

Markets and Market Failures

Antony Eagle

Choices, Models and Morals » Lecture 10

Contents

- Markets
- Morals and Actual Markets
- Morality in Optimal markets

Markets

What is a Market?

- › A market, in the most general sense, is **an institution that facilitates exchange: the mutually advantageous and uncoerced allocation of property between agents.**
- › So much is true of **commodity** markets, where individuals and firms exchange money for goods and services, either directly or through intermediaries.
- › But it is also true of markets in less tangible items, even less tangible than services:
- › The **labour** market, where individuals exchange their time and effort for money.
- › And financial and insurance markets, where entities exchange certain money for risks of having to pay and promises of future receipt.

Exchange and Property

- › Most fundamentally, markets involve **property**, which we can think of as enforceable control of something.
- › What is then traded on the market is in fact the **right to use an item**.
 - ›› Market participants exchange by ceding control of various things to one another.
- › Some items are easily controlled, and hence rights to use them are prime candidates for market exchange. These are known as **excludable goods**, those where it is feasible to restrict use of the good to some specified person (Reiss 2013: 235).
 - ›› These include **private goods**, where one agent's use of them precludes another's simultaneous use – such as food (once eaten, it cannot be consumed again).
 - ›› But there are also **club goods** such as concert tickets, which convey the right to make use of a performance for your own enjoyment, but that right can also be ceded to others simultaneously without diminishing your use (Reiss 2013: 234).

Property and Theft

- › When access **cannot be controlled** (non-excludable goods), rational markets can't exist – no one should exchange anything for a good they cannot be prevented from using – e.g., breathable air [].
- › But actually, almost everything can escape control. Few things can be linked inextricably with an individual by physical properties and yet also be exchanged.
- › So – as talk of property **rights** indicates – we generally have our control of objects **granted** to us by legislation and social convention. We, or our representatives, **decide** what things are under the control of an agent, and where necessary, **enforce** those decisions.
- › Systems of rights, created by tacit **convention**, thus enable markets:

While markets are exceptionally powerful social institutions, they cannot work unless government establish the necessary framework in which they can operate. The core of the economic framework in a market economy, and a central role of government, is the allocation and legal enforcement of property rights. (Quiggan 2019: 7)

Free and Advantageous Exchange

- › Markets also require participants who are capable of **free choices**, and who are capable of **recognising their own interests**.
- › Exchange is then desirable for those participants because it makes it possible for agents to improve their position: to knowingly trade one outcome (condition in which they control an item) for another outcome they prefer (i.e., to realise **gains from exchange**).
 - › Markets don't exist for the coerced, since they are not making the market trades they would prefer to make.
 - › And markets will be imperfect for those who are ignorant of their own preference, for trades will not reflect their actual preferences.
- › Moreover, if everyone had the **same preferences** over outcomes, exchange would not occur – no one would regard themselves as having any advantage in exchanging A for B, because both they and their trading partners prefer A to B.

Optimal Markets

- › If there are lots of free and informed rational participants in the market, each with items or labour to trade, and with lots of opportunities to have their various preferences satisfied, then (given some other conditions about the internalization of externalities) the market will be **optimal**.
 - › The first theorem of welfare economics from **lecture 9**.
- › The **prices** market participants face will be established, after sufficiently many trades, in such a way that no one pays or receives more than is minimally required to produce the good and to make the exchange possible.
 - › In equilibrium, prices equal **opportunity costs**; no better use of resources to satisfy preferences exists for market participants [↔-1954].
- › Of course, actual markets approximate this ideal only imprecisely, but still, many regard the approximation as sufficiently good to explain many actual markets as **competitive** – large markets with high volumes and frequent traders.

Market Failure

- › Everyone needs food, health, and shelter, and can't exchange all of them away. If everyone has enough other tradeable goods about which they have differing preferences, exchange can occur for these goods.
- › But what if the system of property rights **precludes** this?
 - › E.g., a population of subsistence farmers, but some of whom have just barely enough to eat, and the remainder have not quite enough. A market allocation will be static, since no one who wants to trade has anything to trade.
- › Even when trade does go on, it may be **non-optimal**, if the prior distribution of property rights give some agents more power to have their preferences satisfied.
 - › E.g., **monopolies** where (due to historical acquisitions, current policy, or structural features of the good) there is only one provider. That provider can set prices above costs. Some people who want the good will still participate, if they still find the high price on balance advantageous. But many potential purchasers will be priced out.
 - › Or **monopsonies** (one buyer): e.g., in labour markets, workers with very specialised skills may have only potential purchaser of that labour.

