What Kind of Economy Works Best?

The Interplay of Markets and Democracy

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AMERICA'S CONSTITUTIONAL FOUNDERS provided for a system of government that diffused power: the separation of powers into three branches of governments, each checking and balance the others, and tempered by a federal system in which power is dispersed among the states. The reason for this fracturing of government power is that the founding generation believed that concentrated power was a threat to liberty. "The great object of terror and suspicion to the people of the thirteen provinces was power," Henry Adams wrote in 1870. "Not merely power in the hands of a president or a prince . . . but power in the abstract, wherever it existed and under whatever name it was known." The accretion of public power can create tyranny, despotism, authoritarianism – all of which destroy self-government.

And the founders feared concentration of private as well as public power. When the patriots dumped 342 chests of tea into Boston Harbor in 1773, they were not only protesting the tax but the monopoly on tea imports to the colonies that the British Crown had given to King George's cronies at the British East India Company. Plenty of potential competitors were willing to supply tea at lower prices, but they were blocked by the royal tea monopoly. Early in the 19th century, President Jefferson want to great lengths to assure that the new territories would be available to small farmers, and not snapped up by large land speculation companies. That promoted democratic allocation of wealth. Yet the land had been seized from native tribes—and was democratically available only to white settlers.

Markets, like states, depend on rules. And rules reflect power. The rules can be set democratically, or by despots, or by powerful private special interests. Neither sector has a monopoly on virtue, fairness, or efficiency.

Power is not only held in public hands. Private power can be just as dangerous. Private power rears its ugly head when the powerful steal or cheat the weak and when they exploit those with less power. Some companies require workers to sign non-compete and no-poach clauses, so they can't go work for a competitor; they require employees to sign away other rights as a condition of employment. They demand compulsory overtime. That all looks more like private oppression than a free market. Private power can also capture public power, capture government, and then wield government to serve its own interests rather than the public good. The accretion of private power can thus also create tyranny, despotism, authoritarianism – simply of a different sort.

One of the central challenges – perhaps the central challenge – for public policy has therefore been how to control, break-up, and render power accountable wherever it is found. But too often we forget about the relationship between democracy and markets. To many, the two seem to operate in separate spheres: politics and economics, public and private. But the relationship between democracy and markets is not so simple—or so separate. In this essay, we are going to provide an overview of markets: when they work and don't, what their limits are, and perhaps most importantly, how democracy is needed to complement markets to give us a society that provides citizens dignity, equity, and justice – a society that prevents excessive concentration of private power, just as it prevents the concentrated accumulation of public power.

Negative and Positive Freedoms

Why do we care so much about who exercises power? Because we care about freedom. For some, freedom is really just about one thing: the freedom to be left alone from government, to make your own choices without government intervention. This approach channels some of the founders' fears of tyrants and kings. But it has also taken on an economic analogue. The free market is also said to epitomize human freedom. The economist Milton Friedman titled his best-selling book *Free to Choose*. In a free-market system, citizens are free not just to choose what products to buy but what occupations or professions to enter and where to live. Consumers and citizens are sovereign. Market freedoms are described as the economic counterpart of democratic freedoms in politics.

The idea that freedom is about freedom *from* government leaves out a great deal of actual forms of freedom. Do you really feel free when you're sick at home but still have to work? Do you really feel free if you go hungry for days? Would you feel free if you couldn't switch companies because an employer forced you to sign a contract to go to a competitor, or because you were afraid of losing your health insurance?

Freedom can be limited by market forces, or by unfair rules set by governments serving powerful private interests. Freedom isn't just about *not* being oppressed, it's about having the opportunity to flourish.

A retired person with a basic income from Social Security and health coverage through Medicare is thus freer than one who has to worry about putting food on the table and choosing between filling a prescription and eating. A young person who had grants to go to college without paying is freer than one who leaves school with 75,000 dollars in debt. A mom who knows that the local water supply is safe to drink is thus freer than one who has to investigate whether it is toxic and spend money on bottled water. A prospective homebuyer filling out an application for a mortgage that government has certified as honest is thus freer than one who has to worry about whether the banker is corrupt. A worker paid a decent wage is thus freer than a worker who is at the mercy of employers lowering standards and playing off workers against each other.

This second kind of freedom—positive freedom for everyone, regardless of race or gender or religion—tends to come from democracy. It comes from our commitment to ensure

that *everyone* has the basic necessities to flourish. Government—through our democracy—offers retirement security and health care for seniors, regulates water quality pollution and tricky mortgages, and sets minimum wages for workers.

