



THE PERFECT AS
THE ENEMY OF
THE GOOD

MARKET FAILURE OR
MARKET OPPORTUNITY?

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Thinking Economically

Lesson 10

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Key economic concepts at the foundation of our market-based economy, such as value, entrepreneurship, and competition, often get lost in today's complex policy debates. Too often this results in unforeseen consequences that no one involved intended to bring about.

Thinking Economically is a project of the Texas Public Policy Foundation designed to provide a basic economic education for policymakers, the media, and the general public. In this way, the Foundation hopes to highlight the intersection of economics and public policy, and the importance of "thinking economically" when making policy decisions. We are grateful to be able to undertake this project with the assistance of Dr. Arthur Laffer, who has throughout his distinguished career shaped the thinking of many world leaders by bringing sound economic thought into policy debates and the public's awareness.

Thinking Economically

If you've come with me this far, you know that I am very optimistic about the ability of free markets to solve problems. Markets aren't perfect, of course; no human institution is. That's why it always amazes me when smart academics dream up elaborate models showing hypothetical conditions in which Adam Smith's "invisible hand" falls apart—and then they casually assume that bureaucrats will fix it—making no mistakes along the way.

In this final chapter we'll explore some of the typical examples of "market failure" cited in the textbooks. As we'll see, these criticisms of the market often rely on unrealistic models that underrate the innovations of real-world capitalism, and which simultaneously overrate the ability (and nobility) of political saviors.

THE MEANING OF MARKET FAILURE

In economic theory, market failure has a precise meaning. It refers to a situation where the decentralized mechanism of private property—i.e., *laissez-faire* capitalism—does not promote the general welfare. Specifically, we have a textbook case of market failure if the outcome that spontaneously occurs in the market could be changed so that everybody agrees that the new situation is an improvement. This definition is necessary to avoid the economists taking sides. To keep economics as an objective science, we have to treat everyone's subjective preferences as given. We can objectively say that the market fails society as an institution when everyone unanimously prefers an outcome that is technologically within our grasp, and yet the market steers us towards a different outcome.

As I'll soon document, there are plenty of hypothetical scenarios that fit this bill—i.e., cases where economists have discovered market failure when compared to perfect competition. To put it in other words, these economists have discovered we don't live in a perfect world. Of course, this isn't exactly breaking news for the rest of us. So does this really constitute a valid criticism of the market? In context, these condemnations of capitalism usually go hand in hand with appeals to political "solutions." As we'll see below, however, it's not at all obvious that these recommended cures are better than the disease.

THE FICTION OF "PERFECT COMPETITION"

One of the biggest sources of sloppy thinking about real-world markets is the benchmark model of perfect competition, the analysis of which has terrified and bored millions of business majors. In this textbook setup, a market is competitive when all firms are "price takers," meaning that no seller thinks he has any influence on the price. No matter how many units the seller puts on the market, he can unload all of them at the going market price. What's more, the model of perfect competition assumes that firms in the industry sell identical products. There is no reason for a seller to spend money on advertising or to install extra bells and whistles on his product, because if he charges one penny more than the going market price, his sales immediately drop to zero.

Now, most economists aren't crazy (though there are notable exceptions). They know per-

fectly well that perfectly competitive markets don't exist in the real world. But despite its implausibility, economists focus on the benchmark scenario because it is the one knife-edge situation where markets achieve theoretical perfection and allow them to demonstrate and discuss important economic concepts. When sellers think they have no control over the market price, they increase output until the point where the marginal cost of production equals the price of the product. For example, if the TV industry were perfectly competitive and all manufacturers took it for granted that they could sell as many units as they wanted for \$150 each, then each manufacturer would produce TVs until the point where making one additional TV would raise total costs by one penny more than \$150. At that point, making more TVs would reduce profits, so the manufacturer would stop producing.

The perfect competition model interests economists because it gives them a good way of explaining how society's scarce resources can be deployed efficiently. Resources flow into the TV industry to the point where producing one additional TV set would use up more than \$150 in materials (including labor). At the same time, consumers are free to buy as many TVs as they want, at the price of \$150. So they continue to buy until the point at which they don't value an additional TV as much as the \$150 purchase price. Therefore, stepping back and viewing the entire economy, we see that under perfect competition, resources flow into the TV sector until the precise point at which the resources for making an additional television could be better used in a different sector. In this make-believe world, all of society's resources would be perfectly channeled among their competing uses.

