

# 3.5 – Introduction to Political Economy

ECON 306 • Microeconomic Analysis • Fall 2022

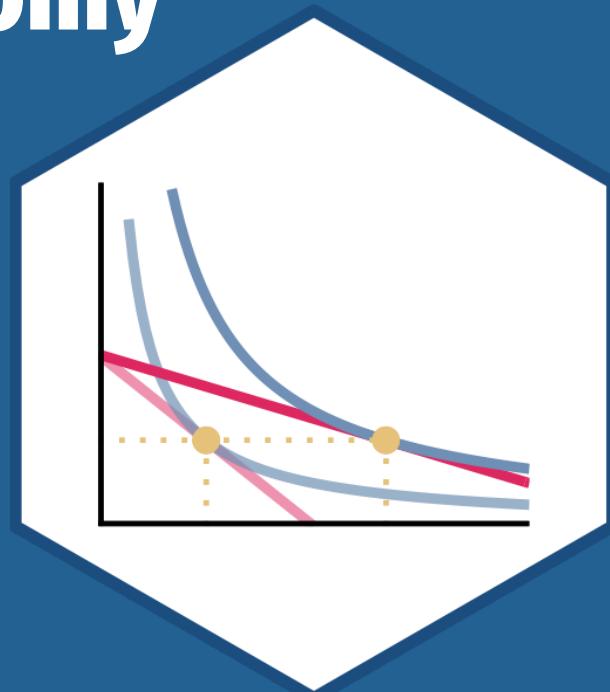
Ryan Safner

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 [ryansafner/microF22](https://github.com/ryansafner/microF22)

 [microF22.classes.ryansafner.com](https://microF22.classes.ryansafner.com)



# Outline

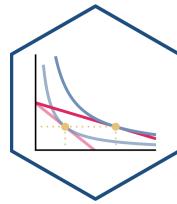


Policies That Raise Transaction Costs & Prevent Equilibrium

An Example: Some Economic Impacts of Covid

Making Fair Comparison

# Welfare Economics, Reminder



- **Markets are great when:**

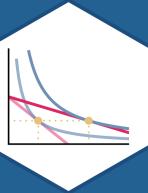
1. They are **Competitive**: many buyers and many sellers
2. They reach **equilibrium (prices are free to adjust)**: absence of transactions costs or policies *preventing prices from adjusting* to meet supply and demand
3. **There are no externalities<sup>†</sup>**: costs & benefits are fully internalized by the parties to transactions

- **Market failure**: if these conditions are not met

- May be role for governments, other institutions, or entrepreneurs to fix

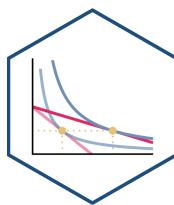


<sup>†</sup> Or public goods, or asymmetric information. But I treat these as special cases of more common externalities.

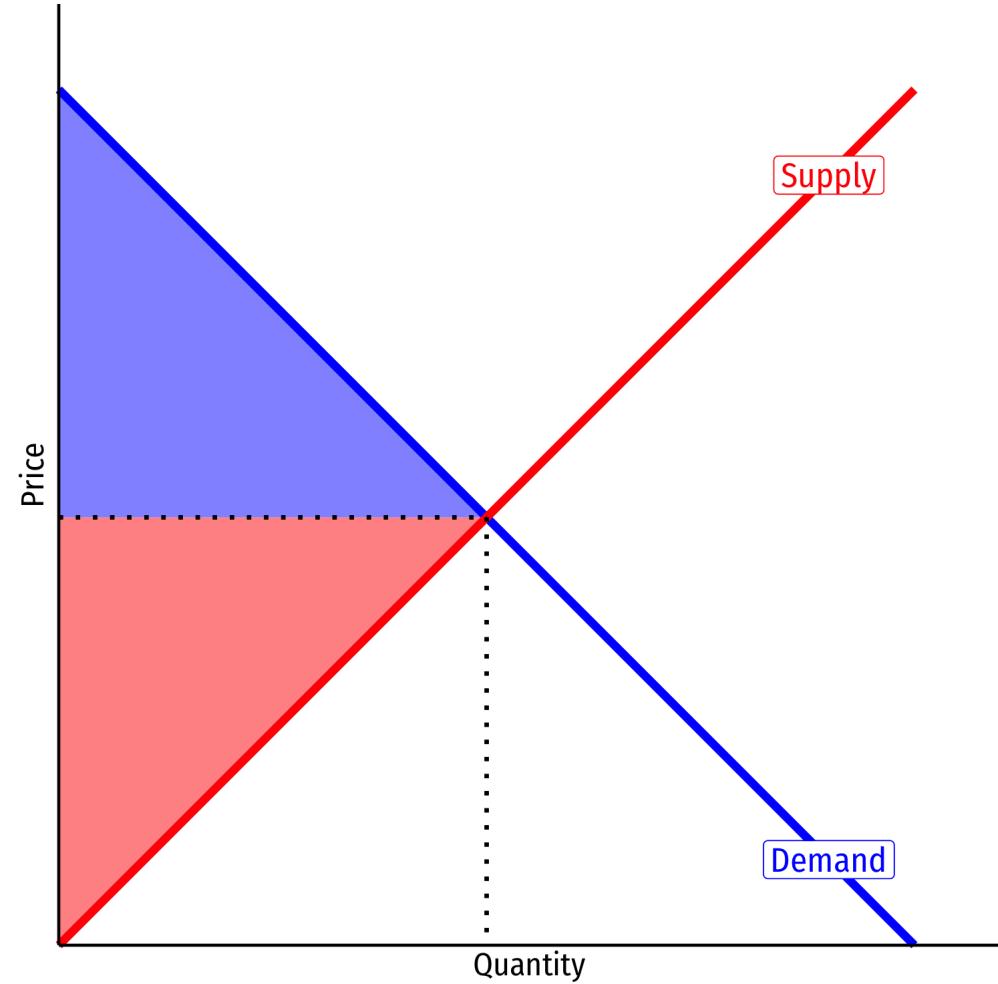


# Policies That Raise Transaction Costs & Prevent Equilibrium

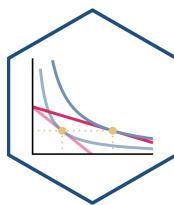
# Dis-equilibrated Markets



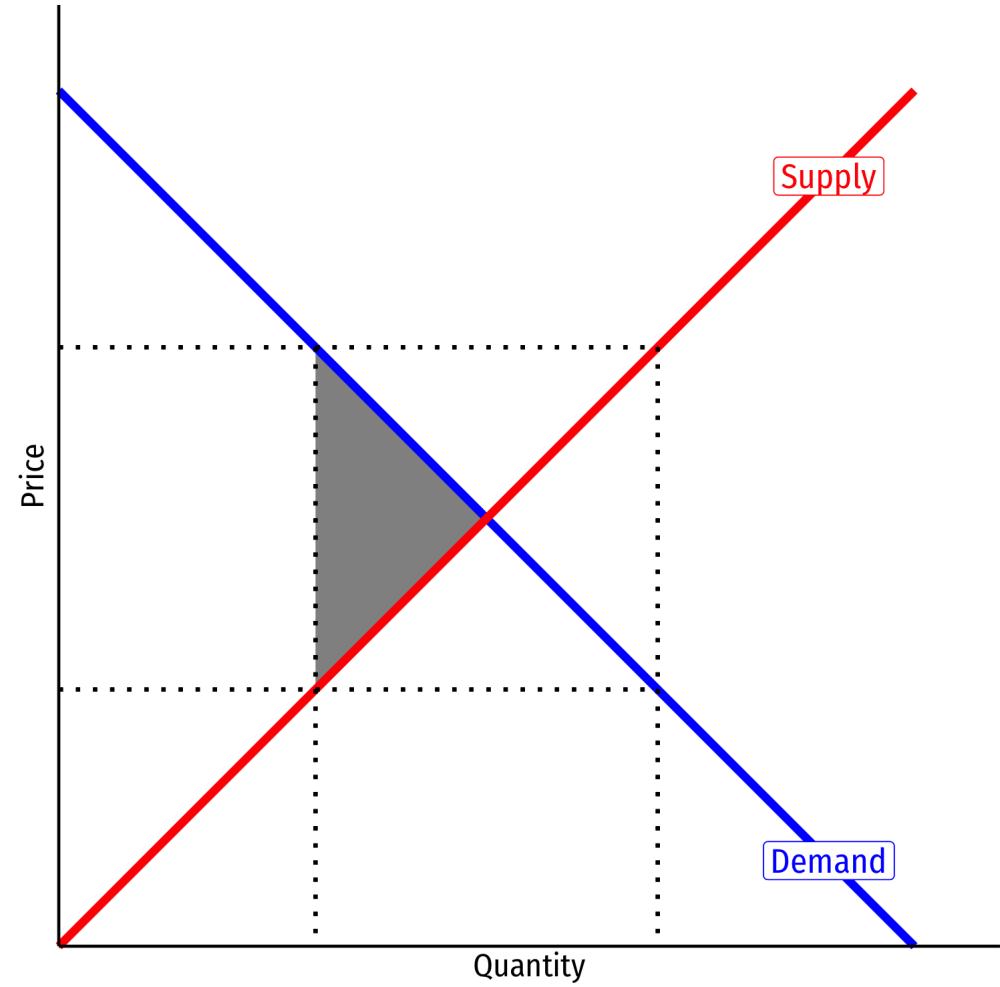
- The **static benefits** of markets all come from markets **being in equilibrium** ([class 3.3](#)):
  - allocative efficiency (CS+PS)
  - Pareto efficiency
  - productive efficiency
- But don't forget the **dynamic benefits** of markets as a **discovery process!** ([class 3.4](#))
  - *discovery* of better allocations of resources
  - creation & elimination of profit opportunities
  - entrepreneurship & innovation



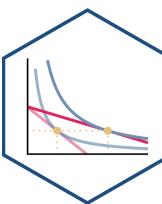
# Dis-equilibrated Markets



- To *reach* equilibrium, market prices need to be able to adjust
  - **Shortage** ( $Q_s < Q_d$ ): price needs to rise
  - **Surplus** ( $Q_s > Q_d$ ): price needs to fall
- There are ***unrealized gains from trade*** that exist in disequilibrium (shaded)
  - **Buyers & sellers** both can be made better off if they can adjust the price

