Do Markets Need Government?

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When I studied and taught economics twenty-five years ago, the basic model of efficient markets was straightforward. Investors and businesses maximize profit, consumers seek value for money, workers search for lucrative jobs. Competitive market forces were central, although market failures were acknowledged: the mal-distribution of income and "externalities" such as pollution and crime not accounted for in market prices. The role of government was to efficiently remediate these failures, to regulate, tax or otherwise "get the prices right."

What happens, however, when self-interested capitalists understand that social inequities and externalities like pollution and nuclear proliferation do long-term financial damage to their portfolios? Short-term profit-driven activities (e.g., extracting oil) may turn out to be terrible long-term investments (rising sea levels threatening major cities and markets). What if markets begin to demand, either for altruistic or self-interested reasons, better performance from corporations on multiple bottom lines? In such a system, does the role of government diminish?

It is tempting to say yes. Institutions with long-term horizons, such as foundations and public pension funds, are teaming up with social investors to address "extra-financial" market risks, taking action through the Investor Network on Climate Risk (INCR, >$4 trillion in assets), signing the UN Principles for Responsible Investment (>$10 trillion in assets), and insisting that companies report on extra-financial performance through the Global Reporting Initiative. These massive investor networks own large chunks of the global corporate sector. If they demand that corporations act responsibly, externalities should diminish, reducing the need for regulation.

In fact, these market forces are extremely useful and leading to meaningful change as companies respond accordingly. Carpet manufacturer Interface's vision is "to be the first company that, by its deeds, shows the entire industrial world what sustainability is in all its dimensions: people, process, product, place and profits — by 2020 — and in doing so … become restorative through the power of influence." But not every company embraces such a deep vision, and systemic performance on social and environmental issues is simply not improving fast enough. Government remains the only actor that can ensure a price on externalities (through taxes and regulation), while requiring full disclosure of extra-financial information.

When government is needed most, it is too often seduced by lobbyists and beholden to corporate interests. This is an old problem, identified a century ago by Woodrow Wilson, who warned that "the government, which was designed for the people, has got into the hands of the bosses and their employers, the special interests. An invisible empire has been set up above the forms of democracy." But wise investors and corporations understand government's crucial role. That's why members of INCR have been calling for SEC-mandated environmental reporting, and employer coalitions are requesting that the government regulate carbon sooner rather than later.

Rational design of a power plant with a 30-50 year useful life is impossible when the cost of the emissions wafting from the smoke stack is so uncertain. Depending on unregulated markets to solve social problems is a pipe dream. Government continues to serve a critical role for citizens, investors, and even corporations when it gets the prices right.