3.5 — Intro to Political Economy

ECON 306 • Microeconomic Analysis • Spring 2021

Ryan Safner

Assistant Professor of Economics

safner@hood.edu

ryansafner/microS21

microS21.classes.ryansafner.com

Outline

Welfare Economics, Reminder

- **Markets are great when:**

  1. They are **Competitive**: many buyers and many sellers
  2. They each **equilibrium** (**prices are free to adjust**): absence of transactions costs or policies *preventing prices from adjusting* to meet supply and demand
  3. **There are no externalities** are present: costs and benefits are fully internalized by the parties to transactions

- If any of these conditions are not met, we have **market failure**

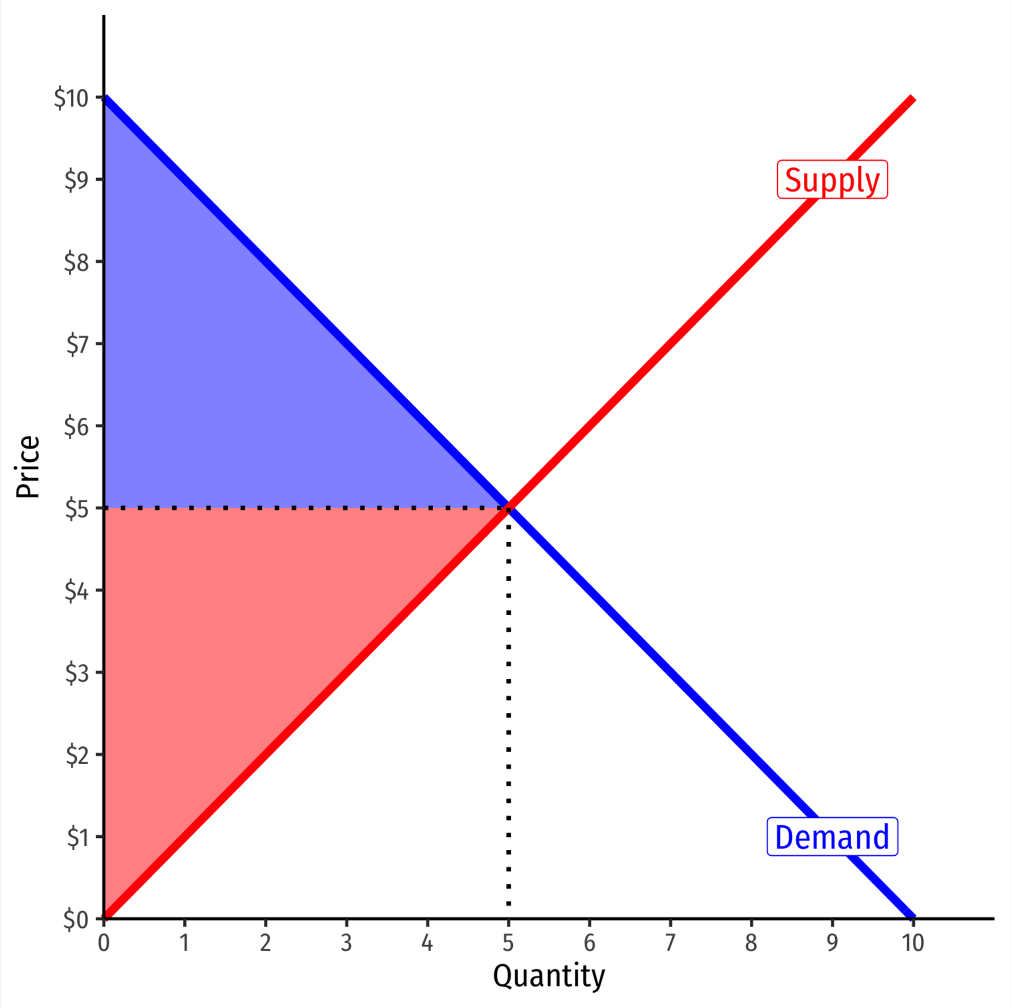
  - May be a role for governments, other institutions, or entrepreneurs to fix