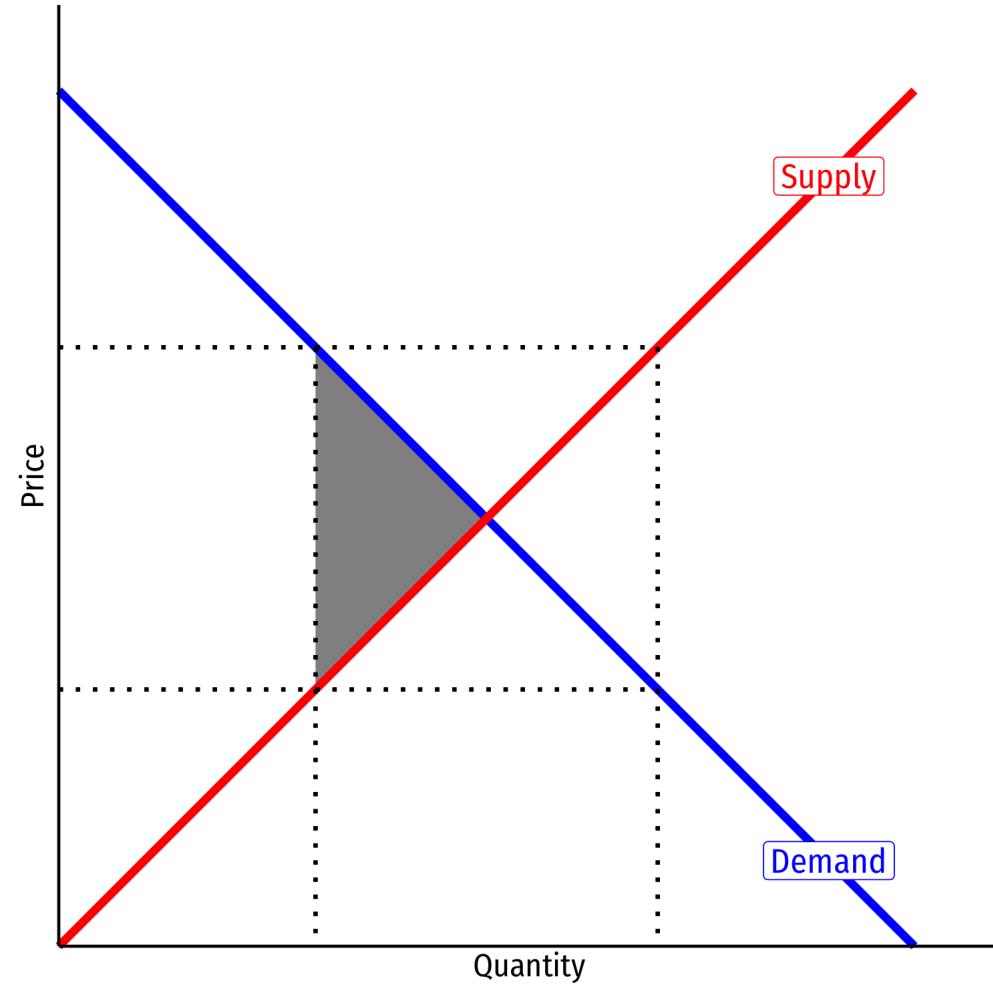


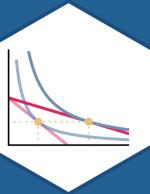
# Dis-equilibrated Markets



- If market prices are *prevented* from adjusting, shortage/surplus becomes *permanent*
- Lost CS and/or PS: **Deadweight loss (DWL)**
  - **inefficiency** created by (permanent) diseq.
- Various government policies can prevent markets from equilibrating & create DWL:
  - **Price regulations** (price ceiling like rent control, price floor like minimum wage)
  - **Taxes, subsidies, tariffs, quotas<sup>†</sup>**
  - These should have been covered in Principles (see my [slides](#) on taxation from ECON 410)

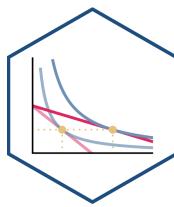
<sup>†</sup> Some may be necessary (taxes fund government), but create market inefficiencies.





# An Example: *Some* Economic Impacts of Covid

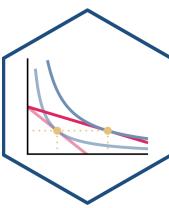
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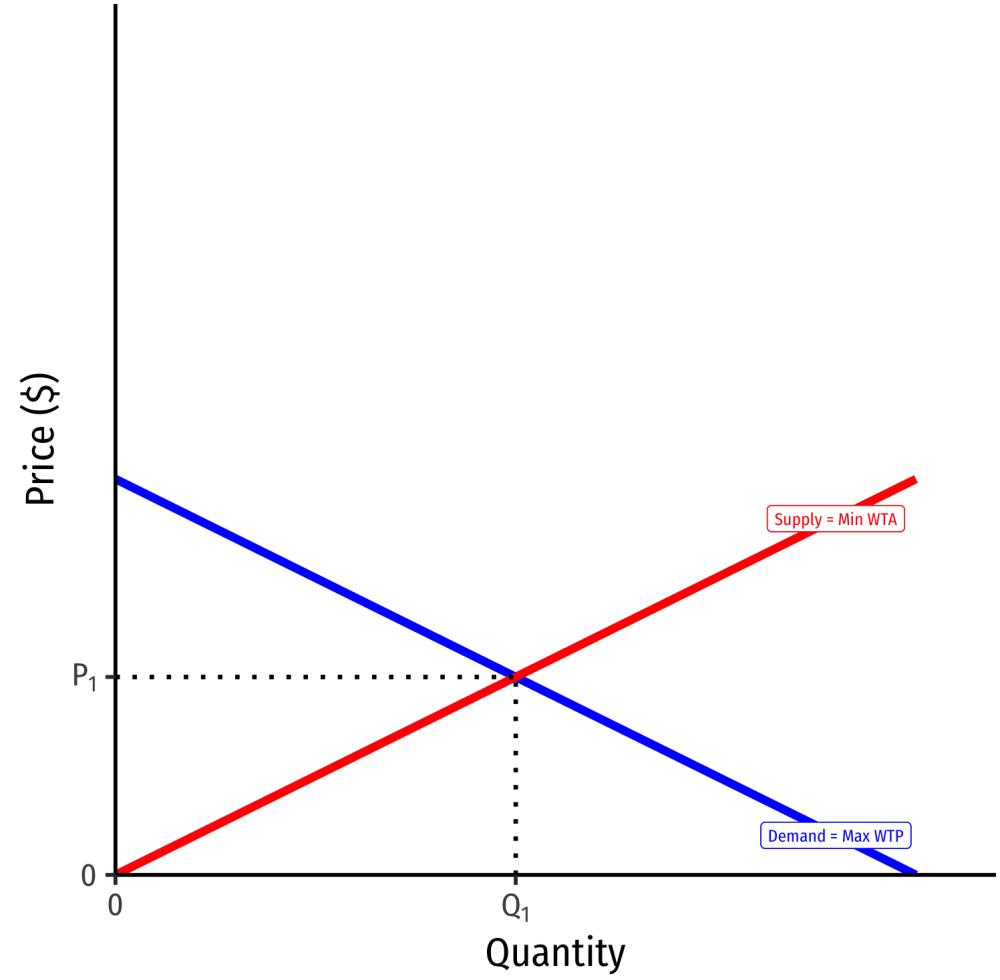
The toilet paper aisle of my Giant grocery store, March 2020

- Where did all of the ... go?
  - Toilet paper
  - Hand sanitizer
  - Masks
  - PPE
  - Ventilators
- Three major issues:
  - price elasticity of supply
  - price gouging laws
  - restrictions & regulations on supply

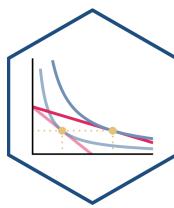
# Increase in Demand



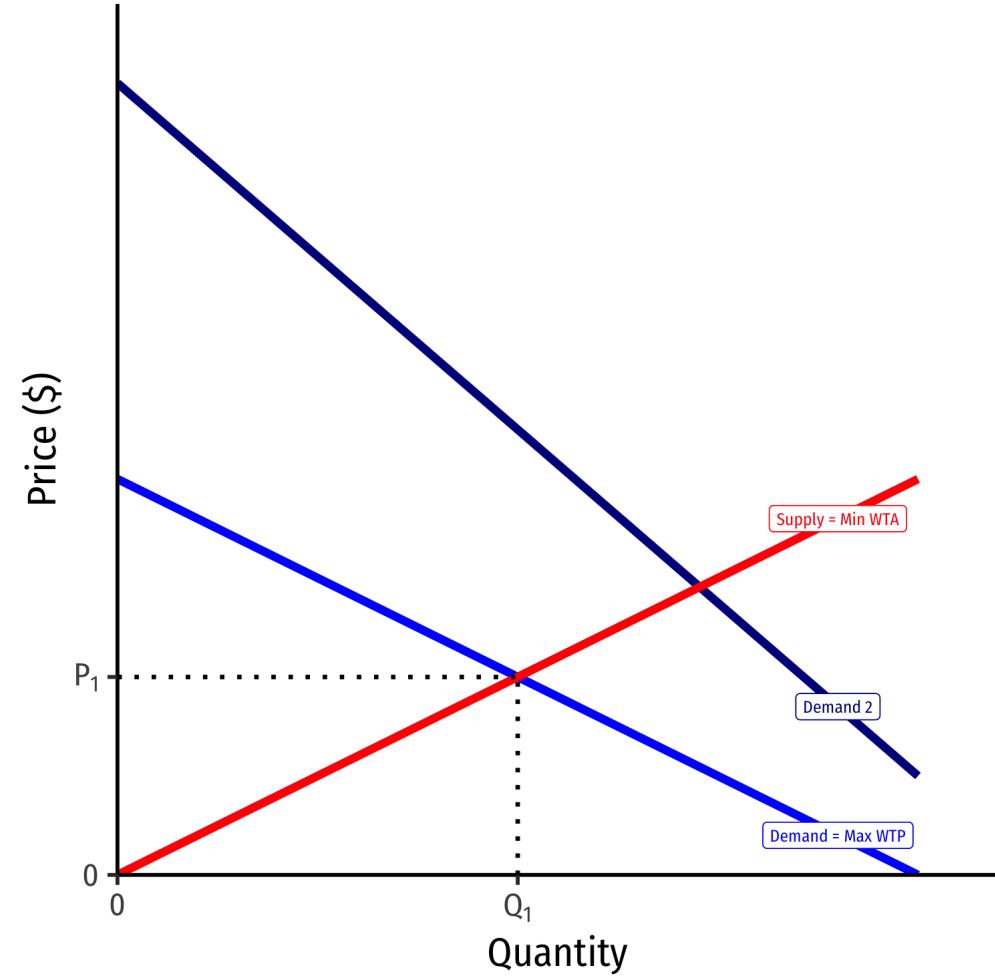
- Consider a market for a good in equilibrium,  $P_1$



