

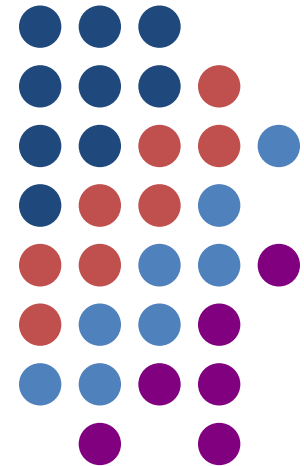
# Class 7: Market and the State

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Introduction to Public Policy

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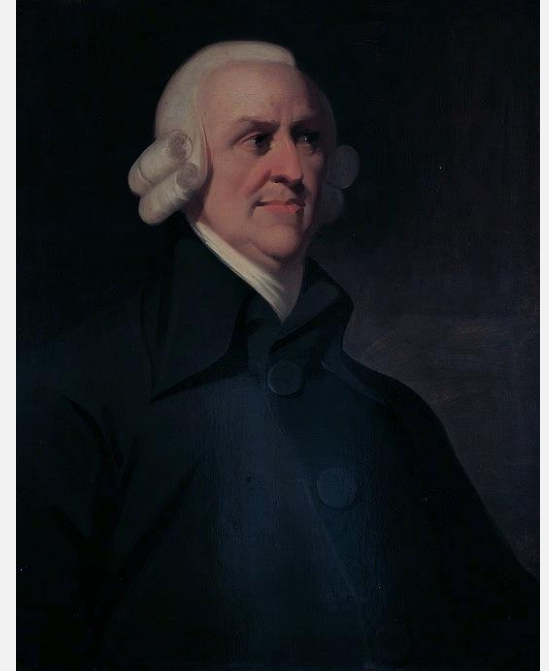


# Adam Smith's Invisible Hand

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## The Wealth of Nations [1776]

*“As every individual, therefore, endeavours as much as he can both to employ his capital in the support of domestic industry, and so to direct that industry that its produce may be of the greatest value; every individual necessarily labours to render the annual revenue of the society as great as he can. He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it. By preferring the support of domestic to that of foreign industry, he intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an **invisible hand** to promote an end which was no part of his intention. Nor is it always the worse for the society that it was no part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it.”*



Adam Smith  
1723-1790

# Perfect Competition

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- Many sellers (producers) so that each individual seller supplies only a small proportion of the total quantity offered in the market. They, therefore, cannot influence the market price.
- Many buyers (consumers). Each individual buyer is a price taker.
- Producers face no barrier to entry and/or exit.
- The products offered by the producers are homogeneous and perfect substitutes.
- Perfect information: the consumers and producers have complete information about the market and product.
- Factors of production including land, labor, and capital are freely allocated according to market forces.
- Production and consumption activities do not create externalities.



# The Consequence of Perfect Competition

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- In a market with perfect competition, the interaction of supply and demand results in a market equilibrium where the allocation of resources is ***Pareto*** efficient.



Vilfredo Pareto  
1848-1923

# Where do we find a market with perfect competition?

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- In ....  
*economics textbooks*
- Although there is no actual perfectly competitive market in the real world, for economic analysts and policymakers:
  - It serves as a very good approximation for many markets.
  - Its shows the power and efficiency of the market.

# Theoretical Foundations for State Intervention

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- Efficiency: Correct market failures
  - Monopoly
  - Information asymmetry
  - Externality
  - Public good
- Equity: Reduce inequality
  - Efficiency vs. Equity
- Merit good: “Paternalistic” state

*Topic of  
Week 7*

# Interventions by the Government to Correct Market Failures

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- The government acts as the provider
- Administrative measures
- Tax/subsidy
- Regulation
- Use the market to correct market failures

# Market and the State

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- Perfect market: no need for the government to intervene
- Imperfect market: the government may intervene
- But, what about an imperfect government?



# Three Types of Government Failures

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- There is a market failure that requires government's intervention, but the government fails to act.
- There is no market failure, but the government intervenes, leading to an inefficient allocation of resources.
- The government intervenes to correct a market failure, but in doing so causes the allocation resources to be more inefficient compared to the case of no intervention.

# Causes of Government Failures

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- Policy analysis, advocacy, and implementation
  - Lack of capacity for policy analysis resulting in wrong or inappropriate selection of policy option
  - Lack of leadership skills causing Thiếu năng lực lãnh đạo nên không vận động được sự ủng hộ, tham gia và nguồn lực để
  - Lack of management capacity leading to wrong or ineffective implementation of policy
- Interest groups
  - Động cơ chính trị vụ lợi: nguồn lực được phân bổ để mang lại lợi ích chính trị cho người hoạch định chính sách
  - Động cơ tài chính vụ lợi: nguồn lực được phân bổ để mang lại lợi ích tài chính cho người hoạch định chính sách

# Correcting Government Failures

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- Resolving the root causes of government failures
- Looking for more effective alternatives to direct interventions by the government
- Institutional reforms  
(Topic of Week 5)