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A Note on the Canard of "Asymmetric Information" as a Source of Market Failure

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ABSTRACT: The notion that so-called asymmetric information is a source of market failure is deeply flawed. Asymmetric information is essentially a synonym for "the division of knowledge (and labor) in society," which is the whole basis for trade and exchange and the *success* of markets. The real asymmetric information problem, moreover, is with government, since all taxpayers are rationally ignorant of almost everything government does. Asymmetric information is therefore a source of government failure, not market failure.

KEYWORDS: asymmetric information, Nirvana fallacy, division of knowledge in society, government failure

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INTRODUCTION

The voluminous literature on "market failure" is, for the most part, a collection of thousands of illustrations of the Nirvana

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Fallacy (Demsetz, 1969)—comparing real-world markets to an unattainable utopian ideal (perfect competition), and then denouncing markets because they fall short of utopia or Nirvana. Having "proven" that markets "fail," the analyst then proposes government intervention under the *assumption* that no such failures will infect government. Markets may not be perfect, but government is assumed to be. This method of analysis is still pervasive despite the public choice "revolution" and its emphasis on the economics of government failure.

Austrian economists have long understood that such a method of analysis is deeply flawed for numerous reasons, not the least of which is that the whole perfect competition/perfect information apparatus simply ignores most or all of the actual market process. In perfect competition there is no competition, as Hayek (1964, p. 96) explained, since all the features of real-world competition, such as advertising, innovation, and price cutting, are assumed away with the perfect information assumption.

An especially egregious example of a deeply flawed theory of market failure is the notion of asymmetric information. Since sellers typically have better information about the product or service being sold than do buyers, the theory goes, they are able to easily swindle consumers by selling them "lemons" (Akerlof, 1970). The basic problem with this theory is that it gets the economic world exactly backwards: asymmetric information is essentially another way of saying "the division of labor," the whole basis of trade and exchange and the *success* of markets.

ASYMMETRIC INFORMATION THEORY VS. THE MARKET PROCESS

Mises (1998, p. 157) properly called the division of labor "the fundamental social phenomenon" (along with human cooperation in general). Cooperative action among individuals is more productive and efficient than "self-sufficient individuals," wrote Mises, because of several fundamental facts: the innate inequality of all human beings with regard to their abilities in the workplace; the unequal distribution of "nature-given, non-human opportunities of production on the surface of the earth"; and the fact that almost all production processes require some kind of team work that no single person could accomplish.

In describing the evolution of the division of labor and specialization in the market process, Mises (1998, p. 164) further wrote of how it "intensifies the innate inequality of men" since "practice of specific tasks adjust individuals better to the requirements of their performance; men develop some of their inborn faculties and stunt the development of others ... people become specialists." Thus, to Mises, the division of labor is nothing less than the source of human civilization. "What distinguishes man from animals is the insight into the advantages that can be derived from cooperation under the division of labor," wrote Mises (1998, p. 827). Without the advantages of the division of labor the average person would live like a "primitive savage."

Mises wrote all of this during the machine age, where the language of "division of labor" was appropriate. Brawn had not yet been replaced by brains as the primary human input in production, as it has progressively done during today's information age. Hayek also lived almost all of his life in the machine age, but he anticipated the information age and spent most of his life studying and writing about the use of knowledge in society. Hence for Hayek—and for everyone in today's information age—the phrase "division of knowledge" may be more precise than "division of labor." As Hayek (1964, p. 80) himself explained:

> 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.

Consider these questions: Who knows more about home building—home builders or home buyers? Who knows more about supplying grocery stores with fresh meat—ranchers and farmers, or average consumers? Who knows more about manufacturing automobiles—automotive engineers employed by automobile manufacturers, or car purchasers? Who knows more about producing and marketing articles of clothing—clothing manufacturers and distributors or clothing shoppers?

The point of these rhetorical questions is that *all* information about all products and services is asymmetrical in successful, capitalist economies because of the division of knowledge (and labor) in society. If we all had symmetrical information about all of the above tasks, none of the above-mentioned businesses and occupations would exist. It is neither desirable nor possible for everyone to have symmetrical information. To paraphrase Mises, what distinguishes man from animals is the insight into the advantages that can be derived from cooperation under the existence of asymmetric information and the division of knowledge in society.

