Making Markets Work

How Effective Regulation Reduces Reliance on Taxation

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policy network paper

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Thomas Aubrey is a senior adviser at Policy Network and CEO & founder of Credit Capital Advisory. He previously ran credit and economic analytics businesses serving as the Managing Director of Fitch Solutions, a provider of credit risk and quantitative analytics solutions and Datastream which is widely used by financial market practitioners for investment decisions. Prior to this he worked as a management consultant turning around failing businesses in Asia, North America and Europe. He has written widely on financial and economic issues including *Profiting from Monetary Policy* published by Palgrave in 2012 and co-authored *Prediction Markets: The end of the regulatory state?* in 2007 with Professor Frank Vibert. Other areas of research have included nonfinancial risks undertaken jointly with the World Economic Forum as well as liquidity, operational and systemic risk. He holds a first class degree from the London School of Economics and an MPhil from the University of Cambridge where he mostly studied the history of economic and political thought before studying mathematical economics at Birkbeck College.

Introduction

This paper argues that social democrats need to move away from a macro tax and redistribution policy and make markets work at the micro level. Progressive politicians therefore need to focus on the politics of pre-distribution in order to improve the outcomes for society by improving market design at an individual market level. By failing to address underlying structural issues at the heart of market failures, progressive politicians have in effect conceded the current debate to conservatism. Indeed, social democrats have been far too complacent arguing that when markets fail the automatic response should be to tax and redistribute rather than trying to fix the market failures themselves.

Ensuring markets work in the public interest, is much closer to what Adam Smith had in mind rather than the narrow neo-classical model promoted today by many conservatives. Smith was highly critical of those with a vested interest in having any role in market regulation. As such, the current political paradigm of more government versus less government – sometimes translated into more regulation versus less regulation - is an unhelpful one for progressive politicians to engage in. What is required is for government to ensure that markets are functioning in the interests of the public or effective regulation.

A brief look at market failures in the housing and pensions sectors highlights how one might improve market outcomes through effective regulation. These current failures continue to demand an ever increasing amount of tax payers' money whilst failing to address the underlying cause of the problem. The root cause of the market failure in housing is that governments of both left and right have ignored Adam Smith and instead actively promoted unearned profits from rising land prices at the expense of productive capital and labour. Pension policy is also failing society due to the lack of transparency provided to consumers leading to asymmetric information and the extraction of economic rent by fund managers from the economy.

The history of radical politics since the idea of progress was formulated during the enlightenment has been one of addressing the root cause of societal issues. This is where social democrats need to be reposition themselves if they are to make progress for all in society once more. Making markets work for society is central to this progress.

Markets and the public interest: Adam Smith and progress

Adam Smith was one of the first proponents of the importance of progress in history. For Smith, progress meant an increase in wealth for *all* in society, although this increase in wealth came at the expense of rising inequality. Such an outcome could be achieved by ensuring that markets worked in the public interest. Smith's notion of progress was somewhat broader in scope arguing that progress in material wealth led to progress in justice and political arrangements. During the 19th and early 20th century, reformist politicians played a vital role in delivering this view of progress. Progressive governments supported globalisation and free trade leading to rising living standards as productivity increased. This rise in wealth forced the machinery of government to become more democratic too. Moreover, when markets generated suboptimal outcomes, governments intervened to try and improve the outcome.

A good example of this was the 1875 Food and Drug Act of the United Kingdom of Great Britain and Ireland which aimed to curtail food adulteration. This reform wasn't just about preventing the release of injurious substances into the food chain but also of protecting the buyer through improved information disclosure ensuring such a result, "that a person who buys an article of a particular description should get a genuine article, and one of which contains the proper quantity of the different elements that an article of that description ought to contain."[1] Finally, where markets were unable to provide efficient and just outcomes such as in education and public works, progressive governments intervened extensively, instigating compulsory education and construction projects such as the London sewer.