In contrast, what happens in the real world? Here, sellers exercise some influence over the prices they charge customers. If they increase output, they will have to lower the unit price; if they reduce production, they will be able to charge a higher unit price (remember, in the model of perfect competition the seller can unload as few or as many units as he wants, at the given market price). This is obviously much more realistic, but this share of "market power" leads sellers to produce too little, compared to the model of perfect competition. Sellers no longer produce TVs, say, until the point at which the selling price just balances the extra cost from making another TV. Instead, the manufacturer stops far short of this level of output, because when he makes additional TVs, he must lower the price that he gets on all prior units. This extra disincentive leads the profit-maximizing producer to set output below the level he would choose under perfect competition. Consequently, not enough resources are channeled into the imperfectly competitive industry. So compared with the model of perfect competition, we have a case of "market failure," where the capitalist system is not doing its job of handling resource allocation.

Now that we understand the fascination with the model of perfect competition, I have to point out its weaknesses. For one thing, as Friedrich Hayek pointed out, the textbook definition of competition has very little to do with how real businessmen actually compete. In business, the way you get ahead is by making a better product, cutting costs, slashing your prices, or some combination of all of these strategies. None of this is allowed in the economic model of "perfect competition." Things like product differentiation and advertising are superfluous in the textbook scenario, because

all sellers and consumers are supposed to have all the relevant knowledge.

But they don't. And neither are most products identical, even those that may look or taste alike. Location, reputation, service, and convenience are all "characteristics of a product" that may cause a consumer to buy one product—and pay more for it—over another. For example, preferring name brands over generic brands or preferring a product in a nearby Mom-and-Pop store over one in an across-town Big Box store.

What has happened with the model of perfect competition is that some economists are abstracted away from the real world and become focused upon relatively trivial issues. They end up with a vision of a proper market that is backwards.

It would be one thing if the strange fascination with the perfectly competitive model were confined to abstruse journals of high theory. However, the bad habits of thought have trickled into other areas, including policy analysis. For example, when deciding whether to allow a proposed merger, a standard practice is to check for the amount of market power the new firm would possess. This mentality comes straight from the textbook model of perfect competition. But people rarely ask, "How did these top firms gain their dominance in the first place?" The answer, of course, is that they supplied a better product that customers preferred. In the market, nobody holds a gun to consumers; profits are earned by satisfying customers.

In the following sections, we'll go over some common (mis)applications of the theory of perfect competition and show why entrepreneurs in a free market are much more creative and competitive than the standard model depicts.



THE COMPUTER INDUSTRY

Nowadays, it's fashionable to complain about Microsoft. (Believe me, my own employees have spent plenty of time with support technicians, so I feel their pain.) Just like the robber barons of yesteryear, the ruthless Bill Gates swept the field, so the story goes, and now enjoys such dominance that outsiders can't meaningfully compete with the operating system he foisted on the world.

What's ironic is that in the early 1980s, at the start of the personal computer revolution, the critics of capitalism said that government intervention was necessary to create standardization! We were told that without political oversight, consumers would be helpless in the face of dozens of incompatible systems. Just as we need one uniform system of weights and measures, we were told, so too we need a standard for computers—which could only be provided by the government, of course.

Well, Bill Gates certainly alleviated that early fear, didn't he? But I don't hear too many people singing his praises. No, these professional naysayers still are quite convinced that government intervention is absolutely essential in the computer industry. It doesn't matter whether the threat is an inefficient, Balkanized

web of rival systems or whether the threat is an inefficient, giant monopoly. Their point is always that the market can't be trusted to get innovation right, while politicians can. (Yet Senator Ted Stevens (R-Alaska) once described the Internet as a "series of tubes.")

On the subject of computers, I have to mention the case of IBM. Back in 1969, the Justice Department filed antitrust charges against Big Blue, the then-undisputed giant in the field. The case was tied up in court for years, with the charges eventually dropped in 1982 after IBM's power had waned considerably. It's true that Microsoft has seemed immune to market forces, but the same was true for IBM in the 1970s. As with every other industry leader, if Microsoft doesn't constantly innovate and please its customers, it will lose market share.