Market Alternatives

- › In cases where the market is non-functional or non-optimal, other institutions might be better at allocating goods, even in the narrow economic sense of better, i.e., **more efficient at satisfying preferences**.
- › Sometimes a monopoly might be broken up, to attempt to bring a non-optimal market closer to a competitive one.
 - › But other goods don't lend themselves to this: water and sewerage pipes are essential (Hausman, McPherson, and Satz 2017: 93), and cannot be plausibly duplicated. A natural monopoly is less efficient; it would be better for water to be priced in some other way – perhaps centralised **state provision**.
 - › As Reiss (2013: 232–33) points out, some monopolies seem beneficial too: the natural monopoly enjoyed by the inventor before their competitors have rushed out cheaper rivals is an incentive for innovation.
- › Some monopsony goods might be only unjustly priced by the market: e.g., military service might be better purchased from citizens by **lottery**, as in a draft, than by letting people set a price on their own lives, given the existing structural inequalities.

Morals and Actual Markets

Moral Constraints on Market Operation

- › One widely accepted requirement is to ensure that **actual markets** function as they ought.
- › This might be an economic ‘ought’, but there is a moral norm behind it.
 - (1) In an optimal (efficient) market, participants can have their outcome preferences sustainably satisfied for the lowest possible cost. (Mathematical result)
 - (2) Agents ought not to have to incur more costs than required for a given outcome. (Moral norm)
 - (3) If an efficient allocation is possible, then we ought to promote it: ‘efficiency provides a reason to distribute goods through the market’ (Hausman, McPherson, and Satz 2017: 93). (1, 2)
- › For example: ‘an inefficient medical system means that people have to pay more for treatment or that they receive fewer treatments’ (Hausman, McPherson, and Satz 2017: 94), since costs they incur aren’t being used most efficiently to purchase medical services.
 - ›› If there is going to be a market in medical services **at all**, there does seem to be a moral imperative here to minimise waste or **economic rents**.

Interference and Efficiency

When markets are inefficient... freedom may be threatened, and it may be possible to make people better off by interfering with and regulating or preventing certain market interactions. (Hausman, McPherson, and Satz 2017: 95)

- › For example, conditions of artificial or natural monopoly might be regulated, to ensure that a market in such goods more closely emulates a competitive market.
 - › Electricity supply infrastructure is a natural monopoly, and the AEMC regulates it ensure that the retail and wholesale electricity markets function efficiently.
 - › The infrastructure of markets themselves can be a monopoly, and may need regulation to ensure transaction costs don't impede efficiency.
- › Markets might fail to be efficient because participants don't make **informed choices**, and regulators might need to protect them from exploitation:
 - › E.g., education or used car markets, where the quality of a good is difficult to evaluate prior to consumption (Akerlof 1970; Reiss 2013: 233–34).
 - › The **endowment effect** shows pitfalls for the inexperienced ([lecture 3](#)).

Costs of Regulation

- › Some will bridle at any regulation of ‘free’ markets. Two lines of argument are of interest:
 1. They may think state intervention, even when it enhances efficiency, **curtails freedom** in an objectionable way (Hausman, McPherson, and Satz 2017: 100).
 - › Markets let participants come to free agreement, without making any **paternalistic** assumptions about how people will choose. To intervene is to in effect destroy a market, because agents are ‘free to choose’ only when the regulator condones their choice.
 - › Market participants, on this view, should be free to exploit their prior advantages, informational or structural. Some of their decisions might be bad, objectively speaking, but at least they are **theirs**.
 2. State intervention, even if potentially efficiency enhancing, is generally **not**.
 - › Food stamps and rent control both show that successful intervention in a market is hard.
- › But if we don’t fetishise freedom, and we allow redistribution not just price-fixing as market ‘interventions’, we can probably respond to these concerns.

