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Chapter 1 : Steven M. Sheffrin | Open Library

Markets and Majorities is ought to learning for anyone who has ever questioned why authorities merely can't seem to get points completed, along with anyone who has requested why it ought to aim inside the first place.

Introduction When Markets Fail Lecturing in Eastern Europe in the autumn of , I was asked in a reproachful way why I did not urge the economics of Professor Friedrich Hayek as the alternative to the economic system there so obviously failing. I replied that this was not a design which, in its rejection of regulatory, welfare, or other ameliorating actions by the state, we in the United States or elsewhere in the nonsocialist world would find tolerable. John Kenneth Galbraith The end of the s and the early s marked a victory for democratic society around the world. Dictators in Eastern Europe were overthrown, the Berlin Wall was tom down, and the former Soviet Union began the difficult and dangerous process of fundamental change. As the secrets spilled out from previously closed societies, the truth was even worse than we had imagined: It also appeared that capitalism would be a big winner. As Marxist professors quickly became unemployed except in universities in advanced capitalist economies , free marketeers airlifted themselves to Eastern Europe and the newly formed republics in the former Soviet Union. In conferences, speeches, and meetings they preached the virtues of self-interest, the efficiencies of competition, and the productive genius of the market. But in this euphoria it is easy to forget an important lesson from the experience of modem successful economies. When markets work well, economic policy is cut and dried: As an example of successful markets, consider how an Eastern European citizen would view our all-purpose drug and convenience stores. Open all hours and jammed with merchandise, they provide envelopes, toothbrushes, cold remedies, film, greeting cards, and the cornucopia of other items that we just assume will be available. As we learn in beginning economic classes, it is a miracle that this vast variety of items can reach the consumer without any centralized planning or production and with minimal, if any, government oversight. Markets also operate silently. They allocate goods and services, generate incomes, reward the talented, skilled, and lucky and punish the less talented, less skilled, and unlucky. A myriad of decisions about the allocation of resources and the distribution of resources are quietly made, prompting economists to describe the silent working of markets as part of a grand circular flow. Consumers purchase goods and services from businesses that, in turn, generate incomes -- wages and profits -- that accrue to workers and investors and are then reinvested in goods and services. But markets can fail to work. And when they do, the silence ends. When markets fail, governments intervene and impose regulations on the economy. Economic decisions are no longer left to the silent workings of markets but become heavily influenced by politics. The grand circular flow is thus transformed into the noisy and chaotic Washington money-go-round. When Washington politics meets the free market, a host of new actors, new factors, and obsessions come into play. Considerations of political equity emerge from the silence. Experts, scientific or otherwise, are called in to share their wisdom, opinions, and prejudice. Raw political power and other political considerations begin to influence economic outcomes. And solutions to social problems based on reintroducing markets are viewed with skeptical eyes since problems seem to have arisen in the first place because markets were not working. It is precisely at this interface of economics and politics, where markets seem to fail, that the grand debates of U. We should be asking how markets can be reformed or regulated in a sensible way to achieve our goals. Instead, in the Washington money-go-round we find thousands of lawyers and lobbyists, special interests, influence peddlers, self-anointed reformers, regulators, bureaucrats, and ambitious politicians. All are out to promote their narrow interests or those of their constituencies. In this environment, there are few honest dialogues on economic policy. Instead, discussions of policy often become just another pretext for promoting self-interest. Occasionally policy rises above the fray, such as with the passage of the Tax Reform Act of , which swept many loopholes and sweetheart deals from the tax code. But this exception, a remarkable detour from politics as usual, proves the rule. The Washington money-go-round provides the media with tales of intrigue, power, and influence that titillate the public. Sometimes this mad scramble for economic positioning may seem amusing, but it deflects attention from the very serious business of making our economy work in a time of increased global economic competition. Special interests thrive in an atmosphere in which there is no consensus or even a general framework for thinking about economic policy. Without any basic ground rules, all claims on government seem equally valid and plausible: Your industry is losing out to foreign competitors? Try a tariff, quota, or "voluntary export restraint. Health care costs rising? Lists like these can and do continue indefinitely. We currently do not have any framework to sort the good claims from the bad. Instead, we rely on the day to day workings of the Washington money-go-round to sort out these claims. Unfortunately, this means that power, influence, and access will often be decisive over common sense and sound public policy. Some reformers claim that the real culprit