Smith's view of progress, interrupted by the brutality of the Great War, was largely shattered during the 1930's. The catastrophic rise in unemployment suggested that a fundamentally different approach was required. Markets it seemed, did not work in the public interest leading to the post-War Keynesian era of big government which attempted to determine market outcomes. This shift in focus during the "golden age" of social democracy from 1945 to 1973 led progressive politicians and in particular social democrats to become more identified with a different set of characteristics than they had been in the 19th and early 20th century. Redistribution and the desire to support a greater equality of income became the mantra. This shift essentially severed the social democrats link with the narrative of progress and a commitment to radical political action.

The rampant inflation of the 1970s, largely caused by governments attempting to determine market outcomes through fiscal policy, led to a renaissance of Smith's ideas of material progress using market outcomes. Although this revival of a narrow element of Smith's model was much heralded, in reality the extent of welfare spending under Margaret Thatcher's government implied that market failures continued in many aspects of the economy, thus requiring the state to step in. Indeed, besides the handful of privatisations, there was not in fact much rolling back of the state at all. This so called neo-classical model was further institutionalised by Tony Blair's New Labour government in 1997 - the main difference being that the extent of market failure was argued to have been more significant and therefore more taxes were needed to redistribute to those who found themselves worse off.

The recent financial crisis has once again highlighted that the neo-classical model appears to have some major flaws in it. Living standards for much of society have gone backwards and inequality has increased significantly. Furthermore, governments do not appear to have progressed much in the way they go about their business. Smith's theory of progress, that promised so much, seems to be failing on all counts. However, this time social democrats do not have anything in their armoury to counter attack. The prevailing social democrat orthodoxy that higher taxes are needed to redistribute to those less well-off is not resonating with voters. Indeed voters are becoming increasingly sceptical that a macro-based tax and redistribute policy leads to much progress at all, only incurring a large cost for little benefit. Social democrats have ended up in a cul-de-sac without a new theory to drive a progressive agenda. This has resulted in a shift towards conservative politics which is more accepting of the status quo implying that the era of progress may have reached its natural end. This echoes Francis Fukuyama's thesis that the neo-classical model does in fact mark the end of the process for historical development for advanced economies. So where does this leave social democrats attempting to re-engage with the idea of progress? The recent debate between Joseph Stiglitz and Greg Mankiw on inequality and market failure is representative of the current cul-de-sac politics finds itself in. However it also sheds some light on where progressive politicians ought to be fighting their cause.

Conceding the debate to conservatism? Stiglitz vs Mankiw

In his recent book on inequality, Joseph Stiglitz the Nobel Prize economist and left leaning thinker argued for a shift back towards government intervention due to persistent market failures and rising

1 The Analyst review of "The Sale of Food and Drugs Acts 1875 and 1879, T. Hedderwick

inequality. Restoring full employment through a growth agenda based on public investment whilst supporting workers collective action and tempering globalisation are all central to his argument. Stiglitz, a long time critique of the neo-classical model argued that without government intervention markets will fail leading to suboptimal outcomes and rising inequality. His thesis is that the system has been skewed in favour of the wealthy, who generate their wealth through rent seeking behaviour rather than efficient economic interactions. As a consequence, the most wealthy have become even wealthier with everyone else seeing little benefit from general economic activity.

The conservative economist, Greg Mankiw, in a recent paper has attacked Stiglitz's rehashing of the post war neo-Keynesian model. Mankiw argues that bigger government has not made any material difference to these supposed market failures and has only taxed the productive element of the economy as part of macro-based tax and redistribute policy. According to Mankiw, "Government has grown as a percentage of the economy not because it is providing more and better roads, more and better legal institutions, and more and better educational systems. Rather, government has increasingly used its power to tax, to take from Peter to pay Paul."

Of more interest is Mankiw's scepticism that the wealthiest have become wealthy due to market failures and rent seeking activities. He argues that these outcomes of the market are both fair and efficient but does concede that, "to the extent that Stiglitz is right that inefficient rent-seeking is a driving force behind rising inequality, the appropriate policy response is to address the root cause. It is at best incomplete and at worst misleading to describe the situation as simply "rising inequality," because inequality here is a symptom of a deeper problem. A progressive system of taxes and transfers might make the outcome more equal, but it would not address the underlying inefficiency."