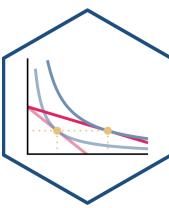
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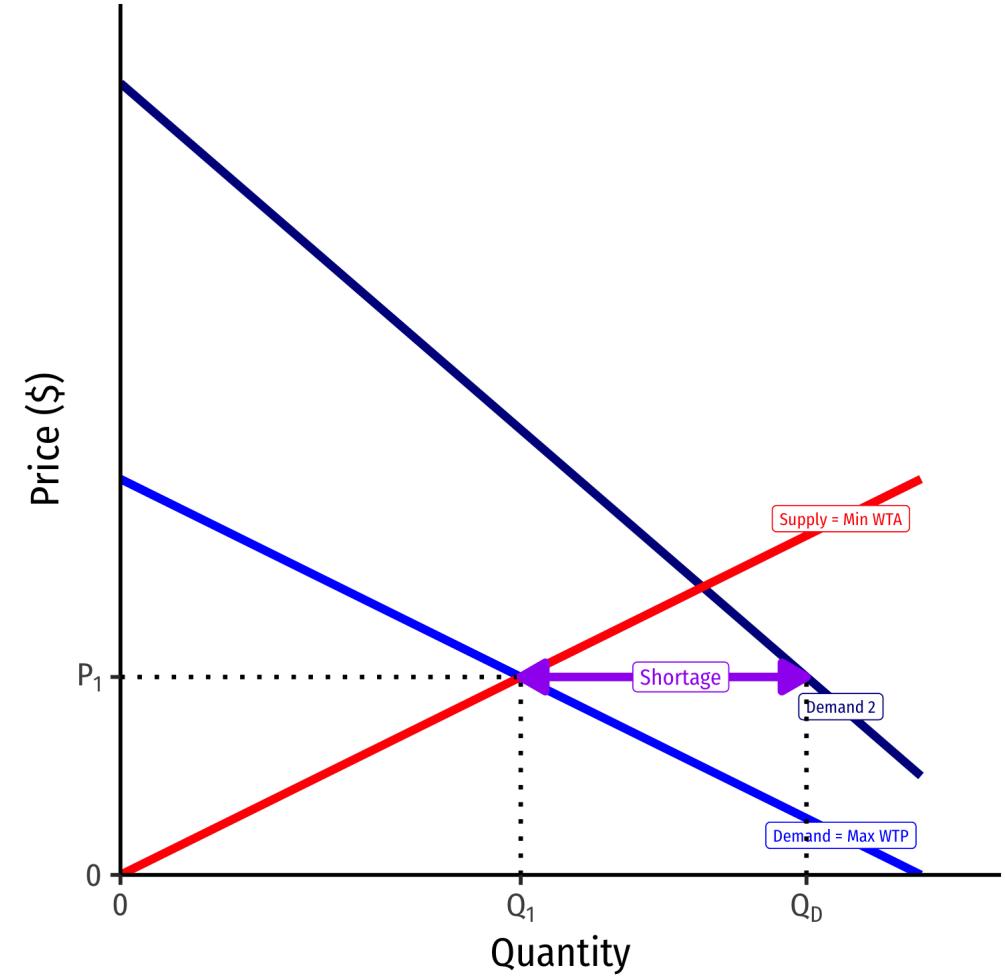
- More individuals want to buy more of the good at *every* price
- Demand *increases*, becomes *less elastic*



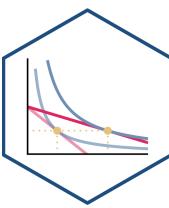
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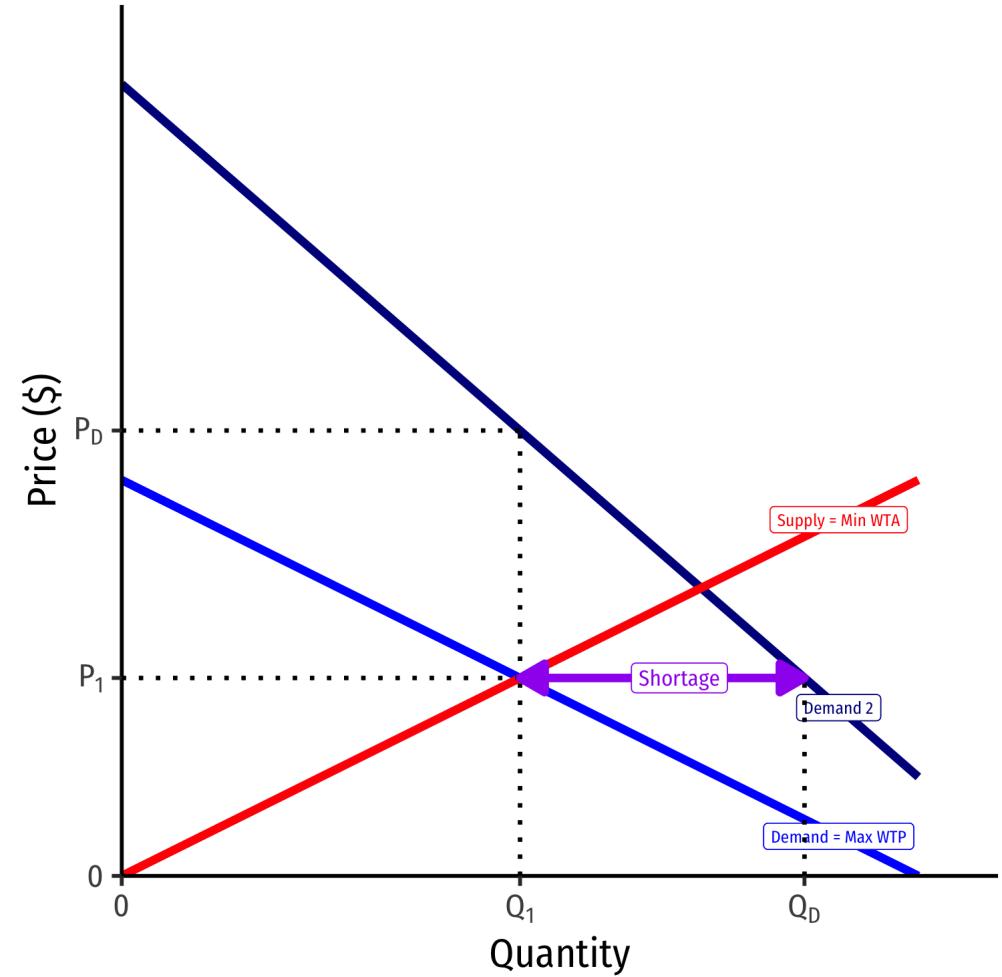
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- At the original market price, a **shortage!**  
 $(q_D > q_S)$



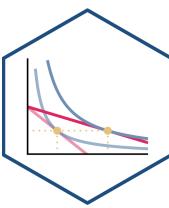
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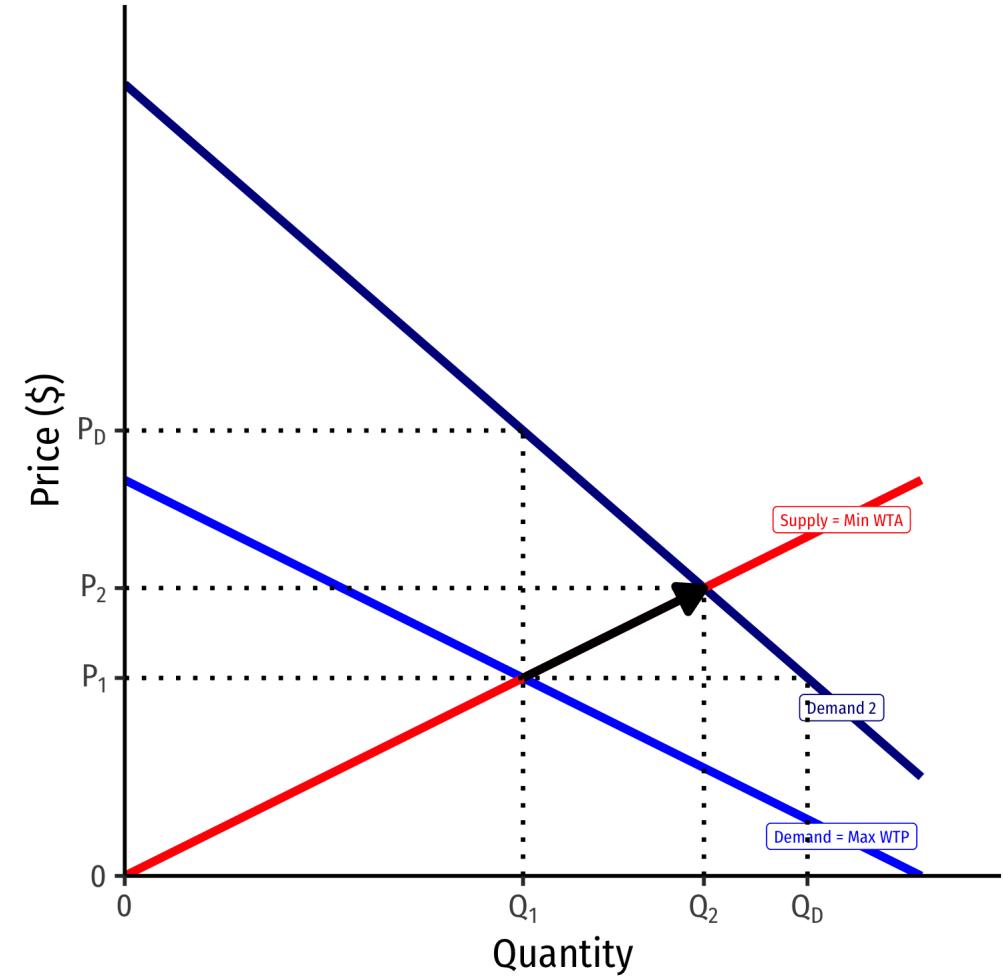
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- **Sellers** are supplying  $Q_1$ , but some **buyers** willing to pay more for  $Q_1$



