



Market Failure, Government Failure, and the Hard Problems of Cooperation

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Diagnoses of market failures are used to justify government cooperation, but government regulations have their own costs. Economists debate whether market arrangements may be superior despite their imperfections. As I shall argue in this brief essay, the terms of this debate are misleading. When taken literally, the notion of a market failure is of little relevance, because perfectly competitive equilibrium, the benchmark against which markets "fail," does not obtain. Questions about the failure of government regulation are also often badly posed, because markets cannot exist without government regulation in the form of coercively protected property rights. Debate over whether government regulation should be instituted to remedy market failures should be recast as an examination of the whole range of benefits and harms particular markets cause coupled with an examination of the specific benefits and harms of government actions to address such harms.

1. COOPERATION AND MARKETS

It's not easy for large numbers of people to coordinate their behavior. Even when conflicts of interest are relatively minor and the advantages to cooperation are considerable, it is hard to align the motives of the members and difficult even to communicate what needs to be done. These problems can be solved by social norms or if there is some sort of authority structure capable of speaking for the group members and enforcing its decisions. The solutions that governments can directly provide are however expensive and clumsy, and social norms cannot be wished into existence. In many circumstances markets can do better. No single institutional framework constitutes "the market." Actual markets differ depending on the legal framework that defines property rights and specifies the methods and limits of exchange. Some markets are open to everyone; others are open only to a narrow group of individuals or corporate bodies. Many markets involve money; others are non-monetized. Whether traders can keep what they trade for or whether the government or the organizer of the market gets a share varies. Different markets permit or prohibit the exchange of different things.

There are many ways in which markets can do better than centralized control at securing cooperation. They might, for example, involve less overt coercion, and as Adam Smith pointed out, they may free individuals from traditional subjugation (1776, Book IV, Ch. 2). There are also ways in which markets may do worse. To the extent that "everything is for sale," other values may be undermined. The individualism of the market may diminish social solidarity, and factory organization can stunt human development (Smith 1776, Book V, Chapter 1, Part 3). Market outcomes may be unjust. Economists have focused on only one particular way in which markets may do better: they may be better at satisfying people's preferences than other institutions. And economists conceptualize the ways in which markets may perform badly as market "failures."

2. MARKET FAILURE

The notion of a market *failure* might be understood as a case where a market fails to satisfy preferences. Francis Bator begins his classic article, "The Anatomy of Market Failure," as follows:

What is it we mean by "market failure"? Typically, at least in allocation theory, we mean the failure of a more or less idealized system of price-market institutions to sustain "desirable" activities or to estop "undesirable" activities. The desirability of an activity, in turn, is evaluated relative to the solution values of some explicit or implied maximum-welfare problem. (1958, p. 351)

So one might think that the theory of market failure would deal with the ways in which markets fail to maximize welfare (interpreted as preference satisfaction). But since economists typically reject the possibility of making interpersonal comparisons, questions concerning market failure must be narrowed to questions concerning *efficiency*. And indeed the most common definition of a market failure seems to be "where the allocation of goods and services by a market is not efficient" (Wikipedia). Efficiency is in turn construed as Pareto optimality.

Inefficiency, which is a defining characteristic of a market failure, is supposed to be bad. The next sentence in the Wikipedia entry reads, "Market failure can be viewed as a scenario in which individuals' pursuit of self-interest leads to bad results for society as a whole." But Pareto inefficient outcomes are not necessarily bad results for society as a whole, because people may be happy to trade off efficiency for other values and because no Pareto efficient outcome may be feasible.

The theory of market failure is not concerned with the general question of when markets are efficient and in that specific regard beneficial, let alone with the whole panoply of ways in which markets may be harmful. One way to see this is to note (as critics of the literature on market failure, particularly from an Austrian perspective, have pointed out), that markets may "fail" even though there are no feasible institutions that could produce a more efficient outcome (Cowen 1988). Furthermore, as Bator suggests in the quotation above and makes

explicit later in his article, the theory is concerned with the failure of a "more or less idealized system of price-market institutions," not with the nitty-gritty failures of actual markets. The massive waste of economic resources that result from mistaken expectations by market participants concerning weather, wars, or fashions are market mistakes, but they are not in the purview of Bator's theory of market failure, which is concerned with when "even errorless profit- and preference-maximizing calculation in a stationary context of perfect (though limited) information and foresight to fail to sustain Pareto-efficient allocation" (1958, p. 352).

The theory of market failure, which might have appeared at first to be a normative inquiry into the circumstances in which markets may fail to be beneficial in some regard or other, thus turns into a theoretical inquiry into those factors that impede the Pareto-efficiency of markets even under idealized circumstances. Many theorists do not limit the sources of market failures as narrowly as Bator does. The causes of market failure may include limits to competition such as monopoly and oligopoly, limits to information, especially when they are asymmetrical, force and fraud, transactions costs, undefined or ambiguous property rights, preference interdependencies, and incomplete contracts.

