CHAPTER 9

ROLE OF GOVERNMENT

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"When is government intervention in the economy warranted?"

This book deals with important and perplexing issues facing the people of Hawaii. From land use regulation to public education to environmental protection, it questions government's role in society. Some chapters, written by economists, are critical of one or more aspects of government intervention. This may lead you to think economists see *no* role for government in the economy. That would be a mistake. Economists actually have a long-standing appreciation of government's role in the affairs of civilized society. Indeed, economic thinking provides some helpful guidelines for that role.

Most economists expect government to address problems that arise when private market transactions fail for one reason or another. To understand the ways government can best do this, you must first understand why many people place great faith in private markets.

The marvels of the market. Much of our daily activity takes place without the direct involvement of government. We purchase gasoline and groceries, work in private businesses, attend movies, and so on. Economists regard these activities as "private" in the sense that the self-interest of the parties usually generates mutually satisfactory results.

Respect for markets comes from two aspects of these private activities. First, each transaction seems to leave both the buyer and seller better off than before. The gas-station owner makes a profitable sale and you have fuel in your car. Presumably, the gas-station owner values the sale more highly than the gas and you value the gas more highly than the money you paid for it (otherwise one of you would not have agreed to the transaction). It's a win-win result. Second, to the extent these transactions take place within a competitive market, they involve prices set by the forces of demand and supply. The price system coordinates your demand for gas with the owner's willingness to supply it.

The combination of these two aspects of private transactions—improved welfare and competitive prices—forms the basis of an important insight of modern economic analysis: perfectly competitive markets efficiently allocate goods and services and thereby improve people's welfare.

This analysis suggests a hypothetical world that would require no government. Competitive markets in all goods and services would exist, and people could acquire those goods and services at the lowest cost. Further, no other way of allocating the goods and services among society's members could improve the welfare of some without reducing the well-being of others. This hypothetical world provides a benchmark against which to compare the real world and helps identify situations in which government involvement may improve social well-being.

Inefficient competition. A case for government involvement can be made by recognizing limits to the efficiency of competition itself. Imagine, for example, Oahu served by ten electric companies. Their competition for your business would presumably drive rates down to the level of costs. This may sound good from your perspective as consumer, but ultimately you could pay more for electricity. Like most utilities, electric companies face high fixed costs. Each of the ten companies would invest in costly plant and equipment, establish a network to deliver electricity to households, and hire personnel to handle billing and customer service. Sound like wasteful duplication of effort? Most economists would agree. Indeed, the most efficient organization for industries like electricity may leave room for only one firm. The industry can then spread high fixed costs over a large number of sales, rather than forcing each of many firms to bear such costs separately.

