (n.d.) of the Independent Trade Union of Taxi Drivers). For the sake of simplicity, let us assume that the calculation underlying the decision was indeed based on this input price and that the calculation was otherwise correct. In my understanding, the price determined in the course of the price regulation as announced in Decree 31/2013 (IV. 18) of the General Meeting of Budapest's Local Governments has been in force for years, despite subsequent changes in petrol prices. If it is true, we may conclude (see *Figure 1*) that the government intervention is likely to have worsened the situation of consumers (taxi users) over the past two years, given that actual petrol prices in this period were lower than the input price considered for the purposes of the price regulation. The decline in the input price, however, was not reflected in the reduction of the price of the service. In a free market this would have been very likely to happen. (As regards the situation of taxi drivers or taxi companies in the same period I would not be as willing to make such a straightforward statement, although our first conclusion would obviously be that the fixed price benefited the taxi drivers in this period).[4]

However, when petrol prices rise above the critical value without a subsequent change in the price of the service, the fixed price appears to benefit consumers and hurt cab drivers. If the administered price of the service does not follow changes in the prices of the key inputs, it is very probable that one of the parties will gain while the other party will lose from the regulation as soon as there is a change in the input price. In this particular case, therefore, price regulation may be questionable.

Of course, a more thorough analysis of the market can also reveal whether the structure of the market needs intervention. Off the top of my head I would think that in consideration of the multitude of market participants, the susceptibility of the market to attacks, the low knowledge, capital or other input requirement of the service, the easy convertibility of inputs, limited specificity and a number of

Figure 1

PETROL AND DIESEL OIL PRICES FROM 2012 TO THE PRESENT



Source: HCSO (3.6.5.) Monthly average prices of selected goods and services. (Downloaded: 07/12/2016) other factors, this market could fundamentally be a competitive (free) market. At first glance, therefore, price regulation by the state does not appear to be warranted in this market. Having said that, we would need to perform a far more thorough market analysis in order to draw sound conclusions.

This example was merely intended to illustrate that there might be some markets where government intervention or state regulation is not really necessary. Perhaps I was also able to demonstrate that even if the opposite was (were) true, it cannot be guaranteed that the right form of intervention was applied in the given case. It may have been possible to find a better solution in the given market either from a consumer or from a social welfare perspective.

It should be noted that despite all this, it may become clear that intervention is perhaps warranted by reasons other than market structure. I will not address such situations at this time, however, I wish to repeat that even if there are arguments supporting the need for regulation – because government intervention may improve the situation in theory – in practice, with all new angles considered, things play out differently sometimes. Sometimes, good intentions are not enough. It may not be enough even if the given step proved to be successful somewhere else. But we should always take it very seriously when somewhere else it failed.

I think it would be nice to have a relatively large number of market analyses, far more than produced or available today. Perhaps the example offered above can duly illustrate that a sound opinion can be formulated on the basis of good market analyses with respect to the desirability of government intervention. However, in order to resolve a normative question we should also be able to decide what the intended outcome should be and whose situation we are trying to improve. We must also agree on the measure of desirability. Economists typically identify long-term social or consumer welfare as a measure to be followed, but the autonomy of the policy is fairly considerable in this regard. The variables included in policy-makers' objective functions and the weights assigned to them are unknown. Some economists – in my view, all members of the Mont Pelerin Society – maintain that it is fairly understandable why the interests of small groups take the upper hand from time to time against the interests of larger groups. The logic of collective action and the theory of community decision making is largely focussed on this issue.

However, in order to close this topic, I would rather remind the readers of an eloquent observation of *Steve Pejovich.* In an article, the eminent representative of property rights economics wrote the following: *"I don't think government can improve economy. If government intervention can improve economic performance and get us out of recession, is it not stupid to wait for recession in order to capture the benefits of government economic policies? But then, if government intervention can improve economic performance and increase the rate of growth, how come socialist/welfare states consistently perform worse than free-market economies?"*[5]

WHAT KIND OF A SCIENCE IS ECONOMICS?

At the beginning of her article, Botos asserts that economics is not a descriptive science (such as history) but neither is it a logical or an experimental science as mathematics and physics. Although the author herself does not offer an answer to this question, I prefer the answer proposed by *Rubinstein* (2006). In Rubinstein's opinion, if economics is viewed as a theory, then it cannot serve as the foundation for any policy recommendation as it is a part of social sciences that investigates concepts (and correlations) typically used in thinking about economics in real life. Economics (as a theory) addresses mathematical models where the models and the terms used are given a specific (economic or policy) interpretation. For instance, the *y=f(x)* function can be understood as a demand curve where *y* is considered to be the quantity to be consumed from a given product and *x* is the price of the product. Of course, due to this particular interpretation, the designation can be altered, for example, as follows: *q=D(p)* . While we do not attach any specific content to the *y=f(x)* function, the case is just the opposite with the *q=D(p)* function, where the term receives a particular meaning.

