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The Embedded Market

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For most of the twentieth century, the left determined the language of political economy. Socialism defined the framework of debate, not only for its supporters but for its opponents.

With changing ideologies in the West, and the collapse of Communism in the East, the right has taken control of the argument. Globalisation and privatisation, not capital and class, are the terms of discourse. This is true both for those who favour these trends and for those who resist them. The claims of economic determinism and historic inevitability, once made by the left, are today made with equal strength by the right. Today, for its adherents, the version of market fundamentalism, which I describe as the American Business Model (ABM),[1] meets the same psychological need for simple, universal explanations of complex phenomena that Marxism once offered its supporters.

But the search for a new 'grand narrative' is misconceived. All modern societies that are economically successful are, in a broad sense, market economies: there are no exceptions to this rule. There are, however, many different types of successful market economy, and each is the product of its own particular history, politics and culture. The market economy is necessarily embedded in the social institutions of the society in which it is found, and cannot function outside the context of these social institutions.

There is no end of history or any reason to think that the evolution of economic and political institutions has a unique destination, or any final destination at all. And the claim that the market economy of the United States has been substantially more successful than other market economies – specifically those of Western Europe – or that sustained and significant differences in performance have emerged in the last decade, does not bear even cursory scrutiny.[2]

The real lesson of recent experience is different. The dissemination of a facile and oversimplified model of how market economies function – the American Business Model – reached its predictable denouement in corporate corruption and the greatest speculative bubble in economic history. Both the process and the outcome undermined the legitimacy and effectiveness of market economies in the United States and abroad.

The American Business Model is a caricature which does not describe the real functioning of the successful American economy. Its fundamental weakness is that it does not acknowledge the central economic role of community, which is neither state nor market. We work and live in communities and we buy and sell in communities. The social values of communities are the principal regulator of economic life, and communities (not markets) are the primary mechanisms through which we handle the risks we encounter in daily life. The most important institution in the modern economy is the large corporation, and the successful large corporation is necessarily a community: a community of shared but not identical objectives. The politics of the corporation, like politics in society, operates best when it mediates these objectives into a common identity. If the corporation fails to achieve this it quickly ceases to be successful, losing both political legitimacy and economic effectiveness.

Communities (including corporations) do not themselves have objectives, though they do have functions. These functions meet (a subset of) the needs and aspirations of their members. Participation in communities is often one of these needs and aspirations in itself: we are social animals. Some of the communities that are important to our economic life are organisations – General Electric, Stanford University, the Transport and General Workers Union. Others are informal communities of shared values and interests[3] such as the City of London, the medical profession and Silicon Valley.

Communities of all these kinds are the mechanisms through which modern economies operate and progress. This is the economics of the embedded market, in which economic activity is conducted through social, political and cultural institutions. In an embedded market the attempt to define precise boundaries between state and market, and to impose a dichotomy between public and private action, fails to acknowledge the real and rich complexity of modern economic life.

The Boundaries of State and Market

The question 'what should be the boundaries between state and market' seems a natural starting point for any discussion of political economy. Implicit in this question is a belief that public and private institutions are of fundamentally different kinds. This difference mirrors differences in the character and motives of those who work there. Business people are risk takers, entrepreneurial but greedy: bureaucrats are risk averse, unimaginative but concerned for the public good. More extreme versions do not concede even a public service ethos to public servants, holding that government employees occupy their posts only because they lack the ability or energy to perform successfully in the private sector.

Given these fundamental differences in the character of public and private institutions, economic policy must assign different and clearly demarcated functions to each. The boundaries between state and market may be determined by regulation or by contract. Regulation may allow private, profit-making businesses to conduct activities – such as the provision of infrastructure and the production of public services – where the inevitability of monopoly and complexity had once seemed to require public ownership and control. Through contracts private profit-maximising businesses can be enabled to provide services that deliver public goods and private benefits.

This view of the nature of economic policy – that its primary purpose is to determine functions of private and public agencies appropriate to their different character – is today widely shared on both left and right. For the modern left, which recognises that direct state control of many commercial enterprises did not work well in practice, the implication is that detailed regulation of private business is needed to alleviate the many instances of market failure. The stance of the modern right differs from this only in believing that market failures are few, and that the potential weaknesses of regulation often outweigh the benefits of state action to correct these market failures.

