On markets

This paper discusses the reliance on the concept of "markets" in the formulation of policy. It is not a fully referenced document and is intended to inform policy discussions. [1]

Context

Since the 1980s there has been in Australia a "reform" program that has put the reliance on markets and competition as a goal at the heart of policy discussions. The concept of the market has been championed as an alternative to central planning.

The perceived advantages of markets have been used as a basis for restricting the remit of Government in regulating economic activity.

This paper is one of a set that discusses the concept of "market" and "competition" as used in public policy. This paper contrasts the view of regulation as response to market failure with an alternative view that all markets are social constructions and that regulation is a task in market design.

Markets as social constructions

The theorists and policy markets use a language that "the market" or "markets" are to be preferred to the alternative, which is usually meant to mean centralised control by "the State". The usage implies the existence of markets outside of any political or social construction.

The concept of a market depends upon the concept of property rights. One person "owns" something and another person "owns" something else and they think they'd both be happier if they traded. That is the atomic concept.

The first observation to make is that "property" (apart from perhaps a nest or cave) only has meaning to human beings. And only human beings have introduced the concept of social enforcement of the property right.

The fact that they are a human construction does not mean that they are the only possible construction. Indeed the earliest forms of social structure were communal. A feature of the earliest engagement of Australian aborigines with the first European settlers was the fact that the indigenes did not understand the idea that the property of the Europeans was not theirs.[2]

A wide sweep of history can show that various communal models have been as prevalent as markets.[3]

So markets exist as a social construction, and they are enforced by social rules. Simple observation shows that in the real world there are lots of different actually occurring markets all with different rules.[4] Some are markets like stock exchanges where transparency of bids, and trades, and "fundamentals" are rigorously enforced. Some are like used car lots that practice price discrimination based on the preparedness of the buyer to haggle. Some are formal auctions, including classic open out-cry auctions.

Markets and market failure

The "market" as usually used in public policy is a reference to one specific kind of theoretical market, the one on which orthodox economics is founded.

This is a market with a sufficiently large (potentially infinite) number of buyers and sellers that no one individual can affect the price paid in the market. It is a market in which all sellers are offering a homogenous product, and in which all buyers are only seeking that one product. It is a market in which buyers and sellers are perfectly informed before any transactions about the preferences of each other and in which all trades happen simultaneously.

The creation of an "ideal" is not unusual in science. The simple explanation of how billiard balls collide (conservation of momentum and energy) does not take into account friction on the ball in the air and loss of energy at collision (in both heat and noise). But we accept the explanation because it has good predictive power. At a more practical level the same calculations are used to assess motor vehicle collisions.

But there are plenty of occasions where the model is useless. These include the movement of sub-atomic particles, the movement of stars, or the movement of charged bodies in a magnetic field.

Theoretical models need to be constrained to use in the circumstances where the assumptions that support them apply sufficiently well to generate the outcome.

In public policy this has come to be labelled "market failure". It creates a theory that markets should be left to operate, but if there is a "market failure" then there is a need for some central action to rectify the "failure".

There exist a number of alternative lists of the different kinds of "market failure"; these include the existence of market power, the presence of externalities (including the case of "public goods") and information asymmetry. To these can be added a concept of "friction"; the costs inherent in undertaking search and transactions that is usually excluded from the model.

John Kay has criticised the "market failure principle" because it both concedes too much ground to the validity of markets and because "the modern left has invested so much in market failure as its rationale for action, there is a temptation to frame everything they want to do as a response to market failure, however tenuous the basis for this may be."[5]

The first of these addresses the fact that market failure is only addresses economic goals. Non-economic goals – such as distributional justice, paternalism and community values – are not captured at all.

Indeed the idea of distributional injustice to the extent that certain groups will be excluded from a market is sometimes incorrectly described as "market failure". But they are really the consequence of the market working. Policies to ensure "universal access" are policies designed to counter working markets.

"Market failure" is ultimately a poor public policy construct because every real-world market falls short of the ideal of the theoretical market, and hence can be claimed to "fail."

Markets and market design

One of the great champions of markets in the Post War era, Freidrich Hayek, contrasted the market with the alternative of collectivist action. For Hayek the problem of creating a rational economic order was the inability for a central agency to obtain the data necessary to make decisions. For Hayek, "The economic problem of society …. is a problem of the utilization of knowledge which is not given to anyone in its totality." [6]

He continues;

> *If we can agree that the economic problem of society is mainly one of rapid adaptation to changes in the particular circumstances of time and place, it would seem to follow that the ultimate decisions must be left to the people who are familiar with these circumstances, who know directly of the relevant changes and of the resources immediately available to meet them. …*

> *Fundamentally, in a system in which the knowledge of the relevant facts is dispersed among many people, prices can act to co-ordinate the separate actions of different people in the same way as subjective values help the individual to co-ordinate the parts of his plan. …*
>
> *I am far from denying that in our system equilibrium analysis has a useful function to perform. But when it comes to the point where it misleads some of our leading thinkers into believing that the situation which it describes has direct relevance to the solution of practical problems, it is high time that we remember that it does not deal with the social process at all and that it is no more than a useful preliminary to the study of the main problem.*

This extensive quote is intended to demonstrate two distinct versions of the value of markets. The first is Hayek's sense of markets as means to communicate information about preference. The second is in the formalism of equilibrium analysis wherein markets result in prices moving to reflect absolutely those preferences (as in price will equal marginal cost).

