Market Failure and the Role of Government.

Christian Thoren.
Grove City College.
01 February 2018.

When justifying government intervention in the economy the most common argument given is that free markets are full of market failures. In introductory courses students are taught that the imperfections in markets cause failures such as positive and negative externalities, merit and demerit goods, monopoly power, and information failures. They are also taught that the free market fails to provide public goods such as national defense or sufficient roadways. This idea that economists have been forwarding for years has given government officials an excuse to intervene in any area of the economy deemed necessary. As long as there is market failure policy makers can make regulations to correct it. But are these market failures really grounds for intervention? Also, are the changes and regulations made to the economy by the government more efficient than the market? The answer to this is that due to the falsity of mainstream market failure theory and government inadequacy, market failure is not grounds for government intervention. The Austrian approach to the subject has a clearer, more realistic viewpoint, and offers better solutions than government intervention. In the end it can be concluded that the free mkt is really more efficient than government interference.

This paper examines the mainstream theory of market failure and critiques it. The fundamentals of market failure theory will be looked at and the rebuttals and criticisms put forth in the literature by Austrian economists will be expounded upon. The Austrian view of the market process and what should be done about market failure will also be discussed. Lastly, the failures of government and its intervention in the market will be examined.

Market failure is one of the biggest arguments put forward in support of government intervention. Accusations of mkt failure have been made in every part of the economy. The majority of the mkt failure theory is rooted in public goods theory and externalities, as well as asymmetric information problems. These are based on the definitions of efficiency and optimality. In simple terms market failure happens when goods are not allocated to their most highly valued ends and there ends up being dead weight loss in economic welfare. In the more technical literature a market failure occurs when a market does not produce the Pareto-optimal outcome when in general equilibrium. Perfectly competitive markets, neoclassical economists say, will produce outcomes in which resources are allocated to their highest valued uses. Also, no one person can be made better off without making some other person worse off. In general equilibrium, prices of all goods are equal to the marginal cost of producing them and everyone maximizes their utility. Lastly, all firms are profit maximizing, but the level of real profits earned is zero, because there is no reallocation of resources that could improve on the current one.[1] With this definition it can be seen why economists seem to uncover market failures in every part of the economy.

Market failure were mostly originally seen as the problem of public goods and externalities. These theories were about how a free market will fail to produce mutually beneficial goods and services. Now many of the theories of what causes market failures are mostly about imperfect information. Both of these areas will be covered but first will be an explanation of public goods and externalities.

The majority of the mkt failure theory is rooted in public goods theory and externalities. These are based on the definitions of efficiency and optimality. Two of the

[1] Steven Horwitz, The Failure of Market Failure, *FEE*, 2011.

earlier economists to write about mkt failure were Paul A. Samuelson and Francis M. Bator. Paul Samuelson wrote an article called “The Pure Theory of Public Expenditure” and Francis Bator wrote an article called “The Anatomy of Market Failure.” These two article were major stepping stones because they specifically laid down the fundamentals of the market failure argument in economics. Tyler Cowen summarized well the key concepts of the two economists in one of his books. He explained that an externality exists whenever one individual’s actions affect the utility of another individual. Positive externalities are those that benefit others. Negative externalities are those that make others worse off. He gives the example of how improving the fire safety of one’s house may be a positive externality on one’s neighbors. A negative externality could be painting one’s house pink. The concept of an externality can be broken down furth by assigning externalities to categories. These include pecuniary or nonpecuniary, marginal of inframarginal, Pareto-relevant or Pareto-irrelevant, etc.[2]

Another key concept of Samuelson and Bator that Cowen explained is transaction costs. Transactions costs are given a number of different definitions in the literature. Many of them conflict. In this discussion by Cowen, transaction costs are defined as any obstacles to market exchanges that interfere with or discourage the process of transacting. Cowen gives the examples of the costs of writing contracts, the costs of finding parties with whom to trade, the costs of enforcing agreements, and the costs of bargaining. Many times transaction costs are informational in nature. When talking about transaction costs, externalities are often considered a source of market failure. Cowen gives the example of a shipping company erecting a lighthouse for its ships. When this happens other shipping

[2] Tyler Cowen, *Theory of Market Failure*, Enskede, 1988.

companies will benefit from the use of the light. Without transaction costs, an entrepreneur who wants to build a lighthouse will contract with all of the relevant ship owners to make sure that they will pay their share of the expenditures of the lighthouse. But transaction costs prevent this kind of an arrangement, even though its benefits would exceed its costs.[3]