Botos, however, is interested in a different issue, namely, whether economics is a suitable foundation for a correct economic policy. Besides the two angles referred to above, I am not aware of any other factors that can be used as a measure to assess the correctness of any economic policy. Moreover, based on the above I can also accept the claim that no policy decisions can be based on economics as a theory. I do not believe that unbiased, real economic policy actually exists. As I have mentioned before – an it should not come as a surprise in relation to economics – that economic policy decisions (as almost all other decisions) require a decision-maker, an objective and an objective function. And decision making also involves constraints. In addition, the measure of correctness is yet to be agreed upon.

THE PROFESSIONAL RECOGNITION OF HAYEK

According to Botos, Hayek firmly believed that the free market price mechanism is capable of providing the necessary information to market participants most effectively and she claims that Hayek was interested in economic issues in their theoretical nature. I am afraid that some readers may deduce from the book review that the position of Hayek and his followers is based on pure belief and the dispute is merely about a simple theoretical question. Nothing can be farther from the truth. It is not merely a logical assumption to start out from the fact that social designers have no continuous access to the information available to decentralised decision makers. *"And the problem of what is the best way of utilizing knowledge initially dispersed among all the people is at least one of the main problems of economic policy – or of designing an efficient economic system"* (*Hayek,* 1995, p. 242). Given, among other things, the pivotal role of "practical knowledge" and "changes", I think Hayek believed not only theoretically but also empirically that a market price mechanism based on decentralised decisions is capable of best ensuring the continuous information flow required for the efficient operation of the economy. *"We need decentralization because only thus can we ensure that the knowledge of the particular circumstances of time and place will be promptly used"* (ibid., p. 246).[6] And market price mechanism is the institutional solution to *"how to dispense with the need of conscious control and how to provide inducements which will make the individuals do the desirable things without anyone having to tell them what to do"* (ibid., p. 249).[7]

Hayek's article containing the quotes above was originally published in 1945 and it was included in the Top 20 articles of the first hundred years of the *American Economic Review* issued by the American Economic Association (detailed in the summary of *Arrow et al.* [2011]). This fact alone demonstrates that Hayek's thoughts were not swept away by time or the Keynesian school of thought and he himself was not relegated to oblivion as an economist. His assertions stood the test of time and they are not only theoretically substantiated but also empirically true.[8] At the same time, as I mentioned before, this does not mean that the state does not or cannot have an important role in the functioning of the market, not to mention the legitimate reason of government intervention.

THE GAME IS OVER

Let us recall my previous references to the legitimacy of government intervention: firstly, I indicated that democratically elected governments can legitimately intervene into the functioning of the market even over and above efficiency aspects and secondly, I mentioned the subject of one of the later articles of another Mont Pelerin Society member, *James Buchanan.*

Even within a democratic framework, the government may be given a mandate from voters to restrict the scope of individual freedom, i.e. exercise state intervention. The trend is pretty clear. A substantial portion of the population does not wish to exercise free control over its destiny; it is scared of freedom. This is because the right to freedom does not exempt people from taking care of themselves and their family (and, I may add, the community). Indeed, a significant part of the population does not wish to take responsibility over its thoughts or actions; it expects the state to take care of its life and well-being. Such individuals, in return, tolerate the state's overexpansion.[9] See Buchanan's (2005) analysis on the subject and the different types of the proliferation of socialist thinking.

THE MONT PELERIN SOCIETY AND ITS INTELLECTUAL LEGACY

The Mont Pelerin Society counts numerous members with truly remarkable intellectual performance.[10] Members of the Society include eight winners of the Noble Prize in Economic Sciences: F. Hayek (1974), M. Friedman (1976), George Joseph Stigler (1982), J. Buchanan (1986), M. Allais (1988), R. Coase (1991), G. Becker (1992), V. Smith (2002).

A. Alchian and H. Demsetz, prominent contributors in the development of the economic analysis of property rights – the theory of the firm (new institutional economics) – were also MPS members. *R. Posner* acquired fame in the economist community in relation to the economic analysis of legal institutions. We should also mention the name of *G. Tullock* who, both as Buchanan's co-author and independently, made a considerable contribution to laying the theoretical groundwork for community decisions and to developing the concepts of rent-seeking.