However, the difference is one of degree, not of kind. Neither would find much to quarrel with in Milton Friedman's contention that:

> It is important to distinguish the day-to-day activities of people from the general customary and legal framework within which these take place. The day-to-day activities are like the actions of the participants in a game when they are playing it; the framework, like the rules of the game they play. . . . These then are the basic roles of government in a free society: to provide a means whereby we can modify the rules, to mediate differences among us on the meaning of the rules, and to enforce compliance with the rules on the part of those few who would otherwise not play the game.[4]

Indeed Friedman's framework is essentially that adopted by those who would substitute the goal of equality of opportunity for the traditional aspiration to equality of outcome. The state cannot ensure that everyone is a winner, but it can and must ensure that everyone comes on to a level playing field with an equal chance of success.

It seems unsporting to upset this apparent consensus. But there is not, in reality, the sharp distinction between the nature of public and private activities which this view of economic life entails. Because we live in communities, because our actions are guided by values as well as rules, there is no clear-cut division between state and market activities, or between the rules of the game and the playing of the game. To understand the reality of economic policy in an embedded market, we should begin by examining the changing functions of government itself.

The Purposes of Government[5]

The traditional functions of the state were to wage war, adjudicate disputes, and levy taxes to finance these functions. And government still does these things, but they are not now the principal things it does. The main role of government today is in the provision of goods and services, rather than the exercise of authority.

In the exercise of authority, the legitimacy of that authority and the propriety of the process by which it is exercised are fundamental. We want judges and policemen to follow the law, we want soldiers to obey orders, and we want tax inspectors to implement the tax code. But in the delivery of services, our primary concern is with outcome, not process. We want to send our children to good schools, we want the bus to come on time, the rubbish to go and the lights to stay on. We want to face retirement with confidence, and to get better when we are ill. The mechanisms by which these results are achieved are secondary. Most people are not very interested in how their hospital is run, just as they are not very interested in how their supermarket is run. Their concern in both cases is that it delivers the goods and services they want.

Systems of public management have largely failed to make the transition which this change in the nature of state functions requires. The process-oriented mechanisms needed for the proper exercise of legitimate authority are inappropriate for the effective delivery of goods and services. Judges could reach conclusions much more quickly and tax inspectors could collect revenue much more cheaply, but we do not want them to: we are concerned with how the result is achieved as much as with the result itself. But efficiency and effectiveness are the criteria we properly apply to the delivery of services.

This transition poses problems for both right and left. The right is suspicious of the state as provider of services, and wishes to limit that role: nervous of the role of government, it seeks to limit its extent by emphasising the traditional process concerns of the public administrator. The left encounters a different problem, a legacy of the history of Marxist socialism.

The Legitimacy of Economic Power

Actions are legitimate if there is a good and widely accepted answer to the question ‘what gives them the right to do that?’ Working-class organisation and politics came into being around the issue of the legitimacy of the private exercise of economic power. The purpose of organised labour, in trades unions and political parties, was to challenge the basis on which private entrepreneurs exercised seemingly arbitrary authority over individuals and used their political power to reinforce that authority. The class struggle defined the roles of political parties and the nature of political rhetoric.

These arguments no longer have much resonance in rich Western economies. Geographic mobility and more flexible patterns of consumption, work and credit mean that competitive markets perform many of the functions which once seemed to require political action. If you don't like a job, or its pay, or its conditions of employment, you find another one. If the milkman waters the milk or the brewer salts the beer you can take your custom elsewhere. The organisation of labour and legislation to regulate economic activity helped to improve working conditions, secure product quality and fair prices: but so did competitive markets.

To the chagrin and eventual defeat of socialists, the market economy proved more effective in achieving these aims – a favourable working environment, the goods and services consumers want – than centralised political control. So in rich societies today attention has turned to the question of why the public sector's provision of goods and services cannot necessarily be relied on to produce the pace of improvement and responsiveness to changing needs that customers of private sector goods and services have come to take for granted.

Business has won legitimacy through success. We accept, even welcome, the authority of Sainsburys and Tesco in delivering our groceries because of the manifest effectiveness with which they have done this in the past. In ensuring food safety, consumers now have more trust in supermarkets, which are competing to sustain their reputation, than they have in government. There is growing concern about the undue influence of multinational companies.[6] Some of this is exaggerated, as in the frequent comparisons of the turnover of companies with the GDP of states.[7] But, to the extent that such concern is well founded, it relates to either the activities of such companies in third world countries – where neither workers nor consumers have the range of competitive options available in the rich West – or to the inappropriate exercise of political influence to advance commercial interests.

