Markets bring prosperity (usually)

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Global Challenges: Prosperity
LUC ~ 9 Feb 2015
What are these guys doing?

https://www.youtube.com/watch?v=6GTDrYlvLuQ
Overview

- The miracle of markets
- Markets, non-markets and missing markets
- Market failure
- Government failure
**Why trade?**

*The propensity to truck, barter and exchange one thing for another is common to all men, and to be found in no other race of animals.*\(^1\) —Adam Smith (1776)

**Note 1:** A trade (or exchange) leaves each side better off.

**Example 1:** I have pizza; you have beer. We trade so we each have some beer and pizza.

All trade comes with *opportunity costs* (time, money, goods), i.e., “pizza costs beer.”

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\(^1\)“No other” is untrue, but irrelevant. Animals trade for similar reasons.
What if you don’t have beer?

Note 2: Trade uses money because it is easier than using pizza.

Example 2: I can make one pizza in one hour (but not beer). You have more money than time. You pay me €20 for a pizza. Now I can buy a case of beer from the brewer.
What if you’re “not good at anything”?

**Note 3:** What you trade depends on *comparative advantage*, i.e., the ability to produce something at a *relatively* lower opportunity cost.

**Example 3:** You can make two pizzas or earn €60 in one hour.

So you can make one pizza and earn €30

*or*

You can earn €60 and pay me €20 to make you a pizza.

I get €20 to buy stuff; you “save” €10.
Comparative advantage increases with diversity. . .

**Note 4:** The greater the range of skills (resources, etc.), the greater the benefits from trade.

**Example 4:** Look at the people, the shops, the goods, the services around us.

Now let’s look at markets from an academic perspective. . .
Supply of goods, services, labor, etc.?

The “supply curve” describes a relationship between quantity and price (holding many things constant).

Higher prices *increase* quantity supplied, e.g., you are willing to work more hours as the wage rises.
Demand for goods, services, labor, etc.

The “demand curve” *also* describes a relationship between quantity and price (holding many things constant).

Higher prices (wages) *decrease* quantity demanded, e.g., your employer wants fewer hours from you.
Supply meets demand

Supply and demand balance at the “market equilibrium,” i.e., where quantity supplied = quantity demanded.
Consumer and producer surplus (static)

Win-win until 19 units, then lose-lose (so no activity).
A outward shift in supply of labor occurs

Some of you decide to work, *but* competition lowers wages, “harming” others.
Transaction costs

The costs of finding, making and completing a transaction depend on “institutions” (formal rules and informal norms).

Some TCs are useful (e.g., the cost of writing a labor contract that protects both sides), but others are not (e.g., the cost of paying a bribe to get someone to do their job).

High TCs can block useful deals or create “missing markets” (more in a bit).
Consumer and producer surplus (dynamic)

**Profit-shares:** Depend on market power (more after the break)

**Profits:** Attract innovators and competitors

**Competition:** Pushes prices down (if supply) or up (if demand)

**Surplus:** Increases with competition for *society*, but some incumbents will lose (e.g., unproductive businesses, poorer renters, etc.)

**Bottom Line:** *Competition* expands and levels the playing field, but it also forces “less efficient” participants to consume less (or elsewhere) or produce more (or elsewhere).

Those outcomes are NOT market failures. They are the small cost for a big gain in market efficiency.
Market action (Flores)
Where is this?
Dutch flower auction in Aalsmeer
Oman
Sarawak, Borneo
Markets not-much action
Transaction costs
Information costs
Non-markets are handled either by individuals or through political processes, e.g., family dynamics or public parks, respectively. Missing markets can be turned into markets (and vice-versa) via politics, e.g., EU Emissions Trading System or carbon taxes.
After the break, we’ll address market and government failures.
Markets versus bureaucracy

Birthdays (1 Jan to 31 Dec)

Go.

NB: Your multi-dimensional, interdependently optimized seating patterns are much more difficult for me to manage.

Why?

Diffused information
Taming complex human behavior

In “The Use of Knowledge in Society,” Hayek says:

- Nobody can possess all relevant information we share
- (Nobody could process it into “behavior” if they did)
- Prices convey information that coordinates our behavior
- The miracle of the supply chain (“woolen coat”)

Hayek is mostly right. Caveats and adjustments:

- Some things cannot be priced (e.g., parental love)
- Many things are mispriced (oil, organs, monopoly, risk)
- Some prices are not “worth” action (high TCs or low benefits)

Many “market failures” can be traced to these problems.
Back to market failure

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<th>Type</th>
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<td>Bounded rationality</td>
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Failure: Monopoly/monopsony

One player facing many can dictate terms, e.g.,

Greater monopoly power translates into greater “reents”
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Market power (?)
Monopoly/monopsony elaboration...