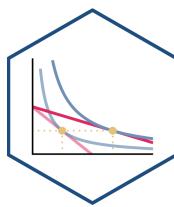
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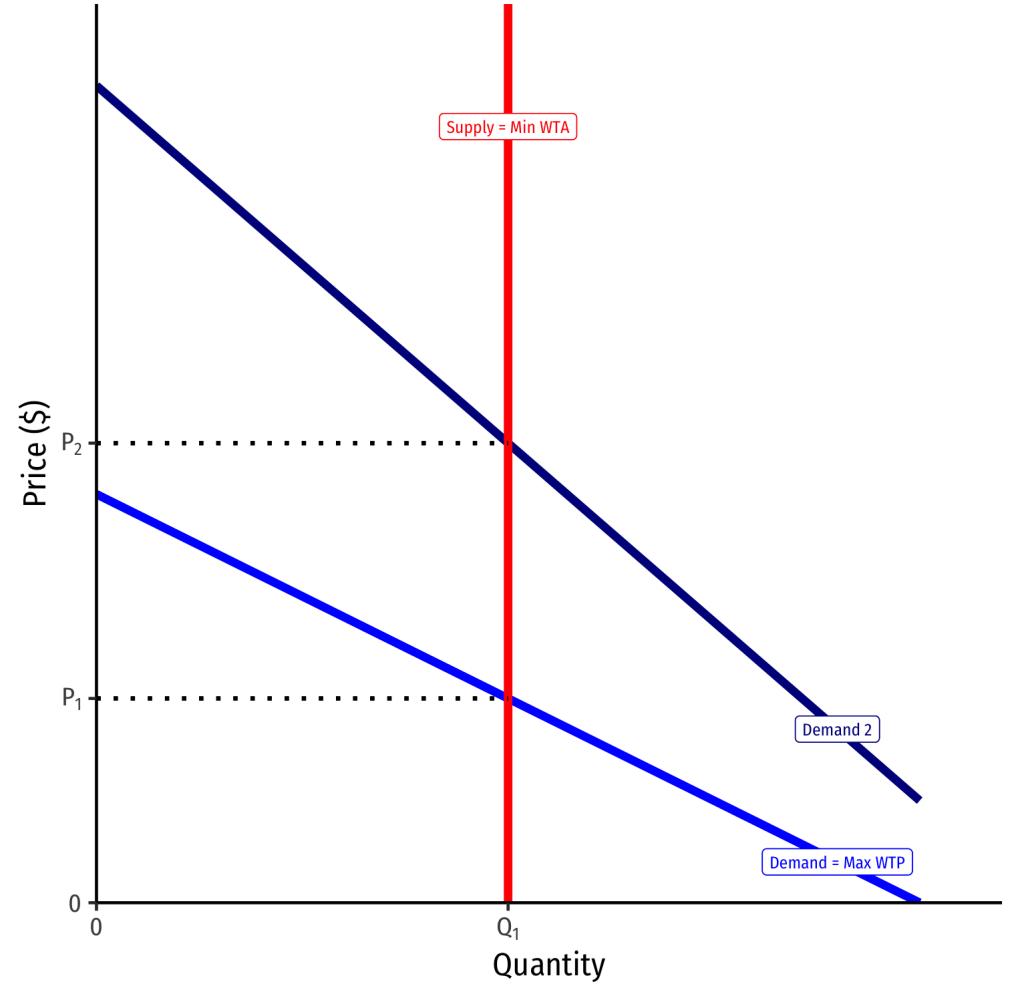
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- **Sellers** are supplying  $Q_1$ , but some **buyers** willing to pay more for  $Q_1$
- **Buyers** raise bids, inducing **sellers** to sell more
- Reach new equilibrium with:
  - **higher market-clearing price** ( $P_2$ )
  - **larger market-clearing q. exchanged** ( $Q_2$ )



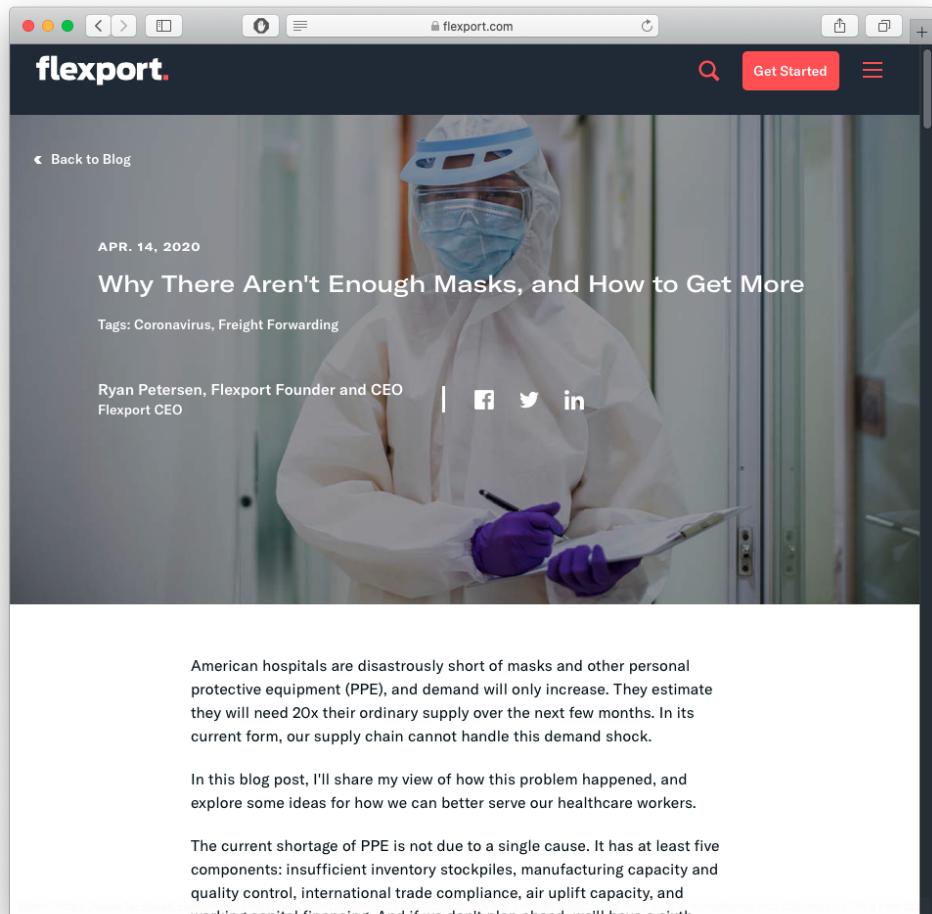
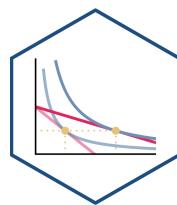
# One Possibility: Inelastic Supply



- It might that **supply** is very *inelastic*
  - Here: *perfectly* inelastic (for convenience)
- Suppliers can't produce and sell more units even if they want to at very high price demanded
  - sudden shock to inventories (short run)
  - rising production costs
  - government regulations & restrictions
- Thus, the new high price is an equilibrium that will persist for a while
  - no “inefficiency,” just a fixed supply of goods we cannot easily change



# One Possibility: Inelastic Supply



flexport.

Get Started

Back to Blog

APR. 14, 2020

## Why There Aren't Enough Masks, and How to Get More

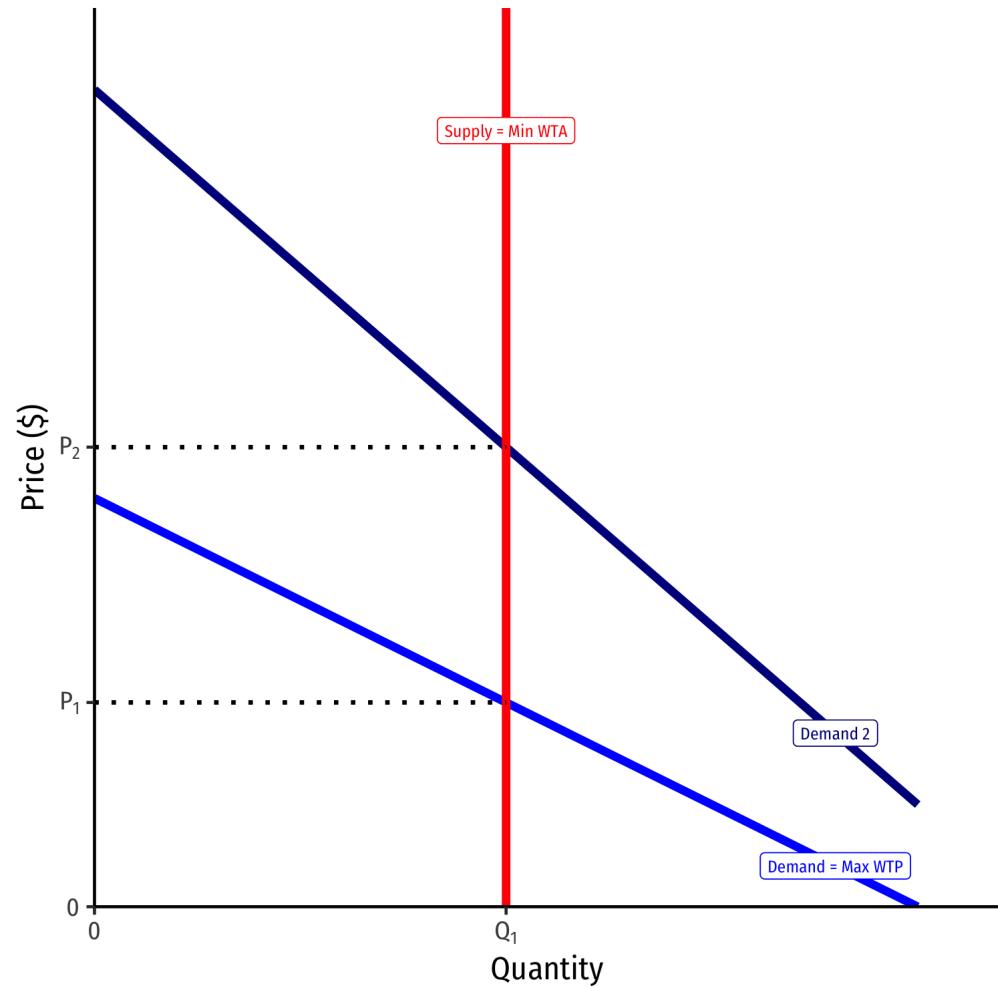
Tags: Coronavirus, Freight Forwarding

Ryan Petersen, Flexport Founder and CEO | [f](#) [t](#) [in](#)

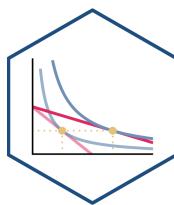
American hospitals are disastrously short of masks and other personal protective equipment (PPE), and demand will only increase. They estimate they will need 20x their ordinary supply over the next few months. In its current form, our supply chain cannot handle this demand shock.

In this blog post, I'll share my view of how this problem happened, and explore some ideas for how we can better serve our healthcare workers.

