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« Flattening that Earth

Market Regulation

July 8, 2009

by Jerry O'Driscoll

Benjamin M. Friedman wrote a review essay for the *New York Review of Books* on the crisis of the economy and the economics profession. In an otherwise very good piece, he took an obligatory swipe at deregulators: "There is a long arc from Roosevelt's acceptance of a useful role for government institutions and government regulation to the conviction of Reagan and Thatcher that the government is never the solution but actually the problem" (p. 43). That is a straw man all around, but one promoted by textbook presentation of markets and the equilibrating role of prices.

Prices are the self-regulating mechanism in textbook presentations. If prices fail to perform that function (e.g., for public goods or externalities), then there is market failure and a role for regulation. As in Friedman's characterization, "regulation" means government intervention. Each step in the argument must be questioned: from failure to regulation to government intervention.

That textbook treatment abstracts from the rich array of institutions under-girding actual markets. First, there is an entire array of institutions summarized by the "rule of law" or the "legal framework. Next, there are a myriad of structures, customs and practices that regulate behavior in markets. There both formal and informal institutions at work. The price system is indispensable for allocating resources. But prices are not sufficient for the purpose.

Lee Hoskins and I made "The Case for Market-Based Regulation" . We built on the UCLA property rights tradition, particularly the work of Armen Alchian; and on the Austrian tradition, particularly Menger and Hayek. We provided numerous examples of regulating practices and institutions evolved spontaneously and treated them part of the larger market process. We also noted that as government takes over the regulating function, market institutions recede. The paper was written before the current crisis, but with the financial system very much in mind. "Safety-and-soundness practices based on market incentives and clearinghouse rules have been replaced by government regulations, central banks, and deposit insurance" (p. 478).

To return to Friedman's observation, is he suggesting that governments are self-regulating in a way superior to markets? That is a heavy burden to carry. And in terms of the current financial and economic crisis, there was an elaborate complex of government regulations and agencies enforcing them that failed systematically to prevent the crisis.

This entry was posted on July 8, 2009 at 8:16 am and is filed under Financial Markets, Regulation, law, private property.

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