

*This article was prepared for publication by the Iberoamerican Association of Local Finance (AIFIL), in tribute to Luiz Villela, who recently died as a result of COVID-19.*

## **PERFECT MARKETS, PERFECT DEMOCRACIES AND PANDEMICS**

**Por Vito Tanzi**

The premature disappearance, due to the pandemics, of Luiz Villela, who, years ago, I had had the pleasure of knowing and with whom I coedited a book –‘Taxation and Latin American Integration’, edited by Vito Tanzi, Alberto Barreix and Luiz Villela, (Harvard University: 2008)—and shared many pleasant conversations, at the IDB, has given me the incentive to think, more as a dilettante philosopher than as a technical economist, about the role that efficient, or perfect, markets and good democratic governments are expected to play in today’s economies and societies. There are some, largely theoretical, roles that economists and political scientists admire and prescribe, and that, with some exceptions, they generally welcome and promote for countries. When economies and governments diverge from these roles, they are criticized.

The main point of this short article will be that, as it is true in various walks of life, perfection may at times come at high costs, and what may be seen as imperfections may have merits and may even play some positive and desirable roles. It should be realized that, both the concept of progress and that of evolution are not consistent with perfection. By definition, perfection cannot be a dynamic process. It is essentially a static concept. Once it is reached, there is no incentive to change. Perfection does not allow, or does not need, change or progress. While perfection reflects a static state, progress and evolution are dynamic processes. They require some imperfections to keep evolving.

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An Italian biologist, Rita Levi Montalcini, who, in 1986, won the Nobel Prize in medicine and died recently at the age of 103, in 1988 published a book called 'In Praise of Imperfections' (Basic books). As she put it:

"It is imperfections -not perfection—that is the end result of the program written into the formidably complex engine that is the human brain, and of the influences exerted upon us by the environment and whoever takes care of us during long years of our physical, psychological and intellectual development". She added: "...don't fear difficult moments, [because] the best comes from them". That is: crises bring opportunities and possibilities for changing things for the better. Perfect states do not.

The above quote suggests a particular way of looking at the world and also at economic and political models that depend on equilibrium and on perfect behavior. These are the models that have dominated economics and politics over recent decades. Let me start with the economic side of the issue, the one I know better. Theoretical economics, especially price theory, as we learned it from great economists such as Alfred Marshall, Milton Friedman, George Stigler and others, tells us that what we should aim for, and should promote with policies, is "perfect" competition, competition that will lead to an equilibrium. Perfect competition implies that the forces of the market will drive companies' profits toward zero and will deliver the lowest prices for goods and services at which consumers can buy what they need. Therefore, it will leave companies with no space to accommodate random shocks. The theory argues that the equilibrium created by perfect competition is consistent with a Pareto optimum, and with the maximum achievable social welfare.

The implication of this equilibrium is that, once it is achieved, enterprises will have no buffer to deal with unexpected and negative shocks. They will also have a strong incentive to keep their inventories very low, and their labor force at a minimum, to keep costs down and to remain competitive. The enterprises will rely on "just in time" deliveries of inputs, to keep the costs of inventories down and on easy to dismiss workers, in case

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the need for then falls. In this equilibrium, workers receive competitive wages which determine their standards of living. Easy access to jobs, which are expected to be created by flexible labor markets, and easy access to credit, imply that the workers will not have much of an incentive to save and the companies to retain some profits for rainy days. Therefore, there will not be accumulated savings to provide some buffer to cope with unexpected economic or other shocks. In many advanced countries, rather than accumulating assets, workers and enterprises have accumulated debts, which are now at historically high levels. These debts have been accumulated especially during a period when market fundamentalism was assumed to prevail, since the 1980s.

On their side, governments have been urged to keep taxes low, and their spending has been generally directed to satisfy short run or immediate needs of the citizens, especially of those who vote, and of enterprises. The election cycle has had much influence on what public money is spent on, because the time horizon of the average voter, the horizon that determines that of the government, is short. The interests of future generations receive little, if any, attention. As a consequence, public spending is often behind, in meeting infrastructure and long run needs. “Peak load” problems continue to be serious in several areas, and “congestions” are frequent. There is little spending that deals with the long run or with unexpected needs, such as major disasters and other shocks, including pandemics, such as creating some spare capacity in hospitals or accumulating enough assets to deal with future pensions needs.

Within the above framework, promoted by prevailing economic theory, a government that decided to spend sufficient money to meet potential future needs ( by building sufficient and long lasting infrastructure, by accumulating assets for future pensions, by creating some spare capacity in some areas, such as health sector, and by using resources for prevention against future natural disasters) would risk losing the next election. Long term problems, for example dealing with “global warming”, or with possible future disasters or pandemics, will receive no or very little attention. The expenses of

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public health systems will be directed at meeting today's needs that are certain, ignoring tomorrow's that may be uncertain. Given the current paradigm, governments cannot justify to create excess capacity with respect to the immediate needs, Preparation to meet potential future disasters, disasters that are uncertain in both time and scope, will play no role.

Short termism and myopia have prevailed in both market and government operations and has been justified by the prevailing models. Short termism is consistent with the equilibrium view of efficiency, a view that stresses the immediate needs of economies and of citizens, and ignores the needs of future generations. This is the essential nature of a market economy and of a democratic government. The first worries about short run costs and the second worries about the votes in the next election.

In recent years governments have been encouraged, by some influential economists with easy access to the media, to cover some of their spending not with taxes but with public debt. Some popular economists have advised governments to abandon what they have called "austerity", while others have advanced a new, strange, theory called the "New Monetary Theory". This theory essentially argues that much government spending could and should be financed with public debt, or even with central banks' money creation, they argue that this would not have serious economic consequences for the present or the future. Naturally, adherence to these advices has made it even more difficult for countries to face future, large unexpected spending needs, such as those associated with disasters or pandemics. The existence of a possibility of budgeting for such future spending should have justified keeping some "fiscal space" to have available to meet the potential future spending needs. Since the decade of the 1970s the level of public debt has increased sharply in most countries. Total debt, for both the public and private sectors, now significantly exceeds the level of the world's GDP. Clearly this does not help countries that now face the need to deal with the pandemics.

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The above situation is partly a consequence of the political and economic models that have been popular in advanced countries. One of the greatest philosophers of all times, Plato, in his 'Republic' had been highly skeptical about a government based on the views of less informed and emotional citizens. He would have preferred a government in which highly trained and educated individuals, that he called "philosophers", made the important decisions. It is highly uncertain how such philosophers would be selected today. Some countries, especially China, have adopted systems in which some individuals survive a filtering process provided by leading parties to assume, presumably time-limited, leadership. Some countries, such as Singapore, have managed to adopt a system that gives a lot of power to those who make policy decisions. In some countries, public enterprises have been created so that, by being "public", they may have less need to follow the strict financial requirements of private enterprises.

The conclusion of this short note is that the ongoing pandemic has exposed some major weaknesses of the competitive, democratic system that we as economists have admired and have promoted. It is not easy to think of satisfactory alternatives to that system. However, it is easier to argue that, in a world in which major disasters and pandemics exist, and they may become more frequent, we will need some new thinking that might indicate some desirable ways to change the modus operandi that we have admired up to now. That thinking should suggest ways to still promote efficiency, and democracy, but do a better job in dealing with major shocks, including pandemics. As Rita Levi Montalcini wrote four decades ago, let us hope that some good may come from the difficult moment that we are experiencing.