ARGUMENT

Playing the Market

Free markets don't exist and they never could. But the phrase is still used to further a political agenda.

By Paul Sabin

"IN CONTRAST TO THE FREE MARKET'S invisible hand, which improves the lives of people," President George W. Bush declared in a 2002 speech honoring the conservative economist Milton Friedman, "the government's invisible foot tramples on people's hopes and destroys their dreams."

Bush's words capture a powerful theme in American conservative thought. Since the New Deal, economic conservatives have consistently campaigned against government regulation and have touted the virtues of the "free market," a realm in which government laws and regulations do not distort how trade and business development naturally unfold.

To be sure, consistent rhetoric hasn't meant consistent action. Political conservatives recently have imposed tariffs on steel imported to the United States and have expanded agricultural subsidies. But more important, their concept of the "free market" has a fundamental contradiction embedded within it.

Markets are social institutions. They function effectively only if governed by rules that establish norms for behavior, for example by guaranteeing property rights, enforcing contractual obligations, regulating business and labor relations, and collecting taxes. These rules don't have to come from government. They can come from dominant companies, national associations, even extended families. But regardless of who sets them, the rules lay the foundation for all market activity. To twist an axiom, there is no such thing as a free market.

Some markets are more flexible and fluid than others, and some are less controlled by government mandate. But in a law-based society like the United States, a market cannot function when unleashed from governmental influence. Calls for free market solutions thus aren't really appeals for the government to stop structuring market relationships, but rather to structure them differently. Pundits like David Brooks, the *New York Times* columnist, should be challenged when they make misleading claims like, "Almost every leading politician accepts that government should not interfere with the basic mechanism of the market system." Free market advocates shouldn't be allowed to take for granted most of the rules and institutions that structure the market and then call the competition that results "free," with its resonant echo of liberty, instead of regulated, guided, and, at times, predetermined.

THE OIL SECTOR ILLUSTRATES THE LIMitations and contradictions in the phrase "free market" as conservatives have popularized it. In the oil economy, government and business are inevitably intertwined. By setting the rules about property rights, government determines how oil gets produced; through labor laws and strict regulation of how oil can be safely handled, it determines how oil gets distributed; and by influencing our use of cars, railways, and other transportation, it determines how most oil gets consumed. It's because of our choices in each of these areas that the United States has drained its oil faster, has become more dependent on cheap energy, and has more avidly promoted its car culture than any other country.

For starters, the federal government's grant of oil rights to whoever owns the land where petroleum is found or whoever can reach it through drilling spurred headlong rushes to produce black gold. After Shell struck oil at Signal Hill in Long Beach, Calif. in 1921, owners of small lots hurried to tap into the riches lurking beneath the surface of their land and adjoining lots. If they didn't drain the oil under their land, their neighbors would. Houses were moved to make way for wells, and derricks soon covered Signal Hill. The system effectively forced the owners and the producers they contracted with to flood the market with their captured yield, even at low prices that barely repaid them. Reporting on the 1920s southern California craze, economist John Ise described "overflowing tanks, and declining prices, frantic efforts to stimulate more low and unimportant uses." He saw around him "dozens of new wells, and more oil, more oil."

By contrast, California's San Joaquin Valley showed in the same decade the measured production that another set of government regulations could create. The land above the oil in the valley wasn't owned by a slew of cash-strapped homeowners. Instead, large tracts were controlled by the federal government or by Standard Oil, in a pattern of ownership that allowed producers to hoard their oil as they waited for prices to rise. At Signal Hill, wells were dug every one and a half acres; in the San Joaquin Valley, the federal lease holders and Standard Oil spaced 8 to 10 acres between each well. The producers in the San Joaquin Valley consequently drew down their reserves more slowly and efficiently. The government could have encouraged such restraint throughout the West if it had granted all oil rights to the federal government, as most countries do, instead of to individual property holders. The choice helps explain why California drained its once plentiful reserves in short order.