- Let's first talk about #2

Policies That Raise Transaction Costs & Prevent Equilibrium

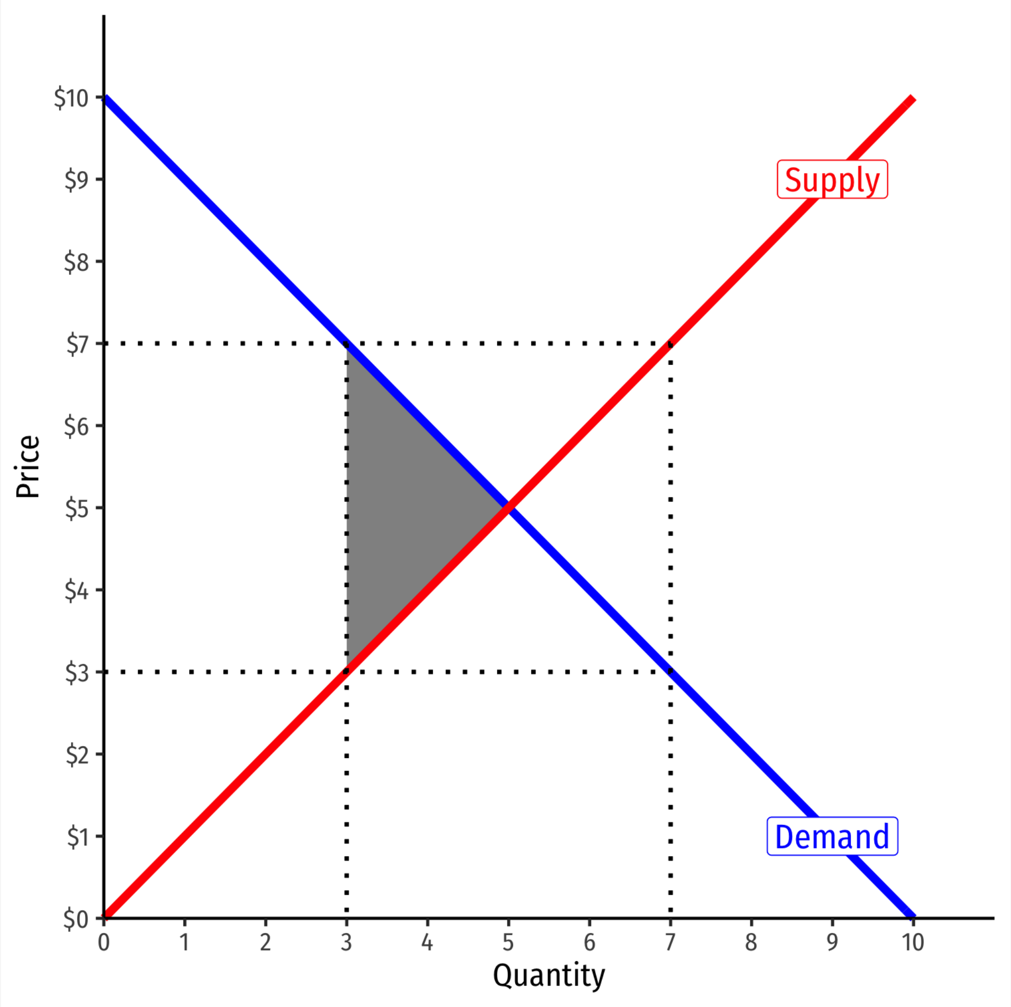
Dis-equilibrated Markets

- The static benefits of markets all come from markets *being in equilibrium*:
  - allocative efficiency (CS+PS)
  - Pareto efficiency
  - productive efficiency
- But don't forget the *dynamic benefits* of markets as a discovery process! ([class 3.3])
  - *discovery* of better allocations of resources
  - creation & elimination of profit opportunities
  - entrepreneurship & innovation



