ACTIVITY 15.1
MARKET FAILURE VS. GOVERNMENT FAILURE VS. NO FAILURE

What Is Market Failure?

The market for apples generally does a good job of allocating apples. Participants buy and sell, and they all feel the benefits exceed the costs. But what if an unethical apple producer used illegal and unsafe pesticides? Then apple buyers would inadvertently be buying a product with costs greater than benefits. When a market does not allocate resources properly, there is a *market failure*. Markets for tangible goods and services fail when participants do not have to bear the full costs of their transactions—like an apple grower secretly using that illegal pesticide. The same principle applies in financial markets. When a dishonest market participant engages in deception or fraud, costs are shifted and the market fails. Consider what would happen if a financial advisor deliberately denied the presence of risk while getting clients to invest in speculative stocks. The clients would end up with riskier investments than they intended—an instance of market failure.

Federal Regulation: The Securities and Exchange Commission

Congress established the Securities and Exchange Commission in 1934, following widespread financial problems that ushered in the Great Depression. Here are three major problems that can make financial markets fail, along with SEC measures aimed at preventing those problems:

1. **Dishonest statements from companies offering stocks.** The SEC combats this problem with reporting and disclosure requirements.
2. **Unfair treatment of investors.** The SEC combats this problem with rules and monitoring of trading.
3. **Outright fraud and theft of investors' funds.** The SEC combats this problem with enforcement actions, including lawsuits.

What Is Government Failure?

In financial markets, government regulation is aimed at providing information and enforcement to prevent dishonest and unfair dealing. But regulation does not always work as intended. Just as there is market failure, so too there can be *government failure*, defined as "policy and budget choices by government officials that result in inefficiency." For example, the Federal Reserve System was set up in 1914 to guard against financial instability in the banking system, but the Federal Reserve failed its first big test in the banking crises of the early 1930s.

The possibility of government failure means we cannot always be sure that regulation will solve a market problem. Below is a recent example.

Bernard Madoff's Ponzi Scheme

The investment scam called a "Ponzi scheme" was named after Charles Ponzi, who was born in Italy but became a swindler in North America. The scheme involves a mythical investment fund that has no real profits or assets. Instead, it recruits investors with promises of high gains. As recruiting continues, early investors are paid with money collected from later investors—but the scheme must eventually collapse because of the lack of actual profits or assets to generate a return over the long term.

The largest Ponzi scheme in history operated right under the SEC's nose for years. It was run by New Yorker Bernard Madoff from the early 1990s until 2008. Investors' losses were estimated at $65 billion.

The Madoff fund operated as a classic Ponzi scheme. It had no real assets or investments, and was able to pay off early investors only from funds invested by new investors. Madoff's Ponzi scheme went undetected by the SEC even though its operations fell clearly under SEC jurisdiction. After the Ponzi scheme fell apart and Madoff went to jail, an internal SEC report laid out the agency's multiple failures in the case of Madoff:

- The agency was repeatedly tipped off about Madoff.
- There were "detailed and substantive complaints."
- There were three examinations and two investigations by SEC staff, but the internal report said no thorough and competent review was performed.

(Source: U.S. Securities and Exchange Commission, "Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme," August 31, 2009, available online: http://www.sec.gov/news/studies/2009/oig-509.pdf)

This was a case of government failure.

When Markets Work but Investors Lose Money

Historically, stocks have yielded high returns, on average, but any one stock is always subject to substantial risk. A company might misjudge markets or fail to control costs or engage in unwise expansion—causing stockholders to lose part, or even all, of the value of their investments. Investors cannot strive for a high return by investing in stocks without bearing risk.

This risk-bearing by stockholders means that good-faith investments may result in substantial losses. Losses may occur even when there is no market failure and no government failure. Regulation by authorities such as the SEC can work to guarantee the integrity of the process of buying and selling stocks. However, it is not designed to guarantee investment outcomes.

Snapple iced tea products provide a good illustration of this point. The shareholders of Quaker Oats expected high returns when Quaker bought Snapple in 1994. Quaker had enjoyed success in managing its sports drink Gatorade, making it a widely recognized and profitable brand. Quaker's success in dealing with grocery store chains and retailers promised similar success for Snapple. Yet Quaker stumbled badly and never made a success of Snapple. After paying $1.7 billion for Snapple in 1994, it sold Snapple for $300 million in 1997. Quaker's shareholders lost more than a million dollars a day on the deal.

As bad as the deal was, it complied fully with securities laws. Investors were warned of the risk. It was simply a business deal that did not work out. Thus there was no government failure and no market failure to blame.

The Blame Game: Market, Government, or Neither?

In this classification game you will be shown several investments that have gone bad. You will be asked to assign blame, indicating your answer by:

- ← Moving to that side of the classroom for "market failure"
- Moving to the other side of the classroom for "government failure" →
- Standing in place if there is no market failure and no government failure.

If more than one answer seems to apply, pick the one you believe is most relevant.

The investment situations you are to consider are listed below. Think about each one and prepare to classify each as a market failure, a government failure or no failure:

- **Pay package snag:** Investment fund managers take on excessive risk because their pay packages reward them for high returns, but provide no penalty for losing shareholders' money. The fund's disclosures meet the letter of the law, but they understate the risk.
- **Grocery startup:** Webvan.com pioneers the online grocery business, grows too fast, and fails. Although there is no fraud, because of the business risk investors lose all the money they put into it.
- **Home-loan mess:** Government housing policy requires risky loans to less qualified customers, and many of the new homeowners are then unable to make their payments. Financial distress spreads and the housing market crashes.
- **AOL-Time Warner:** After full disclosures and despite high hopes, a merger of media giant Time-Warner with Internet startup AOL loses billions of dollars of investor money.
- **Senior sales push:** A high-pressure phone bank sells stocks over the phone to uninformed residents of nursing homes. Although investigators can find no violations of law, it is clear that the buyers did not understand the risks.
- **Your results may vary:** After becoming fully informed about the risks and returns of holding stocks for the long term, an individual investor finds that stocks have gone down overall for a ten-year period.