Limits and Critiques of Free Markets.



Economics 110 B – Lecture 6

Welcome to Lecture 6.

¶ 6.2

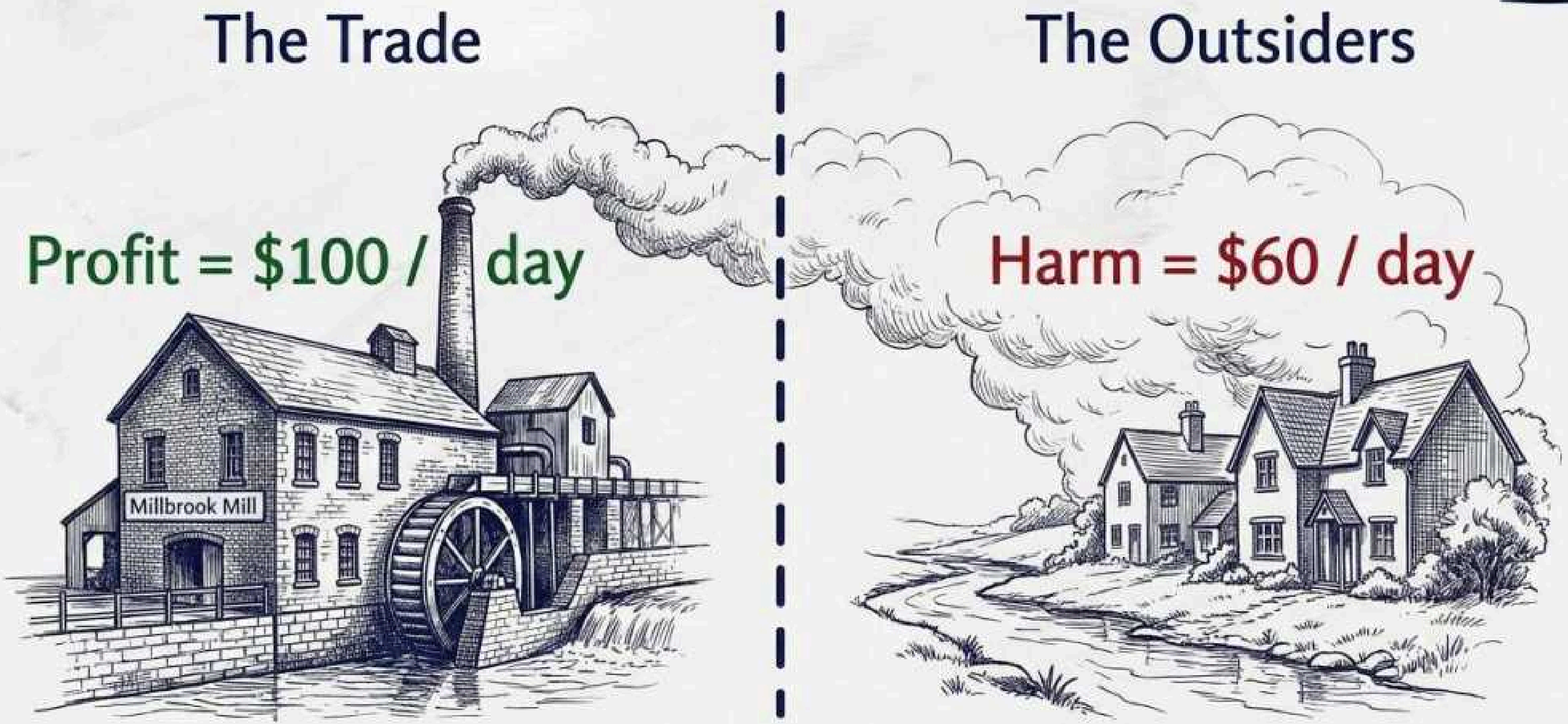
The Strongest Objections to Free Markets

1. Externalities
2. Public Goods
3. Information Problems
4. Market Power
5. Inequality
6. Instability
7. Moral Limits

A fair course must give the other side its due. We examine the objections, look at the evidence, and end with a balance sheet.



The Balance Sheet



An externality is a cost or benefit that falls on people outside the trade. The mill ignores the harm; the price of the product understates its true cost.

Scenario A (Net Gain)	
Profit	$100
– Harm	$60
Δ	+$40 Net Gain

Scenario B (Net Destruction)	
Profit	$100
– Harm	$150
Δ	–$50 Net Destruction

Pigou (1920)

t = harm

Whether the mill should run depends on the numbers. Arthur Pigou proposed a tax (t) equal to the harm, forcing the mill to count what it costs others.

¶ 6.5

Ronald Coase (1960)



If property rights are clear and bargaining is cheap, parties can settle it themselves.

¶ 6.6



Millions affected, bargaining impossible.

[Taxes] [Tradable Permits] [Rules]

Macro-Remedies

Limits of Coase: Pricing carbon makes markets work better, rather than abandoning them. Economists favor pricing harms, though they debate the level.