As oil drilling surged in the West and South through the 1930s and as prices plummeted, oil industry leaders and public officials worked together to harness production. "The present deplorable conditions should be corrected," American Petroleum Institute president E. B. Reeser reported to California Governor James Rolph in 1932. "There are only two methods available. One is what is generally known as the 'survival of the fittest,' or . . . 'the law of the jungle.' We cannot believe this old theory will be acceptable." Reeser advocated for a ballot amendment, ultimately unsuccessful, that would have authorized the California government to set statewide production limits.

He wasn't by any means alone in pressing for such a solution. At that time, none of his fellow oil men favored a free market. California oil and real estate developer Ralph Lloyd, for instance, warned that excessive competition crushed smaller businesses. "If unlimited competition is, as some claim, the life of trade, why not extend it to a world condition and let every nation of the world use the limits of its competitive ability, including that of war, to find out who is entitled to survive?" Lloyd asked sourly in the journal *The Stabilizer*, which advocated oil production cutbacks. He created the Oil Producers Sales Agency, eventually joined by dozens of small and medium-sized oil producers, to pool and control their output.

Spurred by the efforts of oil men like Lloyd and Reeser, the government also made an effort to cut back production. State-led curtailment of oil pumping was one of several methods used to hold down oil output in the 1930s. The federal government set controls on oil field production as well through the National Industrial Recovery Act. Meanwhile, Ralph Lloyd's private marketing association successfully limited production by its members and Standard Oil used its muscle to coerce producers into lowering their output, replacing government production controls with private monopoly or cartels.

Government policy influenced oil consumption as much as it did oil production. By 1940, motor vehicles used 40 percent of

The Star-Spangled Banner waves over the land of the free market.

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each barrel of oil in the United States. Public investment spurred the stupendous growth of the highways that linked far away residences and businesses, building a transportation backbone for employee commuting, commercial trucking, and recreational touring. Highway development became a constitutional issue when automobile and highway construction interests successfully lobbied for state constitutional mandates dedicating gasoline taxes to highway construction.

Since the middle of the last century, the rules of the game in the areas of energy and transportation have yielded extreme dependence on cheap oil and automobile transportation. Property laws spurred rapid development of oil reserves and drove down prices, while tax breaks made drilling more profitable. The federal government's investment of a trillion dollars in the national highways over the past 80 years built an extraordinary infrastructure for oil consumption. Military deployments in the Persian Gulf have put additional hundreds of billions of dollars behind stabilizing the world's primary oil-producing region. This policy tilt and financial investment has broad political and economic implications beyond oil, since virtually every aspect of the United States' economy is tied in some fashion to its energy and transportation systems. Political manipulation of the oil market encourages business to use energy instead of labor or technology, drives land use planning decisions and sprawl, and serves as a substitute for a coherent national and international climate policy.

The massive public investment in the oil economy also underscores why talk of America's free market today is glib. When free market advocates attack federal subsidies and argue that Amtrak's passenger rail service or that solar power technologies must win their place through competition, they obscure the transportation and the energy markets' political histories. Large thumbs have frequently been placed on the competitive scales, often in favor of the companies that argue the loudest for current markets to now go untouched.

Many liberals carry the argument against free markets this far, underscoring and criticizing past subsidies or market distortions. But as the story of American oil development shows, the limitations of the free market concept are more profound. In the markets for energy and transportation, governments had to make decisions that inevitably skewed the economic playing field. Designing a tax system, the national and state governments had to choose whether to

impose taxes on natural resources or on sales and income from employment. To create transportation corridors, governments had to use their powers to take private property. And governments had to find a balance between antitrust enforcement and the creation of property rights that lead to monopoly. If the government were to absolve itself of these roles, even conservatives wouldn't want to live in the resulting chaos.