This distinction has been recently picked up by Kay in his 2009 Wincott Lecture. He states that in their approach to markets, economic researchers and policy-makers have focused too much on the role of prices as signals to guide resource allocation … the role they play in equilibrium analysis. He claims this is at the expense of two possibly more important elements – markets as a process of discovery and markets as a mechanism for the diffusion of political and economic power. [7]

To be clearer about the distinction, market theory assumes a fully informed market that simultaneously clears. The real world is made up of dynamic markets with incomplete information. The actual trades that occur in one time period affect the preferences of participants in the next period.

If the preferences of the participants stay unchanged, the dynamic market will "settle" (or converge) on the position that applied in the static market. However, in many circumstances a market will not converge on that outcome.[8]

In public policy we need to accept that the reason for preferring markets is because of the process of information disclosure (discovery) and empowerment they offer, not because of the static efficiency outcome that the theoretical model describes.

The consequence is therefore to not imagine there is a perfect market and we only adjust for identified failure; instead policy needs to acknowledge that all markets vary from the ideal and that the ways they vary are constructed by social rules, including Government regulations.

Conclusion

The "market" of orthodox economic theory never exists. Regulating for market failure is a poor policy construct as it knows no bounds since all markets "fail", and it does not admit of the need for social regulation where the way the market works would result in social injustice.

However, markets are a preferable model of economic organisation over central planning because of their ability to work to transmit information (a function they are actually presumed not to have in the standard theory).

The focus of public policy needs to be on designing markets to achieve the objectives of facilitating discovery and constraining the exercise of power.

[1] Paper prepared by David Havyatt June 2011.
[2] Inga Clendinnen *Dancing With Strangers: Europeans and Australians at First Contact* Text Publishing 2005.
[3] The reference here is to a book titled "Civilsation" the exact details I'm unable to locate…
[4] See John McMillan *Reinventing the Bazaar: The Natural History of Markets* for examples.
[5] John Kay 'The Failure of Market Failure' *Prospect Magazine* Issue 137 1 August 2007. At http://www.prospectmagazine.co.uk/2007/08/thefailureofmarketfailure/ behind a paywall. Republished in *Beyond New Labour: The Future of Social Democracy in Britain* Patrick Diamond and Roger Liddle (Eds) (http://trove.nla.gov.au/work/28495907)
[6] Freidrich Hayek 'The Use of Knowledge in Society' *American Economic Review* Vol 35 No 4 September 1945 519-30.
[7] John Kay 'The Future of Markets' *Economic Affairs* March 2010
[8] For a full treatment of economic dynamics see Ronald Shone *Economic dynamics: phase diagrams and their economic application* Cambridge University Press 2002.

About DigEcon Research

Purpose

DigEcon Research is a stand alone research body. Ultimately, its pursuit is policy research, the focus of which is the meaning and significance of the Digital Economy. This policy research encompasses both economic and social research.

Researching the significance of the Digital Economy

The concept generally referred to as the Digital Economy is frequently discussed but there is little shared meaning in the term. A key definitional issue is whether the Digital Economy is something yet to happen or in which we are now embedded.

DigEcon Research focuses on the analysis of social and economic change rather than an analysis of a notionally static "Digital Economy". Analysis of the change as it occurs should highlight those areas where there is genuine policy choice rather than merely a need to adapt policy to changes that have already occurred.

Before Thomas Kuhn popularised the idea of "paradigms" J.K.Galbraith railed against the "conventional wisdom". There is no denying that what Kuhn called "normal science" or the repeated application of existing theory to new problems results in most practical developments. It is equally true that the application of existing theory to problems they were not designed for results in, at best, vacuous solutions and, at worst, wildly dangerous outcomes.

The Digital Economy challenges the fundamental concepts of neo-classical economics. It also challenges most of the precepts of how societies are organised. In this context policy research needs to focus on what is different, not on what is the same. The Digital Economy is not just a matter of means of production but about the fundamental structures of social organisation.

Work program

This research is designed both to inform policy makers and to assist those who would seek to influence policy makers or to make business decisions. DigEcon Research however does not provide strategy recommendations nor undertake policy advocacy on behalf of any party.

A key element of the research will relate to the direct regulation of the converging industries of telecommunications, media, consumer electronics and information technology. However, the agenda encompasses the wider economic and social policy issues.

The scope of the research agenda will ultimately depend upon the researchers who wish to participate in what is more an idea than an entity.

In the crowded Australian research field there are a number of "bodies" that share some of the objectives of DigEcon Research. DigEcon Research aspires to contribute to the work of these and any other researchers in the field.

Havyatt Associates P/L (ACN 075 059 504) T/A DigEcon Research (BN98531409)
9 Wood St Eastwood NSW 2122 M: 0414 467 271