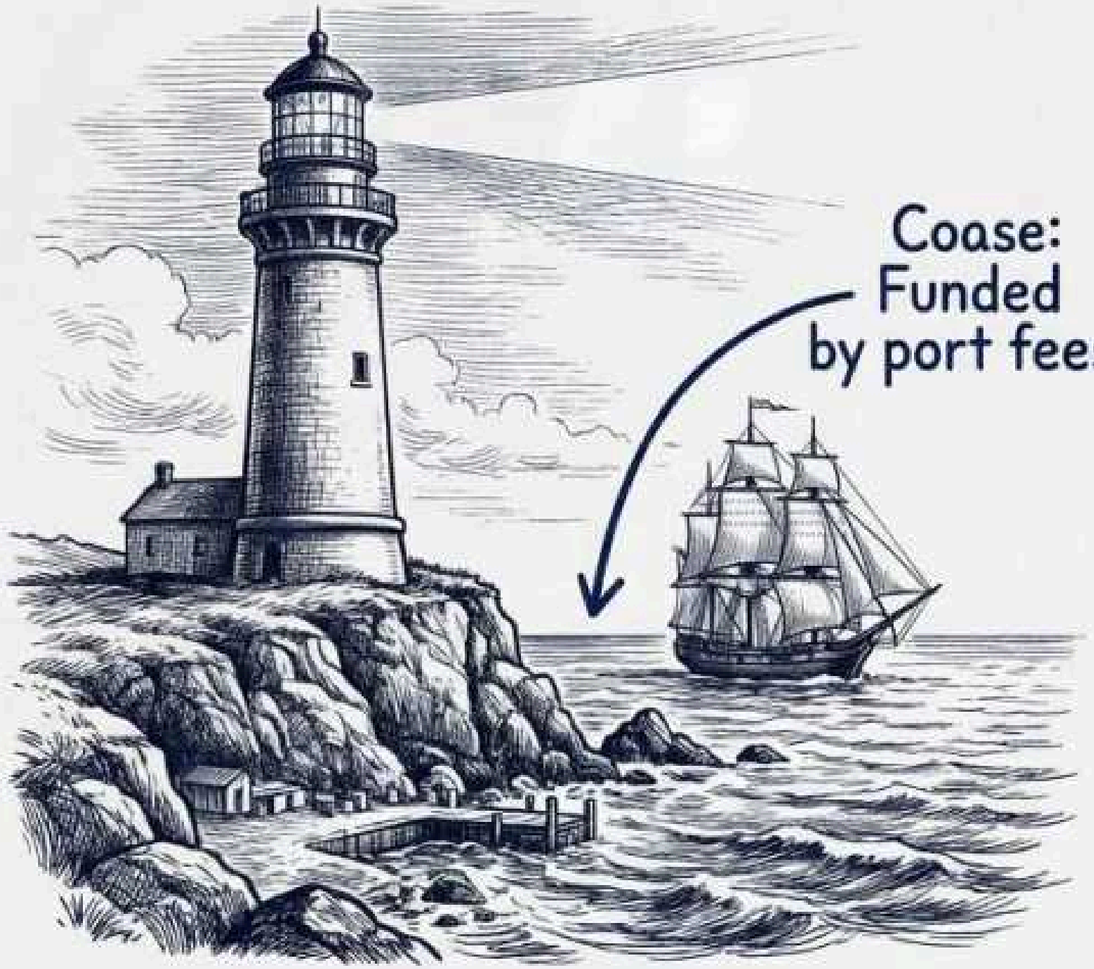
	Rivalrous	Non-Rivalrous
Excludable		
Non-Excludable		

100 residents × $5 value = $500 total value

$500 (Value) > $300 (Cost)

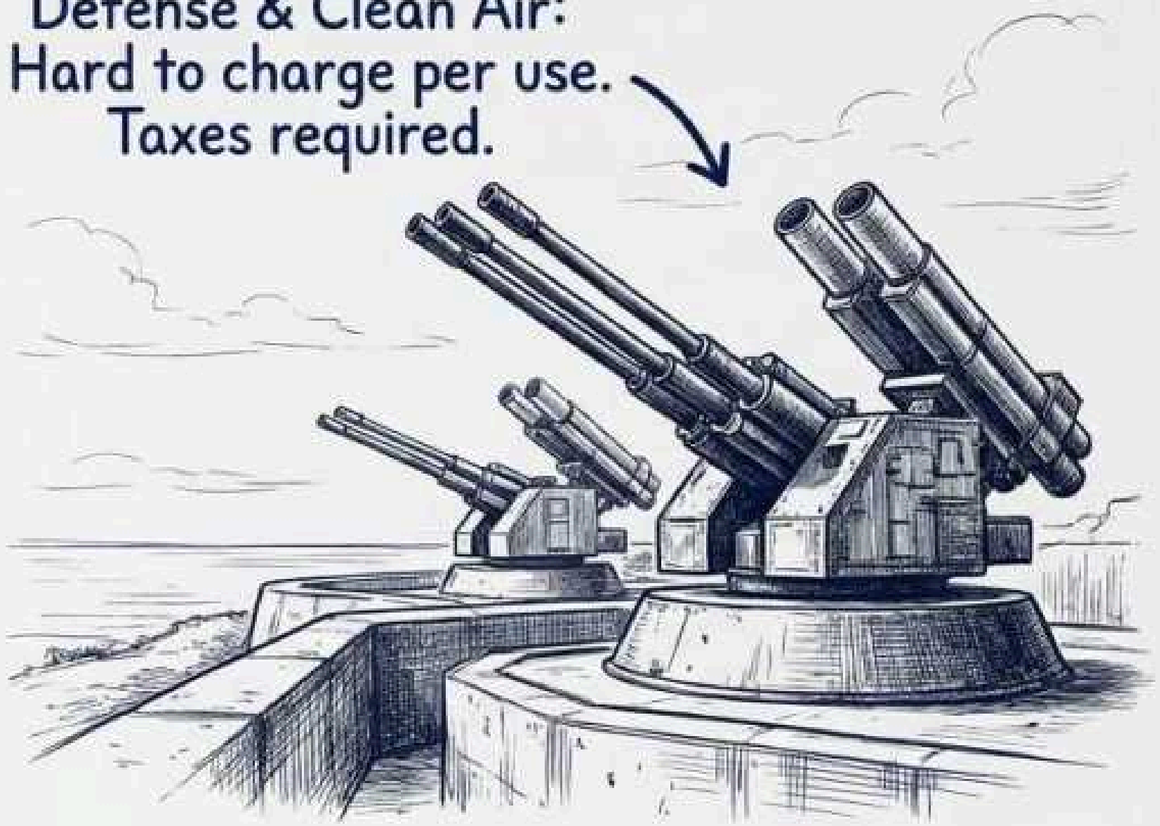
Public Goods: The total value exceeds the cost. But each person can watch without paying, hoping others will pay.

¶ 6.8



Market Workaround

Defense & Clean Air:
Hard to charge per use.
Taxes required.



