Should the Economic Crisis Change our Assessment of Markets and Government?

Clifford Winston
Brookings Institution
Broad Objectives of the Study

• Base policy debates on empirical counterfactual evidence.

• Begin accumulating evidence and identifying common themes so we don’t have to start from “square one.”

• Provide guidance for policymakers.
Sources of Market Failure

- Market power in input/output
- Natural monopoly
- Imperfect information
- Externalities
- Public goods
Assessment

- Is there evidence of market failure?
- Is government policy improving performance?
- Is government policy optimal?
Conclusions Before the Crisis

- Intervention is often unnecessary.

- There are missed opportunities to improve efficiency.

- A greater role for market-oriented policies should be considered.
Conclusions in Light of the Economic Crisis

- A serious market failure—imperfect information—did occur and it led to the economic crisis.

- But the current backlash against markets and broad claims of market failure are misleading and may lead to counterproductive policies.

- There is still little evidence that government micro policies are effective and that government can prevent the market failure that contributed to the crisis.
Approaches to the Issue

- Applied welfare economics
- Counterfactual analysis
- Academic studies
- Not major divisions among studies
- More work clearly needed
Market Power: Antitrust Policy

- Monopolization
- Collusion
- Mergers
- Deterrence
Antitrust Update

Christine Varney, head of DOJ antitrust division, announced that the Department planned to restore an aggressive enforcement policy against corporations that abuse market dominance.

Evidence that this will be an effective strategy?
Natural Monopoly: Economic Regulation

- Substantial partial deregulation
- Agricultural subsidies
- Quotas and tariffs
Imperfect Information

- False advertising
- Product disclosure
- Product safety standards (offsets)
- Workplace safety
- Deterrence
Figure 1a. US Toy Related Injuries, 1994-2002

*Injuries include any toy related injury which requires hospital care and all deaths

Figure 1b. Occupational Injuries for Private Industry, 1973-2001*

*Occupational injuries include all injuries sustained on the job, including those that require time off from work and those that do not.

Imperfect Information Update

- Children’s Toys: One CPCS toy tester.

- HOUSING MARKET: home buyers and investors did not properly weight the credit risks they were assuming.

- Banks and rating agencies underestimated the probability of a major decline in housing prices.

- NOTE: most defaults were centered in regulated financial institutions that purchased and invested in sub-primes. Even Bernie Madoff’s operations were subject to federal regulation.
Consumption Externalities

- Automobile emissions
- Aircraft noise
- Smoking and drinking
Figure 2. Average Ambient Levels of Air Pollutants, 1965-1995


Carbon monoxide and ozone levels are averages of the 95th percentile of daily one hour readings at each monitoring location. Sulfur dioxide and nitrogen dioxide levels are averages of annual means from each monitoring location.
Figure 3. Percentage of Population Exposed to Excessive Aircraft Noise*

1977 FAA Classifies Planes into Noise Categories

1990 Airport Noise and Capacity Act

*Excessive noise is defined as noise levels of 65 dBA or higher

Source: BTS National Transportation Statistics 2002 Table 4-53
Production Externalities

- Air pollution
- Emissions trading
- Water pollution
- Superfund
Figure 4. Water Bodies Considered “Impaired” or Worse by the US Environmental Protection Agency, 1992-2000

Externalities Update

- Raising Corporate Average Fuel Economy standards: consider tradeoffs.

- Cash for Clunkers: new cars are driven more than old cars.

- Cap and trade: rights to emit carbon should be auctioned off.
Public Production

- Highways
- Airports
- Urban transit
Figure 6. Average Annual Traffic Delay in Major Metropolitan Areas, 1982-2001

Source: Texas Transportation Institute
Figure 7. Changes in Air Travel Time, 1977-2004
Figure 8. Government Transit Operating Assistance, 1976-2001

Public Production Update

- Public infrastructure spending: a source of economic stimulus?

- Two tiny villages in Alaska are getting $28 million for airport funds.

- Washington state isn’t using stimulus funds to relieve congestion in Seattle but is spreading the funds to other regions of the state.

- Money for high speed rail!!!
Synthesis Before the Crisis

Less intervention warranted:

- Antitrust
- Monopsony
- Regulation
- Information
Synthesis Before the Crisis

Missed opportunities to improve economic efficiency:

- Consumption externalities
- Production externalities
- Public production
Explaining Performance

- Robustness of markets
- Agency inflexibility
- Policy conflicts
- Political forces
- Do policymakers learn?
Updating the Synthesis

- Market failure related to imperfect information clearly contributed to the economic crisis.

- Government failure is still a major concern as government intervention expands in several areas.

- It is far from clear that government has learned from its past failures. It is clear that markets are learning—but they will never be able to eliminate the costs associated with risk and future crises.
What Should the Interested Lay-Person Take Away?

- Markets make mistakes—sometimes big ones. Does that mean government intervention will improve matters?

- Government Failure imposes large costs; market performance is often better than recognized.

- Retrospective empirical assessments and the accumulation of evidence contribute to “truth.”
What Should the Interested Lay-Person Take Away?

- Policy outcomes and the sources of inefficiencies are similar across an array of policies.

- Challenge advocates to provide scholarly evidence.