Global Perspectives, January 2019: When Should the Government Intervene in the Economy?

It's too early to know the exact economic impact of the most recent shutdown of the federal government, but it seems certain there will be at least some damage. Leaving hundreds of thousands of workers without their paychecks is bound to have an impact, even if the pay is made up later. More broadly, the shutdown got us thinking about the general role of government and government workers in the economy over the longer term. What role should the government have in the economy? How do we gauge whether the government is "too big" or "too small," and how do we know whether a particular government intervention in the economy is justified or not? We think the answers to those questions are key in evaluating a country's investment climate.

Criteria for a Well-Functioning Market

Here at WMI, we're traditionalists. Drawing on several centuries of analysis by leading economists, such as Adam Smith, we believe democratic capitalism coupled with competitive, well-functioning markets free of government intrusion will tend to be the best way to allocate the goods and services people want. Such a system has been well proven to incentivize innovation and production, even as it forces producers to cut costs and become more efficient. By offering riches to those who "build a better mousetrap" and by challenging firms to drive down prices, the system benefits the overall society. Capitalist, free-market economies can suffer from disruptive imbalances, booms, and busts, but on balance, individuals and companies tend to benefit from the system, especially if they monitor what's happening around them and take prudent steps to manage risk and take advantage of opportunities. The system doesn't necessarily produce equal outcomes among market participants, but the wealth it creates is available to be taxed and redistributed to needier citizens if the society decides to do so through the democratic process.

Support for a democratic, capitalist, free-market system isn't just widespread in the United States. It almost seems embedded in our national DNA. It's supported even by those with little or no formal education in economics, and it's often an article of faith for those who have had a college economics class. The problem is that few people seem to remember how nuanced the economic research is: A theoretical system of democratic capitalism and free enterprise may be highly efficient, but it can't reach its full potential unless its various markets are truly competitive and well-functioning. The specific, technical criteria for whether a market is competitive and well-functioning are usually introduced early in an economics textbook (say, the second half of Chapter 1), so they're easily forgotten. By way of a refresher, the following is how we break out the requirements. We consider a market to be competitive and well-functioning if, in the absence of government interference, it is characterized by:

Large Numbers of Buyers and Sellers. At first glance, it seems there are many markets with both multiple sellers and multiple buyers. The markets for automobiles, blue jeans, haircuts, and landscaping services are just some examples. The apparent prevalence of this kind of market is probably one reason so many people have an almost intuitive acceptance of the free market. However, there are also many markets that don't meet this requirement, often with big negative consequences for consumers. For example, since the availability of equivalent substitute products can hold down prices and profits, many companies use advertising, trademarks, and branding to create an impression that they're offering a unique, differentiated product. In other words, they try to establish themselves as a monopoly so they can charge a higher price. The high price of "brand name" consumer goods compared with virtually identical "store brand" substitutes is proof that many companies are successful at this game. Many local labor markets also fail to meet this requirement. For example, imagine a small Midwestern town that once had three small factories but now has only one. In that environment, there may be multiple unemployed welders who effectively have just one potential buyer for their labor, while the factory has "the pick of the litter" and can pay lower wages for even the best workers.

Easy Entry Into and Exit From the Market. This requirement is closely related to the previous one, as it helps maintain balance between the number of sellers and the number of buyers. For example, if a new housing development has created an unmet demand for ice cream in a given neighborhood, low barriers to entry

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would probably encourage some entrepreneur to enter the market and meet that demand. But why are low barriers to exit also important? Since investing and hiring can leave a business with large, fixed, on-going costs (such as debt service), firms will be less likely to enter the market if they fear they can't get out quickly and cleanly in the event things go poorly. This is an especially big problem with the labor market in Europe, where regulations make it very expensive to fire workers. Such regulations act to discourage hiring, which weighs on the overall economy.

Selfish Interests and Low-Cost, Arms-Length Transactions. The requirement that all buyers and sellers seek their own benefit in low-cost, arms-length transactions may seem obvious because it accords with most people's actual experience as they shop for goods and services. However, some markets are structured so poorly that this criterion is violated. For instance, the notoriously inefficient U.S. healthcare market fails this standard in part because health insurance companies are so dominant in the system. Insurers often stand between the consumer and the healthcare provider, paying the provider at negotiated rates that don't necessarily reflect the interest of the insureds. In this system, consumers have little incentive to shop around for the best price as they would in other markets. Another problem is with the flip side of this concept: In theory, "bads" should also only be transferred voluntarily in arms-length transactions. For example, a mining firm that pollutes the water supply imposes a "bad" on the local community. If this transfer happened within a well-functioning market, the firm would have to negotiate with the community members to find some level of compensation they would accept for the level of pollution. Or, if the price were too high, the firm may decide it's cheaper to voluntarily curb its pollution.

