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A Primer On Economics

This primer is written by Steve Szeghi. For discussions with illustrations see the blog "Towards a Moral Economy"http://mecteam.blogspot.com/search/label/EE

Standard economic theory has frequently been invoked by market fundamentalists and libertarians to justify positions which do not follow a priori. These positions center on the notion that all problems are solvable by the market. They further suggest that all problems that are solvable by the market should be solved by the market because the market is better at solving problems than government, community or civil society. It is implicit in these notions that the market is superior to alternative means of allocation and that private ownership is superior to public or common ownership. Market fundamentalism strongly suggests a diminished or non-existent role for the government, for civic organizations, and for society as a whole. Market fundamentalism subtly intones that standard economic theory is in accordance with its positions and with what those positions imply. But standard theory does not suggest the things which market fundamentalism intones. This constitutes a misuse of theory or an attempted hijacking of the same.

This chapter sets out in specific terms what standard economic theory has proven, the assumptions made for those proofs and what theory has not proven in relation to market success and market failure. In other words, it shows what markets can accomplish and what they can not. This chapter does not attempt to present a litany of the limitations, of which there are many (cultural, cosmological, social) in economic theory or to set out a means by which theory itself could be improved.

Don’t expect the market to create social justice or an acceptable degree of equality.

According to standard economic theory, the market can create almost any type of income, wealth, or power distribution. It is up to either society as a whole or the political system, or both, to determine whether it considers such a distribution system to be fair and just. Social Justice must therefore be determined and accomplished outside of the market. If a market determined income distribution is deemed unjust, some steps toward social justice could include redistribution of income (a progressive tax system coupled with income support), redistribution of wealth (a wealth tax, land reform, limits on property, asset formation programs for the poor and working class), and redistribution of power. Prior to redistribution however it is important to note that in most real world political economies there are many factors other than the market that determine the initial income, wealth, and power distribution. These may include hereditary factors, institutional and structural power arrangements as well as laws which lock in power and privilege.

The issue of social justice is an immensely important moral consideration. Standard economic theory offers no insight on what the just distribution would look like. Standard theory merely points out that the market can not be expected to produce a socially just or equitable income, wealth, or power distribution. According to standard theory this is something for society to determine and produce usually through the political process. Once society determines what justice is, economics can offer advice on how best to efficiently obtain the socially just distribution. There is no economic expertise, however, on what justice itself is. That is for society to determine.

Don’t expect economics to answer moral questions.

Modern economics is a positive and not a normative field. Economics asks questions on how people behave and why. It asks questions on how and why things are structured as they are. It does not ask questions on how people should behave or how economies should work, at least not from the moral perspective. It does not even pose the question, is the economy moral. Instead it is concerned with efficiency, in other words the size of the economic pie, in a given industry or a given society. It is not concerned with who gets which slice of the pie and how big a particular individuals slice is. It concerns itself with the value of the economic pie being produced, while being cognizant that the value of the pie is affected by the income distribution.

The exact mix of goods and services which maximizes the total value of output changes depending upon the distribution of income. Change the income distribution, and it is now a different pie with a different mix of goods and services which is efficient, in other words it is a different pie which maximizes the total value of output. Under certain conditions, the market can be efficient. Economics has no list of conditions where the economy could be considered moral or just. Efficiency is neither a necessary or a sufficient condition for social justice or morality.

So when are markets, if not moral, at least efficient?

In order for markets to be efficient, perfect competition must exist. If competition is anything less than perfect then markets fall short of efficiency. We then have a case of what economists call market failure. In case of market failure it is possible for either government to intervene and make things better or for some sort of countervailing power to make things better. Of course it is also possible in these cases for government intervention or countervailing power to make things worse. Perfect competition is a necessary condition but not sufficient for a market to be efficient. In addition to perfect competition, the good in question must be a private as opposed to a public good. (More on this distinction later) There also can be no externalities associated either with this goods consumption or production, or any externalities must have been corrected by government through taxes, subsidies, regulation, or provision. (More on this later as well)

What are the conditions for perfect competition to exist?