Here lies the dilemma for social democrats. By failing to address underlying structural issues at the heart of market failures they have in effect conceded the debate to conservatism. Social democrats have been far too complacent arguing that when markets fail the automatic response should be to tax and redistribute rather than trying to fix the market failures themselves. This is where progressive politicians need to be fighting their cause.

It is possible that social democrats have assumed that there is nothing that governments can do about market failure given that there is little evidence that governments have better information than the market to correct the failure. However this supposition assumes that markets are already functioning as efficiently as they can, which is a rather naïve view of the way markets have developed. In most cases markets function efficiently when sufficient information is available – which in many cases needs to be enforced by governments. There was a reason why the 1875 Food and Drug Act was passed as there was a market failure due to the asymmetric information between consumers and manufacturers leading to potentially known poisonous substances such as mercury entering into the food chain.

Progressive politicians therefore need to shift their policies away from macro tax and redistribute towards fixing market failures. This means distinguishing between individual markets rather assuming there is one general equilibrium market, and on improving market design at an individual market level instead of focussing on macro outcomes. This is much closer to what Adam Smith had in mind rather than the narrow neo-classical model. Moreover, Smith was highly critical of those with a vested interest in having any role in market regulation as "[their] interest is never exactly the same with that of the public". This is a crucial point in Smith's analysis of markets highlighting they must be regulated in the public interest. Such an approach to regulation generates fair and efficient outcomes without having to resort to tax and redistribute. This is how social democrats delivered progress prior to the "golden age" and where they need to return too. This may not generate slogans and sound bites, but it is what can truly make a difference to those struggling in society because of market failures.

Radicalism and market redesign : A return to Smith's model

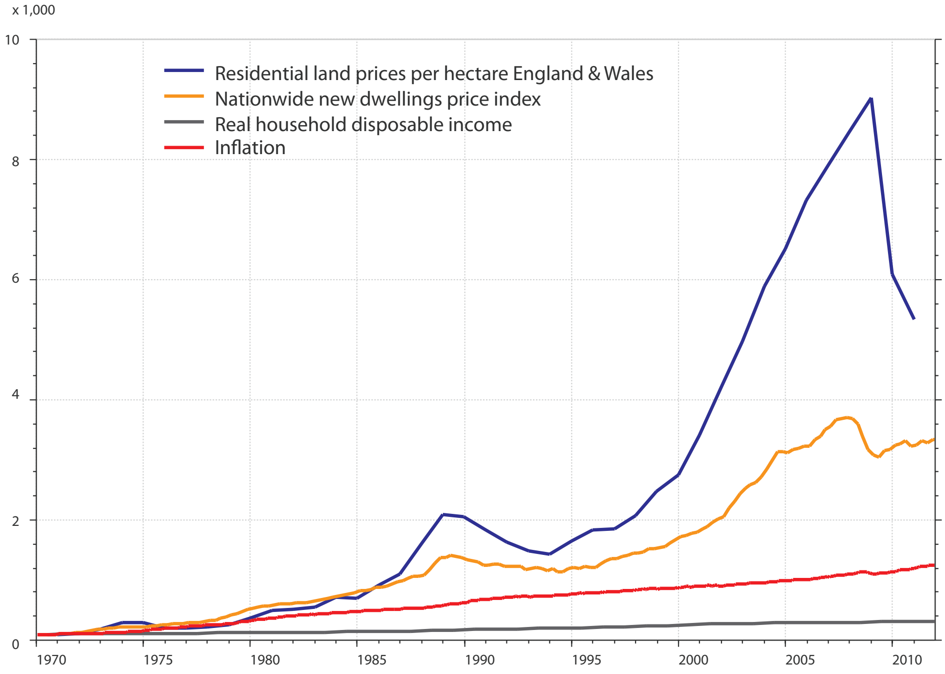
The binary nature of the argument between conservatives and social democrats about the failure of markets is unhelpful at best. As a result of this debate, the idea of progress seems to have been forgotten with debate focusing on more regulation vs less regulation and more government vs less government. Markets only improve when there is effective regulation which in turn requires there to be effective government. Progress requires that markets generate socially optimal outcomes in the first place, but in order to achieve this, governments need to intervene at the institutional level to correct market failures instead of taxing and redistributing. Although this is technically more complex and does not offer attention grabbing headlines, it is incumbent on social democrats to rekindle their radicalism and begin to focus on these micro issues to ensure that progress becomes a reality once more.

