Market Failure:

A Failed Paradigm

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Market Failure: A Failed Paradigm[1]

Philip Booth[2]

If I were to give you an engineering lecture and I were to start by saying, correctly I believe, that the maximum theoretical speed of a perfect car was the speed of light[3] and that a car that travelled at any speed lower than that was a 'failed car' or suffered from 'car failure', you would probably think that it was a pretty useless lecture. And you would be right.

Yet, a common approach in economics teaching is to teach the preconditions of a so-called perfect market – full information, no transaction costs, no externalities and so on – and then look at how markets, in practice, deviate from that textbook model. We then call those deviations 'market failures'. This is despite the fact that it is as impossible to have a perfect market as it is to have a perfect car.

Intuitively, despite not being engineers, you probably understand the best approach when evaluating cars – you take two cars and look at different characteristics and evaluate which is best for a particular purpose. When economists teach about market failure they, instead, suggest policies which governments could, *in theory*, use to make an imperfect market perfect regardless of whether it is possible, in practice, to improve economic welfare by adopting such policies.

The obsession with the market failure approach to policy analysis is relatively new and can probably be ascribed to Pigou. The obvious example, coming from Pigou, is the idea of the optimal tax to deal with pollution. If my factory pollutes your land, the argument goes, the problem can be solved with an optimal tax on my activities. The problem is that we do not know what that tax should be. People's preferences for different economic goods are only revealed by the prices they pay in market transactions.

The government could only have the information to work out the optimal tax if it had all information about the costs and benefits of all potential uses of economic resources. If it had that information, then centrally planning the economy more generally would work. And yet we know that central planning is a catastrophe. The idea seems to be that we have a perfectible government that not only always acts in the interests of market participants but also has the information to correct imperfections in markets. This is surely, the only rationale that can be used to justify the automatic acceptance of government intervention to deal with so-called failings in markets.

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[1] This brief talk was given to an IEA Teachers' Conference in June 2008. As such it is designed for discussion and is not rigorously referenced.

[2] Editorial and Programme Director, Institute of Economic Affairs;
Professor of Insurance and Risk Management, Cass Business School.

[3] This example is not original – I believe it was first suggested by David Friedman.

Regulatory Bodies

This approach to teaching economics is then applied in practical policy. Many regulatory bodies in the UK have adopted the market failure approach to regulation. This means the development of regulation can involve a process by which the regulatory body identifies market failures and then develops instruments focused on 'correcting' them. This statement by the Financial Services Authority (FSA) is of interest:

The FSA has said:

> 'In meeting our objectives in a manner consistent with the principles of good regulation, we have adopted a regulatory approach based on correcting market failure...There are, however, numerous cases where unregulated financial markets will not achieve the best outcome due to some form of market failure, making action on our part *necessary*.'
>
> (FSA, 2003, my emphasis).

This is a strong statement, because all markets fall short of the perfect market model in some way so this suggests no limit at all on regulatory intervention. The last phrase, that government intervention is *necessary* is particularly telling.

Insights of Public Choice Economics

Public choice economics has some uncomfortable messages for the market failure paradigm.

The most important premise of public choice economics is straightforward: we should not assume that people will behave in one way in the political arena and in a different way in the economic arena.

In the economic arena we generally recognise that agents act in their own best interests and that they have imperfect knowledge. In the political sphere agents will have those characteristics too. That is not to say that all agents in the political sphere will act only in their own best interest: altruism is possible in both the political and economic arenas. However, it is prudent to adopt a working assumption of the pursuit of self-interest when judging the acts of voters, bureaucrats and politicians.

There are a number of implications that arise from combining the assumption of the self-interested participant in the political process with our understanding of various administrative aspects of the regulatory process. They are as follows:

- Bureaucrats cannot 'correct' market failure, even if they wished to do so, because they lack the information to know what the outcome of the market process would have been had the so-called 'failure' not existed.

- Bureaucrats will act in their own best interests, taking courses of action that will lead to promotion and advancement. They are likely to wish to avoid scandal, thus becoming risk-averse, so they may regulate to

reduce risks to a greater extent than consumers desire. They will also wish to increase the size of their regulatory bureau.

- Electors in general have no interest in being perfectly informed about political issues because the probability of an individual's vote impacting on the result of an election is tiny.

