Public Policy: An Overview

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Abstract

Understanding the role of the government in a market economy is important for proper dialogue between citizens and policymakers in a democratic governance system. Even though the topic is not novel, the management of economies in developing nations shows that basic economic principles are sometimes ignored. In this context, revisiting the subject of public policy, particularly the role of the government in a market economy, is pertinent. This chapter defines and describes what public policy is and policy instruments available to a government; summarises the theory and empirical evidence on markets' ability to allocate resources efficiently and improve social welfare; and, describes the government's role, within principles of minimum intervention, in creating inclusive economic institutions, maintaining equitable distribution of income, correcting market failures, and ensuring macroeconomic stability.

Keywords

Market economy · Role of government · Market efficiency · Market failures · Economic institutions

2.1 What Is Public Policy?

Policy can be defined in many ways, and there is no single definition that encompasses all the relevant elements of a public policy. A broad definition is that policy is a "purposive course of actions that an individual or a group consistently follows in dealing with a problem". This definition emphasises the *purpose* of the

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policy to address a problem. But it is vague in the sense that it doesn't elaborate on the types of problems, objectives of solving problems, or who carries out the course of actions.

Public policy is defined as "declared state objectives relating to health, morals and wellbeing of the citizenry". This definition reduces the vagueness of the first one by specifying that government undertakes the course of actions. The notion that government should play a major role in maintaining the moral values of a society is archaic: while governments enforce legally relevant morals, like preventing criminal activities through law enforcement, the belief that the state should ensure the entire spectrum of moral values became less relevant as societies evolved into modern democracies. This discussion will focus on the role of public policy in ensuring the well-being of citizens.

Public policy is also defined as "a purposive and consistent course of action produced as a response to a perceived problem of a constituency". This introduces the political perspective of public policy. Citizens will have a list of priority issues which they call upon the government to resolve. In campaigning for elections, a political party's manifesto will lay out certain policies or courses of action; and people elect a government they believe will best address their problems through policy. Despite gaps between what is promised and what is actually accomplished, the process provides opportunity for people to express their desire to have perceived problems resolved through public policy.

Another closely related term is economic policy, which can be defined as "a course of action that is intended to influence or control the behaviour of the economy to maximise social welfare".[1] Public policy and economic policy both concern the well-being of the citizens. In economics, well-being/welfare refers to contentment with one's standard of living, including financial status and material consumption. Economic policy is more precise as it intends to maximise well-being.

There are many different ways to categorise policy instruments; one very broad way is to consider regulation (stick), economic means (carrot), and information (sermon) as the main instruments. Regulatory measures such as use of a catalytic converter to control vehicular pollution are associated with a fine when violated, whereas a tax concession for investors is an incentive (carrot) to promote investments. Daily information about the number of cases of COVID-19 and their geographic distribution alters the behaviour of the public and potentially reduces the spread of the disease. This minimalist typology, on the one hand, emphasises the compulsory nature of the government in its solution strategies. On the other hand, it refers to the resources available to the government.

Also, public policy instruments may be classified by the degree of government intrusion into the market: regulation, expenditure, public property, self-regulation, and exhortation. Regulations are implemented by various government ministries, departments, or agencies to carry out the intent of legislation enacted by the parliament. Expenditure refers to the fact that governments spend tax revenue for

[1] https://www.cliffsnotes.com/study-guides/economics/introduction/economic-policy

public purposes as stipulated in public policies. Regarding property, a government owns various properties such as lands, building, etc. In a broader sense, this property also includes the government's financial resources. The way a government manages public property will have significant economic implications. In the most basic sense, self-regulation involves controlling government behaviour in exercising its powers in achieving its long-term goals. For example, governments generally have powers to acquire private land for public purposes. Self-regulation requires application of this power only when it is absolutely necessary (e.g. when building a road), accompanied by reasonable compensation. Exhortation is persuasive and powerful communication: for example, the state exhorts the public against drug use or to refrain from dumping garbage in public places. The degree of intrusion is highest with regulation and gradually declines towards self-regulation and exhortation.