Grasping the issue of rent-seeking assists economists significantly in gaining an understanding of the nature, persistence and economic impact of the demand for government intervention.[11]

I believe that in consideration of Buchanan's previously mentioned thought process and the concept of rent-seeking we may conclude that the market versus state debate has long been decided in practice, i.e. with respect to economic policy. The state not only provides the market's operational framework and contributes to and is tasked with the provision of public goods, but is also an active participant of the economy as a consequence of other existing or perceived market failures. Government intervention, therefore, has always existed and will exist irrespective of whether it is efficient or not. At the same time, if for no other reason than the latter, economists viewing government intervention with due criticism will always be a part of economic thinking. This is quite simply the consequence of the development of economics. Community decision making in general and particularly, the theories, thoughts and assertions of economists involved in the discussion of the theory and concept of rent-seeking that laid the groundwork for the theory of state failure, as well as the resulting and now independent areas of analysis – economic branch(es) – are simply a part of mainstream economics. Owing to its theoretical soundness and especially to its empirical relevance, the theory of community decision making has become an organic part of economic thinking, discourse and approach.

Notes

1 In the area of theoretical analysis cross-checking the outcomes of certain market structures against an outcome "dictated" by a social designer does not pose a problem. But the efficiency rankings derived from the modelling do not necessarily substantiate an economic policy measure. The outcomes received within the (hypothetical) context of the models may diverge significantly from those observed in reality. Disregarding the differences between the hypothetical institutional framework of the models and the actual framework of real alternatives is the most frequently made mistake. For example, while in reality the information asymmetry between market participants is an everyday occurrence or we take it for granted that access to information is costly, on the side of public institutions we often ignore these factors and the problems they generate. A similar mistake is often made in relation to individual incentives.

2 In general, I prefer not to pose such normative questions; however, in order to illustrate the problem and to be able to remain within the conceptual framework of the original book review, I posed the question in this form.

3 This naturally should have been examined beforehand and it appears that there was indeed such an analysis. Such situations are not entirely new; it does not necessarily require special imagination to foresee the types of problems that may arise and the potential solutions. And even if we face a heretofore unencountered situation, it may still be worthwhile to mull it over after the fact on the off-chance that the phenomenon is repeated in future, in which case we will be more prepared to formulate the questions and seek possible answers or solutions. The regulatory issue raised in the example is not limited to whether we need government interventions or price controls. No. Even if one says yes, the question remains: how should the price regulation take place? I wish to call attention to a trivial question. Is the price resulting from the price regulation a fixed price or a floating price? And in the latter case, is the price adjusted transparently and automatically? Some readers may notice the similarities between our example and bank lending. It seems to me that, besides other and perhaps more important problems, retail bank contracts give rise to similar questions. Interest rates were adjusted non-transparently and flexibly (quickly) upwards and fairly inflexibly (slowly) downwards.

4 This conclusion seems to be supported by the large number of taxis waiting in line at the taxi stands.

5 The article was published in the 25 January 2008 issue of the *Dallas Morning News* and was referred to in the Coordination Problem blog: http://www.coordinationproblem.org/2008/01/steve-pejovich.html

6 Hayek's assessment, of course, is clear: *"I am convinced that if it were the result of deliberate human design, and if the people guided by the price changes understood that their decisions have significance far beyond their immediate aim, this mechanism would have*

been acclaimed as one of the greatest triumphs of the human mind" (ibid., p. 249).

[7] Hayek clearly avoided the trap of the Nirvana approach: "*To assume* all the knowledge to be given to a single mind in the same manner in which we *assume* it to be given to us as the explaining economists is to assume the problem away and to disregard everything that is important and significant in the *real* world" (ibid., p. 251). (Italics added, not included in the original text – L. Sz.).

[8] I think that, as a matter of course, people generally attach a higher value to the performance of market economies – after all, it was not from Western Europe that people fled to Eastern Europe and it was not from Florida that people tried to get to Cuba on life rafts, but the other way around. It is not surprising that socialist countries had to put up fences to avert foot voting if there were no natural obstacles to prevent emigration.

[9] *Mueller* (2003) provides a good summary of the overexpansion of the government, specifically in Section 21.

[10] There are two scientists of Hungarian origin among the founders: Mihály Polányi and György Révay.

[11] The term rent-seeking was coined by *A. Krueger* in an article written in 1974. A brief but essential summary of the topic is provided in the classic introduction of Buchanan – Tullock (1992). For a more detailed discussion of the topic, see also the selections of Rowley – Tolison – Tullock (1988) and Rowley (2005), and the relevant chapters of Mueller (2003).

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