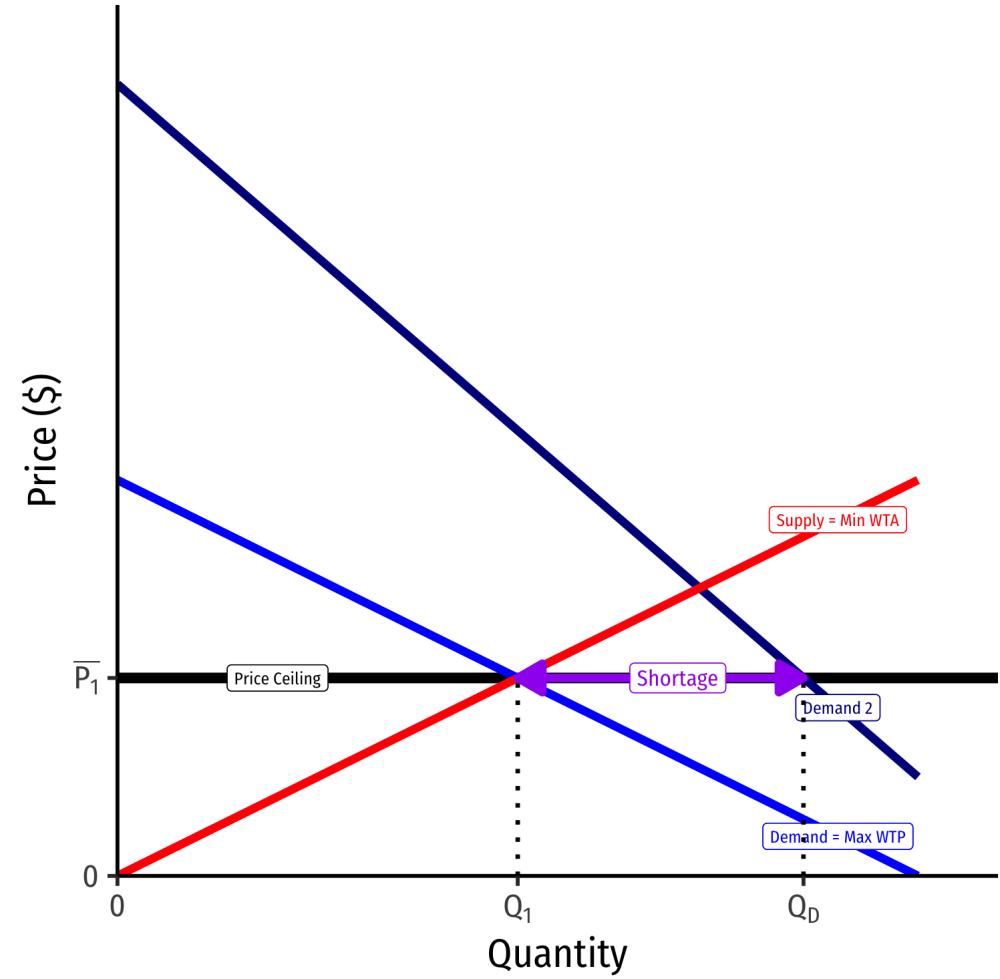
The current shortage of PPE is not due to a single cause. It has at least five components: insufficient inventory stockpiles, manufacturing capacity and quality control, international trade compliance, air uplift capacity, and working capital financing. And if we don't plan ahead, we'll have a sixth.



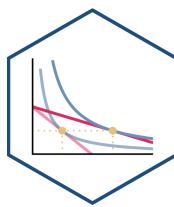
# Price Gouging Laws



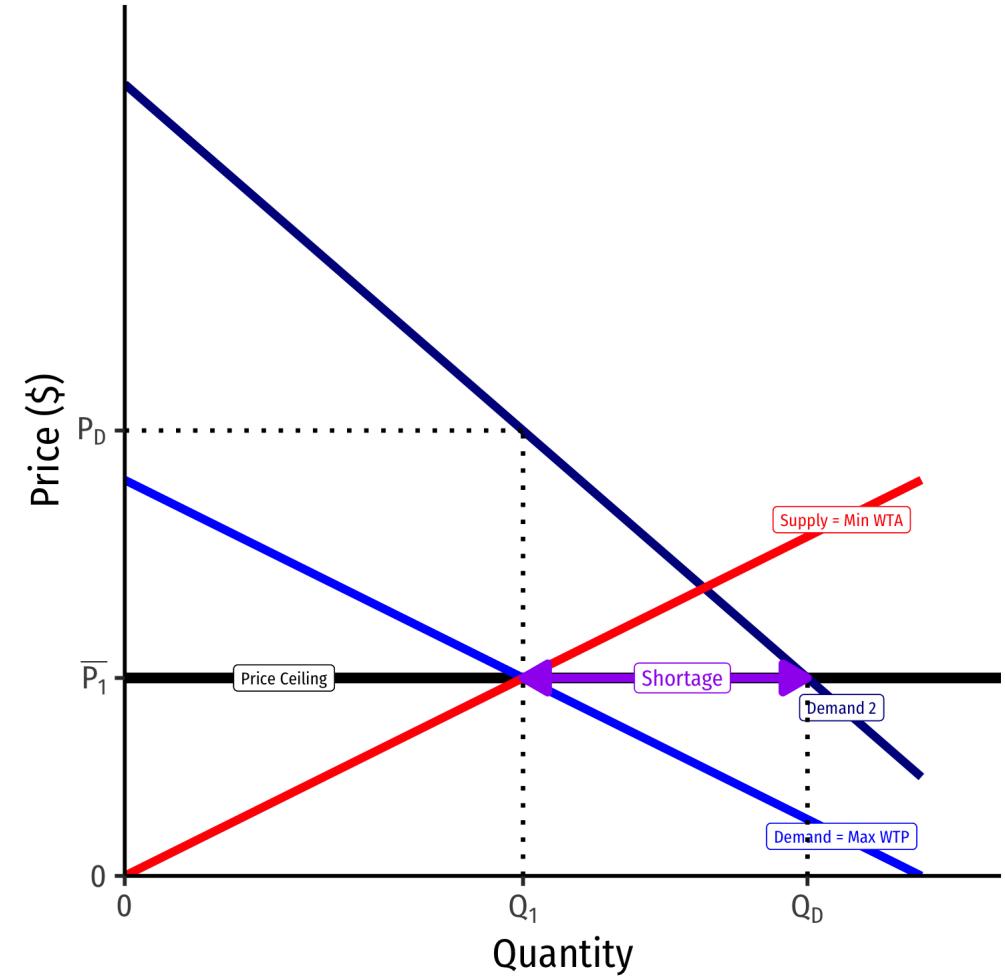
- Additionally, government has **anti-price-gouging laws**, a **price ceiling** at the original price,  $P_1$
- $Q_d > Q_s$ : **excess demand**, a **shortage**!
- Sellers will not supply more than  $Q_1$  at price  $\bar{P}_1$



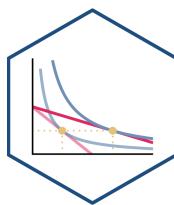
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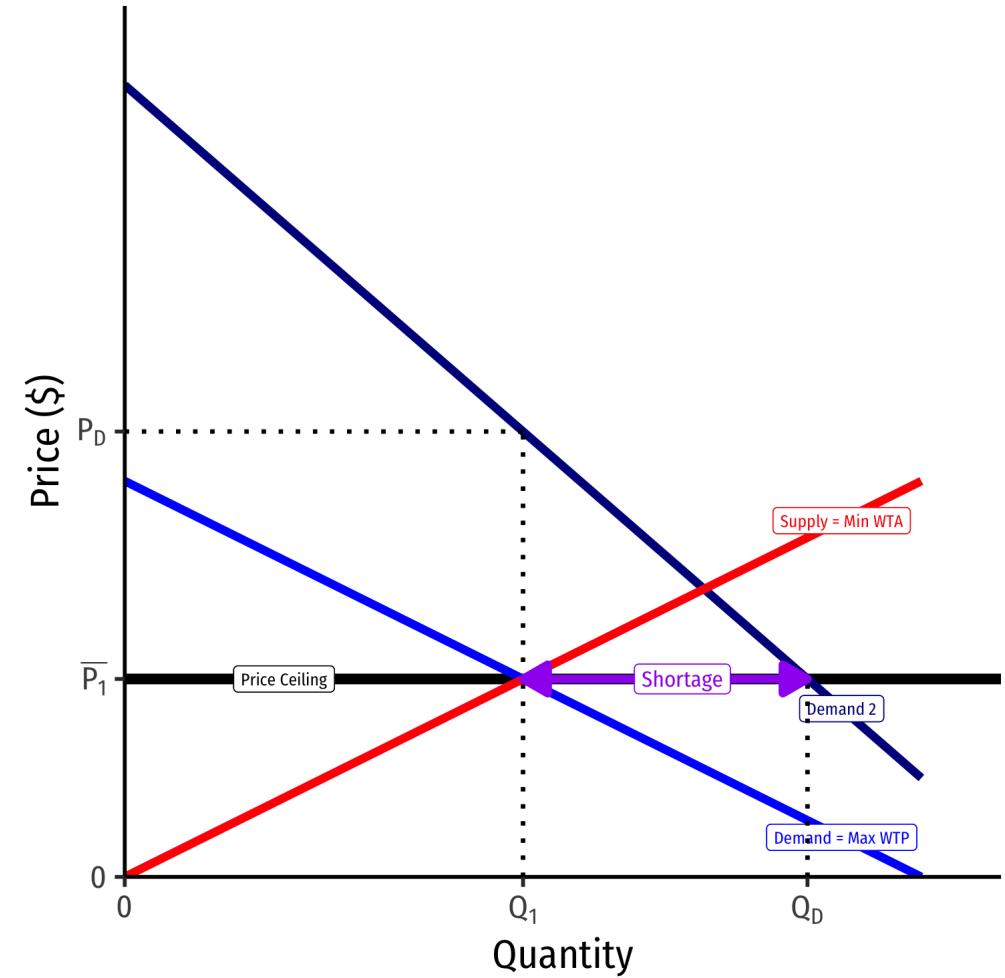
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- $Q_d > Q_s$ : **excess demand**, a **shortage**!
- Sellers will not supply more than  $Q_1$  at price  $\bar{P}_1$
- For  $Q_1$  units, buyers are willing to pay  $P_D$ !



