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Whatever economic system a country adopts, there is always a role for the government due to market failures. Can governments correct market failures? Illustrate your answers with example.

Part One

Adam Smith who proclaimed the principle of the "invisible hand" that holds every individual is led, as if by an invisible hand, to achieve selfishly the best good for all. Smith saw harmony between private interest and public interest. In his view, any government interference with free competition is almost certain to be injurious in the economic world. He recognized that the virtues of the market mechanism are fully realized only when the checks and balances of perfect competition are present. Under the perfect competition and with no market failures, markets will squeeze as many useful goods and services out of the available resources as is possible. However, in reality, markets may fail to function well under numerous reasons. According to Wolf[1], there are two kinds of failures which are i) insufficient allocation of resources in terms of the quality of products and prices and ii) inequitable distribution of income or wealth. To be more specific, it includes the following: the inability to provide public go ods, negative externalities, imperfect information and increasing returns to scale and monopoly.

Public Goods

"A public good is a commodity or service whose benefits are not depleted by an additional user, and for which it is generally difficult or impossible to exclude people from its benefits, even if they are unwilling to pay for them. In contrast, a private good is characterized by both excludability and depletability" [2]. Some examples of public goods are provision of national defense, the building of highway network or the support of basic science. Adequate private production of these public goods will not occur as the benefits are so widely dispersed across the population that no single firm or consumer has an economic incentive to provide them. Since private provision of public goods is insufficient, government must step in to provide public goods.

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[1] Wolf, C Jr (1993) Markets or Governments: Choosing between Imperfect Alternatives, Cambridge, MA: The MIT Press, (p.17)

[2] Baumol, W J (1988) Economics: Principles and Policy, Ch.29, 'The market mechanism: Shortcomings and remedies' (p631-51)

Externality

This is another type of inefficiency arises when there are spillovers or externalities. These effects occur when firms or people impose costs or benefits on others outside the marketplace. The phenomenon of externalities is universal. Since our society has become more densely populated and as the volume of production of energy and other material increases, negative spillover effects will be generated. This is where governments come in. Government regulations are designed to control externalities like air and water pollution, hazardous wastes, unsafe drugs and etc.

Imperfect Information

It is idealist to assume that producers/sellers and consumers/buyers to have all information before they make their decisions. In reality, producers, providers or sellers have more information about their products than their customers. The decision behavior of customers, to a certain extent, is relying on the information they obtain from their friends or mass media. An optimal decision can never be made as it is impossible for the consumers to obtain adequate or perfect information. In this connection, governments in developed countries have to step in to enact legislation to protect consumers.

Increasing Returns to scale

Increasing returns to scale arise when a balanced increase in all inputs leads to a more-than-proportional increase in the level of output. For example, when doubling inputs leads to greater than double the quantity of output, we have increasing returns to scale. As firms become larger and larger, difficulties of control and management may eventually produce decreasing returns to scale.

Monopoly

Perfect competition in a market arises when there is a sufficient number of firms or degree of rivalry such that no one firm can affect the price of that good. Imperfect competition, on the other hand, is a serious deviation from perfect competition. An imperfect competitor is one whose actions can affect a good's price.

At the extreme of imperfect competition is the monopolist, hence, a single supplier who determines alone the price of a particular good. Monopoly power leads to prices that rise above cost and consumer purchases that are reduced below efficient levels. The pattern of too high price and too low output is the hallmark of the inefficiencies associated with monopoly power. In some cases, the government has to take steps to curb monopoly power. The government regulates the prices and profits of monopolies, as is now the case for local utilities.

Part Two

Even though the market mechanism is an admirable way of producing and allocating goods, sometimes market failures lead to deficiencies in the economic outcomes. Government steps in to correct these failures in order to make the economy function more efficiency, maintain the equitably and to promote economic growth and stability.

Direct Regulations

Direct regulation is where most of a good people are allowed to use is directly limited by government. The purpose of the regulations is to stabilize the running of the national economy. For instance, governments attempt to correct monopoly and pollution (externalities) to encourage efficiency by introducing legal antitrust constraints on business behavior or antipollution laws.

Incentive Policies

Incentive programs are more efficient than direct regulatory policies. The two types of incentive policies are either taxes or market incentives. A tax incentive program uses a tax to redistribute income so as to lessen the situation of unacceptable inequalities of income and wealth. In fact, the tax often yields the desired end more efficiently than straight regulation as this solution embodies a measure of fairness about it, i.e. the person who conserves the most pays the least tax.

