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## **MARKET FAILURES AND STATE FAILURES. MARKET REGULATION VERSUS PUBLIC REGULATION**

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**Summary:** The paper commences with the formulation of institutional dichotomy: imperfect market *versus* imperfect state and, subsequently, with accepting the assumption of the common interdependence between market failures and state failures, as well as the related correlation between market and public regulation. In accordance with fundamental neoclassical premise, the aim of the latter is not to replace the market but improve it in a broad sense, within its coordinating and optimizing functions. Market failures and state failures, as well as their interdependence, are analyzed in the context of “market paradigm” and public regulation whose specific definitions are proposed in Section 2. Resulting from those definitions, public regulation becomes *ipso facto* an immanent component of the neoclassically understood market paradigm. The author recognizes general and specific market and state failures and briefly discusses them. The failures concerned are also analyzed in the light of the economic theory of public regulation (Section 3).

**Key words:** market and state regulatory mechanism, market failures, state failures, market paradigm, public regulation, normative and economic theory of public regulation.

### **1. The market and the state as coordination methods – preliminary assumptions**

The starting point of this paper is based on assuming a certain alternative, or institutional dichotomy, in the analysis of mechanisms of macroeconomic (or even global) coordination and optimisation of activities of individual economic entities in a market economy [Demsetz 1982; Wolf 1994]. The alternative rests on juxtaposing two imperfect mechanisms of such a coordination: the imperfect market and the imperfect state. In other words, it is explicitly assumed that both these generally understood mechanisms of coordination are characterised by particular imperfections, or failures, in terms of their ability to steer the development of a market economy in a way which would ensure its movement towards a Pareto optimum, i.e., maximising social welfare with a given – quantitative and qualitative – provision of the economy with broadly understood economic resources on the one hand, and their owners’

preferences on the other.<sup>1</sup> It also means, by definition, rejecting the institutional alternative of contrasting the perfect market with the perfect state.

The assumed alternative implies both the necessity to identify and search for sources of market failures and state failures in a market economy, and to examine potential and actual correlations between these failures. It also means rejecting the extreme neoliberal and neoclassical approaches stating that the vast majority of market failures result from mistakes in regulating the economy by the government. In reference to the assumed institutional alternative, two general hypotheses are made in this paper:

a) Because of the inevitability of regulation failures of both kinds, the market and the state should not be treated as “competitive” but always as complementary mechanisms of the coordination of the individual activities of economic entities.

b) The imperfections (failures) of the state are – generally speaking – connected with the fact that:

- because of the functionally and spatially complex (heterogeneous) structure of the state as an entity regulating the functioning of the economy, it may not be seen in practice as one with a homogeneous operating goal. Quite the contrary, it must be considered a standard situation that there exists a large number of inconsistencies in the bundle of goals which are set at spatially and functionally diverse levels of the state’s influence on the economy;
- there are diverse possibilities of exerting pressure in order to achieve particular regulation goals, especially including those caused by unequal access to information and the asymmetry of information between the organs of government and private economic entities.<sup>2</sup>

Accepting the assumption of the common interdependence between market failures and state failures, as well as the related correlation between market and public regulation, it is at the same time assumed in this paper as a general neoclassical methodological premise that the aim of any form of public regulation is not to replace the market but rather improve it in the broad sense, within its coordinating and optimizing functions. In other words, public regulation is meant (or should be meant) to develop real efficiency of the market as a mechanism of coordinating and optimising the activity of individual economic entities (regardless of their ownership status). Focusing on this premise seems vitally important also in the light of the frequent approach in specialist literature – and common in economic writing – in

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<sup>1</sup> The term “market failure”, now commonly used in English-speaking sources, was first introduced by F.M. Bator [1958]. This paper does not discuss possible semantic differences between the term and similar notions, e.g., “market imperfection”.

