Exclusive

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I. INTRODUCTION

In our presentation, there are four main subjects that we will be explaining today. Those subjects are:
1. Private goods and the Free Market System.
2.The Price Mechanism and the Invisible Hand
3. Public goods and the market failure
4. Public hand and the government failure.

Before we go into the details, let me briefly give you the overview. First we have to approach these questions by asking ourselves… What do we mean by Exclusive?
Of course, the word exclusive can be heard on a regular basis. For example, an exclusive interview with Professor Kim.
Then what does the word exclusive mean? According to the dictionary, the word "exclusive" is defined as "not divided or shared with others"
So how is this relevant to what we are studying? How is it connected to the rights? You might ask…
There were discussions as to what "exclusiveness" meant. In my perspective, there are spiritual and material interests that are protected by the laws. Since, these interests are protected, as the characteristic of the rights, the interest become exclusive when it becomes a right.

In having an exclusive right would mean that a person could enjoy the right at his or her wish. Therefore, we felt that there was a close link to the free market system and the right.
Well, let's go back to the last week's lecture. If you can remember, Sun-young gave us a splendid presentation on the bourgeoisie last week. Then the professor explained to us that the reason that we did not have a revolution of the middle class in Korea was because there was not a combined force of wealth and integrity. And if you could remember, he also told us that in a situation where a relationship of wealth and integrity is cordial, it meant a formation of a democratic society. Whereas a situation where the relationship of wealth and integrity is dominated by the integrity, it meant a communistic society.
Now as Hyun will explain in a minute that a political form of government may or may not have to do with the economic form of the government. However, historically speaking, the countries that formed a democratic society tended to go along with the free market system of economy whereas the countries that formed a communist society

tended to go along with the controlled market system. Also, I would like to point out… or rather question the professor whether the chart that he explained this… showed the relevance of what I have just said.
It seems to me that a situation where the integrity has the power over the wealth has to do with the control… over the wealth and therefore, making this a controlled market system. For the free market system, the relationship between the integrity and the wealth is cordial… and therefore, there is a room for the free market system.
In other words, the word "exclusive" used in Weber's definition deals with the balance between free market system and the controlled market system
Okay. By now, you should be asking another question. "Then why are we approaching this question from an economic standpoint?" Well, I can answer that question. The reason is because from the professor's chart, we are dealing with only wealth for this case. The integrity is something that is not only intangible but also is unlimited. However, wealth… there are only limited resources, and therefore an absolute exclusive right regarding wealth is probably impossible to begin with… Approaching from the historical perspective, this is also true in the sense that there is a shift from Adam Smith's Lasseiz Faire economic principle where there was absolute freedom in economy, to the economic principle where there is a government intervention.
Now, I will turn this over to Hyun for his part of this presentation on Free Market System.

II. FREE MARKET SYSTEM

1) Democracy and Free Market System

The relationship between democracy and Free-market system is one of the most important political questions. Historically, we saw many collapses of democracy caused by crisis of economical situation. However, still there is no exact concept about the relationship. Just there are many theories.

-Direct interrelation
-Democracy will be bad or good influence on economic system (one-sided influence)
-Political or econo-sociological view

2) Principles of Free Market System - Private Interest and Functions of Market

①Basic Principles : Private Ownership in Property, Private planning for a profit, Guarantee about freedom to economic determinism

→ Free Market System(the Denial to interference of Government)

② Free Competition : the principle of scarcity,

→ realization of free competition through private planning for a profit abundances in whole society

③ the Functions of Market : Decision about the kinds and amounts of goods needed in society, motivating efficient production

→ Efficient distribution in resource, abundant life, Increasing social power for supply

III. THE PRICE MECHANISM - THE INVISIBLE HAND

THE INVISIBLE HAND

"The invisible hand' was a metaphor used by Adam Smith to describe the principle by which a beneficent social order emerged as the unintended consequences of individual actions. It was the notion of the invisible hand that enabled Smith to develop the first comprehensive theory of the economy as an interrelated social system.

In general, the concept is composed of three logical steps. The first is the observation that human action often leads to consequences that were unintended and unforeseen by the actors. The second step is the argument that the sum of these unintended consequences over a large number of individuals or over a long period of time may, given the right circumstances, result in an order that is understandable to the human mind and appears as if it were the product of some intelligent planner. The third and final step is the judgement that the overall order is beneficial to the participants in the order in ways that they did not intend but nevertheless find desirable.

