WEP
Warwick
Evans
Publishing

Transactions on Economics, Business and Management Research
ISSN: 2960-1789, eISSN: 2960-2254 | Volume 16
EMFT 2025

Research on the Balance Point between Government Intervention and the Free Market

Dingyuan Liu

Prince of wales Secondary School, Vancouver, BC V6L 3B1, Canada

Abstract. The changing global economic landscape has once again made the relationship between government intervention and the free market a hot topic in economic research. This paper systematically reviews the theories of the two to analyze the dialectical relationship between them, and studies the evolution process and effectiveness of the relationship between the government and the market under different economic systems by using a combination of literature analysis, case comparison, and quantitative analysis. The article first reviews the theoretical development process from classical liberalism to Keynesianism and then to neoliberalism, then dissects the dual predicaments of market failure and government failure, and also explores the reasonable boundaries of government intervention in areas such as infrastructure construction, externality governance, macroeconomic stability, and income redistribution. Finally, by comparing different models in China, the United States, and the Nordic countries, practical approaches to finding the balance point between government and market are presented. The research shows that the ideal balance point is not fixed but is a process of dynamic adjustment in accordance with the stage of economic development, technological progress, and social demand. To build a good interaction mechanism between an effective market and an active government, the intensity and means of intervention should be flexibly adjusted in accordance with specific national conditions to achieve the best combination of economic efficiency and social equity.

Keywords: Government intervention; Free market; Market failure; Government failure; Economic governance.

1. Government Intervention and the theoretical basis of the Free Market

1.1 Overview of Free Market Theory

Adam Smith's "invisible hand" is at the core of free market theory, which holds that market mechanisms can lead self-interested behavior through price signals to achieve the optimal allocation of resources. In the view of the theory, under conditions of perfect competition, the behavior of individuals pursuing their own interests is guided by the market mechanism in a direction beneficial to the overall welfare of society, while government intervention distorts market signals and reduces efficiency. Therefore, the theory of free markets emphasizes that markets have spontaneous order and self-regulating ability, and that the freedom of individual choice is valuable[1].

The free market theory was further developed by economists such as Hayek and Friedman, who believed that the market mechanism could not only effectively allocate resources, but also promote innovation and economic growth, and that the free market, as a decentralized decision-making mechanism, could utilize the knowledge scattered across all sectors of society, convey information through the price mechanism, and achieve economic coordination far beyond the capacity of central planning. Therefore, the theory emphasizes that the government should minimize restrictions on economic activities to ensure that the market mechanism can be fully exerted.

1.2 Overview of the Theory of Government Intervention

The theory of government intervention, represented by Keynesianism, holds that the market mechanism is inherently flawed and thus cannot automatically achieve full employment and economic stability. This theory advocates that the government should actively participate in economic activities and regulate aggregate demand through fiscal and monetary policies to correct market failures and ensure sustained economic development. In "The General Theory of Employment, Interest and Money", Keynes said that during a recession, insufficient private sector demand creates a vicious cycle, and at this time government intervention can reverse the downward[2] trend.

Welfare economics contributes to the theory of government intervention, such as Pigou's study of externalities and Samuel's development of the theory of public goods, which emphasizes that when there are market problems such as externalities, public goods, and information asymmetry, government intervention is not only necessary but also enhances overall economic efficiency. New Keynesianism further develops this idea. It is believed that even long-term markets may not be able to correct themselves, so moderate government intervention is irreplaceable for maintaining macroeconomic stability.

1.3 Historical Evolution of the two theories

Government intervention and free market theory have shown obvious wavering in historical evolution. Classical liberal economics in the 18th and 19th centuries was represented and dominated by Adam Smith and advocated laissez-faire policies, but classical liberal theory was challenged after industrialization in the late 19th and early 20th centuries widened the gap between the rich and the poor and monopoly problems emerged. The Great Depression of 1929 further exposed the limitations of the market's self-regulating ability and gave rise to Keynesianism, and the theory of government intervention became mainstream[3] from the 1930s to the 1970s.

