

Difficulty of Applying the Standard Concept of the “Market Failure” to the Formerly Communist Countries: Observation from the Kyrgyz Republic

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Introduction

In advanced Western economies, the government performs the dual role of providing market freedom and establishing a legal framework in which private businesses can operate. The role of the market freedom is crucial: when entrepreneurs are unfettered by cumbersome regulations and taxes, they have incentives to innovate and expand their business activities. In contrast, when the government imposes onerous taxes and regulations, there is little incentive to produce more, and to upgrade the existing means of production. However, the markets cannot function without the polity. In the absence of the rules of the game enforced by the polity, businessmen engage in opportunistic and unproductive economic activities (Williamson, 1996). To avoid this problem, the government establishes property rights, contract rights and other formal institutions to ensure the “foundation for market transactions” (North, 1990).

The analysis of the government-market interaction in Western advanced economies is straightforward because the limited governments and well-established formal institutions allow markets to work reasonably well. The analysis starts from identifying market failures, and in consequence, the government intervention to correct the market failures. In the case of the government failures (abuse), formal institutions limit the government from predated on the market. This type of “market failure” approach has worked well in the countries with strong markets and limited governments. But, how do we go about studying countries with unlimited (unchecked) governments, nascent markets, and absent formal institutions? As far as we know, most of the underdeveloped and developing countries can be characterized by such systems: abusive and/or corrupt governments, extralegal and/or partially formed markets, and nonfunctioning and/or noncompliant formal institutions.

* Citation as follows: Paper presented at the *International Research Workshop at the Center for New Institutional Social Sciences* at Washington University in St. Louis (May 27, 2004), available at <http://cniss.wustl.edu/summerschool.html>.

Standard Story of Market Failures

In a conventional microeconomic story, economists tend to focus mainly on market failures and, in consequence, the need for government intervention to correct those failures. Schiller (2000) raises three basic questions: Under what circumstances do markets fail? How can government intervention help? How much government intervention is desirable? These are the basic questions we address when we think about the government intervention in the economy.

The market failure can generally be defined as the failure of markets to realize the optimal mix of output attainable with available resources, technology and social values. Conceptually, economists often state that when the forces of supply and demand do not lead us to the best point on the production possibilities curve, we have market failure. In other words, market mix does not equal optimal mix. Hence, the equalization of market mix to optimal mix is a basis for government intervention. This is a very simplified justification, which nevertheless helps us think conceptually about the market failure. In reality, it is a much more complex phenomenon involving many endogenous and exogenous variables that may cause markets to fail to produce the optimal mix of output as well as respond to particular social demands.

It is also essential to note that the discussion of the optimal mix of output is straightforward but the discussion of social demands is very arcane. It is mainly because social demands vary in different societies to different extents and what is considered to be an optimal mix of outcomes for a particular society largely depends on social values of that particular society. At any rate, since the justification for government intervention is not purely positive and sometimes normative, it is very much disputable. At the same time, whether we agree or not with the standard microeconomic justification for government intervention, there are market failures, and the widely used mechanism to correct these failures is through some type of government intervention.

The question that naturally arises is when and how we know about market failures. Again, after many years of challenging research, economists have come up with four main microeconomic sources of market failures: underproduction of public goods, external costs, market power, and inequitable distribution of resources (I exclude the discussion of

macro market failures in this paper). Certainly, these are not the only sources of market failures but these are the ones which are generally manifested in the well-advanced market economies and the ones upon which economists have a general agreement.

The underproduction of public goods derives from the free-rider dilemma, meaning that some individuals may free ride on consumption of goods purchased by someone else. This is mainly because by definition a public good is nonexclusive and “nonrival”, implying that consumption of a public good by one person does not exclude consumption of the same good by another person. As a result, there are no incentives to produce or pay for public goods when others can enjoy it free of charge. Therefore, the market tends to underproduce public goods, leaving society without such essential public goods as defense, free elementary education, etc. In this case, there is a need for government intervention by forcing people to pay taxes and from tax revenues to provide public goods (Schiller 2003).

