Why the Crash of 2008 was not a Market Failure

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Fred Foldvary, Ph.D.
Economist

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All national economies today are mixed economies, a combination of markets and governmental intervention. In a pure market economy, all activity is voluntary, with no restriction on peaceful and honest human action. A governmental intervention changes what people would otherwise voluntarily do. Government policy can be either market enhancing, such as by penalizing theft, or market hampering, such as by taxing human action.

For any outcome such as a recession, we need to carefully analyze whether the cause is the market or whether it is intervention. Yet nowadays there is a chorus of politicians, journalists, and even economists who have leaped to the conclusion that the Crash of 2008 was a market failure. They say there was too little regulation, and that the lesson from the global financial crisis is that government needs to closely supervise the economy and correct market failures.

Such conclusions are made with no economic analysis. Blaming deregulation ignores the heavy hand of governmental institutions such as the Federal Reserve, the Securities and Exchange Commission, Fannie Mae and Freddie Mac, and the FDIC. More importantly, the focus on regulation is too narrow. The broader issue is intervention, which includes taxation and subsidies along with regulation.

First of all, the USA as well as all major countries practice state socialism and central planning with their central banks issuing and controlling the money supply and manipulating interest rates. Secondly, all countries tax and subsidize human action. Third, all governments restrict trade.

A tax on voluntary activity restricts human action. We would not really have free speech if one had to pay a tax when one gave a speech. When government imposes a cost on human action, there is less of it, by the law of demand, by which higher costs reduce activity. A subsidy is a negative tax, and also distorts outcomes, since with a lower price, those who value the activity at less than the real cost do it, which reduces the amount of higher-valued goods.

There is what is called the "first fundamental theorem of welfare economics," which states that a pure free market maximizes economic efficiency. The second fundamental theorem states that an efficient allocation can be achieved by the equilibrium of a free market. The theorems are framed with specific conditions about competition, but the concept applies generally. A pure free market maximizes productivity, and no intervention can improve the outcome.

Most economists ignore these fundamental theorems, because they think these only apply to so-called "perfect competition," to many tiny firms producing an identical product. But the reason markets maximize well being goes way beyond these fundamental theorems. Only free markets can perform the economic calculations needed to maximize productivity and avoid economic waste.

Prices are not just what people pay for stuff. Prices, including wages and interest rates, have a vital job to do in an economy. Human desires are unlimited, but many resources are scarce. A market price effectively adjusts desire to scarcity. It is the job of the interest rate to equalize savings and borrowi [illegible] et savings and investment. The natural rate of interest ensures that all income is allocated to consumption and investment. The market wage ensures that all who seek work become employed. Market prices prevent shortages and surpluses. Market-based profits signal that more of the profitable stuff be made and that losing products and enterprises cease to exist.

Entrepreneurs drive the economy, bringing new products and methods to the market. Tax them, and we get too little innovation, risk taking, and growth. Subsidize entrepreneurs and speculators, and we get too much risk and a misallocation towards goods of lower social value. Any arbitrary restriction, not to prevent force and fraud, distorts well being by preventing folks from getting what they want and, more importantly, because the chiefs of government lack the knowledge of how to run an economy, and their incentive is to please those who finance their power.

Contrary to critics who think that markets are inherently unstable, it is the interventions that cause the economic roller coaster. Every recession is caused by the previous boom, and every economic boom has been accelerated by government subsidies. Artificially low interest rates, expansionary policies, and guarantees for loans and deposits, all pull resources into unsustainable speculative bubbles.

The biggest governmental distortion is the implicit subsidy to land value. These are generated by special tax deductions and exemptions for real estate, by loan guarantees, by the subsidized secondary market for mortgages bought and securitized by Fannie Mae and Freddie Mac, by regulations pushing risky loans for low-income buyers, by allowing deception or negligence in bond ratings, and the moral hazard of encouraging risk with bailouts.