<sup>2</sup> What comes to mind here is an analogy with the principal-agent theory. However, if we consider the state, which acts as the governing body, as the “principal”, then we must remember about the specific plurality of this principal, i.e., the existence of a number of different public entities affecting individual economic entities – both private and public – and about the fact that in practice the degree of information asymmetry between both sides of the regulation game may be multifaceted.

which all forms of state influence on market processes and phenomena are treated as attempts at crowding out or at least limiting the scope of market regulation. It tends to be accompanied by describing the state's regulatory activities as contributing to a general decrease in economic efficiency.<sup>3</sup> In relation to the two aforementioned institutional alternatives, it implicitly undermines yet another dichotomy, i.e., the perfect market vs. the imperfect state. It is a dichotomy which seems to have as little to do with the contemporary reality of well-developed economies as the imperfect market vs. perfect state dichotomy.

The neoclassical approach also implies that the necessity for improving market regulation – through reducing the extent of the occurrence of market failures and limiting regulatory failures of the state – must be viewed in accordance with the paradigm of methodological individualism. In this case it means, above all, the necessity for taking into consideration the costs incurred and benefits gained by those participating in the “regulation game” – entities subject to regulation, regulating institutions, institutions laying the legal and organizational foundations of the regulation (i.e., the broadly understood legislators). Notably, the ability to identify and estimate such costs and benefits, as well as to balance their distribution among those players, is an elementary condition of winning support for the regulatory actions planned by the state.

## **2. Definition of “market paradigm” and “public regulation” in a market economy as a reference point for the analysis of market failures and state failures**

Further in this study, the author suggests a reference point for the analysis of market failures and state failures. It is based on understanding the market as a general mechanism of regulation (coordination and optimisation) on the one hand, and on the other – the definition of public regulation, adopted from specialist literature. The former regulatory mechanism will be referred to as “market paradigm”.<sup>4</sup> It is understood in the following, sequential way:

- when making their supply-demand decisions concerning commodity markets, productive inputs markets and financial markets, individual economic entities are mainly guided by the observation of price changes of market goods, factors of production and financial assets, as well as by related fluctuations in the level of fulfilling their utility function (goal);
- on meeting particular conditions, which may be – in the broadest approach – reduced to the terms of perfect competition (or equivalent, e.g., in the potential

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<sup>3</sup> Lipowski [2002] points out that the so-called “anti-statist approach” demonstrates a number of limitations and deficiencies, without negating the serious degree of the state's fallibility.

<sup>4</sup> This term was proposed and extensively discussed by the author of the present paper and then contrasted with the notion of state paradigm [see Fiedor 2009].

competition model), the above-defined activities of individual entities lead to creating an effective equilibrium in respective markets;

- if the balance is indeed effective, then the respective markets – and in consequence the whole economy – witness a maximisation of the volume of combined economic surplus (achieved by particular groups of individual entities; producers and purchasers of goods in the simplest case), i.e., within existing limitations, the maximisation of social welfare is achieved (Pareto optimum).

Market paradigm understood in this way can be slightly simplified and may come down to the following triad: allocative efficiency of the market – effective market balance – conditional maximisation of social welfare. It is easy to notice that it refers to the situation whereby the conditions of perfect competition are met, so it acts as a certain reference model within which both market failures and state failures are considered.

Economic writing features a large number of definitions of public regulation in a market economy, often considerably different from each other. The definitions cover a range delineated by the broad objective approach on one end, and a very narrow expression on the other.<sup>5</sup> In a broad sense, public regulation is associated with all the forms of impact of the state on economic life, or its use of the prerogative of power, i.e., means of coercion in: planning (e.g., when imposing the procedures of spatial planning), administration, or taxation. The narrow approach comes down to associating public regulation with the administrative and legislative activity of entities responsible for regulating various markets of the real sector (production of goods and services) and the financial sector. The definition of public regulation used in this paper refers to the proposed concept of market paradigm, i.e., the way it serves the coordination/optimisation functions. Thus, public regulation will be understood as the general principles or specific actions of government agencies and other institutions of public administration which directly affect the allocative mechanism of the market by influencing producers' and consumers' decisions concerning supply and demand.

It may be noticed that the definition is clearly based on the following assumption: if due to unfulfilled conditions of perfect competition on the markets of goods and factors of production, as well as financial markets (which are not discussed here in detail because of their specific regulations) the equilibrium on particular markets is inefficient, then even if the conditions of allocative efficiency are met, the market mechanism of regulation does not lead to a Pareto-optimal situation. What is needed then is public regulation, i.e., various forms of state intervention which “rationalise the market” – they allow the economy to move towards the Pareto optimum by removing or limiting the incidence of the state's imperfections. Sometimes, when such an influence is not possible, public regulation may mean activities of the state

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<sup>5</sup> See especially the classic work by Kahn [1991] and also Szablewski [2003].

which lead to welfare improvement through limiting socially and economically negative effects of market imperfections.

