# The Rationale for Intervention

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| ***“(The) underlying rationale is usually founded either in market failure or where there are clear government distributional objectives that need to be met. Market failure refers to where the market has not and cannot of itself be expected to deliver an efficient outcome; the intervention that is contemplated will seek to redress this. Distributional objectives are self-explanatory and are based on equity considerations.***” HM Treasury Green Book[[1]](#footnote-1). |

**Why is it important?**

The rationale for intervention should be dealt with in the Strategic rather than in the Economic Case in the HM Treasury’s Five Case business model[[2]](#footnote-2). However, if there is not a clear rationale for intervention there is a risk that any impact assessment undertaken as part of the Economic Case, will identify limited net additional impacts. The reason for this is that, in the absence of a clear rationale, deadweight may be very high, that is the intervention may be assisting, for example, a company to do what it would have done even without the support. Accordingly having a sound, explicit rationale for intervention (which then shapes the nature of this intervention) underpins the creation of net additional impacts. Given this, it is useful to understand the rationale that justifies public sector intervention in the market, albeit that this is not part of an economic impact assessment.

The main rationales are:-

* **Equity or redistribution**, where public intervention is justified on the grounds that it will result in a more equitable distribution of benefits than the market would produce if left to its own devices. This might mean that support is given to particular target groups (for example the long term unemployed or unemployed young people) or to particular areas where indicators such as unemployment rates may be higher than the national average. Underpinning this rationale is a view that the operation of the market is resulting in distributional impacts that are deemed to be economically, socially or politically unacceptable. One of SE’s main interventions that is primarily justified on equity grounds, is Regional Selective Assistance (RSA) through which additional financial support is provided to companies located in defined geographical areas; and
* **Market failures,** where the market is judged not to be working effectively causing inefficiencies in the use of resources and in the resultant outcomes. In such instances public sector intervention is justified. However, if there is intervention in the absence of such failures then this could be counterproductive, resulting in market distortions and sub-optimal resource allocation.

Accordingly the identification of a clear rationale for intervention should underpin all public sector interventions. Being clear about the justification for intervention should also help to identify what is the most appropriate public sector response. For example, if there are identified barriers to achieving efficiency then any intervention should be targeted at addressing these barriers, in a way that promotes market adjustment. If successful, the barriers will be overcome and the public sector’s role will no longer be necessary. Conversely, if there is no clear rationale, or this is poorly defined, then there are likely to be high levels of impact deadweight, and the intervention may offer poor value for money.

The key question for policy makers should therefore be **“As a result of this intervention will there be economic benefits that would otherwise not come about**?” If the answer is “**No**” then it is likely that there is no justification for intervention. One consequence of this is that interventions justified on the grounds of exploiting opportunities need to be carefully examined to ensure that the private sector would not take these opportunities if left to its own devices. If the public sector intervenes in circumstances where the private sector would take these opportunities on its own then one outcome is likely to be displacement (crowding out) of the private sector and resulting economic inefficiencies.

**What types of Market Failure might be Encountered?**

The Green Book[[3]](#footnote-3) identifies four types of market failure. These are:-

* **Public goods**: this is a category of goods and services which the private sector is reluctant to supply but for which there are strong economic, political or social efficiency cases for provision. In technical terms, public goods are:-
  + **Non-rival** which applies where one person’s consumption does not prevent others receiving the same benefits. An example might be a public museum or art gallery; and
  + **Non-excludable** which applies where there is no mechanism to exclude consumers from accessing the good or service that is created as a result of public sector intervention. An example might be clean air.

If a good or service is “non-rival” and “non-excludable” then there will be little or no incentive for consumers to pay for provision, nor for the private sector to provide it. In such cases the **“free rider”** concept arises which affects consumer behaviour: Why pay for access if you cannot be excluded from consuming it?

The absence of a market in which private businesses supply goods or services to consumers who want these goods and services means that unless the public sector intervenes the likelihood is that no provision will be made. Common examples include, the protection provided by the police and military, the road network and clean air. In a public sector economic development context the public good rationale applies to interventions such as improvements to the public realm and on-line information resources;

* **Externalities** arise when an economic activity results in costs and benefits for others which are not reflected in market prices. An obvious example is a factory that is polluting the water supply. Unless the factory’s operators are required to meet the costs of treating this pollution then their activity is imposing a cost on water consumers which is not reflected in the prices charged for the factory’s final output. These **“negative externalities**” require public sector intervention to “internalise the cost” so that it is either reflected in output prices, or the factory’s operators are required to treat the pollution directly. **Positive externalities** are also possible, for example education provision can bring additional benefits to the wider economy and society, in addition to those gained by the direct beneficiaries and the provider;
* **Imperfect information**: markets can only work well if good quality, accurate and up-to-date information is available on market conditions. Producers need to be aware of such things as what customers want, where and when they want it and the prices they are willing to pay. Likewise, consumers need to know who can supply the good or service, when it will be available and what it will cost. Information failures occur where there are barriers to producers and/or consumers accessing accurate and reliable information. Two broad information failure types can be identified:-
* **Information deficiencies** where there is a lack of information of sufficient quality to enable informed decisions to be made; and
* **Information asymmetries** where either producers or consumers have access to the necessary information but the other party does not.

