

Failing the market

THE BUDGET FOLLIES are upon us again. But what is a cantankerous newsletter editor to do to add to the debate this year? Point out how the state's fiscal crisis has been chosen by those in charge? Been there (issues 24, 22 and 10). Explain the regressive nature of the taxes that will be raised? Done that (issue 26, 18, 16). Discuss some of the insane but overlooked ways the state wastes money? Tried it (issues 33, 28, 22). Outline some promising ways to save money? That, too. (issue 24, 13, 9, 8). All these are available at *whatcheer.net*.

So to hell with all of that. Let's do theory instead.

Market failures

AN ECONOMIC CRISIS of the magnitude our nation is experiencing (or, as indicators imply, will experience) is a serious event. Livelihoods will be lost, opportunities will be passed by and life will get meaner. People will die who might have survived. It's serious business.

Looking for amusement among the wreckage of our nation's economy can seem a bit macabre, but it's there for people who appreciate irony. For example, watching free-market-worshipping bankers explain why their bank's assets shouldn't be assessed at market value. Were assessments to be made in the traditional manner, the banks would be instantly insolvent. These same bankers had no trouble using the market value when the market was paying too much.

The deepest irony I know about, though, is that, in the face of a vast and predictable market failure, politicians and policy makers must still pay verbal fealty to the glory of the free market. Barack Obama, in an interview with CNBC last June, said this:

I am a pro-growth, free market guy. I love the market. I think it is the best invention to allocate

resources and produce enormous prosperity for America or the world that's ever been designed.

This is the verbal equivalent of wearing a flag pin: the *de rigueur* claim that you aren't some kind of awful subversive. Not being a mind reader, I'm not saying he doesn't believe it, but he was introducing a critique of the financial markets, calling them "out of balance." In a sensible world, such disclaimers wouldn't be an essential part of a critique, but we don't live in that world, so sometimes wearing a flag pin is easier. Here's my own version: markets do some things very well. Here's the accompanying truth behind it: not only are there some things markets don't do well, but these are hardly a secret to the economics profession. Sadly, obvious truths like this rarely seem to seep into public discussions of economics.

Let's define market failure. A market is obviously failing when there are sellers who can't find buyers, but there are less obvious forms of failure, too. Buyers who can't find sellers constitute failure in some markets, like housing. This is especially true in situations where the market is for some necessity, again like housing. Economists also speak of different forms of "efficiency." A market is efficient when changes to the distribution of goods and money would use more resources to produce the same quantity of goods, or make some people worse off. Frictionless free markets are always supposed to be efficient, so it's considered a form of market failure when a market is provably inefficient.

So as a public service, here is a list of widely known reasons for markets to fail.

Information Asymmetry In 2001, George Akerlof, Joseph Stiglitz and Michael Spence won the Nobel Prize for work they did on the effects of information asymmetry on markets. This is the situation that arises when I know more about the product I'm selling than any buyer knows. Because no buyer can be sure if what they're buying is any good, the price of everything is depressed,



even the unproblematic good stuff. Akerlof's famous article, "The Market for Lemons," discussed the problem in terms of the used car market, but could there be a better illustration than our current financial crisis?

The financial markets melted down not because of a few million failed mortgages, but because financial derivatives have become so complex that buyers in those markets can't be sure they're not inadvertently buying a piece of some worthless asset. The regulators had nothing to say on the matter, and the private ratings agencies have proven themselves completely unworthy of anyone's trust. We have a situation now where no one trusts anyone. It's impossible even to look under the hood, so perfectly secure businesses have been unable to find credit. Even state and municipal governments, whose risk of default approaches zero, have had to pay elevated interest rates for routine borrowing.

Market Power It has long been known that markets can fail because some of the players simply become too powerful. The whole intellectual structure of anti-trust law exists because people came to understand the risks of monopoly a hundred years ago. They understood the risks because Standard Oil, US Steel, the railroad trusts and many others had repeatedly demonstrated them. It was a Republican president who gave us the phrase "malefactors of great wealth."

Today we have Wal-Mart which now owns more than 6% of the retail market. That might not sound like much, but as of 2003, they sold more than 19% of all the groceries in the country, 30% of all the household staples (toothpaste, shampoo, cleaning supplies) and 15% of all the drugs.¹ The result is that in some market categories, if Wal-Mart chooses to exclude some producer, that producer is denied a vast amount of the American market. Furthermore Wal-Mart routinely exercises its discretion not to carry items in demand by its customers (most notably in the entertainment and publishing markets).

