ANNOUNCEMENTS

Film #1 (note: change of film)

The Corporation

room 3650 Humanities Building
7:00 p.m., Tuesday, September 19
7:00 p.m., Wednesday, September 20

SOCIO-CULTURAL BIKE TOUR OF MADISON

Lead by Erik Olin Wright
Saturday, 9/23, Noon until 3:00 or 5:00
(depending upon how much of the tour you do)
Meet in the parking lot behind Budget Bicycle
1231 Regent Street
Bike Rentals Available

Lectures 4 & 5

September 18 & 20

The Market:
How it Actually Works

Summary from last lecture: Four Virtues of Markets

1. <u>Freedom</u>: Markets are an expression of the value of individual freedom: exchanges are voluntary

2. <u>Efficiency</u>: Unfettered markets result in allocative efficiency (“Pareto Optimality”)

3. <u>Coordination of complex systems</u>: Markets accomplish this remarkable result through supply, demand and the price mechanism

4. <u>Economic Development and Growth</u>: Markets create strong incentives for risk-taking and innovation

[remaining comments from last lecture]
IV. The Market & Limited Government

According to strong defenders of capitalist free markets:	
Things the state should do	***Things the state should NOT do***
• law and order and national defense • enforce contracts • prevent “negative externalities” • provide the most important “public goods” (streets, sanitation)	• help the poor through income support • subsidize higher education • Provide health care • Provide training for unemployed workers • prevent global warming

I. The Market & Freedom

Negative Freedom: "Freedom *from*" – no one can physically force you to do things.

Positive Freedom: "Freedom *to*" = the actual capacity to do things, to realize your goals

Conclusion 1: The market is a pretty good institution for realizing negative freedom.

Conclusion 2: The free market generates great inequalities in positive freedom – it is enhances it for some people and undermines it for others.

II. THE PRAGMATIC ISSUE: INEFFICIENCY & MARKET FAILURES

Sources of Market Inefficiency #1

Faulty consumer information

Markets only allocate products efficiently if people have perfect information about what they buy, but this is often very difficult for consumers, especially because firms have incentives to distort information.

Sources of Market Inefficiency #2

Concentrated Economic Power

Allocative efficiency depends on <u>perfect competition</u>, but American capitalism is dominated by giant corporations.

Sources of Market Inefficiency #3

Negative Externalities

Definition: a negative side-effect of an activity that affects other people.

Market efficiency depends on prices reflecting the true costs of producing things, but firms often systematically displace costs and risks on others in many ways.

Sources of Market Inefficiency #4

Short Time Horizons

Competition among profit-maximizing firms leads firms to have relatively short time-horizons. This imposes costs on future generations for our present production and consumption. (Intergenerational negative externalities).

Sources of Market Inefficiency #5

Under-provision of Public Goods

Definition of Public Goods: a public good is a good which, if it is produced, provides a benefit to people even if they did not contribute to producing it.

Profit-maximizing firms in competitive markets will fail to produce adequate public goods, even those public goods which are necessary for maintaining healthy markets.

THE PRISONERS DILEMMA

PRISONER X

PRISONER Y

		Silent	*Confess*
PRISONER Y	*Silent*	Both get 2 years **A**	X gets 0 years Y gets 10 years **B**
	Confess	X gets 10 years Y gets 0 years **C**	Both get 5 years **D**

Self-interested preference ordering for X: B>A>D>C

THE TRADGEDY OF THE COMMONS

Your choice

		Graze 1 sheep	*Graze 2 sheep*
Everyone else's choice	*Graze 1 sheep*	Everyone earns \$10 **A**	You earn \$20 Others earn \$10 **B**
	Graze 2 sheep	You earn \$4 Others earn \$8 **C**	Everyone earns \$8 **D**

Self-interested preference ordering for X: B>A>D>C

Free-riding & Public Goods problem: Firms Providing Training for Workers

		You provide training	
		YES	*NO*
All other firms provide training	*YES*	$20,000 **A**	$30,000 **B**
	NO	-$10,000 **C**	$0 **D**

Training costs = $10,000
Extra Gross Profits with trained workers = $30,000
Net extra profits if you provide training and keep workers = $20,000
Net extra profits if you provide training and workers leave = -$10,000

THE TRADGEDY OF THE COMMONS

Your choice

Everyone else's choice		*Graze 1 sheep*	*Graze 2 sheep*
	Graze 1 sheep	Everyone earns $10 **A**	You earn $20 Others earn $10 **B**
	Graze 2 sheep	You earn $4 Others earn $8 **C**	Everyone earns $8 **D**

Self-interested preference ordering for X: B>A>D>C
Conditional Altruist (cooperative) preferences: A>B>D>C

Contrast:
Negative Externalities vs Free-rider Problem

Negative externalities:
I benefit from imposing costs on you.

Free-riding problem for public goods:
Everyone is harmed – including me – because of free-riding, but I am even worse off if I individually refuse to free-ride.

The Case of the Ford Pinto (late 1960s)

The problem: because of faulty placement of gas tanks, tendency for cars to explode in some rear-end collisions

Cost of change: roughly $11/car

Ford's calculation: even considering the costs of settling law suits for approximately 180 deaths/year due to exploding Pintos, it was more profitable not to make the change.

Ford's strategy: use their economic and political power to first block legislation and then block effective implementation of stricter safety regulations

Results:the legislation to require higher safety standards was delayed from 1961 to 1966 and effective regulations delayed until 1977. Hundreds of lives lost as a result.