

# The Theory and Practice of Market Capitalism

- Vast changes sweeping through the world economy have focussed on the nature of capitalist economic system
- Market capitalist economies are moving towards pure market system
  - E.g. Hong Kong, Singapore and New Zealand
- Dynamic Efficiency or Technological Dynamism: Creative Destruction (*Capitalism, Socialism and Democracy* by Joseph Schumpeter, 1942)

# THE THEORETICAL EFFICIENCY OF MARKET CAPITALISM

- Why do some of the world's highest real per capita income countries have economies that are market capitalist, such as the United States?
- Probably the strongest reason is the general ability of markets to allocate goods and resources *efficiently through the law of supply and demand.*
  - **A complete, competitive, full-information general equilibrium is efficient**

# THE THEORETICAL EFFICIENCY OF MARKET CAPITALISM

- **Complete:** for any good or service that affects someone's utility, there is a market
- **Competition:** there are many buyers and sellers with free entry and exit, there are well-defined homogeneous goods and services, and no individual supplier has any control over the price in his or her market.
- **Full information:** all agents in the economy know everything about consumer preferences, production technologies, prices, and anything else they might need to know in deciding how to act.

# THE THEORETICAL EFFICIENCY OF MARKET CAPITALISM

- **General equilibrium:** every single market is in equilibrium in the sense that the quantity supplied equals the quantity demanded of the good or service in question.

