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Covering the social costs of market failure – the unsub of the value added

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Abstract. *The article presents some of the conclusions of a larger research project aiming at creating a map of the decisions on negative externalities in the regional development and collaborative governing framework.*
The present regional development models that are focused on the sustainable development (human sustainability, social sustainability, economic sustainability, environmental sustainability) represent the result of the mechanisms quantifying the negative externalities costs on the local authorities' level. The negative externalities represent an assigning criterion based on the subsidiarity principle, especially with regard to the "beggar thy neighbor" policies, namely the environmental pollution, and this provision is in itself a reason for the national economies to act in case of negative externalities. The public decision on covering the negative externalities, taken in accordance with the economic approach of subsidiarity pertaining to the multilevel governance provides a balanced solution for all the interested parties – citizens, economic agents and the government (who are designing a map for covering the social costs raised by the negative externalities , which must be in accordance with both the national and European decisions, but, at the same time, suspending this map whenever it is in conflict with these decisions cannot be an answer, thus leaving the social costs uncovered).

Keywords: regional development, market failure, public administration, social costs.

JEL Classification: H5, H7, R5.
REL Classification: 7D.

Introduction

Regional development arose from the efforts of both economists and of those charged with planning, regional development policy becoming one of the most important and most complex policies of the European Union status arising from the fact that when it comes to its objective(1) of reducing economic and social disparities among different regions of Member States, the European Union acts upon some significant areas for development, such as economic growth and SME sector, transport, agriculture, urban development, environmental protection, employment and training, education.

In terms of regional development(2), strictly conceptual, in contemporary economic theory there was often a tendency of net separations between micro and macroeconomics.

The problems of the individual consumers' behavior or the firms' behavior and their interaction in the market were often treated in isolation from the behavior of macroeconomic aggregates and economic functioning as a whole.

There is however a significant range of issues lying between these two extremes, which demanded an integrated view of the two approaches, and of the problems of the regions, including those of local communities, i.e. addressing the spatial scale of economy.

Thus emerged the investigation area of the regional economics, strictly linked to the regional development process as a fundamental subject in the regional science.

The research blockstart

Regional economy aims to find answers to a number of issues raised by the nature of the factors that determine the results of economic activities and the employment degree in a region. Answers had to be found on differences between some regions and what are the reasons why some regions have more pronounced growth rates compared to others.

It should be noted that regional economics analyzes both interregional and intraregional relations, existing in local economies. Hence the necessity of distinguishing between regional economics, focused on the region as a clearly delineated entity, with consideration of the reports mentioned and economy of urban, rural localities as resulting from its very name, deals with the issue of socio-economic development of localities, through the elements making up the locality as a system and its specific functions.

The regional economics has, as the main reason of its existence, the need to provide a theoretical and methodological rational basis, scientific for the strategies and regional policies, i.e. to establish a coherent set of goals and ways to ways for mitigation of regional disparities in the overall economic and social dynamics, and for identifying appropriate measures and instruments for fulfilling the settled objectives.

The problem of mitigating regional imbalances and in general to support regional development processes reappears in Europe lately, as a major concern both in the literature and in the analysis destined to substantiate the economic and social policy measures.

Explanations of growing interest for such concerns are maintaining – sometimes worsening – imbalances arising in the previous periods, or a new perception on them in the current economic, social and political context, in Central and Eastern Europe.

Current interest in regional issues is determined by the need to address and to solve in the national economic policies the difficulties generated by restructuring and reform processes in the developed countries of Western Europe. Concerns in regional policy field have intensified as a result of problems in relation to the processes involved in economic and political integration

Regional issues, interregional and intraregional disparities and imbalances in levels of economic development of the countries of the European Community (and not only) have appeared in history as a result of uneven geographical development (Iuhas, 2004, p. 57).

Neo-classical economic theories suggest that regional disparities exist only temporarily, and the elimination of these discrepancies might be achieved by adjustments of price and salaries, by movements linked to both the labor market and the capital market, the market mechanism that would make possible the decreasing of these differences from economic activities. The success of the market mechanism in eliminating regional disparities depends crucially on the existence of price competition condition and negligible transport costs and total mobility of labor and capital. If these powers are not met, then a concentration of economic activity, prosperity and employability of the labor force in some regions might appear, while in other regions slowing economic growth, unemployment, lower living standards could appear. Therefore, if the market mechanism is not controlled, it can lead to a spiral effect in which developed regions present the most favorable conditions for companies as well as the existence of a developed infrastructure, a concentration of highly qualified staff, available support for services, leaving to their choice the opportunity to increase or not the economic advantage towards the underdeveloped regions.