1, There must be a large number of both buyers and sellers. It is a number so large that neither buyer or seller has any ability whatsoever to affect the market price. Each can sell or buy as much as she would like at the going price. Whether an individual seller or buyer wants to buy or sell zero or a lot within any given time frame, it will not affect the market price. In a perfectly competitive market firms would have absolutely no use whatsoever for a marketing department.

2, There are no barriers to either exit or entry into a given industry. There are no excessive legal hurdles to jump in order to start producing, no cumbersome licenses to acquire, no patent protections to worry about violating, no politicians who have to be paid etc. There are also no legal hurdles to jump upon exit. In addition there are no excessively high non-recoverable costs, so that existing firms do not have a cost advantage over newcomers.

3, Homogeneous products are produced by all the firms in the industry. All firms in the industry are producing an identical product, identical in substance and in the mind of the consumer.

4, Perfect information is freely available to both consumers and producers. All concerned know the market price. Firms know their entire cost structure and consumers know the attributes and quality of the good they are buying.

So what happens when the conditions of perfect competition are violated?

Whenever any of the above conditions are violated markets are not efficient, in other words markets fail.

1, there are not a large number of buyers or sellers in a market

In the case of monopoly (a single seller of a good) the market will not produce the socially desirable output level. Consumers will pay higher prices for less of the good. It is not merely monopoly, however, where the market fails, anything less than a large number of sellers results in less than the socially desirable output level from the efficiency perspective. According to standard economic theory, anytime there is something less than a large number of sellers, government could potentially play a pro-efficiency intervention role by enacting a price ceiling (that is within a certain range — it can't be set too low or the ceiling itself would cause problems). Government could also play a pro-efficiency role by breaking up large firms, challenging mergers, or even setting up state owned enterprises who would set price equal to marginal cost and compete with the other firms in the industry. All of these are theoretical possibilities consistent with standard economic theory. In addition, in the face of concentrated power on the seller side of the market consumers could play a pro-efficiency role by forming consumer unions or buyers cooperatives to negotiate the price in the downward direction. Consumers would then be a countervailing power to the market power on the seller side. Consumers banding together in a union would work much the same way as the government forcing the price down with a price ceiling. It would be pro-efficient so long as the price was not forced down too low.

Sometimes the lack of competition in a market is not reflected on the seller side of the market, but rather on the buyer side of the market. Probably, for most goods and services there tends to be lots of buyers and just a few sellers. In input markets, however, the reverse may often be the case, particularly in labor markets and in markets for the products of small scale agriculture. There may be lots of sellers and just a few buyers. If there is only one buyer, economists call this the case of Monopsony. Anything less than a large number of buyers results in market failure. In many markets for specific types of labor, imperfect competition exists on the buyer side of the market, particularly when one considers various geographical limitations on the part of the sellers of labor, the workers. In these cases the buyers of labor (the firms) have market power to set the wage. The wage will then be set at sub-optimal levels from the efficiency perspective. Whether or not wages are high enough from the moral perspective is a separate question. In the case of Monopsony or Oligopoly (a few buyers) the wages will be set too low for the market to perform efficiently.

According to standard economic theory government could play a pro-efficiency role by setting minimum wages, in other words enacting a wage floor for specific types of labor. Labor unions could perform a similar role as a countervailing power and negotiate a higher wage. With imperfect competition on the buyer side of the labor market, wage floors or the countervailing power of unions would work towards efficiency so long as the wage was not pushed too high, so long as they didn’t get too carried away with it. In addition the government could introduce some SOE’s into this labor market setting their wages at the value of the marginal product of labor, or find other ways to increase the number of buyers of labor in that market.