# Production possibilities frontier

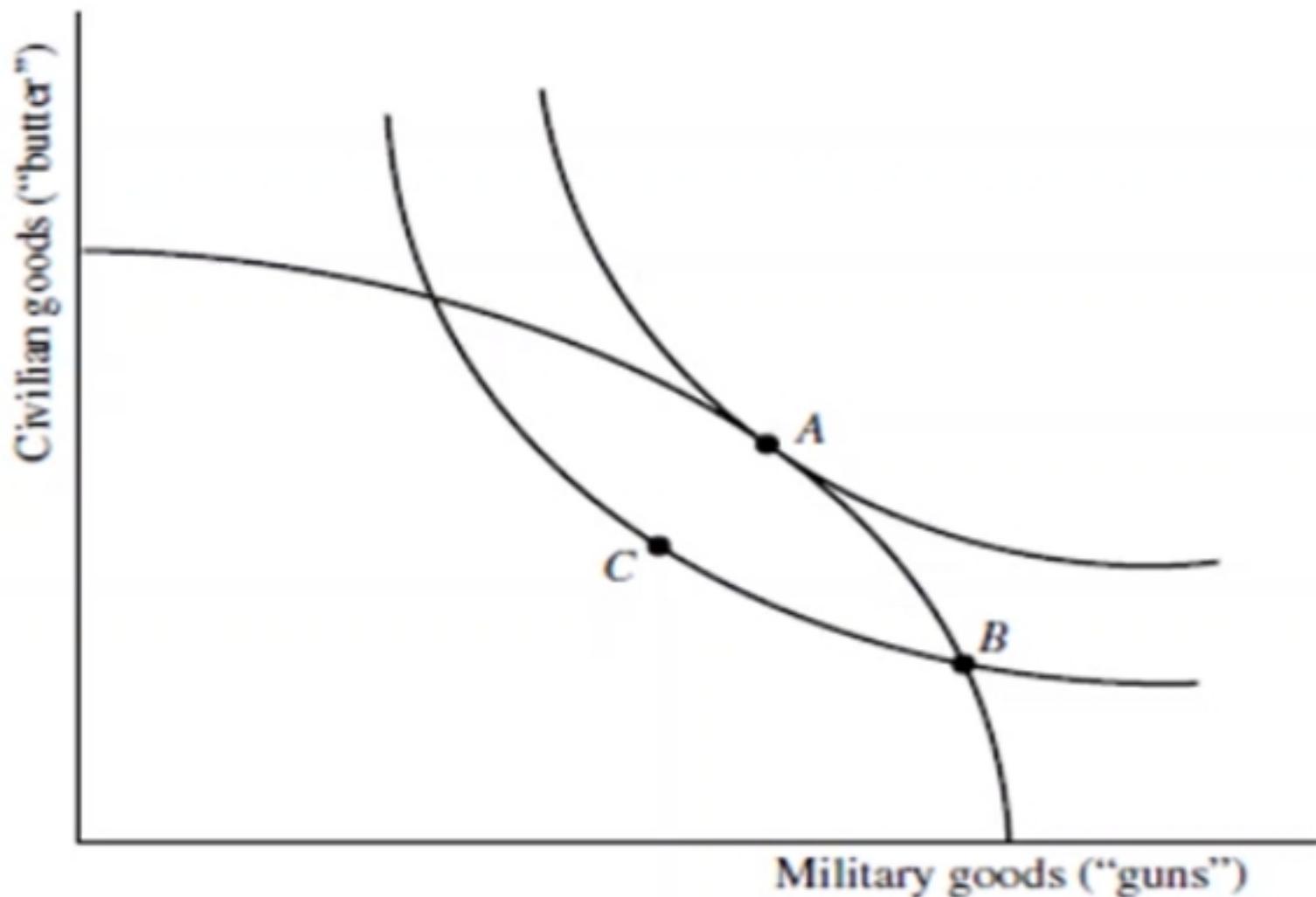


Figure 2-1

# Production possibilities frontier

- If someone can be made better off without making someone else worse off, then the economy is not producing as much as possible of what people want
- But if Pareto optimality holds, no more of what people want can be produced; all that can be done is to reshuffle existing goods and services between people
- But not all points on the PPF are efficient; some may represent combinations of goods and services that people do not want.
  - The former Soviet economy may have been on its PPF but was thought to produce too much military equipment and not enough civilian consumer goods.