Theorists such as (Lazonick, 1984, Glasmeier and Fuellhart 1991, Maskell and Malmberg, 1995), sought to implement existing concepts[(3)] to describe the phenomenon of divergence of the growth paths from one territory to another. The serious interregional disparities at EU level due to the complexity of the process of European economic integration can only be mitigated by the application of integrated regional policy measures.

First, three approaches were incorporated with the main purpose to analyze the economic growth disparities among regions, i.e. neoclassical[(4)] approach, the one focused on exports and the theory of uneven development.

The only theory that establishes a link between the development of a region and its features is the theory of uneven development[(5)]. It considers that the increase process is basically and always uneven, totally contradicting the neoclassical theory[(6)]. Through its effect of amplification the endogenous growth of incomes creates differences between areas and regions, which cause a circular and cumulative causation process.

A series of studies (Armstrong and Wickerman, 1995) indicate two different trends recorded in regional development in the European Union: mitigation and increased regional disparities, respectively convergence and divergence in regional development, which succeeded at different points in time.

Undoubtedly, the simplest explanation of regional disparities is the diachronic type regions traversing a series of stages in the development process, stages that do not start simultaneously for all regions.

It is actually a dual process of divergence followed by convergence process as follows:

- national development is first polarized and then integrated;
- within each region, the development is first concentrated in a small number of centers before it broadcasts (in the beginning interregional integration only links centers in different regions);
- progressive decentralization within urban units is performed for the benefit of the peripheries (Puşcaşu, 1997, p. 16).

Actions to achieve regional policy, developed for specific[(7)] territories, require a high degree of coordination, vertical and horizontal, administrations and improving cooperation between public and private bodies" (Barca et al., 2005, p. 2).

The implementation of regional policy measures at the local level requires their correlation with existing trends at the following levels:

- European for establishing the actions and overall objectives;
- national for adapting the general actions to the national context, and to monitor their implementation, and providing administrative assistance;
- regional with a fundamental role in project selection, resource allocation, and monitoring their implementation;
- Locally with a role in involving local actors, projects drafting and promoting their implementation;

This raises the obligation of cooperation and collaboration at interregional, regional as well as national/European level for implementation of integrated and efficient regional development measures.

Therefore it is recommended that all regional development policy instruments should serve the national economic policy of each EU Member State to reduce existing disparities among the living standards of citizens of the Union(8).

Going in depth

The overall objective is to identify the specific elements of the current economic system that destabilize the public market and lead to the production (almost always) of too much "something" (pollution) and too little "something else" (research) – suggesting an alternative way of organizing the economy. The intervention on such a market can occur both in case of a failure, and if the markets are efficient, but the project has been mainly focused on the intervention generated by market failure (failure of competition, public goods, externalities, incomplete markets, information failure, unemployment, inflation and imbalance).

Research hypotheses

To achieve the overall objective of the project, two derived hypotheses have been formulated:

1. *In the public sector, the decisions are facing both problems specific to the private sector (efficient allocation, productivity, performance) and problems solely raised by the public sector (supply of public goods and services, collective choices, externalities), which puts more pressure on economic policies, forcing them to swiftly adapt.* For example, the dilemmas of the public decision maker (what will be produced, how is going to be produced, for whom will be produced and how are these decisions made (Stiglitz, 1999, p. 14) should integrate the influence of each variable, whether contextual (organizational culture, strategy, management, law etc.) or those affecting the efficiency of decision-making

(economic and social status, technical parameters, etc.). The answer to the first question (What will be produced?) lies in the allocation of resources, and it is often underlined in the literature using the production possibilities frontier (PPF). The second dilemma must seek resolution in the combination of the factors of production (labor, land, capital) found by the government policies (an environmental policy may affect the choice of technology and a fiscal policy can impact the use of labor). The aim of this production is defined by the distribution, in turn influenced by the fiscal policy, social policy or public goods produced to meet the needs of certain groups (the free rider problem).

2. *The inability of individuals to cooperate is emphasized in the context of the increasing complexity of the social systems, thus forcing the economic policies to adapt, aiming at the government's intervention in the market's economic functions in order to correct its negative effects.* For example, the public decision making on the market's distribution function is heavily influenced by the political factors (aiming to reach equity), more than it would be by the other stages of the decision-making process, like knowing the public sector activities and its organization (the financing method, expenditures and taxes on central and local level), or like the anticipation of consequences (the effects of a tax (rising prices, cutting wages), raising the retirement age) or the evaluation of alternatives (Matei, 2006, p. 63). These steps apply to all the public decisions of the other functions, for example, the allocative function as its specific public decisions aim at the government's intervention in the market's allocative function to correct its negative effects, the consequences' anticipation stage turns out to be important (emphasized by the forecasting or strategic models) (Matei, 2003, pp. 26-27).

