The Case for Regulation. The Failure of Free Market Economics

By Dr. Paul Craig Roberts
Global Research, November 10, 2011
The International Economy, Fall 2011 issue
10 November 2011

Region: USA
Theme: Global Economy

The economic mess in which the United States and Europe find themselves and which has been exported to much of the rest of the world is the direct consequence of too much economic freedom. The excess freedom is the direct consequence of financial deregulation.

The definition of free markets is ambiguous. At times it means a market without any regulation. In other cases it means markets in which prices are free to reflect supply and demand. Sometimes it means competitive markets free of monopoly or con-centration. "Free market" economists have made a mistake by elevating an economy that is free of regulation or government as the ideal. This ideologi-cal position overlooks that regulation can increase economic efficiency and that without regulation external costs can offset the value of production.

Before going further, let's be clear about what is regulated. Economists reify markets: the market did this, the market did that. But markets don't do anything. The market is not an actor; it is a social institution. People act, and it is the behavior of people that is regulated. When free market economists describe the ideal as the absence of any regulation of economic behavior, they are asserting that there are no dysfunctional consequences of unregu-lated economic behavior.

If this were in fact the case, why should this result be confined to economic behavior? Why shouldn't all human behavior be unregulated? Why is it that economists recognize that robbery, rape, and murder are socially dysfunctional, but not unlimited debt leverage and misrepresentation of financial instruments? The claim, as expressed by Alan Greenspan along with others, that "markets are self-regulating" is an assertion that unrestrained individuals are self-regulating. How did anyone ever believe that?

When Federal Reserve Chairman Alan Greenspan, Treasury Secretary Robert Rubin, Deputy Treasury Secretary Larry Summers, and SEC Chairman Arthur Levitt browbeat Brooksley Born, head of the Commodities Future Trading Commission, and prevented her from doing her duty to regulate over-the-counter derivatives, they committed one of the most stupid policy mistakes in eco-nomic history.

The financial crisis that resulted has spread its devastating effects everywhere. The explosions in public debt and money creation, resulting from efforts to bail out the financial system from its own stupidity, have brought the U.S. dollar and the euro, the two reserve

currencies of the international financial system, under pressure, undermin-ing confidence in the reserve currency status of the curren-cies and the international financial system, as the price of gold indicates.

Obviously, the lack of financial regulation was dys-functional in the extreme, and the social costs of the policy error are enormous.

Thirty-three years ago in an article in the Journal of Monetary Economics (August 1978), “Idealism in Public Choice Theory,” I developed a model to assess the benefits and costs of regulation. I argued that well-thought-out regulation could be a factor of production that increases GNP. For example, regulation that contributed to the qual-ity and safety of food and medicines contributed to spe-cialization in production and lower costs, and regulations enforcing contracts and private property rights add to eco-nomic efficiency.

On the other hand, bureaucracies build their empires and extend their regulations into the realm of negative returns. Moreover, as regulations increase, economic man-agers spend more time in red tape and less in productive activity. As rules proliferate, they become contradictory and result in paralysis.

I had hopes that my analysis would result in a more thoughtful approach to regulation, but to no avail. Liberals continued to argue that more regulation was better, and libertarians maintained than none was best.

The ongoing financial crisis has given us a taste of what the absence of regulation can produce. Despite the enormous cost, the financial system remains unregulated. As soon as Wall Street devises a new financial instrument and finds new suckers, it will happen again.

The ambiguous concept of freedom in economics has laid other minefields. Until the Clinton administration, economic concentration was seen as impinging on economic freedom. As late as the Reagan administration, AT&T was broken up. The Clinton administration permitted the concentration of the media. Formerly, this concentration would not only have been considered “in restraint of trade,” but also contrary to the American tradition of a diverse and independent press. Today mergers and concentration of economic power are no longer seen as encroach-ments on competitive markets but as necessary to maintain global competitiveness. In the George W. Bush and Obama administrations, we have witnessed enormous financial concentrations.

One consequence has been that financial corporations can no longer be held accountable as they “are too big to fail.” Thus, the economists’ story of how the market weeds out the failures can no longer be told. The failures accumulate and are subsidized with public money. This is the antithesis of economic efficiency.

The dispersed power that made the market a socially functional institution is disappearing. For example, capital is free to concentrate, but labor unions, a “countervailing power” to capital, are being destroyed. Jobs offshoring has destroyed the manufacturing unions, and now politicians are using the state and local budget crises to destroy public sector unions.

Developments since the collapse of the Soviet Union twenty years ago have confused economists and produced results that threaten the edifice of economic theory. Economists have confused jobs offshoring with free trade. However, jobs offshoring is not trade at all. It is labor arbi-trage. Free trade theory is based on comparative advantage. Labor arbitrage is

the pursuit of absolute advantage. Profits resulting from jobs offshoring raise questions about economic theory's justification of profit maximization. Theoretically, profits are justified, because they are evidence that resources were efficiently used in producing consumer satisfaction and are a measure of the economic welfare of the society. This conclusion no longer holds when profits are produced by rendering a country's work force unemployed. Offshoring separates consumers from the incomes and careers associated with the production of the goods and services that they consume. The profits from offshoring reflect the economic welfare of the foreign country. Therefore, the edifice that economists have built that justifies market capitalism as the deliverer of economic welfare to society no longer stands.

Paul Craig Roberts *was formerly Assistant Secretary of the U.S. Treasury during the Reagan administration, and associate editor and columnist for the Wall Street Journal. He is author or coauthor of nine books and numerous articles in scholarly journals.*

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Articles by: **Dr. Paul Craig Roberts**

About the author:

Paul Craig Roberts, former Assistant Secretary of the US Treasury and Associate Editor of the Wall Street Journal, has held numerous university appointments. He is a frequent contributor to Global Research. Dr. Roberts can be reached at http://paulcraigroberts.org

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