The stagflation crisis in the 1970s dealt a setback to Keynesianism, while monetarism, led by Friedman, and neoliberalism, represented by Hayek, took the opportunity to re-emerge and emphasize the reduction of government intervention, deregulation, and the advancement of marketization. Although the Reagan and Thatcher administrations achieved some results in implementing neoliberal policies, But the 2008 global financial crisis once again exposed the risks of overly free markets, prompting the economics community to reevaluate the role of government. In recent years, many scholars in the post-crisis economics community have realized that these two theories are not completely opposed but complementary, and seeking the balance between "efficient markets" and "active governments" has become a new research direction.

2. An analysis of the balance point between Government intervention and Free Markets

2.1 Market Failure and the necessity of Government intervention

The situation where a completely free market is difficult to achieve the optimal allocation of resources is known as market failure. This phenomenon provides a theoretical basis for government intervention. Moreover, externality issues are widespread in the modern economy. For instance, data from the World Bank in 2023 shows that the economic losses caused by global environmental pollution have reached 3.8% of the global GDP. This is especially true in areas such as carbon emissions, air and water pollution. When there are no constraints, market players do not take social costs into account in decision-making, which leads to excessive use of resources. Government intervention through environmental taxes, emissions trading and other means can effectively internalize[4] external costs.

The government has to intervene in the provision of public goods because things like national defense, basic legal systems, and infrastructure are non-exclusive and non-competitive, so the private sector has little incentive to provide them. Take transportation infrastructure as an example, the Global Infrastructure Center has statistically analyzed There is a global infrastructure investment gap of approximately $14.3 trillion from 2020 to 2023, which is difficult to fill by market forces alone.

The problem of information asymmetry is particularly prominent in areas such as finance, healthcare, and food safety. Global spending on medical fraud and abuse was estimated to have reached as much as $420 billion in 2019, and if governments impose regulations and make information disclosure requirements, adverse selection and moral hazard can be reduced. At the same time, problems such as natural monopolies, income inequality, and cyclical fluctuations need to be moderately intervened by the government, especially in terms of macroeconomic stability. In recent years, governments have successfully dealt with various economic shocks, including the COVID-19 pandemic, using counter-cyclical regulation, which shows that government intervention is necessary[5].

2.2 Government Failure and the advantages of the Free Market

Although government intervention is necessary to address market failure, it has its own limitations, namely the problem of "government failure", because incomplete information makes it difficult for the government to accurately grasp the operation of the market, according to research by the Organization for Economic Cooperation and Development (OECD), in the countries with the strongest data collection capabilities, The data on which government decisions are based lags by an average of 6 to 18 months, while market feedback is almost real-time. Therefore, decisions made by governments based on limited information often fail to adapt to rapid changes in the market, leading to misallocation of resources.

Bureaucratic self-interest and rent-seeking are revealed by public choice theory, and the World Economic Forum's 2022 Global Competitiveness Report shows that the global government efficiency index has mostly declined over the past five years by an average of 7.3%, while rent-seeking caused by global government intervention amounts to about $2.6 trillion annually, equivalent to 3.2% of global GDP. So bureaucratic inefficiency and rent-seeking have a significant impact on the effectiveness[6] of government intervention.

Free market mechanisms have a clear advantage over this, as scattered information can be effectively aggregated and transmitted by price mechanisms to direct resources to the most effective uses, according to the McKinsey Global Institute, the average growth rate of labor productivity in highly marketized economies between 2018 and 2022 was 2.1 percentage points higher than that in government-led economies. And market competition can stimulate innovation and improve efficiency. The Global Innovation Index shows that countries with high economic freedom score 35% higher on the innovation indicator on average. Additionally, free markets rely on profit signals to direct investment in order to adapt to changes in consumer preferences more quickly. In the development of emerging industries, market-driven economies tend to be more responsive than government-led economies. For instance, in the digital economy, market-driven economies adopt new technologies on average 1-3 years faster than government-led economies. [7] [8]

