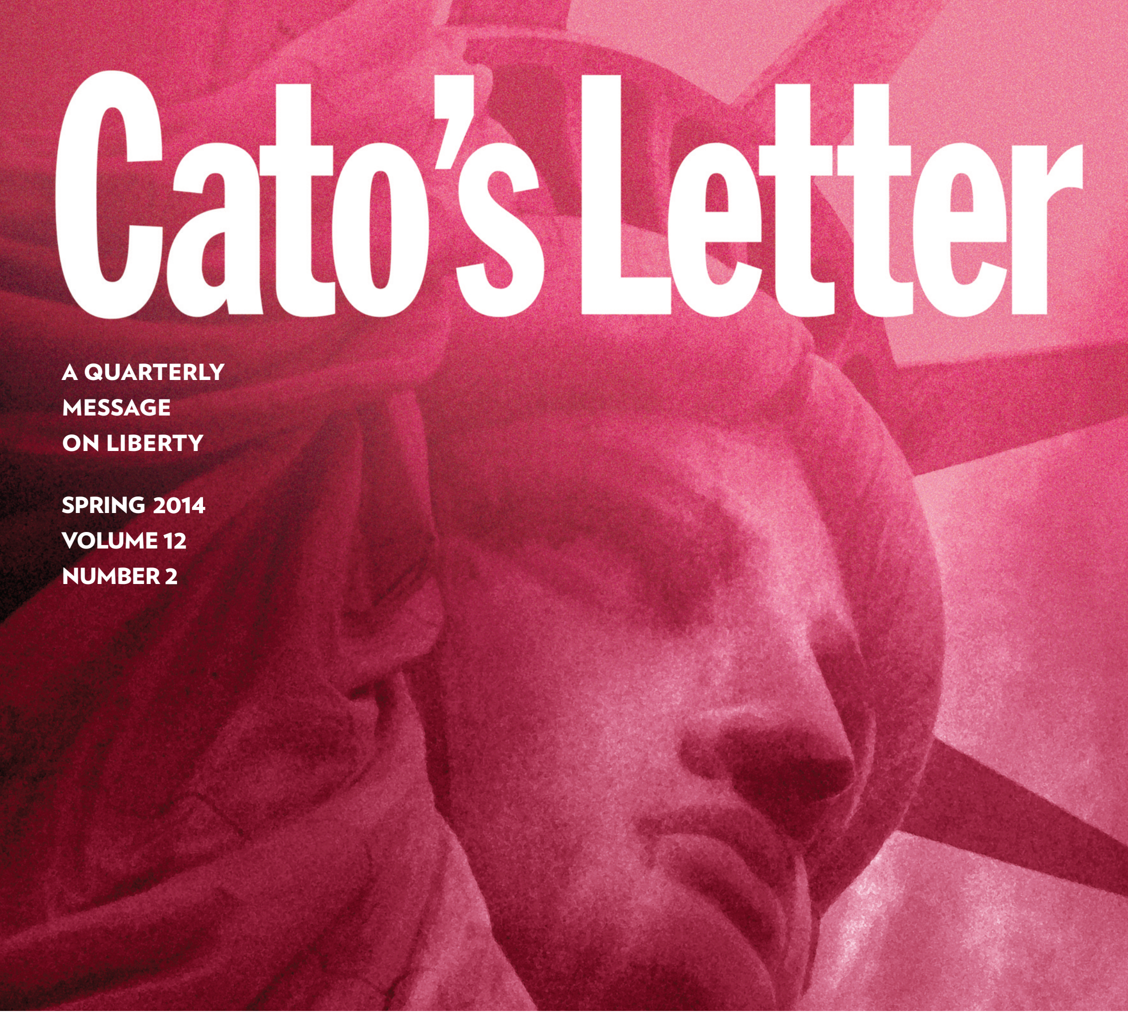

Cato's Letter

A QUARTERLY MESSAGE ON LIBERTY

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Why Failing Well Is the Key to Success

MEGAN McARDLE

You've probably heard the story of what's arguably the biggest movie disaster of all time. The script required a massive set built in the middle of an even more massive body of water, even though water is both difficult and dangerous to work with—if you've ever had a bathroom flood, you can imagine what thousands of gallons can do to a set.

The budget marched rapidly north of $200 million, which in the mid-1990s made it the most expensive picture ever made. The sheer scale of the project attracted guffaws and predictions of doom from the gleeful press. To top it off, the picture was plagued by production delays and a postponed release date.