The proposed way of understanding public regulation in a market economy means that it *ipso facto* becomes an immanent component of the neoclassically understood market paradigm. Therefore, it may even be stated that accepting such an interpretation renders pointless the traditionally understood antinomy of public regulation *vs.* market regulation. They simply become indispensable, complementary mechanisms of coordination and optimisation within the same paradigm.

If we assume that the conditions in which economic entities carry out their calculations, making current and strategic decisions on their basis are subject to significant disturbance in the conditions of anti-equilibrium, especially in the long term, then one of the elements of the neoclassically understood market paradigm is also the necessity of the state's action leading to macroeconomic balance or stability. In short, this may be expressed as the following triad:

- low inflation controlled by independent monetary authorities;
- balanced public finances;
- external balance of the economy.<sup>6</sup>

In other words, this means any activities of the (broadly understood) state which lead to stimulating or restraining the economic situation and – indirectly – to promoting economic growth, carried out within the framework of basic macroeconomic policies: monetary, fiscal and, trade. They should not, however, be associated with public regulation defined earlier. We must make a clear distinction between those state activities which directly (public regulation) and indirectly (e.g., monetary or fiscal policies) influence the conditions in which economic entities operate.

To sum up, in accordance with the neoclassically expressed market paradigm, the two basic fields of operation of the state as an economic entity are:

- public regulation, i.e., direct influence on the conditions of functioning or taking business decisions by economic entities;
- macroeconomic stabilisation, i.e., indirect influence by changing the level of parameters whose extent – or even existence – is beyond the entities' control (except for lobbying or clientelism).

They include, e.g., the reference rates set by the central bank, amount of basic monetary aggregates, tax rates, rates of the broadly understood social security burden, customs duty rates, etc.

The proposed concepts of market paradigm and public regulation unequivocally imply the general definition of market failure. It is therefore an inability of real markets to allocate limited resources in a way which would lead to maximising

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<sup>6</sup> The proposed notion of macroeconomic stability does not directly refer to the classic approaches in macroeconomics, which tend to focus on the “main goals” of macroeconomic policy, including strong economic growth, full employment (low unemployment), low inflation and balanced payments [see Snowdon *et al.* 1998, pp. 9-29].

total economic surplus, i.e., maximising social welfare. Such market failures, or imperfections, may be divided into two large groups:

- imperfections connected with infringing competition principles,
- imperfections connected with the functioning of the system of individual (private) ownership rights (disposal rights).

This division is not entirely disjunctive. For instance, the functioning of natural monopolies, classic and frequent institutional solutions which infringe the principles of perfect competition, is often connected with producing and supplying public goods, in turn adversely affecting the system of individual ownership rights. The necessity for public regulation in this case results from the need to oppose the abuse of monopolist position by the supplier of public goods on the one hand, and restricting the “free rider problem” by the purchaser of these goods on the other.

Due to limited space and the main aim of this paper being interrelations between market failures and state failures, their further analysis or classification is deemed unnecessary at this point [see Medema 2007]. However, it is important to distinguish between those market failures that are universal and those which are specific. Universal failures are connected with general reasons why the market mechanism of allocation and balance is fallible and may appear in any sector or branch of the economy. Disregarding the “duality” of market failures mentioned earlier, we may distinguish the following types of universal market failures according to specialist literature:

- monopolist situations, especially including those connected with natural monopolies;
- occurrence of direct (technological) external effects, both negative and – much less frequently observed – positive;
- presence of public goods (often in conjunction with positive and/or negative external effects);
- information imperfections;
- presence of risk and uncertainty.

Specific failures are in turn those which, because of their type and form, are characteristic of particular markets or – in the case of state failures – regimes of public regulation typical of those markets. Literature devoted to market failures and theory of public regulation in market economies indicates those sectors which reveal an especially high incidence of specific market/state failures:

- production and distribution of scientific knowledge (innovation);
- formal education at various levels;
- environmental protection and management of natural resources [see Jaffe *et al.* 2004].