Externalities Another significant problem with markets is that not everything has a price. When you drive a car, for example, you are polluting air that you're not paying for. The cost of the pollution is borne by someone else in the form of reduced health or soot they wash off

their windowsill or smog. That cost is not worked into the cost of driving, so driving is more expensive than its price. Economists call these factors "externalities" and acknowledge they are present, but also that they can't be accounted for in the standard economics models.

A good that entails externalities is a good whose price does not reflect its cost, so its ultimate distribution cannot be called efficient, by any standard. Take driving again. Since the price is lower than the cost, the demand for driving is higher than if it were priced appropriately. This results in pollution greater than it should be and worse traffic, too. Another example is the cost of waste disposal. Around 7-8% percent of the waste stream is used or broken consumer goods (not counting disposables or junked cars and trucks), but the manufacturers of those goods don't build the price of disposal into the cost of the goods. So we compare the price of a compact fluorescent light bulb to the cost of an incandescent bulb without considering the cost of disposing of the mercury in the fluorescent bulb.²

"Irrational" Behavior People don't shop around nearly to the extent supposed by models of economic behavior. Electricity deregulation was supposed to herald the coming of market electric rates, with people seeking out the best bargains, driving prices down. Didn't happen. People apparently just aren't that interested in having yet one more thing to shop for. According to National Grid, only 197 of Rhode Island's residential customers have opted for something besides the "standard offer" for their electricity, out of 480,000 customers. In Massachusetts, the numbers are slightly higher: 15,000 out of 1.2 million. In New York, the numbers are much higher, but they have incentives for electricity customers to shop around.

Economists call this kind of thing "irrational" behavior, based on their models of rationality, but that's the easy way out. It often seems there are completely rational reasons for most of what people do, but people's lives are far more complicated than the average economist is willing to credit. The widely remarked failure of market-oriented school choice programs seems to stem from this, according to research by UConn's Courtney Bell.³ After all, there is a cost in time to shopping around. Is it really so irrational to value that time enough to want to spend it in some other way?

Non-uniform Goods The important economic models of markets are all to do with commodity prices: the price of things that are substantially the same as each other. A bushel of wheat is a bushel of wheat. Of course there can be slight variations in quality, but a buyer of wheat can

¹BusinessWeek, 10/6/03, "Is Wal-Mart Too Powerful?"

Rhode Island Policy Reporter

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²Or the cost of disease. The Peanut Corporation of America allegedly continued to ship salmonella-contaminated peanut butter because they could be confident that someone else would bear the cost of illness. When it became clear that wasn't true, they fled to bankruptcy court.

³Reference in a review of behavioral economics in **RIPR** issue 31.

get what he or she wants from almost any seller of wheat. A share of GM stock is the same, whether it's bought from me or from someone in China. Economics is pretty good at predicting outcomes in markets like these.

Where economic models routinely fail, though, is in the market for non-uniform goods—and non-uniform buyers. Consider the job market. What else is a rise in unemployment besides a mismatch between buyers and sellers? Even in Rhode Island, it's relatively easy to find employers who want to hire, but can't, either because they can't find people with the skills they need, or because they can't find anyone to take the wages they can afford to offer. In other words, job markets fail routinely, and economists don't say boo about it.

Market Segmentation An issue related to non-uniform goods is that the market may become segmented. This isn't always a bad thing, but bad things can come of it. For example, the housing market is highly segmented. The problem lies in the fact that profits for builders are so much higher at the top end of the market. Builders and investors all want to serve the top of the market, not the bottom. Top-end buyers in Providence have hundreds of vacant luxury condos to choose from, but try finding a cheap apartment.

The same thing happened in the car market in the 1980's. Faced with the threat of import restrictions, Japanese auto makers "voluntarily" restricted their US imports, importing only their more expensive and thus more profitable models. The result was that car prices rose from 23 weeks of the average wage in 1979 to 30 weeks by 1986, a rise of 30% in 7 years.⁴ Low end buyers learned to make do with used cars.

This list is hardly exhaustive. Corruption, ill-considered government regulation, and high transaction costs can—and often do—cause markets to fail, too. Many, perhaps most, markets suffer from more than one of these ills, too. Housing is segmented and non-uniform, the energy markets suffer from unpriced externalities and market power, and the labor market has information asymmetry in a big way. (It's called resumé fraud.) And all markets are dominated by non-rational buyers and sellers.