So how might progressive politicians approach the problem? A cursory analysis of welfare expenditure highlights probable market failures to the extent where government has already had to tax and redistribute resources. Two areas that are of immediate interest to this study are housing policy and pensions. In the UK, pensions account for around 17% of public expenditure and housing around 6%. However housing issues have a much broader impact on other parts of the economy such as productivity and labour mobility. The steady increase in budgets for both departments over time suggests that governments of left and right have not been able to improve the outcomes of these markets. However, there is no reason why a radical approach to market redesign cannot be engineered, thus engendering a more socially optimal outcome and consequently reducing the macro policy of tax and redistribute.

The problem with housing

It is widely accepted that the UK has a growing problem with the provision of housing services. As highlighted below in chart 1, the cost of new dwellings has grown at a much higher rate than income mainly due to rising land prices, resulting in a number of significant economic problems.

Chart 1: Land prices, house prices, income and inflation[2]



Source: Thomson Reuters Datastream, VOA, Housing & Construction Statistics

2 Residential land prices are based on the price index per plot for residential housing at a constant average density for England and Wales. The series collected by the Department for Environment was used from 1963-2000 and published in Housing & Construction Statistics. Between 2000 and 2010 the series compiled by the Valuation Office published by the Department for Communities and Local Government was used. There are two differences between the datasets which have led to marginally higher land values on the latter. The VOA data is for England only and uses valuations as opposed to actual transactions. This was changed because of the substantial reduction in land transactions.

The rising cost of housing services means that an ever greater portion of a households' income is being directed to pay for housing services away from other goods and services. Moreover, the ratio of house prices to income, which has risen from 2.65 in 1961 to 5.24 in 2011, implies that housing services as a portion of income has roughly doubled over the last fifty years. Today, households that pay for housing services through rent are spending on average 28% of their income on rent,[3] and in London it is substantially higher at 59%.[4] Given this rising proportion, governments have intervened in the market on a massive basis with the housing budget increasing 34% between 2008 and 2012 to £26.5 billion.[5] This has reduced the amount paid by renters to 18% (net rent). For home owners the payments are substantially lower at 14% (mainly due to artificially low interest rates), however, this ignores the savings required for a deposit which for first time buyers is now around £28,000.[6]

The shift of consumption towards housing services wouldn't matter so much if each house bought was a new build. However the ratio of new builds to the existing housing stock is around 1:215 and the acquisition of existing housing assets does not directly impact output. The services which help households buy and sell houses that do drive output and jobs are also produced when house prices are stable. Hence rising housing markets, by directing increasing resources away from productive activity have constrained economic growth and job creation. Moreover, without substantial government intervention to prop up consumption through an ever rising housing benefit bill, the economic effect of rising house prices would be substantially worse.

It has been argued that rising house prices are good for growth as they increase consumption through the so called "wealth effect". However detailed micro level analysis highlights that although consumption does tend to increase with house prices, so does borrowing.[7] In essence the effect is indirect with the rising value of housing permitting consumers to borrow more. Borrowing to increase consumption due to rising house prices is not a sustainable policy, and leads to volatile housing markets, which the recent financial crisis suggests ought to be avoided rather than actively promoted. It has also been argued that given the democratisation of home ownership rising house prices is beneficial as it helps top up pension income through home equity release schemes. I.e. it is not just large landowners that benefit from rising land values. However the question for public regulation is whether society should be encouraging a system that depends on "monopoly" pricing to generate future income streams. Moreover, such an approach does nothing for the 36% of households who do not own their own property. The evidence of the benefits of capital accumulation versus monopoly effects and the extraction of economic rent is overwhelming, and something that Adam Smith was at pains to highlight.