in our economic and political system is the corrosive effect of money in politics. They promote campaign finance reform as the answer to our difficulties. Put everyone on an equal playing field, they say, and then we will have sound economic policy. But this argument fails in two important respects. First, try as we may, we can never equalize the power of economic interests in our economy. Large, sophisticated interests will find ways to wield their influence. The evils of today -- political action committees and soft money -- were the byproducts of our previous reform efforts in the s. The law of unintended consequences has worked with a vengeance in campaign finance. Moreover, in a free society it is extremely difficult to place limits on political actions. The Supreme Court has ruled that billionaires are free to spend as much of their own money as they desire to run for office. Wealthy heirs are permitted to set up tax-free foundations to promote their visions of environmentalism. And it is naive to believe that large corporations would not find similar mechanisms to influence political outcomes. But there is a more fundamental limitation to campaign finance reform as a solution to our economic problems. Even if we could level the playing field, without a general framework for thinking about policy, we still could not separate the good claims from the bad. The same conundrum remains: Some basic principles are necessary to decide which claims are worthy of societal support. This book aims to recreate the missing dialogue on economic policy and promote a framework in which to discuss policy rationally. It brings to this task key insights from the science of economics and the art of governance. Through an approach based on understanding the limits of markets and limits of government regulation, it provides a disciplined framework to sort through our difficult economic problems. To begin this process, it is crucial to understand why markets fail to work. There are four broad reasons why markets do not work well. Markets fail to work when they produce distributional outcomes that are politically unacceptable, when there are pervasive individual uncertainties, when markets are missing, and when collective goods or institutional structures must be provided. A first and basic reason why markets are perceived not to work well is that they generate distributional outcomes that are not easily accommodated by the political system. In these cases, the markets may work efficiently -- that is, they deliver goods and services at minimum costs to the highest bidders without any disruptions -- but the political system cannot handle the final outcomes. A good example of this phenomenon is trade policy, a topic analyzed at length in this book. Free international markets are the best way to achieve international specialization and efficient economic outcomes for the world economy. But free trade may hurt some politically powerful domestic interests. These interests often mobilize to impede free trade. Although there are no technical problems with the functioning of markets, the outcomes from market processes are not welcome. Another instructive example is rent control. In the face of rising rents, existing renters may develop sufficient political clout to impose rent controls in the community. Without rent controls, market rents may rise, but the housing market works smoothly without queues or shortages. Developers produce new housing if it is sufficiently profitable. Rent control disrupts the housing market, creates queues and shortages, and, in the long run, leads to a deterioration of the housing stock as maintenance is deferred and new construction comes to a halt. The housing market in New York City is a classic example of the devastation that can be caused by rent controls. Ironically, housing markets perform technically much better before the imposition of rent control but do not work satisfactorily in the sense of producing politically palatable outcomes. It is not simply that the markets produce outcomes that the public finds unacceptable. When economists diagnose market failures, there are technical reasons why the markets do not operate efficiently. The first cause of market failure involves uncertainty. Markets can handle some but not all uncertainties facing individuals. Living is risky -- there are illnesses, sudden deaths, broken families, and changing fortunes. Insurance can provide some assistance in this risky world. Medical, life, and automobile insurance can partly cushion individuals from risks. But there are well-known limits to insurance markets. Take the example of automobile insurance. Suppose a large group of diverse individuals is covered by a single policy and the insurance company is unable to distinguish or not allowed by law to distinguish between members of the group. The good risks in the group such as stable nonelderly adults would like to separate themselves from the bad risks the single, young, and inexperienced in order to obtain less expensive coverage. To the extent that they succeed, the quality of the remaining insurance pool will deteriorate. This exodus necessarily leads to higher rates for those remaining and increased pressures for other relatively good risks to exit. Economists term this phenomenon "adverse selection. Other problems with insurance markets arise because individuals can take actions or engage in behavior that insurance companies cannot see. Large insurance firms cannot find out if we drink too much at parties, drive too quickly, or engage in unsafe sexual practices. The fact that individuals have information that insurance companies do not is known as "moral hazard" and also limits the extent to which insurance can be provided.

