**Government Failure - Introduction**

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**Introduction**

**The idea of government failure**

Even with the best of intentions governments seldom get their policy application correct. They can tax, control and regulate but the eventual outcome may actually be a **deepening of the market failure** or even worse a new failure may arise which requires corrective action. Government failure may range from the trivial, when intervention is merely 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. The consequences of this can take many years to reverse.

Over the last fifty or sixty years, Western governments have intervened to try to improve the social and economic life of their countries on a scale unimaginable to previous generations.  Yet social and economic problems persist.  Policies fail.
*Adapted from “Why Most Things Fail”, Paul Ormerod*

**Government failure in a non-market economy**

The collapse of the Soviet Union in the late 1980s and early 1990s marked, for many people, the final failure of command or planned economies as a means of allocating resources among competing uses. The essence of a command economy was that the state-operated planning mechanism would decide what to produce and how to produce it and for whom to produce.

Government failure occurred when the central planners supplied products that were simply not wanted by consumers – showing a loss of allocative efficiency, since there was no price mechanism to signal changes in consumer preferences and demand. John Kay’s book “[The Truth about Markets](http://www.thetruthaboutmarkets.com/)” has excellent sections on the basic fault-lines in the planning process. Another fundamental failing of the pure command economy was that there was little incentive for workers to raise productivity; few incentives to prevent poor quality control; and little innovation by firms as no profit motive existed.

Command economies also suffered environmental de-gradation because they did not posses structures for valuing the environment and giving consumers and producers the right incentives to protect their environmental heritage.

All of these economies are now moving towards the western mixed economy, though at varying speeds and with varying success. Eight former eastern Bloc countries joined the European Union in May 2004, some of them former state-run economies in the Eastern Bloc. 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 and market liberalisation. Many of them have enjoyed fast rates of economic growth and a rise in relative living standards both before and since their accession to become members of the European Union.

**Possible Causes of Government Failure**

Government intervention can prove to be **ineffective, inequitable and misplaced**. There is a growing body of research in the economics literature on this topic – some of which uses highly mathematical techniques to analyse public policy-making. We will focus instead on the underlying reasons and consider some topical examples along the way.

**(a) Political self-interest**

The pursuit of **self-interest** amongst politicians and civil servants can often lead to a misallocation of scarce resources. For example decisions about where to build new roads, by-passes, schools and hospitals may be decided with at least one eye to the political consequences.

The pressures of a looming election or the **influence exerted by special interest groups** can create an environment in which inappropriate government spending and tax decisions are made. - e.g. boosting the level of welfare spending in the run up to an election, or bringing forward major items of capital spending on infrastructural projects without the projects being subjected to a full and proper **cost-benefit analysis** to determine the likely **social costs and benefits**. Critics of current government policy towards tobacco taxation and advertising, and the controversial issue of [genetically modified foods](http://search.bbc.co.uk/cgi-bin/search/results.pl?tab=ns&q=GM%20foods&recipe=all&scope=all&edition=d) argue that government departments are too sensitive to political lobbying from the major corporations.

**(b) Policy myopia**

Critics of government intervention in the economy argue that politicians have an in-built tendency to look for **short term solutions or “quick fixes” to difficult economic problems** rather than making considered analysis of long term considerations. The risk is that myopic decision-making will only provide short term relief to particular problems but does little to address structural economic difficulties. Consider for example the long term problems facing the UK’s transport network. To what extent has transport suffered from a lack of long-term planning and joined up thinking about how to create a properly integrated transport network which can provide proper solutions to the issues of traffic congestion and the environmental consequences of rising transport use.

Critics of **government subsidies** to particular industries also claim that they distort the proper functioning of markets and lead to **deeper inefficiencies** in the economy.

**(c) Regulatory capture.**

This is when the industries under the control of a regulatory body (i.e. a government agency) appear to operate in favour of the “vested interests” of producers rather than consumers. Some economists argue that regulators can prevent the ability of the market to operate freely.


*Olive growing in Spain – has the CAP encouraged over-production, a waste of resources and caused damage to the economies of many developing countries?*

For example, to what extent has the European Union’s **Common Agricultural Policy** operated mainly in the interests of farmers? Has the CAP worked against the long-term interest of **consumers,** the **environment** and **developing countries** who claim that they are being unfairly treated in world markets by the effects of **import tariffs** on food and **export subsidies** to loss-making European farmers? The CAP is widely criticised as a classic example of government failure and there are many who claim that the current reform process does not go far enough.

