

What is the market system?

Markets are usually a good way to organize economic activity

The collapse of communism in Soviet Union Eastern Europe may be the most important change in the world during the past half century. Communist countries worked on the premise that the central planners in the government were in the best position to guide economic activity. These planners decided what goods and services were produced, how much was produced, and who produced and consumed these goods and services. The theory behind central planning was that only government could organize economic activity in a way that promoted economic well-being for the country as a whole.

Today, most countries that once had centrally planned economies have abandoned this system and are trying to develop market economies. Free market economy is a system that individuals, rather than government, make the majority of decisions regarding economic activities and transactions. In a market economy, the decisions of a central planner are replaced by the decisions of millions of firms and households. Firms decide whom to hire and what to make. Households decide which firms to work for and what to buy with their incomes. These firms and households interact in the marketplace, where prices and self-interest guide their decisions.

At first glance, the success of market economies is puzzling. After all, in a market place, no one is looking out for the economic well-being of society as a whole. Free markets contain many buyers and sellers of numerous goods and services, and all of them are interested primarily in their own well-being. Yet, despite decentralized decisionmaking and self-interested decisionmakers, market economies have proven remarkably successful in organizing economic activity in a way that prompts overall economic well-being.

In his 1776 book, *An Inquiry into the Natural and Causes of Wealth of Nations*, economist Adam Smith made the most famous observation in all of economics: Households and firms interacting in markets act as if they are guided by an “invisible hand” that leads them to desirable market outcomes. One of our goals in this book is to understand how this invisible hand works its magic. Prices are the instrument with which the invisible hand directs economic activity. Prices reflect both the value of a good to society and the cost to deciding of making the goods. Because households and firms look at prices when deciding what to buy and sell, they unknowingly take into account the social benefits and costs of their actions. As a result, prices

guide these individual decisionmakers to reach outcomes that, in many cases, maximize the welfare of society as a whole.

The advantage of free market system is that it is the most efficient system for allocation of resources and labors and capitals. The system also can maximize the well-being of the whole nation and also the national wealth. Moreover, the freedom of economic activities in the free market system will lead to the freedom of the political freedom. However, there exists several weak points the free market system. There is a big possibility of appearance of monopoly economy or oligopoly economy, which are quite negative on the sound development of industry. Problem is the shortage of public goods, which become efficient when produced or operated by the government. In addition, the free market economy cannot smoothly adjust to the economic cycle of “boom and bust”. There also are problems in environment and corruptions in the economic market, and the widen gap between the bourgeois and the proletariat, which can hurt the stability of the whole society.

What is public goods? (by Lee Manho)

Most of the goods we consume are *private goods*--they are goods that can be consumed by only one person at a time. When I am using my personal computer, you cannot simultaneously use it. When I drink a cup of coffee you cannot also drink it. The distinguishing feature of private goods is that their use is exclusive to the people who purchase or rent them.

There is an entire class of goods we consume that are not private goods. These goods are *public goods*; they can be consumed jointly by many individuals simultaneously. National defense, police protection, and the legal system are examples of public goods. When you partake of them you do not necessarily take away from anyone else's ability to consume or benefit from them.

Public good is a good whose benefits are shared by the relevant group if the good is provided or consumed by any one person; the receipt of benefits by one person does not deny those benefits to anyone else. Example: National defense, police protection, environmental quality. “MODERN POLITICAL ECONOMY” Richard B. McKenzie and Gordon Tullock, McGraw-Hill, 1978

In economics, economists are inclined to draw a conceptual distinction between two categories of goods: private goods and public goods. Almost all goods contain a blend of public and private characteristics, but we need to make the distinction clear. A public good is one that

cannot or will not be produced for individual profit, since it is difficult to get people to pay for its large beneficial externalities. A public good is defined as an economic good which possesses two properties:

For one thing, it is *non-rivalrous*, meaning that its benefits do not exhibit scarcity from an individual point of view; once it has been produced, each person can benefit from it without diminishing anyone else's enjoyment. For example, the shoes on your feet stand in sharp contrast to the missile and bomber bases that are scattered throughout the northern part of the continental United States. On these bases are located the Intercontinental Ballistic Missiles (ICBMs) and B-52 bombers that protected the U.S. during the Cold War. Each of those weapons simultaneously protected both you and your neighbors, so that your consumption of the national defense did not diminish the amount available for your neighbors to consume. National defense is thus said to be a public good, to which the principle of rival consumption does *not* apply. Individuals are not rivals in consuming public goods because the amount one person enjoys does not diminish the amount that can be enjoyed by the other person.