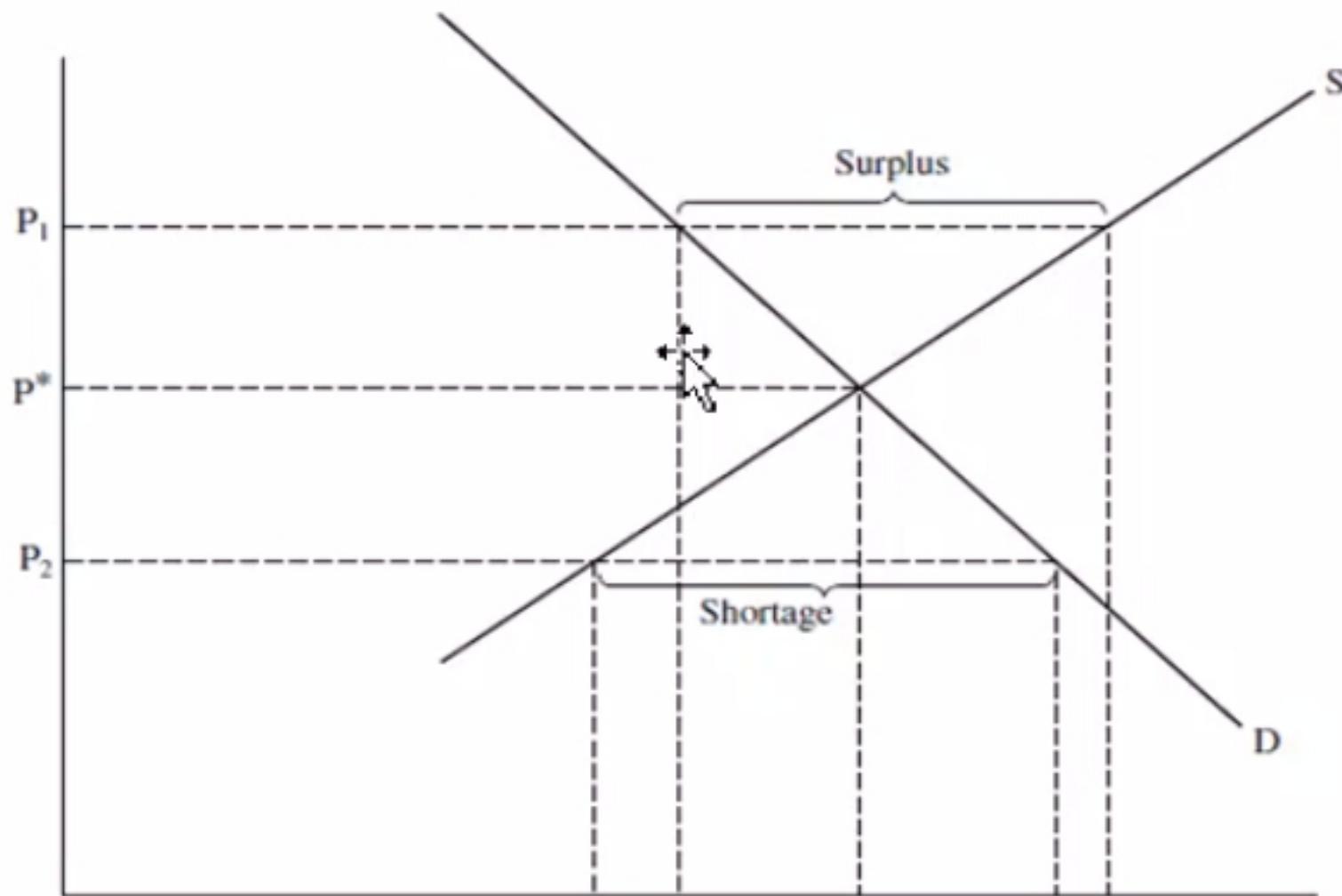
# PPF and Income Distribution

- It does not say anything about income distribution
- An economy might be efficient according to Pareto if it has completely equal distribution of income or if one person has everything and everyone else is starving to death.
  - Just as long as no one can be made better off without making someone else worse off, the necessary condition for Pareto optimality.
- The tendency to unequal wealth and incomes under market capitalism has been one of the major arguments against it raised by socialist critics.

# THE THEORETICAL EFFICIENCY OF MARKET CAPITALISM

- Why is a complete, competitive, full-information, general equilibrium efficient?
- Adam Smith's invocation of the **invisible hand of the market working across all sectors to allocate goods in a way that maximizes the “wealth of nations,”**
  - although Smith had no formal concept of a general equilibrium, which was first defined by Léon Walras in 1874.

# Equilibrium of competitive supply and demand.



# **WHAT ARE THE LIMITS TO THE EFFICIENCY OF LAISSEZ-FAIRE MARKET CAPITALISM??**



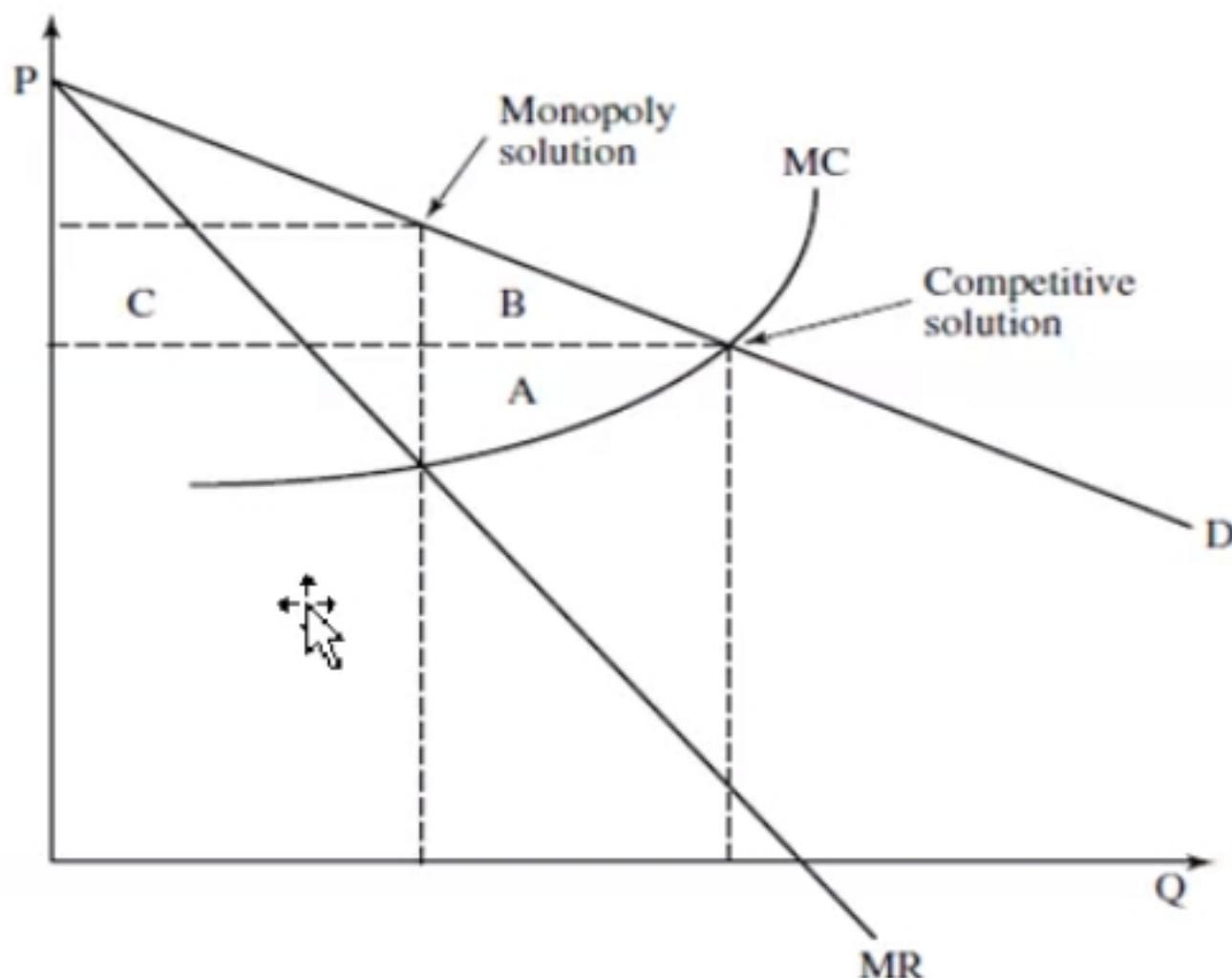
# LIMITS TO THE EFFICIENCY OF LAISSEZ-FAIRE MARKET CAPITALISM