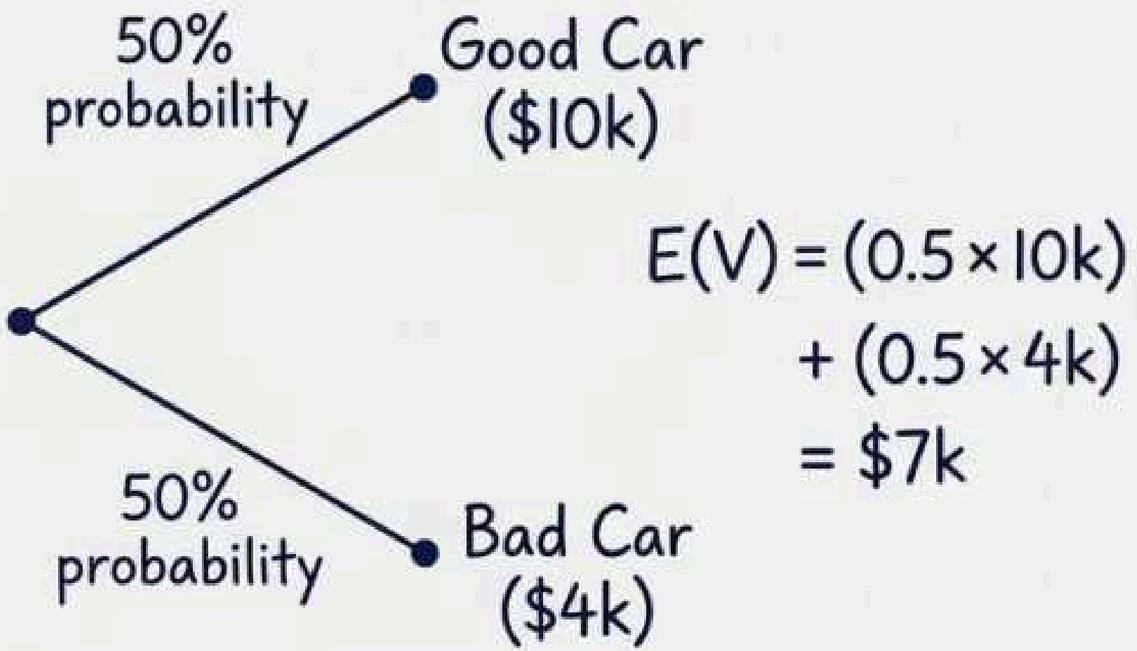
Taxation Required

The Free-Rider Problem: Voluntary contributions fall short of the good's worth.

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Akerlof (1970)



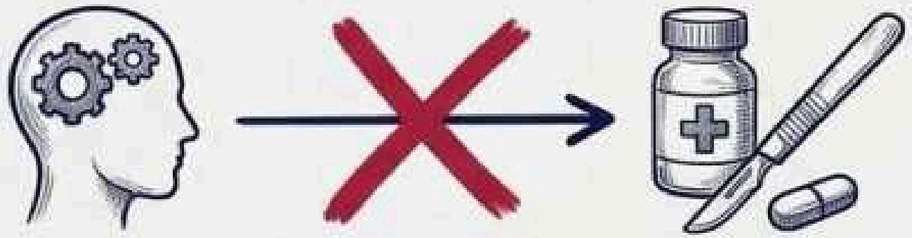


$$E(V) = (0.5 \times 10k) + (0.5 \times 4k) = \$7k$$

Buyers pay the average ($7k). Owners of good cars will not sell at that price. Good cars leave; the market fills with lemons.