In summary then, imperfect competition results when there are either too few sellers or too few buyers in a given market. The market will not then be efficient. It is then possible for either government regulation or some sort of countervailing power to create greater efficiency. The market is not performing well in this circumstance. It therefore needs help.

2,There are barriers to entry or exit

In most industries there are some barriers to entry and exit, in some they are quite substantial. The extent of barriers to entry ultimately affects the number of firms or sellers in the industry or market. It has already been shown how economic theory claims a large number of firms are necessary for efficiency. Barriers can keep the number of firms lower than the optimal level. In addition where barriers exist the likelihood of economic profit or rent increases. Economic profit or rent is any payment to a firm or factor of production greater than the amount necessary to call forth a given quantity of their services. Economic profit or rent can be taxed away completely without any loss of economic incentive or any shrinkage of the economic pie.

Economic theory suggest that legal barriers be eliminated where they exist to protect power and privilege, where not needed for the sake of safety or health.

3. The product of an industry is heterogeneous rather than homogeneous.

Heterogeneous products means that the products of different firms are either different in substance or different in the minds of consumers. If this is the only exception to the conditions for perfect competition, it is known as the model of monopolistic competition. The industry would then fall short of the efficiency found in perfect competition, but probably not in a terribly significant way. Some economists argue that this is just the slight price we pay for differences and that people like differences. Others argue that differentiated products are largely in the minds of consumers, created for the most part by advertising which is socially wasteful. Perhaps the inefficiency found in monopolistic competition could be mitigated with some controls or limitations on advertising.

Where heterogeneous products are combined with other conditions of imperfect competition, particularly when the differences are in the minds of consumers occasioned by large advertising dollars, product differentiation can act as a brake on new entry and substantially lessen the number of firms in the industry. Heterogeneity when combined with other departures from perfect competition can result in substantial inefficiency by strengthening the other departures.

4, Information is imperfect or asymmetrical

Frequently firms have a great deal more information about the products they are selling and even market prices than do consumers. Technology such as the internet has made more information available at little cost as never before. Yet, asymmetries of information remain. The government can rectify the situation somewhat by developing things like the internet which lower the cost of information, by providing information on products through brochures, hotlines, and websites. Alternatively the government can force firms to provide information on the products they sell so that consumers can make informed choices. An example of this is the list of food ingredients and nutrient information on packaged food. Companies provide this information because they are required to do so by the government. Better information at low cost improves the efficiency of markets.

Haven't Economists established on a priori basis or at least empirically the inherent superiority of market allocation verses other forms of allocation such as by command or by tradition.

It may be quite surprising to the reader, but no economic theory has not established that markets perform more efficiently than other allocation mechanisms. Oskar Lange in fact demonstrated in a seminal paper that a command economy under similarly idealized conditions as those found under perfect competition could in fact perform just as efficiently. Economic theory has never claimed the superiority of the market allocation mechanism either under idealized or actual conditions. Contrary to popular opinion, and sometimes even the biases of US economists, the fall of the USSR and its satellites does not prove the greater efficiency of market allocation. One of the problems with empirical as opposed to theoretical economics is that we can not do controlled experiments. Other things were not exactly equal between the USSR and the US and between Eastern and Western Europe. It was not a controlled experiment. Besides the N was far too small for any strong statistical conclusion. In addition when social goals are not the same in two countries, one country can not be judged to be inefficient because it fails to meet the social goals of the other. Nor can an economic system be judged to have been inefficient merely because either the people or the elite decided to try a different system.

The market has also not been proven to be superior to traditional economy under the efficiency standard. In spite of the rather silly way that some textbooks define traditional economy, usually something such as the same goods are produced for generations with no change, no decision making, economic theory has never claimed that market allocation is more in keeping with utility maximization. Human beings derive pleasure from their traditions and perhaps at deeper and richer levels as compared to a consumerist society governed by whim, fads, and artificial wants stimulated by advertising. Hence, the heightened interest in indigenous and traditional peoples in our world today. Traditional economies were not as defined by so many textbooks, static. They were rather quite dynamic, but change didn't occur through the market, not did it occur through the commands of a political structure. Instead change occurred as part of a holistic cultural and social process, involving consensus. To speak of a different type of consensus, there may in fact be a consensus among US and other Anglo-Sphere Economists that the market allocation mechanism is superior to other mechanisms, but it is a consensus based upon feeling and bias and not anything that economic theory has proven either a priori or empirically. Alternatives to market allocation still exist and more are sure to exist in the future.