What's more, market participants, are constantly trying to find new ways to subvert the classical market forces, because "overcoming market forces" is often another way to say, "getting rich." Given all the traps for them it seems a wonder that markets can function at all. But function they do, many of them.

For a picture of market fiasco, it's hard to do better than the local housing market. Along with the glut of luxury condos, and the shortage of affordable housing, homeless people seeking shelter at Providence's Amos House will

inevitably pass more than a handful of boarded-up, foreclosed houses on their way there. These are buyers who can't afford what's on offer passing houses belonging to sellers who can't find buyers. Plain old vanilla economics has perfectly good explanations for market failures like this, but you wouldn't know that from listening to most politicians. ■

BOOK REVIEW

A Long Strange Trip

Nixonland: The Rise of a President and the Fracturing of America

Rick Perlstein, Scribner, 2008, 881 pages

SOMETIMES IT SEEMS as if politics in America is little more than an endless refighting of the battles first joined during the 1960's. We have the cultural conservatives of the religious right decrying the permissiveness of modern culture and "serious" politicians in good suits trying to keep the radicals from taking over the Democratic party, while an environmental movement desperately tries to get the attention of the populace. Plus, domestic political considerations have our soldiers fighting and dying in a foreign war. It all seems as familiar as *Eleanor Rigby*. Since we seem stuck there, doesn't it seem worthwhile to consult a good history of the 60's? Let me recommend Rick Perlstein's *Nixonland* for the purpose.

The book is primarily a chronicle of Richard Nixon's rise to the presidency (and a bit about the fall, too). Since Nixon made his way up by wiggling into and widening the social fissures of the 60's, the story of his career is the story of the decade. Two lessons of the decade seem to have special resonance these days: the importance of opposition and the failings of the national press.

Two sides to an issue The civil rights movement has some landmark legislation to its name, but in many ways, it is a dream as yet unrealized.⁵ By the end of the 1960's it wasn't at all clear that the movement had made a material difference in the lives of most black people. There was certainly symbolic progress and legal success, but disappointingly little change to large numbers of people who still suffered from discrimination and threats of violence. Nonetheless, there is one achievement that stands above all others: the civil rights marchers created two sides to the debate.

Until the early 1960's, the national Democratic party, dominated by southern conservatives, and the Republican party, with its large contingent of northern liberals, largely agreed on questions of civil rights, and they largely agreed that legal discrimination against black

⁴Data from Comerica Bank or Detroit. It's back down to 27 now.

⁵Certainly having a black president says we're on our way, but few beside apologists would call this the goal.

people wasn't that big a deal. Oh, yes, there was that *Brown* Supreme Court decision, but that pretty much settled matters, didn't it? The two parties may have advertised different attitudes about the problem, but they matched each other's inaction.

Our nation has developed tremendous institutional forces designed to limit debate to just two parties. They are both formal, such as ballot access laws,⁶ and informal, traditions of party affiliation. There is a lot to dislike about the way the system stifles third parties, but the biggest issue is simply that when the two parties agree on an issue, there is nowhere else for dissenters to turn.

Through marches, sit-ins, strikes and riots, the triumph of the civil rights movement was a change in terrain: if you cared about civil rights, you voted Democrat. It wasn't an accident, either. When Martin Luther King was organizing (or trying to organize) marches in Chicago and its suburbs, one of his lieutenants, James Bevel, said,

Whatever else it may have done, the civil rights movement created two sides to the debate.

"We will demonstrate in the communities until every white person out there joins the Republican party."

Of course the other side of the coin was

an important part of the story: Republicans saw racial appeals as a perfect strategy for winning elections. Richard Nixon happily "cooperated" with civil rights leaders by fostering the same polarization, developing his "southern strategy" to grab the once-Democratic South for the Republican party. Coded appeals to racial sympathies are still an important part of Republican electoral strategy. Witness Ronald Reagan's stories about "young bucks" on unemployment and welfare queens, and it's why Republicans still focus on welfare and immigration, even in a year like 2008, when we're fighting two largely unsuccessful wars and the world's economy seems to be collapsing.

During the 1960's, black people were not the only group to find themselves without representation by either of the two parties. Antiwar protesters also had nowhere to turn. Unlike the civil rights marchers, though, they failed at changing the terms of the debate.⁷ The Democratic party split over the war in 1968, but it simply remained split. Again, the other side of the coin was important. Pleased with the disarray on the other side, Nixon saw no electoral advantage to heightening the distinc-

tions, and in both 1968 and 1972, disingenuously portrayed himself as an antiwar candidate in public while secretly arranging to prolong and escalate the conflict.

