Markets bring prosperity (usually)

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Global Challenges: Prosperity
LUC ~ 20 Feb 2017
What are these guys doing?

https://www.youtube.com/watch?v=6GTDry1vLuQ
Let’s do an auction! For real money!

When I found this painting it was worth “nothing.” Now it’s been allocated to someone who values it at a transparent price. Markets improve allocations by concentrating buyers and sellers. (Auctions are particularly good for allocating “unique” goods.)
This is the first of three plenaries on “solutions”

Each has its right (and wrong) place.
Core questions for this week

- How do markets contribute to prosperity?
- How do markets have different impacts on different groups?
- How and why do markets fail?
- How can governments “correct” markets?
- How and why might government corrections fail?
The Rule: Manage a good according to its properties

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<thead>
<tr>
<th>Excludable</th>
<th>Non-excludable</th>
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<tr>
<td>Rival</td>
<td>Non-rival</td>
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<td><strong>Private Good</strong></td>
<td><strong>Club Good</strong></td>
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<td><strong>Common-pool Good</strong></td>
<td><strong>Public Good</strong></td>
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1 Some excludable goods are (usually) non-market goods, e.g., love and time.
Why trade?

*The propensity to truck, barter and exchange one thing for another is common to all men...* —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.”
Why trade with money?

**Note 2:** Money, as a “medium of exchange” replaces barter that may not work well, e.g., you have no beer but do have money.

**Example 2:** I can make one pizza in one hour, but I can’t make 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. The most “exotic” stuff comes from farther away because it’s worth shipping.
Competition creates winners and (sort of) losers

Note 5: “Zero-sum” competition drives markets to be more efficient but some people are upset when markets deliver the “mundane morality” of commutative (anonymous) justice instead of the “amiable morality” of favoring a familiar group.

Example 5: Your purchase favors one merchant over another (fair) just as an employer may hire someone other than you (unfair!). Most trade has visible losers and invisible winners. Politicians often pay more attention to losers because they are visible and take a collective action against trade.

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.

Important! Cost vs price vs value!
Consumer and producer surplus (static)

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

Competition lowers wages ("harming" others), but it rewards those who can do the job efficiently.

You are here :-(

\( S \text{ labor} \)
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).
Surplus attracts competition that improves efficiency

**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.)

**Creative destruction:** *Competition* expands and levels the playing field (increasing productive and consumptive efficiency), but it also forces “less efficient” participants to work harder (or elsewhere).

Those outcomes are NOT market failures, but a small cost for a big gain. If special interests use them to block the market, then they can be compensated, e.g., Denmark’s labor laws.
Market action (Flores)
Where is this?

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The flower auction (*bloemenveiling*) in Aalsmeer
Oman
Kingsday/Koningsdag
Transaction costs
Information costs
Let’s do an information experiment

Arrange yourselves by birthday, from 1 Jan (at my left) to 31 Dec (at my right)

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

Hayek explains how prices (“birthdays”) help us organize ourselves.
After the break, we’ll address market and government failures.

http://e.ggtimer.com
Three questions

Smith, Ricardo, Marshall and Roberts. . .

Questions:

1. How does the division of labor help workers? Consumers?
2. Is the price of fish based on value or cost?
3. Given an example of who wins and who loses when you buy a product (like cheese, shoes or a haircut)
What are your answers?

1. Divided labor raises productivity (& wages) and lowers prices
2. Fish is priced by value in the short run; cost in the long.
3. The seller wins, but their competitor does not.
Taming complex human behavior

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

- Nobody can possess all relevant information
- Centralized control, therefore, will fail
- Individuals are best placed to make choices
- Prices help us make better choices

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.
For example

*The Economist* (19 Jan 2017):

Gendercide happens where families are small and the desire for sons is overwhelming... by one careful estimate, at least 130m girls and women are missing worldwide. It is as if the entire female population of Britain, France, Germany and Spain had been wiped out.

... a huge number of men [in China and India] will struggle to find partners... the consequences are bad for societies as a whole, because young, single, sex-starved men are dangerous (more crime, rape and political violence)... Parts of Asia could come to resemble Americas Wild West.
## Types of market failure

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<tr>
<th>Type</th>
<th>Impact</th>
<th>“Solution”</th>
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<tr>
<td>Monopoly/-sony</td>
<td>capture surplus</td>
<td>competition/regulate</td>
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<tr>
<td>Externalities</td>
<td>damage</td>
<td>tax/regulate/rights</td>
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<tr>
<td>Bounded rationality</td>
<td>wrong decisions</td>
<td>inform/regulate</td>
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These solutions often require outside (government or community) intervention, which can “create” a missing market or reduce negative externalities. Interventions can also make matters worse (“government failure”).
Aside on “Neoliberalism” and the Washington Consensus

There’s no such thing as a “society governed by the market” because markets need government (monopoly on force) to make and protect property rights, etc.