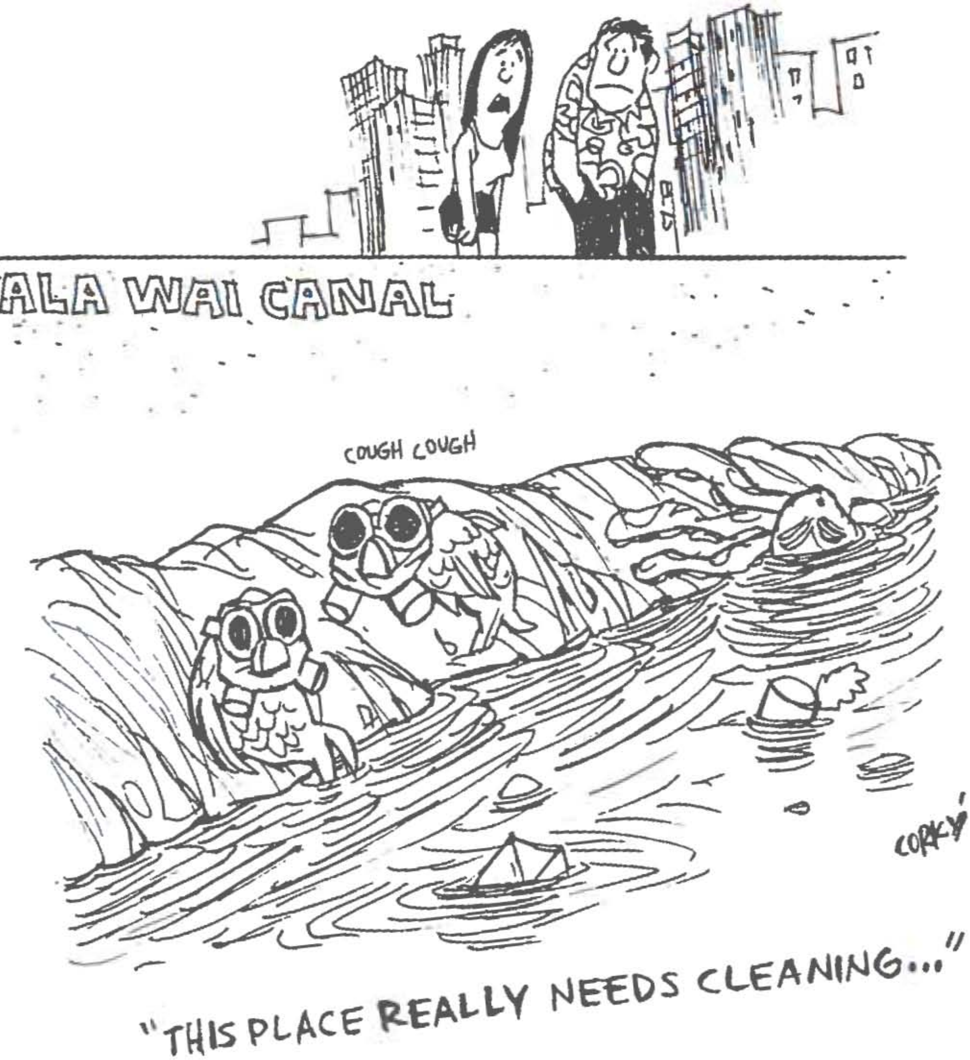
But one firm is the very antithesis of competition! Thus, industries that (for technological reasons) prove more efficient with only one firm provide an exception to the hypothetical competitive model. This, in turn, may call for a governmental mechanism to assure that the firm does not use its monopoly status to raise prices far above costs. That is why Hawaii has a Public Utilities Commission to review requests for rate increases by public utilities like HECO.

Third-party effects. Goods and services whose consumption or production affect people other than the buyer and seller provide another rationale for government involvement. Such transactions are private, but have "third-party effects."

Consider a manufacturing process that generates undesirable waste-water. The cost-minimizing company without government rules and regulations will dispose of the waste as cheaply as possible by dumping into streams and ocean, adversely affecting everyone who uses those resources. The dumping of sludge by the private Hawaii Kai sewage treatment plant in 1988-1989 illustrates how the profit motive can prompt firms to cut corners at the expense of the environment. Government may legitimately prevent these producers from doing what competitive pressures might otherwise force them to do. Because environmental matters are particularly fraught with third-party effects, government must intervene to protect Mother Earth.

Third-party effects can also take a positive form. For example, universal education bestows benefits on both direct recipients and society as a whole. A well-educated population tends to make a productive and wealthy society. If government did not provide free or low-cost schooling, those with few resources would, in most cases, fail to attain their potential, and the larger community would suffer as a result. We may therefore reasonably require all taxpayers to contribute to the costs of public education.

Public goods. A third example of a legitimate government role in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"THIS PLACE REALLY NEEDS CLEANING..."

the economy relates to "public goods." These are goods and services fo which one person's consumption does not reduce the supply availabl for others. Private producers may find denying access to nonpayin consumers impractical or even impossible. This makes private marke arrangements very difficult.

Consider police services. Suppose you and your neighbors hire private security firm to patrol the area. The entire neighborhood woul become more secure. Yet some of the neighbors might refuse to pay hoping to get a free ride. If everyone acted this way, no private fir would supply security services, even though people generally valu them. The government can resolve this problem by financing suc services with tax dollars.

Summary. This discussion does not exhaust the economic argu- ments in favor of governmental intervention in the economy, but i covers a widely accepted area. As you read the other chapters in thi book, keep in mind these economic arguments for government. If chapter deals primarily with private goods for which a competitiv market seems well-suited, then you may understand why that autho questions government involvement.

If government appears substantially and actively involved in som area of the economy, can you identify a natural monopoly, third-part effect, or public good issue? There are good reasons for governmen involvement in the economy and we should expect our political leader to articulate those reasons in each particular case.


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