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The entrepreneur

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Free To Lose: The Bright Side Of Economic Failure

Harding University Team Wins National Honors

The Harding University Economics Team, competing at the International Exposition of Students in Free Enterprise (SIFE), hosted by Holiday Inns, Inc. May 19-21, 1986 in Memphis, Tennessee, was awarded a check for $3,500 and a National Runner-up trophy for their achievements.

The 1986 team is composed of Stephanie Carter, co-captain from Bentonville; Kevin Thompson, co-captain from San Diego, California; Melissa Brenneman from Spartanburg, South Carolina; Bruce Picker from Searcy, Arkansas; Joel Reed from New Haven, Indiana; and their sponsor, Dr. Don Diffine, professor of economics and director of the Belden Center for Private Enterprise Education.

The Harding program entry was "Capitalism is Innovative — It Made America." The Economics Team presentation described 68 projects and programs with 14 on-campus and 44 civic, professional and educational groups in the mid-south.

Harding Economics Team Projects receiving special mention were these: "Capital Day" launched to salute entrepreneurs; an "Important Economic Trivia" prototype game; the "FREE MARKET CALENDAR — A Daily Chronicle of Enterprise;" "All American Economics — Made in the U.S.A., a salute to Wal-Mart's 'Buy American' Program;" Project "Hometown America;" Project "Chain Reaction;" "P.R.O.F.I.T." Theme Contest with Wal-Mart Associates; "Empresa" Program for Spanish-Speaking students; "Images in Free Enterprise" Contest in Visual Arts; and "What Does Johnny's Dad Do?" project.

The national SIFE competition brought 27 regional winners together for two days of intensive competition. Fifty judges from business and industry across the United States evaluated each collegiate finalist.

by
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Success is the professed goal of every economy, and the U.S. economy has had its successes. Those successes are vividly portrayed in statistical terms through the historical records of growth in gross national product, and in more human terms through the emancipation of many Americans from the grip of poverty and in the elevation of many others to riches.

But failures are also endemic to the U.S. economy. A continual flow of news reports on bankruptcies, plant closings, layoffs, stock market slumps, industrial accidents, financial losses and persistent poverty makes the fact of pervasive failures indubitably clear.

While there is no reliable data on the total number of annual business failures in the United States, Dunn and Bradstreet reported more than 31,000 commercial and industrial businesses failed in the United States (one every 17 minutes) last year. And the number of business failures during that year and the previous two or three years was up dramatically from the level of the 1970s. Thousands of farms also went under last year, while tens of thousands more teetered on the brink of bankruptcy.

The prevalence and consequences of economic failure are also reflected by the number of unemployed and dislocated workers. A rising trend in the number and percentage of unemployed American workers has emerged over the past two decades. Although the unemployment rate was falling in the mid-1980s, there were still more than 8 million Americans looking for jobs in the beginning of 1986.

Between 1979 and January 1984, 11.5 million Americans experienced a period of unemployment because of "a plant closing, an employer going out of business, [or] a layoff from which...(the worker in question) was not recalled." Over 5 million of these workers had significant tenure (more than three years) at their jobs, causing them to be officially characterized as "dislocated." And a quarter of these dislocated workers were still looking for work in January 1984.

Unfortunately, it is all too easy to dwell on the dark side of economic forces — on the pain that people feel when affected by business failures. Such pain is brought to life on the television screen when fired or laid-off workers, foreclosed farmers and the homeless are interviewed for nightly news programs. The emotional appeal for governmental remedies is indeed intense and compelling, so much so that policymakers can hardly overlook them. Confronted with the consequences of failures, they are frequently driven to "do something."

"While failures may often be undeserved, unjust and unfair, the system that spawns them may still be just and fair.

The purpose of this paper is to add balance to public discussions of failures by emphasizing a frequently overlooked point: While failures may often be undeserved, unjust and unfair, the system that spawns them may still be just and fair. Democracies have a built-in political bias toward mitigating short-run failures and, in the process, creating long-run mischief. I make these points by first observing that many failures not only have a rational foundation but are often, but not always, expected by economic agents — private citizens (consumers and investors) and government policymakers.

So while failures are avoided where possible, many failures remain unavoidable but still instructive. Indeed, failures often inspire future successes. Moreover, they are often a necessary side effect of success. That is the bright side of economic failure.