There is no similar resentment of the performance of supermarkets as they fulfil their mainstream functions of delivering groceries. This is because, in the main, we like what they do and there are alternatives if we do not. In a modern service economy, legitimacy may be earned by meeting our needs as consumers in a competitive market. What is legitimate is what works: and this is true in both public and private sectors. The traditional left position that the only source of legitimate economic authority is the ballot box fades away, and the conventional significance of the difference between public and private economic power disappears.

Motives and Functions

There is some truth in the stereotypes of the dynamic but self-interested businessperson and the public-spirited but ineffective public servant. But our objective should be to change these stereotypes rather than to build institutions around them.

Services of all kinds are best delivered by people who care about the quality of the service they provide. In the private sector, purely instrumental motivation is rarely successful in the long run. We seem to need to learn this lesson over and over again. We learned it in automobile factories where highly incentivised but boring work led to endless labour disputes and a workforce with no commitment to the final product. We have now begun to understand that complex incentive schemes for managers not only lead to fraud and rapacity but – as in those car plants – create destructive tensions within organisations.

An inappropriate emphasis on shareholder value has not only led to the destruction of great businesses like ICI and GEC, but to an environment in which banks and insurance companies have lost the confidence of their customers and the loyalty of their employees and in which pharmaceutical businesses look at pipelines largely empty of important drugs. Privatised monopolies, whose authority derives neither from democratic election nor success in a competitive marketplace, have not established the legitimacy they automatically enjoyed as public agencies.

Most people – in public or private sector – value material reward, but also value the respect of colleagues and customers, and the satisfaction of a job well done. Successful organisations – public or private – are those which effectively meet this variety of needs. In some public services – like health and education – it is particularly important to us that the service is delivered by someone who cares. These services will be most effectively provided if we take advantage[8] of that ethos. But these are not substantially different from the qualities we seek in the delivery of privately provided goods and services. We learn to discount the synthetic 'have a nice day' of the fast food outlet and distinguish the smiling life insurance salesman from the trusted financial adviser.

Our purpose should be to elide rather than emphasise the differences between public and private sector organisations. In Britain and in some other countries there has been an almost obsessive attempt to shoehorn every possible activity into a corporate framework. Most of these artificial structures have subsequently failed – as in water, the railways, nuclear power and air traffic control.[9] At the same time, there is a requirement for new, more flexible organisational structures in health, education and other traditional public services. In Britain this has led to the reinvention, in a disjointed manner, of a variety of hybrid structures. We need, not two forms of organisation, but a spectrum adapted to the different kinds of services which are delivered and the different market environments and funding structures within which they operate.

The objective should be to substitute across that whole spectrum an ethos of service to the public as customers: an ethos which should replace both the instrumental motivations which are justifiably mistrusted in the private sector, and the emphasis on process over outcome still too often encountered in the public sector. This customer orientation is a major achievement of the more successful privatisations, although privatisation is neither necessary nor sufficient for this result. Public sector reform has brought about greater recognition that taxpayers should be treated as consumers in some functions – even tax collection – where privatisation is inappropriate and competition impossible.

The Origins of Innovation

We do not want our tax inspectors, judges and soldiers to be imaginative and innovative: we want them to conform to the rules and structures that have been established. But we do want these characteristics in our teachers and our doctors, and in the people who create and manage our transport infrastructure. The principal reason the private sector has a much better record of innovation than the public is not the different objectives of private and public organisations, nor the different kinds of people who work in them: it is the result of differences in the way these organisations are structured.

Centrally planned economies fell hopelessly behind market economies in consumer oriented innovation. The single voice of the planners failed relative to the disciplined pluralism of the market. Most innovations do not work, technically or commercially: most experiments fail. Large organisations, public or private, find good reasons not to embark on them. When they do, for motives which generally have a veneer of high rationality but in fact reflect a balance of political power, such innovations are undertaken on a very large scale. Feedback is poor, because decision-makers and those who report to them do not wish to hear, or pass on, bad news. The conflation of conflicting opinions into a single voice and the suppression of honest reporting – were common to the human disaster of Mao's Great Leap Forward and the commercial disaster of Britain's nuclear power generation programme[10] and are replicated, with less extreme consequences, throughout public sector organisations and large private businesses.

