The Myth of Market Failure

In the language of economics, a market failure is, as David Friedman writes, “a situation where each individual correctly chooses the action that best accomplishes his objectives, yet the result is worse, in terms of those same objectives, than if everyone had done something else.” As a rule, the pursuit of individual good in the market brings no such negative result. On the rare occasions when rational individual actions lead to regret by those same individuals, the result is labeled “market failure.”

When I say that market failure is a myth, I *don’t* mean to deny that such regrettable situations can occur. I only mean to deny that they are peculiar to the market. They can occur in all sorts of contexts, including the political context — hence we need a broader, more accurate term. I propose “group-rationality failure.” We might win some support for the free market if more people understood that this kind of failure is not unique to markets but rather is a feature of human action under certain special circumstances. Moreover, as we’ll see, this is less of a problem in the market than elsewhere. (For a discussion of various kinds of “market” failure, see Art Carden and Steve Horwitz’s “Is Market Failure a Sufficient Condition for Government Intervention?”)

A popular example of market failure is the negative externality from pollution. It would seem rational for each producer to avoid the expense of reducing or eliminating harmful emissions by spewing them into the air, but the result is dirtier air for everyone. (If there were only one polluter, the harm would be insignificant.) But similar phenomena occur outside of the market context. Friedman gives an example from warfare:

> *It is sometime in the 12th century, somewhere in Europe, and I am one of a line of men with spears, on foot, facing another bunch of men — on horseback with spears — moving rapidly in our direction. I make a rapid cost-benefit calculation. If we all stand, we might break their charge. If we run, we die. I should stand.*
>
> *The mistake I have just made is the word “we.” I only control me, and I am only one spearman out of several thousand. If everybody else stands and I run, my running has little effect on whether their charge is stopped — and I won’t be one of the men who dies stopping it. If everybody else runs and I stand, I die. So whether the rest of the line is going to run or stand, I should run. Everybody else in the line*

> *makes the same calculation. We all run and most of us die.*

Bryan Caplan has examples from the world of government and politics:

> *Many economists who study politics decry the large negative externalities of voter ignorance. An economic illiterate who votes for protectionism hurts not just himself but also his fellow citizens. Other economists believe externalities in the budget process lead to wasteful spending. A congressman who lobbies for federal funds for his district improves his chances of reelection but hurts the financial health of the rest of the nation.*

Or take this case: I tell a group of people I'll go to Washington, D.C., to lobby for a general tax cut if they help finance my effort. Each person wants lower taxes but calculates that he will get a tax cut whether or not he donates to the cause. So each abstains. Without the money, I don't go to Washington. No one's taxes are reduced.

And there is the famous "failure" from game theory, the prisoner's dilemma. In this case, two people arrested and accused of committing a crime are held in isolation and confronted with the option of squealing on the accomplice or remaining silent. Under the plea deal offered, each person's best possible scenario is to squeal while the accomplice remains silent. The second-best scenario is for both to remain silent. The problem is that, since neither can control what the other does and since they can't coordinate, neither can take the chance that the other will talk — under the plea deal, if one remains silent while the other talks, the first goes to prison for the maximum term while the stool pigeon goes free. Thus both find it rational to talk and (under the deal) serve less than the maximum. Yet had they both taken the greatest risk and remained silent, they would have served even less time. (See the matrix here.)

My question is this: If this same kind of failure can occur in the market, government, battlefield, and law-enforcement contexts, why do we call it *market* failure? The name implies that this problem is unique to the market — but as we've seen, it most emphatically is not.

Such failure in the political realm was largely overlooked until the Public Choice school of political economy brought it to the world's attention. To justify government action, it was deemed sufficient to show that the market led to a suboptimal outcome. The Public Choice thinkers showed that this is an illegitimate argument, because one cannot merely assume

that the outcome of government action would be better than the market outcome. It might well be worse, and we have reason to believe it will be.

If group-rationality failure is ubiquitous, does that mean it can't serve as an argument for the market over the state? No, it does not. As Friedman says, while such failure can be used as an argument *against* laissez-faire, it's an even stronger argument *for* laissez-faire. How so? The key lies in the issue of externalities, that is, in the question of who reaps most of the benefits and bears most of the costs of actions: the particular actor, or the public?

Friedman writes,

> *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 [sic]. 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. [Emphasis added.]*

Moreover, the failures that occur in the market are more easily solved:

> *A market failure is also a profit opportunity. If the result of individuals acting rationally in their own interest is to make them worse off than if they acted in some other way, it follows that an entrepreneur who could somehow move them to the better outcome would produce a net benefit — some of which, with luck, he could pocket. Hence in a market society there is an incentive for private parties to find ways around the inefficiencies due to market failure.*

(See a video of Friedman's FFF lecture on the subject of "market" failure here.)

Broadcast radio and television should have been impossible, because no broadcaster could charge receivers of her signal, who would have every incentive to "free-ride." But some

sharp entrepreneur motivated by the desire for profit came up with the idea of selling commercial time to soap makers. Problem solved. (Elinor Ostrom explored other private ways of solving group-rationality failures involving common-pool resources.)

A similar incentive is not typically found in government. On the contrary, the incentives work the other way: A government failure is often the excuse for bigger budgets and staffs, and more power. According to conventional wisdom, market failure requires more government, while government failure requires more government.

Not only are group-rationality failures far less frequent in the market than in government, in the market such problems contain the seeds of their own solution, thanks to entrepreneurship and the profit motive. Hence, I propose that we stop talking about *market* failure.