THE AMERICAN PROSPECT

The Libertarian Delusion

The free-market fantasy stands discredited by events. The challenge now: redeeming effective and democratic government

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Feb. 27, 2015

The stubborn appeal of the libertarian idea persists, despite mountains of evidence that the free market is neither efficient, nor fair, nor free from periodic catastrophe. In an Adam Smith world, the interplay of supply and demand yields a price that signals producers what to make and investors where to put their capital. The more that government interferes with this sublime discipline, the more bureaucrats deflect the market from its true path.

But in the world where we actually live, markets do not produce the "right" price. There are many small examples of this failure, but also three immense ones that should have discredited the libertarian premise by now. Global climate change is the most momentous. The price of carbon-based energy is "correct"—it reflects what consumers will pay and what producers can supply—if you leave out the fact that carbon is destroying a livable planet. Markets are not competent to price this problem. Only governments can do that. In formal economics, this anomaly is described by the bloodless word "externality"—meaning costs (or benefits) external to the immediate transaction. Libertarian economists treat externalities as minor exceptions.

The other great catastrophe of our time is the financial collapse. Supposedly self-regulating markets could not discern that the securities created by financial engineers were toxic. Markets were not competent to adjust prices accordingly. The details of the bonds were opaque; they were designed to enrich middlemen; the securities were subject to investor herd-instincts; and their prices were prone to crash once a wave of panic-selling hit. Only government could provide regulations against fraudulent or deceptive financial products, as it did to good effect until the regulatory process became corrupted beginning in the 1970s. Deregulation arguably created small efficiencies by steering capital to suitable uses—but any such gains were obliterated many times over by the more than $10 trillion of GDP lost in the 2008 crash.

A third grotesque case of market failure is the income distribution. In the period between about 1935 and 1980, America became steadily more equal. This just happened to be the period of our most sustained economic growth. In that era, more than two-thirds of all the income gains were captured by the bottom 90 percent, and the bottom half actually gained income at a slightly higher rate than the top half. By contrast, in the period between 1997 and 2012, the top 10 percent captured more than 100 percent of all the income gains. The bottom 90 percent lost an average of nearly $3,000 per household. The reason for this drastic disjuncture is that in the earlier period, public policy anchored in a solid popular politics kept the market in check. Strong labor institutions made sure working families captured their share of productivity gains. Regulations limited monopolies. Government played a far more direct role in the economy via public investment, which in turn stimulated innovation. The financial part of the economy was well controlled. All of this meant more income for the middle and the bottom and less rapacity at the top.

Clearly, a more equal economy performed better than a more unequal one. Families with decent incomes could recycle that purchasing power back into the economy. Well-regulated financial institutions could do their job of supplying investment capital to the real economy rather than enriching their own executives with speculative schemes—ones that left the rest of the society to take the loss when the wise guys were long gone. In the case of labor, there was not a single, “accurate,” market-determined wage for each job, but a wide range of possible wages and social bargains that would attract competent workers and steadily increase the economy’s productivity.

The free market doesn’t live up to its billing because of several contradictions between what libertarians contend and the way the real world actually works. Fundamentally, the free-market model assumes away inconvenient facts. Libertarians presume no disparities of information between buyer and seller, no serious externalities, no public goods that markets can’t properly price (Joan Fitzgerald’s piece in our special report in the Winter 2015 issue of The American Prospect magazine discusses one—water), and above all no disparities of power. But in today’s substantially deregulated economy, bankers have far more knowledge and power than bank customers (witness the subprime deception); corporations have far more power than employees; insurers have more power than citizens seeking health insurance. Labor markets can’t compensate for disparities of power. The health insurance “markets” created by the Affordable Care Act can’t fully address the deeper problem of misplaced resources and excessive costs in our medical system.

The conditions of the idealized market model do describe ordinary retail markets, where there are plenty of restaurants, supermarkets, dry cleaners, and hardware stores, and consumers are competent to shop around for price and quality. They don’t accurately characterize the markets in health, education, labor, finance, or technological innovation, to name just five. (What is efficient about a hedge fund mogul taking home $2 billion, or a life-saving pill that retails for $5,000 a dose?)

