Role of the Government in a Market Economy

In this chapter we will discuss about the role of the government in a market economy.

The classical economists like Adam Smith, J.B. Say and other advocated the doctrine of laissez faire which means non-intervention of the government in economic matters. Adam Smith introduced the concept of the invisible hand, which refers to the free functioning of the price (market) system in the absence of government intervention.

And, in the 19th century, the western capitalist economics achieved impressive growth by following the policy of laissez faire. As Paul Samuelson has put it,
"An ideal market economy is one where all goods and services are voluntarily exchanged for money at market prices. Such a system squeezes the maximum benefits out a society's available resources without government intervention".

The doctrine of laissez faire, which means 'leave us alone' held that government should interfere as little as possible in economic affairs and leave economic decisions to the interaction of supply and demand in the market place. However, the great depression of 1929 (which lasted for 4 years) shattered the economies of U.S.A. and other western industrialized countries and forced them to partially abandon the doctrine of laissez faire.

And, in 1936, J.M. Keynes suggested in his revolutionary book: The General Theory that the visible hand of the government should replace, at least partly, the invisible hand of the market. Following Keynesian prescriptions governments in most countries took on a steadily expanding economic role, regulating monopolies, collecting income taxes and providing social security in the form of unemployment compensation or pension for the old people.

To quote Samuelson again**,** "in the real world, no economy actually conforms totally to the idealized world of the smoothly functioning invisible hand. Rather, every market economy suffers from imperfections which lead to such ills as excessive pollution, unemployment and extremes of wealth and poverty".

For all these reasons, any government anywhere in the world, whether conservative or liberal, intervenes in economic affairs. In a modern economy like our own, the government has to perform various roles mainly to correct the flaws (defects) of the market mechanism. The military, policy, most schools and colleges, health centers and hospitals and highway and bridge construction are all government activities, research and space exploration require government funding.

Governments may regulate some businesses (such as banking and insurance), while subsidizing others (such as agriculture and small-scale and cottage industries). And last, but not the least governments tax their citizens and redistribute the revenues to the poor as also the elderly (retired) people.

Four Main Functions of Government in a Market Economy:
However, according to Samuelson and other modern economists, governments have four main functions in a market economy, to increase efficiency, to provide infrastructure, to promote equity, and to foster macroeconomic stability and growth.

1. Efficiency:
First, the government should attempt to correct market failures like monopoly and excessive pollution to ensure efficient functioning of the economic system. Externalities (or social costs) occur when firms or people impose costs or benefits on others outside the marketplace.

2. Infrastructure:
Secondly, the government should provide an integrated infrastructure. Infrastructure refers to those activities that enhance, directly or indirectly, output levels or efficiency in production.

Essential elements are systems of transportation, power generation, communication and banking, educational and health facilities, and a well-ordered government and political structure. Since the cost of providing these essential services are very high and benefits increase to numerous different groups, such activities are to be financed by the government.

3. Equity:

Markets do not necessarily produce a distribution of income that is regarded as socially fair. As market economy may produce unacceptably high levels of inequality of income and weather. Government programmes to promote equity use taxes and spending to redistribute income toward particular groups.

4. Economic Growth or Stability:

Fourthly, governments rely upon taxes, expenditures and monetary regulation to promote macroeconomic growth and stability to reduce unemployment and inflation while encouraging economic growth.

Macroeconomic policies for stabilization and economic growth include fiscal policies (of taxing and spending) along with monetary policies (which affect interest rates and credit conditions). Since the development of macroeconomics in the 1930s governments have succeeded in bringing inflation and unemployment under control.

Countries with low state capability need to focus first on basic functions: the provision of pure public goods such as property rights, macroeconomic stability, and control of infectious diseases, safe water, roads and protection of the destitute. Recent reforms have emphasized economic fundamentals. But social and institutional (including legal) fundamentals are equally important to avoid social disruption and ensure sustained development.