These problems persist today. Even if this past election offered as clear a choice as any in a generation, there are points of agreement that leave dissenters without any place to turn. How do you cast your vote for universal health care? McCain and Obama had very different stances on health care, but they seemed to agree that we have nothing to learn from the rest of the world, and neither embraced the health care system used by every other important industrialized country. Even a vote on the war was clouded by Obama's insistence on following the counsel of military advisers.

In Rhode Island, the situation is much worse. Which way do you vote if you don't think unions and poor people are the source of all the state's ills? Which way do you vote if you want more state support of our cities and towns? Which way do you vote for sensible bottom-up economic development that fosters the businesses we have here already instead of competing with other states to lure businesses here with tax breaks? Which way do you vote if you think stupid land-use decisions are ruining our state's local character? You'll find no support for any of these in either party.

Why was there unrest in the 1960's? Protests, riots, dropping out, cultural revolution? Was it a story of irreconcilable generational conflicts, or was it simply that a vast portion of America realized that it had no representation in the halls of power?

The elite press: wrong then, wrong now The New York Times of Sunday, February 1, had an astonishing front page. Was it the introduction of front-page advertising? No, they've had tiny ads there for a long time, way down on the bottom, though the display ads are a big change in scale. Just above the ad there was an article about who in Washington is important enough to have Barack Obama's email address. Barack Obama's presidency was only ten days old. Think of it: our nation's economy was continuing to melt down; a huge and widely misunderstood stimulus bill was foundering in Congress; we are engaged in two wars whose pursuit Obama has pledged to change dramatically; huge congressional battles loom just over the horizon on global warming, health care, and labor law reform. And the New York Times editors can't think of any better use of front-page real estate than to discuss issues more appropriate for a middle-school lunch table.

One of the most fascinating parts of *Nixonland* is Perlstein's accounting for the shocking behavior of the political press. What was shocking about it was how easy it was for Nixon to manipulate them. His 1972 re-election bid, for example, was a marvel at how the soi-disant guardians of our democracy gave him a free pass on

⁶Currently being challenged in Rhode Island in court and in the Assembly by the new "Moderate" party.

⁷It is true that in 1972, they succeeded in fielding an antiwar candidate for President, but it's not as if the Democratic party closed ranks behind George McGovern. Quite the contrary, hawkish Democrats like Senator Henry "Scoop" Jackson of Washington and George Meany of the AFL-CIO continued to wield great influence, and effectively undermined McGovern's candidacy whenever possible.

pretty much everything. He answered no questions about broken campaign promises from 1968 about Vietnam, crime, civil rights, or the huge disruption of the world economy he perpetrated the previous year by unilaterally abandoning the world's monetary controls and instituting temporary wage and price controls. He ignored his Democratic opponents in public, while harassing them with IRS audits and outright sabotage in private. But he did invite the White House press corps to witness ceremonial bill signings in the rose garden, and he did fly to China and take Walter Cronkite, John Chancellor, Barbara Walters and lots of photographers with him, all of whom were grateful for the chance to see the Great Wall.

We all know how this worked out. While the quality press was being spoon-fed pap by the President and his press secretary, a couple of police-beat reporters—journalism peasantry—were actually following facts where they led. Virtually all the material Bob Woodward and Carl Bernstein uncovered was available to others on the front page of their newspaper months before the November election. Their culminating article, outlining not just the Watergate break-in, but also the larger picture of sabotage and harassment by the President's minions, appeared in early October, 1972. The information was there for anyone who wanted to look, but the White House press corps didn't look.

One lesson we might have learned from this is that the role of the press corps elite is to mislead. If you want to know what's really going on in our nation, don't turn to them. After all, what exactly is the point of a White House press corps? Are they there to report on what the president does? They may have the inside scoop on his daily schedule, but what of it? Isn't it more important to know what his administration is doing? That information is far more easily found by talking to members of Congress, or by following the actions of administration agencies. The important actions of the president take place in Congress, at the Pentagon, in the Department of Agriculture, in overseas embassies and other such places, not at the White House. The effects are measured in farm fields, manufacturing statistics, military graves, and by policy changes felt in elementary schools and town halls around the country. Being at the White House itself seems

to be only an opportunity for elite reporters to be suckered by their own status and the trappings of state into gulping down whatever is fed them.