To produce an economy that is more equitable as well as more efficient, government uses a variety of tools. It regulates to counteract market failure. It taxes to provide revenues to pay for public goods that markets under-provide at affordable prices—everything from education to health to research and development. Sometimes government passes laws to sustain other elements of a social contract, such as the laws protecting workers' rights to form unions and to collectively bargain.

Government can invent things that markets never would have imagined. Apple has created wonders, but it has piggybacked on government investment in advanced semiconductors and the Internet. America's biotech industry's success was reliant on massive government investment in the Human Genome Project and other basic research. Later in the special report in the magazine's Winter issue, Fred Block's piece describes the indispensable government role in innovation. Commercial broadcasters were disinvesting in radio as a serious medium of news, public affairs, culture, and humor, when along came public radio, partly underwritten by government and partly by listener-subscribers. NPR demonstrated that ingenious and high-quality noncommercial programming could attract an audience that for-profit companies did not know was there.

There is another, more fundamental point ignored by libertarians: The market itself is a creature of government. As Karl Polanyi famously wrote in a seeming oxymoron, "laissez-faire was planned." Markets could not exist without states defining the terms of property ownership and commerce, creating money, enforcing contracts, protecting patents and trademarks, and providing basic public institutions. A Robinson Crusoe world never existed. So the real issue is not whether government "intrudes" on the market—the capitalist system is impossible without government. The practical question is whose interests the state serves.

So the core libertarian claim that markets are efficient stands demolished by historical evidence. However, libertarians make a second claim: Free markets are the sublime expression of human liberty. This second contention gives libertarian ideology much of its persuasive power. In the resurrection of free-market theory after its first burial in the wake of the Great Depression, a remnant of libertarian economists led by Friedrich Hayek engaged in a technical duel with John Maynard Keynes about whether markets were self-correcting after all. Hayek won few converts. But in the 1940s, Hayek hit pay dirt with his argument that markets epitomized freedom. This claim was taken a step further by Milton Friedman a generation later.

In the idealized libertarian world, individuals are "free to choose"—never mind that some are born with far more resources with which to choose than others. In the Hayek-Friedman world, government, except for its minimal role of keeping the peace and protecting property values, is the enemy of freedom. Hayek went so far as to write a book in 1944, The Road to Serfdom, contending that democratic forms of planning were destined to lead down the same road to totalitarianism that ended with Stalin and Hitler. Hayek remained a revered figure to libertarians—he even won a Nobel Prize—despite the fact that there is not a single case where democratic planning led to dictatorship, but countless instances where market turbulence led displaced citizens to turn to anti-democratic strongmen. Adding insult to injury, the Hayek-

Friedman remedy for when markets don't work is: We need even more market. We saw how well that worked in the financial collapse.

Beyond assuming away inherited disparities, the Hayek-Friedman equation of markets and freedom leaves out the role of government in promoting affirmative liberties. A young person from a poor family who does not need to incur crippling debt to attend university is a freer person. A low-income mother who cannot afford to pay the doctor attains a new degree of freedom when she and her children are covered by Medicaid. A worker who might be compelled to choose between his job and his physical safety becomes freer if government health and safety regulations are enforced. The employee of a big-box store who can take paid family leave when a child gets sick is freer than one whose entire life is at the whim of the boss; likewise a worker with a union contract that provides protection from arbitrary dismissal or theft of wages. An elderly person saved from destitution by a government-organized Social Security pension has a lot more liberty than one bagging groceries at age 80 to make ends meet, or one choosing between supper and filling a prescription. An aspiring homeowner who doesn't need to spend countless hours making sure that the mortgage won't explode is freer to spend leisure time on other activities if government is certifying which financial products are sound and is prohibiting other kinds.