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Patient Blindness



Cannot judge
treatment efficacy



Insurer Blindness



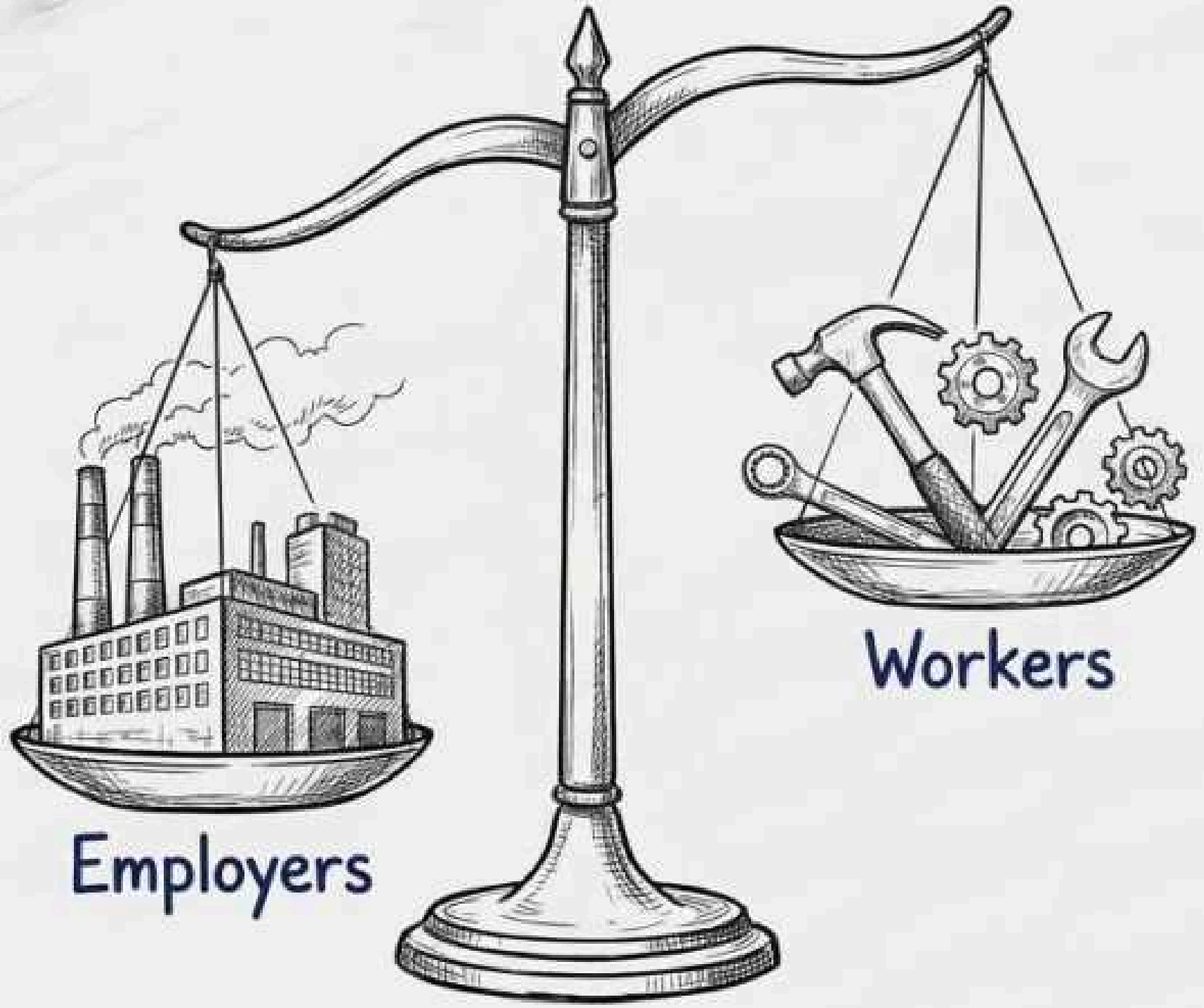
Cannot tell who
is latent sick

Kenneth Arrow (1963): Information features make medicine different from ordinary goods. Warranties and regulation repair some issues, but public provision debates remain.

¶6.11

Adam Smith:

Masters... always and everywhere in a sort of tacit but constant combination not to raise wages."



Counterweight (Defender): Competition & Mobility.

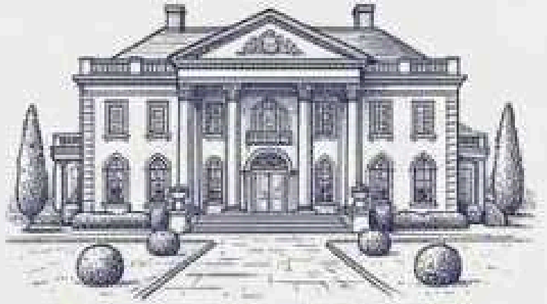
Counterweight (Critic): Unions & Minimum Wage.

Market Power: When few firms hire locally, employers hold power over workers.

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Veil of Ignorance





Grand Estate



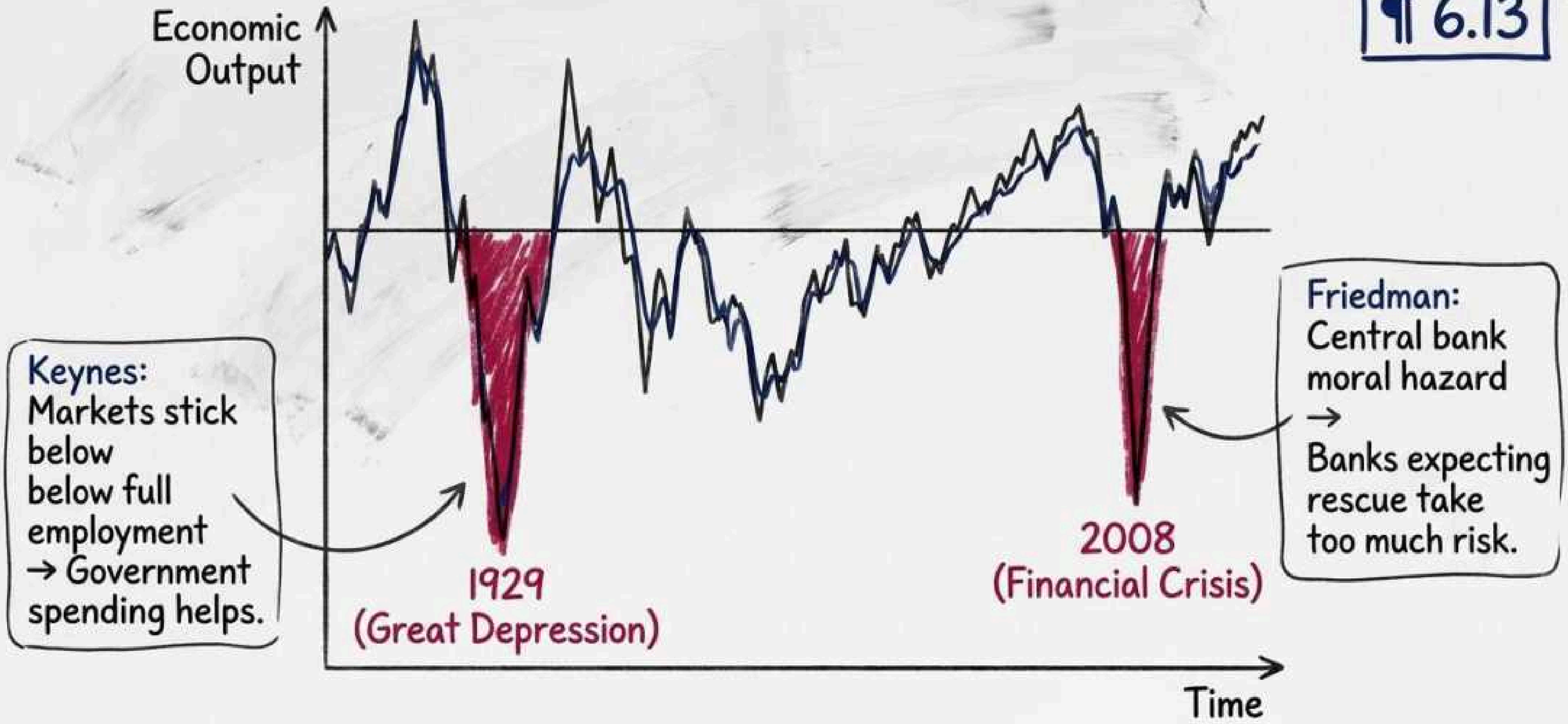
Standard House



Broken Structure

Inequality: Markets pay for scarcity. Defenders cite unequal contributions and mobility. Critics cite differing starting points. Rawls asks: What rules would you choose if you didn't know where you would end up?