MEGAN MCARDLE IS A COLUMNIST FOR *BLOOMBERG VIEW*, WHERE SHE COVERS ECONOMICS, BUSINESS, PUBLIC POLICY, AND THE OCCASIONAL KITCHEN GADGET. SHE SPOKE ABOUT HER NEW BOOK, *THE UP SIDE OF DOWN*, AT THE CATO INSTITUTE IN FEBRUARY.

The film finally debuted four months late, in Tokyo, to a reception that the *New York Times* described as "tepid," "muted," and "subdued." By that time, the studio heads had privately started saying things like, "If we can just break even…." The director himself admitted—well after the release—that he "labored on" for the last six months "in the absolute knowledge that the studio would lose $100 million. It was a certainty."

Journalists and movie buffs across America had by then already spent months wallowing in schadenfreude. How could anyone have thought this was a good idea? Which just goes to show why so few journalists end up making millions in Hollywood.

> "The universe is an inherently uncertain place. We tend to think that we can somehow engineer failure out of the system, but we can't."

Titanic went on to become the top-grossing picture of all time—at least until its director, James Cameron, went on to make the even more successful *Avatar*. Perhaps you were expecting me to name *Waterworld,* the Kevin Costner extravaganza that cost almost as much as *Titanic,* and grossed just $85 million before an ignominious close. That's certainly what many people were expecting when *Titanic* hit movie screens in 1997. The 1995 *Waterworld* debacle was still a fresh memory when *Titanic* debuted, and the parallels must have chilled even James Cameron.

All of which illustrates William Goldman's famous observation about Hollywood: no one knows anything. Until you put a movie into a theater, there's no way to tell for sure what's going to happen.

But there's something else our exercise illustrates even more compellingly. It's easy to believe, especially in hindsight, that you can reason your way to a good prediction. I fooled you a bit by telling you that it was arguably the greatest movie disaster of all time, rather than the greatest disaster movie. But the reason I was able to get away with this is that the line between the two is much thinner than we realize.

We like to think that there's a plan—that failure comes when you do not prepare. But if you actually look at the marketplace, that's not what you see. Let me talk for a moment about a product that was really well-planned.

Once upon a time, an old soft drink company was being threatened by a hot, young competitor. The Coca-Cola company was frightened that customers had begun taking the "Pepsi Challenge" and seemed to prefer the taste. So Coke started a top-secret project to develop a replacement. These men weren't stupid: they knew that this was risky. And so they went out and commissioned the biggest market research study in history. Even before they had finished developing the new product, teams were criss-crossing the country, conducting surveys, assembling focus groups, and offering free samples to determine how people might feel about the change. It turned out people loved it.

> "In America, the assumption is that in your failure, you've learned a lot of valuable lessons on somebody else's dime."

The company decided to repeat the process, commissioning the biggest market research study in history *again*. The results showed that while a minority of customers were resistant, the overwhelming majority couldn't wait to get their hands on this new creation.

Once it hit store shelves, however, New Coke lasted less than three months and nearly took the company down with it. What happened? The problem was that the executives at Coke didn't understand the limits of their experiments. The question they thought they were asking was "If we replace Coca-Cola with this new soda, will you buy more of it?" But the only question their test could actually answer was "Which of these small samples would you prefer to drink in a parking lot, if I gave it to you for free?" That's not even close to the same question, but it's the best they could do. In short, there is ultimately no way to know whether something works until you put it out there and see how your target audience reacts.

The universe is an inherently uncertain place. We tend to think that we can somehow engineer failure out of the system, but we can't. It strikes me when I read stories about entrepreneurship that they all tend to follow the same narrative: Genius inventor comes up with brilliant idea and is now standing, arms crossed, on the cover of a business magazine. But when you actually talk to entrepreneurs, that's not the impression you get. They are basically like baseball players. A great batter fails to hit the ball 7 out of 10 times. If you take a group of people who want to start a successful business—let's say they all have solid business plans, good venture capital support, and won't run into imminent cash crises—those people will succeed only 3 times out of 10. Most entrepreneurs fail.

Not long ago, a guy named Peter Skillman, who was head of user experience for Palm, assembled a variety of groups—from American students to Taiwanese telecom engineers—and gave them each 20 pieces of spaghetti, a meter of tape, a marshmallow, and a piece of string. The teams had 18 minutes to create the tallest freestanding structure that would support a marshmallow.