The Economy of Failure

The Failures of Scarcity

Economists have long noted that because people's wants far outstrip their abilities to produce, choices involving the allocation of resources are unavoidable. That point, while patently obvious, is fundamental because it acknowledges that not all goods and services can be produced. Nor is it reasonable to expect that all goods currently produced will continue to be produced. Some producers will fail to secure the necessary resources to start production. Others, already in production, will fail to retain the resources they have.

In other words, choice and the necessity of allocation make failure certain and unavoidable. However, it cannot be forgotten that while some firms fail, others succeed.

The prevalence of scarcity ensures the pervasiveness of failure. This is because of the pervasiveness of success — that is, the ability of some to secure resources, at the same time, denies resources to others. Firms go bankrupt, factories close and workers are unemployed because strategic resources are reallocated to other more successful firms, factories and workers.

Indeed, the failures of some increase the probability of success for others. The failures release resources that can then be employed (at possibly lower resource prices) by the remaining competitors. The reduced supply of goods and services can then be sold at higher prices and, thus, on more profitable terms.

The growth in the number of business failures during the early 1980s is partially a product of the twin recessions, spawned in large measure by government policies to reduce inflation. However, many failures were also spurred by the emergence of new firms and the expansion of established ones. There has been substantial growth in new incorporations, although the number of new incorporations is only a rough measure of the emergence of new businesses. There were 600,000 businesses incorporated in 1983, more than twice the number of 1970.

The businesses that emerged in the 1970s and 1980s caused the demise of others by driving up the price of resources to the point where some firms were no longer competitive.

Relative Performance and Failures

The economic source of failure is, in a world of scarcity, a matter of relative performance levels. The firms that fold may be well organized; the plants that close may be efficient; and the workers unemployed may be productive.

The fundamental goal of every economy is presumably to produce the highest consumer satisfaction with the resources available. The process of failure is driven by peoples' efforts to get the most possible from these limited resources.

Policymakers often lament the impact of imports on domestic production and relate imports to plant closures and unemployment. Textile and apparel trade restrictions, for example, have been proposed on the proposition that expanding imports caused the closure of as many as 250 textile and apparel plants between 1980 and 1985, robbing American textile and apparel workers in the United States of hundreds of thousands of jobs. From my research in this area, it appears that other American producers are, in effect, the competitive culprit, at least in the textile industry. The firms in and out of the textile industry that were *relatively* more cost effective in production have expanded sales — the least efficient firms and plants went out of business.

While textile, apparel, and several other U.S. industries blame foreigners for many of their troubles, the industries have substantially "failed" in their competition with other domestic producers for control over available and limited resources. Other American producers have been, in effect, the competitive culprits because they are the ones that were relatively more successful in capturing the country's comparative advantage in production and in being able to export (and not face import competition).

Information and Failures

The process of failure is greatly aggravated by the scarcity of one critically important resource — information.

Knowledge on customer wants and competitors' plans is imprecise and costly to obtain.

The information problem is made more complex — and more subject to the constraints of scarcity — by the amount and kind of information that can help achieve success and avoid failure. Regrettably, such information is not readily accessible. Information on the availability of resources is widely scattered among thousands, if not millions, of people and must somehow be induced from its holders. It is influenced by the amount of resources applied to gathering information, i.e., the amount and quality of information obtained will depend greatly on its cost.

Public policy "solutions" to failure may accomplish nothing more than reallocating resources — redistributing successes and failures.

To say the absence of adequate information is a source of failures is to state the obvious, but such obvious points are often overlooked when policymakers consider remedies for failures, especially remedies that fail to address the information problem. Moreover, there may be no solution to the information problem because key bits of competitive knowledge may not be available at any price. Public policy "solutions" to failure may accomplish nothing more than reallocating resources — redistributing successes and failures. Indeed, changing people's incentives to provide and acquire information may aggravate the problem of failure.

Much has been made of information problems inherent in a market economy. Since the multitude of market participants has only limited information, i.e., their own individual plans that are not coordinated with the plans of all others in the market, economic resources may be wasted. In a market economy, the left hand often does not know what the right hand is doing. Housing, for example, goes through boom and bust cycles because individual contractors, who are uncertain of each other's plans, overbuild, causing precipitous price drops, bankruptcies and contractor failures.

Many critics presume that centralizing the decision-making process would solve the information problem. Central planning of production may solve some information problems — for example, how much is supplied — but it would not answer how much production consumers want. Furthermore, central decision-making runs amok when attempting to allocate resources among available producers.