SAM'S CLUB, COSTCO, AND OTHER WHOLESALERS

One of the shortcomings of the perfect competition model is that it only allows sellers to charge a constant, per-unit price. This is the source of the belief that it is inefficient when firms have market power—when a firm expands output, it has to lower prices, and loses revenues not only on the additional units but on all of the earlier ones too.

But in the real world, entrepreneurs faced with such a situation don't throw up their hands in despair. No, when there are inefficiencies in the status quo, the resourceful innovator sees an opportunity for profit. Wholesale clubs such as Costco work by charging a flat membership fee and then charging very low prices on the items customers purchase. This arrangement allows customers to buy large quantities with very little markup, yet it also provides the



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right incentive for the wholesalers to provide this opportunity. To someone who hasn't been trained in orthodox economics, this novelty in pricing won't seem so shocking. Yet just this little tweaking of the rules allows for markets to operate far more effectively than one who only knew the model of perfect competition would think possible.

THE IMPORTANCE OF INFORMATION

As I said above, the model of perfect competition assumes that everyone in the market has perfect information. That's why a firm instantly loses all business if it charges one penny more than the given price. But, of course, this isn't true in the real world. People don't have perfect information. Because the world is not perfect. And we can't make it that way, no matter how hard we try. Once we reflect on this, a lot of the "wasteful" happenings in the marketplace make a lot more sense.

The most obvious example is advertising. To the cynic, as well as to the diehard believer in perfect competition, advertising is a gross waste of resources, a negative-sum game. In this

view, any advertising expenses within an industry would never be regained. Yet in practice, any advertising expenses by Nike or Camel are designed to steal market share from their rivals. Furthermore, they must believe that advertising works or else they would discontinue the practice.

In a socialist society, some might argue, production decisions would be made rationally, in the interests of the whole community. Expensive arms races in terms of ad budgets would be eliminated, allowing for more output of goods and services that actually provided direct benefits to people.

This type of criticism sounds plausible at first, but it collapses once we start analyzing the situation. For one thing, when a new product is developed, advertising is vital to alerting potential customers of its existence. To this end, money-back guarantees or warranties reassure the experimenting consumer; the lack of perfect knowledge also explains why a new restaurant might distribute coupons to every mailbox in the same ZIP code. Even in a socialist society, there would have to be some way to alert citizens to a new product. If the announcement czars didn't dedicate professionals to dreaming up catchy slogans and jingles, the monotonous messages wouldn't catch the ears of as many comrades.

Even advertising by established giants is a way of giving consumers what they ultimately want. Part of why people go to McDonalds rather than a mom-and-pop burger joint is that they know what they are getting before they walk in the door—and its about more than just hamburgers. Those commercials that the elites may see as boorish have provided much needed information to a whole class of consumers.

The same is true when it comes to sneakers. Air Jordans gave greater enjoyment to their owners precisely because they had become associated with the basketball star. It wasn't simply a matter of the physical material, but also psychological. But folks wouldn't have this association if it weren't for those high dollar advertising campaigns. This phenomenon of paying far more for something associated with a famous person might strike some as crazy or silly, but it is widespread. If the critic of advertising doesn't like this fact about most humans, he should at least admit that he wants to place his own vision of what is good for them above their own opinion.

Besides commercial advertising, there are plenty of mechanisms that provide information in a market. *Consumer Reports* is an obvious example. Another is Underwriters Laboratories, which places the familiar "UL" symbol on products that it has tested and found safe and reliable. But many people would be surprised to learn that credit card companies also provide a valuable conduit of information allowing strangers to interact on mutually-advantageous terms. For example, members of American Ex-



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press pay a hefty annual fee, but in exchange they often receive discounts and other perks when using their card. Part of the explanation for this is that hotel and restaurant owners know that the holder of an American Express card will likely be better for business than someone using Visa or cash. In a sense, American Express is performing a valuable screening operation, where a certain group of the population pays a large fee in order to signal their traits to potential business associates. Distributing coupons (rather than marking down the price directly on the tag) is another method whereby businesses sort out their customer base, this time into those who are very sensitive to price versus those who are in a hurry.

Once we realize that information is scarce, the market economy makes a lot more sense. Customers need help deciding how to spend their money, and merchants need help evaluating potential customers. Yet there is no room for any of this in the model of perfect competition or in the typical diatribes against the “wasteful” marketplace.