Unsurprisingly, the engineers did very well. MBA students finished dead last because apparently they spent too much time arguing about who was going to be in charge of the spaghetti. Lawyers didn't do well either.

The most successful group, however, was kindergartners. How did they beat the engineers? By the simple process of experimentation and iteration. They didn't follow rules:

the kindergartners were the only group to ask for more spaghetti. And because they had more spaghetti, they just dove in and started creating. They ruthlessly called out what didn't work and discarded it. With that process—what Silicon Valley calls "failing fast"—these five-year-olds ended up with structures that were on average a full inch taller than what the engineers had achieved.

This is how evolution works, it's how the economy works, and frankly it's how most learning works. If you think about tennis, nobody learns how to play by developing an elaborate theory of tennis ball physics. You learn first by hitting the ball and watching it go in the opposite direction you had hoped. Over time, you begin to hit it in the right direction and your brain learns through repetition of those rare events.

When you talk to Europeans who have done business in America, and vice versa, they tell you the same thing: a European executive who works for a company that has failed is an executive who no longer has a career. In America, by contrast, the assumption is that in your failure, you've learned a lot of valuable lessons on somebody else's dime.

In the business world, we are very good at recognizing the fact that failure holds an enormous amount of critical information. We are not so good at recognizing this in the prison system. In fact, the United States is much worse than any other country in the world, having essentially wrecked the lives of two million young men by making them unemployable. Most of the people in prison have done things they shouldn't have done. But it's a phenomenal waste—both for them and for society—that we've thrown away all of that human capital.

In a certain sense, the genius of America's economic system is that it is so forgiving. The United States is far and away the bankruptcy capital of the world. Most of us don't realize how uniquely generous it is. But it's a system that fosters innovation and risk taking, encourages entrepreneurship, and helps folks who make mistakes, even bad ones, get back on their feet. Everywhere else, bankruptcy is a stigma, an enduring disgrace, a permanent stain. Here it's just as likely to be the doorway to a business empire. By wiping old debt off the books, we help the economy by speeding up the redeployment of capital—both human and financial.

> "America spent several centuries being really good at failure, and somewhere along the way we built the biggest, richest country in the world."

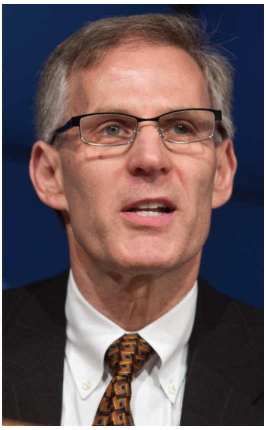
For small-time entrepreneurs, easier personal bankruptcy mitigates the considerable risks of starting a business. But that's not the only way easier bankruptcy laws encourage entrepreneurship. Taking entrepreneurial talent and strapping it to old debts is an enormous waste of a scarce resource. By freeing people from the sunk costs of their failed business, we free them up to try again.

You might say that all this is worth it if we're punishing the profligate—keeping people from running up bills they can't pay on foolhardy ventures. And it's true: making bankruptcy more difficult probably does prevent some of that. But the price tag of easier bankruptcy is surprisingly cheap.

I want to close by saying that the pain from failure should be short, it should be sharp, and it should incentivize us to overcome without tearing us away from the social fabric of society. It's not enough to encourage people to fail. It matters as much, maybe more, what we do next. How easy do we make it to recover?

Failing well means learning to identify mistakes early. It means learning to understand those mistakes so they can be corrected. Most of all, it means overcoming our natural instincts to blame someone whenever something goes wrong. Societies and people fail best when they err on the side of forgiveness.

America spent several centuries being really good at failure, and somewhere along the way we built the biggest, richest country in the world. We did it mostly because we were willing to risk more, and forgive more easily, than most other countries in the world. We lend more freely and let debtors off the hook; we regulate more lightly and rely on a hit-and-miss liability system instead. These things are often painted as weaknesses, but in fact they are great strengths. They are the sign of a country more invested in the future than the past. ■



CATO SCHOLAR PROFILE

Jeffrey A. Miron

Jeffrey Miron is the director of economic policy studies at the Cato Institute and the director of undergraduate studies in Harvard University's department of economics. His area of expertise is the economics of libertarianism, with particular emphasis on illegal drugs. From 1992 to 1998, Miron was chairman of the department of economics at Boston University. He is the author of *Libertarianism, from A to Z* and *Drug War Crimes*, in addition to numerous op-eds and journal articles. Miron received his PhD in economics from MIT in 1984.