Imperfect information is probably the most common type of market failure that public agencies address. However, the intervention need not always be the direct provision of information. For example:-

* A company may want to attract external investment, but does not know who, how or when to approach potential lenders. Here, the appropriate response may be to signpost the company to relevant information sources and advice to overcome this deficiency rather than to set up an investment fund; and
* Potential investors may not have sufficient information about an applicant, or about its products or markets, to enable them to make rational investment decisions. Again, the appropriate response may be to assist the applicants to supply, or the investors to access, the necessary information thereby overcoming this asymmetry**;** 
  + - * **Market power**: efficient markets imply that there is no concentration of power among a single or small group of producers (monopoly) or consumers (monopsony or a buyers market in which a small number of consumers dominate the market). The abuse of monopoly power can result in market prices for goods and services being above the levels that would prevail were there more competition between suppliers, thereby generating abnormal (or supernormal) profits for the monopolist. Likewise, the abuse of monopsony power can force businesses to pay higher prices for labour or other inputs than would otherwise be the case, or drive down market prices making it difficult for businesses to operate profitably. The abuse of market power can also result in high barriers to entry which discourages new entrants.

**Market Failure versus Symptoms**

There can be a tendency to confuse the symptoms of market failure with the underlying cause which may, or may not, be a market failure. Examples include:-

* **Risk averse behaviour**: for example investors may be unwilling to invest in a company because it is felt to be too risky. This can be a perfectly rational decision, if there is sufficient information on which to come to an informed judgement. However, it could also be symptomatic of a market failure, in particular imperfect information, if investors are not being provided with the information needed to fully assess a proposition’s chances of success or failure; and
* **Cultural factors**: it is often claimed that the failure to fully exploit the commercial potential of academic research reflects a cultural barrier in terms of poor attitudes to business among academics and vice versa. In reality, it may simply be that academics (and the business community) are not fully aware of the potential benefits (and costs) of engagement with one another: again imperfect information.

Given this,it is important to go beyond a simple statement of market conditions, and of the observed problem, to try to understand what the underlying cause of the problem is. This should help to clarify if this is actually a market failure or some other issue. This can then make any resultant intervention more effective. This is illustrated in Figure 1 below which gives examples showing how symptoms can be indicative of underlying market failures.

FIGURE 1 Symptoms of Market Failures

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**Clarifying if a Market Failure Exists**

In an appraisal the identification of the market failure rationale should be undertaken in parallel with other intervention development tasks. Table 1 below sets out the “gold standard” approach, which would be expected to be used when the intervention accounts for a substantial amount of public sector investment.

In an evaluation, the validity of the market failure rationale set out in the appraisal can be tested through direct questioning of beneficiaries and other market participants about:-

* The nature of the constraints that were faced;
* The deficiencies in their capabilities and capacities to respond to these;
* How they had tried to address constraints in the absence of support; and
* How support had changed their behaviour in a way that was consistent with market adjustment.

**TABLE 1 Stages in the Clarification of the Market Failure Rationale**

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| **Stage** | **Action** | **Details** | **Outcome** |
| **Stage 1:**  **Identifying the Problem/ Opportunity** | Clearly identify and describe the problem to be addressed. | * Why is it a problem? * What is its scale? * Why is it our responsibility to intervene? | A clearly defined intervention specification. |
| **Stage 2:**  **Develop Initial Rationale for Intervention** | Based on understanding of the problem, develop an initial proposition that describes the rationale for intervention. | This should be based on an applicant’s own experience and/or general evidence from other similar projects. | An initial proposition for market testing. |
| **Stage 3:**  **Develop the Evidence Base for the existence of the intervention rationale** | Need to develop beyond a general theory – it needs an evidence based approach. | Source of evidence could include:-   * Evaluation evidence; * Market research; * Published research; * Partners input; * Similar projects; and * Own experience. | A suite of research and other evidence that can be used to assess the validity of the rationale for intervention and provide justification for it. |
| **Stage 4:**  **Review Proposition** | Review the initial proposition based on the available evidence and revise as appropriate. | * Does the evidence support the initial proposition? * How robust is the evidence? * What does the evidence tell us? * How does it support our proposition? | A confirmed rationale for intervention against which the intervention will seek to deliver. |
| **Stage 5:**  **Inform Project Design** | Need to show how understanding of the rationale has been addressed through intervention design. | * How should we intervene? * How will the intervention specifically address the underlying identified rationale? * What changes would we expect to see as a result? | An intervention specification that clearly shows how it will address the identified intervention rationale. |
| **Stage 6:**  **Monitoring and Evaluation** | Develop an M&E framework that is able to test the intervention’s rationale proposition from an evaluation perspective. | * How will we know if market correction has occurred? * What indicators/measures will be used to track progress? * What are the key questions an evaluation will be asked to confirm? * How will it show progress towards market correction? | An effective M&E framework with feedback and communication so that formative evaluation can take place. |

**Relating the Intervention to the Rationale**

The specific nature of any intervention needs to relate to the identified rationale. For example, if it is felt that there is an information failure, and that overcoming this would bring net economic benefits, then any intervention should seek to provide this information rather than undertake some other activity. As an example, if it is felt that start-up companies in a specific sector have difficulties in gaining funding, as they do not know how to present a case to investors, then the intervention should be the provision of information to enable them to make such a case. Establishing a separate investment fund would not be justified on this evidence.

Indeed if the nature of any intervention is not justified by the rationale then there is a risk that any subsequent evaluation will identify high deadweight and limited additionality.

**Does a Rationale for Intervention Imply that an Intervention is Justified?**

The presence of a sound intervention rationale is a **necessary** **but not sufficient** condition to justify public sector intervention.

Even if the rationale can be evidenced, a specific intervention can only be justified if it passes other appraisal tests for whether or not it:-

* Is aligned with wider policy and strategic objectives;
* Will help promote market adjustment; and
* Will generate benefits in a cost effective manner.

If these tests cannot be passed then it may be that an intervention is not justified.

**Need more help?**

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