For the other thing, it is *non-excludable*, meaning that once it has been created, it is impossible to prevent people from gaining access to the good. Some public goods also have the attribute that, once they are produced, it is impossible (or at least prohibitively costly) to *exclude* or prevent individuals from consuming them. For example, no one can be denied the benefits of national defense for failing to pay for national defense. (Although they may be denied their freedom, because they are in jail for not paying their taxes. Nevertheless, even prisoners are protected from nuclear attack by our national defense system.)

Public goods are "pure" when they possess these properties absolutely, which means if individuals cannot be *excluded* from consuming the public good once it has been produced. The classic example, used in almost all discussions of public goods, is national defense. If national defense is provided, all in the country can share benefits which provision of defense may bring. There is virtually no way that a person, if he belongs to the group, can be excluded from the benefits resulting from the presence of the military. Because empirically pure public goods are small in number (though they include such important cases as national defense and the system of property rights), in common parlance among economists the phrase "public goods" often refers to impure public goods or those confined to particular localities. A public good would be for society as a whole (the public), while a "collective good" is merely for a sub-set of society.

Does Price Mechanism work well with Public Goods?

(Hun-Jip Kim)

The Price Mechanism is that government makes no attempt to influence what, how and for whom goods and services are produced in a free market economy. Prices are the only signals that guide the decisions of buyers and sellers. Therefore, the price mechanism operates automatically and does not need people to supervise its operation, so no administrative bureaucracy is needed, and it also has only the characteristics of private goods. However, when goods are available free of charge, or public goods, the market forces based on the Price Mechanism can not allocate resources in our economy because these goods do not have a price attached to themselves.

Economists draw a distinction between "private" and "public" goods. The defining characteristic of private goods is that they are "rival" and "excludable" in consumption in the sense that, for a given production total, greater consumption, by one individual, necessarily implies less by others. For instance, there are ice-cream cones. An ice-cream cone is excludable because it is possible to prevent someone from eating an ice-cream cone. Also, an ice-cream cone is rival because if one person eats an ice-cream cone, another person can not eat the same cone.

However, public goods are "non-rival" and "non-excludable" in consumption in the sense that the total quantity available can be consumed by any one individual without reducing the quantity available for consumption by others. For instance, national defense is a public good. Once the country is defended from foreign aggressors, it is impossible to prevent any single person from enjoying the benefit of this defense. Also, when one person enjoys the benefit of national defense, he does not reduce the benefit to anyone else. Therefore, even if total

consumption is the sum of the individual quantities consumed in private goods, public goods indicate that the amount available for consumption by each individual can be thought of as equal to the social total.

Because of the rival and excludable nature of consumption, private property rights can normally readily be established for private goods. However, in the case of public goods, private property rights are often difficult to establish since the non-rival and non-excludable nature of consumption can make it difficult to exclude non-payers from access to the good. That is, public goods are available free of charge for everyone. For example, everyone prefers to live in a society without poverty. In this case, taxing the wealthy to raise the living standards of the poor can make everyone better off. The poor are better off because they now enjoy a higher standard of living, and those paying the taxes are better off because they enjoy living in a society with less poverty. Therefore, among these kinds of public goods are pensions, unemployment benefits and other welfare benefits derived from government's public goods and externality considerations.

Externality is an external effect on others following from the actions of an individual or group. This effect is not bought by those affected and may be unwished for. Thus, while the acquisition of a car may benefit one household by improving mobility, it generates pollution and creates congestion for others. Therefore, this side effect in a market can be very inefficient in society as a whole. In aluminum manufacturers, for example, we can not rely on the market to prevent these manufacturers from polluting the air we breath. Buyers and sellers in a market typically do not take account of the external effects of their decisions for private goods. Therefore, the market works badly and inefficiently when the good is clean air.

Also, for both public goods and common resources, if one person were to provide a public good, such as national defense, other people would be better off, and they could not be charged for this benefit. Similarly, when one person uses a common resource, such as the fish in the ocean, other people are worse off, and they are not compensated for this loss. Because of these external effects, private decisions about consumption and production can lead to an inefficient allocation of resources, and government intervention can remedy the market failure and raise economic well-being.

The government provides public goods because the private market on its own will not produce an efficient quality and quantity of a public good. The free-rider problem—a free rider is a person who receives the benefit of a good but avoids paying for it—prevents the private market from supplying any goods because public goods are not excludable and rival. However, if the government decides that the total benefits exceed the costs, it can provide the public good and pay for it with tax revenue, making everyone better off.

Therefore, when the government determines what kinds of public goods to provide and in what quantities, he depends, as a part of cost-benefit analysis, on the “Demand-Revelation Mechanisms”, rather than the Price Mechanisms, for the provision of public goods and the allocation of externalities that induce accurate revelation by charging consumers as a function of the declared evaluation of other consumers, rather than their own declared evaluation.