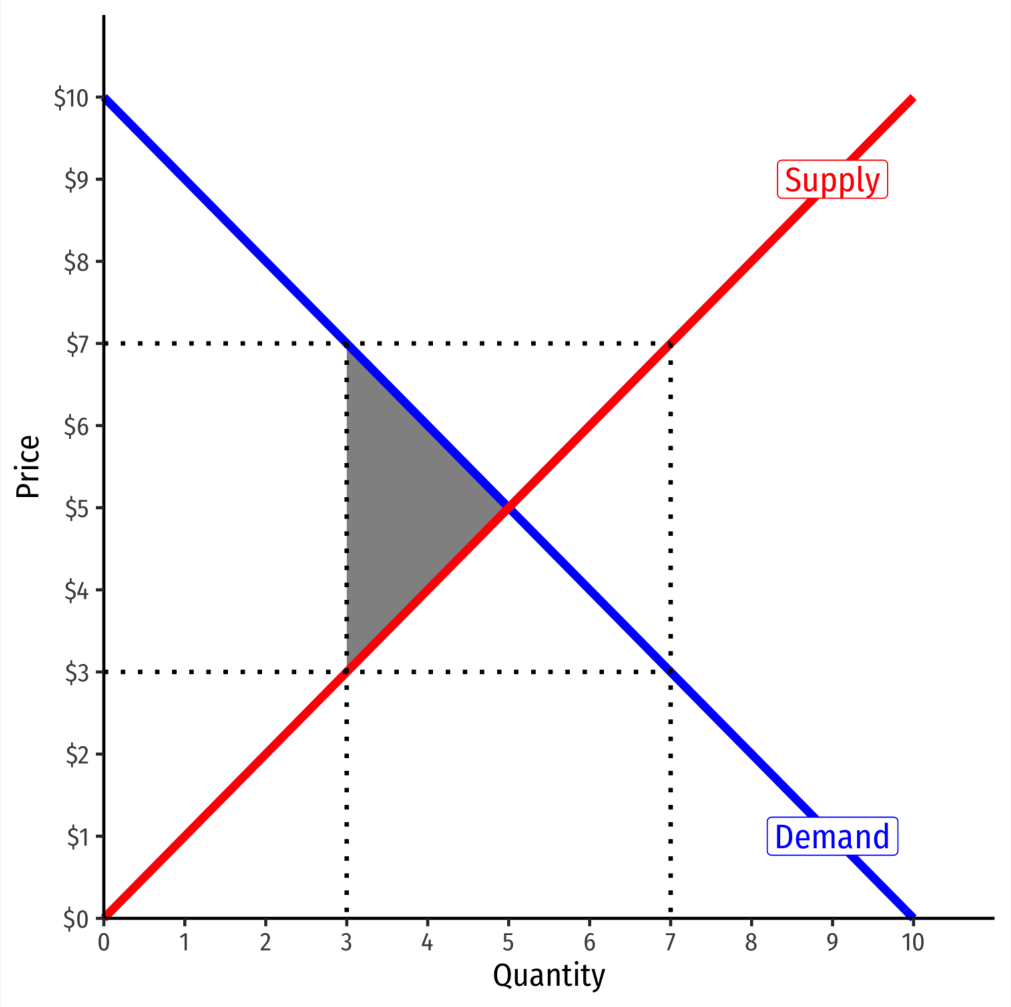
Dis-equilibrated Markets

- To *reach* equilibrium, market prices need to be able to adjust
  - Shortage: price needs to rise
  - Surplus: price needs to fall
- There are ***unrealized* gains from trade** that exist in disequilibrium (shaded)
  - Buyers & sellers both can be made better off if they can adjust the price



Dis-equilibrated Markets

- If market prices are *prevented* from adjusting, shortage/surplus becomes *permanent*
- Lost CS and/or PS: **Deadweight loss (DWL)**
  - **inefficiency** created by (permanent) diseq.
- Various government policies can prevent markets from equilibrating & create DWL:
  - **Price regulations** (price ceiling like rent control, price floor like minimum wage)
  - **Taxes, subsidies, tariffs, quotas**†
  - These should have been covered in Principles (see my slides on taxation from ECON 410)