**(d) Government intervention and disincentive effects**

Free market economists who fear government failure at every turn argue that attempts by the government to reduce income and wealth inequalities can actually worsen **incentives** and **productivity** in the economy. They would argue against the [**National Minimum Wage**](http://www.dti.gov.uk/employment/pay/national-minimum-wage/index.html) because they believe that it can lead to real-wage unemployment. They would also argue against raising the **higher rates of income tax** because it is deemed to have a negative effect on the incentives of wealth-creators in the economy and generally acts as a disincentive to work longer hours or take a better paid job. They are critical of the government focusing welfare benefits on the poorest using **means-tested benefits** because they might damage the incentive to find work.

The opposite point of view is that a lack of effective government policies to reduce the scale of income and wealth inequality is also a cause of government failure since inequality can, over the longer term; create many deep-rooted problems for society once social cohesion starts to break down.

(e) **Government intervention and evasion**

A decision by the government to raise taxes on de-merit goods (such as cigarettes) might lead to an increase in attempted **tax avoidance, 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.

**(f) Policy decisions based on imperfect information**

How does the government establish what citizens want it to do in their name?  Can the government ever really know the true **revealed preferences** of so many people? Our current electoral system is not an ideal way to discover this! Turnout in every type of election, (local, national, European etc) is falling, there is general disinterest in the political process. Furthermore, people rarely vote purely out of their own self-interest or on the basis of a well informed and rational assessment of the costs and benefits of different government policies.

Proponents of government failure argue that the free market mechanism is, in the long-run, 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.

Often a government will choose to go ahead with a project or policy without having the full amount of information required for a proper **cost-benefit analysis**. The result can be misguided policies and damaging long-term consequences.

How does the government know how many extra houses need to be built in the UK over the next twenty years? Is building thousands of extra homes in an already congested South-east the right option? Are there better solutions? There have been plenty of instances of government housing policy having failed in previous decades!

**(g) The Law of Unintended Consequences!**

*This law lies at the heart of many of the possible causes of government failure in markets!*

The law of unintended consequences says that a government policy will always lead to at least one reaction from either consumers or producers that are unanticipated or unintended.Economic agents do not always act in the way that the economics textbooks would predict – this is of course the essence of a social, behavioural science – we do not live our lives in sanitised laboratories where all of the conditions can be controlled. The law of unintended consequences is often used to criticise the effects of government legislation, taxation and regulation. People find ways to circumvent laws; shadow markets develop to undermine an official policy; people act in unexpected ways either because or ignorance and / or error.
Unintended consequences can add hugely to the financial costs of some government programmes so that they make them extremely expensive when set against their original goals and objectives.

**(h) Costs of administration and enforcement**

Government intervention can prove costly to administer and enforce. The estimated social benefits of a particular policy might be largely swamped by the administrative costs of introducing it.

**A summary of the arguments**

* **Free market economists** are naturally distrustful of government intervention in the economy
* They believe that the **signalling, incentive and rationing functions of the price mechanism** should be given more freedom to operate
* They believe that government failure can occur at a **microeconomic level** (e.g. introducing minimum prices in markets, rent controls, producer subsidies etc) and at a **macroeconomic level** (pursuing inappropriate exchange rate, tax or interest rate policies etc)
* When government failure exists, the result can be a **deepening of an existing market failure**
* The result is a further **loss of allocative and productive efficiency** because of the waste of scarce resources – leading to a **reduction in consumer and producer welfare**
* Often we can accuse the government of policy failure only with the **benefit of hindsight**
* **Limited information** - no government has the resources and information available to it to make fully-informed, objective judgements. That is the nature of politics.
* Government failure is most likely to occur when decisions are made in the **vested interest of special interest groups,** at the expense of other groups (the result is a **loss of equity**)
* But **government failure is rarely total**. Policies may be ineffective, expensive and inefficient – but providing that policies are flexible and adaptable, (i.e. lessons are learned) then intervention can often work in the interests of the majority
* Advances in our understanding of how consumers and businesses behave and respond to changing incentives are helping government policies to evolve. For example the growing interest in **auctions and traded permits** as a means of controlling pollution and other forms of environmental damage