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I could go on, but you get the idea. These are not arcane examples, written in the algebraic idiom of formal economics. They are common-sense experiences familiar to us all—and fruits of government spending or regulation. Clearly, there will never be enough charity, benign employer paternalism, or self-correction on the part of markets to solve these problems. Lately, as markets have gained ground at the expense of social counterweights, more of us find ourselves at the mercy of market forces, as played by bosses, insurers, and financial engineers.

Why, then, does the libertarian appeal persist? The free-market fantasy violates both the reality of big events like the financial collapse and the lived experience of most Americans. Jeff Madrick, in our Winter issue special report, explains why the free-market model persists among economists—it creates a nice pseudo-science, and society's most powerful people tend to reward professional economists who solemnly advise that government should keep away. But why does the libertarian ideal seduce so many regular people?

Here, we need to introduce the other main protagonist in this drama—government. To Hayek, Friedman, and other libertarian theorists, government is a hopeless case because the state is a monopoly. Even in a democracy, periodic elections are a clumsier form of accountability than the instant discipline of adjustments in price—the market's version of self-correction. Fellow libertarian theorists such as James Buchanan, another Nobel laureate, added the thought that governments might serve the general interest in theory but in practice bureaucrats were prone to feathering their own nests. Buchanan, missing the irony, termed this behavior “rent-seeking,” which is an old-fashioned economists’ term for pursuit of monopoly profits by market players. Any fair assessment of who is the bigger rent-seeker would point to bankers and corporate monopolies far more than public officials.

However, the story gets more complicated when there is a revolving door between government officials and industries. In that case, it isn’t “the state” or “the market” that is the inefficient culprit, but a corrupt symbiosis between the two. That reality tends to blur the argument. When Hayek and Friedman were first writing, their story was less plausible because government and the larger social contract that it sponsored were delivering for most regular people. That’s less the case today.

Ann Hagedorn, in her article for this special report, describes privatization as a case of corrupt government-market symbiosis. Chris Christie, governor of New Jersey, steers contracts to a crony to operate government-supported halfway-house prisons. The halfway houses are a disaster—conditions are deplorable; inmates are able to walk away; the vendor is reaping windfall profits. Who is to blame? Voters conclude that the public officials and private contractors are all scoundrels. And such arrangements aren’t devised only by market-loving, government-hating Republicans like Christie. The public is just as cynical when the Obama administration bails out Wall Street. One of Obama’s top White House economic officials, Michael Froman, in a previous career at Citigroup, ran a private equity group that tried to privatize the Pennsylvania Turnpike. In Chicago, parking meter costs have gone through the roof because of a privatization deal promoted by Democrats with Wall Street connections.

As Michael Lipsky writes in a new paper for Demos, “Rulemaking as a Tool of Democracy,” regulation is more popular than many politicians think. It is unpopular in the abstract, but citizens count heavily on government regulation to protect against everything from polluted air, to unsafe food and drugs, to dangerous conditions at work. Nonetheless, the anti-regulators are on the march. Republicans are promoting a general regulatory rollback. Lipsky quotes the libertarian Cato Institute website: “There is no greater impediment to American prosperity than the immense body of regulations chronicled in the Federal Register.” Of course, nearly all of these regulations are there because of some market failure or corporate abuse that resulted in citizen pressure on Congress for reform. Yet even some Democrats are seduced by the supposed inefficiency of regulation. Cass Sunstein, who served for nearly three years as President Obama’s regulatory czar, actually bragged in a recent book that the Obama administration in its first four years had issued fewer regulations than its three predecessors had done—this at a time when new corporate abuses were proliferating.

Unfortunately, the neat story of an inefficient, unjust, and calamity-prone market, contrasted with a public-minded government as democratic counterweight, is harder to tell in 2015 than it was, say, in 1965. Half a century ago, there were clearer bright lines between what was public and what was private. The state governed the market, producing economic security, opportunity, and rising living standards for most working families. But today's reality of revolving doors and corrupt "public-private partnerships" blurs the argument, both as ideology and as politics.