In Smith's economic theory described in the *Wealth of Nations*, money, prices and profit and loss provide the signals that lead to corrections in resource misallocation and to economic growth, while the economic institutions of markets, money and division of labor all emerged in an evolutionary process. The notion of spontaneous order in the sense of a self-ordering system continued to provide the foundation of economic science and especially general equilibrium theory throughout the 19th century and up to the present. The invisible hand still makes the system run, but the optimality of the result is not always generally guaranteed.

PRICE MECHANISM

The price mechanism is a system of determination of prices and resource allocation. It operates in a free market situation where forces of demand and supply dictate prices. It is the process by which changes in prices guide and shape changes in the value and types of the goods and services that are produced. The price mechanism will determine: “WHAT IS PRODUCED, HOW MUCH IS PRODUCED AND FOR WHOM A GOOD OR SERVICE IS PRODUCED FOR.”

The Law of Supply and Demand

The prime movers in our model market are the forces of supply and demand. They determine the price of the good and the quantity exchanged in any given market. The shoe market is an example of a competitive market where a number of firms compete to meet the demand for certain products or services. Two kinds of participants operate in it: those who have money and want shoes (demanders) and those with shoes who want money (suppliers).

For the demanders of shoes there is an inverse relationship between the price of shoes and the quantity demanded. Such a relationship is described by curve *DD* in Figure 1-1. This curve is a market demand curve and, as such, it incorporates the individual demands of all the households. Its negative slope reflects the Law of Downward Sloping Demand.

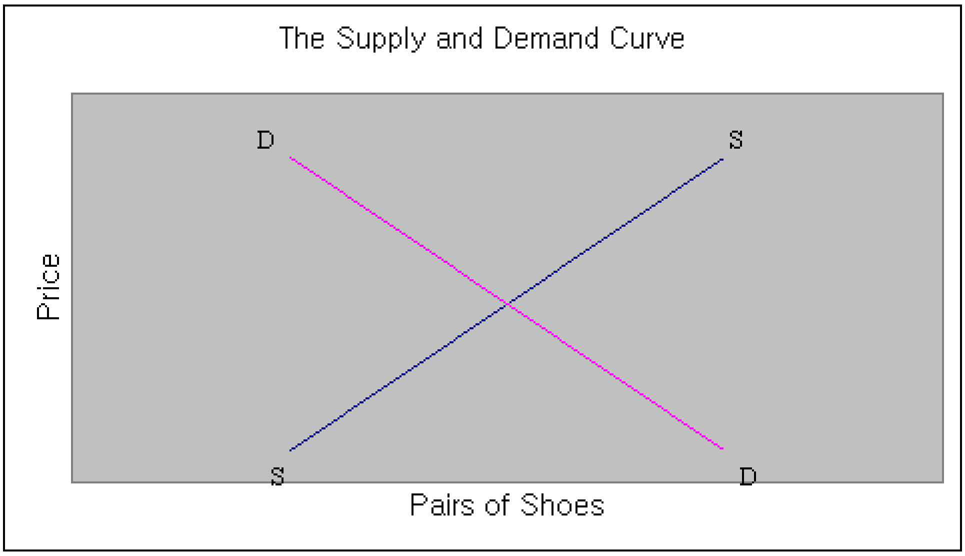

Figure 1-1

For suppliers of shoes the relationship is somewhat different. Because of the Law of Diminishing Marginal Returns, a higher price induces a greater output than does a lower price. Consequently, a direct relationship exists between the price of shoes and the quantity that potential sellers are willing to supply to the market. *(Refer to Figure 1-1)*

In representing the forces of supply and demand as a supply curve *(SS)* and a demand curve *(DD*), the quantities demanded and supplied are pictured as being dependent only on the price of the commodity. However, many other factors are hidden in such a simplification. The *ceteris paribus* assumption applies in drawing the demand curve[1] and the supply curve.[2] If any one of these variables should change, the demand curve and the supply curve for shoes would be altered. The demand and supply curves are tools necessary for us to discover how prices and quantities in any given market are determined.