The third key concept of Samuelson and Bator's arguments, which Cowen describes, is public goods. Public goods are made up of two concepts. They are nonexcludability and nonrivalrous consumption. Nonexcludability means that at times there is an impossibility of preventing non-paying individuals from reaping the benefits of a good or service. Nonexcludability is used to describe an externality. Cowen once again gives the example of a lighthouse as a nonexcludable public good. Each shipping company owner knows that if another shipping company constructs a lighthouse, his own ships will be able to use the light as well. So, each ship owner will try to keep from paying his share of costs and in that benefit from the efforts of others without cost. Even if the benefits of a lighthouse exceed the costs, the market may not provide it, because there is no way of excluding non-payers from reaping those benefits. Because of this, markets will under produce goods and services whose supplying would bring about positive externalities. Also, goods and services whose supplying would bring about negative externalities will be overproduced when there are transaction costs.[4]

Nonrivalrous consumption is used to describe when an individual's ability to consume a good or service is not lowered by allowing other individuals to consume it.

---

[3] Tyler Cowen, *Theory of Market Failure*, (Enskede, 1988), 2.
[4] Ibid, 3.

Cowen gives the example of a movie theater as an example of nonrivalrous consumption. Until there is crowding, it is possible to allow additional individuals to enter a theater and watch the movie without affecting the consumption of those already in the movie theater. Since one individual's consumption of a movie does not stop another individual from consuming the same good it is nonrivalrous. Cowen points out that nonrivalrous consumption may be a matter of degree. Most public goods experience crowding at high levels of use. The theory of public goods and externalities suggests that nonrivalrous consumption may bring about pricing inefficiencies even when it is possible to exclude people who do not pay for a good or service. Cowen describes a scenario in which it is possible to allow additional individuals to enter the movie theater at zero or negligible marginal social cost. Charging a profit-maximizing price might exclude some of them. Whatever the profit-maximizing price is, anyone who would like to see the movie but is not willing to pay this price will be inefficiently excluded. As with externalities, nonrivalrous consumption is not a problem when there are no transaction costs. If transaction costs such as a movie theater's were costless, a business could charge each individual a separate entrance price just below each individual's marginal valuation. Businesses whose goods and services are considered to bring about some kind of nonrivalrous consumption include transportation, communications, and public utilities. There are economists that says these types of industries' pricing inefficiencies can be mitigated by having the government supply the goods and services at marginal cost, then financing them through taxation.[5]

[5] Tyler Cowen, *Theory of Market Failure*, (Enskede, 1988), 2-4.

As for the asymmetric information problem, today's economists use this to find market failures in every sector of the economy. This is due to the fact that individuals in an economy can never have perfect information and are unable to make an informed choice. Individuals in an economy then make mistakes. Market failures have been identified everywhere from the simple used car markets, as described by Akerlof[6], to more the complex situations of mergers and divestitures.[7] Akerlof's article on the used car market is one of the more commonly quoted examples in literature amongst mainstream economists. Akerlof made the claim that used car markets would become progressively dominated by lower and lower quality cars, if the market did not disappear altogether, because of the ease with which used car salesmen can sell "lemons" to ill-informed buyers. So as one can see, the claim of asymmetric information can be made by an economist in any area of the economy. In order to overcome these market failures, economists will suggest that the government intervene by putting into place regulations that put certain restrictions on entrepreneurs. They think that regulation can solve the problems that market failures create.

This next section will give a critique of the neoclassical approach to market failure. In general, there are a few simple ways that market failure can be discredited. Peter Boettke describes three of these ways. He describes the definitional, institutional, and entrepreneurial ways of discrediting market failure. Boettke says about the definitional way:

---

[6] George Akerlof, "The Market for "Lemons." *The Quarterly Journal of Economics, 1970.*

[7] Peter Klein, "Do Entrepreneurs Make Predictable Mistakes?" *The Quarterly Journal of Austrian Economics,* 2001.