Related to the first source of market failure is the problem of externalities. To put it simply, the market tends to underproduce goods that yield external benefits and overproduce goods that yield external costs. In the presence of externalities, we need government intervention. The government also intervenes into the market to prevent monopoly from abusing its market power mainly through antitrust laws and other government regulations. The logic is very lucid: when we have an only one producer or supplier (monopoly) of certain goods, there is no competition and hence there is an incentive for a monopoly to charge high prices and restrict supply. To get rid of this problem, we need government intervention. Finally, economists generally agree that the market in its pure form is inequitable and needs to be corrected by the government intervention, using taxes, transfer payments and providing the fundamental necessities called merit goods. By and large, there is a general compromise among economists on the microeconomic sources of market failures and on the importance of government intervention in addressing them.

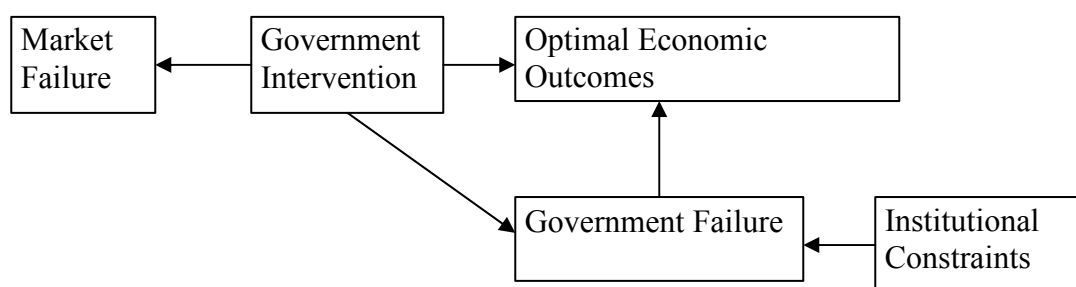
Rethinking Market and Government Failures

As a matter of fact, the government intervention is not perfect. It may sometimes cause more harm than good. For example, the government may end up wasting public resources and therefore may fail to provide public services adequately, which is commonly referred

in the literature as the “government waste.” The government waste can occur in the face of inefficiencies that may occur when the government distributes or provides public goods inefficiently and in the face of opportunity costs in producing private goods and services we give up to obtain public goods and services. Thus, when the government intervention entails considerable waste in the form of inefficiencies and opportunity costs, the government, instead of improving market failures, may indeed make the situation worse (Schiller, 2003).

The conceptual reasoning of the government failure in microeconomics is straightforward: the government intervention, instead of equalizing the market mix of output to optimal mix of output, indeed may make the difference even larger. This argument works well in the countries where the market economies work reasonably well and polities are relatively democratic. Hence, scholars and practitioners initially focus on market failures and then focus on the government improvement of these failures. In the face of government failures, the democratic natures of these countries provide political and legal mechanisms to address the government failures by balancing the size of the government and restraining the behavior of political actors. This is how the political economic systems generally work in the advanced market societies. The standard approach to examine the government-market interaction in such societies can be illustrated schematically as follows:

Figure A. Schematic Sequence of the Government-Market Interaction



According to Figure A, when we study the government-market interaction, we examine conditions, under which markets do not produce optimal mix of output called market failures. The conditions of market failures justify the government intervention to correct the markets to achieve optimal economic outcomes. However, since the government

intervention is not perfect, we may end up with government failures. When there are government failures such as government waste or abuse, formal institutions such as the separation of the branches of government, democratic elections, competing parties and interest groups, the rule of law, regulations and other institutions restraint the government action and provide democratic environment where political, economic and social actors establish checks and balances on each other.

The difficulty of applying the same conceptual approach, illustrated in Figure A, to the countries in transition emanates from the fact that the countries in transition do not have well-functioning markets per se and do not have functioning formal institutions and democratic systems that can restraint the abusive behavior of political and economic actors. The problem in transitional economies therefore is mainly with the governments rather than with the markets. Because of the lack and ineffectiveness of formal institutions in countries in transition that would provide the rules of the game for the market participants, we also need to examine informal constraints that shape the behavior of political and economic actors in these countries (North, 1990).

FOR EVIDENCE, SEE TWO OF THE ATTACHED PAPERS:

“Corruption in the Private and Government Sectors: The Challenges of Reforms in Kyrgyzstan”

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