Democracy v. Capitalism: An Inquiry Into the Role of Government in the Economy

Daniel J Boyle

Available at: https://works.bepress.com/daniel_boyle/3/
Democracy v. Capitalism

An Inquiry into the Role of Government in the Economy

Presented at the Annual International Conference on Politics & International Affairs, Athens, Greece, 17-20 June, 2013
Many people can recite Thomas Jefferson verbatim: “We hold these truths to be self-evident: that all men are created equal: that they are endowed by their creator with certain unalienable rights; that among these are life, liberty, and the pursuit of happiness.”

Fewer persons can recite the next sentence: “That to secure these rights, Governments are instituted among Men, deriving their just powers from the consent of the governed—that whenever any Form of Government becomes destructive of these ends, it is the Right of the People to alter or to abolish it, and to institute new Government, laying its foundation on such principles and organizing its powers in such form, as to them shall seem most likely to effect their Safety and Happiness.”

But the real task of representative democracy was captured by Madison in the Federalist Number 51: “If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls on government would be necessary. In framing a government which is to be administered by men over men, the great difficulty lies in this: You must first enable the government to control the governed, and in the next place oblige it to control itself.”
The Real World of Clashing Ideologies: Democracy versus Capitalism

Classical Economics

The market is perfect and self-sustaining

Government intervention can only be a detriment to the economy

David Ricardo

Historical Perspective: Classical economics came of age during and after industrialization.

Say’s Law: Supply Creates its own demand. The economy is stimulated when more goods are produced.

Austrian School Economics

"Like all artificially created bubbles, the boom in housing prices cannot last forever. When housing prices fall, homeowners will experience difficulty as their equity is wiped out. Furthermore, the holders of the mortgage debt will also have a loss. These losses will be greater than they otherwise would have been." - Ron Paul, 2003.

Keynesian Economics

"To fight this recession, the Fed needs more than a snapshot; it needs soaring household spending to offset moribund business investment. And to do that... Alan Greenspan needs to create a housing bubble to replace the Nasdaq bubble." - Paul Krugman, 2002

There is all the difference in the world between treating people equally and attempting to make them equal.
- F.A. Hayek


Balancing the Real World with the Ideal World: A System of Systems Perspective

Democracy v. Capitalism: Fallacious Foundations

All Men Are Created Equal
Free Marketplace of Ideas
Corporations are Persons

All Other Things Being Equal
Steady State Equilibrium
Efficient Market Hypothesis

APPROACH CONSTRUCTS

1. Model with Dynamic Programming Tools and Reflecting Multiple Objective Functions
2. Systems Overlay Focuses on the Role of Government to Promote Equity, to Generate Positive Externalities, and Avoid Negative Externalities
3. Adjustment Mechanism to Externalities Fuels Conflict
Mediated Influences:
- Constituencies
- God/Morality/Religion
- Ideology
- Treaties
- Lobbyists
- Interest Groups
- Executive Influence
- States
- Congress Itself

Objective: Influence, Control, Punish

Formation of Law by Legislature → Statutes → Implementation of Law by Executive

Deciders: Congressional Members
Objective: Stated or Unstated Purpose
Constraints: Constitutional Powers
Budgetary
Re-election

Deciders: Administrative Agencies
Objective: Compliance with Statute
Constraints: Statutory Language

Intersection with Reality:
- Cases
- Claims
- Controversies

Creation of Law by Courts

Formation of “The Law”

Output:
- Rules
- Regulations
- Procedures

Copyright 2013, All rights reserved
Overview of System of Representative Democracy & Rule of Law

A Dynamic and Evolving Decision Model of the Interlinked Stages of “The Law”

Return Function

HOLDINGS

RULES, REGS & PROCEDURES

STATUTES

Stage 3
Adjudication (Judicial Process) Courts

Stage 2
Implementation (Legal Process) Executive

Stage 1
Formation (Political Process) Legislature

Decision Variables that Can Be Independently Manipulated: Goals, Interpretations, Constraints

Mediated Reality: Stage 0

Feedback Loop

Pragmatic Questions: What is the Optimal Performance of This Process? How Do We Ensure It?
A Systems View of Capitalism: Free Market Exceptions that Swallow the Rule

Pareto Optimal Edgeworth Box Model

Assumptions

“The assumptions underlying the perfect market economy model are often not made explicit. The following presents a list of the general assumptions. Additional assumptions follow.

1. Utility maximization (opportunism).
2. Perfect rationality (Strong-form rationality).
3. Firms maximize profit (Strong-form efficiency).
4. Preferences are transitive and stable.
5. Perfect competition (Price taking agents).
6. Perfect information.
7. Certainty.
8. No externalities (e.g. no pollution, no network externalities, no look-ins).
9. No asset specificity i.e. no quasi rents.