Direct controls applied to avoid undesirable behaviour or actions are another policy instrument available to a government. According to this explanation, direct controls can be applied to enforce certain desirable behaviours by the public too. Banning some pesticides (Dichlorodiphenyltrichloroethane, commonly known as DDT) and narcotics (like heroin) and prescribing certain mandatory technologies (such as the use of energy-saving bulbs in all the government building) are examples of direct controls. Economic regulations, such as maintaining desirable interest rates, promoting economic growth by various means, imposing taxes and duties, providing subsidies for selected sectors, and setting or removing tariffs to promote exports or to control imports, form a major part of public policy.

Governments implement development projects, such as roads, power plants, irrigation, water supply, etc. Contracting is a policy instrument available to the government in selecting the best companies or organisations to carry out civil works. When a government owns assets like forests, oil fields, or mineral deposits, it provides concessions to individuals or companies via an agreement granting rights to develop and use these resources. Public services such as water supply may also be operated as a concession.

Direct loans, loan guarantees, and public insurance are another set of policy instruments frequently used by the Sri Lankan government. The supply of certain goods and services through government corporations, such as Sri Lankan Airline, Ceylon Electricity Board, and the Port Authority, are also commonly used public policy instruments. Fees (for various government services such as issuing passports), charges (for water pollution), various legal obligations, and public information are also frequently used policy instruments by the government.

The above list is not complete but should provide a broad understanding about the various instruments available to the government to implement its policies.

2.2 The Market and Its Efficiency

Understanding the role of markets is a prerequisite to understanding the role of the government as a policymaker. Consequently, it is essential to examine the concept of a free market economy.

The free market economy is one in which decisions regarding investment, production, and distribution are mainly based on supply and demand which are themselves based on the decisions of individuals. Prices of goods and services are determined by the interaction of supply and demand. Supply represents the cost aspects of the economy; demand, consumer preference or the value (benefits) consumers assign to various goods and services. Market equilibrium balances the costs and benefits and provides equilibrium prices. Prices or price changes dictate the best allocation of resources, ensuring economic efficiency, which ensures the highest level of social welfare.

The word "free" means that market forces, supply and demand, are allowed to function without intervention by the government. There is always *some* intervention by the government; at the very least, it has to collect taxes and spend tax money on national defence, health, and education, as well as provide some level of regulation of markets, like setting standards for health and safety and facilitating the exchange function. Therefore, there is no absolutely free market anywhere in the world. Markets are subjected to government interventions at various degrees, and the "free market economy" is a relative term and that implies minimum government interventions.

The interest in free market economies is based on its well-known ability to improve the well-being of citizens. Adam Smith, the father of economics, first asserted the markets' ability to improve social welfare. He explains in *The Wealth of Nations* (Smith 1776) that the motivation to maximise profits drives a free market economy. Individuals, acting in their self-interest, generate demand or supply, compelling others to buy or sell goods or services. In return, s/he either receives or pays compensation and one party makes a profit. In this process of exchange in a free market economy, resources are allocated in the most efficient manner. Smith uses the term "invisible hand" to describe the market process, distinguishing the government's role as the "visible hand".

The invisible hand theory basically states that without any intervention, if all individuals in an economy act in their best self-interest, the result is automatically in the best interests of the economy and always better than in a centrally planned and regulated economy. If each consumer is allowed to choose what and how much to buy, they will allocate their limited income to maximize their well-being. Similarly, when each producer is free to choose their production quantity, technique, and prices, producers would use an efficient method of production to cut costs and charge low prices to maximise revenue. Consumers would buy from sellers who offer the lowest prices. Also, investors would invest in industries that maximise their return. All this would take place automatically if the economy is set free from government intervention.

Every individual would endeavour as much as s/he can both to employ their capital in support of economic activities like industry or agriculture that produce the greatest value. Here, individuals *neither know nor intend* to promote the public interest. By supporting such economic activities, s/he intends only their own security. Similarly, by engaging in the economy in such a manner as to produce the greatest value, individuals intend only their own well-being. By pursuing her/his

own self-interest, individuals frequently promote society's best interests more effectively than if s/he actually intends to promote socially desirable outcomes. In fact, Smith claims that he has never known those who endeavour to effect socially desirable ends to do much good (Smith 1776).