In the case of production and distribution of scientific knowledge (inventions, innovation, etc.), the biggest specific failure is the contradiction between the requirements of social optimisation of the production system on the one hand and the system of distributing knowledge on the other. From the first point of

view, optimisation requires at least a temporary information monopoly in order to appropriate privately the benefits resulting from the use of private resources to produce knowledge. The socially optimal distribution is a system in which knowledge is freely accessible or at most accessible at marginal distribution cost, which would in turn discourage private investors from investing in its production. A possible regulatory solution, which to some extent mitigates this contradiction, is the patent-licence system supervised by the state or public subsidies for producing knowledge in private enterprises. As far as formal education is concerned, the most elementary specific failure is the huge discrepancy between the public and private rates of return on investment in education, which legitimises the regulatory solution of extensively subsidising costs of formal education by the state or, e.g., subsidising such costs incurred by private persons (families) in the form of school vouchers or other systems of indirect support. In the field of environmental protection and resources management, a specific market failure is the market mechanism's inability to reveal – through prices – the social preferences pertaining to those goods and environmental amenities which define its quality and, in consequence, the degree of social welfare. Due to the public character of the majority of such goods, the role of economic instruments (e.g., taxes or charges for the use of environmental resources) is limited here, so the common solution is introducing regulatory regimes of the direct type, i.e., legal and administrative.

Of course, each of the sectors with a high incidence of specific market failures may also suffer from the occurrence of failures with more general characteristics. For example, in the environmental protection and resource management sphere, we deal, to a varying degree, with all the market imperfections known as universal failures.<sup>7</sup> However, the ability to identify, assess results, and appropriately address the specific failures characteristic of each sector within the regimes of public regulation is an especially important prerequisite for the effectiveness of this regulation and lowering its costs, also from the point of view of the regulated subjects, which means an increase in the economic efficiency of public regulation.

With reference to the proposed concept of market paradigm and public regulation in a market economy and also by analogy with the category of market failures, it is suggested that state failures should be generally understood as:

- the state's inability (or limited ability) to address, within the narrowly understood public regulation, market imperfections in order to increase their real ability to ensure allocative efficiency and reaching the state of effective equilibrium in particular markets;
- undertaking actions (legal, institutional, organizational, etc) which *per se* become reasons for weakening the market's ability to efficiently allocate resources and reach the state of effective balance in particular markets; in this case state failures will be specific sources of market failures, although clearly it does not mean

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<sup>7</sup> This is discussed extensively in Fiedor [2005, pp. 85-96].

accepting the extremely liberal view of the universal nature of such conditions for market regulation failures.

The proposed definition of state failures, and implicitly also of market failures, has a “narrow” character, which means that it does not associate these failures with other levels of the state’s interaction with the economy, and particularly with:

- classically understood interventionism, i.e., fundamental macroeconomic policies (fiscal, monetary, and trade);
- broadly understood structural policy, i.e., the policy of integrated, pro-growth impact of the state on the economy within its regional, scientific, educational, and ecological policies, as well as basic sector policies (industrial, agricultural, transport, etc).<sup>8</sup>

For instance, the accepted definition of state failures does not include regulatory imperfections connected with inappropriately formed basic monetary aggregates or interest rates set by the central bank as a result of its failure to attain the expected level of inflation rate. Likewise, according to the definition, state failures do not include those fiscal solutions which result in increasing budget deficit or public debt. This is justified by the fact that both these (and analogous) cases deal with an indirect influence of state agencies on the conditions in which economic entities operate, without identifying their goals or preferences, and basing on the mere premise that they function as a classically understood *homo oeconomicus*, maximising utility functions unknown to the state regulator. The situation is not essentially changed by assuming alternative models of behaviour, e.g., modifying the concept of *homo oeconomicus* by the hypothesis of rational or adaptive expectations, or strategic behaviours in game theory. It is also worth mentioning that certain decisions related to political cycles and pertaining to fiscal or monetary policies are made for non-economic – and sometimes even ideological – reasons. Similarly, the category of state failures (state regulation) should not be linked with various fields of state activity within the framework of structural policy (in the meaning proposed above). For instance, this understanding of market failures does not include those setbacks of regional policies which result from attempted bridging of gaps in development among particular regions, which – if we view it from a reverse perspective – amounts to increasing the country’s economic and social cohesion. By the same token, in the context of such disparities, it is inadvisable to see them as regulatory market failures because territorial concentration – as is the case with all kinds of production clusters – is in fact a positive indication of the optimisation functions of market mechanisms, leading to economies of scale, synergy, increased dynamics of innovation, etc, within each cluster. However, to the degree in which the structural policy, and especially basic sector policies, is pursued in the horizontal (but not selective) manner, meaning that it “approximates” public regulation in the sense