> Economists can show that terms such as externality, public goods, monopoly, and macro-instability have conceptual difficulties and that by clarifying terms the critique of the market economy fades away. In The Economic Way of Thinking, for example, the ambiguity associated with the term monopoly is explored --- if you define the relevant market broadly enough no monopoly is evident, but if your definition is narrow then every good will exhibit monopolistic characteristics. In Rothbard's Man, Economy and State externalities and public goods are also called into question as well as monopoly. However conceptually correct this response is, it tends to dismiss critics of the market out of hand. And while it doesn't necessarily lead to this, it has the potential of cutting the discussion off too early so that the failure of government and the power of the market are not explored in their full details.[8]

As for the second way to discredit market failure Boettke says:

> Another response is institutional. If property rights are clearly defined and strictly enforced then market failures also fade away. Externalities result, for example, due to conflicts over property rights, clarify the property rights and the so-called externality is internalized. Market failures are really legal failures. Again, however correct this intellectual exercise may be it results in missing out on explaining the reasons for government ineptness and market robustness.[9]

[8] Peter Boettke, “Coordination Problem”, 2017.
[9] Ibid.

The last way is entrepreneurial. This is the most relevant to the Austrian view and also the most useful. Boettke says:

> On the other hand, the entrepreneurial perspectives sees the market as an on-going process of adjustment to changing circumstances. Today's inefficiency represents profit opportunities for those individuals who can act to eliminate them. Admitting the existence of 'market failure' sets up the analysis of entrepreneurial responses. By admitting the frictions in the market, the economists can see the way that market participants respond to ease those frictions and realize the gains from trade and technological innovation.[10]

Another Austrian critique of market failure can be found in Roy Cordato's book "Efficiency and Externalities in an Open-Ended Universe." In the introduction he says that there are several objections that Austrians raise to the standard neoclassical approach. They all center on certain tenets that are essential to economics and neoclassical economists seem to ignore them. There are three tenets, the first one is market activity should be analyzed as a dynamic, disequilibrium process. The second is, the concepts of value and utility are strictly subjective and therefore unobservable and unmeasurable (radical subjectivism). The third is knowledge of market phenomena, by both market participants and policymakers, is imperfect.[11]

The general critique of the neoclassical market failure perspective can be put in another way. Steven Horwitz in one of his articles gives a general argument of this view. His argument goes that by the neoclassical definition, markets are always failing. Only

[10] Peter Boettke, "Coordination Problem", 2017.
[11] Roy Cordato, *Efficiency and Externalities*, 1992.

with an Austrian perspective can someone understand that the different imperfections in a market are not only part of real markets. They also are what drive entrepreneurship as well as competition to find ways to improve outcomes. That is, what markets do best is enable people to see imperfections and attempt to improve on them, even as those attempts at improvement, successful or not, lead to new imperfections. It should be understood that people are not fully informed, that they do not know what the ideal product should look like, and that they do not know what the optimal firm size is. Then it can be understand that these diversions away from the ideal are not failures but opportunities. Horwitz says that the drive to improve market outcomes is the entrepreneurship that lies at the heart of the competitive market. For this reason, the importance of markets is not that they will obtain perfection, but that they have endogenous processes of discovery that facilitate people to correct the market's imperfections. Horwitz says, "Just as it's the very friction of the soles of our shoes on the floor that enable us to walk, it is the imperfections of the market that encourage us to find the new and better ways to do things."[12]

That ends the overview of the general critique of neoclassical market failure theory. Now a more specific response to the public goods theory will be given. Cowen describes the possibilities of how there can be private production of public goods. He refers to an article by Kenneth D. Goldin called "Equal Access vs. Selective Access: A Critique of Public Goods Theory." The article's main focus is that most goods can be supplied in two different ways. The first way involves what Goldin calls equal access. This allows all consumers of the good to use it free without cost. A concert in a large

[12] Steven Horwitz, The Failure of Market Failure, *FEE,* 2011.

public park and a police patrolman walking the beat are examples of this. In both of these situations, all consumers have equal access to these goods and externality problems prevail. The second way involves what Goldin calls selective access. This allows nonpayers to be excluded. The argument can be made that music can be supplied by a private recital, and safety can be supplied by locks and burglar alarms. Cowen says that Goldin's article goes over many of the classical examples of public goods and describes how there is a possibility that those goods can be supplied through selective access. Cowen says that the free-rider problem loses some of its importance and it becomes necessary to compare the costs of equal and selective access. Goldin makes a comparison of private and public goods. If a public good is not able to be created by the market, it is only because the current state of technology makes the exclusion of nonpayers economically impossible. But the production of private goods has a similar problem. Cowen gives the example that at certain points in time the production of light bulbs and television sets was either impossible or too costly because the necessary technologies were not available.[13]