Economic literature in the post-Adam Smith period looks at the welfare impacts of markets in various ways. In particular, trade theory further extended the role of markets by demonstrating that free trade improves the welfare of all trading partners. The culmination of this process was Nobel laureate Kenneth Arrow mathematically proving that free market equilibrium maximises social welfare. The ability of markets to improve standards of living is formally described by the first fundamental theorem of welfare (FFTW): free market economic equilibrium is Pareto efficient. Pareto efficiency means that the economy has removed all inefficiencies in investments, production, and consumption and no additional efficiency gains are possible; i.e. one person's welfare cannot be improved without harm to others. Simply, the economy is at the best state in terms of the aggregate welfare of its people, given the resource endowments, technology, and peoples' preferences.

The above is the most powerful theory in economics: it heavily influences economic policies throughout the world. How has this powerful economic theory performed in the real world? There is ample empirical and historical evidence of the markets' ability to take societies towards prosperity. The post-Second World War economic prosperity of nations belonging to the Organisation for Economic Co-operation and Development (OECD) is mainly due to their reliance on the market economy. While some countries regulated markets (e.g. European countries) more than others (such as the USA), all these countries followed a free market economic policy. Economic assets, particularly the physical infrastructure of European countries, were very badly damaged by the war. The USA helped these countries to rebuild their damaged infrastructure through the Marshall Plan, and, following rehabilitation, these countries followed a free market policy. Within about 20 years, they became rich countries again. Many factors contributed to this development but the free markets played the main role.

Opposite to the free market economy is the centrally planned economy. Today, only North Korea seems to have a centrally planned economy. The largest centrally planned economy, the Soviet Union, collapsed in December 1991 in the middle of a huge economic crisis. Vietnam, China, Lao PDR, and Cuba were all once centrally planned economies; they now claim to be socialist countries, but use market economic principles to a large extent in managing their economies. Up to about the 1960s, the centrally planned economies showed better progress in addressing issues of employment, housing, universal access to education, and universal access to health. By the late 1980s, these countries were far behind market economies like OECD countries. The abandonment of the centrally planned economic model by many countries during the 1980s and 1990s signals that the free market system is better than central planning as a method of organising an economic system.

What caused the failure of centrally planned economies? There were several reasons, including complex world politics. However, it would be fair to state that the failure was largely due to the absence of market forces that provide signals and

incentives on what, how much, at what quality, and at what cost to produce: an efficient link between producers and consumers. This identifies a fundamental problem with centrally planned economies. No planning body, over time, can match the efficiency of markets in connecting producers and consumers. Other problems such as guaranteed incomes that minimise the incentives for hard work and innovation, thereby undermining technological progress in meeting consumer demands, have also contributed to the failure of centrally planned economies.

The superiority of free market economies can also be explained using the two main strategies followed by market and centrally planned economies: export promotion versus import substitution. Many developing countries adopted import substitution policies as a developmental strategy during the initial phase of post-independent history. For instance, between 1970 and 1977 Sri Lanka pursued import substitution, switching to open market policies in 1978. During 1970–1977 period Sri Lanka recorded a very low economic growth owing mainly to import substitution policy though the unfavourable external factors such as food crisis and higher oil prices also contributed to the poor performance. The Sri Lankan economy grew fast as a result of adopting free market policy after 1977. But the Civil War changed the development trajectory of the country, and Sri Lanka could neither complete the necessary free market reforms nor realise the full benefits of a free market economy.

India adopted import substitution policies for much longer than Sri Lanka, initiating reforms to liberalise its economy around 1991, leading to fast growth. The Asian tigers (South Korea, Singapore, Hong Kong, and Taiwan) did not pursue import substitution, instead choosing a path of export promotion. These countries became the first set of developing Asian countries, along with Japan, to become rich. More recently, the rest of Asia has shown economic growth and increasing prosperity simultaneously with moving towards more free market, export-oriented economic policy stances.

China's development experience perhaps provides the best example of how a free market economy improves social welfare. Like other fully socialist countries, the Chinese economy was managed via state ownership and central planning. From 1950 to 1973, Chinese real Gross Domestic Product (GDP) per capita grew at a rate of 2.9 per cent per year on average, while neighbouring countries such as Japan, South Korea, and Taiwan were growing at much faster rates. Starting from 1970, the Chinese economy entered into a period of stagnation and, after the death of Mao Zedong, the Communist Party leadership turned to market-oriented reforms to salvage the failing economy. Communist Party authorities carried out market reforms first on an experimental basis and then in two stages. An initial experiment of private farming in one province showed remarkable growth in agriculture. The first stage of reforms, in the late 1970s and early 1980s, involved the de-collectivisation of agriculture, opening up of the country to foreign investment, and permission for entrepreneurs to start businesses. However, most industries remained state-owned. The second stage of reform, in the late 1980s and 1990s, involved privatisation, contracting out of many state-owned industries, and lifting of price controls, protectionist policies, and regulations, although state monopolies in sectors such as banking and petroleum remained. The private sector grew