Competitive Bidding and Equilibrium

Both producers and consumers base their respective production and consumption plans on the prevailing market price. When consumers pay a price for a commodity, they motivate the producer of that commodity and hence more of the same is produced and vice versa. The price paid becomes a vote for more production. Thus resources are channeled there.

Suppose consumers decide that they want to spend more on shoes. More consumers show up at stores hoping to buy shoes. The stores see the higher demand, raise their prices, and also order more shoes from producers. Higher profits from making shoes induce firms to expand production. Higher prices for shoes curb demand. Thus the system returns to a stable point with more production and purchase of shoes, and less production and purchase of other goods. Thus “prices” act as a “mechanism” that guides the allocation of productive resources--machines and workers--to different sectors of the economy.

The plans of the buyers and the plans of the sellers are balanced at a point, at which a transaction can take place, by the operation of the price mechanism (market mechanism or Invisible Hand). This balancing of forces, this perpetual tendency toward equilibrium, is the *Law of Supply and Demand.*

The concept of the equilibrium is of the utmost importance in economic theory. Equilibrium is a state of rest, when there is no reason for anything to change unless disturbed by an outside shock. At the equilibrium price quantity supplied equals the quantity demanded. $Q_S = Q_D$ is the equilibrium condition.

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[1] The tastes and preferences of the household sector, its income level, the prices of other goods, and the number of demanders are all held constant in deriving the demand curve.
[2] The prices of the inputs, the input-output relationship, and the number of sellers are all assured to be constant in drawing a single supply curve.

The Supply and Demand Curve

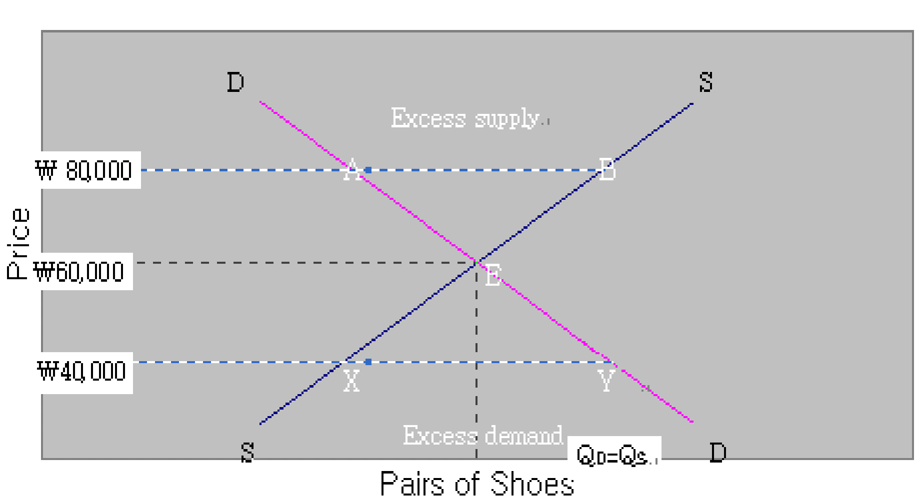

Figure 1-2

If intended supply > intended demand, price will fall

If intended supply < intended demand, price will rise

If intended supply = intended demand (equilibrium)

Therefore, suppliers will have to raise or lower their prices when the intended supply does not equal the intended demand.[3] That is, they will have to engage in competitive bidding. This is a process in which either demanders or suppliers will adjust to an undesirable situation by raising or lowering the prices at which they offer to buy or sell. Therefore, ultimately returning to a state of equilibrium.

The Functions of the Price Mechanism

The price mechanism determines what is produced, how much to produce and for whom to produce it for. If the price mechanism is to work it must simultaneously fulfill several functions

The Signaling Function and Incentive Function

Prices must convey sufficient information to all traders in the market for their economic activities and plans to be coordinated. The signaling function of the price

[3] Intended supply and intended demand must not be confused with realized supply and realized demand. Realized demand is the actual amount demanded and realized supply is the actual amount sold. It follows that realized demand would always be equal to realized supply.

mechanism can be illustrated by looking at the market for trainers. Assume that some advertising campaign has recently made such goods popular thus shifting the demand curve to the right.