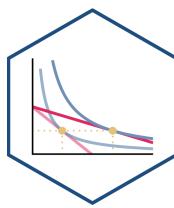
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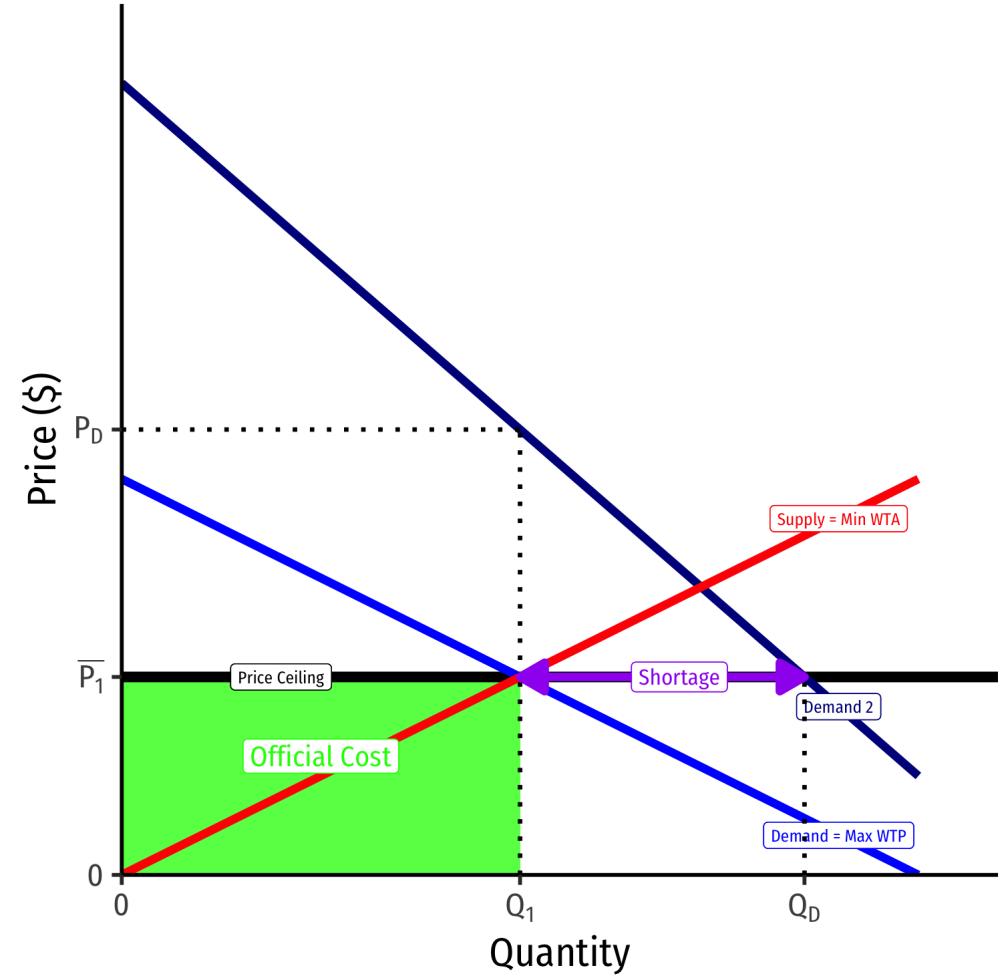
- If prices were allowed to adjust: buyers would bid higher prices to get the scarce  $Q_s$  goods
- Sellers would respond to rising willingness to pay, and produce and sell more
- But the price is not allowed to rise above  $\bar{P}_1$ !



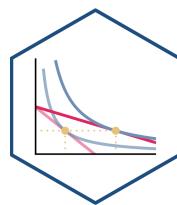
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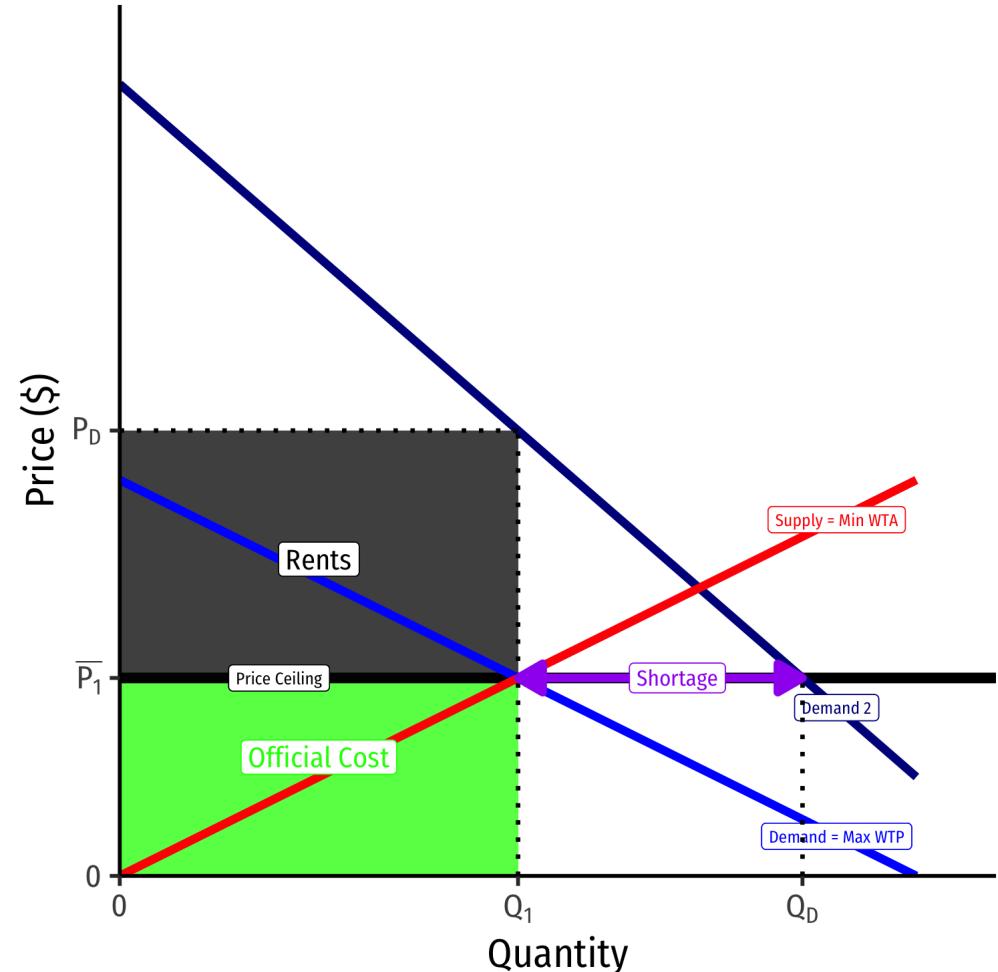
- Official price is  $\overline{P_1}$ , sellers gain monetary revenues



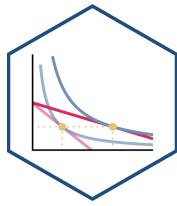
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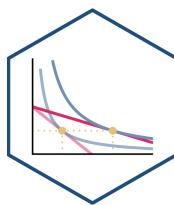
- Official price is  $\overline{P_1}$ , sellers gain **monetary revenues**
- Competition exists between buyers to obtain scarce  $Q_s$  goods
  - Buyers willing to pay  $P_D$  *unofficially*
- Goods are distributed by non-market means:
  - Queuing
  - Black markets
  - Political connections, favors, corruption
- **Economic rents:** excess returns (above opp. cost) to those who own the scarce goods



# Forms of Rents



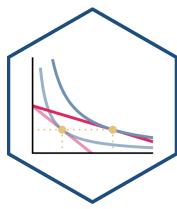
# (Temporarily) Raising Prices Can Solve the Shortage



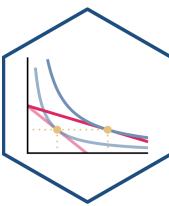
A relatively high price:

- **Conveys information:** good is relatively scarce
- **Creates incentives for:**
  - **Buyers:** conserve use of this good, seek substitutes
  - **Sellers:** produce more of this good
  - **Entrepreneurs:** find substitutes and innovations to satisfy this unmet need

# (Temporarily) Raising Prices Can Solve the Shortage



# (Temporarily) Raising Prices Can Solve the Shortage



Birger

@Birger\_s · Follow



A supermarket in Denmark got tired of people hoarding hand sanitizer, so came up with their own way of stopping it.

1 bottle kr40 (€5.50)

2 bottles kr1000 (€134.00) each bottle.

Hoarding stopped!

#COVID19 #Hoarding pic.twitter.com/eKTabEjScc (via @\_schuermann) cc @svenseele

2:28 AM · Mar 18, 2020



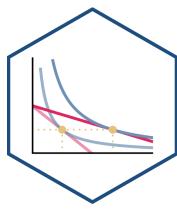
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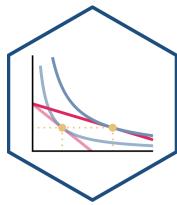
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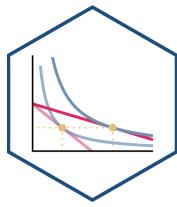
# Supply-Side Restrictions & Regulatory Burden



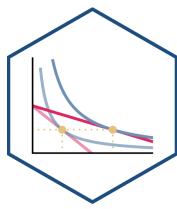
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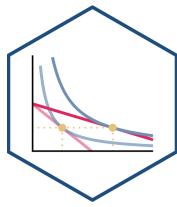
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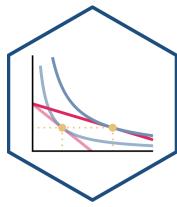
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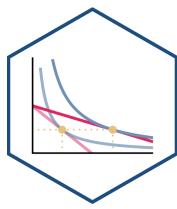
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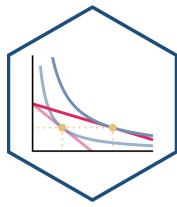
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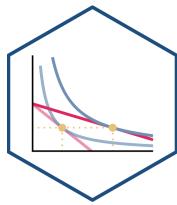
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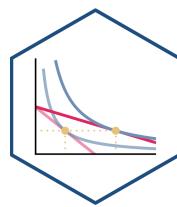
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# Supply-Side Restrictions & Regulatory Burden



Skip Tognetti 🍻  
@togneter · [Follow](#)



Honestly, I'm not sure people completely understand how small distilleries, generally with VERY little capital on hand, are changing their business models in just a week. We appreciate the outpouring of love. We're working like crazy to get what we need to make more sanitizer.

12:40 PM · Mar 25, 2020 from Seattle, WA



[Read the full conversation on Twitter](#)

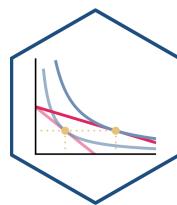
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# Supply-Side Restrictions & Regulatory Burden



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Replying to @togneter

Meanwhile, we're being required to denature the alcohol to make it not drinkable...so that it doesn't get TAXED AS AN ALCOHOLIC BEVERAGE, just in case you wanted to drink a 160-proof ethanol/glycerin/hydrogen peroxide cocktail. But denaturing agents are nearly impossible to find.



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There is literally no medical reason to denature. Taxation. That's it.

In WA, that means if I sell a liter for \$10, which I'm barely covering my costs on, the tax owed between state and federal governments is EIGHT DOLLARS AND TWENTY THREE CENTS.

And yet...

