4. How a Capitalist Market System Works

LEARNING OBJECTIVES

- Adam Smith and the "invisible hand"
- markets in a modern economy
- characteristics of a market economy
  - market strengths
  - market failures
- what should be the role of the government?

All the bad things you hear about the markets are true: unemployment, inflation, inequalities of income and wealth, monopoly power, negative externalities, and insufficiently supplied public goods. You know, there is only one thing that is worse than the market, and that is no market.

Csaba Csáki, Rector of Economics, Budapest University of Economic Sciences (formerly Karl Marx University), speech, August 1990.
The theory of the Invisible Hand

- If each consumer is allowed to choose freely what to buy and each producer is allowed to choose freely what to sell, the market will settle on a product distribution and prices that are beneficial to the entire community.
- Individual self-interest leads to a social optimum than when people try to promote the general well-being.
- *Homo* ____________
- *Laissez-faire*

Perfect Markets

- A complete, competitive, full-information general equilibrium is efficient.
- Are markets ever perfect?
- Inefficiencies in markets are created by violations of the three conditions
  - market failures
    - failure of competition
    - failure of information and incentives
    - failure of incomplete markets
  - usually disagreements about relative importance of market failures

Market (Capitalist) Institutions

- Private ownership of capital (free enterprise)
- Equality of ______________
- Market equilibrium
- Goods markets: sovereign consumers, disturbances
- Factor markets: \( w, r = \) __________
- Simple and complex markets
- Capital markets
  - both the “” and the “”
  - absence \( \rightarrow \) __________
  - Arbitrage and speculation
- rule of law
The strengths of the market system
1. _________ are self-correcting
2. the need for information is _________
3. innovation is stimulated
   • via ____________ and/or ____________
4. relative prices reflect relative _________
5. opposition to concentration of _________
   • complexities of planning

The Use of Knowledge in Society

F.A. Hayek

- planning requires ________________
- in capitalism, all one person needs to know is about her/his own circumstance and preferences
- _________ signals provide the rest
- there is a mechanism in capitalism that automatically brings about an efficient outcome (at least under ideal conditions)

Government’s involvement

- Adam Smith
  •
  •
  •
  •
  - In a modern market economy, the gov’t extends its involvement into
    •
    •
    •
  - Why is that the case?
    • market _________
    • ________________ of the social product
Market failure

1. Market power (failure of ____________)
   • why is this a failure?
   • P - MC
   • natural monopoly, (unnatural or artificial) monopoly, oligopoly, monopsony, etc.
   • antitrust policy
     - removing barriers to entry
     - prohibiting mergers that would harm consumers
   • market power in the supply of labor (_______)

2. Lack of information
   • providing information when information collection is _______ for consumers
   • licensing and regulation

3. Provision of public goods
   • private goods: ___________ + ___________
   • public goods: MC of consumption is ____ + free rider problem
   • in reality, many gov’t provided goods and services are not purely public (quasi-public)
     - justification: the ________ concerns

4. Externalities
   • positive and negative
   • private costs social costs
   • example:

Conclusion:
• there might be a role for government to correct market failures and to increase efficiency in cases where markets are not perfect
• But, government might not be better than imperfect markets
  - capture of ____________
  - ________________ (collective actions)
Other problems with markets

- Poverty
- Income inequality
  - MRP \( \rightarrow \) “______” income distribution
- Economic insecurity
- Recessions and depressions
  -
- Rent seeking

Government activities (functions)

1. Allocation (improving allocative efficiency)
   - correcting ______________
2. Distribution
   -
3. Stabilization
   -

Redistributive government

- transfer payments, tax expenditures
- What determines income?
  - talent & ability, acquired skills, effort, inherited wealth, accumulated savings, and S&D factors
- Arguments (rationale) for redistribution
  -
  -
  -
  -
Other gov’t involvement

- Industrial policy
  - gov’t promotion of economic growth
  - tools: subsidy, tax relief, finance…
  - should the gov’t engage in ind. policy and when?

- Trade policy
  - assisting exports
  - protecting domestic markets
  - free trade vs. political pressures

- Developing human resources
  - education
  - health care
  - should health care be privatized?

Gov’t expenditure (as % of GDP)

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<th>Total</th>
<th>Defence</th>
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Health Care Expenditure

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