22 GOVERNMENT FAILURE

22.1 What is Government Failure?

Normally, a failure of the free market is an economic justification for some form of government intervention. This intervention is designed to correct for market failure and thereby achieve an improvement in economic and social welfare.

Likewise, a government may choose to intervene to achieve a more equitable distribution of income and wealth. For example the government might seek to regulate the activities of firms with monopoly power, subsidise the provision of merit and public goods, or introduce pollution taxes to compensate for the effects of environmental pollution.

But what if intervention leads to further inefficiencies? What if government policy decisions prove to be costly to implement but ineffective in the final event? When this happens, government failure can exist.

Some economists believe that even with good intentions governments seldom get their policy application correct. They can tax, control and regulate but the eventual outcome will be a deepening of the market failure or even worse a new failure may arise.

22.2 Government Failure in a Non-Market Economy

The collapse of the Soviet Union marked the failure of command or state-run economies as a means of allocating resources. The essence of a command economy was that the government planning mechanism would decide what to produce and how to produce it and for whom to produce – 3 fundamental questions.

Government failure occurred when the central planners produced products that were not wanted by consumers – a clear loss of allocative efficiency, since there was no price mechanism to signal changes in consumer preferences and demand. Another fundamental failing of the pure command economy was that there was little incentive for workers to raise productivity; poor quality control; and little innovation by firms as no profit motive existed. Command economies also suffered massive environmental degradation.

All of these economies are now moving towards the western mixed economy, though at varying speeds and with varying success. They are known as "transition economies". Ten countries have been accepted as new members of the European Union in 2004, some of them former state-run economies in the Eastern Block. Countries such as Hungary, the Czech Republic and Poland are all moving towards a market based system for the allocation of resources for example through programmes of privatisation.

22.3 Possible Causes of Government Failure

The following factors are important causes of government failure:

- **The pursuit of self-interest** amongst both politicians and civil servants rather than operating on behalf of citizens which leads to a misallocation of resources (for example decisions about where to build new roads, by-passes, schools and hospitals, inappropriate tariffs and other forms of import control and also decisions as to which industries and markets to offer government subsidies)
- **Electoral pressures leading to inappropriate government spending and tax decisions** - e.g. boosting state welfare spending in the run up to an election, or decisions to bring forward major items of government capital spending on infrastructural projects ahead of an election without the projects being subjected to a full and proper cost-benefit analysis
- **A tendency to look for short term solutions to economic problems** rather than making considered analysis of long term considerations (examples might include important decisions about transport policy or extra funding for the National Health Service). The risk is that **myopic decision-making** will only provide short term relief to particular problems but does little to address **structural problems**. A decision for example to build more roads, widen existing roads and build new by-passes might simply add to the problems of traffic congestion in the long run encouraging an increase in the total number of cars on the roads. Short term financial subsidies to the steel industry or to coal producers to keep open loss-making steel plants and coal pits might eventually prove to be a waste of scarce resources if the industries concerned have little realistic prospect of achieving an economic rate of return in the long run
- **Regulatory capture**. This is when the industries under the control of a regulatory body begin to move policy options so as their outcome is in their favour. Some economists argue that

regulators can prevent the ability of the market to operate freely. We might find examples of this in agriculture, telecommunications and the other utilities and also in environmental protection.

- **Disincentive effects** created by measures designed to reduce income inequalities (including the poverty trap) or the loss of business competitiveness caused by the introduction of the National Minimum Wage or the Working Families Tax Credit – thousands of small & medium sized enterprises have faced higher costs because of the increasing levels of red tape brought about by new government regulations. Equally a decision by the government to raise taxes on de-merit goods (such as cigarettes) might lead to an increase in tax evasion, smuggling and the development of grey markets where trade takes place between consumers and suppliers without paying tax. Equally a decision to legalize and then tax some drugs might lead to a rapid expansion of the supply of drugs and a substantial loss of social welfare arising from over consumption.
- **The Environmental impact of government price support for farmers** (including the long term impact of exemptions from taxation for farmers selling land to developers, the externalities arising from increasing use of subsidized fertilizers, and the long running issue of structural excess supply arising from guaranteed intervention prices for farmers within the CAP)
- **Imperfect information -** How does the government establish what citizens want it to do? Our electoral system is not an ideal way to discover this! Proponents of government failure argue that the free market mechanism is the best way of finding out (a) what consumer preferences are and (b) aggregating these preferences based on the number of people that are willing and able to pay for particular goods and services. Government failure may range from the trivial, when intervention is ineffective, but where harm is restricted to the cost of resources used up and wasted by the intervention, to cases where intervention produces new and more serious problems that did not exist before.
- **Conflicting policy objectives** – governments of all political persuasions face conflicts and trade-offs when trying to achieve their macro and microeconomic objectives, e.g. attempting to redistribute income by taxing high income earners may reduce work incentives, worsening other economic targets.