B 1 Framework for State Intervention

By the end of this chapter you should understand that a legal system and framework exists which enables the state to intervene in the market through different policy measures. You will be expected to be able to:

- identify examples of market failure and consider them as the basis for government intervention
- identify the range of interventions available to government such as taxes, subsidies, regulations, and direct provision of services.

The Invisible Hand

Allocative efficiency, the most efficient allocation of resources, was the central theme in Section A. Economic theory suggests the only way this can be achieved is through the operation of the free market. For the market to work effectively and for the **invisible hand** to work, five conditions have to be met. There must be:

1 **Consumer sovereignty**. Consumers determine what, how and for whom goods and services are to be produced.

2 **Perfect competition**. Producers are price takers and are free to enter or exit the industry.

3 **Perfect information**. This is essential for good decision-making. Government provides a framework for fair dealing, with consumer legislation.

4 **Perfect mobility**. Resources must be able to move from *sunset* to *sunrise* industries, so for example a typewriter repairer can become a computer technician.

5 **No externalities or public goods**. There must be no side-effects. The costs and benefits should only affect those directly involved in the production or consumption of the good or service.

Market Failure

Market failure occurs if any of these conditions is not present, and there is a case for government intervention. The following problems occur in each of the five conditions described above:

1 Consumer sovereignty is manipulated, firstly by the action of firms when they advertise, and secondly by government when it determines that some goods are **merit goods**, meaning they are considered good for us, and they are to be encouraged. Government also classifies some goods as **demerit goods**, meaning they are considered bad for us and should be discouraged.

2 Most firms operate in imperfectly competitive arrangements, and perfect competition is not often seen in reality.

3 Information is not freely available, either because it is considered to be "commercially sensitive", or because it is not physically possible to ensure all consumers are adequately informed.

4 Perfect geographic and occupational mobility does not exist, so government assists mobility with retraining and relocation schemes.

5 Market signals work well for private goods, where there are no externalities (side effects) and clear property rights exist. However some goods are not produced in socially acceptable quantities, and government has to regulate, or provide the good.

List the five conditions that have to be met for the free market to work.

Give an example of a 'sunset' and 'sunrise' industry.

Identify one problem in meeting each of the requirements for the invisible hand to work.

What is market failure?

What justification is there for government intervention?

Market failure provides the justification for government intervention. The aim of government intervention is to help price signals carry the correct information so that the market can work again.

Government Intervention

Taxation

Taxes are compulsory payments to government. Taxes can raise revenue for government to provide welfare and other services to the public. Taxes can be charged on certain commodities to discourage their consumption; for instance, high excise taxes on cigarettes, alcohol etc. **Progressive taxes** tax those on higher incomes at a higher rate than the poor. These can be used with welfare payments to redistribute income from the rich to the poor.

Transfers

Transfers include welfare payments provided for those who can no longer provide for themselves because of ill health, old age, disability, accident etc. In most cases, these benefits are **means tested** which means that a person's income is taken into consideration before they become eligible for a benefit. Transfers also include income support, where government tops up people's income if it is insufficient to cater for their responsibilities such as the numbers of dependent relatives (children or the elderly).

Subsidies

Subsidies are payments made to producers by government. A subsidy will have the effect of reducing the cost of production and shifts the supply curve to the right, resulting in lower prices to consumers. They are used when government would like to encourage more consumption or production of a commodity, such as to ensure children receive health care, dental treatment, or education. Government may wish to encourage certain activities, such as farmers planting steep hillsides to prevent erosion.

Public Provision of Goods and Services

Sometimes the private sector fails to provide certain goods (public goods), or not at socially desirable prices or quantities. In this situation, government could provide these directly, such as state housing, state education, and public health care.

Regulations

When necessary, the government can enact laws to protect the consumer, control the activities of monopolies, provide environmental protection and safety provisions for workers, discouraging or banning demerit goods, regulating the activities of natural monopolies, for example regulate fishing by setting quotas or bag limits and planning controls.

Economic Objectives of Government

The economic objectives (or aims) that most government have had are to encourage:

1 economic growth
2 price stability
3 full employment
4 a balance of payments equilibrium
5 an equitable (or fair) distribution of income.

For each of the following, identify what type of intervention is used and suggest a reason why it is necessary.

(a) Cycle helmets.

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(b) State housing.

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(c) Free immunisation.

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(d) Street lighting.

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(e) Fishing quotas.

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(f) Resource Management Act.

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(g) Building permits.

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(h) Excise tax on cigarettes.