Indeed, Smith was resolute that rising and high land prices did little for capital accumulation and the process of wealth creation. He argued in the Wealth of Nations that, "[the same regulations] keep so much land out of the market that there are always more capitals to buy than there is land to sell, so that what is sold always sells at a monopoly price…To purchase land is everywhere in Europe a most unprofitable employment of small capital…The small quantity of land therefore which is brought to market and the high price of what is brought thither prevents a greater number of capitals from being employed." Of course landowners do benefit from this as do businesses that rely on rising land prices to make a profit. However, as Smith implied these profits are "monopoly" effects which act as a constraint to capital accumulation and wealth creation. So what might be done to improve the public regulation of the market itself as Adam Smith would have recommended?

There are a number of drivers behind this inexorable rise in land prices. Firstly the planning system has created a problem given that insufficient land has been allocated for housing leading to a massive differential between the value of agricultural land, and land with planning permission for housing of £20,000 per square acre to £1.87 million per square acre respectively.[8] Secondly, the pattern of land ownership which in the UK remains highly oligopolistic[9] allows landowners (in non-

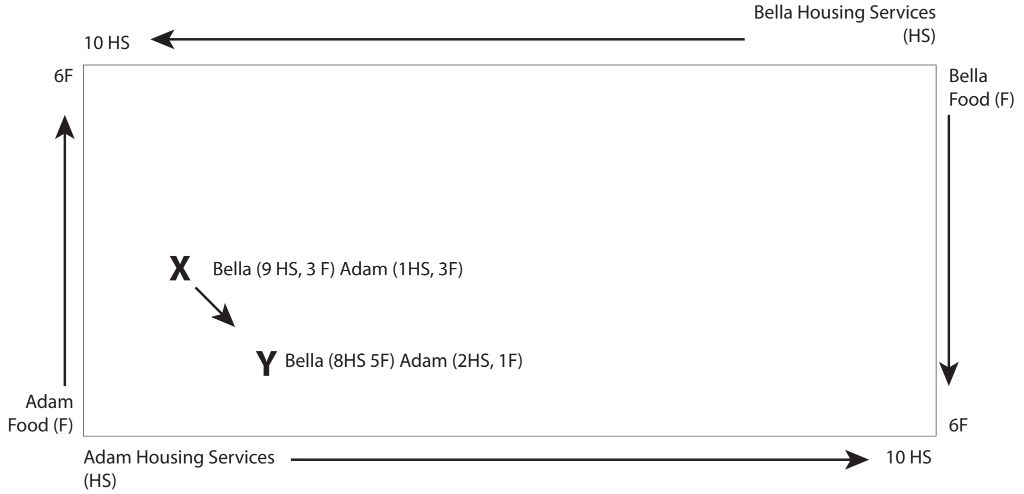
3 ONS, Housing Expenditure December 2012
4 Data from Shelter quoted in http://www.bbc.co.uk/news/uk-england-london-20943576
5 Table 5.1 Public sector expenditure on services by departmental group 2012 - 2013
6 According to Shelter, deposits are 20% of the average first time buyer property. A couple earning average salaries need to save a fifth of their income for 6 and half years to meet this level. http://england.shelter.org.uk/
7 See Campbell J. and Cocco J. (2005) How do house prices affect consumption? Evidence form micro data
8 IPPR Together at Home June 2012
9 Who owns Britain, Kevin Cahill

green belt areas) to drive profits by restricting supply. Thirdly, there is no tax on the profits of rising land prices even though those profits have been generated by the industry of others. Lastly, central and local government have not been particularly effective in managing their land holdings in the public interest.