Chapter 2 : Markets and Majorities eBook by Steven M. Sheffrin | Official Publisher Page | Simon & Schust

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The loss of Congressional control would make life increasingly difficult for the President and have major implications for policy. Here we look at the possible election scenarios and assess their market implications The outcome will have major ramifications for economic and trade policy, which will set the battleground for the Presidential election. Currently, the Republicans hold the Presidency and majorities in both the House of Representatives and the Senate, but Democrats will be looking to break this stranglehold. All House of Representative seats are up for grabs along with 35 of the Senate seats. This means the Democrats need to make a net gain of 25 seats to wrestle control of the House from the Republicans. In the Senate, the Republicans have a wafer-thin majority. However, of the 35 seats being contested in November the Democrats have 24 up for election along with the two independents, while the Republicans only have nine. As such, the Democrats need to win two of the nine Republican-controlled Senate seats, while holding on to all of the seats they currently occupy to gain control of the Senate. Betting odds and polling analysts suggest the most likely outcome is that the Democrats will win control of the House of Representatives, but fall short in their quest for the Senate. A subsequent research note will go into details on the current state of the polls, what history tells us and what could yet influence voters. This note is focused on the possible post-election scenarios and look at the likely market reactions. Odds of Democratic control of Congress after Mid-terms 26 September The chance that the Democrats win the Senate but not the House is considered negligible. Members of the House of Representatives serve two-year terms whereas the President has a four-year term and a Senator has a six-year term. Senators terms are staggered so one-third of the member Senate are up for re-election every two years. This year there are 33 Senate seats being voted on in regular elections with two an additional two special elections due to Senators resigning before their term ended. He is fully immersed in trade right now and can also celebrate a strong jobs market, but he has made little progress on his infrastructure spending plan. In the run-up to mid-term elections global investors are quite heavily positioned; long dollars, long US equities and short US Treasuries. The context here is a pump-primed US economy, whose loose fiscal and tight monetary settings have driven US rates and the dollar higher, while at the same time pressure testing the external balance sheets of some of the largest emerging market economies. Trade and infrastructure plus further tax and healthcare reform are likely to be his key policy thrusts in the second half of his term, but he will need support from Congress. This underlines the significance of these mid-term elections. In this regard, we feel that there are three major issues we should focus on before diving into the scenarios since they will have a major influence on the likely successes and the market reaction. Historically we have typically seen Federal budget deficits widen out during Republican presidencies and narrow under Democrat Presidents. Even without any further fiscal boost, the Congressional Budget Office believes the Federal deficit will hit 4. If, for whatever reason, growth starts to disappoint, questions about US government debt sustainability may start to adversely affect financial markets and feed into economic sentiment, possibly creating a vicious downward cycle. However, should the Republicans retain control of Congress both the House and the Senate then there is scope for further fiscal expansion, which could put an additional strain on the medium- and longer-term government finances. President Trump has been very vocal on trade, calling out what he believes are unfair practices and levying significant tariffs. With the mid-term election out of the way pro-trade Republican politicians and corporates, who have been quiet in the lead up to polling, may be prepared to make a more forceful stand against protectionist measures. However, Democrats have a history of being more protectionist and may well back the President to some degree on his attitude toward China. The alternative argument is that Trump instead chooses to double down and implement further protectionist measures. In the near term at least he may feel that a strong economy and buoyant asset prices will act as a backstop to becoming more aggressive on trade and protecting intellectual property. But if concessions are not forthcoming and the trade war intensifies this would risk hurting growth and also equity markets, which he often views as a key barometer of his performance. A weaker economy and falling US household wealth would not stand him in good stead for a defence of his presidency in A topic never far from the lips of media commentators. The most plausible scenario is if the investigation of Russian interference in the election by special Counsel Robert Mueller shows direct and incontrovertible evidence to support impeachment. A simple majority in the House in favour of starting proceedings would result in a Senate trial. Given this would require a supermajority of 67 out of Senators who are likely to largely vote on party lines, Trump would survive unless a substantial number of Republican senators turn on him. If the Democrats were to fail to make any gains in the Senate it would require 18 Republican Senators to cross the floor and vote with the Democrats. This sounds unlikely, especially if they believe President Trump can pardon himself - as he has stated. And the campaign for will in effect start as soon as the mid-terms end. That suggests political tension will remain high in the US. Scenarios and market implications We see four broad scenarios for the post-November landscape and it is through a prism of fiscal, monetary and protectionist policy that we should view the market impact. This may lead to further tax cuts and deregulation, a more hard-line stance on immigration and trade, and a generally belligerent approach to politics both at home and abroad. In the near term, this may provide a further boost to equity markets and domestic demand, but concerns will likely increase around the US fiscal deficit, the impact from trade wars, and perhaps around the geo-political environment and the role America chooses to play. Longer-dated yields will also rise in response to wage gains and higher inflation resulting from stronger growth, while the question of