remarkably, accounting for as much as 70 per cent of China's gross domestic product by 2005. From 1978 until 2013, an unprecedented growth of 9.5 per cent per year occurred. This growth has had major development impacts; average wages rose sixfold between 1978 and 2005, while absolute poverty declined from 41 per cent of the population to 5 per cent from 1978 to 2001. By 2015, China had become the world's second-largest economy, next to the USA (US Congressional Research Service 2019).

2.3 Role of the Government in a Market Economy

If the markets do such a good job of allocating resources and improving welfare, what is the role of the government in a free market economy? First and foremost is the inaction; one of the most important principles of public policy is that the government governs best that governs least. In other words, the government should allow the market to function without managing the day-to-day functioning of the economy. In particular, the government should not supply goods and services which can be supplied by the private sector. Instead, the government should provide oversight of the economy's overall functioning.

The outcome of market processes depends on the economic institutions or working rules ("rules of the game") created by the government. Establishing economic institutions that enforce property rights, create a level playing field, maintain competitive pressure among firms, and encourage investments in new technologies is fundamentally a part of the government's role in a market economy. In the early economic literature, this role is referred to as the first-order engagement of the government in the economy. Adam Smith (1776) described the importance of the government establishing proper economic institutions. He not only identified it as one of the fundamental roles of the government but also highlighted how economic institutions affect the distribution of the economic outcomes of a nation:

> According to the system of natural liberty, the sovereign (government) has only three duties to attend to;. . . . The third duty is erecting and maintaining certain public institutions which it can never be for the interest of any individual, or a small number of individuals. (Smith 1776)

In addition, governments have three very important roles commonly known as the second-order engagement. One aspect relates to the inability of markets to distribute economic outcomes equitably. The bulk of the returns in an economy may be earned by a few rich people. For example, in the majority of Asian economies, about 30 per cent of the income is earned by the 10 per cent of richest households. Ensuring some form of equity, as desired by society, is government's responsibility. Another aspect is that market processes fail to achieve efficiency when there are market failures, such as externalities (pollution problems, nature conservation, etc.); public goods (national defence, health, and education); natural monopolies (public utilities such as power transmission lines); and information failures. Government should intervene to

correct these market failures using direct provision, standards, rules, taxes, subsidies, and other policy instruments. Finally, governments should ensure sound macroeconomic management by spending the collected taxes on productive areas, ensuring healthy balance of payments, exchange rates, and interest rates. Market economies encounter business cycles, and, during slow growth periods, public investments should help to lift the economy out of recession.

2.4 Economic Institutions

What are economic institutions? They are the conventions, rules, and entitlements that define the domains of choice for economic agents. From an institutional economics perspective, an economy is a set of ordered relations among self-interested agents. The essential problem of economic organisation is to design a set of signalling devices which will guide these self-interested agents to act in the interest of the larger community: what individuals must or must not do (duties); what they may do without interference from other individuals (privileges); what they can do with the aid of collective power (rights); and, what they cannot expect collective power to do in their behalf (incapacity or exposure).

Institutions consist of the rule of law, a level playing field for individuals to participate in the economy which fosters competition and economic growth. Establishing the rule of law, including national defence, protection of human rights, maintenance of law and order, and establishing secure property rights, is of paramount importance for the markets to play their role in the economy.

Well-defined property rights play a vital role in market development and provide correct incentives for individuals to participate in and benefit from their economic activities. Such rights should be universally understood by economic agents and should exclude others from enjoying the benefits of an individual's economic activity. In addition to universality and excludability, rights should be transferable in order for economic exchanges to take place. The many economic exchanges taking place every second in an economy are actually transferring various rights. For instance, a customer purchasing a loaf of bread for LKR 100 exchanges their right to LKR 100 for the right to that bread. Government restrictions on exchange of rights curtails the development of markets. Also, there should be a mechanism to resolve disputes arising in exchanges.