An Example: *Some* Economic Impacts of Covid

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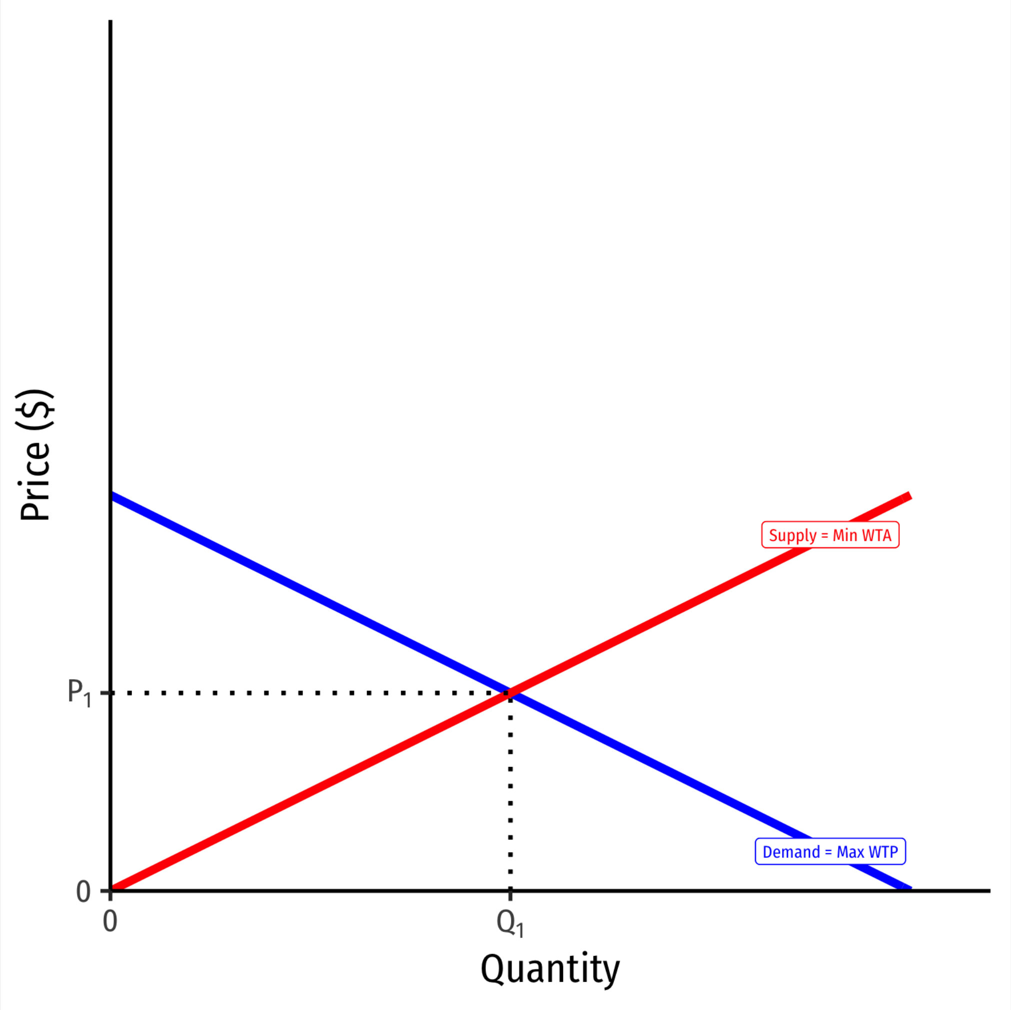
The toilet paper aisle of my Giant grocery store, March 2020

- Where did all of the ... go?
  - Toilet paper
  - Hand sanitizer
  - Masks
  - PPE
  - Ventilators
- Three major issues:
  - price elasticity of supply
  - price gouging laws
  - restrictions & regulations on supply

