Market Failure Theory as Reproach to Government Practice

The theory of market failure is a reproach to the free-market economy. Unless you have perfect competition, perfect information, perfect rationality, and no externalities, you can't show that individual self-interest leads to social efficiency.* And this anti-market interpretation is largely apt. You can't legitimately infer that markets are socially optimal merely because every market exchange is voluntary.

Contrary to popular belief, however, market failure theory is *also* a reproach to every existing government. How so? Because market failure theory recommends *specific* government policies – and actually-existing governments rarely adopt anything like them.

What do I have in mind?

1. When markets produce too much of something, market failure theory tells governments to impose corrective taxes that correspond to the severity of the excess – then let people do as they please. In the real world, in contrast, governments normally pass a phone book's worth of regulations. They rarely consider the cost of the regulations, and almost never just let people bypass regulations by paying a high fee. Thus, you can't buy your way out of an Environmental Impact Statement or heroin prohibition – and if the theory of market failure is right, this rigidity is deeply dysfunctional.

2. When markets produce too little of something, market failure theory tells governments to provide corrective subsidies that correspond to the severity of the shortfall – then let people do as they please. In the real world, in contrast, governments tend to directly run industries with alleged positive externalities. Public education and health care are the obvious example, but the same goes for national parks, government lands, etc. Furthermore, government firms routinely offer even non-rival products for gratis or next-to-gratis – even when the products have clear *negative* externalities such as road congestion and subsidized energy.

3. While the theory of market failure abhors monopoly, actually-existing governments do much to stifle competition. This is most grotesque for real estate and immigration, which most governments view with dire suspicion, but perhaps most blatant for occupational licensing. Again, if negative externalities were the real rationale for these restrictions, governments would just impose taxes – then let everyone build, move, and work as they please.

I could go on and on, but general point is that market failure theory does more than complain about markets; it also tells governments how to repair them. Any government that fails to comply with these impressively precise instructions ipso facto fails. Indeed, non-compliant governments are a textbook case of government failure. And while the severity of this government failure varies, every known government fails severely.

*Contrary to poorly proof-read textbooks, markets *can* yield social efficiency even if these assumptions are violated. A polluting monopoly is the classic example, but there are endless others. Standard assumptions are a sufficient, not necessary, condition for social efficiency.