3. Rationale for public intervention

Summary

This chapter presents the microeconomic foundations for public sector intervention in the economy. They relate primarily to the justification of the need for intervention for a better allocation of resources according to the criterion of Pareto efficiency. Secondly the need to intervene is for reasons of equity, distributive justice, improve and ensure more equal opportunities than that which would result from the operation of free markets. Finally, we analyse the potential conflict between pursuing objectives of equity and efficiency. Markets are powerful tools for communicating information between economic agents and lead to an efficient allocation of resources if they are competitive, the goods are private, the costs of the decisions of agents (consumers and producers) are internalized and information between them is symmetrical. This result is known as the first fundamental theorem of welfare economics. An efficient allocation of resources is one in which no one can be made better off without decreasing the well-being of some other agent (the Pareto criterion). The assumptions underlying the theorem clarify at the outset the conditions of markets failures (partially), which means that they do not generate an efficient allocation of resources. The lack of competition creates inefficiencies. It can result in markets where few companies operating (oligopoly) or where there is only one active (monopoly) and this situation is the result of natural conditions (decreasing average costs) or artificial factors (barriers to entry).

The existence of public goods, the costs of the action of agents on third parties, without compensation, and asymmetric information are other sources of market failure. A market failure is a situation where there may be a price at which buyers and sellers would be willing to transact, but this transaction will not proceed.

Public goods are those where there is no rivalry in consumption and that the exclusion, if possible at low cost, is not desirable. In the presence of public goods market equilibrium, i.e. the quantity produced would be either zero or positive, but below the optimal level. The optimal level of production of a public good would be about one that equalled the sum of the marginal willingness to pay for the public good to the marginal cost of production. In theory there is a mechanism to determine the optimal amount that would, through an auctioneer, to whom each individual would reveal their marginal willingness to pay for the public good. In practice, individuals adopt free rider behaviour and underestimate its appreciation of the public good. So it is the political system which, although imperfectly, solve the problem of determining the level of production of public goods (see Chapter 4).

The actions of individuals or companies generate costs (or benefits) to third parties that are not transmitted through the price system. When this happens we are in the presence of a negative externality (or positive), and markets tend to produce too much (or too few) of the good and at a price below the optimal (or above the optimum). This is because there is a difference between the marginal social costs (or benefits) and marginal private costs (or benefits). The former incorporate the latter and also the marginal external cost (or benefit) associated with the negative externality. The existence of externalities suggests that in order to improve efficiency governments may tax (or subsidize) the activity giving rise to a cost (or benefit). The Pigouvian tax (subsidy) is a unitary tax (subsidy) equal to the marginal external cost (benefit) at the optimal level of output. Public goods, externalities, imperfect competition and the asymmetry of information between economic agents, give a rationale for public intervention on efficiency grounds.

A separate argument for public intervention is fairness. A particular state of the economy can be efficient but unfair. In fact the markets operate on the basis of an initial distribution of property rights (on land and on capital, etc...). This distribution can be seen as unfair, and therefore the results of the market outcomes (e.g. income distribution) largely reproduce these inequalities and initial injustice. A "social state" that is both efficient and fair is called a social optimum. The second fundamental theorem of welfare economics shows that it is possible to achieve any social optimum (whatever that is) if there is first an appropriate redistribution of property rights and then let the markets work freely. The problem is to determine the social state which is both efficient and fair. Although there is no consensus on this issue there are two major alternative ways to address it. Utilitarianism considers the welfare of society as the sum of the levels of well-being of all individuals in society. Thus, policies that do improve the welfare aggregate, improve social welfare. If it is not possible to increase the aggregate utility of a society then it would be in a utilitarian social optimum. The utilitarian perspective has implications for the optimal distribution of income. Assuming equal individuals, decreasing marginal utility of income and lack of redistribution costs, the optimal income distribution would be egalitarian. With costs of redistribution, the social optimum also occurs when the marginal utility of income is equal among individuals, but now for different levels of individual income.

On the other hand, the Rawlsian approach (of John Rawls) is different. First of all because it gives greater importance to equal opportunities in terms of a set of primary goods – the merit goods (education, primary health care, minimum income) - that all individuals should have access to develop their life plans whatever they are. Then it evaluates the social welfare, and its evolution (positive or negative), by the level of welfare of those who are the worst off in society and its variation over time. Rawls, like Amartya Sen, does not focus on the distribution of income, but mainly on the basic capabilities of individuals in a just society. The optimal redistribution of income will be the one that maximizes the levels of welfare of those that are worse off.

There may be a conflict between equity and efficiency, that is, policies that promote equity can have efficiency costs and vice versa. This trade-off should be considered in policy evaluation and in order to evaluate the trade-off it is necessary to weight efficiency and equity.