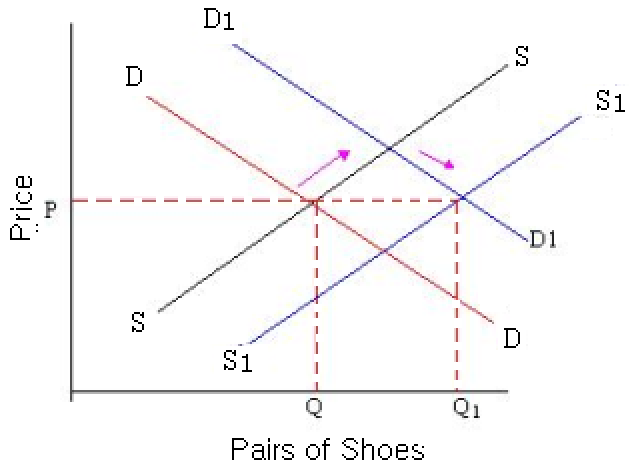

Figure 1-3

The initial shift to the right would act as a signal for other firms in other markets. In response to an incentive signaled by the high price, firms would shift their resources into the production of training shoes.

The Rationing Function

When consumers and firms respond to the information and incentives provided by prices, scarce resources are rationed between competing uses. Prices function as a mechanism for allocation. For example, say the price for a pair of shoes is ₩ 40,000 and say this is well below the market clearing price. In a free market situation prices will rise to eliminate this disequilibrium. This illustrates the rationing function.

The Allocative Function

The price mechanism will also ensure that goods will be allocated efficiently. If prices are set above equilibrium, suppliers will find themselves with a surplus of stock. Prices will fall to clear the market and allocate resources efficiently.

In the Market Economy

The price mechanism lies at the heart of the market economy. It is the central instrument through which firms decide what to produce, how to produce it and whom to produce it for.

The price mechanism determines what is produced as people spend their incomes on goods they want. Therefore, the price of goods reflects demand for their profitability. These prices act as signals to the producers and through the price mechanism they decide what to produce.

Once a firm has decided what to produce it must decide how to produce it. In the market economy, it is assumed that firms will wish to maximize profit, which means minimizing costs in respect to their competitors. Those firms which fail to do so will eventually be driven out of business and so to ensure survival and maximum profit, the firm has to combine inputs in the least cost combination and try to and undercut the price of its rivals. The price mechanism plays an important role. The prices of the different factors of production act as signals to the producer who will employ the factors, which are cheapest in respect to their marginal revenue product. Therefore, the price mechanism leads to an efficient allocation of resources in their least cost combination to the entrepreneur.

Price mechanism also has several other effects. Both economic and technical efficiency are achieved which means that not only is there a minimum wastage of resources but also resources are used to their most valuable use.

The price mechanism serves as an invisible hand, which guides entrepreneurs in search of profit and efficiency. It is also very flexible and allows the market economy to change readily with changing economic circumstances. It makes the consumer sovereign, as it is ultimately the consumer who decides what is produced.

There were discussions as to what "exclusiveness" meant. In my perspective, there are spiritual and material interests that are protected by the laws. Since, these interests are protected, as the characteristic of the rights, the interest become exclusive when it becomes a right.

IV. MARKET FAILURE AND PUBLIC GOODS

Free market system has the function which is called "invisible hand" which brings about economic efficiency. Invisible hand, however, does not work for some reasons. When it does not work, free market system cannot make economic efficiency. This situation is called "market failure." There are some reasons which cause market failure.

1. Externalities

Externality is defined as the side effect on an individual or entity due to the actions of another individual or entity. When you take actions regarding economy: production, selling and buying, your action has effects to the others who do not relate to your activity directly. It is externality. If you can look at this phenomenon, externality, you will find that externality is divided into two: benefit and expense.
For example, you can find beneficial externality when you look at the case of traffic or public project such as construction of roads or dams. It benefits not only people who use it but people live in its community.
And if you look at the case of pollution, you can realize that this is the other side of externality. When this happens, market system does not bring about economic efficiency.

2. Monopoly

Few modern markets meet the good conditions required for a perfectly competitive market. It allows a strong company to monopolize the market. The existence of monopoly power is often thought to create the potential for market failure. Since a company which monopolize certain market can control supply and price of the product, the flow of benefit goes one way. So economic efficiency does not exist in this situation.