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Rank the economic objectives according to your own set of values.

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Economic Functions of Government

(a) Maintaining Legal and Social Framework

Government provides the legal framework so that economic activity can be undertaken in a civilised manner. Examples include contract law, property rights, Companies Act, Commerce Act, Consumer's Guarantees Act. Various regulations provide for safe practices and protect the environment etc.

Give examples of government providing a legal framework.

(b) Maintaining Competition

Government can improve the allocation of resources by promoting competition and by removing any artificial barriers to entry into a market.The Commerce Commission will stop takeovers and other activities that reduce competition, such as: price agreements, price-fixing and market-sharing arrangements, the use of a dominant position in a market to restrict entry into a market, to deter competitive conduct, or to eliminate a competitor from a market.

What organisation maintains competition in NZ?

(c) Government Provision of Public Goods

Public goods are those that "the market" is unable or unwilling to provide because it is impossible to make consumers pay and as a result business firms are unable to make a profit. Examples include such things as national defence or the road network. In this case government can use tax revenue and provide the good collectively. The state will also encourage the production and consumption of merit goods.

How are public goods provided?

(d) Redistributing Income

The free market will reward those who own resources in short supply with higher incomes, while some may not be able to sell their resources at all (the unemployed). The market incomes may not reflect socially desirable outcomes, with the rich getting richer and the poor getting poorer.

Government redistributes incomes with a system of progressive taxation which taxes the rich at a higher rate than the poor, and provides benefits and other income support through the welfare system. Thus, income is taken from the rich and given to the poor.

Explain how government redistributes incomes.

(e) Correcting for Externalities

Externalities occur when some of the costs or benefits associated with the production or consumption of a product "spill over" to third parties, that is, to parties other than the direct producer or consumer of the product. (See page 58.) Government can use taxes, penalties and regulations to restrict negative externalities and subsidies and direct provision to encourage those activities with positive externalities.

How does the government correct for externalities?

(f) Stabilising the Economy

Government can use monetary and fiscal policies to reduce the impacts of the booms and busts resulting from the business cycle (see Chapter C1). It is not possible to achieve all the government's economic objectives simultaneously, because policies required to reduce one problem may cause other problems, for example reducing inflation led to rising unemployment in the short term.

What main policies are used to stabilise the economy?

Changing Role of Government

The scale of government involvement in the economy peaked in the 1980s at a time when economic performance was dismal. The economy was in need of restructuring.

State Sector Reform: The state sector was restructured, and many aspects of the economy were deregulated (reducing the regulations, and level of government intervention). The reform process that started in the mid-1980s shocked the country into change. It consisted of **corporatisation**, where government departments that had significant trading activities were converted into State Owned Enterprises (SOEs). A good example of this was when the New Zealand Post Office was turned into three separate SOEs, which were Telecom, NZ Post and Post Bank. These SOEs had to function as profit-oriented businesses and pay dividends to government. Some SOEs were sold to the private sector, a process known as **privatisation**. Examples included Telecom and Post Bank.

User pays was introduced in some areas to reduce welfare spending; and in education and health. Part user charges were introduced for pharmacy prescriptions and tertiary education. The role of funder and provider were separated in the health sector to achieve greater efficiencies through operating as a "competitive market". With the change in government in 1999 many of these reforms are being reversed.

Economic Choices

This whole section of economics relates to choices, and ultimately political decisions. There are two widely differing views held on what sort of economy can best meet the economic objectives of its people.

A managed economy. Firstly there is the view that the state should intervene and manage the economy, with politicians deciding which objectives are most urgent, then steering the economy towards achieving them. John Maynard Keynes (1883-1946), one of the most influential economists of the 20th century, proposed the prevention of financial crises and unemployment by adjusting the level of demand through controls on credit and fiscal policies. The New Zealand government adopted Keynesian type economic policies, using fiscal and monetary policies to manage the level of spending in the economy, and to smooth out the business cycles.

Free market. Secondly, there are those who believe that the free market, with a minimum of state involvement, is the only way to achieve economic success because this ensures greatest efficiency and growth.

New Zealand has seen both approaches used in recent times. The arguments cover a wide range of values including:

- Socialist Left versus the Libertarian Right
- Public provision versus private provision
- Total public provision versus totally user pays.

The rest of this section explores the theories behind this debate.

Suggest why the government was keen to reform the state sector in the 1980s.

Distinguish between corporatisation and privatisation.

Distinguish between free provision and user pays in the state sector.

Which current political parties would support a managed economy?

Which current political parties would support a free market economy?