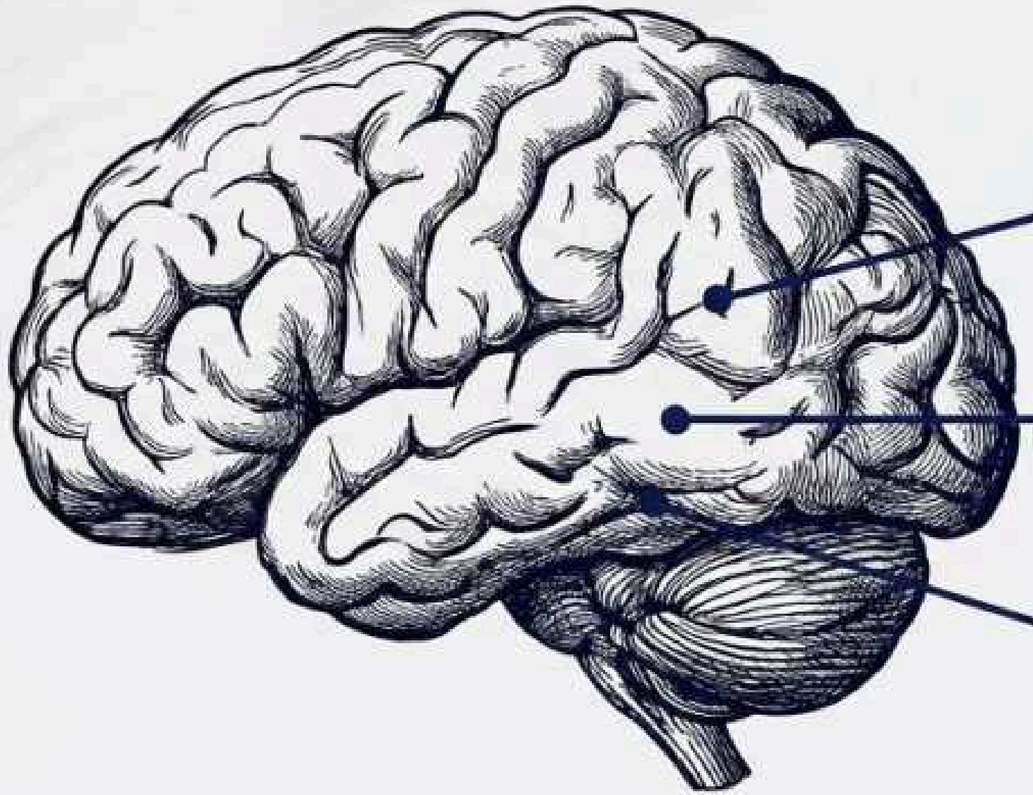
¶ 6.13



Instability: Collapses in output and jobs. How far to regulate finance remains a central dispute.

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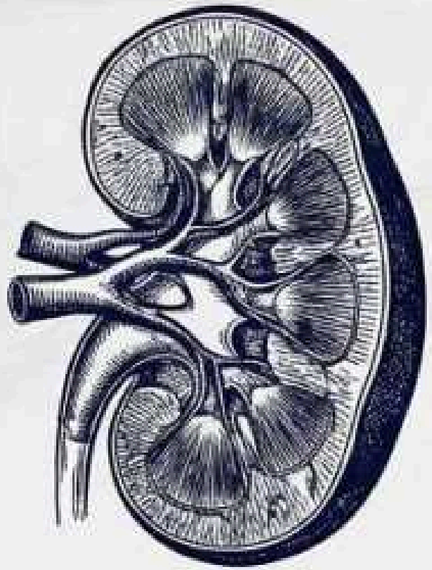
Kahneman & Tversky Findings



- Misjudging Risk
- Herd Mentality
- Yielding to Temptation

A behavioral critique: People are not perfectly rational. Defenders reply that officials share these biases, and market competition gives firms a reason to serve rather than exploit.

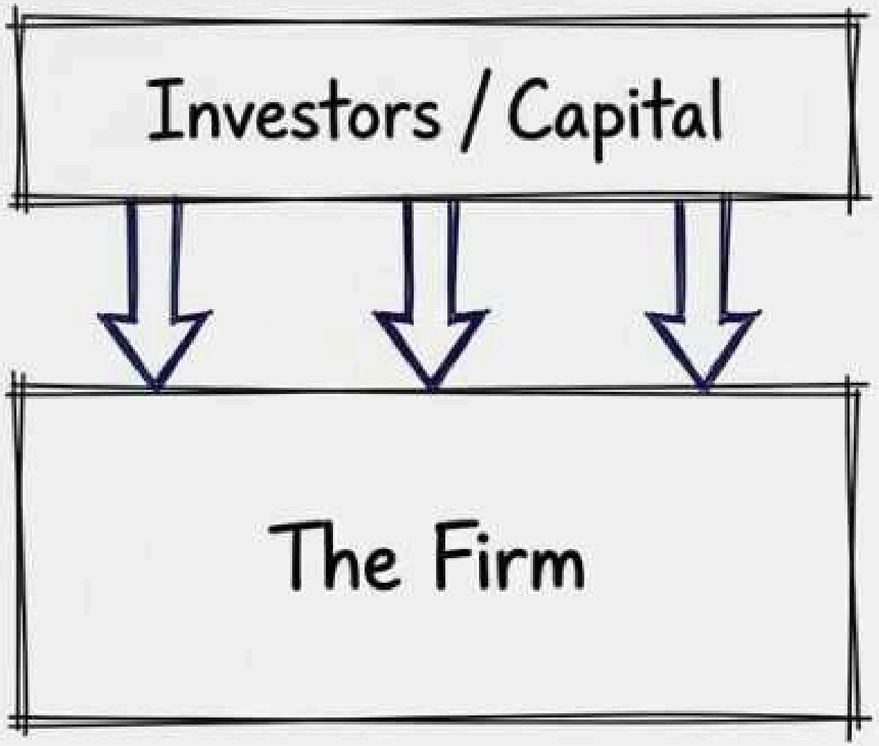
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Michael Sandel	Alvin Roth
- Money corrupts fairness - Buying a place in a queue - Banned Market	- Designing systems of exchange that avoid payment - Moneyless Matching System