For younger voters, it has been a long time since government provided the economic security and opportunity it offered their parents and grandparents. If government is providing little help, young adults are more inclined to bet on the free market and save some tax dollars. Market applications such as Airbnb, which allows travelers to save money by booking rooms in private homes, seem modern and hip. Young people who grew up with iPhone apps like the coolness and convenience of the Uber ride-sharing service (never mind that most drivers can't make a living).

A number of social scientists and journalists, such as Tom Frank (who is both) in his book, What's the Matter with Kansas?, keep wondering why working-class voters, especially whites, fail to vote their economic self-interest. In surprisingly large numbers, they support Republicans, who would remove the weakened social protections that remain, cut back Social Security and Medicare, make the tax code even more regressive, and make American workers even more vulnerable to low-wage competition from overseas. Frank blames the cultural conservatism of much of the white working class.

But there is a more disconcerting explanation. It has been a long time since government effectively did its job of tempering the market in the interest of ordinary people. A further problem of this blurring between the public and the private is that it adds great complexity. That makes regulations and government programs harder to administer, and diffuses blame when citizens find themselves frustrated with the result. Ultimately, the government tends to take the fall more than the market.

Consider the Affordable Care Act. Because Democrats lacked the votes and political will to fight for a true public program, we were left with a mandate for citizens to buy private insurance, subject to complex regulations, subsidies, and enrollment procedures. The launch of the program was a mess. To many citizens, the fiasco confirmed everything they suspected about government and liked about markets. How come it's so easy to order a book on Amazon and so hard to enroll for health insurance on Healthcare.gov?

You had to be a political scientist to appreciate the full explanation that Obamacare was the bastard child of market institutions (drug and insurance industries) that had become too powerful and a government settling for the best it could get. It was also a product of some moderate Democrats' misplaced belief that a government-regulated "insurance market" could solve problems in a public good (health care) that markets haven't solved and can't solve. At this writing, some government officials are chiding frustrated citizens, who like the coverage but are exasperated by Healthcare.gov, for their failure to do enough shopping around for insurance. Most citizens would prefer the convenience, reliability, and simplicity of a trusted public program like Medicare to the ordeals of comparison shopping and detail-deciphering on their laptops.

Or take the case of the Dodd-Frank Act. More than four years after the act was passed, most of its key provisions have yet to be carried out. That's because the act requires several hundred separate "rule-makings" by beleaguered and often compromised government agencies. Dodd-Frank is drowning in regulatory complexity because it failed to deal with the underlying complexity of the financial industry. It would have been far better had Congress passed a law setting a few hard-to-evade bright lines, such as bringing back the 1933 Glass-Steagall Act that separated government-insured commercial banking from stock brokerage and investment banking. The more complex the process of government regulation, the less citizens know whom to blame when the economy goes off the rails.

This blurring of accountability was on display in the passage of the December 2014 budget resolution. As their price for not shutting down the government, Republicans demanded and got a watering down of a key provision of Dodd-Frank prohibiting bankers from speculating with government-insured money. In principle, that ploy should have set up a clear, politically useful differentiation—Republicans are toadies of Wall Street and Democrats are for tough regulation to protect taxpayers and investors. Except that 57 House and 32 Senate Democrats, many with close ties to Wall Street, voted for the deal.

Based on the evidence, the case against the libertarian market and for democratic government is stronger than ever. But when government gets into bed with private industry and finance at the expense of regular people, the citizenry loses confidence in government. Republicans bet that if they could just hamstring government, more voters would either stay home or would conclude that they were better off voting for the party that wants to slash government. This cynical Republican view was rewarded with an increase in anti-government attitudes in public opinion. The turnout in 2014 was the lowest since 1942, and much of the falloff was among groups that vote for Democrats when they vote at all—minorities, the poor, and the young.

So if we are to win the argument with the libertarians, we need to take back effective government. Friedman was wrong to argue that the cure for market failure is more market. However, the cure for weak or corrupted democracy has to be more democracy. The only way to redeem public confidence in government as a necessary check on the market is to repair faith in democracy itself. It is not difficult to prove that the claim of market efficiency is delusional. Reclaiming our democracy will be harder—but it must be done.