Given the benefits that rising land values have for a certain portion of society, the housing debate has generally not been approached from the market failure perspective, but rather as an effect of rising capital accumulation. Moreover the idea that society has decided to intervene in the market to support the acquisition of housing services has traditionally focussed on ideas of fairness rather than market failure per se. One way of trying to resolve such problems is to use a simple model of two people bargaining their goods to understand where markets are failing if it all. In the 19th century the Irish economist Francis Edgeworth developed a very useful tool to analyse the process of exchange between two parties known as the Edgeworth Box. It showed that for any initial allocation of two goods between two people, the process of exchanging goods benefits both sides of the trade as long as the exchange does not leave either party worse off. This tool has been subsequently used to argue for free trade and defines what is known as Pareto optimal exchanges where neither party is left worse off.

In the following example Adam and Bella have been given an initial allocation of housing services and food, and are bargaining to improve outcomes without making either of them worse off than the initial allocation. The initial allocation of goods between Adam and Bella is at point X where Bella has 9 units of housing services and 3 units of food and Adam has 1 unit of housing services and 3 of food.

Diagram A: Purchase of housing services



They then make a trade as Adam wants to increase his consumption of housing services and is willing to bargain 2 units of food for an extra unit of housing services with Bella. Bella also wants to increase her consumption of food. The result of the trade is point Y. Given this exchange has been made voluntarily and both see the trade as an improvement it can be assumed to be a Pareto efficient point which leaves neither party worse off.

If we now add the market clearing price of housing services, which in this case costs 3 units of housing services, Adam's exchange to point Y does not leave him in a worse off position but given the initial allocation of goods, he is unable to buy the cheapest form of housing. Indeed, even if he sells all his food with the market price of food to housing at 2:1, it is impossible for Adam to achieve his goal of buying housing services. Indeed, the idea that this trade is Pareto efficient in many respects is central to the problem because Pareto's framework fails to take account of the initial allocation of resources. However is this a market failure, or just an optimal outcome that society sees as unfair and therefore is willing to stump up cash to redistribute?

The process of entering into and adhering to the rules of an exchange is contingent on there being a benefit for both parties. If it is not possible to make exchanges for what Smith argued were the necessities of life, then Pareto's framework in this instance cannot be said to be optimal. Therefore rising and high land prices are clearly a market failure given that part of society is unable to acquire such services without government intervention. Smith observed in the 18th century that the wages of a labourer *could* afford him the necessities of life including "food and clothing, the comfort of a house, and of a family" but not much more.[10] Smith's concerns on the "monopoly" pricing of land suggests that society has in fact regressed rather than progressed. As such, the housing market's inability to provide housing services at market clearing levels that are affordable without the need for massive government intervention can only be described as a catastrophic market failure.

Any resolution to this market failure needs to result in falling or at least stable land prices permitting Adam to buy housing services based on an initial allocation. A number of policies might be implemented to achieve this goal thereby restoring the efficient functioning of the market. Levying a tax on unearned profit, or economic rent, has been considered by most economists from left and right as being the most efficient solution.[11] That means where communities decide not to allow house building thereby driving up land prices and the value of their homes, they should have to pay a tax on this rise in land values (excluding the value of capital sitting on the land) as their decision has worsened the market failure. As Winston Churchill argued in the House of Commons in 1909:

Roads are made, streets are made, services are improved, electric light turns night into day, water is brought from reservoirs a hundred miles off in the mountains— and all the while the landlord sits still. Every one of those improvements is effected by the labour and cost of other people and the taxpayers. To not one of those improvements does the land monopolist, as a land monopolist, contribute, and yet by every one of them the value of his land is enhanced. He renders no service to the community, he contributes nothing to the general welfare, he contributes nothing to the process from which his own enrichment is derived.

Such an approach was broadly recommended by the Mirrlees Review on reforming tax. It argued that business rates ought to be based on frequent land valuations instead of the current approach, particularly as there is increasing evidence that business rates have been a significant factor in increasing unemployment in the retail sector.[12] For housing, the Mirrlees Review proposed a Housing Services Tax, which in many respects would be similar to extending council tax bands returning to something to akin to domestic rates.[13] Critically, moving towards taxing unearned profits as opposed to income earned through hard work and effort is more conducive to ensuring both fair and efficient outcomes and critically to support the growth of capital and labour. This is how Adam Smith saw progress. Efficient markets would permit prices to fall allowing real wages to increase.