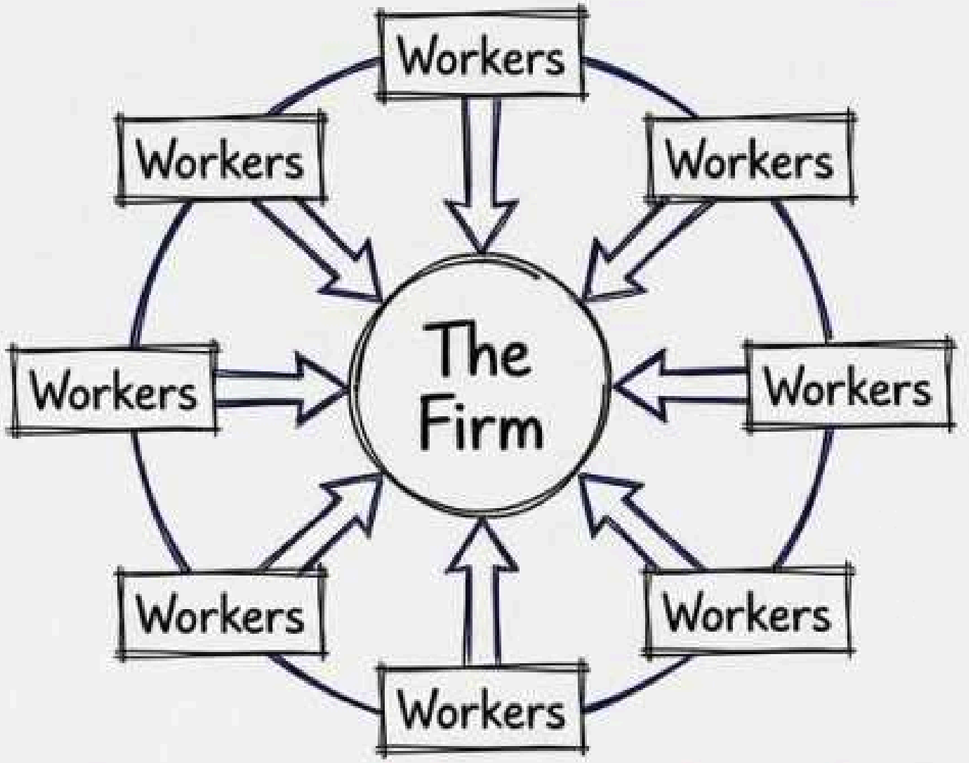
Moral Critiques: Some things should not be sold at all. Can we design systems that solve the scarcity without the money?

Top-down Investor Ownership



Pros: Raise capital, take risks.

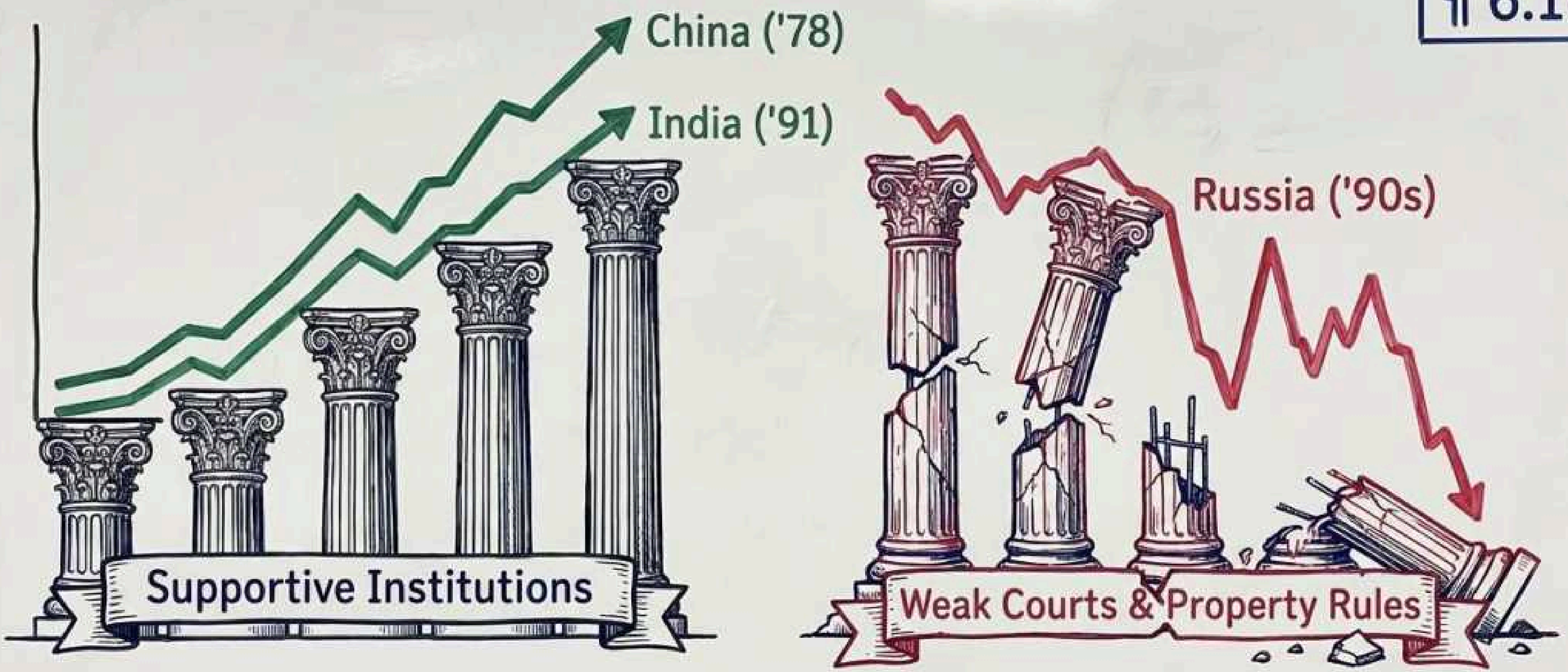
Circular Worker Cooperative



Some socialists accept markets but alter ownership.