A level playing field means that competition among economic agents should be ensured, and there should be no entry or exit barriers. In the absence of competition, private entities retain a high market share and influence the price mechanism. For instance, in Sri Lanka, the higher prices for rice during the December–January period and lower prices of unmilled rice at harvesting times are due to the concentration of market power among a few rice millers. Furthermore, there are numerous entry and exist barriers in the Sri Lankan economy. Among numerous examples, three-wheeler drivers do not allow cheaper and safer Uber and other taxi services in many parts of the country.

Quality institutional systems reduce transaction costs in the economy. Transaction costs refer to the cost of obtaining information, negotiating contracts, and enforcing contracts. Even in the information technology era, barriers to obtaining information remain in Sri Lanka. Negotiating contracts is still very informal and the costs of enforcing contracts very high in terms of long delays in dispute resolution. A well-functioning legal system that supports the economy should have clear lines of authority and division of responsibility among governmental units; clarity and precision in legal rules; mechanisms and processes for the protection of property rights; procedures that offer stability and predictability; a sense of fairness in litigation processes; and, accessibility of the legal system to the public.

The existence of laws is necessary but not sufficient for ensuring a well-functioning market economy. As stated in the World Bank's World Development Report (2017), laws may be used to empower change-actors or reinforce existing power; to provide order and certainty or create conflict and exacerbate confusion; to build or undermine legitimacy; and, to enhance competition or undermine it. Like many countries in Asia, Sri Lanka should strengthen the rule of law in promoting, enforcing, and institutionalising a culture of fair competition. Mechanisms that help give less powerful, diffused interest groups a bigger voice in the policy and governance arena could help balance the influence of more powerful, narrow interest groups. However, participatory mechanisms in regulatory institutions are still relatively uncommon in Sri Lanka.

Conventions, beliefs, and culture constitute an important segment of institutions. In Sri Lanka, there is a mistrust of markets which often leads to an economic policy based on unwarranted controls and regulatory measures. For example, reluctance to seriously reform or privatise state-owned enterprises (SOEs) may be due to mistrust of the markets. Except for the state-owned banks, all SOEs run at huge losses: the tax revenue which should be spent on long-term investment in physical infrastructure, health, and education are instead diverted to maintain SOEs, undermining economic development.

Sri Lanka graduated to lower middle-income country status in 2019. Many countries get stuck at this level of income for a long period of time: a phenomenon known as the middle-income trap. Lower middle-income countries should transform their economies to knowledge-based economies to compete with advanced countries and avoid the middle-income trap. Related to this, the World Bank identifies four incentive pillars of economic institutions of a knowledge-based economy: effectiveness of legislation influencing entrepreneurship; effectiveness of juridical system in keeping transaction costs low and supporting effectiveness of market mechanism; and, competitive pressure and effectiveness of labour markets (Robertson 2008).

Total factor productivity (TFP) measures the quality of institutions in an economy. As shown in Fig. 2.1, Sri Lankan GDP growth fluctuated throughout the post-independence period. Initially, it was thought that this erratic behaviour was mainly due to the war, but this pattern continued after the war highlighting fundamental problems in the economy. Figure 2.2 shows that TFP and GDP growth follow a very close pattern. Also, the figure reveals that growth of TFP has stagnated. Generally, in any country with sustained growth for a long period, TFP is an upward sloping

