Topic 2: Markets and Government in a Modern Economy

Eco-political systems

- Laissez-faire (Leave us alone) or Market Economy: Non-intervention by the government in economic activity or rule of markets, description of capitalist economies
- Welfare state: market driven as far as day-to-day economic activities are concerned, but government regulates markets for welfare reasons (provides pensions, health care, education, unemployment relief, relief for natural calamities, etc.)

Command economy

- All decisions regarding what to produce, how to produce and for whom to produce (i.e., regarding production, distribution and consumption) are taken by a central political agency and the lower economic units (such as firms, farms are asked to implement the same). Curbs individual freedom and does not provide incentive for better performance.

Choice of Eco-Political Systems

- Which economic system to follow? (Two polar systems)
  - Capitalism (rule of markets)
  - Command Economy (Rule of the government)
- Role of Government (state) vs Markets in solving socio-economic problems:
  - Economic systems: Command economy, capitalism, mixed economy, etc. (Who owns the resources in the system)
  - Political systems: democracy, dictatorship, communism, socialism, welfare state, etc. (Who takes the decisions for the nation?)

- Utopia (dream about the ideal situation) vs Realism: Necessary to understand the selfish instinct in human beings. Failure of communism and socialism due to utopian ideas and harsh reality. Human beings need incentives for increasing production. A judicious combination of state and market required.

When are markets successful?

- When consumers and producers are rational and they maximize their private net benefits, a set of markets where each person has the opportunity to exchange every good with every other person, it will generate a socially optimum allocation of resources.

Markets: An invisible hand

- for interaction of buyers and sellers which determines the price. Not necessarily a geographical place, but a mechanism for exchange (e-trading).
- Price serves as a signal for resource allocation (by producers) and for consumption (to the consumers).
- A rise in prices will induce producers to produce more and consumers to consume less in the normal situations.
- A fall in prices will induce producers to produce less and consumers to consume more in the normal situations.

Market Equilibrium:

- When demand becomes equal to supply, there is no tendency for prices to change. Such a situation is described as market equilibrium.

How market solves the three problems:

- What to produce?

  Money that consumers are willing to spend on various goods. Profits that producers expect to earn by producing various goods

How to produce?

- Technology which can minimize the costs, but keeping in mind the tastes and preferences of consumers. These decisions will also be affected by the nature of competition in the market.

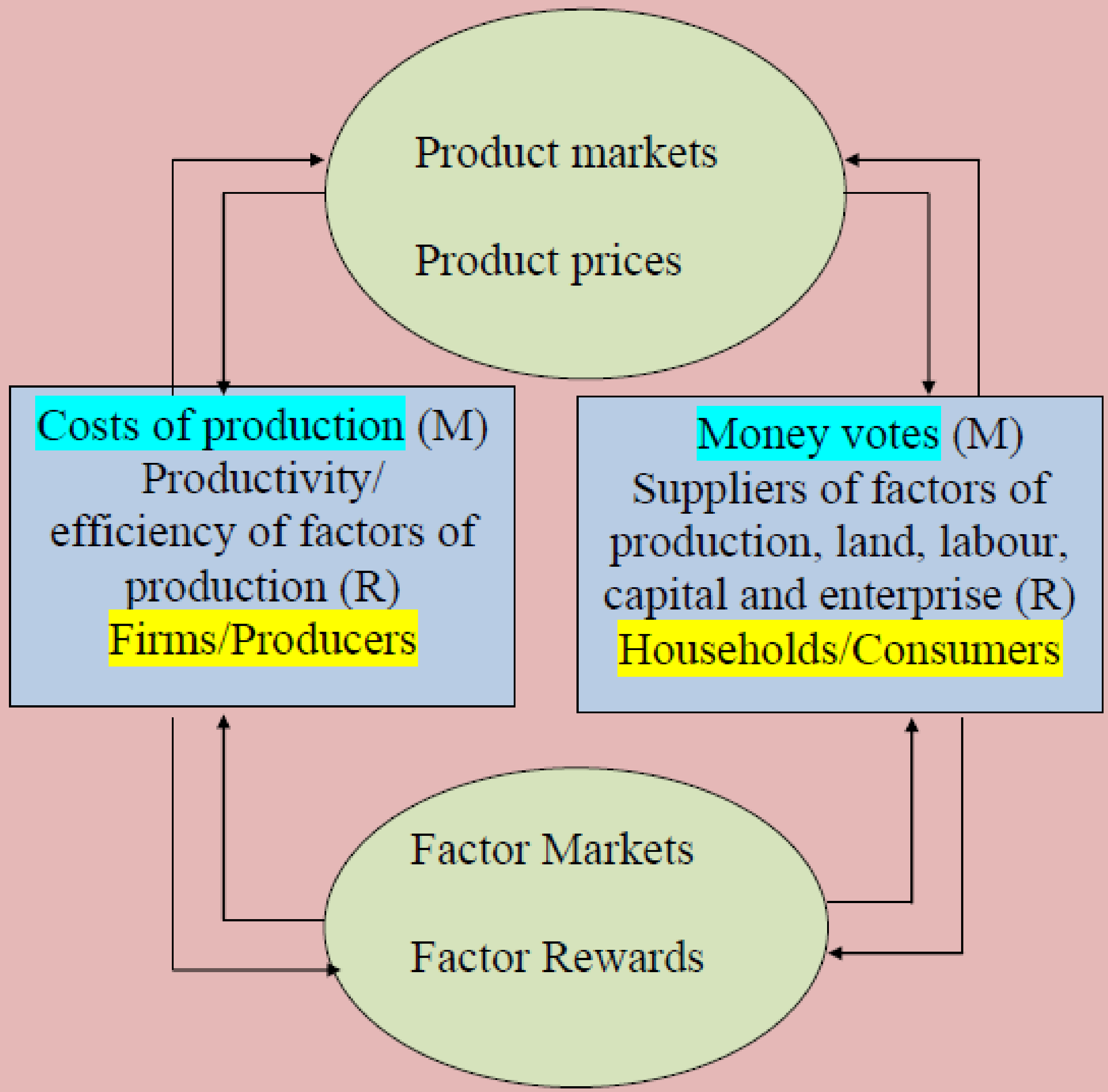
For whom to produce?