Increase in Demand

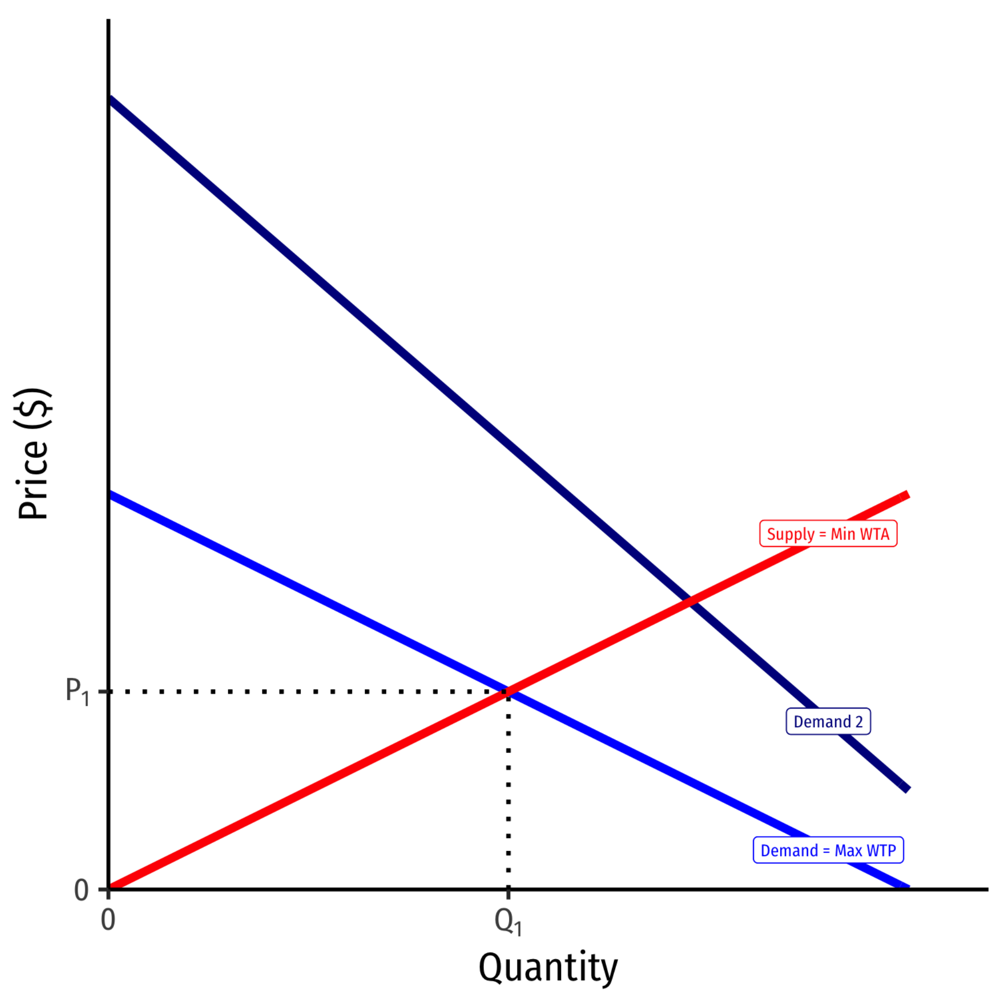
- Consider a market for a good in equilibrium, P_1