Perfect Flow of Information. For buyers and sellers to accurately compare the benefits, costs, and price of a product, they need to have all relevant information about it. However, many markets fail in this regard. Another problem with the U.S. healthcare market is that consumers often can't get clear information on the price of a product or procedure until after it's bought. Many other markets fail this standard, even if it's not immediately obvious. For instance, even for a product as simple as a can of peas, the consumer has no way of knowing how sterile and clean the production plant was. The problem is especially acute in the market for lemons (but not the kind you eat): In the person-to-person market for used cars, you never know if the car you're about to buy might have some big, undisclosed problem (making it a lemon). Buyers therefore tend to heavily discount what they're willing to pay for a used car. That, in turn, discourages people from selling problem-free cars, which leaves the market even more dominated by lemons and further discourages the sale of problem-free cars.

No Natural Monopoly. A "natural monopoly" is defined in economics as a good or service in which the average cost of production continues to fall as more and more of the product is produced, up to the point where all demand is satisfied. It's not possible to fully explain the concept here, but the key point is that in a natural monopoly, it's more efficient for one company to serve the whole market. For example, municipal water systems are typically natural monopolies, since it's cheaper to serve the community with just one network of pipes than to build multiple, duplicative systems. All the same, it's important to remember that this requirement is dependent on the level of technology available at the time. For decades, the nation's fixed-line telephone system was treated as a natural monopoly, but the incumbent firm (AT&T) was ultimately broken up as new technologies allowed competing firms to offer communications services at low average costs.

No Public Goods. As with the natural monopolies, "public goods" have a very specific definition. Given the current state of technology and practicability, a public good is one that is "non-excludable" (i.e., it's hard to exclude non-payers from enjoying its benefits) as well as "non-rival" (i.e., one person's enjoyment of it doesn't diminish the ability of others to enjoy it). The classic example is national defense: There's no good way to exclude someone from the benefits of a strong army and navy, even if they don't bother paying their taxes. And even if they enjoy those benefits, other people's enjoyment of those benefits isn't directly reduced. The criminal justice system is also a public good. Lighthouses are public goods, and roads and bridges can be as well if it's impractical to convert them into tollways. Because of their non-excludability, public goods usually won't be provided by profit-seeking private firms. Public goods can be quite valuable, so government should provide them, at least if their value exceeds their cost.

The Government Response to Market Failure

From the discussion above, it should be clear that the criteria for a competitive, well-functioning free market are actually quite restrictive. Many or even most markets will likely fail to meet all the requirements discussed above, so "market failures" are probably extensive and common (see Table 1 on last page). We think people often have a vague sense of those market failures, even if they can't measure them or describe them in terms of the technical economic requirements discussed above. That may be why politicians, bureaucrats, special interests, and individuals seem so quick to raise the alarm about them

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and start lobbying for new government regulations. The question for investors is this: How and to what extent should the government respond to possible or actual market failures? In our view, the attractiveness of a country's investment climate depends in large part on how its government responds to that question.

Just as we look at several key criteria to decide whether a market is truly competitive and well-functioning, we look at whether a government is following several key principles as it deals with market failures. Below are the main policy principles we look for to assess a government's approach to market failures:

A Fundamental Preference for the Free Market. The efficiency and wealth creation promised by the free market would alone argue for the government to take a "hands off" approach to the economy unless absolutely necessary. Besides, an alleged market failure may just be an excuse for government action that will serve the selfish designs of kingdom-building bureaucrats, special interests, and the like. We therefore think society's default response to a possible market failure should be skepticism that it actually exists and, if it does exist, reluctance to have the government respond unless it is highly certain that the response will be successful. In baseball, a tie goes to the runner. In economics, a tie should go to the free market.

Openness to the Possibility of Market Failure. All the same, any large, complex, well-developed economy is certain to have many market failures, as discussed above. By definition, a market failure can produce an outcome that is considerably less desirable than you'd get if the market were competitive and well-functioning. Therefore, in spite of our belief that society should be cautious about recognizing market failures, we think people should be willing to objectively analyze the situation when evidence suggests a market failure might exist. Where the requirements for a well-functioning market are quantifiable, measure and quantify them. Where the requirements are more qualitative, at least pull together the qualitative information. But in all cases, address the possibility head-on. If well-functioning free markets are really good for people, poorly-functioning markets are likely to be bad, so there should be no reason to resist such an analysis.