- Goods and services are produced for the owners of the factors of production (labourers, capitalists, entrepreneurs, landlords, i.e., who can spend their income on the purchases of goods and services). Money that we are willing to pay for getting goods and services is like a vote that we give for production of those goods and services.

Features of a modern economy

- **<u>Trade, Money and Capital</u>**
- Trade: Widening of markets, possibility of specialization, division of labour, competition, reduction in costs and prices
- Money: lubricates the process of exchange, reduces the need for double coincidence of wants
- Capital: produced means of production, roundabout method of production, increases productivity

Interaction between Consumers and Producers:
Real and Monetary



Market Failures

- Markets can fail if prices do not communicate society’s desires and constraints accurately. Prices can understate the total value of services provided by the asset or prices may not exist at all so as to signal the value of the asset.

Externalities/spillovers:

- Firms and consumers impose costs or provide benefits to others outside the market place. Examples of externalities:
- Positive externalities, such as benefits accruing to a person from municipal garden in the locality.
- Negative externality: Pollution borne by the pedestrians due to vehicles.

Two basic characteristics of a good/bad

1. Rivalry in consumption
2. Excludability (technology related)
   - <u>Public Goods/Bads</u>
     - Non-rival and non-excludable
   - <u>Private goods/bads</u>
     - Rival and excludable

Types of Goods

Characteristics of goods/bads	Rival	Non-rival
Excludable	Private	
Non-excludable		Public

Economic Role of the Government

- **Inefficiency**
- **Inequality**
- **Macroeconomic Stability**

Economic Role of the Government

Failure of Market Economy	Government Intervention	Policy Action
Inefficiency i) Monopoly/ imperfect competition ii) Externalities iii) Public Goods	Encourage competition Govt intervention in markets Provide public goods	Restriction on monopolies and restrictive trade practices Anti-pollution laws,Provision of defence , infrastructure, etc.

Economic Role of the Government

Failure of Market Economy	Government Intervention	Policy Action
Inequality	Redistribution of income	Progressive taxation, distribution of food at low prices

Economic Role of the Government

Failure of Market Economy	Government Intervention	Policy Action
Macroeconomic Instability i) High inflation & unemployment ii) Slow growth	Stabilization through macroeconomic policies Revive growth	Monetary policy ΔM, ΔI Fiscal Policy Tax & expenditure policy Inv in Capital (Physical & Human)

Governments failure

- Ignorant/corrupt policy makers
- Inefficiency
- Lack of incentives as the rewards may not be related to efforts.