

## Chapter 5

# The Role of Government in a Liberal Market Economy: A Double-Edge Sword

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### ABSTRACT

*This essay is a critical assessment of the market failure theory and public choice theory. While the market failure theory provides a justification for government intervention in the economy, the public choice theorists are very skeptical about the role of government as a corrector of market failures. Since government failures can be worse than market failures, the imperfections in the market process, they argue, do not necessarily call for government intervention. These two theoretical perspectives, notwithstanding their difference, do share something in common. Both assume that individuals are self-interested. This essay contends that a shift from rational self-interested behavior to bounded-rational behavior provides a less contested role for the government. With bounded-rational behavior, the state should no longer be viewed as a mere surrogate of the market, but as “a choice architect,” “an entrepreneur,” and “a manager of conflict.”*

### INTRODUCTION

For at least two hundred years, starting with the publication of Adam Smith’s seminal work *The Wealth of Nations*, economists have spoken with dissenting voices with respect to how a nation’s resources should be allocated, given the ubiquitous situation of scarcity. On one hand, it is argued that social efficiency - the net gain to society from all exchanges that are made in a particular market (Gruber, 2007) – can be maximized through the spontaneous and voluntary cooperation between self-interested individuals. As Smith (1776) argues, it is not from the generosity of the butcher, the brewer, and the baker that we have our dinner, but from their regard to their own self-interest. Since the world runs on individuals pursuing their self-interest, the scope of government should be limited because “the great advances of

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civilizations, whether in architecture or painting, in science or literature, in industry or agriculture, have never come from centralized government (Friedman, 2002, p. 3). Friedman's case about the primacy of spontaneous interactions and free enterprise echoed his much-admired mentor F. A Hayek (1944) who believes that that coordination of men's activities through central direction is the road to serfdom and poverty, while the coordination of men's economic activities through voluntarily cooperation is a road to freedom and plenty.

On the other end of the spectrum, some believe that the economic activities of millions should be coordinated by what Hobbes calls the "Leviathan", a command system where the means of production are owned by the state, with the exclusive power to determine what to produce and how much to produce. However, the collapse of the Berlin Wall in 1989 along with the planned economies of the Eastern blocs – not to mention the horrors of Nazi and fascist government prior to 1989<sup>1</sup> – seemed to undermine the idea that a centralized government is the best solution for the allocation of society's scarce resources. Today, few economies (such as North Korea and Cuba) still maintain a planned economic system. Consequently, the market system along with the liberal democracy was touted by such scholars as Fukuyama (1990) and Friedman (2005) as the best political and economic system. But, as it happens, the market, in many instances, has failed to live up to that standard as many goods, due to their nature, are either underproduced or overproduced or not being produced at all. When the invisible hand of the market is unable to achieve an allocation of resources that is Pareto optimal<sup>2</sup>, government should step in to correct market failures.

However, such scholars as Tullock, Seldon, and Brady (2002) and Buchanan and Tullock (1990) are less enthusiastic about the role of government as a corrector of market failures. They argue that government failures can be worse than market failures. Government failure arises, "when government has created inefficiencies because it should not have intervened in the first place or when it could have solved a given or a set of problems more efficiently, that is, by generating greater net benefits" (Winston, 2006, p. 2). This view known as public choice theory holds that a politician is a self-interested agent, and as such he will take the course of action that pleases the interest group that supported him or the policies that are likely to lead to his reelection. In other words, instead of improving economic welfare, government intervention may actually reduce it. Provided that government is imperfect, do the imperfections in the market process necessarily call for government intervention? And, will resource allocation in a society be necessarily improved by removing a market failure?

This essay is a critical evaluation of the theory of market failure as well as public choice theory. These two approaches, notwithstanding their different policy implications, do overlap in their shared assumption of rational self-interested behavior. And once we shift from rational self-interested to bounded-rational behavior, the role of the state becomes less contested inasmuch as individuals no longer have this powerful computational ability and foresight bestowed upon them by these two theoretical frameworks to always make the best choice when facing many alternatives. With bounded-rational behavior, the state should no longer be viewed as a mere surrogate of the market, but as "a choice architect," "an entrepreneur," and "a manager of conflict."

This paper is thus organized as follows. First, I will briefly look at the 2008 subprime crisis as an instance of both market failures and government failures. The second section addresses the economics of market failure, government intervention and its drawbacks. The third section discusses a more practical role for government that transcends the behavioral assumption of market failures and government failures. And, fourth, I conclude.

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