Demsetz Revisited:

“A primary function of property rights is that of guiding incentives to achieve a greater internalization of externalities. Every cost and benefit associated with social interdependencies is a potential externality. One condition is necessary to make costs and benefits externalities. The cost of a transaction in the rights between the parties (internalization) must exceed the gains from internalization. In general, transacting cost can be large relative to gains because of “natural” difficulties in trading or they can be large because of legal reasons. . . . property rights develop to internalize externalities when the gains of internalization become larger than the cost of internalization. Increased internalization, in the main, results from changes in economic values, changes which stem from the development of new technology and opening of new markets, changes to which old property rights are poorly attuned. . . . At each step of this adjustment process, it is unlikely that externalities per se were consciously related to the issue being resolved. . . . [T]heir viability in the long run will depend on how well they modify behavior to accommodate to the externalities associated with important changes in technology or market values.”

From Theory to Reality:

• Initial allocations are a given before this model and proof are invoked. The inequities of birth and situation such as handicaps, race, ethnic group, historic precedent affecting property rights, and natural endowments of talent and wealth, rural versus urban and other circumstances of access to opportunity are completely ignored. A “free market” can never address or solve those problems, creating a primary role for government or some other non market actor to fulfill society’s aspirations to address inequities.

• Externalities are pervasive and dynamic, therefore price is never a static intersection of supply of demand. The real market intersection based on a long list of free market distortions whose presence ‘swallow the rule.’ A realistic view would consider when and where government should intervene, or how the role of government generates benefits and costs to society—the essence of the social contract.
Externalities Drive Dynamic Behavior of Buyers & Sellers, Creating Price and Value Changes and Gaming Behavior to Internalize Benefits and Externalize Costs
A System of Systems: Democracy Versus Capitalism & the Modern Social Contract

<table>
<thead>
<tr>
<th>Growth</th>
<th>Wealth</th>
<th>Innovation; R&amp;D</th>
<th>Public Infrastructure</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Education</strong></td>
<td><strong>Health</strong></td>
<td><strong>Monetary Policy</strong></td>
<td><strong>Public Safety &amp; Stability</strong></td>
</tr>
</tbody>
</table>

**Generate Positive Externalities**

**Representative Democracy:**
- Human Rights
- Property Rights
- Contract Rights

*Equity Derived From Communitarian Beliefs (Can’t we all just get along?)*

**The Role of the Government in the Economy**

**Capitalism:**
- Creativity, Innovation
- Create Wealth
- Endowments of Property, Capital, Labor; Bargaining Power & Influence

*Equity Earned from Wealth Accumulation (Survival of the Fittest)*

**Avoid Negative Externalities**

<table>
<thead>
<tr>
<th>Pollution</th>
<th>Poverty</th>
<th>Crime</th>
<th>Corruption</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Fraud</strong></td>
<td><strong>Disease</strong></td>
<td><strong>Threats to Health &amp; Safety</strong></td>
<td><strong>Abuse of Power</strong></td>
</tr>
</tbody>
</table>

Copyright 2013, All rights reserved
Democracy v. Capitalism: Constrained System of Systems Optimization

Real Effects Trump Ideology:

• Bounded Rationality; Herding Effects

• Moral Hazard

• Adverse Selection and Free Riders

• Agency Theory in Context of Representative Democracy

• Imperfect and Asymmetric Information

• Mediation of Meaning, Lobbying, and the Loss of Objectivity

• Unequal Bargaining Power, such as Corporate Persons with Free Speech

• Game Theory and Mechanism Design—Cooperative & Uncooperative Games; Multi Session Games

• Institutional Desire for Survival Drives Long Term Overhead Impact of Regulatory Apparatus

• Discounting of Future Impacts and Impacts on Others
A Systems View of Economic Consequences: Chaotic & Cataclysmic Results

Phases of the Business Cycle

- Boom
- Stump
- Recession
- Recovery
- Boom
- Stump
- Recession
- Recovery
- Boom

Peak
Long-Term Trendline
Trough

GDP relative to 25-year trend

1803 1805 1836 1853 1883
1798 1809 1821 1843 1865
1816 1829 1849 1871 1886

ECONOMY

THIS ISN'T FUN AT ALL!

© PFS Group

Copyright 2013, All rights reserved
Democracy v. Capitalism: Concluding Remarks

• How do we define and measure economic justice and fairness; and what is the government role?

• Real interactions between representative democracy and capitalism begin with the mediation of reality, a never ending dynamic clash of values and interests.

• The essential impact of the law is to correct for inequities or to create externalities. Jurisdictional boundaries are system boundaries—one jurisdiction’s law can act as an externality to another’s.

• Boundary and externality effects at international borders constrain freedom of action and independence. These different spatial effects of law as an externality are not synchronized temporally. Economic actors game these boundaries in a “race to the bottom” or to capitalize on “regulatory arbitrage.” The dynamic system response can impose costs across borders, exporting poverty through negative wealth effects.

• Property rights and the freedom to contract are legal protections at the heart of capitalism that have fueled many positive externalities. Government regulation to avoid abuse drives dynamic adjustments and market imperfections that give rise to a cyclical need for re-regulation.

• Inequities are beyond a free market’s reach based on trading of endowments. The government cannot make all men equal, but there are times when we expect the government to provide safety nets, to establish equality of opportunity.

• Viewing the law as an externality allows us to own the consequences while acknowledging how economic actors will vie endlessly to internalize benefits and externalize costs. This systemic reality is unavoidable but predictable. Eternal vigilance is the price of economic freedom.