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Governments should stop trying to fix 'broken' markets, and focus on not breaking them

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“The market is not working as it should” has been Theresa May’s economic justification for energy price caps. In most public policy debates it suffices to yell “market failure” or the “market is broken” to rationalise any intervention you desire. How many times in the past few years have we heard about a broken housing/childcare/energy market without any analysis of the underlying causes?

Economists, at least, have a very clear definition of market failure: a deviation from a perfectly competitive world with perfect information, no transactions costs, and no effects on third parties from the production or consumption of the good or service.

Theoretical government policies can then supposedly be applied to remedy situations where these assumptions do not hold. But judge any industry, from food through to manufacturing to healthcare, by the unattainable standards set out above, and they will be deemed failures.

The real question is not whether markets are perfect, but whether government interventions to solve perceived failures do more harm than good. In other words, markets may not be “perfect”, but that does not mean they are perfectable by governments.

This is pertinent, because both Theresa May and Jeremy Corbyn have used the “broken market” terminology regularly to justify their policies. The impression they give us is that laissez faire, free market capitalism is failing and ripping off consumers and tenants, requiring an interventionist government.

In fact, the truth is closer to the exact opposite for the housing, childcare and energy sectors they talk most about. The desire now to “do something” stems from previous policy mistakes to try to correct market failures – or, as economists would call it, “government failure”.

To stop the supposed market failure of urban sprawl and unplanned communities, for example, Britain introduced greenbelts, land use planning regulations and essentially nationalized development rights in the mid-20th century.

The economists Christian Hilber and Wouter Vermeulen estimated that as much as 35pc of the average house price can now be attributed to these planning constraints. High rents and prices, as well as insufficient building, are primarily caused by very tight land-use planning laws.

Indeed, the Conservative party has implicitly admitted this by pledging less generous compensation for land owners subject to compulsory purchase orders. Granting only the value of the land today rather than the potential value with planning permission means the Government gets to retain the uplift when permission is granted. They want to do this precisely because this premium is high, showing how distortive the Government's monopoly power on development is.

The proposed fixes from the Conservatives and Labour, in the form of council house building or rent controls, are simply ill-thought-through responses.

The past two decades have also seen the Government more involved in childcare on market failure grounds. Childcare would be underused absent state support, we were told, because parents would not fully recognize the social benefits of more women working or early education. Regulation was required because uninformed parents would not choose the right amount of "high quality" care.

Successive governments have therefore formalized the sector and regulated it more heavily, contributing to higher prices and ballooning subsidies. The UK now has some of the most stringent staff: child ratios in Europe, and mandates that staff and childminders are in effect early years' educators. The number of childminders has fallen by more than half as a result. Now, surprise, politicians are worried about the affordability of care.

In energy, prices actually plunged in the UK between 1990 and 2004 when the sector was privatized and liberalized. Now, environmental obligations to solve the market failure of climate change continue to raise bills, and come on top of increased wholesale prices.

Stephen Littlechild has highlighted on these pages how it was the energy regulator Ofgem's 2008 attempts to eliminate "unfair" price discrimination too which actually led to an upward compression with lower tariffs raised. Its restrictions on doorstep selling and marketing likewise contributed to lower customer switching rates.

Now the Conservatives see both high bills and low switching as problems and want to intervene further with a price cap. Yet nobody from the party can explain how this will make providers more efficient and able to deliver the lower prices economically.

The lesson is clear: government intervention has been highly damaging. To make the sectors more competitive and responsive, any government would need to unpick the knot of existing policies rather than engage in further crude interventions.

Adopting price controls and subsidies simply to signal you care would be a mistake. "Doing something" for the sake of acting to "restore faith" in markets is as naïve as it is ahistorical. Most interventions by the Government have perverse consequences, without solving the perceived problem. This leads to more frustration and a growing demand for ever-tougher action.

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