- Monopoly Power
- Externalities
- Collective Consumption Goods
- Imperfect Information
- The Role of labour Unions
- Macroeconomic Instability of Market Capitalism

# Monopoly Power

- In general, laissez-faire market capitalism will not be completely efficient; this situation is called the problem of **market failure**
- Monopoly power is a source of inefficiency and can arise in a laissez-faire economy.
- This type of market failure happened in the United States at the end of the 1890s, culminating in a great concentration of monopoly power that was attacked by President Theodore Roosevelt, the “Trust Buster,” after 1901

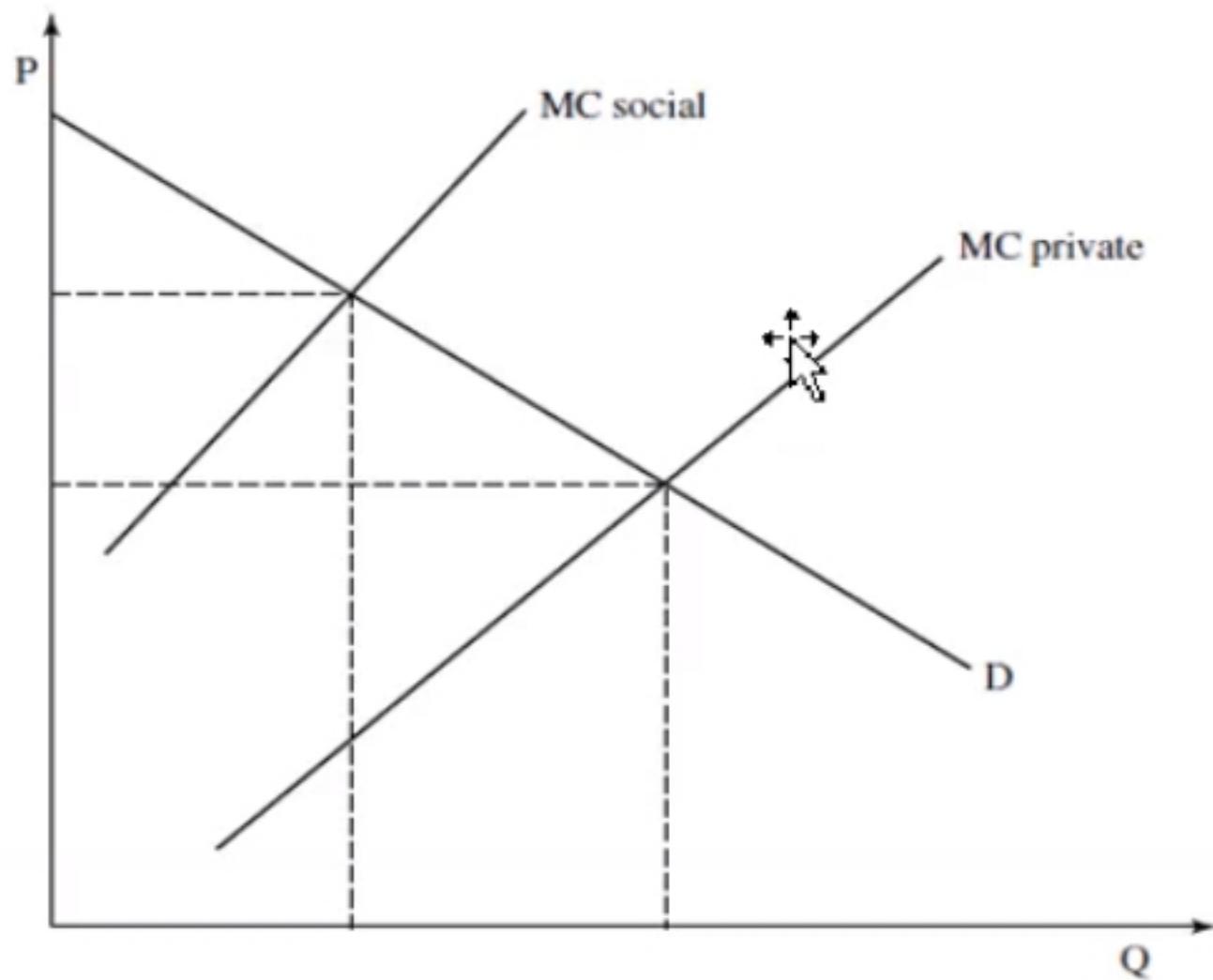
# Monopoly and perfect competition compared