One of the great virtues of markets is that they divide responsibility for obtaining and handling information among a host of market participants, especially information that can minimize the chance of failures. Centrally directed economic activity can impose superhuman demands on the limited capacity of planners to handle information. Increases in the complexity of production processes that may emerge with the integration of the world economy and with technological development only increase demands that would be imposed on planners.

Risk, Uncertainty, and Rational Failures

Information deficiencies ultimately translate into problems of risk and uncertainty about future economic events. Risk, which is grounded in probability, means that some ventures will not go as planned. That is to say, risk is a statement about the distribution of successes and failures over a series of ventures. For example, 7 out of 10 restaurants will fail. The missing information is which ventures will succeed and which will fail, and the information is often missing because of its cost.

Uncertainty, on the other hand, amounts to a lack of information about the distribution of outcomes — numbers of successes and failures. Uncertainty emerges because of lack of experience and difficulty in obtaining the requisite information on the probability of successes or failures. The cost of information no doubt plays a role in establishing the degree of uncertainty.

Risk and uncertainty ensure failures. Not everything can turn out right. Attempting to eliminate failure in the face of risk and uncertainty could be counterproductive because the costs of doing so probably would be higher than the costs endured through failures. In other words, in spite of the undesirable results of failure — closed plants, unemployed workers and erosion of a local economic base — the costs of protecting against failure — slower economic growth, a retarded pace of innovation, and lack of international competitiveness — may be far greater in the long run.

In its raw form, risk and uncertainty imply that many failures are no less founded in rational planning than are production and consumption decisions that do not always match expectations. Less than perfectly suitable goods and services are produced because the benefits of improving them would not be worth the cost. Plants close because the cost of preventing their closure through the acquisition of more market information is greater than the costs associated with a shutdown.

In each instance of failure, an economic cost exists, of course; and as with any other cost, the cost of failure would preferably be reduced, if not totally avoided. However, most failures are not isolated ventures but are part and parcel of a whole complex of ventures, all of which combined have some risk and uncertainty of not working out as planned.

Risky and uncertain ventures typically carry the greatest rewards, partially to overcome the costs associated with failure and partially to compensate for people's natural or learned inclination to avoid risky and uncertain outcomes. (In the jargon of economists, many people are "risk averse.") If an outcome is more risky and uncertain, the reward tends to be greater.

We can draw an analogy with the stock market investor who understands that the purchase of stocks entails risk and uncertainty along with the prospect of rewards. An investor typically assembles several different stocks in a portfolio, understanding that one or more of his purchases occasionally, perhaps even frequently, will not appreciate in value as he or she expected. The investor evaluates the selections by how the entire portfolio does *on balance.* In this sense, failure is planned, expected and even sought.

Firm managers and workers typically deal with risk and uncertainty through what amounts to "portfolios" of activities.

To ensure that no stock ever fails is a prescription for a less desirable return on the portfolio of stocks. However, because expected income is increased through the development of a portfolio of stocks, the investor is better able to buy more stock — in turn suffering additional failures but also realizing greater successes.

Firm managers and workers typically deal with risk and uncertainty through what amounts to "portfolios" of activities. Managers develop a variety of products and run several plants knowing that some plants will have to be closed. In effect, they develop portfolios of products and plants and plan for failures, although they simultaneously will do what they can (or what is economically reasonable) to avoid these failures.

By developing portfolios, managers expect to increase their production incomes on *balance.* Their ability to spread risks and increase their firm's income means more products will be developed and more plants opened. But it also means a greater number of failures, although the failure rate may be reduced through greater experience with more products and plants and through a greater capacity to absorb the costs of avoiding failure.

Workers and consumers also engage in "portfolio management." Workers often develop a variety of skills (or keep their skills general, applicable to many different work environments) and engage in a variety of activities, one of which is a job. They understand that through time and over the course of many activities and jobs, they will at times fail — become unemployed or find their skills and abilities of less value than planned.

Many consumers also buy appliances that they know are not "top of the line" and will occasionally fail. They buy what they do in anticipation that their portfolios will yield them a greater net return than if they bought more expensive appliances with a lower chance of failure. The important point is that in spite of the failures, consumers and workers manage their portfolios with the intent of raising their incomes.

Learning from Failures

It is all too easy to think solely of failure as tragedy. After all, we do expend considerable energy seeking to avoid individual failures.

