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Limits of the Market*

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The market system is subject to limits that have to do with externalities, inequalities and excessive market concentration. These can only be taken care of by government action. But governments are also subject to limits in their capacity to act. In my book "The Limits of the market" I analyze the nature of these limits and how they can be overcome.

Capitalism's success in promoting material prosperity has been overwhelming. Many attempts to organize the economy other than through the market mechanism have failed. From the 1980s onwards, the market triumphed and expanded its operating radius. It seemed that capitalism was unstoppable and that nothing could stop the rise of that system. And then came the financial crisis of 2008 that triggered a first major shock wave in our belief that nothing stood in the way of capitalism. When the corona crisis hit, it suddenly became apparent how fragile capitalism really is and how dependent it is on government support.

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It now appears that there are limits to the expansion of the market system. The dynamics of the system sometimes seem unstoppable, especially since it generates material prosperity in a way that no other system can. But every time it seems to hit limits and falls victim to its own success.

The limits of a market system have to do with the fact that the link between individual and collective rationality can be broken. That link is broken when the search for self-interest by millions of individuals does not lead to a state perceived by everyone as the best possible. How do such situations arise where capitalism hits its limits? In my book, The Limits of the Market, I investigate how such situations become possible.

A first limit has to do with the fact that individual decisions often influence other individuals (positively or negatively), without our taking this into account. Economists call this externalities (or external effects). They are individual decisions that are actually not really individual because they affect the prosperity of others. In a market system, these externalities are not taken into account, because the actors in this system (consumers and companies) are not rewarded for doing so.

Let's clarify this with an example. When a company produces steel, it also produces harmful substances that it will release into the air or water. This is a cost that must be borne by people outside the steel company. For example, the residents will inhale harmful substances, which will affect their health and cause them to die earlier. Those who don't die immediately are sick and less productive and so on. These are all costs that the steel company does not include in its cost calculation for a ton of steel. The price of the steel will not reflect these external costs. The steel is actually too cheap, with the result that there will be too much demand for it. This leads to the important conclusion that what is good for the individual steelmaker and for the individual buyers of steel is not good for many other people. Individual rationality does not coincide with collective rationality.

A second limit has to do with income and wealth distribution. A free market system is completely indifferent about who wins and who loses and how evenly incomes and wealth are distributed. There was a time when economists believed that capitalism would naturally lead to less severe income and wealth inequality. That turned out to be untrue. There is a dynamic that leads to increasing inequality. If that is the case, people's resistance will increase against a system that allows too great inequalities. Many people will think that the system is not fair and only serves the rich. This can lead to political upheavals, even revolutions that destroy the market system.

A third limit arises from the paradox of competition. In any competitive system, some individuals, call them entrepreneurs, will be more successful than others. The more successful will then gain a larger market share. This gives them more resources to further increase their market share. It is therefore not inconceivable that the successful entrepreneur will abuse his position to charge too high prices. Every entrepreneur's wet dream is to be so successful that he takes out all his competitors and is left alone. Then, as a monopolist, he can make super profits. The result is that, left to itself, the market system creates a dynamic in which it is less and less free. It is heading for a situation in which large and successful companies are conquering more and more power, not only in economic, but also in political life. Capitalism is becoming less and less capitalist. The limit against which the market system collides is that it undermines the competition that is necessary to make the system attractive and legitimate.

During the financial crisis of 2008-9 and now with the Corona pandemic, we have found that if a very big shock occurs, the market system is severely disrupted. When the coronavirus broke out in the beginning of 2020, companies had to stop producing because supplies of raw materials and components came to a standstill and because employees no longer could reach the workplace. This, in turn, led to a dramatic loss of income for businesses and employees, so that demand for goods and services also came to a standstill. The economy fell into a black hole (a deflationary spiral): demand for goods and services imploded, causing production to drop even more, causing people's incomes to drop even further, and so on. A vicious circle. We discovered a new limit of the market system. The latter cannot easily pull itself out of the black hole. The market system is not Baron von Münchhausen, who managed to free himself from the swamp by pulling his hair.

From the foregoing we conclude that the market system cannot exist on its own. It needs an external body, the government, to impose limits on market forces. That government must call those who cause external costs to order by imposing taxes (for example a CO2 tax). That government must also ensure that there is a strong social security that helps the people who fall by the wayside. The government is also the only body that can prevent the market system from going into a downward spiral after a shock such as the Corona pandemic. The government is also needed to counter the tendencies towards monopoly formation that are ingrained in a market system. Finally, the government must counter the ever-increasing inequality through a progressive tax system whereby the highest incomes will have to give up a larger part of their income. Too great inequalities undermine not only the market system but democracy as well, as the super rich use their immense financial resources to bend the system to their will. Without these government interventions, the market system will not survive because the social consensus that this is a good and fair system serving the interests of the entire population will disappear.

So, governments have an overwhelming responsibility. It is not certain that they can handle that, because governments are also subject to limits. These limits arise because the many private interests (the polluting companies, the monopolies, the super-rich) try to use the political system to serve their interests.

In my book, however, I conclude that we should not despair. Democracy remains the best system (the least bad according to Churchill) to overcome the major challenges posed by global warming, inequality, and concentrations of power. It will be difficult, but we have no other choice but to take the action.

About the author

Prior to joining LSE, ***Paul De Grauwe*** *was Professor of International Economics at the University of Leuven, Belgium. He was a member of the Belgian parliament from 1991 to 2003. He is honorary doctor of the University of Sankt Gallen (Switzerland), of the University of Turku (Finland), the University of Genoa, the University of Valencia and Maastricht University. He obtained his PhD from the Johns Hopkins University in 1974. He was a visiting professor at various universities- the University of Paris, the University of Michigan, the University of Pennsylvania, Humboldt University Berlin, the Université Libre de Bruxelles, the Université Catholique de Louvain, the University of Amsterdam, the University of Milan, Tilburg University, the University of Kiel. He was also a visiting scholar at the IMF, the Board of Governors of the Federal Reserve, the Bank of Japan and the European Central Bank. He was a member of the Group of Economic Policy Analysis, advising President Barroso. He is a research fellow at the Centre for European Policy Studies in Brussels and the Centre for Economic Policy Research, London.*

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