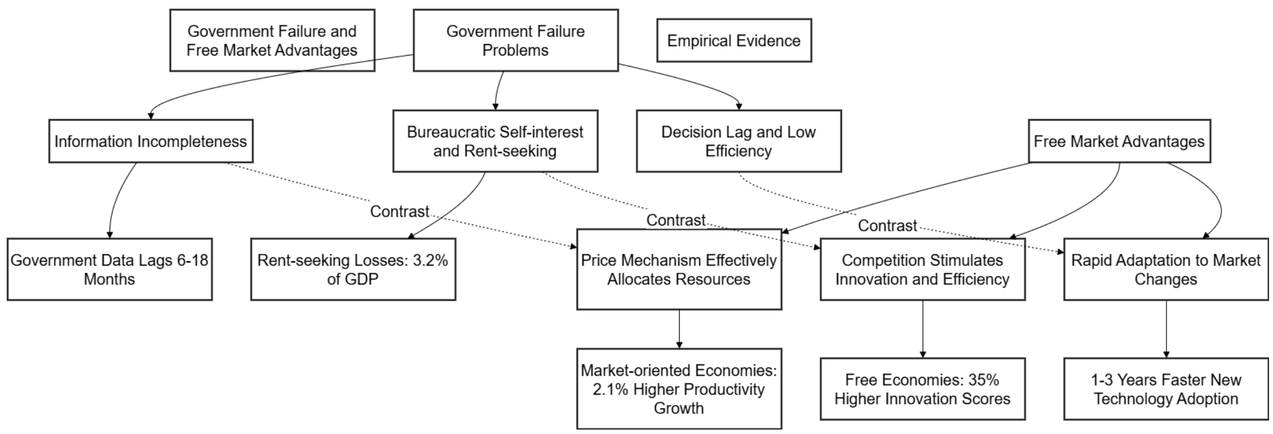

Figure 1. Government Failure and the advantage of a free market

3. Practical Case Studies on Equilibrium Points

3.1 Practical Experience of balance Points in Developed Countries

During the long-term process of economic development, developed countries have each formed their own unique balance models between government and market. Take the United States as an example. Its model is characterized by "limited government and market dominance", but the government has never been absent in key areas. Data from 2018 to 2022 shows that the proportion of government spending in the US GDP is approximately between 35% and 38%. The government plays an irreplaceable role in areas such as basic research and defense technology in the United States. For instance, the Advanced Technology Project Research Agency (DARPA) has driven the development of revolutionary technologies such as the Internet and GPS, and for every dollar invested by the government, it has driven about 8.6 dollars of private investment. And during the pandemic, the US government quickly rolled out a large-scale fiscal stimulus package, demonstrating its ability to actively intervene in times of crisis, while the market mechanism ensured the efficient allocation[9] of resources.

The coordinated development path of "strong government, strong market" is represented by the Nordic model. In countries like Sweden and Denmark, government spending accounts for 45-52% of GDP and the social security system is quite comprehensive and well-developed. At the same time, the market is very open and highly competitive The World Economic Forum's Global Competitiveness Report 2022 shows that Nordic countries are leading in both government efficiency and market competition. These countries rely on efficient and transparent government governance, flexible labor market policies, and innovative industrial policies to ensure social equity and maintain economic vitality. Denmark's "flexible and safe" employment model enables companies to employ workers flexibly and provides adequate protection and training for the unemployed, resulting in a low unemployment rate of 5.2% and high mobility in the labor market.

Germany's "social market economy" model aims to strike a balance between market efficiency and social equity, where the government uses industrial policies, dual vocational education, and labor-management consultation mechanisms to guide the market but does not directly intervene in micro-decision-making[10]. Small and medium-sized enterprises in Germany contribute 55% of the country's economic output and 63% of its jobs because of the government's financial support, technical services and international promotion. From 2019 to 2023, the German government spent over 200 billion euros on infrastructure modernization and green transformation. This creates a favorable environment for market entities and achieves a coordinated development of environmental protection and economic growth. The practice of these developed countries shows that finding the balance point is not a simple competition between government and market forces, but rather a mutual complementarity and cooperation between the two and continuous improvement of institutional quality[11].