longer-term fiscal sustainability could add further upward pressure. This will be a tricky situation to manage before the inevitable bust when we see longer-dated yields drop on expectations of a policy reversal from the Federal Reserve. Likewise, the dollar could strengthen further into under this scenario. However, investors will become increasingly concerned by growing twin deficits and will be looking to sell dollars at the first signs that the fiscal stimulus is wearing off and the US is left with the baggage of higher deficits. Putting timings on this is difficult, but if the economy holds up until it may be enough to secure a second term for President Trump. Trump tapered high probability In this scenario â€” which betting markets and pollsters believe will be the most probable outcome - Democrats win control of the House with a modest majority, but fall just short in the Senate. President Trump was already somewhat limited by congressional deadlock, but this situation becomes even more challenging for him and he struggles to pass major legislation. Bi-partisan action may be possible on areas such as infrastructure spending, but for the most part divisions between and within the two parties remain material. Faced with this Trump focuses on areas executive powers give him more leeway to set the agenda such as trade policy. This makes the outlook for trade policy difficult to call. If trade is the only real source of authority the President has, he could continue pushing hard for China to make concessions to get the bi-lateral deficit lower. While trade is not necessarily a critical issue for the Democrats, it is unlikely that they will support a trade war with traditional allies like the EU. Given there is a reduced prospect of additional fiscal expansionary policy in a split Congress the fears on debt sustainability may subside. We think this scenario will be fairly neutral for the economy, but there is the risk of government shutdowns given differences of opinion on government funding. In terms of financial markets there is heavy long positioning regarding the US right now, so perceptions of a more limited room for fiscal manoeuvre might trigger some mild profit-taking on the dollar and US equities, but probably not a sharp sell-off. Rest of the World economies do not have particularly compelling growth stories right now and unless Trump surprises by scaling down protectionism it is hard to see a dramatic rotation into overseas asset markets. If the Democrat-controlled House were to vote in favour of impeachment there would likely need to be overwhelming evidence from the Robert Mueller investigation to get the required number of Republican Senators to cross the floor and vote to impeach their President. Given this challenge the Democrat leadership may be reluctant to act quickly and if they do pull the trigger there is a strong likelihood Trump would be found not guilty. Grand Bargain low probability If the Democrats win control of at least the House, their position would strengthen considerably. One possible, though perhaps unlikely result, could be that President Trump and his Democratic opponents choose to bury the hatchet and work together. Further fiscal spending including infrastructure and potentially more tax cuts targeted at lower-income household is at least in theory appealing to both sides. This scenario would likely be positive for the domestic growth story with political risks dramatically scaled back. Further fiscal loosening with a benign backdrop may also lead to a slightly more aggressive Federal Reserve interest rate tightening cycle. Together with congressional consensus on the pursuit of the trade war with China, this should be a mild positive for US asset markets, but positioning probably restrains bigger moves. Worries about the medium-term fiscal sustainability could come more to the fore too with longer-dated yields pushing higher. Given these compromises, there would be little likelihood of impeachment. All-out war in D. This means complete gridlock, frequent risk of government shutdowns, and an even more volatile political environment ahead of the presidential campaign which in effect begins as soon as the mid-terms are over. President Trump would be limited to Executive Powers only. This scenario is not necessarily negative for growth, but could pose major headwinds for risk assets given greater political uncertainty. If Robert Mueller does find evidence of a Russian link, the Democrats may use the resulting political momentum to start impeachment proceedings against the President. A strong Democrat majority in the House would likely vote in favour but it would still need several Republican Senators to vote against the President to reach the 67 votes required to force him out. The Federal Reserve may at the margin take a more cautious approach to policy tightening, particularly if the threat of shutdowns and impeachment are realised. Trump would also likely push his executive powers on trade, which may add to the headwinds for growth. However, he would likely be more restricted under this scenario. Complete gridlock in Washington and a higher risk of government shutdowns and impeachment proceedings argue that the correction in US asset markets is more aggressive than under the Trump-tapered scenario. Further appointments to the Federal Reserve would also be at risk, though historically Fed appointments have been less of a partisan issue. Conclusions President Trump has primarily targeted healthcare, taxation and trade in the first half of his Presidential term. The upcoming mid-terms could easily scupper that plan assuming the Democrats perform as well as pollsters expect. Our base case is that a split Congress will mean his legislative agenda is curtailed, but not completely blocked though this will require working with the Democrats, such as on infrastructure. Further tax reform is possible, but new initiatives would need to be focused at the lower end of the income distribution to get Congressional support. This is a relatively benign story for the economy and asset markets. However, the challenges the US economy faces will intensify. The fading support from the fiscal stimulus, the strong dollar and higher interest rates together with growing concerns about the prospects for emerging markets are all likely to weigh on activity. An all-out trade war would compound these problems and risk a downturn in US growth prospects and asset markets. Such a situation would pose even bigger challenges for President Trump if, as most analysts expect, he seeks re-election in

Chapter 3 : Markets and Majorities: The Political Economy of Public Policy - Ebook pdf and epub

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