12:40 PM · Mar 25, 2020 from Seattle, WA

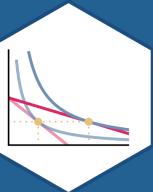


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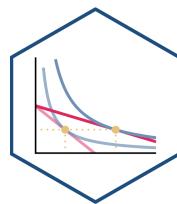
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# Making Fair Comparisons

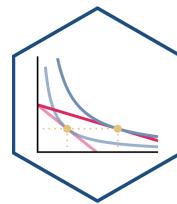
# Government Failure & Market Failure



- We've talked about **market failure** under certain conditions
- However there is also **government failure**
  - corruption, rent-seeking, voter ignorance, voter irrationality, special interest groups, regulatory capture
- So stop comparing *ideal* institutions in theory and see how *they work in practice*
- Learn more in my [Public Economics](#) course



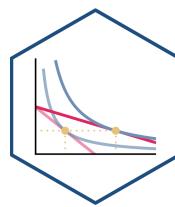
# Economic Theory *Assumes* Good Institutions



- Markets & price theory: how consumers & producers specialize, produce, & exchange within **given, well-functioning markets (& politics)**
- **Assumes** existence of "good" economic & political institutions that facilitate market exchange
  - low transaction costs
  - clear and enforced property rights
  - rule of law
  - contract enforcement
  - capable, high-capacity, non-corrupt government
  - dispute resolution



# Two Fundamental Problems of Political Economy

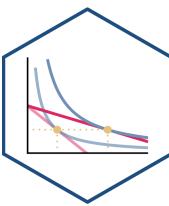


- All societies face two fundamental problems, which institutions emerge (or are created) to address:

**The Knowledge Problem:** How to coordinate the *tacit, fragmented* knowledge of opportunities and conditions *dispersed* across millions of individuals (and accessible to none in total) in order to maximize the ability of individuals to achieve their goals

**The Incentives Problem:** How to structure incentives that individuals face in a way that maximizes cooperative behavior (voluntary exchange and association) and minimizes non-cooperative behavior (cheating, opportunism, exploitation, violence, rent-seeking)

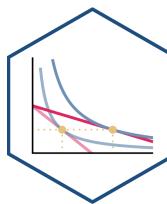
# Robust Political Economy



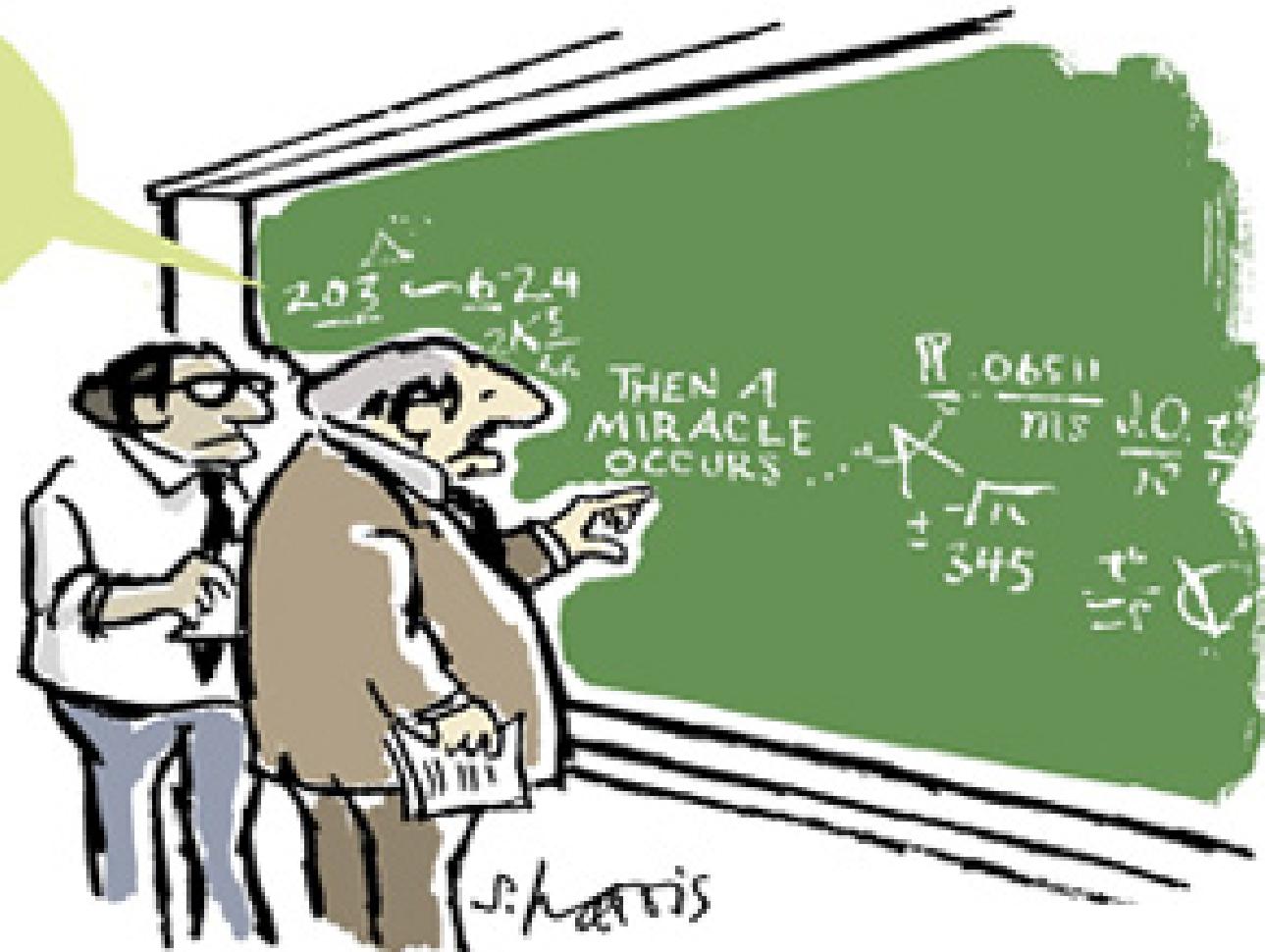
- **No system is perfect**
- We need to find arrangements that are **robust** to knowledge & incentive problems
- **Easy (unpersuasive) case:** perfect information & pure benevolence
  - every system works *in theory!*
- **Hard (persuasive) case:** uncertainty & selfish behavior
  - what works best *in practice?*
- Treat people as they are: sometimes good, bad, smart, stupid, opportunistic, altruistic, *depending on the institutions they face!*



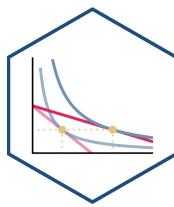
# Robust Political Economy



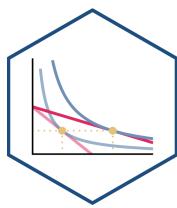
I THINK YOU  
SHOULD BE MORE  
SPECIFIC HERE IN  
STEP TWO



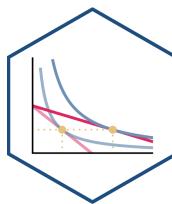
# A Bad Argument for Markets



# A Better, Comparative, Argument for Markets



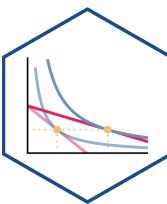
# Robust Political Economy



- People often recommend optimal policies as if they could be installed by a **benevolent dictator**
  - A dispassionate ruler with **total control**, **perfect information**, and **selfless incentives** to implement optimal policy
  - A “**1<sup>st</sup>-best solution**”
- In reality, **1<sup>st</sup>-best** policies are distorted by the knowledge problem, the incentives problem, and politics
  - Real world: **2<sup>nd</sup>-to- $n^{\text{th}}$ -best outcomes**



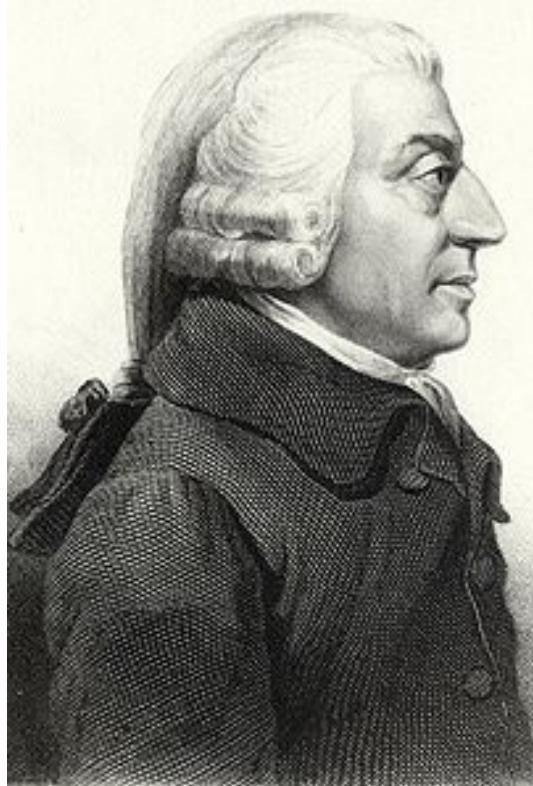
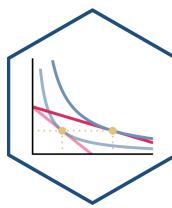
# Comparative Institutional Analysis



- Compare imperfections of *feasible* and *relevant alternative* systems
  - **The “Nirvana Fallacy”:** comparing an imperfect system in reality with an ideal system in theory
- Economics: *think on the margin!*
  - One system's “failure” does not automatically imply another will be “successful”!
  - Real world requires **tradeoffs**
  - “economics puts parameters on people's utopias”
  - “compared to what?”



# Institutions: Operationalizing Adam Smith



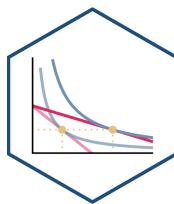
“[Though] he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention...By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it,” (Book IV, Chapter 2.9).

Smith, Adam, 1776, *An Enquiry into the Nature and Causes of the Wealth of Nations*

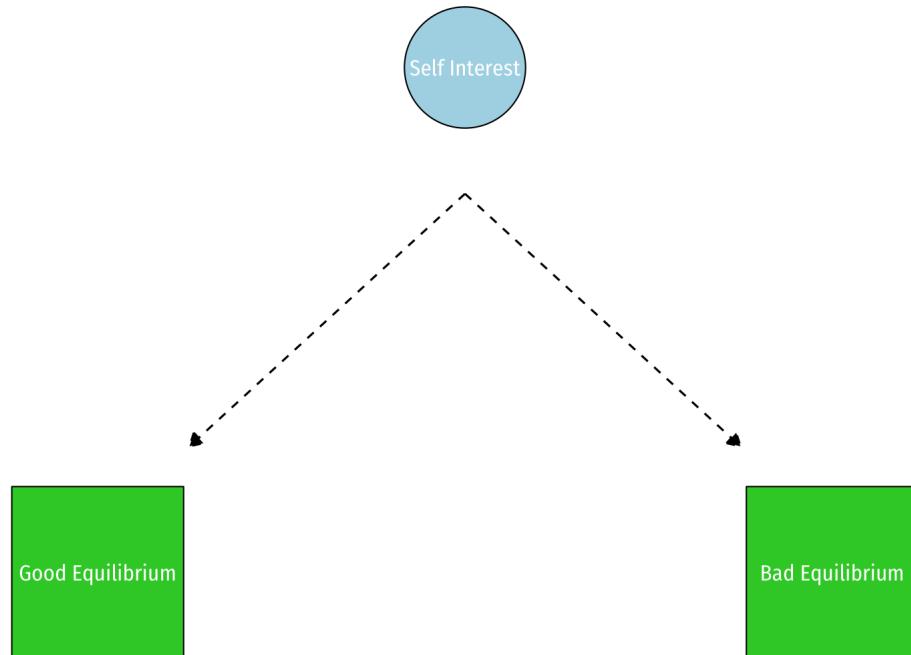
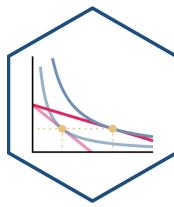
Adam Smith