3.2 Practical Experience of balancing Points in Developing countries

When seeking the balance point between the government and the market, the challenges and opportunities faced by developing countries are different from those of developed countries. The development model in East Asia demonstrates a unique path for "development-oriented countries". South Korea achieved rapid industrialization by selectively formulating industrial policies and implementing an export-oriented strategy. At the beginning, the government would protect and support strategic industries. As the economy has gradually loosened regulation and strengthened the role of the market, the proportion of government spending in GDP has risen from 15%-18% in the 1970s to approximately 32% now, indicating a change in the role of the government. In the last five years, South Korea has achieved remarkable results in deregulation and promoting innovation, with the number of start-ups increasing by 73%. The country's innovation capacity has risen from 12th to 5th in the world, demonstrating a good interaction between government guidance and market vitality.

Latin American countries have gone through a tortuous journey from government-led development to market liberalization and seeking a balance. Chile is a relatively successful example, achieving a balance between government intervention and market mechanisms within a stable institutional framework, relying on counter-cyclical fiscal policies and social security reforms, the Chilean government has strengthened economic resilience while maintaining market vitality. Despite being hit by the pandemic in 2020-2022, Brazil's economy recovered faster than the Latin American average and its unemployment rate was controlled at around 7.8%. Brazil has innovative policy tools such as conditional cash transfer, which effectively reduced poverty during its market-oriented reforms, benefiting more than 14 million households. Poverty was reduced by 12 percentage points and had a positive effect[12] on economic growth as well.

In recent years, India has explored a government-market synergy model driven by technological innovation through Digital India and Made India initiatives. It has built the world's largest biometric identity system (Aadhaar) covering more than 1.3 billion people, providing infrastructure support for market transactions and improving government service efficiency. The system led to a 350% increase in mobile payments transactions in India from 2019 to 2022 and a 37% reduction in government subsidy leakage rates. The practice in developing countries shows that finding a successful balance requires considering the characteristics of the development stage, institutional capacity building, and the path of gradual reform, among which the role of the government in providing the basic institutional environment and guiding structural transformation is particularly crucial.

3.3 Practical explorations of Government intervention and Market regulation in China

Over the past four decades since the reform and opening up, the Chinese government has been adjusting its relationship with the market and exploring a balanced model with Chinese characteristics. The shift from a planned economy to a socialist market economy system reflects a deeper understanding of the importance of the market mechanism. And since the 18th National Congress of the Communist Party of China, China has clearly pointed out the direction of reform that the market should play a decisive role in resource allocation and that the government should play a better role, thus further separating the government from the market.

In terms of macro-control, the Chinese government has adopted more precise and moderate intervention measures. During the pandemic from 2020 to 2022, the Chinese government implemented a fiscal policy of appropriate scale and a prudent monetary policy instead of "flooding the economy with liquidity", and supported market entities through precise measures such as tax cuts and fee reductions and relief assistance, reducing the burden on enterprises by more than 8.8 trillion yuan cumulatively. Such precise intervention, which prevented major economic shocks and maintained market vitality, has kept China's economic growth rate among the top of the world's major economies.

China's industrial development has gradually shifted from direct intervention to indirect guidance. After the implementation of the national innovation-driven development strategy, the government has established various innovation funds, improved intellectual property protection and optimized the business environment, creating a favorable environment for market entities to innovate and start businesses. In the past five years, China's R&D investment has increased by an average of more than 10 percent each year. In 2022, R&D investment accounted for 2.55% of GDP, with enterprises contributing 76.8% of R&D investment, significantly enhancing the innovation vitality of market entities.

In the field of social governance in China, a new model has been explored, which is a combination of government leadership and social participation. Take the rural revitalization strategy for example, the government relies on top-level design to guide resources, thereby mobilizing market and social forces to participate in rural construction, ultimately achieving a situation where multiple subjects of government, market and society work together. In practice, the relationship between the government and the market in China has evolved towards strengthening institutional supply, creating an environment, reducing micro-intervention and direct resource allocation, gradually forming a benign interaction mechanism between an effective market and a proactive government, providing institutional guarantees for the sustained and healthy development of the economy and society.