If the Great Leap Forward caricatures the failures of planning, the evolution of the personal computer industry exemplifies the successes of the market. Its central feature was a haphazard process of development which no one controlled. Almost all predictions of future developments were quickly falsified and most innovations – even those which ultimately proved key to the emergence of the industry we see today, such as the invention of the general purpose microprocessor, the graphical user interface, and the promotion of universal operating standards – were commercially unsuccessful for those who devised them.[11]

The process of disciplined pluralism, which allows continuous waves of incremental experiment and rapid feedback on the performance of that experiment, explains why we have the products we see today. The absence of such a process explains why, despite the Soviet Union's substantial capabilities in military electronics, no remotely comparable developments occurred there.

The difference is not the product of a difference in motivation – in practice, financial incentives seem to have played a rather minor role in major twentieth century innovations (and the financial rewards from them were correspondingly modest). The real issue is the contrast between planning and centralisation on the one hand, and pluralism and decentralisation on the other.

Disciplined Pluralism

We sometimes talk of the 'marketplace in ideas'. The metaphor identifies the most important characteristic of a marketplace: not the jingle of cash registers, but the effect of disciplined pluralism. In the marketplace for ideas new concepts are constantly floated, most of them wrong or foolish, all subject to assessment and evaluation. A few survive these tests, and knowledge advances. The modern marketplace for ideas evolved when the disciplined pluralism of scientific rationalism replaced the single voice of religious authority. It is not an accident that the development of disciplined pluralism in intellectual life was contemporaneous with innovation in commercial institutions. The co-evolution of technology with economic, social and political institutions has been the essential dynamic of Western societies since the Renaissance and Reformation.

Democracy itself is a marketplace in political leadership. Representative democracy acknowledges the need for political leadership and authority, but insists that the ideas which leaders implement and the authority they exercise is regularly contested. Ideological diversity and personal ambition provide the pluralism, the electoral process provides salutary discipline. The convergence of almost all developed societies on a democratic model which gives governments renewable tenure in office of four to five years illustrates the emergence of a particular form of disciplined pluralism through institutional evolution.

The competitive market for goods and services is the most familiar example of disciplined pluralism. By distributing economic authority, it allows free experiment in the manufacture and distribution of products and in the organisation of their production. The discipline comes from the interaction of the market for goods and services with the market for capital, which together cut off finance for experiments that fail.

The evolution of health care demonstrates two different models of disciplined pluralism. In pharmacology, we have competitive development of blockbuster innovations by corporations. The process is highly regulated and protected by patents and commercial secrecy. This is very far from the picture of a market established by the ABM: patent legislation creates an artificial but lively competition, discipline is provided by regulatory authorities and clinical choice. But it is a successful, if far from ideal, model of disciplined pluralism: by comparison, centrally planned economies performed very poorly in pharmaceutical innovation.

In surgery and treatment protocols, we have piecemeal innovation by individual practitioners and teams, with almost no formal regulation, and open sharing of methods and results in a peer review process. Both mechanisms of innovation work: a central problem of the management of health care everywhere is that organisational innovation does not keep pace with technological innovation.

The interaction of the intellectual pluralism of modern scientific thought, the political pluralism of democracy, and the economic pluralism of competitive markets, has together produced the co-evolution of institutions which is the basis of technological advance and economic growth. Anonymity is a common feature of all these mechanisms of pluralism. In the marketplace for ideas, the outcome is the verdict of many appraisers: in the marketplace for political leadership the outcome is the verdict of many voters, in the marketplace for goods and services the outcome is the verdict of many consumers.

The anonymity of disciplined pluralism is infuriating to people who rail against the impersonality of market forces. And it is constantly challenged by those who would replace these competitive markets by monopolies – those in government who feel the need of the single voice.[12] Authoritarian figures on both left and right repeatedly try to dictate the course of scholarship, dominate political leadership, and control the evolution of their industries. For a time, some of them succeed. The price of progress is constant vigilance in support of free enquiry, democratic election, and genuinely competitive marketplaces.