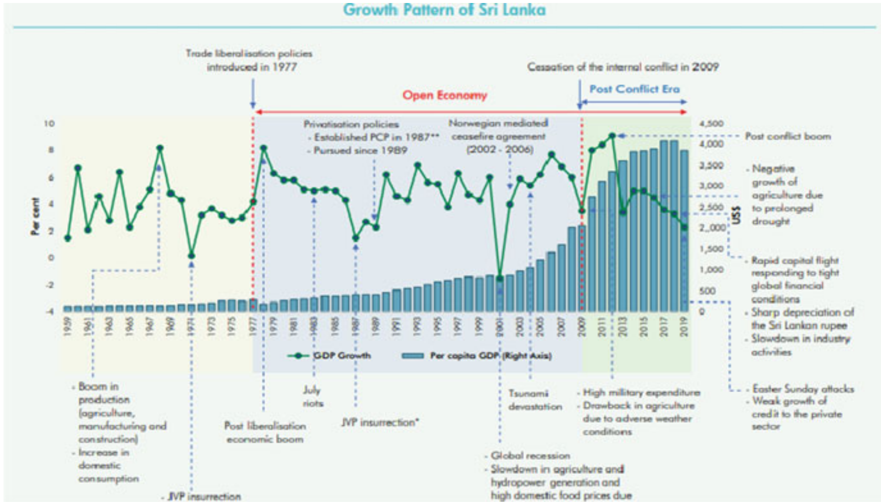

Fig. 2.1 Growth of GDP in Sri Lanka between 1960 and 2014. Source: Adopted from Asian Development Bank (2017)

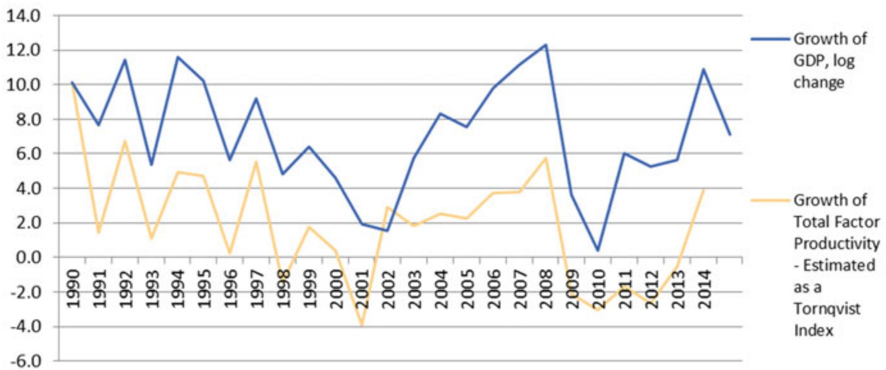

Fig. 2.2 Sri Lanka's GDP and TFP growth between 1990 and 2015. Source: Global Productivity database (2020)

curve. These two graphs clearly indicate that Sri Lanka's economic institutions are of poor quality.

Acemoglu and Robinson (2012) in *Why Nations Fail* assert that extractive economic institutions are the main reason for underdevelopment and poverty: "Inclusive economic institutions that enforce property rights create a level playing field and encourage investments in new technologies and skills are more conducive to economic growth than extractive economic institutions that are structured to extract resources from the many by a few and that fail to protect property rights or provide incentives for economic activity" (p. 430). They further point out that while

inclusive economic institutions are supported by and support inclusive political institutions, extractive economic institutions perpetuate extractive political institutions. Inclusive political institutions distribute political power widely in a pluralistic manner and achieve some amount of political centralisation required to establish law and order which is the foundation of secure property rights and an inclusive market economy.

2.5 Ensuring Equity

As observed in many Asian countries, market economies may produce high-income inequality. The market economy inherently favours capital over labour, skilled over unskilled labour. Moreover, it tends to support growth in coastal and urban centres rather than inland and rural centres. Coupled with unequal access to education and health facilities, job opportunities, capital, and land, this results in large income disparities. Income inequality can create disparities that transmit to future generations. For example, the Asian Development Bank (2012) reported that in two decades (1990 and 2000), Asia witnessed rising inequality in 11 economies (including the People's Republic of China, India, and Indonesia) comprising 80 per cent of Asia's population.

Access to quality education and spatial difference are two important determinants of inequality in many Asian countries. This is compounded by the ageing population as disparities accumulate over time with age (Deaton and Paxson 1994). Inequality excludes talented people from the labour force, creates social disharmony, and eventually leads to political instability. Therefore, government programmes should promote equity through use of tax revenues for a variety of social welfare programmes. Improving equity with minimum disturbances to the market process is a challenging task for any government.

In previous decades, Sri Lanka enjoyed low income inequality and good social indicators, backed by social welfare spending on universal food subsidies, free education, and free health care. But since the 1970s income inequality measured by Gini coefficient significantly increased from 0.32 in 1970 to 0.43 in 1980. This has been attributed mainly to the policy of economic liberalisation in the late 1970s. Income inequality, measured by Gini coefficient, has since ranged between 0.43 and 0.49. Sri Lanka's ethnic conflict is eventually an equity issue as well, and the war has created further inequality between southern and northern populations. The main causes of the two insurrections in 1971 and 1989 are youth unemployment and inequity. Given this history, Sri Lanka has to make every effort to ensure further growth does not widen income disparities.