3. Uncertainty

Producer and consumer do not always have information enough about a certain good. In order to make free market system work efficiently, they should know information about the goods well. Especially, in the case of technical things, people do not understand it and cannot make correct judgment.
Uncertainty refers to failure of distribution of information about a good. If people do not have information enough, they do not have correct judgment and their economic activity becomes dull.

4. Uncertainty of right of property

Actually, I don't know if this is words to express what I want to say. What I mean by uncertainty of right of property means that property right of something, resources does not belong to anybody. In this situation, there will be no competition so that market system won't work well. In order to make it work, property right should be guaranteed.

For example, copy right aims to guarantee the intellectual property to the author. If it is not guaranteed, anybody can use the ideas of the author. And the author cannot take his/her economic activity.

5. Public goods

Public goods refer to some socially desirable goods and services that private firms do not find it profitable to produce. For example, roads and lights along the road. These are goods or services, which provide benefits that are not marketable to individual purchasers. In many cases these benefits are not marketable because the good or service must be provided to all members of society.

Characteristics of public goods

When you talk about public goods, you have to understand two concepts: rivalry and excludability. Usually, if one consumes a good or service, the others cannot consume the same unit of a good or service. The word, rivalry, refers to this situation. However, certain goods or services such as national defense can be enjoyed by all people as long as they want to.
Excludability is the concept which is to exclude certain consumers with setting price for a good or service. However, certain goods or services cannot set price for consumers. If the price is set, the cost will be higher than benefit.
As a definition of public goods, public goods must have the characteristics of non-rivalry and non-excludability.
If a goods or service which has characteristics of non-rivalry and non-excludability is supplied in the market system, people who do not pay the price also can enjoy them. Those people are called free rider. The existence of free rider makes it impossible that free market system cannot supply the public goods.
Some public goods are called merit wants which has the characteristics of rivalry and excludability, but should be supplied to anybody even if they do not pay. For example, if you think about preventive injection, you can set a price for it. However if some citizens, who do not get injection because they do not pay, got disease, it means you cannot stamp out the disease. In order to stamp out the disease, you should give the injection to everybody without fee.

V. PUBLIC HAND AND THE GOVERNMENT FAILURE

Public Hand

A group of economists, referred to as public hand economists, argue that government is more the result of rent seeking (the use of resources to transfer income from one sector to another) than it is market failure. The study of public hand focuses on how government actions are the result of the self-interested behaviors of voters and politicians. Whereas the efficiency justification of government argue that it is only in cases where the market does not work that the government steps in, the public hand theory says that the government may be brought into the market system whenever someone or some group can benefit, even if efficiency is not served.

According to the public hand economists, price ceilings or price floors may be enacted for political gain rather than market failure; government spending or taxing policies may be enacted not to resolve a market failure but instead to implement an income redistribution from one group to another; government agencies such as the Food and Drug Administration may exist from one group to another. Each such instance of manipulation leads to a larger role for government in a market economy. Moreover, government employees have the incentive to increase their role and importance in the economy and therefore transfer income or other benefits to themselves.

Government Failure

Even though efficient prices provide information about scarcity, people simply do not like to pay high prices. When prices are high, people complain and demand that the government do something about it. Little do they realize that the high prices are providing them important information about demand and supply conditions. Nor do they realize that having the government do something to lower prices does not improve those scarcity conditions and may actually make them worse. Producers and consumers make the wrong decisions when market prices do not accurately represent scarcity conditions, so market outcomes are inefficient. One name used to refer to market inefficiencies created by government policies is **government failure**.

The primary policy tool that governments use to reduce prices of market goods is a **subsidy**. Subsidies can take many forms. One form is a **price subsidy**. To subsidize a market price, government uses some of the revenue it collects from taxpayers to pay part of the price of supplying a good in a private market. This government expenditure results in a lower price for consumers and a higher price for suppliers in the subsidized markets. This price subsidy makes consumers and producers in the subsidized market better off, so they support politicians who pass the legislation creating the price subsidy. However, the consumers and producers are being made better off only by making taxpayers worse off .