Testing the hypotheses

The entire research developed around the case of negative externalities, as part of the six situations where markets are not Pareto efficient – (1) The failure of competition, (2) public goods (3) externalities, (4) incomplete markets, (5) failure of information and (6) unemployment, inflation and imbalance – primarily due to its timeliness and intense debate that was triggered in the EU-27 (Community guidelines on State aid for environmental protection 2008/C82/01; Treaty establishing the European Community (Nice consolidated version) – Part Three: Community policies – Title XIX: Environment – Article 174 – Article 130r of the EC Treaty – (Maastricht consolidated version) which establishes the polluter pays principle (PPP), and so on) and, secondly, because of the sensitivity of the best known negative externalities (pollution). Its extremely sensitive feature, which actually allows the intervention, refers to both sides of a failure. One is that the best possible outcome was not achieved followed by the need to act, and the other is that the actors are not able to cooperate.

To substantiate the importance and timeliness of the problem, our goal was to firstly review the research in the field of the economic policies on inefficient markets' intervention, choosing the institutions' alternative actions on both regional and central or local level. The market failure customizes this research, due to its role in the current economic crisis and its effects. Basically, the project aimed to establish certain guidelines that could be used in the future to expand the research on the other five directions of market failure, previously unexplored by this research, which aimed to analyze the negative externalities (cross-border) as an assigning criterion based on the principle of subsidiarity, with particular reference to the "beggar thy neighbor" policies, i.e. air or water pollution and trade protection (Pelkmans, 2003, p. 5).

A similar situation can be also found in the decision-making context of the function of stability, which occurs in case of macroeconomic imbalances such as inflation, unemployment, economic downturn, trade balance deficits and balance of payments deficits etc. (Ailenei, 2002, p. 29). In turn, the public decisions on regulatory function aiming to reduce the monopolistic tendencies or, in the context of this research, the negative externalities, refer to setting limits on discretionary behavior and freedom of individuals, by imposing rules (through a functional legal system), thus underlining the stage of the decision-making process pertaining to knowing the public sector activities and the organization.

In terms of innovation, the project firstly drew attention on the cause and only after on the solution. In other words, the adverse method was used, and, as a consequence, after a thorough analysis of the negative externalities, namely pollution, it provides a better regulatory solution. The adverse method required a clear analysis of the negative externalities, so that the decision makers know what they are dealing with when they draw the public policies and implement decisions in order to reduce the phenomenon. Look first at the cause, not at the solution. The research in this field showed that the current policies emphasize the solution (fiscal policies, multilevel governance) (Blank, 2010; Pelkmans, 2003, pp. 54-55; Termeer et al., 2010; Ostrom, 1990; Dietz et al., 2003; Dinu et al., 2004, pp. 142-146 ; Molle, 2009, pp. 34-42; Miron, 2002, pp. 453-465), and not the cause (negative externalities) (Martinas et al., 2010, pp. 104 -110; Pelkmans, 2003, pp. 53-54) .

The targeted impact was on public decisions on national fiscal problems triggered by the need to solve the problem of negative externalities, namely the eco – duties (such as environmental taxes) (Matei and Dinu, 2014). The government's intervention is seen as a remedy only if it provides a net benefit, which surpasses the costs of intervention. Otherwise, the need for action becomes the need to justify the inaction.

The research finish line and future challenges

The result of the research presented a decision-making map for this particular market failure (namely, the negative externalities, or spillovers), making use of certain instruments supplied by multi-level governance approach and by the principle of subsidiarity, so that the link between the costs and benefits of an environmental policy is strengthened. This map, referring in fact to a specific methodology, ensures a correspondence between the procedural part of the decision-making (correlating the national and the European level) and the formal part, which can be easily found in the formula weighing the elements behind the social costs (Matei and Dinu, 2014).

The *challenge* was to review both the field literature and the case studies on eco-duties on both national and European level, as a result of *actions* like establishing the fiscal rules, either by giving into the bargaining power of the negative externalities' 'producer', or into the bargaining power of the negative externalities' 'consumer', thus reaching the *result* of maintaining the regulation costs to a minimum, so that the market failure does not turn into a regulation failure.

