Government Intervention as an Optimal Response to Government (not Market!) Failure*

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Abstract

This paper provides a theory of government intervention, such as government ownership, regulation, mandatory public schooling, subsidies, and industrial policy, as an optimal policy response due to the inability to commit not to expropriate private investment or bail agents out. If the government cannot commit not to expropriate the capital of private firms ex post, private firms may not invest ex ante. The government may hence need to undertake investment itself. Thus, government ownership may be optimal, and, indeed, may be optimal even if government owned firms are less efficient. Public enterprise as a remedy for lack of private investment due to the threat of expropriation by the government should be particularly important in capital intensive sectors such as manufacturing, extraction of natural resources, and services which require large infrastructure investments, which is consistent with the data. Similarly, if the government bails out households which do not invest in schooling or save for retirement ex post, the government has to enforce universal schooling and force agents to save through social security systems ex ante. Government intervention may thus primarily be a response to government failure rather than market failure.

Keywords: Public enterprise, time inconsistency, optimal policy.

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