Historically, Sri Lanka has had lower spatial inequality because of various government policies that supported rural populations. This has been changing and, as of 2015, 41 per cent of national GDP is accounted for by the Western Province (Asian Development Bank 2017). This underscores the importance of a balanced approach for regional development and inclusive economic growth.

As explained earlier, access to education and health are important determinants of inequality. In the early 1970s, social welfare expenditure comprised over 40 per cent of government expenditure, equivalent to over 12 per cent of GDP (Asian Development Bank 2017). Today, the country's health and education spending remain among the lowest regionally and globally due to declining tax/GDP ratio. Given the public sector's dominance in health and education, this low public expenditure on health and education is a cause for concern.

There is a trade-off in reducing inequality. Many measures to reduce inequality and redistribution of income require higher taxes, and taxes reduce economic growth. Therefore, efforts on reducing inequality should be carefully selected to avoid unnecessary slowdown of the economy. Avoiding inequality in terms of "unequal access to market opportunities and public services" provides opportunities to reduce inequality without undermining the growth prospects of a nation. Therefore, an efficient fiscal policy, interventions to support lagging regions, and more employment-friendly growth should be the focus in helping bring Sri Lanka's growth trajectory to a more inclusive one.

2.6 Correcting Market Failures

Market failures – monopolies, externalities, public goods, and information failures – are reasons for direct intervention by the government in a market economy. Monopolies (i.e. only one firm produces the good or service) produce less than optimal quantities of goods and services for sale at prices that are higher than in a competitive market price, thereby reducing social welfare. It is the government's duty to promote competition by avoiding monopolies or oligopolies (few firms in the market). The absence of a sound competition policy is a major deficiency in Sri Lanka for the free markets to deliver good economic outcomes.

There are some industries, like water supply, sanitation, and energy, which behave like monopolies because of their technical nature. For example, having several firms lay pipes for water transmission in an area would be wasteful. These industries have very high initial costs and ever-declining average cost curves which prevent them behaving like the usual competitive market firms.

This type of firms is known as natural monopolies, and the government should provide such natural monopoly goods and services or properly regulate the private sector provision of them. Most physical infrastructure belongs to this category. This a rare occasion that justifies the direct supply of goods and services by the government.

The government should not be involved in direct provision of goods and services that can be profitably produced by the private sector without reducing social welfare. Government agencies may not be as efficient as private enterprises in delivering goods and services due to structural constraints (such as the structure of incentives for employees and relationships with the political leadership) and rules of engagement with the public.

In Sri Lanka, based on the above, SOEs like the Petroleum Corporation, Ceylon Electricity Board, Sri Lankan Airlines, State Timber Corporation, etc., may be considered as social welfare reducing initiatives. It is evident that regulatory mechanisms for SOEs in Sri Lanka are not robust enough and lack resources and independence from political interference which undermine their effectiveness. To move forward, the functions assigned to SOEs must be efficiently carried out without colossal losses. This may require that some SOEs are maintained at least as cost recovering SOEs and others privatised or operated through public-private partnership models.

Externalities such as pollution, decreasing biodiversity, and destruction of ecosystems create a diversion between social and private costs undermining economic efficiency. The economy cannot sustain growth unless these environmental problems are solved. Climate change has become the most challenging environmental problem with threats to the very survival of the human race. Sri Lanka is extremely vulnerable in this regard. It is the responsibility of the government to correct such externalities through strict controls, taxes, subsidies, permits, and other policy instruments to reduce pollution and protect finite natural resources.

Public goods occur when exclusion is not possible in consumption: one individual's consumption does not prevent others from consuming it. The protection I get from national security does not prevent others from enjoying it. This results in free-riding which undermines the capacity of the private sector to supply optimal quantities of such goods. In such situations, government provision of goods like national defence is necessary. Education and health are quasi-public goods: this justifies the public provision of health and education with a carefully designed role assigned to the private sector. Regulating, rather than prohibiting, the private sector in the health and education sectors is an important government function.