Doesn't economic theory prove the greater efficiency of private ownership of the means of production
(land, capital, raw materials) as compared to public, state, or communal ownership?

Actually no, economic theory has never proven this either a priori or empirically. In fact even the biases of US and other Anglo-Sphere economists are not as strongly tilted in favor of private ownership as they are in favor of market allocation. The case for private ownership is significantly weaker than the case for market allocation. There are many alternative ways that the means of production can be owned. Given the right set of conditions many of these can be equally efficient. There is more than one way to skin a cat and there is more than one way to have an efficient economic system. Why would there be only one type of tenure that can work for all times and all places? Nonetheless almost 2500 years ago Plato and Aristotle debated the efficacy of public verses private property. In another 2500 years I am quite sure that debate will still go on. Economic theory will not be able to claim the one more superior than the other in terms of efficiency. Which one is more moral is a separate question.

What are these public goods mentioned earlier?

Perfectly competitive markets without externalities will provide an adequate amount of private goods. They will not provide an adequate amount of a public good. What is a public good? First, a public good is not necessarily any good provided by government. If the government began to provide hamburgers to all comers every Saturday morning, those hamburgers would not be public goods. They would be called merit goods, goods the government provides for free such as library books, because as a result of citizenship or otherwise an individual merits them. A hamburger remains a private good.

A public good has two facets. A public good is a good that is what economists call non-rival in consumption, once it is provided to one person it is available for others to consume at little or no extra social cost. In other words one person can consume it without destroying the ability of others to consume the same good. The other facet of a public good is that once it is made available to one person it is either difficult or quite costly to exclude those who do not pay for it from the benefits of the good. Examples of pubic goods typically include national defense, fire and police protection, clean air, clean water, wilderness, and biodiversity. Once made available to one person they are available for all, and non-payers can still enjoy the benefits.

Economic theory has firmly established that the market will never ever provide an adequate amount of national defense, clean air, or biodiversity, principally because of the free rider problem. In order to have an adequate amount of any public good the government must either provide the good, or take steps to insure its provision. The market will not provide an adequate amount of the good, nor will voluntary efforts prove sufficient. When it comes to public goods, the market doesn’t work, the market fails. The concept of public goods provides a framework to deal with environmental goods, many of which either have one or both aspects of a public good. Some authors, have defined social justice as a public good, which in an interesting fashion incorporates social justice into the standard framework. When it comes to public goods, the market does not work well. It does not behave efficiently.

What about externalities?

An externality occurs whenever the full costs or benefits of a goods production or consumption is not exclusively borne by the immediate consumers or producers of the good. Many textbooks make brief mention of externalities and talk about how they can be corrected for with an appropriate tax (for negative externalities) or subsidy (for positive externalities). The reader is often left with the impression that externalities are quite rare. Upon more careful consideration externalities are found to be abundant even ubiquitous. One example of a negative externality in consumption would be second hand smoke. An example of a negative externality in both consumption and production would be the production of pollution and green house gases. Costs are being generated for society that the immediate consumers and producers are not paying for. From an efficiency point of view, too much of the good will be produced by the market because the market does not consider the additional costs to society, only the costs and benefits to the immediate consumers and producers of the good.