So the fundamental question is not how to turn everything into a market. It's about what kind of economy and society do we want? Looking at the actual economy, as opposed to an idealized marketplace, it's clear that we express choices as citizens and not just as consumers; and that a society reduced just to a market is likely to be one of extremes.

Indeed as even Adam Smith recognized in *The Wealth of Nations*, all markets require rules. These rules define private property rights, including patents, trademarks and copyrights; they include rules that insist on basic standards of safety, and clean air and water; rules that allow people to compete in the marketplace by offering them a public education; rules that specify when someone in the private market has amassed so much monopoly power that a fair marketplace ceases to function. Rules can be made democratically--or they are made by those with the most wealth and power, for their own benefit. It is as citizens of a democracy that we decide what sort of economy and society we want. We decide who has power, and how it is allocated.

What Markets Do Well—and Not So Well

A good example of when markets work well is the classic case of the fish market. If there is too little tuna for sale, and consumers want more tuna, the fishmonger will raise the price, so that there is neither a shortage nor a surplus. Consumers in turn will modify their selections based on price, purchasing less tuna as the price goes up. If there is too much cod, the seller had better lower the price or it won't sell. These price signals will be transmitted back to fishing fleets, to pursue more tuna and less cod. Sellers of fish follow this discipline not because they have Ph.Ds in economics. It is intuitive. If they get it wrong, they will be left at the end of the day with a pile of rotten fish. Most of us don't go to fish markets anymore. But the supermarket isn't so different. There is competition for your business, and consumers have enough information to shop around to compare price and quality. That, in turn, disciplines producers. Changing demand and supply determines the price.

To enthusiasts of the free market, one of its virtues is that the price-setting is *automatic*. Markets determine price and supply more precisely and efficiently than any commissar possibly could. That is what Adam Smith meant by an unseen or invisible hand.

But consider a market that is fundamentally different from a fish market or even a supermarket: the market for health care. There, the discipline of supply and demand does not produce the best outcomes. Why not? For one thing, health care is expensive. If we left it to private purchasing power, many people could not afford doctors, drugs, or hospitals. A lot more people would get a lot sicker, and epidemics would spread to others. That's not efficient for society (and it's definitely not good for those who are afflicted with illnesses).

Secondly, medical care is complicated. It is pretty simple to select a piece of fish. But how do you decide what treatment to pursue for cancer? You necessarily rely on your doctor. But the medical profession requires ethical and legal standards, so that doctors don't use their

privileged knowledge to take advantage of patients. In addition, we can't predict in advance whether we are likely to get seriously ill. So most of us buy insurance. Yet private markets do not necessarily make available affordable insurance for those who need it.

The market does not solve any of these problems. It takes regulations, subsidies, and public programs to make sure that most of the population is insured; that doctors are not quacks; that insurance companies do not arbitrarily turn people down for insurance because they are likely to get sick; and that even low-income people can get medical care.

Here is the nub of the problem. Are more markets like fish markets where the market disciplines itself, or like health care markets where it does not? It turns out that for a great deal of the economy, the market left to its own devices does not produce efficient outcomes. And note that even the fish market might not work so well if we look at it from a different perspective. Fishermen all have an incentive to catch more fish, so they can sell more fish and make more money. But if every fisherman expands the size of their catch, the number of fish in the sea will dwindle and can even disappear. Independent individual actions will eventually mean no fish at all!

There are many costs and benefits that private supply and demand leaves out, and places where the private market gets the price and the quantity wrong. Markets do a bad job at pricing public benefits such as basic science and medical research, clean air and water, or the systemic public and private costs of global climate change. A cost to society (pollution, financial collapses) or a benefit (education, public health) that markets fail to price accurately is called an *externality*, because the costs or benefits are external to the immediate transaction. Economists also call these market failures.

Market Failures

Two of the great market failures of our era are global climate change and the costs of the 2008 financial collapse. Carbon fuel is plentiful and cheap. So we buy a lot of gas, oil, and coal. But today's price at the pump or the electric meter only counts the cost of extracting and delivering the fuel. It does not factor in the immense costs of pollution and climate change. Only government policy aimed at phasing out carbon-based fuels in favor of renewable ones can counteract the myopia of the market.