# Externalities

- Another source of inefficiency in a laissez-faire equilibrium can be externalities
- These are either costs or benefits that are borne by or accrue to an agent other than the agent generating them
- External costs are **negative externalities, the most controversial one being environmental** pollution
- External benefits are **positive externalities, such as technological** invention without patent protection for inventors

# Negative externality.



# Externalities

- Four broad approaches to resolving the problem of externalities have been proposed within market economies:
  - Pigouvian Solution
  - Command and Control
  - Coasian Approach or Coase Theorem
  - Tradeable Emission Permits
- The earliest approach was provided by A.C. Pigou, who suggested taxation of negative externalities and subsidies of positive externalities
- This taxation strategy has been little used in the United States.
- Countries using it include France and Germany, with the thrust of their policies being not to raise the cost so high as to discourage polluters from polluting but to raise money for subsidy programs that pay polluters to clean up.

# Externalities

- A second policy, widely used in the United States, is command and control quantitative or technological restrictions
- A third approach takes a more laissez-faire attitude and emphasizes the clear definition and enforcement of property rights. ❤
- This approach derives from the **Coase Theorem**
- This states that if property rights are well defined and transactions costs (or negotiation costs) are negligible, then externalities will be automatically internalized by a market capitalist economy.
- Ronald Coase presents the example of a railroad whose trains generate sparks that start fires on property adjacent to the railroad's tracks. By mutual negotiation a solution is worked out, such as the railroad compensating the property owners or buying their property.

# Externalities

- When property rights are poorly defined and a natural resource is an open-access, common property resource, such as fisheries in international waters, there is a tendency for the resource to be overexploited
- The Coase Theorem implies serious limits: Property rights may be impossible to define, and negotiation costs may be very high.
- These conditions are likely to coincide when the externality involves an inherently collective good “owned” by large numbers of people, such as the global air quality and global climate in discussions about global warming.
- As the inability of world leaders to agree on how to implement the Kyoto Protocol on global warming demonstrates, negotiations to resolve disagreements are far from costless.

# Externalities

- Awareness of the Coase Theorem has stimulated the search for market mechanisms to use where possible to resolve pollution problems.
- An innovation now used widely in the United States is tradeable emissions permits.
- Marketable emissions permits directly attack the problem of *incomplete markets underlying* the inefficiency of unresolved externalities.
- As long as there are enough parties to make such a market reasonably competitive, it will achieve the least costly solution to cleaning up the given amount of pollution.
- Those firms that can clean up cheaply do so and sell their “permits to pollute” to those that cannot