Morality in Optimal markets

Types of Moral Failure in Markets

- › Perhaps more interesting are cases where a market is or could be optimal, but still **ought to be limited** in some way.
 1. Perhaps the market prices do not reflect all the **externalities**, the costs imposed on non-participants in an exchange.
 2. Perhaps some goods should not have a market-based allocation at all.
 3. Perhaps the prior property distribution is **unjust**, and a market-based allocation comes to reflect that injustice.
- › Since externalities occur when market prices don't reflect all the costs and benefits that are the product of an exchange, it may be thought that these market failures can be responded to 'internalizing' those, perhaps in a broader market.

Externalities

- › Neither petrol buyers nor sellers (currently) bear the full costs imposed on **all of us** by their exchange and subsequent consumption of fossil fuels.
- › Efficient trade in that market causes more fuel to be consumed than would be the case if those costs were priced in.
- › The natural response: we should **expand** the market, in effect introducing third parties – even society as a whole – as market participants: ‘many of the problems with markets can be solved through markets themselves’ (Hausman, McPherson, and Satz 2017: 96).
- › One way: introduce property rights for the externalities, grant them to the harmed third parties (or the state), and have the harmers purchase a right to harm (Coase 1960).
 - ›› So if carbon emissions were priced, fuel consumers would be required to purchase permission to emit, and the price paid for those permissions would have two effects: reducing the fuel consumed, as compensating the rest of us for the harmful effects we experience as a result of the residual consumption (Quiggan 2019: §§10.3, ch. 16).

Externalities and Welfare Economics

the [first] theorem assumes there are no externalities. In fact, if in an exchange economy person 1's utility depends on person 2's consumption as well as his own, the theorem does not hold. ... In a similar vein, the theorem assumes there are no public goods, that is, goods like national defence, judicial systems or lighthouses, that are necessarily non-exclusive in use. If such goods are privately provided (as they would be in a completely *laissez-faire* economy), then their level of production will be suboptimal. The [first] theorem assumes there are no public goods, that is, goods like national defence, judicial systems or lighthouses, that are necessarily non-exclusive in use. If such goods are privately provided (as they would be in a completely *laissez-faire* economy), then their level of production will be suboptimal. (Feldman 2008: 4)

- › More on Pigou and Coase (Feldman 2008: 5)

Trade in Impermissible Goods

- › But not every market failure can be solved by more markets.
- › If a market fails because it shouldn't exist in the first place, then it will not be possible to remedy that by introducing more items to be traded.
- › A **slave** market, where human persons are the goods (their labour then extracted indefinitely for free) creates many negative externalities for society:

Enslavers do everything in their power to get society to pay for the high costs of controlling their human minions. Throughout history, including the U.S. antebellum South, enslavers used taxpayer monies to discipline their slaves, put down rebellions, return runaways, and so forth. They distorted republican governance processes to further their ends and deliberately stymied economic development (literacy, communications, transportation infrastructure, etc.) <https://historynewsnetwork.org/article/165483>

- › Pricing these externalities might 'correct' the market, making the slave trade uneconomical in the long run. But surely the long run isn't short enough!

Repugnance to Markets

- › There are intermediate cases, where there is a **repugnance** to market allocations but where there is some case that non-market solutions are not succeeding.
- › The case of organ donations is one such example. Many people are repulsed by the idea of buying and selling organs to the highest bidder, precisely because access to live-extending transplants should not (many feel) be dictated by prior economic advantages (Hausman, McPherson, and Satz 2017: 98).
- › On the other hand, there is huge unmet need for organs, and one would expect supply to follow demand if it were permitted to do so.
- › Our repugnance to a market solution in this case might be even more harmful in terms of life-years lost than the moral harms of commodifying human organs (Hausman, McPherson, and Satz 2017: 97).
- › A purely economic insistence on efficiency won't differentiate the slave and organ markets from a market for grain. But a purely intuitive perspective won't differentiate slave and organ markets – and perhaps they should be distinguished.