- Because of this, there are information asymmetries between regulatory bureaus and those to whom they are ultimately accountable: electors. Thus electors are at a relative disadvantage when assessing the merits of proposed regulations.

- Where the benefits of government action are concentrated among particular voter groups, or institutions or companies, such groups have an incentive to lobby for increased regulatory protection. Where the cost of such regulation is dispersed among voters the losers will have no incentive to lobby to oppose increased regulation because the expected cost of lobbying to the individual voter will be large relative to the expected benefit.

- Politicians will, other things being equal, respond to the preferences of the 'median voter' rather than act to create regulatory institutions that might address genuine problems of market failure.

The features described above tend to bias political institutions in favour of a greater level of regulation than will lead to welfare maximising solutions. It will also bias political institutions in favour of forms of intervention that benefit interest groups on which benefits are concentrated. So, if we are to use the 'market failure' concept at all, which I do not think we should, we should be careful to balance it with the idea of 'government failure'. Public choice economics suggests that it is not possible, in practice, to ever perfect a so-called imperfect market. But, we can go further than this and I would suggest that we ditch altogether the market failure idea. We can come to this conclusion by understanding better the process of competition.

Insights from Austrian Models of Competition

The textbook model of perfect competition is a situation where there is perfect knowledge, and where identical products are sold at a price equal to marginal cost. This leads, when combined with other assumptions, to all opportunities for welfare maximisation being exploited. But it should be obvious that a perfectly competitive market cannot exist. If we had perfect competition prevailing, there would be no innovations or product differentiation. If consumers or producers were to discover new knowledge, either it would have to be shared immediately with all others in the market or the state of perfect competition would come to an end. Yet new knowledge and innovations occur continually in real life markets. Indeed, an economy in which this was not the case would be regarded as stagnant.

So competition should be understood as being the *process* by which consumers and producers seek new knowledge to enable the production of new goods or existing goods at lower cost, thus enhancing welfare. If the theoretical ideal of perfect competition were to exist, the *process* of competition would have come to an end.

So, I would argue that, if we are to have regulatory interventions then they best serve the market by removing inhibitions on the process of competition rather than by trying to recreate the hypothetical result that arises from so-called perfect competition.

There is a second problem, too that comes from this market failure model. The absence of perfect competition means that there are some undiscovered opportunities for enhancing consumer welfare. But what are they? We cannot know because we require the process of competition to discover them. A regulator cannot know what the undiscovered opportunities for welfare enhancement in an imperfect market actually are. Thus, as Hayek put it, 'If the factual requirements of "perfect" competition are absent, it is not possible to make firms act "as if" it existed.'

Alternatives to Market Failure

So, if we should not use the market failure approach, what should we do? One approach is to evaluate which of alternative approaches to economic organisation is most effective – both in theory (under certain assumptions) and in practice. That is what we do when we compare racing cars. There are other approaches too. I started with the example that my factory may be polluting your land. How should we deal with this? Pigou suggested the optimal tax. An alternative is to think how the market can be made more complete by defining property rights properly so that you can pay me not to pollute (if the right to pollute is legally mine) or I can pay you for the right to pollute (if the right not to be polluted is legally yours). This is a much better solution than the so-called optimal tax. It can lead to a solution that reflects the preferences of the people involved in the transaction rather than those of bureaucrats who are disciplined through a very imperfect mechanism of their political masters being subject to quinquennial elections. So, instead of having governments correcting failed markets, governments can focus on trying to remove the institutional constraints on markets becoming more complete.

But we then get into perhaps more difficult areas, such as controlling CO2 emissions, where what I do in London might affect somebody in (say) Pakistan. The transactions costs may be too large to develop a solution that involves making the market more complete. But, nevertheless, public choice economics, Austrian ideas of competition and insights from Coase do give us a better framework of thinking. We should not be asking ourselves the question, 'what is the optimal tax?' but a series of more subtle questions such as, 'given what we know about the imperfections of government, might non-intervention be better than intervening?', 'if we intervene, how do we minimise the possibility of bureaucratic capture?', 'how do we ensure that rights to produce CO2 are held by the people who value them most?'. These are the

sorts of questions that I think classical economists would have wanted to address. Those who pursue the market failure approach to analysing how to put right the wrongs in imperfect markets, end up posing a conceptually simple question that has no practical answer.