The Great Recession and Government Failure

When comparing the performance of markets to government, markets look pretty darn good.

By GARY S. BECKER WSJ sept 2, 2011

The origins of the financial crisis and the Great Recession are widely attributed to "market failure." This refers primarily to the bad loans and excessive risks taken on by banks in the quest to expand their profits. The "Chicago School of Economics" came under sustained attacks from the media and the academy for its analysis of the efficacy of competitive markets. Capitalism itself as a way to organize an economy was widely criticized and said to be in need of radical alteration.

Although many banks did perform poorly, government behavior also contributed to and prolonged the crisis. The Federal Reserve kept interest rates artificially low in the years leading up to the crisis. Fannie Mae and Freddie Mac, two quasi-government institutions, used strong backing from influential members of Congress to encourage irresponsible mortgages that required little down payment, as well as low interest rates for households with poor credit and low and erratic incomes. Regulators who could have reined in banks instead became cheerleaders for the banks.

This recession might well have been a deep one even with good government policies, but "government failure" added greatly to its length and severity, including its continuation to the present. In the U.S., these government actions include an almost $1 trillion in federal spending that was supposed to stimulate the economy. Leading government economists, backed up by essentially no evidence, argued that this spending would stimulate the economy by enough to reduce unemployment rates to under 8%.

Such predictions have been so far off the mark as to be embarrassing. Although definitive studies are not yet available about the stimulus package's overall effects on the American economy, most everyone agrees that it was badly designed and executed. What the stimulus did produce is a sizable expansion of the federal deficit and debt.

The misdiagnosis of widespread market failure led congressional leaders, after the 2008 election, to propose radical changes in financial institutions and, more generally, much wider regulation and government control of companies and consumer behavior. They proposed higher taxes on upper-income families and businesses, and extensive controls over executive pay, as they bashed "billionaire" businessmen with private planes and expensive lifestyles. These political leaders wanted to reformulate antitrust policies away from efficiency, slow the movement by the U.S. toward freer trade, add many additional regulations in the medical-care sector, levy big taxes on energy emissions, and cut opportunities to drill for oil and other fossil fuels.

Congress did manage to pass badly designed laws concerning financial markets, consumer protection and medical care. Although regulatory discretion failed leading up to the crisis, Congress nevertheless added to the number and diversity of federal regulations as well as to the discretion of regulators. These laws and the continuing calls for additional regulations and taxes have broadened the uncertainty about the economic environment facing businesses and consumers. This uncertainty decreased the incentives to invest in long-lived producer and consumer goods. Particularly discouraged was the creation of small businesses, which are a major source of new hires.

The expansion of government resulting from the stimulus and other government programs contributed to rising deficits and growing public debt just when the U.S. faced the prospect of big increases in future debt due to built-in commitments to raise government spending on entitlements. Social Security, Medicaid and Medicare already account for about 40% of total federal government spending, and this share will grow rapidly during the next couple of decades unless major reforms are adopted.

A reasonably well-functioning government would try to sharply curtail the expected growth in entitlements, but such reform is not part of the budget deal between Congress and President Obama that led to a higher debt ceiling. Nor, given the looming 2012 elections, is such reform likely to be addressed seriously by the congressional panel set up to produce further reductions in federal spending.

It is a commentary on the extent of government failure that despite the improvements during the past few decades in the mental and physical health of older men and women, no political agreement seems possible on delaying access to Medicare beyond age 65. No means testing (as in Rep. Paul Ryan's budget roadmap) will be introduced to determine eligibility for full Medicare benefits, and most Social Security benefits will continue to start for individuals at age 65 or younger.

In a nutshell, there is little political will to reduce spending on entitlements by limiting them mainly to persons in need.

State and local governments also greatly increased their spending as tax revenues rolled in during the good economic times that preceded the collapse in 2008. This spending included extensive commitments to deferred benefits that could not be easily reduced after the recession hit, especially pensions and health-care benefits to retired government workers.

Unless states like California and Illinois, and cities like Chicago, take drastic steps to reduce their deferred spending, their problems will multiply as this spending grows over time. A few newly elected governors, such as Scott Walker in Wisconsin, have pushed through reforms to curtail the power of unionized state employees. But most other governors have been afraid to take on the unions and their political supporters.

Numerous examples illustrate government failure in other countries as well. Highly publicized are the troubles facing Greece, Portugal, Ireland, Italy and Spain that are mainly due to the growth in spending and debt of their governments prior to the 2008 crisis. Perhaps the governments of these countries, and the banks that bought their debt, expected Germany and other rich members of the European Union to bail them out if they got into trouble. Whatever the explanation, the reckless behavior by these governments will greatly harm businesses and consumers in their countries along with taxpayers of countries coming to their rescue.

The traditional case for private competitive markets goes back to Adam Smith (and even earlier writers). It is mainly based on abundant evidence that most of the time competitive markets work quite well, usually much better than government alternatives. The main reason is not that individuals in the private sector are intrinsically better than government bureaucrats and politicians, but rather that competitive pressures discipline market behavior much more effectively than government actions.

The lesson is that it is crucial to consider whether government regulations and laws are likely to improve rather than worsen the performance of private markets. In an article "Competition and Democracy" published more than 50 years ago, I said "monopoly and other imperfections are at least as important, and perhaps substantially more so, in the political sector as in the marketplace. . . . Does the existence of market imperfections justify government intervention? The answer would be no, if the imperfections in government behavior were greater than those in the market."

The widespread demand after the financial crisis for radical modifications to capitalism typically paid little attention to whether in fact proposed government substitutes would do better, rather than worse, than markets.

Government regulations and laws are obviously essential to any well-functioning economy. Still, when the performance of markets is compared systematically to government alternatives, markets usually come out looking pretty darn good.

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