There are many other examples of disciplined pluralism. Universities compete with each other to establish reputations. The pluralism of US higher education has massively outperformed the centralisation of Europe, and the discipline is provided, not so much through financial incentives, as by a competitive marketplace for the brightest students and the most capable faculty. This is but one example – from the not-for-profit sector – of how the disciplined pluralism involved in the creation of brands and reputations fosters innovation and raises standards. Doctors and museums, cities and sports clubs, compete with each other in similar ways.

The processes of disciplined pluralism are not necessarily fair. Priority in scientific ideas is often credited to the wrong person: the processes of peer review often reject the genuinely original. Only occasionally do pioneers in commercial innovation become leaders who build great businesses. Voters need give no reasons for casting their votes, and there is no appeal against their verdict. The absence of objective, transparent criteria is both disconcerting and important. A requirement to lay down the basis of assessment in advance necessarily runs into the common problems of socialism and regulated capitalism discussed more fully below. That basis of assessment can never be quite well enough specified. Those who are subject to targets aim at the targets rather than the objectives of the targets. We want good schools and, within a broad range, we know good and bad schools when we see them. If we knew exactly the characteristics of a good school, we would not need to entrust the task of establishing good schools to head teachers.

Disciplined pluralism is an evolutionary process. The extraordinary intellectual contribution of Darwinism outside biology itself was its demonstration that evolution could produce more sophisticated, and better adapted, organisms than could be created by design. But that analogy should be treated only as an analogy. Adaptation in institutions and in economic life is not random and the mechanisms of selection and the 'replicator dynamics' are different. Social evolution is more Lamarckian than Darwinian.

If you believe in disciplined pluralism, you believe in the merits of experiment and appraisal, but you are not confident in market outcomes, and you certainly do not assume that they are efficient simply because they are market outcomes. You worry about the concentration of too much power in the hands of Microsoft, because it threatens pluralism. You don't see a problem if one leading City of London investment bank is acquired by an American firm: you do see a problem if all are.

Decentralisation to local agencies will often be a means to pluralism, but it is not the same as pluralism, and sometimes local political control will be less pluralist than centralism. The requirements of pluralism would be better met by several autonomous state-owned hospital chains than by local monopolies of health care under local political control. If you believe in pluralism you want central government to undertake small-scale experiments – and you want it to be ready to acknowledge failure. The hallmark of successful centre-left government is what Franklin Roosevelt, probably its greatest exponent, described as 'bold and persistent experimentation'.[13]

Incentive Compatibility

It is a mistake to seek to establish a distinctive character for public and private institutions: rather we should inculcate the common virtues of disciplined pluralism in both. It is also a mistake to believe that we can define a clear boundary between state and market through regulation and contract. The attempt to decentralise social objectives in this way was pursued most extensively in the planned economies of Eastern Europe. To allocate scarce resources between competing ends – the central problem of any economic system – it is necessary to assess what it is possible to produce and what the needs of consumers and firms are. But almost all this information has to be obtained from the various proponents of the competing ends.

How can they be persuaded to assess it diligently and reveal it accurately? Most people are honest and well intentioned, and if you ask them for information they will give it. But they may discover that doing so is not to their advantage. If targets are set and resources allocated on the basis of information revealed, then you will do better if you are conservative about what is possible, pessimistic about what is needed and optimistic about the benefits which will result. But the people to whom you supply the information will realise you are doing this, and calibrate their expectations accordingly. This process became known as 'plan bargaining' in socialist economies.

No society in history offered such a wide range of rewards and punishments as the Soviet Union, from the economic and political privileges of the *nomenklatura* to the slave camps of the Gulag. The Soviet economic problem was not an absence of incentives: incentives to conform to the dictates of the centre were very strong. The Soviet economic problem was that the planners did not have good information on which to base their direction.

It was on these twin problems of information and incentives that the Soviet economy foundered; and the information problem is the more fundamental. If a powerful state could accurately calibrate both abilities and needs, it could enforce production according to abilities and assignment according to needs. That is what the Soviet state sought, and failed, to do. 'Plan bargaining' was not confined to the Soviet Union, though it was endemic there. 'Plan bargaining' is found in any planning system: in government regulation of business, in the control of public services, and in the management of large private sector organisations. When regulators supervise utilities, when governments set targets for schools and hospitals, they face the same problem: the information needed to determine the targets appropriately is held by people in electricity companies, in schools and hospitals, not people in government departments.

