



Notes – Topic 2

Topic 2: Markets and the Market Economy

- I. Gains from Trade
 - a. Most of attention devoted to markets for two reasons
 - i. Primary mechanism for coordinating life
 - ii. By far the most *successful* mechanism in history (measured by ability to raise standard of living)
 - b. What is a market?
 - i. Institution thorough which agents (buyers, sellers) are brought together for *VOLUNTARY* transactions.
 - ii. Voluntary transactions make all agents “better off.”
 1. No rational agent will agree to a truly voluntary transaction otherwise.
 2. This is the concept behind “Gains from Trade”
 - iii. Judgments about “better off” can be mistaken. Based on agent’s own perspective.
 - iv. Must be well-informed.
 - v. There’s no assurance the transaction is “fair.” Agents *judge* transaction to be best among alternatives. “Best I can do.”
 - c. Example
 - i. Peasant woman trading 16 hours of labor to Nike for \$0.50 per hour.
 - ii. Is the transaction voluntary?
 1. Was she coerced? Threatened?
 2. Did she fear the alternatives? Was there familial pressure?
 3. Line is usually drawn at threats of violence. Otherwise it’s voluntary.
 - iii. Is she well-informed?
 1. Is she aware of the working conditions?
 2. Was she being misled by Nike?
 - iv. If both are true, there *are* Gains from Trade – she considers herself “better off”
 1. Doesn’t mean she’s “happy,” just that it’s better than the alternatives.
 2. Doesn’t mean it’s “fair.” Gains from Trade are imbalanced, but *small* gains are still gains.
- II. Alternatives to Markets
 - a. Markets are a very recent development.
 - b. Tradition
 - i. Patterns for live, individuals’ roles handed down through generations
 - ii. No asking “what transaction is best?” – just make transactions based on what tradition says.
 - iii. Dominant mechanism in most societies in history.
 - iv. Almost complete lack of economic growth or technological dynamism. Markets provide more incentives
 - c. Authority
 - i. Those with political power determine how economic resources are to be used.
 - ii. Egyptian pyramids (no benefit or profit, but political power demanded they be built), Soviet Union
 - d. Voluntary Cooperation and Sharing
 - i. Never really implemented
 - ii. Socialist Utopia
 - iii. Undertake productive activities for the general welfare.
 - iv. Perhaps human nature just isn’t “up to the challenge” – some fundamental human drive for self-betterment might exist.
- III. The Market Economy
 - a. Freely determined prices → Prices aren’t set by people with power, but by many individual transactions between buyers and sellers.

- b. Competitive Markets → Prevents any individual supplier from gaining undue power.
 - c. Monetized Trade
 - i. Trade conducted through some standard exchange – id est money.
 - ii. No direct exchange of one service for another.
 - d. Meaningful Property Rights
 - i. Crucial government role. Define and enforce property rights. “Referee”
 - ii. Don’t steal property, honor contracts, etc.
 - iii. Even those who are against government involvement agree that this role of government is necessary.
 - e. Adam Smith
 - i. First modern economist?
 - ii. “Invisible Hand” guides economy.
 - iii. Laissez-faire → Best government is one that governs least.
 - f. Karl Marx
 - i. Market economy enormously efficient but inhumane and unstable.
 - ii. Exploitation, poverty, alienation.
 - iii. Prone to crises
 - iv. Doomed to collapse and replacement by socialism.
 - v. Proposed very democratic system, completely *unlike* what the Soviet Union became.
- IV. Soviet Union
- a. Very different from the socialism Marx proposed.
 - b. Soviet Union practiced *extreme* socialism – “Central Planning.” Government controlled everything.
 - c. Very closed society. Nobody really knew how well it was doing economically.
 - d. Did very well in 1950s with low-tech industrial development (steel, coal, oil – very easy to control production), but very poorly at later high-tech industry.
 - e. Collapse of USSR meant death of ‘Centrally Planned’ socialism.
- V. Approaches to Markets Today
- a. Market Advocates
 - i. Central Group
 - ii. Reigning philosophical orientation toward markets.
 - iii. Republicans and right-of-center democrats.
 - iv. Conservatives (“Liberals” in Western Europe, just to make it confusing)
 - v. Dominant ideology in US presently.
 - vi. Government too involved, need more reliance on markets in everyday life.
 - vii. SOME government still! Still fund education, for example, but perhaps not run schools.
 - b. Social Democrats
 - i. Central Group
 - ii. Dominant ideology in Western Europe
 - iii. Progressives / Liberals. A little left-of-center.
 - iv. Labor Unions, left-wing democrats.
 - v. Nothing against principles of markets.
 - vi. Markets fail regularly in important areas like Health Care, Environment Protection, Education, etc.
 - vii. These important parts of the economy should be under government control.
 - c. Libertarians
 - i. Fringe Group
 - ii. Laissez-faire purists. Government sets only the basic rules and plays no other part.
 - iii. Has *some* influence on the Republican party.
 - d. Radical Economists
 - i. Fringe Group
 - ii. “Market Socialists” Remnants of socialism with “Market” thrown in the name to remind everyone of the lessons learned from the Soviet Union

iii. Little-to-no influence since the collapse of the Soviet Union. Decreasing influence if anything.

VI. Markets and Capitalism

- a. "Capitalism is a specific form of market economy based on unlimited private ownership of capital."
- b. Mainly a technicality since the terms are used interchangeably.