Similarly, in the financial collapse of 2008, bankers had invented mortgages and other kinds of securities whose highly risky nature was hidden from both consumers and investors. Bankers themselves borrowed a great deal of money to speculate in these products. They had conflicts of interest. When many of these securities turned out to be worthless, the entire banking system came crashing down like a house of cards. If financial markets worked as advertised, these risky products would have had higher prices, to reflect their greater risk. But financial insiders succeeded in obscuring the risky reality, because there was so much money to be made. Even though free markets are supposed to be good at pricing products correctly, they got this one disastrously wrong. The cost to the economy was upwards of $20 trillion. Millions of innocent homeowners who had played by the rules lost their homes. But the rules had been

rigged in favor of bankers. And the government had to bail out the banks, lest the entire economy collapse. So much for the unseen hand.

Another challenge for markets is what happens when the playing field is not level. Some people start out with a lot more wealth and power than others. Children of rich parents enjoy a whole suite of head starts that they did not earn. Rich parents can provide high-quality pre-K, a fine public-school system or private school, all sorts of extra enrichment programs; and when the child goes off to college (often an elite one, thanks to the good secondary-school education), parents pay tuition, so there is no lifetime of college debt. When the child marries, affluent parents often help with a down payment on the first house, as well as help with getting a good head start for grandchildren.

The children of those who are not rich enjoy nothing of this economic head start package. They are competing in the market system just like the affluent kids, but with far fewer chips to put on the table. As the concentration of wealth has become more extreme and as public programs of mobility have become threadbare, the result is just what you would expect. The economic status of parents increasingly predicts the economic success of children. In a truly fair and free market, in contrast, success would be based on talent and even people not displaying exceptional talent would have dignity.

Intergenerational advantage and disadvantage are further compounded by inequalities of race. Due to the legacy of slavery, segregation and discrimination, black families have had far fewer opportunities to accumulate wealth than their white counterparts. The premise of a free market, equally open to all, leaves out these historical legacies, positive and negative.

The long era of slavery and then another century of official segregation reflected collusion between private slaveholders and governments; collusion between racial discrimination practiced by private economic interests--and permitted *and even required* by governments that segregationists dominated. In principle, if talented women and people of color were available and willing to do skilled work, efficient markets should have given them that opportunity. But until the 1960s, women and African Americans were mostly barred from skilled professions. The advantage that white men got from relegating women and blacks to scut-work was too powerful a force for markets to overturn. When remedy finally came, it was through the democratic process, not through markets correcting a mistake.

The simple story of free markets gets even more complex if we think about human nature. Even in well-functioning markets, there are fraudsters, hucksters, crooks, and cheats, hunting for unsuspecting prey. Big banks were found to deliberately target racial minorities in the run-up to the 2008 financial crash with the worst, most dangerous, and trickiest financial products. In recent years, some have been found opening fake bank accounts for customers. The market might ultimately discipline bad actors like these—but in the meantime, people are cheated with complicated terms and conditions or faulty products. Who will punish the cheats? Who will make sure the promises in economic contracts are upheld? The answer is government. And in a democracy, we the people make the rules to shape all of these choices—to ensure markets work efficiently, to ferret out the cheats and hold them

accountable, and to ensure that everyone has an opportunity and can compete on a level playing field.

In the late 19th century, a great deal of economic power became concentrated in a few hands. In new industries such as oil, railroads, telephones and banking, monopolies known as trusts managed to seize control, choke off competition, and jack up prices. Supported by both political parties, Congress passed two Antitrust Acts, in 1890 and 1914. Monopolies represented market excesses leading to abuses; this was concentrated economic power that market forces could not fix; remedy required democratically set rules. For much of the 20th century, antitrust enforcement kept monopoly abuses within tolerable bounds. But in recent decades, abusive economic concentration has roared back, abetted by allies in government. The drug industry practices rampant price gouging. Mergers have left just a handful of competitors in sector after sector. The big "platform" companies such as Google, Amazon and Facebook both spy on users and crush potential competitors. Once again, we need democratically set rules in order for markets to live up to their promise.

Wealth, Power, Markets, and Rules

All markets depend on rules – whether the issue is climate change or financial markets, fisheries or health care. Good rules can help make markets work for everyone. Bad rules entrench the already wealthy and powerful, and reinforce racial dominion. These rules are set by government, and government in turn is influenced by the distribution of both political and economic power. This means that there is a virtuous or vicious cycle that emerges. The economically powerful can gain political power and use it to further their economic power. Those without economic or political power simply get left behind.

The aspiration of a political and economic democracy is that both political and economic power will be dispersed among the people, diffused so that no one has so much that they can oppress their neighbors or capture the state. The central question for policy, therefore, gets back to who has power – power in the economy and power to shape the rules of the economy.