Complexity in Government and Markets, and Consequences

By

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Systems Complexity

- Mechanical, Economic, or Social Systems can be, in principle:
- **Simple**, predictable and easy to understand.
- **Complicated** and difficult to build, but still predictable in their outcomes to experts. Their mechanism and working can be understood by the trained specialists who have built them.
- **Complex,** difficult to fully understand and less predictable in their results.

Systems Complexity

- Over past decades:
- Some government operations or systems became not just complicate but complex and less predictable.
- Private markets also increased in complexity.
- The result was that some recent crises and some outcomes were not anticipated. Examples: the financial crisis of 2007-2008; and the growth of income inequality in recent decades.

Systems Complexity

- Let me cover some historical background.
- The distant past had experienced the era of Laissez- faire, although it was never *pure* laissez faire. Laissez-faire was easy to understand.
- Then came the period between the Two World Wars, when laissez faire was challenged by, and competed ideologically with, economic planning. (See Hayek and Keynes).
- World War Two was followed by the creation of welfare states, or quasi welfare states.

Systems Complexity

- The period immediately after World War Two was one of optimism, both by central planners and by market economists.
- The planners thought that “they had seen the future [in central planning in Russia], and it worked”.
- The market economists thought that they had discovered “nirvana”, in both Keynesian stabilization policies, and in allocation and perhaps redistribution.
- With corrections for *market failures,* and with the use of *welfare policies*, market economies could be made to produce miracles, such as abolishing poverty and other economic and social “evils”. See Beveridge, Rooselvelt, Johnson, etc.

Systems Complexity

- In market economies, the economic role of the state grew rapidly. Welfare programs were introduced.
- The number of public employees and the tax levels increased sharply in many countries to administer and finance the new government programs created.
- Not only tax levels grew but the objectives pursued through tax systems also increased. Some new taxes were also introduced.
- Inevitably, tax systems became increasingly complex.
- And so did many newly-created government programs. The “law of growing public spending”.
- Government regulations also grew at a fast pace, in societies that were becoming increasingly urban and creating more externalities.

Systems Complexity

- The nature of the private market also started to change more rapidly.
- The view of the market, that was popularized by Hayek and Friedman, started to conflict with reality.
- In several growing sectors, market prices started to convey less information on the true value of the products or services exchanged.
- The assumption of "symmetry in information" in exchanges became increasingly questionable.
- Ackerlof's "lemons" became more frequent.
- Also, honesty in market behavior seemed to become less common in exchanges between and with strangers.
- While this was happening, *government failures* were becoming more evident and were attracting more attention from economists of the School of Public Choice and the Chicago School.

Systems Complexity

- In the 1970s,iInfluential, conservative economists started pushing for less government and more market.
- “Market fundamentalism” was born in theoretical models. It called for more trust in the market and for a return to more reliance on “laissez faire” policies .
- That call was accompanied by a belief that economic behavior was essentially *rational*.
- Concepts such as “rational expectations”, “Ricardian equivalence”, and rationality in individual behavior , became popular and, among many academic economists almost a religion.
- *Efficiency* became a more important objective than *equity*.
- Market results had to be respected, because they had acquired ethical value.
- The Thatcher and Reagan’s era had arrived. It would lead to major policy changes in the following decades.

Systems Complexity

- Ironically, this was happening at the same time when some psychologists (Kahneman and Tversky) had started to promote the view that individuals often act irrationally, and while the globalization of economic activities and the growth of services had started to challenge the assumption that the market was inherently efficient.
- The psychologists' views would in time contribute to the view that markets might not necessarily be efficient and some developments would reflect irrationality.
- Increasing complexity in various areas of the market (financial market, health sector, services) and in some government operations (tax system and government programs) made some outcomes increasingly less predictable.

Systems Complexity

- The Thatcher -Reagan era would change many policies and some attitudes in several countries.
- It would reduce marginal tax rates, and especially the taxes on capital incomes.
- It would favor highly differentiated, “incentive”, compensations.
- It would authorize the payment of huge bonuses to corporate managers.
- It would reduce the power of labor unions and the wages of normal workers in industrial enterprises.
- It would change the ratios of managers incomes to workers incomes.
- It would give increasing protection to the owners of “intellectual capital”.
- The net result would be: huge incomes for some; significant increases in Gini coefficient;, and, with time, growing concerns about the income distributions.

Systems Complexity

- Moving from the private market to the governments' actions, the complexity in the tax system would encourage lobbying for small changes, for favorable interpretations of some laws and regulations, and more tax evasion, tax avoidance and corruption.
- The complexity in some government programs (invalidity pensions, procurement, others) would promote abuses and corruption .
- The length of bills presented to the legislatures would grow and the tax code and the code of regulations would become enormous.
- Those with more means, more knowledge, and more connections would gain. Lobbyists would become more important, and capitalism would acquire some characteristics of "crony", "casino", or even "pinata capitalism".

Systemic Complexity

- Equity and the distribution of income would attract increasing popular attention.
- Questions would be raised about the claimed merits of the market economy.
- Populism would raise its ugly head.
- Concerns would be raised whether a new, permanent dominating class had come into existence and was dominating policy, as it had done in the past.
- A question that Keynes had asked in 1925 became relevant: Do we need new wisdom and new policies? What kind? This has become the new classic 64 thousand question.