Yet failures can be highly instructive and productive. They help, perhaps more than successes, to outline the bounds of profitable and productive economic acitivity. Failures instruct those who fail on what they should not do the next time, if there is a next time. More importantly, they tell others in the market what was done wrong and what will have to be done to become and/or remain successful. Economic failures are, thus, a critically important source of information. As such, they provide market participants with the necessary incentives and disincentives (instructions) on what people, acting independently of one another, should and should not do.

International competition and domestic deregulation may be sources of greater risk of failure for U.S. firms, but what American managers have learned in the process is that they must rethink management practices and investment strategies. As a result, the performance of the U.S. economy will likely show feedback effects in improved growth during the 1990s, if not sooner.

The market system is a portfolio writ large: Over the course of many individual decisions and economic circumstances, the welfare of the vast majority of people will be enhanced through individual successes and failures.

The market system is itself a portfolio writ large. One justification for free markets is that over time — and over the course of many individual decisions and economic circumstances — the welfare of the vast majority of people will, on balance, be enhanced through combinations of individual successes and failures. The pricing system is a critically important force in minimizing failures because it provides people with necessary market information, coordinating individual activities by the well-known "invisible hand."

The Justice of Failure

Clearly, not all failures are just or fair. Some failures are the consequence of violations of contracts. Banks have failed because employees have embezzled funds. Real estate deals have failed because contractors did not build buildings as they said they would. And manufacturing plants have closed because supplies have not been delivered as promised or strategic employees did not fulfill their contracts. The injustice of these instances of failures are interesting because they represent behavior that violates the prevailing roles of economic behavior.

However, many failures may be just in the sense that no previously agreed-upon rules have been violated. All contracts may have been honored; all rules obeyed. The firms simply failed as a consequence of problems associated with scarcity, namely risk and uncertainty. Indeed, the failures may have been anticipated, and no loss of income may have resulted.

Individual instances of failures, isolated from successes, may all appear to be unjust or unfair, but this does not mean that the system that led to the failures is unjust or unfair. Again, no previously agreed-upon rules may have been violated. In addition, failures may mirror an increase in income for those who experience the failures. People may be hurt by their own failures, but they can be helped by their other successes and by the failures and successes of others that result in improved goods and services they buy. The result can be a greater income from a system that allows failures than one that deliberately attempts to contain them. The prospects of greater income, in spite of the prospects of failures, can be the impetus for the consent of those within the system.

Still, not everyone is likely to gain from a market system that permits unchecked failures. There will be those who fail at everything or practically everything and end up as net losers from the system. The question of whether net losers should be helped by public means is a difficult question, one that cannot be fully treated here. Participants may agree to a system that allows for some compensation to be paid to the losers, thus maintaining the necessary public support for the market system. Under those circumstances, it is particularly hard to see how the system could be viewed as unjust.

The Samaritan's Dilemma

Those who seem to object to public efforts to help businesses that go bankrupt, farmers whose farms are sold at auction and workers who experience involuntary unemployment are often viewed as unfeeling — unable to empathize with the economic difficulties, encountered by others. However, differences on what should be done to remedy failures arise even among those who care. This is because of the ever-present Samaritan's dilemma: Should those in need be helped by public means if it means future reliance on outside help? The answer is not so obvious as might be presumed.

If public aid had no consequence beyond mitigating the adverse effects of failure, the debate would not be nearly so intense as it often is. However, as with failure, relief also has consequences. It can encourage the very problem that is the object of the public remedy. Relief can make failures more palatable and, thereby, more likely. It can reduce the tendency of a market economy to economize on failures and to learn from them. Hence, it does not follow that those who object to public remedies necessarily object to helping others. Objectors can be concerned about those future groups who will suffer from failures that are encouraged by policies adopted today.

The more dynamic, venturesome and growth-oriented a market economy is, the more it will be fraught with failures. High levels of business bankruptcy are not the product of capitalism's failure but of its success.

The more dynamic, venturesome and growth-oriented a market economy is, the more it will be fraught with failures. High levels of business bankruptcy are not the product of capitalism's failure but of its success. People undertake new enterprises because of the possibility of success. A policy of rewarding failure would inevitably require restricting new truly viable enterprises.

As the late Joseph Schumpeter has reminded us, the paradox of capitalism is that it is most successful when most dynamic, and when most dynamic, it is most destructive. The large numbers of economic failures in the United States are an inevitable companion to the substantial expansion of sales, employment and profits in recent years. Perhaps the most convincing evidence, then, of the bright side of economic failure is the invidious comparison of U.S. economic success to the economic performance of the more security-conscious nations of Western Europe.

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