2.7 Ensure Macroeconomic Stability

Though allowing the markets to play a dominant role in the economy, government assumes the responsibility to help the economy achieve goals of growth, full employment, and price stability. Justification for macroeconomic management by the government has its origin in the Great Depression in the 1930s. Prior to the Great Depression, the thinking was that cyclical swings in employment and economic growth would be modest and self-adjusting. A reduction in aggregate demand in the economy will result in the decline of prices and wages. A lower price level, including low interest rates and wages, would induce employers to make capital investments and employ more people, stimulating employment and restoring economic growth. The depth and severity of the Great Depression, however, severely tested this hypothesis and showed that the self-adjustment process didn't work.

Keynes showed that during recessions structural rigidities and certain characteristics of market economies would exacerbate economic weakness and cause aggregate demand to plunge, further prolonging the recessions. In order to come out of the great depression, Keynes advocated a countercyclical fiscal policy.

He asserted that during periods of economic slump, the government should expand public investment in areas like infrastructure to make up for the decline in investment and boost consumer spending in order to augment aggregate demand and investor confidence (Sarwat et al. 2014). Over time, the role of government in macroeconomic management evolved to be in two major areas: fiscal policy and monetary policy.

Through fiscal policy the government uses its power to collect taxes and to spend them on infrastructure development, national defence, health, education, and so on. Fiscal policy is a frequently used tool for reducing inequality too. Both taxation and government spending can be used to reduce or increase the total supply of money in the economy – the total amount, in other words, that businesses and consumers have to spend. When the country is in a recession, the appropriate policy is to increase spending, reduce taxes, or both. Such expansionary actions will encourage businesses to expand and consumers to buy more goods and services. When the economy is experiencing inflation, the opposite policy is adopted: the government will decrease spending, or increase taxes, or both. Such contractionary measures reduce spending by businesses and consumers in order to push inflation down.

Through monetary policy, the government uses its power to control the money supply and level of interest rates. Monetary policy is exercised by the Central Bank which is empowered to take various actions that decrease or increase the money supply and raise or lower short-term interest rates, making it harder or easier to borrow money. When the Central Bank notices that inflation is rising, it will use contractionary monetary policy to raise interest rates which will eventually decrease the money supply in the economy. When interest rates are higher, borrowers have to pay more for the money they borrow, and banks are more selective in making loans. Because money is "tighter" – more expensive to borrow – demand for goods and services and prices will fall. To counter a recession, the Central Bank uses expansionary monetary policy to increase the money supply and reduce interest rates. In practice, it may take a short or long period to respond to monetary policies, depending on the characteristics of the economy.

In addition, the government also takes steps to maintain a stable exchange rate for the local currency. When there is excessive depreciation of the currency, government may intervene in currency markets to stabilise exchange rates as a short-term measure. In the longer term, measures such as export promotion and tourism expansion are taken to stabilise exchange rates. Managing budget deficits, domestic and international debts, and balance of payments are some of the other areas of macroeconomic management by the government.

2.8 Conclusion

In understanding the role of the government or the purpose of public policy, the first step is to comprehend the fact the markets are efficient and maximise aggregate social welfare. But markets should be facilitated by the government by erecting

inclusive economic institutions. When good-quality institutions are not in place, economic outcomes are not optimal. Most of the time, such failures are misunderstood as failures of the market. Once the enabling economic institutions are established, the government should follow a hands-off approach, allowing the markets to work freely.

This minimal intervention approach works only when markets are doing a good job. But the market has its weaknesses in some sectors of the economy which mandate government intervention. There are three types of failures. Firstly, the market outcome does not guarantee equitable distribution of incomes: here the government has to intervene for redistribution of incomes as desired by society. Secondly, there are market failures, such as monopolies, natural monopolies, externalities, public goods, and information failures. The government should either directly supply goods and services when the market fails or regulate the relevant markets to ensure optimal outcomes by private-sector provision. Finally, the government should ensure macroeconomic stability and work proactively to sustain economic growth and prevent economies from falling into recessions.

The above description of the role of the government in a market economy provides a sound framework for discussing the economic problems of Sri Lanka today.

To relate this discussion to Sri Lanka, the reader may use this framework to evaluate some of the government policies, such as maintaining a 1.4 million and increasing public-sector workforce (Japan with 140 million population has 850,000 public servants), maintaining many loss-making businesses such as airlines, electricity utility, Petroleum Corporation, sugar factories, etc., and direct provision and heavily subsidized provision goods and services.

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