Cowen continues with this discussion by drawing from Harold Demsetz. Demsetz wrote an article called "The Private Production of Public Goods." In it he discusses the problem of pricing inefficiency in situations where it is possible to prevent nonpayers from consuming public goods. Examples of this are a movie theater and a road. Demsetz mentions that it is possible for an entrepreneur to charge each consumer a price set slightly below that consumer's marginal valuation of a good. When this happens, there will not be inefficient exclusion. So, the entrepreneur will be able to collect revenue as

[13] Tyler Cowen, *Theory of Market Failure,* (Enskede, 1988), 5.

well as make a profit. In another article by Demsetz titled “The Exchange and Enforcement of Property Rights,” he makes suggestions for the private provision of public goods. Two of them involve tying arrangements and the character of marginal cost pricing. A tying arrangement connects the supplying of a private goods to the purchase of a public good. Cowen uses the same example that Ronald Coase used. Eighteenth century British lighthouses are an example of a tying arrangement. Lighthouses may be a public good, but port space is a private good. So, during those times it was possible to charge ships for their use of a lighthouse by charging them for their use of the port. In these specific situations, free-riding behavior can still be persist, as in some ships may use a lighthouse’s services without docking at the port. However, in the case that Coase discusses, the port tolls were more than enough to pay for the lighthouses.[14]

Other examples of tying arrangements that Tyler Cowen gives, include shopping malls and condominiums. He says that in the case of shopping malls, public goods such as streets and security are paid for through the supplying of private goods such as shoes, clothing, and books. The stores in a mall make a deal with the mall owner to split the proceeds that come from the relationship of the private and public goods. As for condominiums, the private good is living space and the public goods may be something such as fire protection or well-kept recreational facilities. This provision of public goods is reflected in the rent or selling price of a condominium.[15]

Some other examples of private and public goods coming together were given by James Buchanan in this article “An Economic Theory of Clubs.” Examples included

[14] Tyler Cowen, *Theory of Market Failure,* (Enskede, 1988), 8-10.
[15] Ibid.,10.

trade associations, lecture series, golf clubs, charities, and swimming clubs. These private, voluntary associations formed for the purpose of providing public goods.[16]

Moving on, next will be a discussion specifically about the rebuttals toward the asymmetric information problem. A good article about this asymmetric information problem is by Thomas DiLorenzo. In it he explains how the mainstream economic view is false and how asymmetric information is basically a synonym for the division of knowledge which is the whole basis of trade and exchange and the success of markets. In the introduction he talks about how conditions for mkt failures are unrealistic. The literature on market failure is mostly a collection of cases of the Nirvana Fallacy set forth by Demsetz. This being comparing real world markets to an unattainable utopian ideal, and then criticizing markets because they fall short of utopia or Nirvana. Then the economist will suggest government intervention. He talks about how Austrian economists have shown this line of thinking to be wrong, and says that Austrian economists have long understood that this method of analysis is deeply flawed for many reasons. One of them being the whole perfect competition and perfect information model ignores the actual market process. But this was already previously discussed.[17]

He goes on to assert that one of the worst theory flaws of market failure is asymmetric information. The theory says that since sellers typically have better information about the product or service being sold than buyers, they are able to easily trick consumers by selling them “lemons,” referring to Akerlof. DiLorenzo thinks that the main problem with this theory is that it gets the facts backwards. This being that

---

[16] Tyler Cowen, *Theory of Market Failure,* (Enskede, 1988), 10.
[17] Thomas DiLorenzo, “A Note on the Canard of "Asymmetric Information." *The Quarterly Journal of Austrian Economics, 2011*.

asymmetric information is basically another way of saying “the division of labor,” which is the whole basis of trade and exchange and the success of markets. The division of labor is more productive because of the facts that human beings are unequal when it comes to their abilities in the workplace, there is an unequal distribution of natural, non-human opportunities of production on the earth, and almost all production processes require some kind of team work that no single person could accomplish.[18]

The division of labor is especially important in today’s information age. Now DiLorenzo thinks that because of the use of knowledge in society, it may be more appropriate to use the term “division of knowledge” as opposed to division of labor. Hayek explains this idea in more detail:

> We need to remember only how much we have to learn in any occupation after we have completed our theoretical training, how big a part of our working life we spend learning particular jobs, and how valuable an asset in all walks of life is knowledge of people, of local conditions, and of special circumstances.... The shipper who earns his living from using otherwise empty or half-filled journeys of tramp-steamers, or the estate agent whose whole knowledge is almost exclusively one of temporary opportunities, or the arbitrageur who gains from local differences of commodity prices--are all performing eminently useful functions based on special knowledge of circumstances of the fleeting moment not known to others.[19]

---

[18] Thomas DiLorenzo, “A Note on the Canard of "Asymmetric Information." *The Quarterly Journal of Austrian Economics, 2011*.
[19] Hayek, F. A. "Individualism and Economic Order." 1996.

