ECONOMIC RATIONALE FOR STATE INTERVENTION

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Market failure and the concern for equity provide the economic rationale for government intervention. But there is no guarantee that any such intervention will benefit society. Government failure may be as common as market failure. The challenge is to see that the political process and institutional structures get the incentives right, so that their interventions actually improve social welfare.

Market failure refers to the set of conditions under which a market economy fails to allocate resources efficiently. There are many sources of market failure and many degrees of failure. The implications for the role of the state and the form of public intervention can be quite different in each case.

Public goods are goods that are ***nonrival*** (consumption by one user does not reduce the supply available for others) and ***nonexcludable*** (users cannot be prevented from consuming the good). These characteristics make it infeasible to charge for the consumption of public goods, and therefore private suppliers will lack the incentive to supply them. National public goods, such as defense, benefit an entire country; local public goods, such as rural roads, benefit a smaller area. ***Private goods*** are those that are both rival and excludable, ***common property goods*** are nonexcludable but rival (an example is groundwater irrigation), and ***club goods*** are nonrival but excludable (examples are interurban highways and toll roads).

Externalities arise when the actions of one person or firm hurt or benefit others without that person or firm paying or receiving compensation. Pollution is an example of a ***negative externality***, which imposes uncompensated costs on society; the broader benefit to society at large of a literate population is a ***positive externality*** of primary education. Governments can curb negative and promote positive externalities through regulation, taxation or subsidy, or outright provision.

A ***natural monopoly*** occurs when the unit cost of providing a good or service to an additional user declines over a wide range of output, reducing or eliminating the scope for competition. But left to operate freely, monopoly providers can restrict output to increase prices and profits. Governments have addressed this problem by regulating private monopolists or providing the good or service themselves. Changes in technology have created new scope for competition in services once considered natural monopolies, such as telecommunications and power generation.

Incomplete markets and ***imperfect*** or ***asymmetric information*** are pervasive problems and can result in inefficient outcomes. Markets are incomplete whenever they fail to provide a good or service even though the cost would be less than what individuals are willing to pay. Imperfect information on the part of consumers can lead to systematic undervaluation o some services, such as primary education or preventive health care. Asymmetry of information — when suppliers know more than consumers, or vice versa — can lead to excessive or supplier-induced demand, for example in the provision of medical care. Problems of adverse selection and moral hazard can lead to the failure of insurance markets. ***Adverse selection*** occurs when buyers of a service tend to impose higher-than-average costs on the service provider, or when sellers are able to exclude such high-cost customers. Health insurance provides an example: those who are more likely to need care are more likely to buy insurance, and more likely to be turned down by insurers. ***Moral hazard*** is present when persons carrying insurance have an incentive to cause or allow the insured-against event to happen. An example is the tendency of health care consumers to seek, as well as providers to provide, more treatment than they need when a third party, the insurer, is paying most of the cost.

Governments have sought to address these problems by ensuring widespread coverage and holding down costs. They have done this by either regulating private insurance, financing or mandating social insurance, or providing health care themselves.

Equity may prompt state intervention even in the absence of market failure. Competitive markets may distribute income in socially unacceptable ways. Persons with few assets may be left with insufficient resources to achieve acceptable living standards. Government action may be required to protect the vulnerable.

Functions of the State

<table>
<tr><td></td><td colspan="3">Addressing market failure</td><td>Improving equity</td><td></td></tr>
<tr><td>Minimal functions</td><td colspan="3">Providing pure public goods:

Defense
Law and order
Property rights
Macroeconomic management
Public health</td><td>Protecting the poor:

Antipoverty programs
Disaster relief</td><td></td></tr>
<tr><td>Intermediate functions</td><td>Addressing externalities:

Basic education
Environmental protection</td><td>Regulating monopoly:

Utility regulation
Antitrust policy</td><td>Overcoming imperfect information:

Insurance (health, life, pensions)
Financial regulation
Consumer protection</td><td>Providing social insurance:

Redistributive pensions
Family allowances
Unemployment insurance</td><td></td></tr>
<tr><td>Activist functions</td><td colspan="3">Coordinating private activity:

Fostering markets
Cluster initiatives</td><td>Redistribution:

Asset redistribution</td><td></td></tr>
<tr><td></td><td colspan="4"></td><td></td></tr>
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