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<sup>8</sup> This broad approach to market failures and state failures is quite common in the theory of economics [see Lipowski 2002, pp. 303-322].

proposed in this paper, it becomes the field of potential incidence of state failures (according to our definition). For example, the horizontal way of understanding and pursuing industrial policy implies that state failures should be, generally speaking, understood as the inability of agencies which carry out the policy of reducing barriers of entry and exit to particular industrial markets, to stimulate the transfer of science and technology aimed at increasing the industry's innovative dynamics, or to initiate institutional solutions which increase the private rate of return on investment in developing new products and technologies, thus creating stimuli for increased interest among private entities to invest in research and development.

By analogy with general and specific market failures, we may also distinguish general and specific failures of the state as a regulator. They are in fact strictly interdependent within the proposed concepts of market paradigm and public regulation. Hitherto, this paper has referred to the general notion of state failures. Specific failures are those that result from the inability to identify, and then appropriately address within regulatory regimes, those market imperfections which are characteristic of a given sector or branch. For instance, the market mechanism is not capable of assuring the extraction of natural, especially non-renewable, resources which would be compliant with the criterion of intergenerational justice – a fundamental condition of sustainable development from the ecological point of view.<sup>9</sup> In this example, specific failures of the state as a regulator include its inability to create instruments for direct regulation (legal and administrative) and economic regulation (especially fiscal), which favour a more sparing use of resources, replacing non-renewable resources with renewable ones or even with entirely new technologies, or replacing them with so-called anthropogenic (man-made) capital in order not to limit the degree of meeting the needs of future generations thanks to fulfilling the condition of leaving the total capital resources undiminished for these generations (in this simplified case – the natural and anthropogenic capital). In the case of educational policy, a good example of a specific state failure is its inability to create a mechanism of accreditation which effectively counteracts the functioning of institutions with very low-quality study programmes or establish public institutions which would prepare long-term forecasts of specifically qualified staff required by the economy, culture, and other fields of social activity. All this assuming, of course, that the market itself is unable to provide sufficient supply-and-demand information about the expected long-term structure of qualifications and skills required by the economy.

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<sup>9</sup> For an extensive discussion of the issue see Neumayer [2010], especially Chapter 3: Resource, The Environment and Economic Growth. Is Natural Capital Substitutable?.

### 3. Market and state failures in the light of the economic theory of public regulation

The reference point of our considerations so far has been the implicit normative theory of public regulation, with its fundamental principle stating that the aim of regulation is improving social welfare. In a more practical, operationalised sense, it means that the state's regulatory activities lead to increasing the aggregate economic surplus, achieved by the suppliers and purchasers of goods on a given market operating under a regulatory regime.<sup>10</sup> According to the normative approach to public regulation in a market economy, if the social costs and losses connected with the occurrence of market imperfections vastly exceed the costs of potential regulation, then the state should regulate the market in order to maximise social welfare or – in other words – to diminish the losses of welfare level in the pre-regulatory situation. It must be emphasized here that the costs of regulation may be both direct and indirect. Direct costs are connected with establishing and implementing the regulation, i.e., with law-making (legislation costs), founding and running regulatory agencies, etc. Indirect costs, far more difficult to estimate, may have a very diverse character and include, e.g., alternative costs connected with the inability to expend the state's tax revenues assigned for establishing and operating regulatory regimes on implementing other public goals, or information and transaction costs connected with negotiations between the regulatory agencies and the economic entities which are under regulation (e.g., concerning energy tariffs) or with establishing specific regulatory instruments.