# Collective Consumption Goods

- Another source of inefficiency for laissez-faire equilibrium can be **collective consumption goods, also known as *public goods***
- The characteristics of a pure public good are *non-excludability of consumption and non-depletability of consumption; the former is more crucial*
- The essential problem for private market provision of true collective consumption goods is the **free rider problem**

# Collective Consumption Goods

- Finally, the **public choice school observes that decisions regarding private versus public ownership** are made by legislative bodies at any level of government.
- These bodies are subject to complexities of majority rule, logrolling, lobbying by special interest groups, and sheer inertia, suggesting that they are ill suited to efficient decision making regarding the proper balance between the private and public sectors.
- Even though there is a case for public provision of collective consumption goods, the public choice school sees the public sector as so inefficient and corrupt that generally privatization is the preferred market solution

# Imperfect Information

- Of all the assumptions needed for the efficiency of an equilibrium outcome, that of perfect information is the most unrealistic.
- There is no perfect information anywhere about anything, but special problems arise when one party in a transaction knows more than another; this is known as **asymmetric information**.

# Imperfect Information

- George Akerlof analyzed the used-car market, in which there is asymmetry of information between the owner of the used car, who knows its flaws, and the potential customer, who does not.
- But the potential customer understands this disparity and therefore is suspicious of all used cars, suspecting them to be “lemons” their owners wish to dispose of.
- The inefficiency exists for anyone who seeks to sell a used car that is *not a lemon at a decent price*.

# Imperfect Information

- Such asymmetries are rife in market economies. In contractual relationships this is known as the **principal-agent problem, in which someone is hired who does not do what** is best for the employer because of his ability to mislead the ignorant employer

# Imperfect Information

- Such information asymmetries can lead to suboptimizing behavior because of **moral hazard**, especially in the insurance industry.
  - Those most needing insurance **will** seek it out and **will** conceal their need from the insurers, thereby raising rates for those who need insurance less.
  - Those who are insured then may behave more carelessly than they would if they were uninsured.

# Imperfect Information

- There is no easy way out of the dilemmas posed by imperfect information and asymmetries of information.
- However, a possible remedy available to government is simply to increase the amount of relevant information generally available.
- This constitutes an economic efficiency justification for government data-gathering agencies such as the Bureau of Labor Statistics and the Census Bureau

# Imperfect Information

- Another perspective is that the essence of markets is information transmission about relative scarcities through price signals.
- Hayek argues that a central planner can never possess adequate information for carrying out optimal or even remotely intelligent planning.
- Free capitalist markets may suffer from imperfect information, but according to this view, they beat command socialist planning in this regard.
- Decentralized and profit-motivated market capitalists respond to price signals to move the economy along optimally, even though the individual actors possess only limited knowledge.
- But ultimately, the problems of imperfect and asymmetric information remain unresolved for all economic systems.

# THE ROLE OF LABOR UNIONS

- Another issue arising in market capitalist economies is the organization of labor into unions.
- If labor markets are perfectly competitive and lacking in discrimination on characteristics irrelevant to productivity, unions may not contribute to economic efficiency redistribute income to their members and deal with safety, job security, benefits, social functions, and political lobbying for broader social outcomes.
- If they do not offset the monopsonistic power of big firms doing the hiring, their exercising monopolistic power in supplying labor may result in inefficiency

# THE ROLE OF LABOR UNIONS

Table 2-3

Percentages of the Labor Force Belonging to Unions

Country	1955	1975	1995
United States	24.7	21.7	14.2
Japan	n.a.	34	24
Austria	63	59	41.2
Belgium	53	66	n.a.
Denmark	59	67	80.1
Finland	31	75	79.3
France	25	25	9.1
West Germany*	34	33	28.9
Italy	n.a.	47	44.1
Netherlands	38	40	25.6
Norway	54	61	n.a.
Sweden	68	82	91.3
United Kingdom	44	51	32.9

\*Unified Germany after 1991.

# THE ROLE OF LABOR UNIONS

**Table 2-4**  
Days Lost to Labor Disputes (per 1,000 Workers)

Country	1985–1989	1990–1994
United States	86	43
Australia	227	157
Belgium	52	57
Canada	424	231
Denmark	235	37
France	57	30
West Germany	2	23
Italy	300	240
Japan	5	3
Netherlands	9	16
New Zealand	491	105
Norway	135	72
Sweden	121	57
Switzerland	0	1
United Kingdom	180	37

Source: U.S. News & World Report 120(16), April 22, 1996: 18.