Even though economists differ in what factors they take to be causes of market failure and which are practical complications from which theory abstracts, conceiving of market failures as departures from perfect competition reflects the theoretical preoccupations of economists. Taken literally, it is arbitrary and of no practical use, because it implies that market failures are ubiquitous and unavoidable. Since perfect competition is impossible, there are no market successes, and it is difficult even to define what it would mean to get "close" to a market success. Economists have little idea what the many possible perfectly competitive equilibria would be like and, given the theory of the second best, they have no reason to believe that curing specific market imperfections brings the economy closer to the fantasy of a market without any of the sources of market failure. Furthermore, as those who trace market failures mainly to transactions costs have pointed out, it seems arbitrary to regard transactions costs as causing prices to diverge from those that successful markets would determine, while regarding other costs, such as those involved in transportation or marketing, as properly reflected in the prices of perfectly functioning markets (Cowen 1988).

3. APPLICATION OF THE THEORY OF MARKET FAILURE

Whatever practical value of the theory of market failure may have lies in the list it provides of ways in which individual markets (as opposed to the whole economy) can "go wrong." To pursue this line of thought, economists cannot however take a global perfectly competitive equilibrium as the benchmark in terms of which individual markets fail. What economists need to do instead is to suppose that they can examine the functioning of an individual market or some small set of interdependent markets and "bracket" the rest of the economy. Call this "separability" – *the assumption of the separability of market failure*. As the theory of the second-best implies, it is false in general, though it could be a reasonable approximation with respect to some markets. It implies that any improvement in the

operation of the specific market or markets under examination is an improvement in the economy as a whole. The worse the consequences of the imperfection in the specific market or markets, the more reasonable it seems to assume separability of the failure of the specific market from success or failure elsewhere. But actually justifying the assumption as a reasonable approximation is difficult and rarely undertaken.

If economists assume the separability of market failure, then theoretical work on market failures provides them with a checklist of the possible causes of failures of the particular market or markets they are studying. Absent any of these factors or any excess supply or demand, one has a market success. The value of this checklist is questionable for two reasons. First, the presence of possible causes of market failure does not imply that there is a market failure. A monopolist might, after all, charge the competitive market price. A confidence man might bring about just the result that would have occurred without the fraud. To be sure, the presence of possible causes of market failures raises red flags, and, assuming separability, it is never harmful to efficiency and sometimes beneficial to eliminate possible causes of market failure. But assuming separability does not make it true, and eliminating some of the causes while leaving others in place can in fact make things worse. There might not be a market failure, and if there is, one possible cause of market failure can neutralize another.

The second reason why the checklist of possible causes of market failures is of limited use is that markets that do not "fail" may nevertheless have harmful effects, including consequences for preference satisfaction. In the case of so-called pecuniary externalities, such as those that occurred when power looms destroyed the livelihood of hand weavers or computers put typesetters out of work, there is no inefficiency – the outcome is Pareto optimal. Nevertheless, some people have benefited and others have been harmed. Moral questions about whether to attempt to improve upon the market outcome are in order (Hausman 1992).

4. MARKETS VS. GOVERNMENT

Armed with this cursory account of market failure and its relationship to the wider range of harms markets can do, we can now turn to the question of whether government intervention is justified. Even those economists who are most hostile to government action recognize that government actions can sometimes improve upon market outcomes. They can do so either by substituting some other mechanism of coordination for the market or by changing the setting and rules for markets. Government interventions are not costless, and there are many cases where it is better to live with market failures than to call on the government to fix the problem. But there is no way to make the general case that government intervention is always harmful. The most that fans of *laissez-faire* can reasonably maintain is that a "constitutional" barrier to government intervention will have better efficiency effects than attempting to calculate on a case-by-case basis whether it is better to intervene (Brennan and Buchanan 1985).

Even that case is unsustainable, especially when one considers the many ways in which markets can cause harms and the fact that market malfunctions often trace back to previous governmental action. Improvements in the effectiveness of the enforcement of contracts, the protection of rights, and the arbitration of disagreements enhance efficiency at low cost. Clarifying property rights, especially in the context of technological changes that give rise to new kinds of property, typically enhances efficiency, although the costs can be considerable, since such clarification, particularly in the form of patents, copyrights, and various government regulations are responsible for many monopolies.

Government intervention with respect to a specific market faces major problems: (a) administrative costs, (b) lack of information, (c) rent-seeking, (d) unforeseen consequences for other markets, (e) inflexibility, and (f) corruption. There is no simple formula that determines when intervention is justified. Here are three simple rules of thumb:

1. As the regulatory and administrative apparatus that is required grows, it becomes more difficult to justify the intervention.
2. If the intervention imposes large costs on a small number of agents or provides them with the opportunity to enjoy large benefits, then the dangers of rent seeking and corruption will be greater and, other things being equal, it will be harder to justify intervention.
3. If the products, technology, or organization of the market are changing rapidly, then it will be harder to base policy on good information, harder to anticipate consequences for other markets, harder to be flexible, and thus harder to justify government interference.

5. CONCLUSIONS

Markets are versatile and sensitive institutions, and even if they cannot do everything, they can do many things extremely well. They can cause many harms, too; and the theory of market failure captures only some of these harms. Market outcomes are highly sensitive to the institutional details, which means that there are often many different market solutions to social problems, each with a different mix of costs and benefits. Rather than conceiving of social problems as either market failures or matters for somebody else to worry about, normative economists can play a more constructive role by focusing on how institutional design bears on a wide range of relevant values.

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