- Labor unions and farmer co-ops arose to “counter” company power
- Competition undermines “market” monopolies, e.g., Apple v. Samsung
- “Legal” monopolies need not innovate, e.g., USPS
- Corrupt politicians mix up these types when it suits them, e.g., “Mickey Mouse Copyright Act”
Failure: Collective goods/Externalities

- Private gains can destroy collective goods (e.g., LUC’s smoking area)
- Garret Hardin’s 1968 paper, “The Tragedy of the Commons,” examined the problem of population increase
- Parents love their children, but environmental costs fall on everyone

Other examples: climate change (fossil fuels), health (vaccines), oceans (fisheries), defence (NATO), etc.
Collective goods/externalities (Sarawak hardwood)
Externalities (Saudi petrol)
Externalities
Collective goods elaboration...

On population, for example:

- Benefits are domestic (soldiers, voters, workers)
- Costs are international
- Government subsidies for children
- One Child policy doesn’t work so well (violence)
- “Cap and trade” on total, subsidy for born?

Potential solutions rely on privatization (property rights) or rules/regulations (club goods), but high transaction costs (and opposition) can block solutions, e.g., global cap and trade for children...or carbon!
The big one

Climate change is the greatest market failure the world has ever seen, and it interacts with other market imperfections. Three elements of policy are required for an effective global response. The first is the pricing of carbon, implemented through tax, trading or regulation. The second is policy to support innovation and the deployment of low-carbon technologies. And the third is action to remove barriers to energy efficiency, and to inform, educate and persuade individuals about what they can do to respond to climate change.

Potential losers (e.g., fossil fuel companies) have worked to block 1–3. Politicians and “energy consumers” have helped them.
Failure: Bounded rationality

People make “bad” decisions (sometimes due to manipulation, i.e., advertising)

▶ Failing to buy insurance
▶ Not going to school
▶ Choosing wrong investments

Should they be protected from themselves or *caveat emptor*?
Bounded rationality
Bounded rationality

The photo doesn't show 56% apples!
Bounded rationality elaboration...

- More information, “nudges,” education may not work
- Regulations may do a better job
- Lobbyists often push for their regulations

Examples: People do not buy “enough” solar or housing, so gov’t gives subsidies. US pharmaceutical companies sell drugs on TV. Pharmacists and “religions”, respectively, block access to aspirin and birth control.
Government failure

- Lots of theories of what government should do
- Governments need not provide “market” goods
- Governments can “correct” markets, but
  - Sometimes it is not useful (e.g., underprovision of flowers)
  - Sometimes it is ideological (e.g., more home ownership)
  - Sometimes it is corrupt (e.g., protect farmers)
  - Sometimes it is just right (e.g., CO$_2$ tax in BC)
- Winners and losers try to influence government
- Politicians and bureaucrats knew this...

**Question:** Who is more corrupt? The politician who takes the bribe or the businessman who gives it?

The answer depends on who has more “market power”...
Regulatory capture

CORPORATIONS OWN THE GOVERNMENT!

THEY NEED TO BE REGULATED.

BY WHOM?

THE GOVERNMENT!
Regulatory capture is based on “public choice”
Governments have their role, but... 

Markets: Increase efficiency for consumers and producers, workers and employers, but they can fail

Governments: Can increase market efficiency, but they can fail

Political-Economy: Addresses this challenge

For example...
Markets bring prosperity (usually)

Voluntary markets help everyone (what did Smith say about the worker and the African King?), but

- Some markets (e.g., child labor) are not obviously voluntary
- Distribution of surplus (“reward for success”) seems to increase inequality (e.g., $2 divided between each Windows consumer and Bill Gates)
- Market power has a bigger impact

**Bottom Line:** Markets are good at efficiency (making “the pie” bigger). Government can influence the distribution of the surplus (“dividing the pie”) for better...

or worse...
Next week: Inequality

GDP Density

GDP per square kilometer
- $0 - 499
- $500 - 1,099
- $1,100 - 2,999
- $3,000 - 8,099
- $8,100 - 21,199
- $22,000 - 59,999
- $60,000 - 162,999
- $163,000 - 441,999
- $442,000 - 546,000,000
- No Data