The future research shall go in depth of all the six market failures that this research established in the beginning, namely the public decisions on the intervention triggered by market failure. Therefore, the decisional map will similarly be drawn for all – (1) failure of competition, (2) public goods (3) externalities, (4) incomplete markets, (5) failure of information and (6) unemployment, inflation and imbalance – and it will provide a set of case studies that can easily be discussed during seminars as they focus on up to date situations.

The research methodology

The investigation methods and instruments were selected in order to allow a better testing of the hypotheses. In fact, all the derived hypotheses (four in total – *see* Appendix) were integrated through the *zoom in* method, from a broad image provided by the economic theory on subsidiarity connected with the multi-level governance, to a narrow image of national public decisions on negative externalities.

The first three derived hypotheses were tested by appealing to a methodology consisting in a broad bibliographical research so that the reasoning behind the project is clearly underlined. Moreover, the research uses the direct observation and field text analysis on public decisions in the tax and environmental field.

The qualitative research has been greatly improved by using the search engines provided by the Legislative Council of Romania and EUR-Lex, which allowed us to better correlate the national public decisions with those taken on a European Union level, going in depth of the adoption process, motivations and application deadlines. At the same time, the data was collected from the national statistics institutes.

The fourth hypothesis involved an interpretative work of the results and analyses of the previous stages. The used methodology also involved a qualitative research and mainly took the form of short targeted interviews. The interviewees were selected from all three fields that the public decision on negative externalities aims at: the citizens, the economic agents and the public administration.

Notes

(1) The proposed objective was to understand and to characterize the processes of growth in the regions.

(2) Should we perform a terminology analysis of the concept, some experts associate regional policy in terms of action, the notion of “spatial planning”. In some countries for example in France this term has acquired an economic content, while in other countries it corresponds to terms such as “spatial organization” in Germany; “natural planning” in England; “Territorial organization” in Spain, with an exclusively spatial term connotation. In the official international texts especially within the European Union and OECD on regional policy , the general term “regional development” is used to remove ambiguity, estimating that it “covers” broadly regional policy coordinates.

(3) Neoclassical, Keynesian, neo-Marxist, monetarist conceptions have represented the economic landmarks that contributed to understanding and streamlining the process of regional development.

(4) In the late nineteenth and early twentieth centuries, economic thinking was dominated by the neoclassical school. Although the regional economy problems have not been revised by the school, it managed to influence some researchers that have addressed regional issues, such as G.H. Borts and J.L. Stein.

(5) In the early 1960s a number of theories of uneven development such as core-periphery were highlighted, among the most important representatives of which are John Friedman, Stiard Holland and Gunar Myrdal. The basic idea of development theory as a chronological differentiation was formulated by Nobel laureate for economics, Gunar Myrdal.

(6) Neoclassical theory is based on the idea of a world where competition is perfect, the factors of production are highly mobile and profits and utility are maximized to explain why regional growth is the result of different forces. The main conclusion of the neoclassical conception is

that market mechanisms provide the most efficient allocation of resources and that any intervention distorts the system, removing it from the market optimum, which is not desirable.

(7) Within specific territories "D areas" are covered as well which are defined as strictly delineated territorial geographical areas, facing major economic, social and educational problems.

(8) V.R. Ionescu, Gabriela Marchis (2006), Community and regional development strategies; Editura Fundaţiei Academice Danubius, Galaţi, p. 45.

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Appendix

1) The economic theory of multilevel governance specific to the European Union, with its core consisting in the subsidiarity principle, puts more pressure on national distribution decisions, which also includes the integration costs, although it interferes in all state's functions and their particular decisions.
2) For the principle of subsidiarity to be applied in the European Union environmental field, the EU should be competent in the field of the environmental policy.
3) Although the integration has led to a single market, it cannot be considered to be governed by a single authority such as is the case in a federation, but it is still a fact that it has to deal with cross-border issues.
4) The negative externalities (cross-border) is an assigning criterion based on the principle of subsidiarity (the Treaty establishing the European Community (Nice consolidated version) – Part One: Principles – Article 5 – Article 3b – EC Treaty (Maastricht consolidated version)) in particular with regard to the "beggar thy neighbor" policies, namely air pollution, and this provision is, in itself, a reason for the national economies to act in the event of certain negative externalities. The public decision on negative externalities coverage, taken in accordance with the economic approach of the subsidiarity specific to the multilevel governance provides a balanced solution for all the stakeholders – the citizens, the economic agents and the government (which make a map to cover the social costs created by the negative externalities and which must be in accordance with both national and European decisions, but, at the same time, pending this map when it is in conflict with these decisions is not an answer, as it leaves the social costs not covered).