### Government failures: The risks of government action

The existence of a market failure is not a sufficient condition for government intervention. The decision to intervene needs to weigh both benefits and risks, since government failures can make public intervention impractical or even counterproductive. In other words, not all market failures are fixable, at least not at a reasonable cost to society relative to the benefits.

Bravo-Biosca (2014) discussed several reasons government attempts to fix market failures (as well as system failures) in the access-to-finance space might fail to work as desired, some of which are briefly summarized here:

* No advantage and possible disadvantage for governments in fixing failure relative to the operations of the market (for example, for grant initiatives, governments will probably need to undertake costly due diligence, as would the private sector; but they may be worse than the private sector at selecting prospective projects and investees)
* Asymmetric information and misalignment of incentives (for example, public loan guarantee schemes may give banks incentive to be less careful when selecting companies to fund)
* Limited additionality and crowding out (for example, aggregate investment may increase by less than the amount of public funding provided)
* Rent seeking and capture (for example, government action may be captured by special interest groups or established incumbents, leading to inefficient interventions)
* Political factors (for example, election cycles may encourage politicians to choose short-term policies)
* Bad policy design (for example, governments may copy policies from other countries that aren’t suitable or fail to provide holistic policies that consider the full innovation cycle and ecosystem)
* Implementation failures (for example, good policies may fail as a result of inefficient bureaucracies and inexperienced staff)

Therefore, rather than assuming all market failures can or should be fixed, the focus should be on tackling those that are socially desirable to address, given the limitations of government action.

Policymakers should note that there can also be additional positive policy impacts above and beyond the impact of the financing, particularly on the recipient businesses. Some of these impacts can be observed through a process called behavioral additionality (see Box 1).

|  |
| --- |
| **Box 1. Behavioral Additionality—Does Innovation Funding Have Other Effects?** |
| Policy instruments like grants and R&D tax concessions are designed to deliver financial support to businesses. They can, however, also have a broader impact on recipients and even on unsuccessful applicants. This is called behavioral additionality, and a variety of behavioral additionality effects can be induced by government funding:   * If robust, a grant application and assessment process forces the business to articulate and justify its business plan and commercialization strategy, and the reporting process helps build its administrative and financial management capabilities. * Studies of several countries (for example,Finland and Japan) have shown that government funding not only allowed firms to accelerate the completion of R&D projects (enabling them to introduce new products or services into the market sooner), but also encouraged them to launch projects that entailed greater technological challenges than they might otherwise have pursued. * Government funding can encourage firms to engage in more collaboration in R&D projects. A German study indicated that existing partnerships were intensified and new ones initiated as a result of government funding*.* A study of the U.S. Advanced Technology Program showed that many consortia and joint projects were formed directly as a result of government funding, and that collaboration continued beyond the participation in the government-funded project—often on different projects. * A range of different methodologies can be used for measuring behavioral additionality, each with its own strengths and weaknesses. Surveys allow for the collection of information from a large set of firms, but they must often be based on the results of more in-depth interviews that identify the range of behavioral changes that can be induced by a particular government program and the point in business innovation processes at which government assistance is sought. Econometric techniques can further highlight relationships between participation in a government R&D program and changes in firm behavior. A robust approach would combine methodologies.   Source: OECD (2006). |