Governments Create Problems; Markets Fix Them

My article "Complete Liberalism" prompted an unexpected challenge. An interlocutor, who says he owns a business and thus is not antibusiness, claimed that my article suggested that, unlike government regulators, businesses never get things wrong. Yet business failures outnumber successes 10,000 to one, this person said, for all kinds of reasons, both innocent and malign, including a desire to pull the wool over consumers' eyes for as long as possible.

The problem with the comment is that my article never claimed that business people always get it right or are always virtuous. I've pointed out repeatedly that the best economists — especially the Austrian economists — never ignore the inherent existence of error in describing how markets work. And libertarian writers have never suggested that business owners cannot have bad intentions, which are magnified by access to state power. Quite the contrary! What these thinkers have emphasized are the systematic incentives and disincentives produced by free competition that reward pro-consumer performance and penalize incompetence and malevolence. Think of all the libertarian criticism of the malignant relationship between business and government. Now think of Ayn Rand's businessmen-villains in *Atlas Shrugged*.

One need only read the accessible writings of Ludwig von Mises ("Profit and Loss," *Bureaucracy*), F. A. Hayek ("The Use of Knowledge in Society," "Competition as a Discovery Process"), or Israel Kirzner ("Economics and Error") to see that the plague of uncertainty, error, and incomplete and dispersed knowledge figures heavily in good economic analysis. The question they sought to answer is: how can people coordinate their productive social cooperation in the face of such ignorance? Individual freedom produces the only answer for a great society: prices.

In fact, if it weren't for imperfect knowledge, free markets would be unnecessary and profit and loss would disappear. Mises wrote:

> If all people were to anticipate correctly the future state of the market, the entrepreneurs would neither earn any profits nor suffer any losses…. What makes profit emerge is the fact that the entrepreneur who judges the future prices of the products more correctly than other people do buys some or all of the factors of production at prices which, seen from the point of view of the future state of the market, are too low….
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> On the other hand, the entrepreneur who misjudges the future prices of the products allows for the factors of production prices which, seen from the point of view of the future state of the market, are too high. His total costs of production exceed the

> prices at which he can sell the product. This difference is entrepreneurial loss.

It’s hard to believe that an economist who writes about entrepreneurs with correct or incorrect judgments about the future could have thought that business owners were infallible. Economic analysis, after all, is supposed to be about real human beings who, whether they are acting as producers or consumers, are fallible.

The free-market position is that free and competitive markets are not perfect *but better* than government bureaucracies at detecting and correcting errors about what consumers will want and what they will be willing to pay. That’s what counts, isn’t it? Since omniscience is not an option, we want the *best method available*. That’s all we can hope for, and it turns out not to be too bad. We must always ask about any touted solution to a problem: compared to what? Thomas Sowell’s Law — “There are no solutions, There are only tradeoffs” — is relevant here.

David D. Friedman is another important scholar who has shed on the relative merits of bureaucracies and markets in his important article “Do We Need a Government?” (I recommend his video lecture.) Friedman addresses a different matter than the one I’m concerned with, namely, the collective-action problem, one manifestation of which is called “market failure.” But much of what he writes applies. Here’s the key, which is about systematic incentives:

> In private markets, most of the time, an individual who makes a decision bears most, although not all, of the resulting costs, and receives most of the resulting benefits. In political markets that is rarely true. So we should expect that the market failure that results from A taking an action most of whose costs or benefits are born by B, C, and D should be the exception in the private market, the rule in the political market. It follows that shifting control over human activities from the private market to the political market is likely to increase the problems associated with market failure, not decrease them.

This shouldn’t be controversial. We experience this as shoppers when we spend our own money on the very goods we then bring home and use, and as voters, where the disconnect among choices, costs, and benefits is stark. This has critical implications for both business owners and bureaucrats. A fundamental contribution of public-choice theory is that the normal principles of human action apply to government employees. Bureaucracies are filled with ambitious people too, so this is only fair. They don’t become sainted creatures with perfect knowledge and perfect virtue merely because they step across the threshold and take government jobs.

Incentives matter, as we all know first-hand. The same human being operating in two different institutional environments should be expected to behave differently. And indeed they do.

In a competitive — that is, free — market a business owner's mistake or bad conduct is someone else's chance to make a profit. Because entrepreneurs know this, they are on the lookout for errors. "Hence in a market society," Friedman writes, "there is an incentive for private parties to find ways around the inefficiencies due to market failure."

Nothing is more powerful than the profit motive, something that even opponents of the market readily concede.

The same incentive is not to be found in bureaucracies, which are not profit-and-loss organizations. Most important, bureaucrats don't have the price information that entrepreneurs have. Their revenue is obtained by force — taxation — and their "products" are not offered on markets where prospective buyers can pass them by for competing offerings. That's an entirely different ballgame from market activity.

Notice that bureaucratic failures are routinely portrayed as market failures (most people's economic ignorance leaves them gullible) and are used to justify even more government: larger budgets, bigger staff, and wider powers. If (alleged) market failures require more government, as some people believe, how can government failures require, not more markets, but more government?

We should want the incentives for spotting and fixing errors to be as undiluted as possible. The way to achieve that is to keep the government from interfering with people's peaceful activities.