The problem with pensions

The rising cost of pension provision is becoming increasingly problematic in advanced economies for a variety of reasons. Firstly is the fact that the retirement age has not risen proportionally to longevity, thus driving up costs substantially. Secondly, the provision of these benefits to some extent still comes from taxing current workers rather than from investing in financial assets. This issue is becoming more acute given that the ratio of pensioners to workers is increasing in advanced economies. Thirdly, where returns do come from investing in financial assets, the returns have been insufficient resulting in a demand for incremental welfare benefits paid for by a macro tax-and-redistribute policy. The first two issues are policy decisions rather than market failures, however the third is a market failure largely caused by asymmetric information.[14]

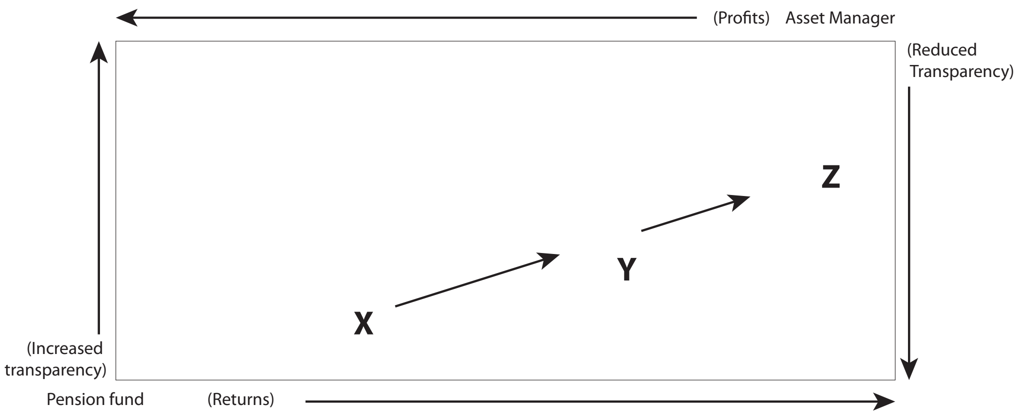
10 Smith, A., Theory of Moral Sentiments
11 See a list of economists from left and right advocating such an approach http://earthfreedom.net/lvt-advocates
12 http://www.telegraph.co.uk/finance/newsbysector/retailandconsumer/10160982/A-blueprint-to-overhaul-business-rates-and-help-save-the-high-street.html
13 Domestic Rates were charged at a percentage of the estimated rental value of the property
14 Stiglitz J., Weiss A., Credit rationing in markets with imperfect information 1981

Despite the fact that the average OECD pension fund has barely returned the rate of inflation since 2001, mainly due to volatile equity markets[15], asset managers have still earned substantial profits. Asset managers it appears do not have exactly the same interests as their pension fund clients. Indeed, according to a recent report asset managers have little incentive to either improve the performance of the companies that they invest in or to improve the absolute return they give back to pensioners.[16] Moreover, the lack of information provided to a pension fund of exactly how the management fees are spent by the fund manager creates an information asymmetry. This makes it difficult for asset owners to ascertain where the positive and negative value drivers are and to compare these costs across providers.[17] Having access to this information would help in driving down the costs of the service thereby improving market efficiency. Hence as a result of this information asymmetry, the returns to pensioners are lower than they would have been, with the asset management industry according to some estimates retaining up to a third of the returns.[18] In essence the opacity of charges, which is benefiting the product providers, highlights that the market is not regulated in the public interest. However, major structural improvements that have come from within the industry itself highlight a potential path ahead for regulation.