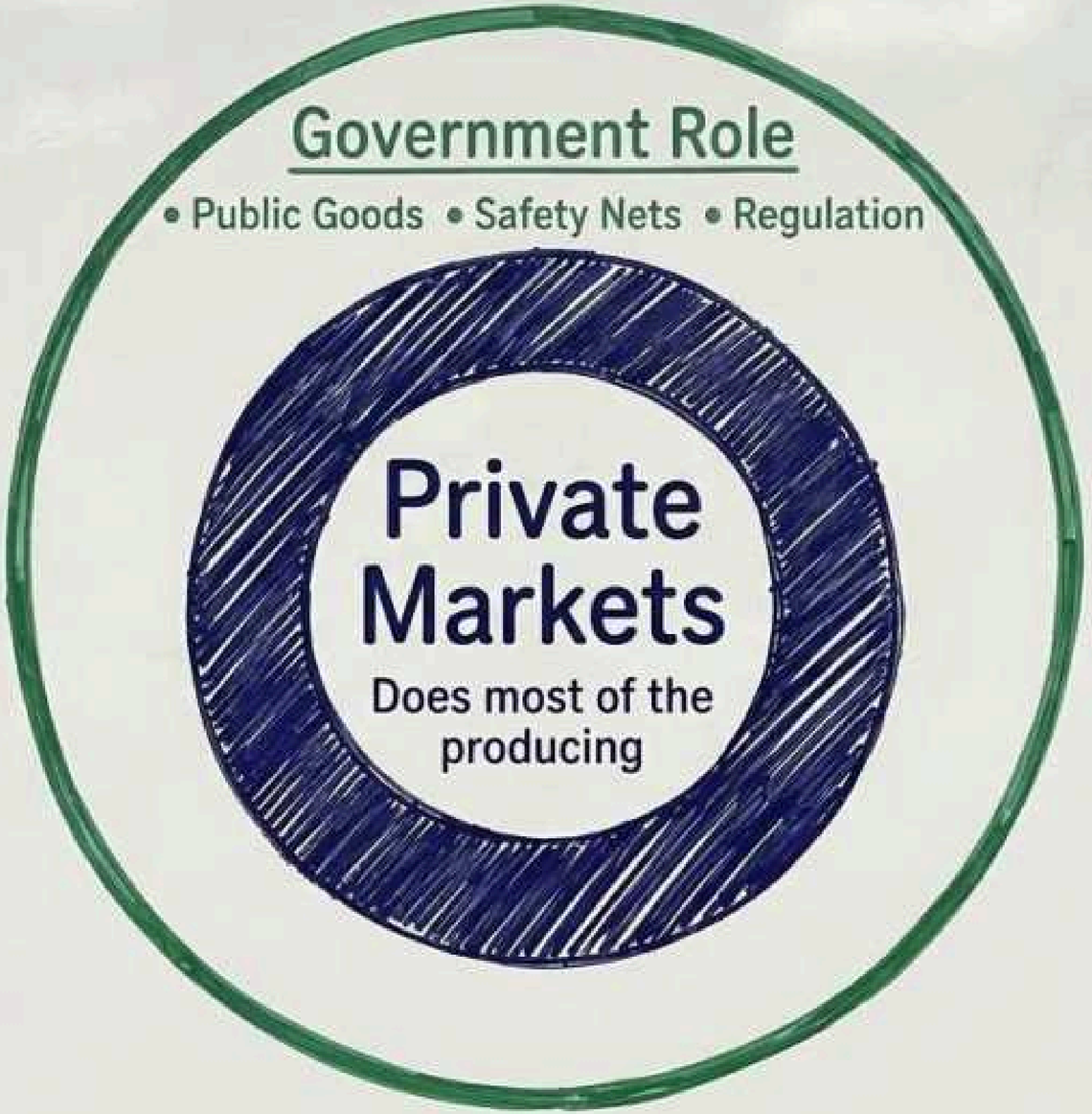
Who owns the firm? Markets and capitalism are not identical. Cooperatives can thrive within a market system, though they remain rare.

¶ 6.17



The Empirical Evidence:
Rapid market reforms work best where institutions support them.
Markets and institutions are partners, not rivals.