DiLorenzo asks a series of rhetorical questions about who knows more about specific processes, as in the worker or the consumer of the end product. For example who knows more about home building, home builders or home buyers? Or who knows more about supplying grocery stores with fresh meat, ranchers and farmers, or average consumers? The purpose of the questions is to help one realize that all information about all products and services is asymmetrical in successful, capitalist economies because of the division of knowledge in society. If everyone had symmetrical information about all of the processes in society, none of the businesses or jobs in society would exist. So there should not even be motivation for everyone to have symmetrical information. It is not even possible. In fact it is the discrepancies in information that are the cause of trade. Trade takes place because of the different valuations of goods. DiLorenzo thinks that those different subjective valuations come from the informational differences, or asymmetric information, in the minds of buyers and sellers.[20]

DiLorenzo also responds to Akerlof's popular "lemons" article and gives a strong rebuttal to his claims. DiLorenzo here shows the flawed thinking of many mainstream economists. As with most market failure arguments, the lemons article does not take into account real world markets. DiLorenzo points out that the article was wrong even when it was published because it ignored the existence of product warranties in real world used car markets. Akerlof said that used car markets would be overtaken by lower and lower quality cars because of the ease with which used car salesmen can sell "lemons" to buyers with less information. Thirty day warranties were actually common in used car

[20] Thomas DiLorenzo, "A Note on the Canard of "Asymmetric Information." *The Quarterly Journal of Austrian Economics, 2011.*

markets at this time, and that should have been enough time to know if car is a “lemon” or not. So the “lemons problem” was already solved when Akerlof wrote the article.[21]

DiLorenzo also makes the point that this kind of asymmetric information literature does not take into account the implications of the dynamic nature of competition. If a used car dealer is known to be dishonest, then he creates a profit opportunity for a competitor. In a competitive market more honest car dealers will take market share away from the less honest ones, which is the opposite of what Akerlof thought. Reputation is important for a business. But this is also something not taken into account by the asymmetric information and market failure literature. Market competition penalizes dishonesty in business and rewards honesty in business affairs. DiLorenzo says that “the real lemon here is the theory of "lemon problems" based on asymmetric information.”[22]

In this next part of the paper the Austrian view of market failure will be explained. In an Austrian perspective a market imperfection is not a failure. It is what drives entrepreneurship and competition to find ways to improve outcomes. In order to understand this view of market failure, the Austrian theory of efficiency must be explained. In his article “The Austrian Theory of Efficiency and the Role of Government” Roy Cordato goes into detail of how the theory works. In this article he shows that if you start with different views of efficiency then you will get different conclusions about government intervention. In this article he describes the Austrian approach to economics and how the Austrian theory of efficiency is derived. The

[21] Thomas DiLorenzo, “A Note on the Canard of "Asymmetric Information." *The Quarterly Journal of Austrian Economics, 2011*.
[22] Roy Cordato, “The Austrian Theory of Efficiency.” *The Journal of Libertarian Studies,* 1980, 393-403.

discussion begins with the individual and asks what constitutes efficient activity for the individual actors in society? It is concluded that efficiency must be seen in terms of the purposeful behaviors of individuals or whether that behavior is consistent with attaining the purposes and goals that are being sought. So the efficient course of action would be to apply means that are consistent with attaining the desired end goal. Inefficiency occurs when means are chosen that are not consistent with the desired goals. The efficiency of the goals or ends are not what is being questioned, but the means. Efficiency is important to an Austrian because the degree to which an individual acts efficiently determines the success or failure of his or her economic life.[23]

He then moves on to talk about society and efficiency. Austrians also see the economic problem facing society as obtaining efficiency. But, they do not see the efficiency of society to be different from the efficiency of the individuals that comprise it. So society cannot have goals apart from the individuals within it. This idea is expressed in a quote he gives by Israel Kirzner:

> Society is made up of numerous individuals. Each individual can be viewed as independently selecting his goal program… and each individual adopts his own course of action to achieve his goals. It is therefore unrealistic to speak of society as a single unit seeking to allocate in order to faithfully it given hierarchy of goals. Society has no single mind where goals of different individuals can be ranked on a single scale. Efficiency for a social system means the efficiency with which it permits its individual members to achieve their several goals.[24]

[23] Roy Cordato, "The Austrian Theory of Efficiency." *The Journal of Libertarian Studies*, 1980, 393-403.
[24] Israel Kirzner, *Market Theory and the Price System, 1963.*

With this concept of social efficiency Austrians see that the free mkt is the most efficient system. There is an emphasis on voluntary cooperation and each individual is allowed to pursue their goals in the most efficient manner possible.[25]

Next Cordato talks about the determinants of efficiency. They are knowledge and coordination. He says that knowledge is the key to efficiency. The extent to which an individual can act efficiently depends on the amount of knowledge he has with respect to the means for attaining his ends. He gives the example of Mr. Jones wanting to buy a car. Due to his extreme lack of knowledge Mr. Jones first goes to a department store to make this purchase. Obviously his lack of knowledge makes him inefficient. He must go through trial and error in order to gain the knowledge he needs and gain efficiency. Overall market efficiency also depends upon individual knowledge of mkt conditions. The key to efficiency for a society then is the coordination btw buyers and sellers. The extent to which coordination exists reflects the amount of knowledge of opportunities in a mkt. To be efficient an economy requires knowledge of opportunities between buyers and sellers. For Austrians then, perfect efficiency will only exist when there is perfect knowledge and coordination.[26]

Moving on Cordato talks about inefficiency and the coordinating process. It is obvious that a state of perfect efficiency and perfect knowledge is not possible. Information is spread across the market, plans are uncoordinated, and inefficiencies come about. But the mkt corrects these inefficiencies. Price and entrepreneurial activity bring about the spread of knowledge and the efficient use of resources. Basically, the price

[25] Roy Cordato, “The Austrian Theory of Efficiency.” *The Journal of Libertarian Studies*, 1980, 393-403.
[26] Ibid.

system make information available and entrepreneurs take the information and use to improve efficiency. The price system makes known inefficiencies through discrepancies in prices. Buyers go for the lower prices and the higher prices must eventually come down, making a uniform market price for a good. So, when inefficiencies or price discrepancies occur, the opportunity for profit presents itself to entrepreneurs. These opportunities for profits and entrepreneurial activity tend to promote coordination and efficiency in a market. Cordato concludes that in a free market, inefficiencies promote their own corrective action. Again he quotes Israel Kirzner:

> A price discrepancy means a chance to make profits. By definition entrepreneurs seek profits; thus the very situation that symptomizes the need for a correction creates the force capable of inducing such actions. Moreover… the entrepreneurial search for profits implies a search for situations where resources are misallocated.[27]

Cordato says that someone may say that entrepreneurs will not be able to recognize every inefficiency in the market or correctly perceive the ones that do exist. While this is true the fact is the mkt will reward successful entrepreneurs and penalize unsuccessful ones. Quoting Kirzner again he says "So the market process itself… attracts only those most able and competent to direct the future course of the process. If the best entrepreneurial talent is insufficient to remove all misallocations, even with the inducement of the profit motive, then the remaining misallocations must simply be undetectable."[28]

---

[27] Israel Kirzner, *Market Theory and the Price System,* 1963.
[28] Roy Cordato, "The Austrian Theory of Efficiency." *The Journal of Libertarian Studies,* 1980, 393-403.

The next part of the paper government intervention and how it compares to the market in terms of efficiency. Obviously the Austrian consensus is that the market does a better job than government intervention. Even if market failures do exist, the government is still much less efficient and causes more harm than good. Harold Demsetz in the late 60's argued that, markets may fall short of perfection, but so does government. To point to market imperfections as proof of the need for government intervention, he said, is to partake in the "Nirvana Fallacy." By doing this we compare imperfect real markets to imaginary governmental institutions that do not have imperfections.

Here is a quote from Peter Boettke of what he thought of government intervention versus the market:

> An understanding of government ineptness results from an examination of government efforts to serve as a corrective to so-called market failures. Government decision-making is prone to certain systemic perversities that public choice theory has exposed. But public choice theory begins with recognition that markets may indeed fail, but that government 'cures' may be worse than the identified 'disease'.[29]

This sums up in short why the government is less adequate than the free market.