The passive investment revolution instituted by John Bogle at Vanguard has been crucial to a fall in the amount of fees charged on certain financial products. Some estimates suggest that this revolution generated a tenfold increase in productivity when these funds were introduced as fees fell from 5% to 0.5% on passive funds. Bogle argued that there was a direct conflict between the model of active asset managers who wanted to earn high fees from advice and the interests of the asset owners who wanted to generate higher returns.[19] Moreover, according to Bogle, there was little evidence that "expert" investment advice led to higher returns. As a result Bogle advocated that paying low costs for market returns through an index tracker fund such as the S&P 500 was the most effective way to invest. Most of the academic research in this area over the last 40 years has proven Bogle right.[20] Although around 25% of funds are now passively managed, there is still a large amount of active management that is extracting economic rent due to lower information disclosure.

Using the Edgeworth Box again, we can map out how the industry has changed with increased transparency over time, generating better returns for pension funds at the expense of profits earned through "monopoly" pricing. The analysis implies that by forcing regulatory change to expose more information, pension fund returns would improve further at the expense of economic rent flowing to asset managers. This would lessen the need to continue with macro tax and redistribute policies.

Diagram B: Information transparency, asset manager profits and pension fund returns



Point X is an approximation of the relationship between information transparency, asset manager profits and pension fund returns before the index revolution in the early 1970's. The returns to pension funds after costs were less than stellar and neither was there much transparency. Conversely,

15 OECD Pensions Outlook 2012
16 Kay review of UK equity markets and long term decision making 2012, paragraph 2.5
17 LCP Investment Management Fees Survey 2013
18 Analysis undertaken by David Norman at TCF Investments
19 Bogle J. The first index mutual fund 1997
20 Baks, Metrick & Wachter (2001) Should investors avoid all actively managed mutual funds?

the asset manager did very well with good returns, increased by limited or negative transparency. Through time part of the industry has shifted to point Y, largely as a result of the Bogle revolution which marketed low cost funds that provided market returns through tracking an index. The profits to Vanguard and other index tracking funds are therefore driven by scale and a continuous focus on cost reduction and productivity. This allowed investors to have exposure to market returns whilst ensuring that the costs they were paying for this exposure were kept to a minimum. Given that on average, fund managers are unable to continuously beat the market, the returns flowing to pension funds after costs have been higher from index funds than active funds. This implies that active fund managers are still able to generate substantial profits without providing the value back to their client.

If we now turn to point Z in the box, which is an aspirational point where the returns to pension funds would increase at the expense of asset manager profits from "monopoly" pricing. This outcome, which would be realised through increased transparency, would be more efficient and thus reduce the need for incremental tax and redistribute policies. However for the industry to move up to point Z where profits to fund managers are based on the value they are adding rather than their ability to extract economic rent, new rules on information transparency will need to be introduced and enforced. Such rules would need to detail how much is spent on research, trading costs how often the portfolio is churned as well as platform fees, advice and administrative costs. More importantly individual savers should be able to see these costs on their statement and how they impact their own returns in money terms over the life of the pension as well as in per cent.

A system of mandatory disclosure of the detailed costs for all funds would help the industry to drive down costs leaving less room for the extraction of economic rent and therefore higher returns flowing to pensioners. This in turn would lead the fund management industry to search for new ways to add value such as improving corporate governance which would help drive absolute returns. By focussing on making markets work, progressive politicians would be able to improve outcomes for all in society without having to solely depend on a macro-based tax and redistribute policy.

Conclusion

Social democrats need to move away from their current macro tax and redistribution policies towards making markets work at the micro level. By failing to address underlying structural issues at the heart of market failures, progressive politicians have in effect conceded the debate to conservatism. This paper shows that market failures within the housing and pensions sector have led to a significant reallocation of resources based on a macro approach of taxing and redistribute due to perceived unfair outcomes. However tax and redistribution policies are increasingly seen by the electorate as an ineffective response to the underlying market failure. Through effective regulation progressive politicians can improve the efficiency of market outcomes alleviating the need to redistribute – an implementation of the ideas of pre-distribution.

The history of radical politics since the idea of progress was formulated during the enlightenment has been one of addressing the root cause of these issues to ensure that life for all sections of society improves. This is where social democrats need to reposition themselves in order to make Smith's vision of progress become a reality once more: Making markets work for the benefit of society is central to this progress.

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