Increase in Demand

- More individuals want to buy more of the good at *every* price

- Demand *increases*, becomes *less elastic*



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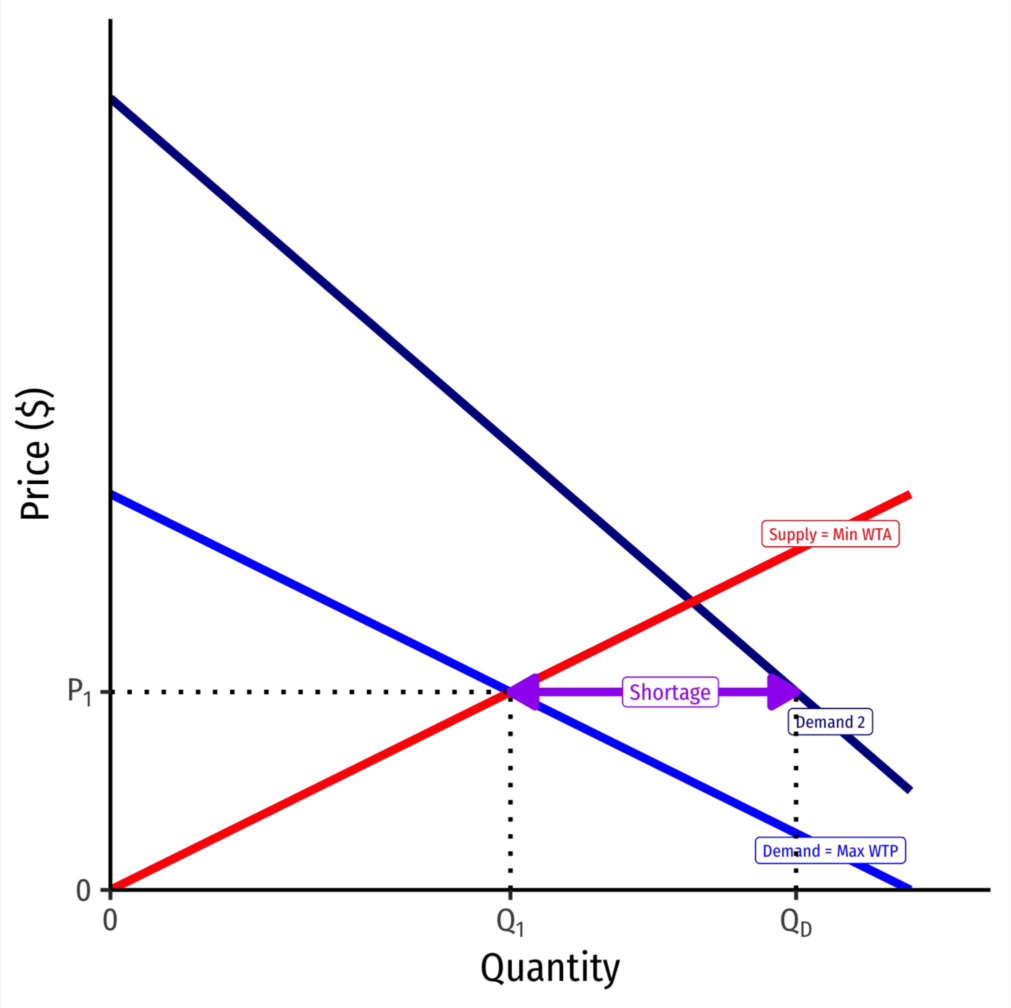

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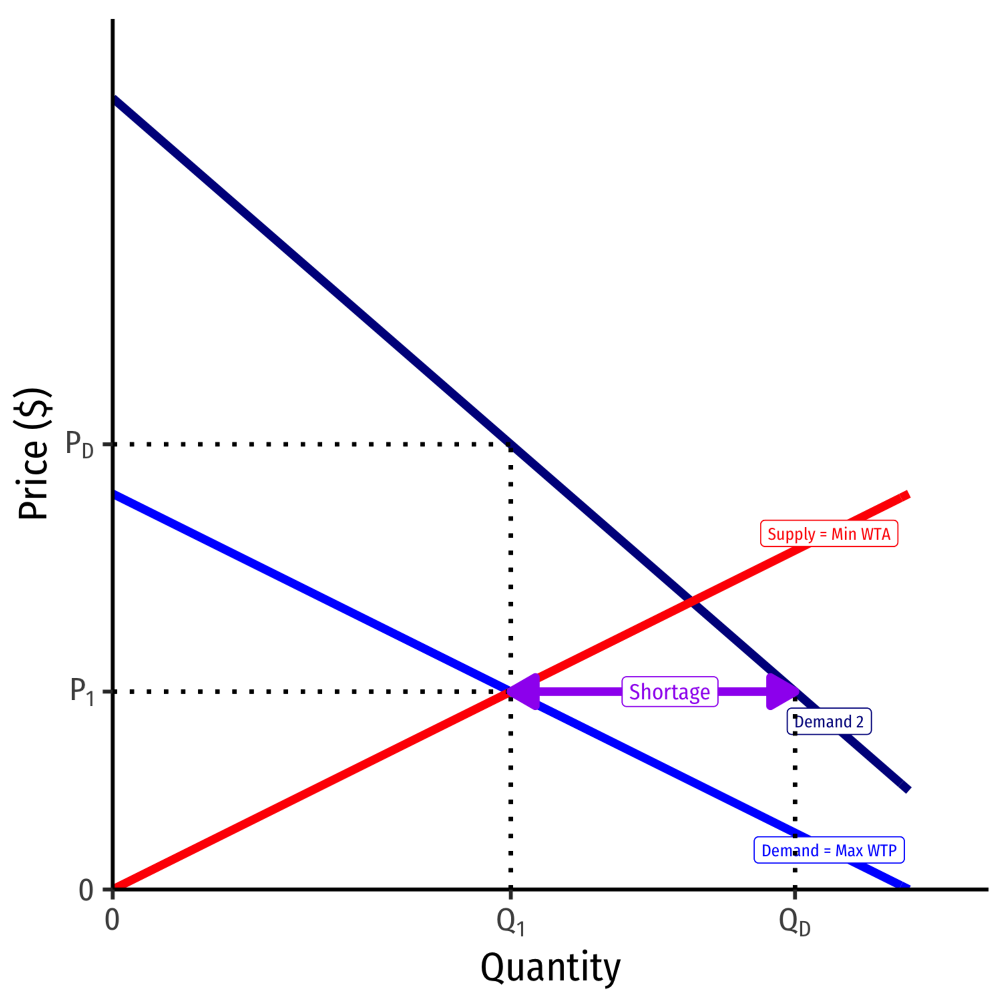