IS IT TOUGH BEING A LIBERTARIAN AT HARVARD? HOW WILL YOUR WORK AT CATO COMPLEMENT YOUR UNIVERSITY RESPONSIBILITIES?

Harvard has welcomed my libertarian views. I do not mean that most people agree; quite the contrary. But rather than being hostile, faculty and students seem to enjoy debating my perspective. The regular pushback helps sharpen my arguments and nudges me to give other views their due. And the incredible stream of research that is produced and discussed in the economics department forms a great foundation for my role at Cato.

My work here will fall into three main areas. First, I will work with those scholars who write on economic policy issues. Second, I will try to get more outside scholars involved with Cato. I think academia contains more libertarian-leaning economists than outsiders realize. I hope to energize these folks behind libertarian themes.

Finally, I will continue my own work in two main areas: drug policy and government debt. We appear to be entering a great moment for drug legalization, though much work remains. In particular, we should legalize all drugs, not just marijuana. On debt, my goal is to emphasize that the problem is much worse than conventional numbers like the debt-to-GDP ratio imply. The implicit liabilities of federal, state, and local governments in the United States are overwhelming and growing.

HOW DO YOU APPROACH ECONOMICS? WHAT IS THE COUNTRY'S ECONOMIC OUTLOOK MOVING FORWARD?

Overall, my approach to economics is utterly mainstream: I use theory and empirical methods in the same way as other academics. The main difference is that, relative to some, I emphasize the unintended consequences of intervention and the potentially enormous gap between intentions and outcomes.

I am torn about the country's outlook. On the one hand, the United States is still an incredibly dynamic economy that has the potential to grow as robustly as it has in the past. On the other hand, counterproductive interventions keep expanding, and the long-term fiscal outlook is dismal due to entitlement growth. The country needs a substantial change in direction—toward smaller government—to avoid falling far down the list of rich (or free) countries.

One of the toughest challenges for libertarianism is the ingrained assumption that government spending is necessarily good spending and we therefore always need more. This is not even true in the textbook Keynesian model that has fostered this view, a framework that faces serious theoretical and empirical difficulties. But because the benefits of more spending are often more obvious than the costs—and since vested interests are effective at protecting their programs—reigning in excess spending is hard. Cato's economic analyses are a vital antidote. ■

Treat Yourself!

Cato University is right around the corner—July 27 through August 1—and you should consider attending if you possibly can. It will be held this year at the lovely Rancho Bernardo Inn in San Diego. Spending a week at Cato University is a wonderful, comfortable, and enriching experience, the kind of event you'll remember for years to come. We consider Cato University to be our premier educational event of the year. But it's also great fun!

Participants and faculty travel from across the country and around the globe. Just to give you a quick flavor, this year Jeff Miron of Harvard University will be lecturing on such topics as the economics of cooperation and coercion. Cato senior fellow Tom Palmer will boldly endeavor to explain the history of libertarian thought in just a few cogent lectures. Rob McDonald of the U.S. Military Academy at West Point will impart a whole new perspective on U.S. history, especially that of our founding years. Randy Barnett of Georgetown Law School will bring legal and constitutional issues into focus.

If it's simply not possible for you to trek to San Diego, you can avail yourself of the Cato University Home Study Course. The 12 modules of this program are available separately—as downloads or on CD. Indeed, you should bear in mind that just about all the events we host at Cato are available online. That equates to a pretty amazing archive of topflight presentations and information, since we host events just about every day. The events themselves range from book forums to panel discussions to full-blown, multi-day conferences.

The Cato Institute is delighted to offer a comprehensive catalogue of timely events and publications—all accessible via www.cato.org. Our multimedia page proffers policy wonks and novices alike unfettered access to daily podcasts, TV and radio highlights, and our entire event archives—which is your front-row ticket to the most exciting and important public policy discussions of the day. Joined at the podium by renowned experts, our scholars debate essential issues and propose liberty-minded solutions to policy challenges. The *Cato Daily Podcast* is your source for breaking analysis of pressing issues, from health care to global warming. And media highlights feature our eminent scholars as they bring libertarian perspective to the national forum via major network appearances.

Cato's scholarly work and its remarkable website are designed with you in mind. We try to put the best policy ideas in front of you, making them accessible through an array of formats. If you like our offerings, please consider making an annual contribution to Cato at whatever level is comfortable for you. And please also think about remembering Cato in your will—or as a designated beneficiary of a retirement account—so that generations to come will have the same superb Cato resources available to them. ■

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