

Notes from seth

Incentives in Command

- Requires deliberate, planned coordination of production and consumers' preferences
 - Requires altruism on part of producers to act on consumers' preferences or coercion by planners
- What is the motive for coercion?
- Satisfy all preferences requires producers' omnibenevolence or planners omnipotence
- In free market, profit motive mimic these things
- Satisfying consumers preferences is the only way to...make money (mimic suppliers benevolence), avoid losing money (mimic planners punishment)

Distribution in a free market

- Automatic: you get to keep your profits
- Interference with distribution obscures information and destroys incentive

Advantages

- Constrains greed (privatizes costs as well as benefits—you have to bear the losses)
- Partly sensitive to individual choices (work vs. leisure, investment vs. consumption, grad school vs. job)

Disadvantage

- Partly insensitive to merit, moral qualities, desert, etc.
- Partly sensitive to chance: genetics, upbringing, inheritance, market fortunes (time and place)

Distribution in a Command Economy

Goods must be centrally allocated

- Requires enormous, omniscient, omnipotent, and omnibenevolent bureaucracy
- Requires a basis on which to distribute the goods
- What basis? Need? Desert Equality? Effort?
 - All hard to apply. Who decides?

Price Mechanism in a FM coordinates the activity of millions of people

- Each pursuing her own self-interest
- Coordination is monetary, unintentional, unconscious
- Prices mimic omniscience with respect to consumers preferences
- Profit motive mimics omnipotence/omnibenevolence with respect to satisfying preferences
- Results beneficial to all (exchanges are voluntary so must be mutually beneficial)
- FM rational even though not conscious (most efficient use of resource in satisfying preferences)

End result: Maximal utility compatible with voluntariness

Real World

- Perfect free markets do not and could not exist in the free world
- If 1, then we should embrace a command economy and reject a free market economy

Important conditions for a free market

- Exchanges must be voluntary among rational, self-interested, fully-informed people
- The exchanges take place if and only if they are mutually beneficial
- Then, there is an equilibrium, where supply=demand
- This is also an equilibrium in utilities: No one can do better given what the others do

Some important conditions for a perfect market

- NO monopolies
- NO transaction costs and times
- Then equilibrium in utilities is NOT met

Rationale for 1

- No completely free markets because not all exchanges are fully informed, voluntary, or rational; also there are monopolies (partial and full) and significant transaction costs and times

Response: Reject 1

- Imperfect, partially free markets still work well
- Economists have generated models for...less than perfect rationality, information, and instantaneous exchange
- These shows that many of the advantages of a free market are present even in imperfect, partially free markets

Objection: Models must incorporate all of these at once, not just one at a time

Response: Reject 2

- Government action can make up for these failings while still retaining a largely free market economy
- Mostly free market with judicious government interference is still much better than a command economy
- Pure lemon juice AND too much sugar and water are both HORRIBLE (need happy medium)

Govt intervention can help

1. Exchanges not fully informed

- Problem: NO one is fully informed about all the consequences of their actions, especially long-term consequences
- Solution: Govt action? Regulating in the interests of safety (test toys for lead, FD), providing information to consumers (health info, scientific research into effects of cigarettes, car safety), this is NOT substituting for free market but rather supplements it
- Distributing risk to make up for our lack of full knowledge of it (spread risk, can NOT eliminate it)
 - US bankruptcy laws redistribute risk to creditors

2. Exchanges are not fully voluntary

- Sometimes people interact—or one just acts unilaterally—and a third party is affected

- The third party gains some of the costs or the benefits of the exchange non-voluntarily
- But markets can only be expected to be efficient only in cases are mutually beneficial not guaranteed if they are involuntarily (failures of security and externalities are common sources)

Common sources of involuntary exchange

1. Failures of Security

- Solution: Govt-provided security?
- Army: Protects citizens from external coercion (Individual citizens can't father intelligence on ISIS< protect against invasion
- Policy, courts, protects citizens from coercion by other citizens
 - Enforce laws and contracts, maintain order, prevent theft and interpret laws

2. Externalities

- Involuntary exchange gives rise to externalities
 - An action gives rise to an externality: The private cost of doing the action is different from the total cost
- Market fails to make everyone better off in these cases
- Actions have a game structure

Negative Externalities—Oversupplied

- The cost to those who benefit is less than the total costs
- Private costs are less than the social cost
- They dump costs on others without their consent
- Because some costs are borne by others, the action is excessively cheap. So markets tend to oversupply these. Others subsidize your actions