Voluntary efforts will not solve the problem of second hand smoke, nor will they solve the problem of pollution. The textbooks all cite a tax being levied on consumption or production which is equivalent to the cost to society. Also quite consistent with economic theory, although not as frequently mentioned in the texts is government regulation, or social custom to either limit or eliminate the behavior which causes the externality. In practice regulation oftentimes seems far more practical than a tax. Right now we as a society are regulating second hand smoke rather severely. We are not instead levying taxes on a smokers right to smoke in public, probably because it is not as practical as simple straightforward regulation. Do economists have something of a bias against simple regulation? Yes, they do, but economic theory has not proven taxes or cap and trade to be superior to regulation or social custom in correcting for negative externalities. It merely posits them as alternatives.

Positive externalities in production are a bit difficult to come by. Perhaps you the reader can think of one or two. A positive externality in consumption would be education. An individual receives benefits from their consumption of education but as a result of their education, they create additional benefits for other people, for society as whole. The market will not produce an adequate amount of education because the market does not consider these additional benefits. One way to get the market to produce the efficient amount of education is to subsidize education, but another way, perhaps more practical is for the government to provide either for free or at a discount.

So are the concepts of public goods and externalities sufficient to deal with environmental issues?

The concepts of public goods and externalities do definitely provide a framework with which to deal with environmental issues within the standard economics models. Yet, most economics models do not deal with environmental issues in any substantial way, even though a framework exists for them to be dealt with. Passing mention may be made of environmental issues or concerns and how they could be incorporated into the model at a future date. The model itself usually fails to deal with these issues or concerns in any substantial manner, because of valuation problems primarily, what to include and what not to, how to value it etc. It is just too difficult to do.

Even if all the issue revolving around valuation techniques were resolved, however, it is important to recognize that the environment is being considered solely in terms of its usefulness to human beings. That is how economists define efficiency. The rest of nature has value only insofar as human beings either value it to look at or use it. Efficiency so defined is highly homocentric and may very well not be moral at all. In addition, the valuation techniques attempt to establish market values for environmental goods. How the market values a particular good is dependent upon a particular income distribution. If the income distribution is vastly unequal, as it in fact is, then the rich individual has more influence over how environmental goods are valued than do the poor, and wealthy modern economies have far more influence than do indigenous peoples. That is probably not a fair or just way to value environmental goods. So even if economists could discover these market values for environmental goods, those values would be based solely upon human beings, not the rest of nature, and the market values would reflect any injustice inherent in the income distribution. Such an analysis would incorporate the environment into the efficiency standard. It could say whether or not this policy or action was or wasn't efficient. It could not however say whether or not it was moral.

Doesn't economic theory show that economic inequality if not moral, is at least necessary for efficiency?

Actually no, it does not make any such claims. There are many reasons for income and wealth inequality that have little or nothing to do with economic efficiency or the market. These would include discrimination, institutional power, structured inequalities, cultural attitudes, cronyism, corruption, social connections, and inheritance.

If all of these influences were eliminated, even then with markets determining the income and wealth distribution economic theory has not proven that such an income distribution is necessary for efficiency.
This is true for the following reasons. Only when the product market as well as labor and other factor markets are competitive with a large number of buyers and sellers will labor earn a wage equal to the value of the marginal product of labor. If the labor market is characterized by a large number of workers but a small number of firms buying labor, then the wage rate will be less than the value of the marginal product of labor. Actually, it will even be less than the marginal revenue product of labor if the labor market is less than perfectly competitive. In this case of workers earning less than the marginal product of labor, the labor market will not be efficient. The labor market will have failed to perform efficiently. A similar result is also possible if firms possess an information advantage over workers.

When all markets are competitive, both product labor market, then workers will earn the value of their marginal product. Even in that case however, the payments to the other factors of production are not necessarily functional. Unless one of the other factors of production such as capital or entrepreneurship has a value of marginal product automatically defined as residual income, each factor earning the value of marginal product will not necessarily generate a factor bill equal to total income. There is no proof on efficiency grounds or otherwise, that the residual or surplus income should belong to one of the other factors rather than labor. Empirical attempts to measure the marginal product of capital or of entrepreneurship which do not rely on residual income are difficult at best and are riddled with controversy. In addition even if the marginal product of capital or entrepreneurship could be measured, there are still questions pertaining to the marginal product of ownership. Does ownership of capital have a marginal product? The marginal product of the ownership of capital is distinct from the marginal product of the capital itself. Does efficiency require that the owner of capital receive a payment equal to the value of the marginal product of capital? That has never been proven.