In fact, Mises (1998, p. 325) criticized the notion of asymmetric information as an alleged flaw of the market, although he did not use that exact language. "In an economic system in which every actor is in a position to recognize correctly the market situation with the same degree of insight," he wrote, "the adjustment of prices to every change in the data would be achieved at one stroke. It is impossible to imagine such uniformity in the correct cognition and appraisal of changes in data except by the intercession of superhuman agencies." We would have to assume that "every man is approached by an angel informing him of the change in data," Mises continued. Moreover, even if market participants did possess the same data and information, they are bound to "appraise it differently," Mises wrote.

Indeed, differences in information—and different interpretations of the meaning and importance of information to each individual—is the sole cause of trade and exchange. Trade and exchange take place because different individuals value the same physical goods (or services) differently. Those different subjective evaluations are derived from informational differences in the minds of buyers and sellers—from asymmetric information, in other words.

Like most other "market failure" models, the asymmetric information/lemons model studiously ignores real-world markets. Even Akerlof's widely cited "lemons" article was wrong the moment it was published because it ignored the existence of product warranties in real-world used car markets, which were modeled by Akerlof. Akerlof asserted 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. But even at that time, 30-day warranties were quite standard in U.S. used car markets. Thirty days is plenty of time to determine whether or not a car is a "lemon." Indeed, today there are companies like CarMax that offer seven-day, no-questions-asked return policies on all used cars that they sell, thereby eliminating any possibility of lemons problems. The free market had already solved the "lemons problem" when Akerlof (and the rest of the mainstream of the economics profession) discovered its existence.

The Akerlof-inspired asymmetric information literature also ignores the implications of the dynamic nature of competition. If a used car dealer is known to be dishonest, he creates a profit opportunity for a competitor in doing so. In a competitive market more honest car dealers will take market share away from the less honest ones, precisely the opposite of the outcome predicted by Akerlof. Brand name is a valuable asset to any business—perhaps its most valuable asset—but this is ignored or downplayed by the asymmetric information/market failure literature. Competition will not eliminate dishonesty, but it does penalize it while rewarding honesty in business dealings. In addition, word-of-mouth communication, publications like *Consumer Reports*, and myriad online information sources make it increasingly easy for consumers to educate themselves about the sellers of almost every product on the market in today's world. Hence, the real lemon here is the theory of "lemon problems" based on asymmetric information.

THE REAL ASYMMETRIC INFORMATION PROBLEM

Asymmetric information is simply another way of saying the division of knowledge and labor exist in human society. When potential problems do arise, such as superior knowledge on the part of a used car dealer, marketplace competition provides a solution, as described above. No such solutions exist in government, however, which is where asymmetric information *is* a serious problem. In this case we are dealing with the well-established fact that, in their capacity as voters, people tend to be "rationally ignorant" of almost all of what government does. In fact, government is so pervasive that no human mind could possibly comprehend the tiniest fraction of one percent of what government in a country the size of the U.S. does. Consequently, special-interest groups dominate all democratic governments; government spending, taxing, borrowing and regulatory powers are essentially unlimited; and rent seeking runs amok. The result of all of this in recent years has been unprecedented budget deficits and even the impending bankruptcy of entire governments, from California to Greece.

Foreign policy is a single case in point of the severe asymmetric information problems in government: All of the negotiations, discussions, and strategy sessions that might lead an entire nation into war are always done by a few people in the executive branch of government in complete secrecy from any citizens. The citizens must then rely on whatever they are told by the spokesmen for the government regarding the supposed reasons for the war. The entire world now knows, for example, that the reason given for the U.S. invasion of Iraq in 2003—that Saddam Hussein had "weapons of mass destruction" and intended to use them in the U.S.—was false. Rational ignorance gives politicians infinitely more latitude to lie to the public compared to the most dishonest used car dealer in the world.

In markets, dishonest business people can be quickly penalized with the loss of business or bankruptcy. (In addition to losing customers, suppliers will also abandon dishonest business associates). It is quite the opposite in government. Unseating a dishonest member of Congress is virtually impossible because the entire U.S. Congress has been so gerrymandered, and incumbents have given themselves such monopolistic advantages (dozens of staffers who are essentially tax-financed permanent campaign staff; free mailing privileges; dozens of subcommittees that are used to dole out pork barrel spending, etc.), that congressional re-election rates have averaged over 90 percent for the past half century in the U.S.[1]

Even if this were not true, members of the U.S. House of Representatives remain in office for two years; U.S. senators for six years;

[1] See, e.g., www.opensecrets.org/bigpicgture/reelect.php.

and presidents for four years. By contrast, a consumer can switch products in an instant if he decides that a company's advertising was deceptive. The real asymmetric information problem is a problem of government failure, not market failure.

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