THE TRAGEDY OF THE COMMONS

The final area we’ll examine concerns communal resources, an area where the free market allegedly falls flat on its face. For example, we can’t all buy our own individualized supply of the atmosphere, so a polluting factory might harm everyone in the region. If the factory doesn’t take these costs into account, it will produce too many units of output and, hence, too much pollution. In this scenario, efficiency can only be restored with government action to correct yet another example of market failure.

What’s ironic about this typical example is that, historically, the English common law pro-



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vided redress for neighbors who were harmed by a polluter. As Ronald Coase pointed out in a famous paper, local governments in the late 19th and early 20th centuries shielded businesses from legal liability for their actions—the thinking was that rapid industrialization was necessary for economic progress. Far from being a case of market failure, therefore, polluting factories can be laid at the doorstep of misguided political intervention—which, or course, has led to even more misguided political intervention.

There are countless other examples where market innovation solves the problems of common resources. The term “tragedy of the commons” refers to a pasture where the owners of the cattle have no property rights in the land. Even though the herders know that their animals collectively are overgrazing the land, no individual has the incentive to restrain his own animals because that would simply benefit his rivals.

Historically, the tragedy of the commons in pastures was solved by the invention of barbed wire. This low-cost technology finally made it

practical to divide land into parcels where owners could restrict grazing and allow the land to recuperate.

We can expect similar innovations when it comes to fisheries. Currently the government does a poor job protecting the oceans and other publicly-owned bodies of water from overfishing. There are inefficient, poorly-enforced rules regulating the types of nets, the seasons for permissible fishing, the size of the catch, and so forth. But because the government overseers do not directly profit from enhancing the value of the assets under their management, they do not exercise the same care as would private owners. Naturally, the analogy is not perfect, and there would be practical difficulties in, say, completely parceling out the ocean and selling it to private owners. Even so, the exploitation of the ocean's vast resources will be far more effective once private property can be instituted in this new realm.

CONCLUSION

The theoretical case for market failure can be tied to the benchmark ideal of "perfect competition." As we've seen, this standard is both unrealistic and a poor guide for public policy. The real-world market is far from perfect, but in a free market, free individuals constantly innovate in order to better serve their customers, i.e., all of us. Even when free markets are easily shown to be suboptimal, one cannot presume that a government solution is optimal. There's often a slip twixt the cup and the lip, and, in practice, government frequently doesn't perform up to the standards of theory.

To understand why, remember that I said everybody must agree that the proposed solution is an improvement in order to label the existing situation a market failure. Keeping this in mind, why has the existing situation been labeled a market failure in the first place? Most likely it is because the real world situation hasn't matched up well with the model of perfect competition. But we've already seen the problem with this. Well, who says the proposed solution is better than the existing situation? Usually a few dozen, hundred, or thousand politicians, bureaucrats, economists, and others involved in the political process—the same ones that weren't satisfied with the status quo. So we see that the political solution to a supposed market failure almost always substitutes the opinions of a few special interests—or even an economic model—for the opinions of tens of thousands or even millions of consumers that have shown their satisfaction with the existing situation by freely making purchases in the marketplace.

Consumers are uniquely situated—unlike the government—to make value judgments about how their wants and needs align with their purchasing options. In the real world, government solutions are far from perfect—and certainly will never get us to the place of perfect competition so revered by the models and the policy wonks. If you don't believe that, just go to the Department of Motor Vehicles (DMV) for your driver's license, or to the post office, or the public schools, or the welfare office, or... ♦

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Arthur B. Laffer is the founder and chairman of Laffer Associates, an economic research and consulting firm that provides global investment-research services to institutional asset managers, pension funds, financial institutions, and corporations. Since its inception in 1979, the firm's research has focused on the interconnecting macroeconomic, political, and demographic changes affecting global financial markets.

Dr. Laffer has been widely acknowledged for his economic achievements. His economic acumen and influence in triggering a world-wide tax-cutting movement in the 1980s have earned him the distinction as the "Father of Supply-Side Economics." He was also noted in *TIME*'s 1999 cover story on the "Century's Greatest Minds" for inventing the Laffer Curve, which it deemed one of "a few of the advances that powered this extraordinary century." His creation of the Laffer Curve was deemed a "memorable event" in financial history by the *Institutional Investor* in its July 1992 Silver Anniversary issue, "The Heroes, Villains, Triumphs, Failures and Other Memorable Events."

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