Assuming each factor of production has a marginal product which is readily identifiable and assuming each factor of production earns the value of its marginal product, economic rent, both pure and infra-marginal still exists in the income distribution. Rent is any payment to a factor of production beyond the amount required to call forth its services. Economic rent can be taxed and redistributed without any loss of efficiency. The combination of regressive forms of non-market based income, income derived from non-competitive markets, the issue of residual income, and the prevalence of economic rent leave ample latitude for taxation of income for the purpose of progressive redistribution, without any loss of economic efficiency. In other words it is very possible according to economic theory to redistribute income without shrinking the size of the economic pie. We can change who receives what slice of the pie without baking a smaller pie.

Surely economists would at least be opposed to any redistribution which taxed away non-rental income thereby causing the size of the economic pie?

Actually economic theory can take no position on this issue. It would merely point out that taxing away non-rental income, income needed to call forth the services of a factor of production, would cause an efficiency loss, due to a loss of incentive. At this point there would be an opportunity cost to redistribution causing the size of the economic pie to shrink. In other words, at this point, a trade off would exist between what society considered justice through redistribution on the one hand and efficiency on the other. It would be nonetheless a tradeoff which society could wisely choose. The role of economics in this case is to merely point out the opportunity cost of redistribution. Valuing perceptions of justice in a trade-off against efficiency is beyond the scope of economics and is for society to decide.

Does economics teach that trade is always beneficial between countries and that freer trade is always better than less free trade?

Economics has built many models, with varying assumptions, which show that trade between countries is mutually beneficial. It does not contend that the benefits of trade are equal for both countries. Trade barriers sometimes reduce the benefits of trade in many models, but under certain assumptions, there are models which show an optimal tariff. In addition, what constitutes freer trade depends on definitions and assumptions. Economics has never proven on a theoretical basis that trade which safeguards labor rights, the environment, and human rights, offers fewer benefits than trade which only protects property rights.
The theoretical science of Economics can not be used as a justification for a trade promotion agenda that neglects the enforcement of all rights save those of property.

If trade is mutually beneficial to countries, don't most people in those countries benefit?

When trade is beneficial, economics has never proven that most people necessarily benefit. Economics makes no claims as to the proportion of people who will benefit, when trade benefits the nation as a whole. It does show that there will be both winners and losers within a country as a result of trade. If the country as a whole benefits, economics does teach that it will be possible for the winners to compensate the losers. We do not live in a country or in a world, however, where losers are very often compensated by winners. Quite to the contrary losers are often ridiculed and marginalized in societies throughout the globe.

But how is it possible for most people to not benefit, if the country as a whole benefits?

A simple illustration will suffice. If for every winner, who gains a million dollars in benefits there are 99 losers who each lose $10,000 in benefits, the nation as a whole would benefit, but the median person would not, even though on average there would be a $100 gain.

What do trade models and the trading system specifically fail to address?

The trade models which demonstrate the benefits to be gleaned through specialization in one's comparative advantage fail to adequately address environmental costs. Environmental costs are seldom incorporated into determination of comparative advantage. The current global trading system is unequipped to take account of such considerations, just as it fails to address the aesthetic values of heritage and tradition.

Any final thoughts?

I have laid out in this chapter what standard economic theory teaches and what it does not. It has something to say about efficiency. It has nothing to say about morality other than you can not count on the market delivering a moral economy. When economics establishes something as inefficient, that does not make that something immoral. When economics establishes something as efficient that does not make that something moral.