¶ 6.18



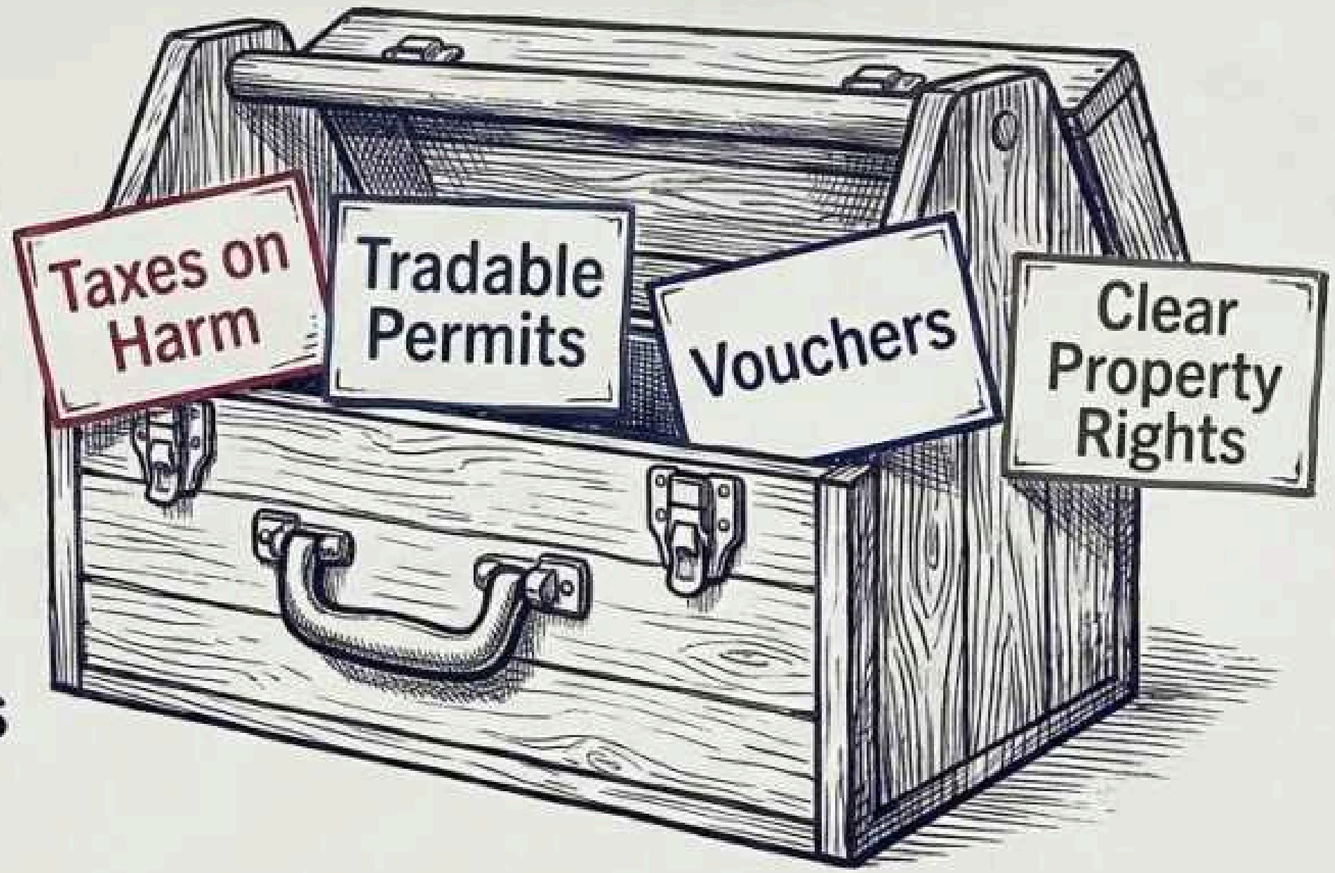
Economic freedom correlates with higher incomes.

The real argument is about the mix, and which tool suits which problem.

Every rich country is a Mixed Economy.

¶ 6.19

Market Failure ≠ Gov Success



The Toolkit

- ☑ Use incentives
- ☑ Compare real institutions

The Free-Market Rebuttal: Market failure does not prove government will do Compare real institutions with real ones, and look for fixes that use incentives. (Critics reply: climate and health still need collective action).

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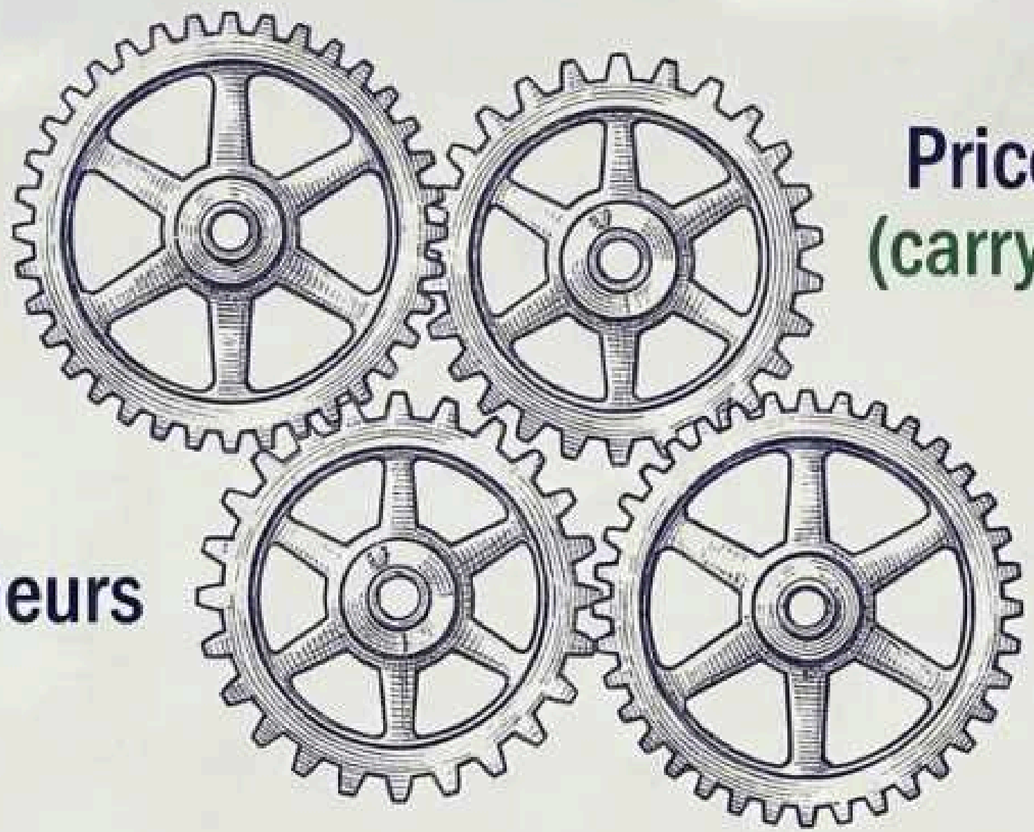
Credits / Pros	Debits / Cons
• Voluntary exchange creates value	• Externalities
• Prices carry knowledge	• Public goods
• Profit rewards service	• Information gaps
• Competition disciplines firms	• Market power
• Entrepreneurs drive innovation	• Inequality
	• Instability

The Balance Sheet: Neither list is short, and honest people weigh them differently.

¶ 6.21

Trade
(creates value)

Prices
(carry knowledge)



Property/Entrepreneurs
(make it work)

Competition
(disciplines power)

Government faces limits. Markets have real failures.
Ask: What is the alternative?

Course Retrospective. Trade disciplines power, but requires thought.

¶ 6.22

Chosen Policy: _____

Best Case FOR Free Market	Best Case AGAINST Free Market

Which facts would change your mind?

Which arguments depend on values?

The Final Question. State the strongest cases on both sides.

Thank you for taking Economics 110 B.

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