Going beyond these basic services are the intermediate functions, such as management of externalities (pollution, for example), regulation of monopolies, and the provision of social insurance (pensions, unemployment benefits).

States with strong capability can take on more-activities functions, dealing with the problem of missing markets by helping coordination.

Matching role to capability involves not only what the state does but also how it does it. Rethinking the state also means exploring alternative instruments, existing or new, that can enhance state effectiveness.

Opportunity Cost:

Every scarce goods or activity has an opportunity cost. Opportunity cost of anything is the cost of the next best alternative which is given up. It refers to the cost of foregoing or giving up an opportunity. It is the earnings that would be realized if the available resources were put to some other use. It implies the income or benefit foregone because a certain course of action has been taken.

Markets and social objectives:

One of the key arguments for government intervention in the behavior of business is that, if left to its own devices, the Private enterprise system will fail to achieve ‘social efficiency’.

Marginal social benefit (MSB):

The additional benefit gained by society of producing or consuming one more unit of a good.

Marginal social cost (MSC):

The additional cost incurred by society of producing or consuming one more unit of a good.

Social efficiency:

Production and consumption at the point where $MSB = MSC$.

Externality:

Externality refers to the consequence of an economic activity that is affected by unrelated third parties. An externality can be either positive or negative. All the factors like political, economic, technological, environmental and legal comprise externality.

External benefits:

Benefits from production (or consumption) experienced by people other than the producer (or consumer).

External costs:

Costs of production (or consumption) bore by people other than the producer (or consumer).

Social cost:

Private cost plus externalities in production.

Social benefit:

Private benefit plus externalities in consumption.

Public good:

A good or service which has the features of non-rivalry and non-excludability and as a result would not be provided by the free market. Examples include pavements, flood control dams, public drainage, public services such as the police and even government.

Non-rivalry:

Where the consumption of a good or service by one person will not prevent others from enjoying it.

Non-excludability:

Where it is not possible to provide a good or service to one person without it thereby being available for others to enjoy.

Free-rider problem:

When it is not possible to exclude other people from consuming a good that someone has bought.

Merit goods:

Goods which the government feels that people will under-consume and which therefore ought to be subsidized or provided free.

Nationalized industries:

State-owned industries that produce goods or services that are sold in the market.

Privatization:

Selling nationalized industries to the private sector. This may be through the public issue of shares, by a management buyout or by selling it to a private company.

Imports:

Imports are foreign goods and services bought by citizens, businesses, and the government of another country. It doesn't matter what the imports are or how they are sent. They can be shipped, sent by email, or even hand-carried in personal luggage on a plane.

Trade Deficit:

If a country imports more than it exports it runs a trade deficit. If it imports less than it exports, that creates a trade surplus. When a country has a trade deficit, it must borrow from other countries to pay for the extra imports. It's like a household that's just starting out. The couple must borrow to pay for a car, house, and furniture. Their income isn't enough to cover the necessary expenses that improve their standard of living.

Price discrimination:

Price discrimination refers to the practice of selling the same product at different prices to different buyers.

Mrs. Robinson defines it as "charging different price for the same product or same price for differentiated product".
Prof. Stigler defines price discrimination as "the scale of technically similar products at prices which are not proportional to Marginal costs".

Tax:

The compulsory payment by individuals and companies to the state is called tax.
According to Phillips Hardwick, “Taxes are compulsory transfer of money from private individuals, groups or institutions to the Government.”
Basically there are two types of taxes i.e. direct taxes and indirect taxes.

Direct Taxes:

The taxes, for which the burden of taxes cannot be transferred, are called direct taxes. Income tax, wealth tax, property tax, etc are the examples of direct tax.

Indirect Taxes:

The taxes, for which the money burden can be transferred to others, are called indirect taxes. Sales tax, custom duty, excise duty etc are the examples of indirect tax.

Subsidies:

A payment by the state to producers in order to reduce prices is called subsidies.