Public regulation may be viewed from an entirely different perspective than in the normative theory, however. The reference point of public regulation does not have to be the benefits gained in the social scale, i.e., improved social welfare as implied by the normative approach, but rather group benefits gained by both sides of the regulatory process – the entities which are under regulation (including households) on the one hand, and the state agencies responsible for founding the bases for legal and institutional regulations, their implementation and observance on the other hand. This general “philosophy”, or rather cognitive-ideological outlook on public regulation, forms a starting point in various alternative, non-normative, theories of regulation.<sup>11</sup> Due to limited space, later in this paper I will concentrate on just one group of alternative approaches – economic models of regulation. Without going into too much detail as to each of them, I will attempt a reconstruction, or synthesis, of the economic theory of public regulation as a whole.<sup>12</sup> As a starting point, let us approach public regulation, or to be more precise, its particular legal and institutional solutions as a commodity. It is therefore necessary to identify both the demand for

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<sup>10</sup> This is discussed in detail in Fiedor [2006, pp. 217-236].

<sup>11</sup> For a detailed review, see den Hertog [1999] and P.G. Hägg [1997].

<sup>12</sup> I discuss it in detail in Fiedor [2006].

this commodity and its supply.<sup>13</sup> The reconstruction in question may be expressed as follows:

- The main resource vested by the state is its right to enforce the law, i.e., to exact behaviours which comply with established legal norms.
- All participants in political and economic life, including politicians, legislators, and regulators (employees of regulatory agencies), as well as entities under regulation, act rationally and maximise their utility (utility function).
- Politicians are predominantly driven by the criterion of gaining and/or maintaining power. Interest groups, competing with each other, offer them their support or money to run political campaigns. Politicians “choose” the highest-rated group and after an electoral success offer them regulation which more than compensates for their lobbying costs, clientelism, etc.
- Economic entities usually have a better ability than households (consumers) to effectively (i.e., in accordance with expected benefits) influence regulatory solutions. This results from two correlative factors. Firstly, economic entities are far less numerous groups, which facilitates reaching a collective consensus. Secondly, their motivation is stronger because in case a success in the form of an expected regulatory solution is achieved, their actual individual benefits are bigger than those of consumers [Klimczak 2002].
- The game of interests leads to an optimal distribution – though usually not in the Pareto sense – of regulatory benefits among entrepreneurs and consumers on the one hand, and politicians (legislators) and regulators (regulatory institutions) on the other.
- This approach to public regulation, consistent with the generally understood economic theory of public regulation, implies the existence of a political market of regulation and *ipso facto* means that public regulation is treated as a specific commodity.

Such an approach to public regulation requires a different interpretation of state failures than has so far been presented in this paper. According to the economic theory of regulation, state failures include:

- incapability to identify the main groups of entities incurring specific costs of regulatory solutions on the one hand and those benefitting from such regulations on the other. The term “benefits” does not only mean direct financial profits, but also broadly understood social and environmental gains, etc;
- inability to predict and estimate costs and benefits of regulation and their distribution among particular groups of entities, considering different time horizons at which such costs and benefits may appear;
- incapability of the state (legislative and regulatory institutions) to create regulatory solutions accepted by all the main groups of entities to which a given regulation is addressed;

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<sup>13</sup> It is connected with the concept of political market in the analysis of the influence of the state on the economy, introduced by J.M. Buchanan [1975]. See also Buchanan [1993].

- inability to establish regulatory regimes which would oppose an excessive concentration of benefits resulting from regulation in the hands of one group of entities (participants); classic examples here include the cases described by the so-called capture theory of regulation, which states that all the regulatory benefits are appropriated by the regulated enterprises;
- inability to solve and appease conflicts that may appear on the supply side of the regulation, i.e., those between legislative bodies acting as creators of regulation, and regulating agencies which are responsible for its implementation and execution;
- specific alienation of government agencies, including the regulatory ones, which means that the bureaucracy which runs them tries to safeguard its own interests, regardless of social preferences present in the mechanism of democracy in the form of representative bodies of various levels;
- making regulatory decisions influenced by conditions of political cycles rather than on the basis of a reliable calculation of costs and benefits resulting from particular regulatory solutions [Acoella 2002, p. 355; Wojtyna 1992].