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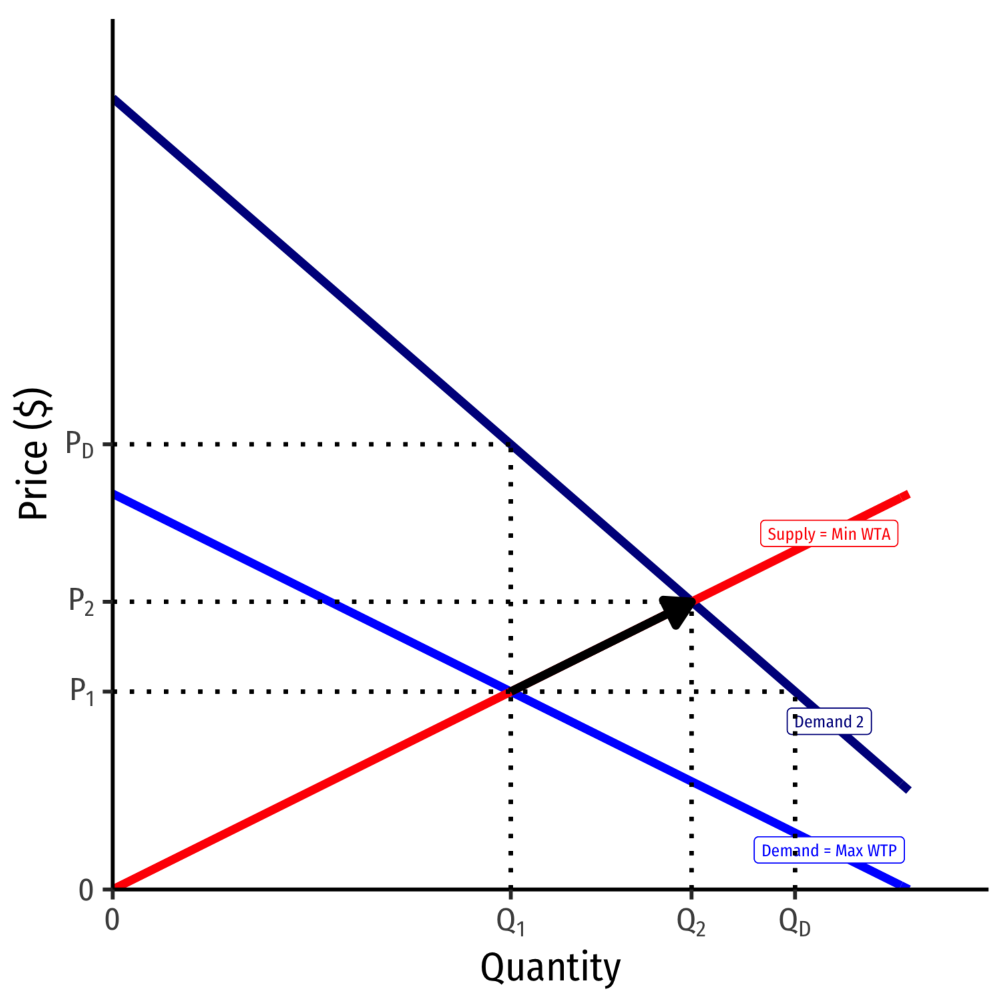
- Buyers raise bids, inducing sellers to sell more

