July 8, 2009

Markets work, even when they don’t

Remember when it used to be cool to be an advocate of free markets? I do, but after the events of the past year or so maintaining that position feels a bit like being an ice cream vendor in a snowstorm—a peddler of a product that just doesn't suit the environment.

Joseph Stiglitz, skeptic and 2001 recipient of the Nobel Prize in Economic Science, put it this way in his most recent *Vanity Fair* entry:

> … historians will mark the 20 years since 1989 as the short period of American triumphalism. With the collapse of great banks and financial houses, and the ensuing economic turmoil and chaotic attempts at rescue, that period is over. So, too, is the debate over "market fundamentalism," the notion that unfettered markets, all by themselves, can ensure economic prosperity and growth. Today only the deluded would argue that markets are self-correcting or that we can rely on the self-interested behavior of market participants to guarantee that everything works honestly and properly.

I'm not sure how many people identifying themselves as "market fundamentalists" actually subscribed to the notion that markets "guarantee that everything works honestly and properly," but at the very least the ranks of the "no new regulation" camp are growing pretty thin. This shift is undoubtedly appropriate, but that is not quite the same thing as throwing out this following major tenet of "market fundamentalism" thinking: Markets are, everywhere and always, one step (or more) ahead of regulators.

The cautionary examples are legion, but a recent one has been on my mind for a couple of weeks. Writing, about a month ago, on the minimum wage, UC-Irvine professor David Neumark noted the following:

> Despite a few exceptions that are tirelessly (and selectively) cited by advocates of a higher minimum wage, the bulk of the evidence -- from scores of studies, using data mainly from the U.S. but also from many other countries -- clearly shows that minimum wages reduce employment of young, low-skilled people. The best estimates from studies since the early 1990s suggest that the 11% minimum wage increase scheduled for this summer will lead to the loss of an additional 300,000 jobs among teens and young adults. This is on top of the continuing job losses the recession is likely to throw our way.
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> The reduction in jobs for youths might be an acceptable price to pay if a higher minimum wage delivered other important benefits. Many people believe, for instance, that it helps low-income families. Here, too, the evidence is discouraging.… Research I've done with William Wascher of the Federal Reserve Board and Mark Schweitzer of the Cleveland Fed indicates that minimum wages increase poverty.…
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> How can this be? Because the relationship between being a low-wage worker and living in a poor family is remarkably weak. Many low-wage teenagers and young adults are in higher-income families, and many poor families have no workers.…
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> *In addition, when deciding which low-wage worker to retain following a minimum wage increase, employers may opt for a teenager, who may have high potential, over an adult who, because he still earns a low wage, likely has much lower potential. Thus, the job-destroying effects of minimum wages fall particularly hard on low-skilled adults in poor families.*

I added the emphasis on the last part because it is the relevant bit for my present purpose. Labor markets are arguably imperfect—and could hence fail to guarantee that everything works properly—because information is asymmetric. Indeed, it was for the exploration of the economic effects of imperfect information that Professor Stiglitz won his well-deserved Nobel citation.

What is the essential informational imperfection in our labor market example? Workers have attributes—innate skills, adaptability and maturity, preferences between shirking versus expending effort—that are difficult for employers to observe. As a consequence, employers look for signals about these things. Professor Neumark offers one such signal: If you are an adult and still in a minimum wage job, chances are you have those attributes that are associated with low productivity. If you are a teenager, on the other hand, there is still a chance you are a high-productivity type. Faced with a government mandated hike in the wages paid to workers in minimum-wage jobs, the percentages dictate you go with the teenager. Which leaves in the cold the people we probably most want to help.

My point is an obvious one (and the one I associate with advocates of "market fundamentalism"): Markets may not "guarantee that everything works honestly and properly," but neither does regulation. I'll turn again to Professor Stiglitz, who had this to say in an earlier (and oft-cited) *Vanity Fair* article:

> As an economist, I certainly possessed a healthy degree of trust, trust in the power of economic incentives to bend human behavior toward self-interest—toward short-term self-interest, at any rate, rather than Tocqueville's "self interest rightly understood."

That particular article was provocatively titled "Capitalist Fools," an interesting choice as the primary objects of the Stiglitz barbs were not "capitalists" but *regulators*. And there remains the thorny question of how to keep at bay the unintended consequences of regulatory policy when human behavior gets bent by incentives and market forces—a phenomenon clearly evident in the perverse impact on low-skill adult workers as a result of the minimum wage.

Something to keep in mind as we go about the job of addressing the very real problems in financial markets that past two years have revealed.

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July 8, 2009 in Labor Markets, Regulation | Permalink