Lenin claimed to have found the answer to this problem: ‘seize the decisive link’.[14] Because the information required to control the system completely is extensive and impossible to obtain, the centre must focus on a few supposedly key variables. But these are subject to ‘Goodhart’s Law’[15] – any measure adopted as a target changes its meaning. If hospitals are judged by the number of people who wait more than 12 months for an operation, then the number of people who wait more than 12 months for an operation is likely to fall, but whether the service given to patients is better or worse is another matter altogether. If corporate executives receive bonuses related to earnings per share, then reported earnings per share may rise, but whether the business is better or more valuable is, again, another question.

The inevitable result of these processes is the complication and proliferation of targets. These become confusing and inconsistent, and undermine the authority and morale of those who engage in the activities which are being planned. The problems of incentive compatibility – the desire to provide information that will yield personal advancement rather than information which is true – undermines the process of rational decision-making within the planning system itself. This is the common experience of everyone who has worked within a large centralised organisation.

Regulated Self-regulation

The fundamental problem of incentive compatibility (conflicting objectives combined with imprecise and distributed information) explains why the provision of public services, or the pursuit of social objectives, cannot be decentralised through a process of tightly defined contracts, except in narrow areas where outcomes can be precisely described and methods of achieving these outcomes are obvious and widely accepted. This view of contractualisation and decentralisation matches the experience of the private sector itself. General Motors would once distinguish sharply between customised components whose production the company must itself control, and commodity purchases which could safely be outsourced from the cheapest supplier – until Toyota demonstrated that better product quality, faster, leaner production, and a more flexible response to changing market conditions could be achieved by looser trust relationships among a *keiretsu* of favoured suppliers. The manufacture of complex products in a modern economy has become possible only by making permeable the boundaries between firm and market. The delivery of complex services in a modern state will be possible only by making permeable the boundaries between state and market in a similar way.

The traditional distinction between policy and implementation is therefore one which, in economic matters, can rarely be made. The idea that relationships between the state and other agents must be transparent, precisely defined, and non-discriminatory, which still, for many people seems a fundamental requirement of public administration – is incompatible with flexibility, innovation, discretion and judgement. Trust relationships are, necessarily, the product of social relationships in communities rather than legal structures.

This poses a challenging agenda. How to achieve for government the relative informality of commercial relationships between firms which is the real basis of the successful market economy, without opening the door to the corruption and arbitrariness which the legal regulation of relationships between the state and private sector is intended to prevent? The worst outcome – and a current danger – is to construct relationships between government and private firms which are formal in appearance but informal in substance: the elaborate contract is renegotiated, or set aside, whenever it comes under pressure from the inevitable occurrence of unpredicted events.

Relationships between state and market are therefore neither simply nor mainly matters of law, regulation and contract. The atmosphere in which they are conducted is critical. Economic policy is not simply, or primarily, a question of what the government should do. Government is simply one of the means by which the social context of the embedded market is expressed. Concepts such as reputation and legitimacy are equally important expressions of that context and play an equally central role in regulating economic activity.

So statutory regulation and self-regulation are not alternatives. In a properly functioning embedded market, they are complementary. Law generally can only be enforced in a democratic society if it corresponds to the behaviour most people would engage in, or at least wish to see engaged in, anyway. And this is even more true of economic regulation, which cannot function by bullying recalcitrants into submission: its objectives are too complex and its subjects too sophisticated for such mechanisms to be very effective. The collapses of Enron and WorldCom were reminders, if reminders were needed (they clearly were), that detailed prescriptive rules cannot constrain those who have no intention of being bound by their substance rather than their letter. When the young Alan Greenspan wrote that 'at the bottom of the endless pile of paperwork which characterises all regulation lies a gun',[16] he was talking nonsense: if economic regulation requires a gun for its enforcement, it will inevitably fail.

We cannot achieve truth in accounting reports or securities prospectuses by rules unless these rules are internalised by private business themselves. Without elements of external regulation, self-regulation rapidly degenerates into self-congratulation – as it has in professions such as law, accountancy and medicine – but external regulation on its own can never fully secure the information or display the adaptability needed to achieve its purposes. In the financial services sector, as in others, the most powerful vehicle of regulation is mutually supportive reputation – respected traders deal only with respected traders, and confer that respect grudgingly. This mechanism was allowed to unwind in the last two decades when maximum greed within minimal rules became the credo of the market economy.