1. Fiscal policy discipline
2. Simplify and broaden the tax base (property taxes!)
3. Replace subsidies (e.g., gasoline) with pro-growth, pro-poor services (education, health care and infrastructure)
4. Use market interest rates and exchange rates
5. Liberalize imports, set uniform tariffs and allow FDI
6. Privatize state enterprises (excludable goods!)
7. Deregulate to encourage competition but regulate safety, environment, consumer protection and financial institutions
8. Secure property rights (most important for the poor!)
Failure: Monopsony (market power for buyer)

One employer facing many unemployed LUC grads can dictate terms (e.g., free interns) and get “rents.”
Market power for seller

FLIGHT DELAYED... 😞 😞 😞

CANCELLED...... 😞 😞 😞 😞 😞

Need IMMEDIATE CONNECTION with your own private flight........

BALI (USD2,370) payload 233Kg.*
LOMBOK (USD1,860) payload 248Kg.*
*3 Passengers if within payload.

DON'T PANIC JUST CALL
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+62 813 3951 4075
Market power (?)

A guest post w/ 110,000 views and 115 comments (20x record)
Addressing monopoly/monopsony

- Unions and co-ops balance company market power
- Competition breaks “innovation” monopolies, e.g., mobiles
- “Legal” monopolies need not innovate, e.g., postal service
- Politicians give monopolies for $ (“Mickey Mouse Copyright”)
Failure: Collective goods/Externalities

- Private goods can damage collective goods (smoking)
- Tragedy of the Commons via overpopulation (Hardin, 1968)
- Parents love their children, but everyone bears environmental costs of moving from 3.5 to 7.48 billion, w India passing China in 2021!

Other examples: climate change (fossil fuels), health (vaccines), oceans (fisheries), defence (NATO), etc.
Externalities in a picture

NB: Costs “spill over” from excludable to non-excludable goods
Collective goods/externalities (Sarawak hardwood)
Externalities (Saudi petrol)
Addressing externalities

On population, for example:

- Benefits are domestic (soldiers, voters, workers)
- Costs are local and international
- End subsidies for children? No. Negative health, education impacts
- China’s one child policy? No. It was unnecessary
- “Cap and trade” on total, subsidy for born? Good luck.

Population helps explain the difficulty in addressing GHGs
The big one

Climate change is the greatest market failure the world has ever seen... an effective global response [requires] pricing of carbon, implemented through tax, trading or regulation; innovation and the deployment of low-carbon technologies; and removing barriers to energy efficiency and persuading individuals to respond to climate change. — Stern Review on the Economics of Climate Change (2006)

Potential losers (e.g., fossil fuel companies) try to block these actions. Trump may be the last, as renewables are increasingly competitive.

In 2015, the IMF estimated that energy subsidies cost $5.3 trillion per year (6.5% global GDP) in lost taxes, environmental damages, etc.
People make “bad” decisions due to manipulation or inattention.

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

Should they be protected from themselves or *caveat emptor*?
Bounded rationality/Caveat emptor
The photo doesn't show 56% apples!
Thé Royal
Racine Pour Grossir
Egue Contre la Chute des Cheveux
Pour Sourir
Viagra pour Grimper au Rideau
Viagra Express pour Femme
Thé à la Menthe
Verveine Citronnelle
AH bio champignons
250 GR
7.16 per KG

1.79

nah kleine champignons
175 GR
10.23 PER KG

1.79
Addressing bounded rationality

- More information, “nudges,” education may not work
- Ban advertising?
- Regulations can help, but lobbyists push for their regulations
Government failure

- Governments should not provide “market” goods, and governments can “correct” markets, but
  - Sometimes it is not useful (e.g., subsidies for “beautification”)
  - 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, and politicians and bureaucrats knew this...

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

Start with the question: Who has more “market power”? 
Government failure: Regulatory capture

Public choice/Baptists and Bootleggers
Overregulated markets

Regulations can protect incumbent firms from competition, e.g., “local content” or maximum floor space.

Regulations can protect workers from competition, e.g., occupational licensing, minimum wages, long term contracts, etc.

Fewer firms and fewer jobs means less prosperity and less employment.

Unemployed people feel worse (“useless”), which can lead to depression and/or violence (complicated).
Government failure: Helping workers

The national minimum wage is $260/mo. 70+% of workers are in informal economy.

The Dutch 2015 the Work and Security Act (Wet werk en zekerheid) has helped some workers get permanent contracts but prevented others from keeping their jobs.
Government failure: Invalidating “black market” money

What will people eat? ATM cards?
Government failure: Distributing food
Summary

**Markets** can turn chaos into efficiency, but “they” can fail

**Politicians** can increase market efficiency, but also fail

**Communities** can better balance (non) market costs

**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. This is Dubai.
Next week: The state

Friend?

A wise and frugal Government, which shall restrain men from injuring one another, shall leave them otherwise free to regulate their own pursuits of industry and improvement, and shall not take from the mouth of labor the bread it has earned. This is the sum of good government —Thomas Jefferson (1801)

Or foe?