1723-1790

# Self-Interest Doesn't Always Benefit Society

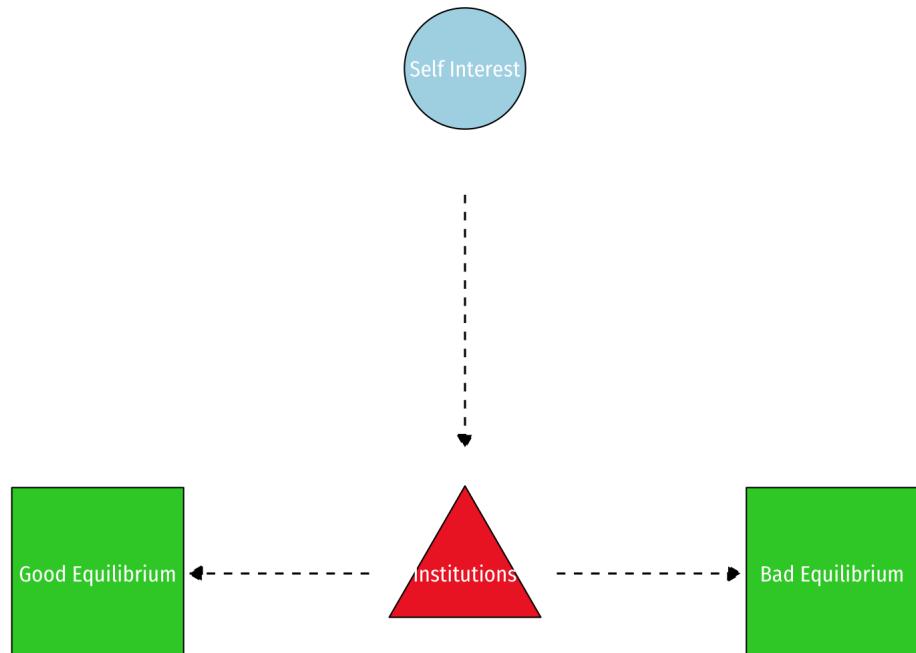
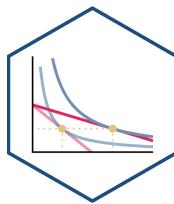


# Institutions: Operationalizing Adam Smith



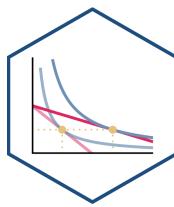
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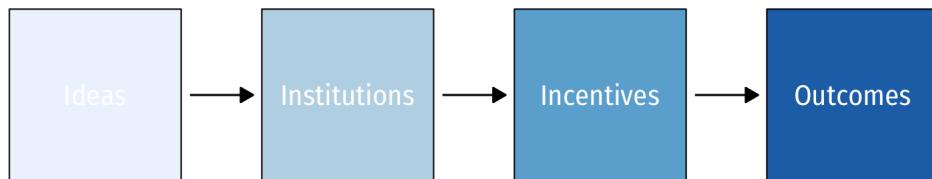
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# A Logical Framework for Political Economy

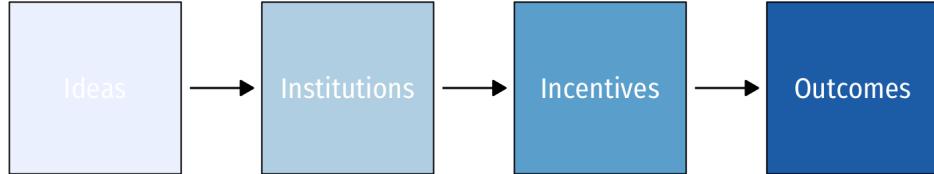
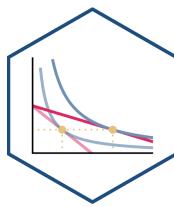


- **Outcomes:**

- relative level of wealth or poverty
- relative level of equality or inequality
- stability of politics, finance, macroeconomy

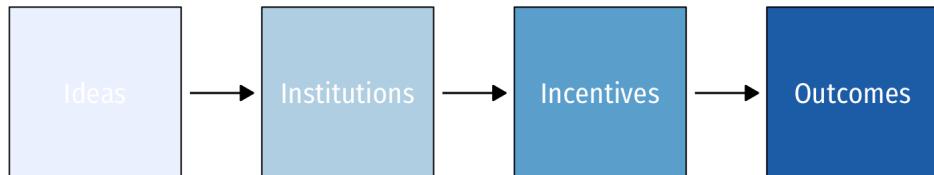
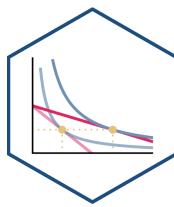


# A Logical Framework for Political Economy



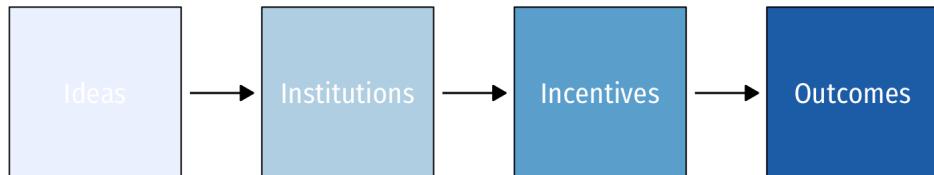
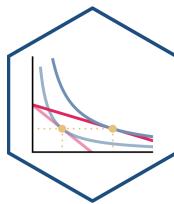
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  - profits and losses
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# A Logical Framework for Political Economy



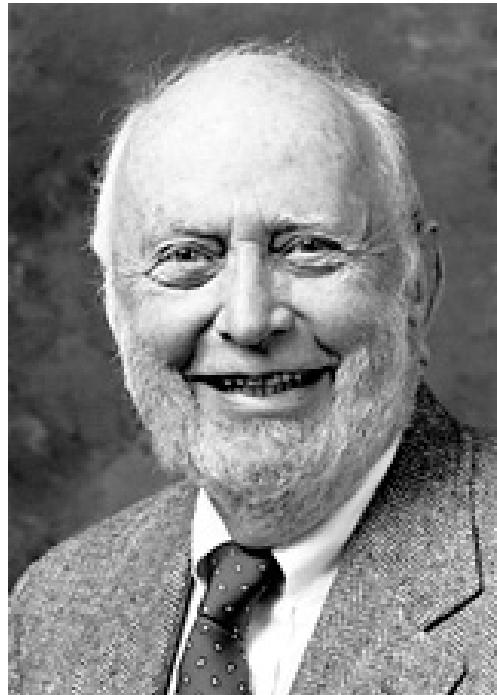
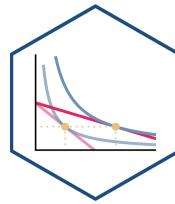
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  - (in)equality before the law or corruption
  - constraints on politics and economics

# A Logical Framework for Political Economy



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  - (in)equality before the law or corruption
  - constraints on politics and economics
- ...are determined by **Ideas:**
  - political and social worldview -"isms"
  - which groups (should) have status

# What are Institutions?



Douglass C. North

1920-2015

Economics Nobel 1993

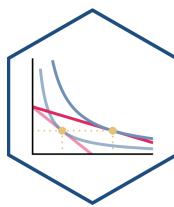
“Institutions are the humanly devised constraints that structure political economic and social interaction. They consist of both informal constraints (sanctions, taboos, customs, traditions, and codes of conduct), and formal rules (constitutions, laws, property rights),”  
(p.10)

“Institutions are the rules of the game in a society,”  
(p.1).

North, Douglass C. (1991), "Institutions," *Journal of Economic Perspectives* 5(1): 97-112.

North, Douglass C. (1990), *Institutions, Institutional Change, and Economic Performance*

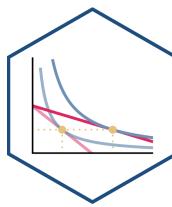
# Incentives are Structured by Institutions



“Who needs this nail?”

“Don't worry about it! The main thing is that we immediately fulfilled the plan for nails!”

# Institutions Channel Entrepreneurship



William Baumol

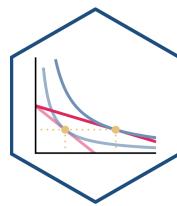
1922-2017

"If entrepreneurs are defined, simply, to be persons who are ingenious and creative in finding ways that add to their own wealth, power, and prestige, then it is to be expected that not all of them will be overly concerned with whether an activity that achieves these goals adds...to the social product," (pp.897-898).

"The rules of the game that determine the relative payoffs to different entrepreneurial activities do change dramatically from one time and place to another. Entrepreneurial behavior changes direction from one economy to another in a manner that corresponds to the variations in the rules of the game," (p.898).

Baumol, William J. (1990), "Entrepreneurship: Productive, Unproductive, and Destructive," *Journal of Political Economy* 98(5): 893-

# Profit Seeking and Rent Seeking



**Productive entrepreneurship**

Profits from serving customers



**Unproductive  
entrepreneurship**

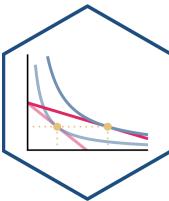
Rents from political  
privileges



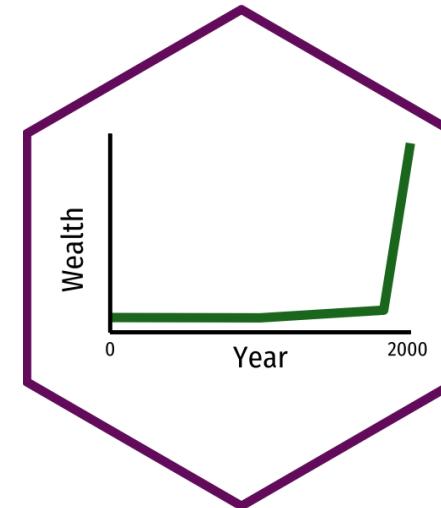
**Destructive  
entrepreneurship**

Loot from theft and  
violence

# For More



ECON 410 – Public Economics

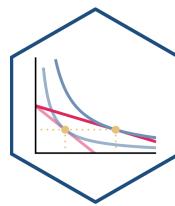


ECON 317 –  
Economics of  
Development



ECON 315 –  
Economics of the  
Law

# A Parting Note on Political Economy



“The first lesson of economics is scarcity: There is never enough of anything to satisfy all those who want it. The first lesson of politics is to disregard the first lesson of economics.”

“There are no solutions, there are only tradeoffs.”

Thomas Sowell

1972-