Analyzing Whether the Market Failure Can or Should Be Addressed. Another reason we think people shouldn't necessarily fear an investigation into a possible market failure is that not all market failures can or should be addressed by government regulation. With objective analysis, we think many apparent market failures would be considered too small or insignificant to warrant any special action by the government. For instance, if only a single ice cream entrepreneur has bothered to invest in a new store to serve a growing neighborhood, so that he or she effectively has a local monopoly, it's hard to imagine that would require any governmental action at all. In other cases, a market failure may be significant, but if there is no practical way for the government to address it, it might make sense to just live with it.

When Possible, Replicate the Free Market. In those cases where a market failure is both significant and addressable, we want to see the government taking the lightest, most cost-effective approach to rectifying it. In some cases, that might be through taxation, such as a tax on carbon emissions to reduce pollution. In other cases, it might involve some kind of regulation. In the example above, where a consumer has no way to know how sterile and safe a vegetable canning operation is, government regulators may be sent to visit the plant and enforce certain standards. In all cases, however, the important thing is to maintain a preference for keeping the market as free and unregulated as possible. In fact, we think the gold standard is for regulation to replicate as closely as possible the outcomes that would arise from a competitive, well-functioning market. That's typically the approach with electric utilities and other entities considered natural monopolies. Once those facilities are certified as "used and useful," they're usually regulated to produce the rate of return that a similar company would earn in a free market.

Continual Reassessment of Regulations. As noted above, changing technologies helped erode the idea that a telephone company like AT&T had to be a natural monopoly. Going forward, we expect new technologies and new business methods will eliminate many market failures, even as they create new ones. In addition, new technologies and new bureaucratic methods will probably change what kinds of regulation or other powers government can use, just as they helped spawn the development of the income tax and social security systems beginning in the 1800s. All this means that businesses, regulators, politicians, industry groups, and individual citizens should regularly re-visit the regulatory decisions of the past. Over time, there should be plenty of opportunity for adjustments that better align the regulatory system with what society really wants or needs.

Summary and Conclusion

Over the centuries, the system of democratic capitalism and free enterprise has proved its worth as a way to spur economic growth and raise the standard of living for millions of people around the world. However, this analysis has shown that many of the different markets for goods and services in a modern, highly complex economy

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will likely fail to meet the technical criteria for being truly competitive and well-functioning. Market failures are probably extensive and common. One potential response to that would be for the government to take an extremely active role in addressing market failures through regulations, tax policy, fiscal policy, and the like. The problem is that heavy government regulation can and does impede businesses, so we would see that a negative for a country's investment climate. The opposite potential response would be for the government to take an extremely hands-off approach and basically accept market failures as a fact of life, but we think that would leave the economy with more economic inefficiencies than necessary.

What we look for is a government that lives by the following principle: Maintain a fundamental preference for the free market, but be willing to intervene in the market in two instances: a) when there is both a significant market failure and a practical, cost-effective way to address it; and b) when the society, through the democratic process, determines it wants to override the efficiency of the market in order to accomplish some other cherished national value.

We actually have a guardedly positive view of how the United States responds to market failures. Based on good historical precedence and the positive features of American democracy, we think the U.S. political system will generally keep following the principles we look for. American democracy has typically done a good job of identifying, evaluating, and dealing with market failures. It's true that the United States has suffered long periods when regulation was "too light" (as in the era of the "Robber Barons" in the late 1800s) or "too tight" (such as in the late 1960s and early 1970s). Even today, regulation seems reasonable in some industries but too light or too heavy in others. All the same, we think regulation has generally been calibrated just about right by Americans' cultural embrace of entrepreneurship and independence and a political system that gives voice to the businessman as well as the worker and other private citizens. It's the nation's political system that decides whether a market failure exists and, if so, what to do about it. In America, the political system has done a very creditable job at that task, even if we sometimes suffer messy policy fights and government shutdowns.

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Table 1
Examples of How to Apply the Criteria for a Free, Well-Functioning Market:
How Should These Goods and Services Be Provided?

Characteristic / Market	Golf Balls	Canned Peas	Elementary Education	Residential Drinking Water	National Defense
Many Buyers and Sellers?	Yes	Yes	Yes	N/A	N/A
Easy Entry and Exit?	Yes	Yes	Yes	N/A	N/A
Self-Interested Buyers & Sellers / Cheap, Arms-Length Transactions?	Yes	Yes	Yes	N/A	N/A
Perfect Flow of Information?	Yes	No	Potentially	N/A	N/A
Absence of Natural Monopoly?	Yes	Yes	Yes	No	N/A
Absence of Public Goods?	Yes	Yes	Not Clear	N/A	No
Best Way to Provide the Product	***Free Market***	***Regulated Free Market***	***Regulated Free Market OR Government***	***Regulated Monopoly OR Government***	***Government***

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