As seen the list, state failures expressed by the economic theory of regulation have a specific nature – it is the political market of regulation that constitutes their reference point. And in turn, it would be difficult to discuss market failures *sensu stricto* in reference to such a market. Perhaps, but only hypothetically, we might consider here discussing general failures or imperfections of the coordination mechanisms of individual actions within social groups. For instance, these could be situations described in the prisoner's dilemma, whereby members of groups, especially numerous ones, are often unable to reach a solution or at least a proposal of a solution which would benefit all the members of this group. From the point of view discussed in this paper, it clearly means introducing a regulatory instrument which would be beneficial for this group.

#### 4. Final remarks

a) If we accept the assumption that market imperfections do occur in real-world economies, then public regulation in a market economy must be regarded as an inevitable phenomenon rather than an institutional solution which depends on a particular theoretical or political option. The institutional dichotomy assumed in this paper – imperfect market vs. imperfect state – implies, however, that regulatory failures of the state are also inevitable. This is especially visible from the perspective of the economic theory of regulation described in the paper.

b) Market imperfections should not be treated ahistorically. It is necessary to assume an evolutionary approach instead, especially taking into consideration the fact that contemporary developments of technology may at least weaken the range and effects of their occurrence. This provides an objective opportunity for market

deregulation or changing the methods and instruments of regulation used in many existing markets. Typical examples of areas in which such needs are already observed are the telecom and energy markets.

c) When designing regulatory systems, and in order to minimise losses in social welfare caused by state failures (in the normative approach to public regulation), the state must always consider costs and losses implied by those systems. In other words, the following relationship must be examined: an irreversible loss in welfare in a pre-regulatory situation *vs.* costs of the regulatory regime.

d) It must always be borne in mind that specific failures of the state as a regulator may occur, so an increase in welfare due to removing or reducing the incidence of market imperfections may be accompanied by a fall in welfare caused by regulatory failures.

e) In certain situations, failures of the state as a regulator become an independent source of distortions in the functioning of markets. However, this supposition does not mean that we accept the ultra-liberal assumption that state failures are common, or most frequently observed, sources of distortions of the market mechanism of coordination and optimisation.

f) In accordance with the economic theory of regulation, and also taking into account the fact that regulation is always a specific form of revenue redistribution, while improving the existing and introducing new regulations we should take into consideration the interests (costs and benefits) of the participants in the regulatory game. This is one of the fundamental conditions of effective public regulation in a market economy, especially in the relationship: costs and benefits of the producers *vs.* costs and benefits of the recipients of the goods that they offer.

g) Particular regulatory instruments should be – just like all other instruments of economic policy – assessed not only from the point of view of their effectiveness, but also their economic efficiency. This means that what is necessary here is a comparative analysis of potential instruments from the perspective of the criterion of costs of achieving regulatory goals.

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## **BŁĘDY RYNKU A BŁĘDY PAŃSTWA. REGULACJA RYNKOWA VERSUS REGULACJA PUBLICZNA**

**Streszczenie:** Artykuł rozpoczyna się od sformułowania dychotomii instytucjonalnej: niedoskonały rynek *versus* niedoskonałe państwo i – w konsekwencji – przyjęcia założenia o powszechnej współzależności błędów rynku i błędów państwa. W zgodności z fundamentalną neoklasyczną przesłanką, celem regulacji publicznej nie jest zastępowanie rynku, lecz jego szeroko rozumiane usprawnianie w zakresie funkcji koordynacyjnych i optymalizacyjnych. Błędy zarówno rynku, jak i państwa są analizowane w kontekście “paradygmatu rynku” i re-

gulacji publicznej, których specyficzny sposób rozumienia przez autora został zdefiniowany w drugiej części artykułu. Jak wynika z tych definicji, regulacja publiczna staje się *ipso facto* immamentną częścią neoklasycznie rozumianego paradygmatu rynku. Autor wyróżnia ogólne i specyficzne błędy rynku i błędy państwa oraz krótko je omawia. Błędy te są także rozpatrywane z punktu widzenia ekonomicznej teorii regulacji publicznej w gospodarce rynkowej (część trzecia).

**Słowa kluczowe:** rynkowy i państwowy mechanizm regulacji, błędy rynku, błędy państwa. paradygmat rynku, regulacja publiczna, normatywna i ekonomiczna teoria regulacji.