An alternative to direct regulation is some type of market incentive

program that is a plan requiring market participants to certify total consumption. For example, when there is high inflation and unemployment rate, the government introduces monetary policies, hence, the changes in money supply and interest rates with a view to stabilizing through macroeconomic policies. Or, during slow economic growth, the government will reduce budget deficit and raise national savings rate in order to stimulate growth.

Provision of public goo ds

In case there is inefficiency in public goods, government must step in to provide public goods by spending expenditures. Apparently, the government plays an important role in promoting efficiency, achieving a fairer distribution of income, and pursuing the macroeconomic objectives of economic growth and stability. However, in reality, government intervention does not allow fine-tuning, and when the problems change, the government solution often responds far more slowly. Government intervention leads to more government intervention.

In short, Government can in some instances improve and extend the functioning of the market. However, the result of government intervention sometimes is worse that if it did not intervene at all. This is what we call non-market failures, i.e. “government failure”. Due to the difference in demand and supply in government, its bureaucratic structure, the step in of the government may create more harmful effects than market failures.

Inefficiency

The revenue that supports government’s activities is mainly generated from taxes. Unlike other business sectors, the output of the government is difficult to measure. As it is not required to maintain competitiveness in order to survive, a government is unlikely to try its best to explore possible ways to improve its efficiency. The sometimes inherently inconsistent objectives or unrealistic goals may also lead further inefficiency. As there is no competition, cost overruns are also common in some government sectors. The government contractor may often revise their prices upwards in the mid-course as they viewed that raising prices is justified. The disjunction between costs and revenues leads the government fails to address the issue in an efficient manner.

Cost ineffectiveness

The government sectors have its own internal standards. According to Wolf[3], it calls "internalities". They may include the agency's goal which are used to guide and evaluate that agency's performance and the performance of its personnel. Government agencies usually stick to standard operating procedures and are reluctant to make changes. They tend to protect and increase benefits to the interest groups they are supposed to regulate. Moreover, there are numerous reasons for government agencies to maximize their budgets. They will try their best to spend it all at the end of the year. If not, it will be allocated a smaller amount in the next year. In this connection, government agencies would prefer to invest their money in more advanced technological systems and cares very little about a newer technology really works or is cost effective or not. For example, they would prefer to invest money in national defence, the most advanced weapon systems rather than other more useful purposes that will bring substantial benefits to public. Moreover, most of the government sectors such as the foreign affairs and intelligence agencies wish to collect and control timely information. However, acquisition and protection of information requires great cost and there may be a point at which there is a diminishing return. Therefore, internalities tend to inflate costs and raise supply functions.

Derived externalities

When government intervenes due to market failure, it may create unintended or unanticipated side effects which may not be known immediately. This is called a "derived externalities". For example, in Oct 1997, HK's stock market came under attack from currency speculators. The HKSAR Monetary Authority refused to take proactive action during the early stages, but decisively intervened in the stock market in Aug 1988. The intervention not only damage HK's image as a free market economy but also starts a series of economic crises such as deflation, high employment rate and the greater public demand for more government assistance to disadvantaged groups.

Distributional inequity

[3] Wolf, C Jr (1993) Markets or Governments: Choosing between Imperfect Alternatives, Cambridge, MA: The MIT Press, Ch 4

Market activities may produce distributional inequity, however, government intervention that intends to remedy a market inequity may itself generates another kind of distributional inequity in form of power and privilege. As an extreme example illustrated by Wolf, in communist society, the government correct inequity create a system in which both power and privilege and quality of life are much worse than before.

Conclusion

In fact, both market and government may fail. Perfect market or government is never existed. I opine that government's intervention, to a certain extent, is essential in maintaining the market's order. However, over-intervention may cause more harmful effects. Therefore, what is more important is who is running the government. An effective government is performing the role of check and balance. It sets up regulations and guidelines so that the private business sectors can follow and enable then to take on global competition. And, at the same time, it helps to protect our labour and avoid exploitation. On the other hand, there are areas in which the market can help government, such as in the areas of education and the privatization of government agencies. Therefore, whether the harmony between the government and market can be maintained depends solely on the one who runs the government.

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PA 302: Assignment One

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