Ethical Principles and Limits to Markets

- › **Why** is a market in slaves (or friends, or votes) wrong?
 - › Is it because we should **respect persons**, and avoid ‘corrupting’ anything distinctively linked to human life and autonomy? Relatedly, should we avoid market pricing for anything which ‘should be honored or respected’ (Hausman, McPherson, and Satz 2017: 99)?
 - › Or is it because, given people are as they are, there are in fact harmful **consequences** (to well-being or the global good) from the existence of such markets – though had things been different, such markets might be fine?
- › That markets corrupt the inherently valuable depends on a quite distinctive view of **value** – one that is unlikely to be shared by all potential market participants. If enough people want to participate in such a market – consider the market for sex – that might lead to significant harms to those whose other options may be no better for them (Hausman, McPherson, and Satz 2017: 99).
 - › Linked to the general idea that people often know what’s best for themselves, and market mechanisms often allow them to make the tradeoffs they are comfortable with (Quiggan 2019: §5.2).

Consequentialist Limits to Markets

- › There may be more buy-in to the idea that markets have limits due to contingent consequences they have. A number of illustrations.
 2. Market prices can distort **judgements of value** – in the case of blood donation (Titmuss 1970), paying for donations put a price on blood that was lower than the ‘gift of life’ donors had thought they were giving – indeterminate social sanctions were replaced by a small fee foregone. (And a market in social sanctions isn’t easy to establish.)
 3. Many markets have participants who are **not rational or fully informed**, because of contingent features of the educational or political system – e.g., child labour markets (Hausman, McPherson, and Satz 2017: 101–2). Some older children may rationally sell their labour; but the consequences such an example sets are worse than the costs of restricting these sellers.
 4. Finally, markets reflect prior **inequality**, which can lead to worse outcomes overall. For example: if some people are so privileged or desperate that they will work for whatever salary they can, with no minimum. But this ‘affects the wages that *other* people are able to command’ (Hausman, McPherson, and Satz 2017: 100), and may leave almost everyone worse off. Maybe better: have a high minimum wage and directly support those then priced out of the labour market.

Policy Responses

- › If markets have bad consequences, how should we respond?
- › No **simple answer** suffices, because it will depend on how and why those consequences come to pass.
 - › If child labour is caused by family poverty, the market might be undermined by giving the families more options – better welfare, for example.
 - › But if it is caused by scepticism about secular education, the market might be undermined in a different way (Hausman, McPherson, and Satz 2017: 103).
 - › If it just because people are persistently immoral, maybe the market ought to be banned outright.
- › In many cases, however, the reduction of inequality can make market provision more successful, by giving participants more options and hence more bargaining power (Quiggan 2019: chs. 12–13).

Causes and Moral Consequences

- › Whether we ought to regulate markets, how we might do it if we do, and how we might alternatively allocate resources, are partly empirical and partly conceptual issues.
- › The empirical component will depend on the nature of the goods in question, the psychological facts of people's responses to them, and the causes and effects of trading the good.
- › The conceptual component will depend on the structure of moral consequence: what kinds of effects of exchange are impermissible, and what kind of conditions can be imposed to limit markets to acceptable outcomes.
- › We cannot answer the empirical questions from the **philosophical armchair**.
- › But the conceptual questions – and specifically, the nature of well-being, have been our **quarry already**.

References

References

- Akerlof, George A (1970) 'The Market for "Lemons": Quality Uncertainty and the Market Mechanism', *The Quarterly Journal of Economics* **84**: 488–500.
- Coase, R H (1960) 'The Problem of Social Cost', *The Journal of Law and Economics* **3**: 1–44. doi:[10.1086/674872](https://doi.org/10.1086/674872).
- Feldman, Allan M (2008) 'Welfare Economics', in Steven N Durlauf and Lawrence E Blume, eds., *The New Palgrave Dictionary of Economics*: 1–14. Palgrave Macmillan UK.
- Hausman, Daniel, Michael McPherson, and Debra Satz (2017) *Economic Analysis, Moral Philosophy, and Public Policy*, 3rd edition. Cambridge University Press.
- Quiggan, John (2019) *Economics in Two Lessons*. Princeton University Press.
- Reiss, Julian (2013) *Philosophy of Economics*. Routledge.
- Titmuss, Richard (1970) *The Gift Relationship: From Human Blood to Social Policy*. Penguin.