4. Conclusions

This paper systematically studies the relationship between government intervention and the free market and concludes as follows: The balance between the government and the market is not a fixed static point but a dynamic process that adjusts with the stage of economic development, technological changes, social demands, and changes in the external environment. In the modern economic system, a completely free market mechanism should not be blindly promoted and government intervention should not be overly relied upon. The efficient resource allocation function of the market mechanism should be complementary rather than opposed to the macro-guiding role of government regulation.

Practice shows that countries should explore government-market relationship models that fit their national conditions based on their own economic development level, institutional background and historical and cultural traditions. The limited intervention model of the United States, the welfare state model of Nordic countries and the socialist market economy model of China have all been adjusted in the process of constantly seeking the best balance. So future economic governance will have to pay more attention to institutional innovation and flexibility, and on the basis of ensuring market vitality, correct market failures through precise and effective government intervention to achieve the unity of economic efficiency and social equity and lay a solid foundation for sustainable development. This also requires us to break away from the traditional binary oppositional thinking and build a new economic governance paradigm of coordinated development of government and market.

References

[1] Shuyi Wang, Xinyan Zhang, George Q. Huang. A game-theoretic approach to green tourism development strategies: Government interventions and sustainable practices across diverse markets[J]. Tourism Management,2026,113

[2] Zhong qiang Zhou, Yu wei Zhang. Government Intervention and Capital Market Welfare: A Comprehensive Analysis of "National Team" Shareholding[J]. Journal of Risk Analysis and Crisis Response,2025,15(3):

[3] Leehyun Jung, Youngsig Jun, Minhyuk Jeong, Yena Song, Kwangwon Ahn. The impact of government intervention on housing market network: Evidence from the Seoul metropolitan area[J]. Chaos, Solitons and Fractals: the interdisciplinary journal of Nonlinear Science, and Nonequilibrium and Complex Phenomena,2025,200(P3):

[4] Paula Ortega Perals, Fabrizio Maturo, Salvador Cruz Rambaud, Javier Sanchez Garcia. The moderating role of government intervention in the relationship between investment in artificial intelligence and the development of financial markets[J]. International Review of Economics and Finance,2025,103

[5] Fudong Wang, Zhibin Liang, Yiying Zhang. Stackelberg equilibrium strategies between insurance demand and government interventions[J]. Journal of Economic Dynamics and Control,2025,179

[6] Jun Gou, Changjian Hu, Wengang Xie, Yanlin Si, Yanling Li. Social capital, government intervention, and regional economic resilience[J]. Finance Research Letters,2025,86(PA):

[7] Julia Aicher. The Hand behind the Invisible Hand: Dogmatic and Pragmatic Views on Free Markets and the State of Economic Theory[J]. ORDO,2025,74(1):

[8] Tibor Rutar. Free-market institutions and income inequality: Did the link persist around the world even in times of falling within-country inequality, 2000–2021? [J]. International Journal of Comparative Sociology,2025,66(4):

[9] Enea Baselgia, Isabel Z. Martinez. Wealth-Income Ratios in Free Market Capitalism: Switzerland, 1900-2020 [J]. Review of Economics and Statistics, 25,107(4):

[10] Weshah Razzak. Free Market and Perfect Competition: Global Data Trends[M]. Taylor & amp; Francis:2025-07-02.

[11] Yang Jianxun; Rebalancing between Government Intervention and Market Regulation: Economic Law Reflections and Implications for Financial Crisis Liability Fees [J]. Modern Jurisprudence,2010(06):74-81.

[12] Wu Di Zheng; Two Patterns: Government Intervention and Laissez-Faire - A Brief Analysis of the Different Characteristics of Free Market Economies in Singapore and Hong Kong [J]. Guangxi Social Sciences,1993(02):14+21-24.