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Effectiveness of Government Intervention in Correcting Market Failure

Meher Jain

Abstract: ***The article critically evaluates the effectiveness of government in correcting market failure.***

Keywords: Market failure

Classical economists like Adam smith were strong proponents of Laissez-faire philosophies, such as minimizing the role of government intervention and taxation in the free markets, and the idea that an "invisible hand" guides supply and demand. These ideas reflect the concept that each person, by looking out for him or herself, inadvertently helps to create the best outcome for all. However smith's theory does not hold true in today's world where we find so many market failures.

What is market failure?

Marketfailurearises due to the socially inefficient allocation of resources in a free market. The various reasons of market failure include externalities, demerit/merit goods, lack of public goods, monopoly power and environmental concerns.

Causes of market failure:

1) **Positive and negative externalities**: An externality is an effect on a third party that is caused by the consumption or production of a good or service. A positive externality arises from the consumption or production of a good or service like although public education may only directly affect students and schools, an educated population may provide positive effects on society as a whole thereby creating a positive effect whereasa negative externality is a negative effect on third parties like indulging in passive smoking may negatively impact not only the health of people who are actively smoking but also the ones surrounding them.
2) **Environmental concerns:** Harmful effects on the environment due to production and consumptionare important considerations concerning the sustainable development.
3) **Lack of public goods:** Public goods are goods where the total cost of production does not increase with the number of consumers. Public goods can be under produced when there is little incentive from a private standpoint. This problem when someone benefits from resources or goods and services without actually paying for the cost of the benefit is known as the free rider problem.
4) **Underproduction of merit goods:** A merit good is defined as a good that is not optimally produced or rather under produced even in the presence of positive externalities. Its examples include education, healthcare, and sports centres.
5) **Overprovision of demerit goods:** A demerit good is a private good that society believes is over consumed due to the presence of negative externalities. Its examples include cigarettes, alcohol, and prostitution.
6) **Abuse of monopoly power:** Imperfect market restriction of output in an attempt to maximize profit is an abuse of the monopoly power.

What does the Government do in such a situation?

The government usually responds to varying degrees during market failures. Government responses include legislation which involves the enactment of various laws including the prohibition of smoking in restaurants. The directprovision of merit and public goods which involve the controlling of supply of goods like supplying high amounts of education, parks, or libraries which have positive externalities. Taxation is a common feature implying the placing of taxes on certain goods to discourage their use and it also helps in internalizing the external costs. Some examples include the placing of a 'sin-tax' on tobacco products thereby increasing the cost of tobacco consumption so reducing its demand in the economy. Subsidies are also a step taken by the government which aim to lower the price of a good/serviceto benefit the public and encourage economic activity that has positive externalities. Tradable permits allow firms to trade permits with other firms to increase or decrease the amount they can produce. It forms the basis behind cap-and-trade, an attempt to reduce pollution etc.Individuals and firmsare subject to fine for causing pollution in certain areas. Governments also indulge in advertising wherein they help to promote awareness on certain issues like the harmful effects of the consumption of tobacco, promoting various initiatives like the Swatch Bharat etc. By international cooperation governments work together on issues that affect the future of the environment.

Lapses in the approach of the government:

However, government intervention isn't always successful in correcting market failure. The arguments against the role of government in correcting market failure include the government'sspending on public goods and merit goods, they may lead towardsexcessive bureaucracy and inefficiency.The industries owned by the state tend to lack any profit incentive and hence tend to be run inefficiently. Politicians don't follow the same market discipline of seeking to efficiently make use of the limited resources available. It is argued that government intervention results into more problems than its solutions. For example, the support by the state to industries may encourage the survival of inefficient firms. If governments bailout the banks, it may create a moral hazard where in the future banks will lack incentive to avoid bankruptcy because they expect a government bailout.Government officials often manipulate polices to suit their own interests and tend to be corrupt defeating the whole purpose of their existence.

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