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Harnessing the power of markets

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The proven way to power economic growth is by encouraging free and open markets, argues Martin Neil Baily, the Bernard L. Schwartz Chair in Economic Policy Development at the Brookings Institution.

The biggest opportunity for future growth is for policy makers and the citizens who elect them to take advantage of market forces. Not all countries have to do the same thing, but all economies that have achieved success have seized this opportunity.

Good policies take advantage of the enormous benefits of a competitive and innovative economy, as evidenced by the industrial revolutions in Europe and the United States and, more recently, by China's decision to embrace markets and global competition. Well-functioning markets are unmatched in their ability to encourage innovation and quickly allocate capital to the most productive uses. There are too many economies that have been left behind because regulation and corruption instead stifle growth and state-sanctioned monopolies are content to coin money while fostering inefficiency.

What makes this issue tricky is that markets can get it wrong. The Great Depression and the Great Recession are stark reminders of the dangers of market instabilities. The fact that CO_2 emissions are not priced in most economies has brought us to a danger point for global warming. CO_2 emissions are a "negative externality" where the lack of pricing has resulted in the uncontrolled release of billions of tons of CO_2 into the atmosphere. There are also positive externalities where market forces alone result in too little output. Scientific research, for example, requires government or foundation financial support.

In some cases, the solution to a market failure is recognized but the political will is lacking. Taxing carbon, for example, is unpopular, plus multiple countries would have to reduce emissions in order to solve this global problem. In other cases, it is harder to know how to correct a serious market failure. We know that financial sectors around the world were too fragile and their failures triggered a deep recession, but have we found a good solution? Too little regulation could trigger another crisis. Too much regulation or the wrong kind could lead to slower economic growth or even stagnation. Competing political ideologies cloud the decision-making process, making it harder to understand and steer market forces in the right way.

The most vexing problem for the future of market economies is the rise of inequality. Left unchecked, the growing gulf between haves and have-nots may cause social unrest and a backlash against market solutions. Further, broad-based income gains will be necessary to sustain the growth of markets for many products and services. Can this problem be addressed in ways that provide broad prosperity for citizens while still rewarding effort and innovation? Historically, technological advancement and international trade have been two of the main pillars of successful economic development, but today they are blamed for eliminating good jobs while enhancing the wealth of those already rich.

The wrong response to inequality is to put up roadblocks either to the adoption of new technologies or to trade and investment. Such roadblocks attempt to fight market forces rather than shape them. Instead, governments should set the stage for strong markets by equipping their workforces with the skills to make them competitive; designing tax and transfer systems to encourage work while protecting those with low incomes; and designing and enforcing intelligent regulations that support investment and growth. These are the policies that will achieve sustainable growth for the many.

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