A price subsidy isn't always inefficient. If there are **positive externalities** from either **consumption or production** of a good, the market outcome is inefficient because too little of the good is consumed and produced. A price subsidy can remedy this problem. For example, demand for the treatment of infectious diseases has positive external benefits for people outside the market because they could catch the disease. Another example is the supply of apples. Apple production has positive external benefits because the springtime apple blossoms are enjoyed by people outside of the apple market. In these cases, the unsubsidized market will produce a quantity that is less than efficient. However, if there are **negative externalities** from either **consumption or production** of a good, a price subsidy will increase the external effects. For example, if consumption or production of a good damages the environment, the market equilibrium quantity will be larger than the efficient quantity. A price subsidy increases the quantity even more. Thus, a price subsidy on a good whose consumption or production damages the environment will increase the amount of environmental damage. Price subsidies on nonpolluting goods can also worsen environmental damage. This occurs when the subsidized good is an input to the production of a polluting good. For example, if the government subsidizes loans to firms, their costs of production will decrease, thus increasing supply of the good produced by the firm. The same ideas can be applied to credit subsidies on consumption.

Some inputs to production may be **public goods**, such as roads, airports, harbors, or highways. If general tax revenues are used to pay for these public goods, the effect on the production of private goods is the same as the effect of subsidized credit. A better transportation infrastructure lowers the cost of getting goods to market, thus decreasing the marginal private costs of supplying goods. The supply and demand diagrams look exactly like the ones in the slide show on subsidized credit.

Tax breaks are another form of subsidy. Tax breaks are reduced taxes on either income from or inputs to production. The effect of tax breaks is the same as the effect of the credit subsidy. Tax breaks lower the marginal private cost of producing a good, which increases its supply. The new market equilibrium results in a larger quantity of the good, so total external costs from production are increased. The supply and demand diagrams look exactly like the ones in the slide show on subsidized credit.

The types of policies that utilize all these different forms of subsidies include (1) **economic development policies,** (2) **trade protection policies**, (3) **cost of living policies,** and (4) **infrastructure policies**. These policies produce inefficient outcomes in markets for private goods, thus intensifying the effect of negative externalities in those markets.

For example, in order to encourage **economic development**, governments often **subsidize inputs** to production such as water, roads, electricity, fuel, loans, and fertilizer. The subsidies cause market prices to be lower than the efficient price. At the lower price, quantity demanded increases for those inputs. With below-cost prices for inputs, the firms' marginal costs of production are reduced and they are willing to supply more goods to market than before. In other words, the supply of market goods shifts out to the right, the equilibrium quantity increases, and the market price declines. If there is a negative externality associated with production of those outputs, the total external costs will increase.

A classic example of these forms of government failure is deforestation of tropical rain forests in countries like Brazil. In order to spur development, the government builds roads into the forest and the surrounding land is given away to individuals who convert the forest land into agricultural land. By subsidizing the roads, the government has decreased the private costs of agricultural production, thus making it more profitable to engage in agriculture. By not charging a price for the land, the government decreased the private costs of acquiring agricultural land. These two policies spur economic development, but the full opportunity cost is not reflected in the market for agricultural land. These opportunity costs consist of the lost environmental services that had previously been provided by the tropic rainforest land.

To **protect domestic markets** from world trade competition, governments may also subsidize **outputs** of agriculture, fishing, and forestry. In other words, the price of domestic goods is less than equilibrium price while the price to domestic producers is greater than equilibrium. Foreign imports cannot compete with the lower consumer prices for domestic outputs. Domestic production expands when given this form of **trade protection**. If there are negative externalities associated with production, trade protection policies can increase environmental damage.

Moreover, by making production of these outputs more profitable, the demand for other resource inputs will increase. For example, subsidies on prices of agricultural output will make it more profitable to convert virgin forest land to agriculture land, thus increasing the private opportunity cost of keeping land in its natural state. Consequently, land use policy decisions will be distorted by input and output subsidies elsewhere in the economy. Similarly, if the price of fish is subsidized, it will be more profitable to fish, thus increasing the private opportunity cost of keeping the parent stock and worsening the problem of over-fishing.

Subsidizing environmental damage negates the effects of environmental policies. In essence, the right hand of government undoes what the left hand has just accomplished. Because of government failures, improving environment quality will not result just from having more and better environmental policies. Government failures need to be corrected, too.