CENTRE FOR
ECONOMIC PERSPECTIVES
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Why We Need Governments

The man regarded as the father of economics devoted a great deal of time and a big chunk of his work talking about how free markets produce the best outcomes for everyone involved. Adam Smith, in his book “The Wealth of Nations”, told us about the invisible hand that guides us all in this chaotic world and makes sure we all get what we are willing to pay for. Now if we take his ideas and look at them out of context, it might seem that any form of governance or regulation we have ever seen is unnecessary. So are we perpetually pointlessly regulating the markets, or was Adam Smith, one of the greatest scientists in history, completely wrong? Well, neither. Adam Smith’s ideas are still quite useful and the world is as close to free markets as it has probably ever been. What governments and regulators do, or at least what they are supposed to do, is to fix market failures.

Let us first recall the most fundamental concepts of economics: supply and demand. We know there is a direct relationship between the good’s price and its supply, so basically the higher the market price, more of the product will be provided, and that there is an inverse relationship between the product and its demand, so a higher price results in lower demand. Think about almost everything you have ever bought or thought about buying and these ideas will seem only natural. The free market advocates say that in order to achieve the optimal allocation of goods, such that all the willing buyers buy and all the willing sellers sell their products is to do nothing at all. The buyers will find the sellers and vice versa, exchanges will occur, the price will fluctuate until the market reaches a steady state, which is called the equilibrium (number of sellers = number of buyers). So why do we have all those countless regulations and laws? And why do they differ from sector to sector? The answer can be put in one phrase: market failures. There are numerous cases when the market is unable to produce the best outcome. A firm might exploit its position as the monopolist, or a few firms might conspire in order to increase their profits at the expense of the consumers in case of an oligopoly, or some firms might use certain uncompetitive practices such as selling at a lower price than their own cost in hopes of outlasting everyone else in the market and creating a monopoly for themselves.

Much less discussed and a bit more complicated type of market failure are externalities. As defined by Oxford Reference dictionary, an externality is “the indirect effect of one agent's consumption activity or production activity on the well-being or economic activities of other agents”. Basically, whenever you buy or produce something that creates a cost or a benefit for someone else, an externality is created. While the term market failure sounds quite negative, externalities are not always bad. The term is only supposed to signify that the market fails in allocating the resources optimally. Economists distinguish between positive and negative externalities depending on whether a cost or a benefit is caused. Governments need to understand all the implications of those to be able to correct them. Let us now consider a few examples of externalities and see how they are being dealt with in the modern world.

One of the most common externalities nowadays is the emission of harmful elements into the environment. Ever since the industrial revolution, a myriad of human activities is synonymous to CO_2 emissions and many other gases and substances that pollute the air that we breathe, reduce our standard of living, and generally speaking, make the world a worse place. One would think that rational decision-makers would take this into account and stop the emissions or find alternatives, and currently there is quite the progress being made on that account on the level of corporations as well as policymakers. However, let us understand the emitters' perspective and see why this serves as the perfect example of a negative externality.

There are millions of factories in the world, most of them emitting hazardous substances into the atmosphere all the time. If we look into one of those factories, we will see certain inputs and raw materials transformed using machinery and human labor into a certain final product. The company calculates how much each of those products costs, considering all the expenses made and yet to be made, adds a profit margin so that it can make money from the product and sells it to the willing buyer. The social cost of the CO_2 emissions is not taken into account, and neither the producer nor the buyer pay any of it. The cost, by definition, is paid by the society as a whole, and with no consent of the latter. So the production cost of, say 90, is in reality closer to 110 (that is, if we somehow calculate the exact amount of the social cost incurred to be 20), while the product was sold for only 100. From an accounting and even from the economic point of view of the firm, it has created value, but from the standpoint of the society as a whole, value was destroyed. This is where governments and regulations are actually needed. If the government has estimated the social cost to be 20, which we will take as accurate for now, it can tax the factory or the buyer with that 20 for each product produced and sold, and instead of the people who never even saw the product, the interested parties will be the ones to bear the burden of the social cost they created. What such a tax does is essentially privatize the social cost.

Externalities are not necessarily negative. There are countless cases when the production or the consumption of a certain good or service results in a social benefit to a certain group of people, or, maybe, to the society in general.

When making a decision to purchase a product, or actually doing anything, a person takes into account all the personal costs and benefits of the action and if the benefits outweigh the costs, the action is taken, the purchase is made. When an 18-year-old high school graduate considers attending college or starting her/his career at a local bank branch as a teller, she/he considers the tuition and other expenses that are going to be 30000 per year and she/he knows she/he could have earned at least 25000 per year if she/he opted for the job instead of attending college. At the moment her/his internal cost calculation amounts to 55000 per year. Now following the logic described above, her/his decision will depend on whether the benefits of attending college are greater or smaller than 55000 per year. Of course, it is quite the complicated task to express the advantages of college education in money terms, but still she/he manages to come up with the number of 50000 per year. One would think she/he is better of taking that job at the bank, and considering the information given until now, she is indeed. However, an educated person does not only get the private benefits of their education, but they also create a positive externality in the form of a social benefit to the people around them. An educated person as your neighbor provides benefits to you too: they advocate certain projects for the neighborhood at their job which they got thanks to their expertise and education, they make educated and rational choices in the local elections, meaning you get a better local government, etc. So the benefit of getting an education is greater than 50000, maybe even 55000, but not for the decision-maker herself/himself. Now again, it is the government's prerogative to make sure the additional benefit is accounted for. If the additional benefit amounts to 10000, then the government could provide the graduate with a subsidy of at least 5000 for attending college, which would tip the scales of her/his decision to get an education, which would result in a benefit of 10000 for everyone involved. If the government does nothing, the potential 10000 worth of benefits would be lost.

As mentioned previously, it is not the easiest task to put a price on the social cost of a kilogram of CO_2 emitted, or the social benefit of having an educated neighbor, which is why the governments' efforts in correcting market failures do not necessarily result in the corrections of the said failures. Costs can be underpriced resulting in a part of the social cost still being paid by the society, or they can be overpriced, resulting in a reduced output from the factory way more than what was necessary. Most economists agree that government failures can get far worse than market failures, so governmental corrections should be taken with great care and account for all the implications of the decisions made by the producers, the buyers, the society and the government itself.

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