Steven Horwitz went into more detail about the failures of government versus the free market in one of his articles. He claims that even if markets fail, this does not mean that government intervention will fix or improve things. The ideas applied to the market are not the same ones applied to the government. Markets do not have the neoclassical

[29] Peter Boettke, "Coordination Problem", 2017.

models' requirements that would allow them to achieve perfection. The same applied to governments. In order to figure out which one is better, Horwitz says that we must ask, "Which process has better built-in mechanisms to provide the knowledge and incentives necessary to notice imperfections and improve on them?"[30] The question with how well the markets and the political process respond to imperfections. He concludes that markets are better because they are better able than government to react when there is failure.

In the last part of Thomas DiLorenzo's aforementioned article, he says that the real asymmetric information problem is within the government. When problems emerge in a market, competition provides a solution. This is not the case in government. DiLorenzo gives the example that as voters, people tend to be "rationally ignorant" of almost all of what government does. Most people do not have any idea of the amount of things the government does on a daily basis. This is why special-interest groups dominate all democratic governments. Government spending, taxing, borrowing and regulatory powers are almost unlimited. "The result of all of this in recent years," says DiLorenzo, "has been unprecedented budget deficits and even the impending bankruptcy of entire governments, from California to Greece."[31]

Another reason why government intervention is inefficient is because of the different incentives. In order to get anything done the wants of politicians, bureaucrats, voters, and special interest groups all have to be considered. The participants in government are self-seeking individuals. They are subject to the laws of human action. But in government, political actors face different incentives. Individuals who choose and

---

[30] Steven Horwitz, The Failure of Market Failure, *FEE*, 2011.
[31] Thomas DiLorenzo, "A Note on the Canard of "Asymmetric Information." *The Quarterly Journal of Austrian Economics, 2011*.

act in the market generate outcomes that can be judged to be value-maximizing for participating individuals. The nature of the process itself insures that individual values are maximized. This "value maximization" perspective cannot be extended from the market to politics since politics does not directly embody the incentive compatible structure of the market.

So then all of this begs the question, if all the evidence is against market failure and government intervention, why do economists forward these ideas? One of the more obvious explanations is ideological bias. But, a full explanation is beyond the scope of this paper.

In conclusion the answer to the question, is market failure grounds for government intervention, is no. As was stated in the beginning of the paper, due to the falsity of mainstream market failure theory and government inadequacy, market failure is not grounds for government intervention. The Austrian approach to the subject has a clearer, more realistic viewpoint, and offers better solutions than government intervention. In the end it can be concluded that the free market is really more efficient than government interference.

Bibliography

Akerlof, George A. "The Market for "Lemons": Quality Uncertainty and the Market Mechanism." *The Quarterly Journal of Economics*84, no. 3 (1970): 488-500. http://www.jstor.org/stable/1879431.

Boettke, Peter. "Responding to Claims of Market Failure." Coordination Problem. Accessed December 1, 2017. http://www.coordinationproblem.org/2006/05/responding_to_c.html.

Cordato, Roy E. *Efficiency and Externalities In An Open Ended Universe: A Modern Austrian Perspective*. Boston, MA: Springer US, 1992.

Cordato, Roy. "The Austrian Theory of Efficiency and the Role of Government." *The Journal of Libertarian Studies*, 1980, 393-403.

Cowen, Tyler. *The theory of market failure a critical examination*. Enskede: TPB, 1988.

DiLorenzo, Thomas. "A Note on the Canard of "Asymmetric Information" as a Source of Market Failure." *The Quarterly Journal of Austrian Economics* 14, No. 2 (Summer 2011): 249-255.

Hayek, F. A. "Individualism and Economic Order." 1996.

Horwitz, Steven. "The Failure of Market Failure | Steven Horwitz." FEE. December 08, 2011. Accessed December 1, 2017. https://fee.org/articles/the-failure-of-market-failure/

Kirzner, Israel. *Market Theory and the Price System*. Princeton, N.J.: Van Nostrand Co., 1963.

Klein, Peter G., and Sandra K. Klein. "Do Entrepreneurs Make Predictable Mistakes? Evidence from Corporate Divestitures." *The Quarterly Journal of Austrian Economics*. https://mises.org/library/do-entrepreneurs-make-predictable-mistakes-evidence-corporate-divestitures.