You don't have to confine yourself to discussing Nixon to see the problem. As I write this, soldiers and civilians continue to die in Iraq because of Washington reporters who were duped by administration stooges like Colin Powell and Richard Perle. Thankfully, not all reporters are so gullible. The Knight-Ridder (now McClatchy) reporters Jonathan Landay, Warren Strobel and John Walcott produced reams of skeptical reporting about the administration's plans in Iraq. In interviews since (links at whatcheer.net), those reporters have pointed out some differences in approach. One said this, in an interview with the American Journalism Review:

"Knight Ridder is not, in some people's eyes, seen as playing in the same ball field as the New York Times and some major networks," Strobel says. "People at the Times were mainly talking to senior administration officials, who were mostly pushing the administration line. We were mostly talking to the lower-level people or dissidents, who didn't necessarily repeat the party line... I'm not saying we didn't have any top-level sources," Strobel says, "but we also made a conscious effort to talk to people more in the bowels of government who have a less political approach to things."

Some news sources that got it wrong in a big way had a few reporters who were quite right. The Washington Post's Joby Warrick, a writer who specializes in intelligence issues, wrote insightfully about the limitations of the information we had about Iraq's weapons programs, but his articles were relegated to the inner pages when they were published at all.⁸

One of the most important things these reporters had to help them see through the official story was having background in the specific policy area at issue. The news of

⁸"Doubts Remain About Purpose Of Specialized Aluminum Tubes", Washington Post, Thursday, February 6, 2003, page A29.

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our nation often hinges on the answers to fairly technical questions. The business about aluminum tubes before the Iraq war is a good example, as is the contents of the famous stimulus package. It's not reasonable to expect all reporters to be expert in the field they're reporting on, but it is reasonable to expect them to be well versed enough not to have to resort to giving both sides equal numbers of column inches in order to measure "fairness." It will be a great day for journalism when it is universally acknowledged that a reporter not qualified to make such judgments about a subject is not qualified to write on it.

Everyone develops some expertise over their career. From the perspective of a news consumer, it would seem that deep knowledge of some policy area is not the route to the pinnacle of journalism. The high-profile reporting jobs don't go to intelligence experts, or specialists in education or business, but instead seem to go to people whose primary expertise is the field of interpersonal relations. We get endless stories about the boyish personality of this candidate or the aloof mien of that one. In *Nixonland*, Perlstein does a superb job of demonstrating that a concentration on the personality of Richard Nixon served our country miserably, for two reasons. The first is that by focusing on these matters, real issues slid by, completely ignored. By concentrating on whether Nixon was "ready to lead" in 1968, the quality press refused to press him on his vague and contradictory statements about Vietnam.

The second reason is more direct. Setting themselves up as judges of character, our nation's political journalists have shown themselves, time and again, to be incompetent at the task. Did Richard Nixon have more "integrity" than George McGovern, a decorated bomber pilot, subsequently Senator, peace activist and now spending his days addressing world hunger? Much of the press said so. And, of course, recent events show us the same pic-

ture. Was George W. Bush any more impressive a man than either Al Gore or John Kerry? The quality press obviously thought so, endlessly calling Gore a liar⁹ and Kerry inconsistent.¹⁰ These distinctions didn't just color the coverage of those elections, they shaped it.

Woodward and Bernstein, who had nothing before them but the facts of the story they were tracing, found the truth, and became journalist heroes. Perhaps that was because they did not attend news conferences. Unfortunately, the profession has taken exactly the wrong lesson from their success. The lesson taken was one of attitude, not homework. The real moral of Watergate should have been about the importance of mastering the facts and largely disregarding the official pronouncements, but instead we have a culture of journalism that fetishizes the official pronouncements. Where homework is done, it seems to consist largely of dredging up putatively contradictory quotes that might exist on tape somewhere, as if the only subject that matters is the honesty and consistency of the subject.

Honesty matters, but a media and politics that focuses exclusively on the personal qualities of the politicians who lead us served us terribly while we had Dick Nixon to kick around—and ever since. ■

⁹All of the "lies" and exaggerations so routinely attributed to Gore in the 2000 campaign—inventing the internet, Love Canal, Love Story, the doggy pills, union lullaby, and all the rest—were either exaggerations or outright inventions of reporters (and not Fox News or Washington Times reporters, either). For exhaustive documentation, check out dailyhowler.com.

¹⁰Kerry's famously unfortunate quote about voting for a bill before he voted against it was about two versions of a bill, one of which Bush supported and one of which he didn't. Kerry was no more inconsistent than Bush. Obviously the video of him saying so was significant, but if the video was more important than the substance, isn't that making my point more succinctly than I have here?

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