THE RHETORICAL STRUGGLE OVER THE IDEA of a free market has a long history. After Franklin Delano Roosevelt's New Deal expanded federal involvement throughout the economy, conservative critics attacked Roosevelt's program as un-American, claiming that the United States had previously been free of government intervention in the economy. Critics like former President Herbert Hoover decried the "New Deal attack upon free institutions." Liberal scholars rose to the defense of the New Deal by pointing to earlier moments in American history. The Committee on Research in Economic History, sponsored by the Rockefeller Foundation, published several books in the late 1940s and early 1950s that countered the conservative ideological attack. With support from the committee, scholars like Harvard's Louis Hartz and Oscar and Mary Handlin and Columbia University's Carter Goodrich showed how state governments had actively planned, regulated, and promoted economic development in the 19th century.

In his 1948 book on economic policymaking in Pennsylvania, Hartz attacked the "laissez-faire cliché" that he said had distorted contemporary understanding of early American history. He described how the government of Pennsylvania had invested more than $100 million in railroads, canals, and river improvements. Promoters envisioned that tolls from these public works would relieve the state of the burden of taxation. Although Pennsylvania did not become tax-free through its investments, Hartz demonstrated how in both theory and practice, the state aggressively embraced public sponsorship of economic development.

The legal historian James Willard Hurst carried to new heights this historical investigation of how government relates to the economy. Hurst's 1964 book, *Law and Economic Growth,* examined the different components of the Wisconsin lumber market, describing how short-sighted political leadership created a system that encouraged Wisconsin lumber companies to clear-cut the state's forests. By classifying and taxing timber lands as if they were agricultural land which the state taxed higher than forest lands, Wisconsin created a powerful incentive for timber companies to buy land, quickly strip the timber, and then dump the clear-cut land to avoid paying taxes on it.

Arthur McEvoy, now at the University of Wisconsin, expanded on Hurst's analysis in his 1987 study of the California fisheries, *The Fisherman's Problem*. McEvoy's book traced the tumultuous rise and decline of the sardine, salmon, and tuna fisheries off the California coast. Most striking for the history of markets is McEvoy's discussion of successive approaches to managing the fisheries, beginning with aboriginal limits on fishing, moving to ethnic fishery associations, and followed by state and then federal fisheries laws—each favoring different social groups and economic outcomes. Aboriginal fishermen set cultural prohibitions that limited the harvest and determined who benefited from it. Similarly, Chinese and Italian fishermen in the San Francisco Bay Delta enforced communal property rights by keeping interlopers out, sometimes by violently attacking them. Regardless of the approach, the California fisheries were never free of controls, whether imposed by tribe, ethnic association, or government.

CONSERVATIVES WHO CRITICIZE HOW government distorts the "free market" and liberals who decry "market failures" share the common assumption that "capitalism" and the "market" can exist, and have existed, apart from government. It is often said that government at some moment "intervened" in the market, either to save it or to destroy it, as though the government didn't have a role in the market from the outset. If we recognize that government is inextricably part of our market structure, then we can acknowledge that we are making choices over *how* we influence markets, not whether we do. Terms such as "flexible regulation" or "competitive market" don't roll off the tongue, but they accurately represent the difference between rigid government mandates and more flexibly regulated industries. They also correctly frame the challenge of creating efficient and effective public governance of the economy.

For instance, tradable permits for air pollution, which allow companies to sell permission to emit specific amounts of pollution, are often described as a free market solution preferable to policies that mandate upgrading pollution-control equipment. But how free is the market when the government has decided what the permits will cover, how much they will cost, and how the trading system will function? Still, the market is a competitive and flexible one, in that individual firms can choose for themselves how to respond to the incentives the permits create.

As with other markets, tradable permits operate freely only within the parameters that the government has set for them. We can structure markets blindly, or with careful intent. Either way, markets remain social institutions whose rules inevitably shape economic outcomes, helping to determine whether oil is expensive or cheap, whether cars are a requirement or an option. Candor about this matters. If we're honest about the degree to which the rules we set decide how the game is played, we can see who and what is favored. We can see whether there is a sensible fix to a genuine problem—or whether a fix is in. ■

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