MARKET FAILURE

By Woojin Jung

The equilibrium of supply and demand maximizes the sum of consumer and producer surplus.

That is, the invisible hand of the marketplace leads buyers and sellers to allocate resources efficiently. Nonetheless, for various reasons, the invisible hand sometimes does not work. Economists use the term 'market failure' to refer to a situation in which the market on its own fails to allocate resources efficiently.

Main causes of market failure are:

1. The abuse of market power, which can occur whenever a single buyer or seller can exert significant influence over prices or output e.g. Monopoly. When a firm has market power it tends to cut back production (output) to drive up prices and increase profits. The concentration of power in markets results in market dominance and abuse of monopoly power.
2. EXTERNALITIES – when the market does not take into account the impact of an economic activity on outsiders. Externalities are the unintended spill over effects on third parties of economic activity. For example, the market may ignore the costs imposed on outsiders by a firm polluting environment. Generally producers and consumers only take into account the private costs and benefits of production or consumption – how they themselves are affected – and ignore any unintended spill over effects on third parties (someone not directly involved) of their decisions. The existence of externalities (e.g. pollution & training) causes private and social costs and/or benefits to diverge.
3. PUBLIC GOODS, such as national defense. A private good is both rival and excludable. A good which is both non-rival (an individual's consumption of the good does not reduce the amount of the product available to other consumers) and non-excludable (once the good is provided, others cannot be excluded (stopped) from benefiting from the product) is called a public good. Because public goods are non-excludable, profit-seeking firms will not provide them. The non-excludability of a public good encourages some consumers to avoid payment and become *free riders*. Firms cannot collect all the revenue needed to supply the public good and make a normal profit. Markets cannot provide the incentives needed to supply essential services such as policing and national defense and so there is allocative inefficiency.
4. When there is incomplete or ASYMMETRIC INFORMATION or uncertainty. Consumers and producers require complete information if they are to make efficient

choices. Imperfect information means consumer or producers (economic agents) cannot accurately value the 'true' cost and/or benefit of a good or service. Information failure occurs when economic agents have inaccurate, incomplete, uncertain or misunderstood data and so make potentially 'wrong' choices. When somebody knows more than somebody else such asymmetric information can make it difficult for the two people to do business together. Transactions involving asymmetric (or private) information are everywhere. A government selling broadcasting licenses does not know what buyers are prepared to pay for them; a lender does not know how likely a borrower is to repay; a used-car seller knows more about the quality of the car being sold than do potential buyers. This kind of asymmetry can distort people's incentives and result in significant inefficiencies.

5. Equity (fairness) issues. Markets can generate an 'unacceptable' distribution of income and social exclusion where people on low income - the relatively poor - are denied access to essential goods and opportunities considered 'normal' by a society e.g. food, clothing, housing, and education

Abuse of market power is best tackled through ANTITRUST policy. Externalities can be reduced through REGULATIONS, a tax or subsidy, or by using property rights to force the market to take into account the WELFARE of all who are affected by an economic activity. The SUPPLY of public goods can be ensured by compelling everybody to pay for them through the tax system.

Taehun Choi

What is the solution?

While most people are unaware of it, markets often solve public goods and externalities problems in a variety of ways. Businesses frequently solve free-rider problems by developing means of excluding nonpayers from enjoying the benefits of a good or service. Cable television services, for instance, scramble their transmissions so that nonsubscribers cannot receive broadcasts. Both throughout history and today, private roads have financed themselves by charging tolls to road users. Other supposed public goods, such as protection and fire services, are frequently sold through the private sector on a fee basis.

Public goods can also be provided by being tied to purchases of private goods. Shopping malls, for instance, provide shoppers with a variety of services that are traditionally considered public

goods: lighting, protection services, benches, and rest-rooms, for example. Charging directly for each of these services would be impractical. Therefore, the shopping mall finances the services through receipts from the sale of private goods in the mall. The public and private goods are "tied" together. Private condominiums and retirement communities also are examples of market institutions that tie public goods to private services. Monthly membership dues are used to provide a variety of public services.

Lighthouses are one of the most famous examples that economists give of public goods that cannot be privately provided. Economists have argued that if private lighthouse owners attempted to charge ship-owners for lighthouse services, a free-rider problem would result. Yet lighthouses off the coast of nineteenth-century England *were* privately owned. Lighthouse owners realized that they could not charge shipowners for their services. So they didn't try to. Instead, they sold their service to the owners and merchants of the nearby port. Port merchants who did not pay the lighthouse owners to turn on the lights had trouble attracting ships to their port. As it turns out, one of the economics instructors' most commonly used examples of a public good that cannot be privately provided is not a good example at all.

