Big business should be allowed to fail

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Across the developed world we are witnessing an outbreak of bailout mania by governments.

In the U.S. and Europe, governments have injected tax-financed life support to financial institutions.

This includes the mother of all bailout packages, the $US700 billion plan by the Bush administration.

Citibank is a recent beneficiary of a government bailout, and the US and Europe has been discussing similar bailouts for car manufacturers.

Closer to home the Federal government is bailing out car manufacturers and childcare centres. The government has also introduced a deposit guarantee for banks.

These interventions aim to preserve existing economic activities and jobs.

The problem is that governments may not know when to stop. The Commonwealth has recently announced a $2 billion debt guarantee to car dealers across Australia.

To understand why government bailouts are undesirable, we need to appreciate how markets work. Businesses compete for the dollar votes of customers.

If a business satisfies its customers by producing high quality outputs at lower prices, it can cover its costs and gain reward of profits. If not, it could incur losses and perhaps become insolvent if the business doesn't change its practices to suit consumer preferences.

Profitable businesses promote consumer welfare and, through it, the broader wealth of nations.

Business failures are painful for those immediately concerned, but they tend to carry broader benefits. The resources tied up in failed businesses are re-allocated towards higher valued uses.

This cleanses the economy, paving the way for renewed growth. Business failures also teach aspiring entrepreneurs what not to do when entering the marketplace.

The ubiquity of business failures is outlined in a 2006 book by Paul Ormerod, Why Most Things Fail. About 48 of the world's top 100 companies in 1912 no longer existed by 1995. Only 19 of the top 100 companies in 1912 remained so in 1995.

This corporate adjustment did not prevent the global economy growing by a factor of 12 over that period.

Only 39 of the top 100 Australian companies from 1990 survived to 2002.

Some argue that government bailouts should assist firms that are too big to fail. The reality is that the bigger the unproductive firm that wastefully consumes an economy's scarce resources, the sooner it should be allowed to fail. That way, labour and capital can be gainfully utilised by more viable businesses sooner.

The risk is that businesses may come to perceive recent government rescue packages as a fixture of corporate practices.

This raises a moral hazard effect, where the expectation of a bailout will do nothing but encourage inefficient or risky business practices.

Some targets for the bailout mania are industries whose investments have been supported by government subsidy, or have been fuelled in recent years by the aggressive credit expansion of central banks.

However, bailouts in these cases are just as improper as for other industries, if not more so given the great economic costs of the initial government interventions.

When it comes to market capitalism, it is true when they say there is a silver lining to every cloud. This is on the proviso that we let markets do their adjustment work.

The sooner governments abstain from bailing out firms, the sooner we can all get on with the next phase of growth and prosperity.