Those interventions, however, are swamped by the colossal subsidy to land value of governmental works. Highways, streets, parks, security, schooling, and all the other government services and subsidies all increase the demand for the lands serviced by these works. If landowners directly paid for these, the payments would capitalize land values back down. But since taxes are almost all on labor, business profits, goods, and trade, worker-tenants get double billed, paying both taxes and higher rents, while landowners get subsidized.

Land values capture much of the gain from economic expansion, and then rising land values induce speculation that adds to the demand and pushes land values to such a high level that those who want to buy land to use it get squeezed out. Land values then stop rising, and the previous construction becomes a "malinvestment," vacant properties.

We have seen land values plunge, and since most of that value is mortgaged, the real estate crash brings down the whole financial system. The securitized mortgages and derivatives on these loans collapse, creating colossal losses for banks and other financial firms. With loan assets wiped out, banks stop lending, and enterprises dependent on credit fail and employees lose their jobs. That became the situation in 2008.

The key intervention is the land-value subsidy, which makes land value capture the economic expansion, which then attracts the speculators and fools the builders into thinking they can profit from construction as the land appreciates. Warnings of a real estate bubble go unheeded as these actors get blinded by the huge profits and bonuses, and the chiefs forget their fiduciary duty to their shareholders, as with their golden parachutes they can jump off the nose-diving firms. There is indeed massive corruption and greed, and regulations should penalize negligence and fraud, but the greed was stimulated by the land-value subsidy.

Yet both critics and defenders of markets ignore the role of the land-value subsidy. Often this is willful ignorance and deliberate rejection. Conventional economics ignores land and the capitalization of public works into site values — you will not find this in any commercial economics textbook. Mor market and anti-market think tanks that supposedly educate the public institutes are funded by landed interests, so their publications have to reject any article that hints at the land-value subsidy.

The landed interests — big landowners, real estate firms, developers, oil companies, and the financial firms that service them — not only fund political campaigns, but they have also corrupted economic thought, blinded all the free-market institutes to the role of land, and promoted the statist bias against markets. Any bad outcome such as recession, unemployment, poverty, and pollution is ascribed to market failure, and government is always cheered on as the benevolent and competent fixer. The landed interests promote statism because that enhances their land subsidy.

The 2008 bailouts and government takeovers of banks, bad loans, insurance firms, Fannie and Freddie, and the massive injection of funds into the financial system all have one overriding goal: to maintain the subsidy to land values. If the goal instead was to stop the economic collapse, it would be more effective, simpler, debt-free, and less interventionist to just give every person several thousand dollars in currency. Economies are crashing because of credit constraints, and cash is the ultimate credit.

Statist doctrines misled economists and government chiefs to blame the Great Depression of the 1930s on markets instead of interventions. The US government responded by ending the gold-money standard, greatly increasing regulation, and creating institutions such as Fannie Mae to subsidize mortgages. These governmental institutions, guarantees, and subsidies all failed to prevent the Crash of 2008, and the Federal Reserve also failed to prevent it. Yet instead of concluding that regulation has failed, people say that the market has failed. But nobody has explained how something that does not exist — a pure free market — can possibly cause anything.

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Fred Foldvary, Ph.D.

Economist

FRED E. FOLDVARY, Ph.D., (May 11, 1946 — June 5, 2021) was an economist who wrote weekly editorials for Progress.org since 1997. Foldvary's commentaries are well respected for their currency, sound logic, wit, and consistent devotion to human freedom. He received his B.A. in economics from the University of California at Berkeley, and his M.A. and Ph.D. in economics from George Mason University. He taught economics at Virginia Tech, John F. Kennedy University, Santa Clara University, and San Jose State University.

Foldvary is the author of *The Soul of Liberty*, *Public Goods and Private Communities*, and *Dictionary of Free Market Economics*. He edited and contributed to *Beyond Neoclassical Economics* and, with Dan Klein, *The Half-Life of Policy Rationales*. Foldvary's areas of research included public finance, governance, ethical philosophy, and land economics.

Foldvary is notably known for going on record in the *American Journal of Economics and Sociology* in 1997 to predict the exact timing of the 2008 economic depression—eleven years before the event occurred. He was able to do so due to his extensive knowledge of the real-estate cycle.