Other public goods problems can be solved by defining individual property rights in the appropriate economic resource. Cleaning up a polluted lake, for instance, involves a free-rider problem if no one owns the lake. The benefits of a clean lake are enjoyed by many people, and no one can be charged for these benefits. Once there is an owner, however, that person can charge higher prices to fishermen, boaters, recreational users, and others who benefit from the lake. Privately owned bodies of water are common in the British Isles, where, not surprisingly, lake owners maintain quality.

Property rights are a less effective solution for environmental problems involving the air, however, because rights to the air cannot be defined and enforced easily. It is hard to imagine, for instance, how market mechanisms alone could prevent depletion of the earth's ozone layer. In such cases economists recognize the likely necessity of a regulatory or governmental solution.

Contractual arrangements can sometimes be used to overcome other public goods and externalities problems. If the research and development activities of one firm benefit other firms in the same industry, these firms may pool their resources and agree to a joint project (antitrust regulations permitting). Each firm will pay part of the cost, and the contributing firms will share the benefits. In this context economists say that the externalities are "internalized."

Contractual arrangements sometimes fail to solve public goods and externalities problems. The costs of bargaining and striking an agreement may be very high. Some parties to the agreement

may seek to hold out for a better deal, and the agreement may collapse. In other cases it is simply too costly to contact and deal with all the potential beneficiaries of an agreement. A factory, for instance, might find it impossible to negotiate directly with each affected citizen to decrease pollution.

The imperfections of market solutions to public goods problems must be weighed against the imperfections of government solutions. Governments rely on bureaucracy and have weak incentives to serve consumers. Therefore, they produce inefficiently. Furthermore, politicians may supply public "goods" in a manner to serve their own interests, rather than the interests of the public; examples of wasteful government spending and pork-barrel projects are legion. Government often creates a problem of "forced riders" by compelling persons to support projects they do not desire. Private solutions to public goods problems, when possible, are usually more efficient than governmental solutions.

Government failure

By Lee, Sungjin

What is Government Failure?

Some economists believe that even with good intentions governments seldom get their policy application correct. They can tax, control and regulate but the eventual outcome will be a deepening of the market failure or even worse a new failure may arise.

Possible Causes of Government Failure

- (1) The pursuit of self-interest amongst both politicians and civil servants rather than operating on behalf of citizens which leads to a misallocation of resources (for example decisions about where to build new roads, by-passes, schools and hospitals, inappropriate tariffs and other forms of import control and also decisions as to which industries and markets to offer government subsidies)
- (2) Electoral pressures leading to inappropriate government spending and tax decisions - e.g.

boosting state welfare spending in the run up to an election, or decisions to bring forward major items of government capital spending on infrastructural projects ahead of an election without the projects being subjected to a full and proper cost-benefit analysis

(3) A tendency to look for short term solutions to economic problems rather than making considered analysis of long term considerations (examples might include important decisions about transport policy or extra funding for the National Health Service). The risk is that myopic decision-making will only provide short term relief to particular problems but does little to address structural problems. A decision for example to build more roads might simply add to the problems of traffic congestion in the long run. Short term subsidies to the steel industry or coal producers to keep open loss-making steel plants and coal pits might eventually prove to be a waste of scarce resources if the industries concerned have little realistic prospect of achieving an economic rate of return in the long run.

(4) Regulatory capture. This is when the industries under the control of a regulatory body begin to move policy options so as their outcome is in their favour. Some economists argue that regulators can prevent the ability of the market to operate freely. We might find examples of this in agriculture, telecommunications and the other utilities and also in environmental protection.

(5) Disincentive effects created by measures designed to reduce income inequalities (including the poverty trap) or the loss of business competitiveness caused by the introduction of the National Minimum Wage or the Working Families Tax Credit ? thousands of small & medium sized enterprises have faced higher costs because of the increasing levels of red tape brought about by new government regulations.

Equally a decision by the government to raise taxes on de-merit goods (such as cigarettes) might lead to an increase in tax evasion, smuggling and the development of grey markets where trade takes place between consumers and suppliers without paying tax. Equally a decision to legalize

and then tax some drugs might lead to a rapid expansion of the supply of drugs and a substantial loss of social welfare arising from over consumption.

(6) The Environmental impact of government price support for farmers (including the long term impact of exemptions from taxation for farmers selling land to developers, the externalities arising from increasing use of subsidized fertilizers, and the long running issue of structural excess supply arising from guaranteed intervention prices for farmers within the CAP)

(7) Imperfect information - How does the government establish what citizens want it to do? Our electoral system is not an ideal way to discover this! Proponents of government failure argue that the free market mechanism is the best way of finding out (a) what consumer preferences are and (b) aggregating these preferences based on the number of people that are willing and able to pay for particular goods and services.