Conclusions

It is time to be humble about economic policy. It is chastening that the experience of the deliberate coordination of economic systems and of economic development demonstrated that such state coordination was generally worse than no coordination at all. The experience of economic planning under social democracy is no more encouraging, if perhaps less calamitous, than the experience of economic planning under Communism. The fundamental, and intractable, problem is that such intervention presupposes knowledge of the economic system and economic environment which no one can validly claim to have. These claims are as empty when made by the visionary leaders of private businesses whose superior insights are confirmed by their large salaries as when they come from politicians whose superior knowledge of the course of future events is established by their victory at the ballot box. Those who do claim to have such knowledge are less worthy of our trust than those who recognise the limits of human understanding.

The correct lesson to draw is that the modern market economy, necessarily embedded in a social, political and cultural context, is a sensitive instrument whose functioning we understand only imperfectly. If the dismal experience of planned economies is illuminating, so is the dismal experience of New Zealand: the country which from 1984 to 1999 followed the liberal prescriptions of the ABM more vigorously than any other developed economy, and enjoyed the worst macroeconomic performance of any developed country over the same period. The lesson of Soviet failure is not that the Marxist vision of economic organisation redesigned on entirely rationalist lines was the wrong vision, but that any attempt to implement grand economic designs is likely to end in failure.

Economic policy is properly subject- and context-specific. The institutions that are right for electricity generation are not the same as those that are right for water supply. The mechanisms of regulation appropriate for financial services are not the same as those for food retailing. But the key themes of this chapter – the role of community in supporting economic life, the absence of a sharp distinction between the nature and functions of private and public business, the overriding requirement for disciplined pluralism in every area of economic life which involves the delivery of services, and the necessity of the interaction of rules and values or 'regulated self-regulation' in the control of economic activity – provide some general principles for the development of a political economy relevant to the government of market economies for the 21st century.

Notes

1 For a more detailed account of this see Kay, J. A., *The Truth about Markets*, London, 2003.

2 See for example, Turner, J. A., *Just Capital: The Liberal Economy*, London, 2001, or his Queen's Prize lecture (http://cep.lse.ac.uk/queens/).
3 The interests referred to here encompass three different senses of interest: concern, subject or hobby, advantage or profit. Not coincidentally.
4 Friedman, M., with Friedman, R. D., *Capitalism and Freedom*, Chicago and London, 1962.
5 Osborne, D. & Gaebler, T., *Reinventing Government*, Plume, 1993.
6 Monbiot, G., *Captive State: The Corporate Takeover of Britain*, London, 2000; Klein, N., *No Logo*, London, 1999; and Hertz, N., *The Silent Takeover: Global Capitalism and the Death of Democracy*, London, 2001.
7 There is a simple economic confusion here between turnover and value added. But the more fundamental weakness of the comparison, which is directly relevant to the comparison here, is that states exercise a monopoly which corporations largely function in competitive markets: thus neither turnover nor value added is a real measure of power (including economic power).
8 This word is chosen carefully. The benefits are – and should be – shared between the individuals who provide, the customer who receives and the government which finds. Too much emphasis on any one of these stakeholders – as in all contexts – jeopardises the benefit to all.
9 For a more extensive discussion of the successes and failures of UK privatisation see, Kay, J. A., 'Privatisation: A Policy in Search of a Rationale', in *Economic Journal*, 96, March, 18–32, or in *Privatisation and Corporate Performance* ed. D. Parker, Edward Elgar, 2001.
10 Kay, J. A., *The Truth about Markets*, London, 2003.
11 *Ibid*. The development of PCs is discussed in chapter 9.
12 Cited in Henderson, P. D., 'Two British Errors: Their Probable Size and Some Possible Reasons', in *Oxford Economic Papers*, vol. 29, issue 2, 1977.
13 Rauch, J., *Demosclerosis: The Silent Killer of American Government*, Times Books, 1994.
14 Kornai, J., 1992, *The Socialist System*, Oxford, 1992.
15 'Any observed statistical regularity will tend to collapse once pressure is placed upon it for control purposes'. Goodhart, C., *Monetary Theory and Practice: The UK Experience*, London, 1984.
16 Alan Greenspan quoted in Rand, A., *Capitalism: The Unknown Ideal*, New York, 1967.