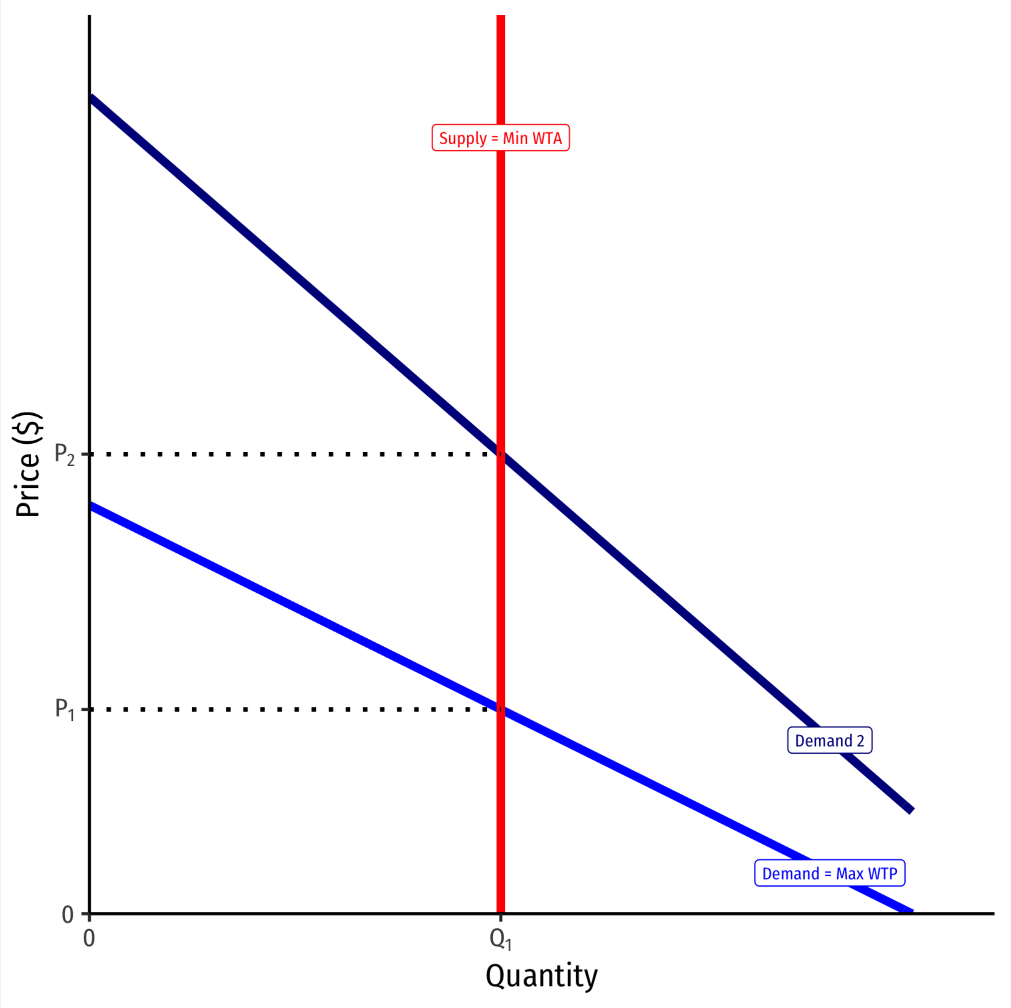
- Reach new equilibrium with:

  - **higher market-clearing price** (P_2)



One Possibility: Inelastic Supply

- It might that supply is very *inelastic*
    - Here: *perfectly* inelastic (for convenience)
- Suppliers can't produce and sell more units even if they want to at very high price demanded
    - sudden shock to inventories (short run)
    - rising production costs
    - government regulations & restrictions
- Thus, the new high price is an equilibrium that will persist for a while
    - no "inefficiency," just a fixed supply of goods we cannot easily change



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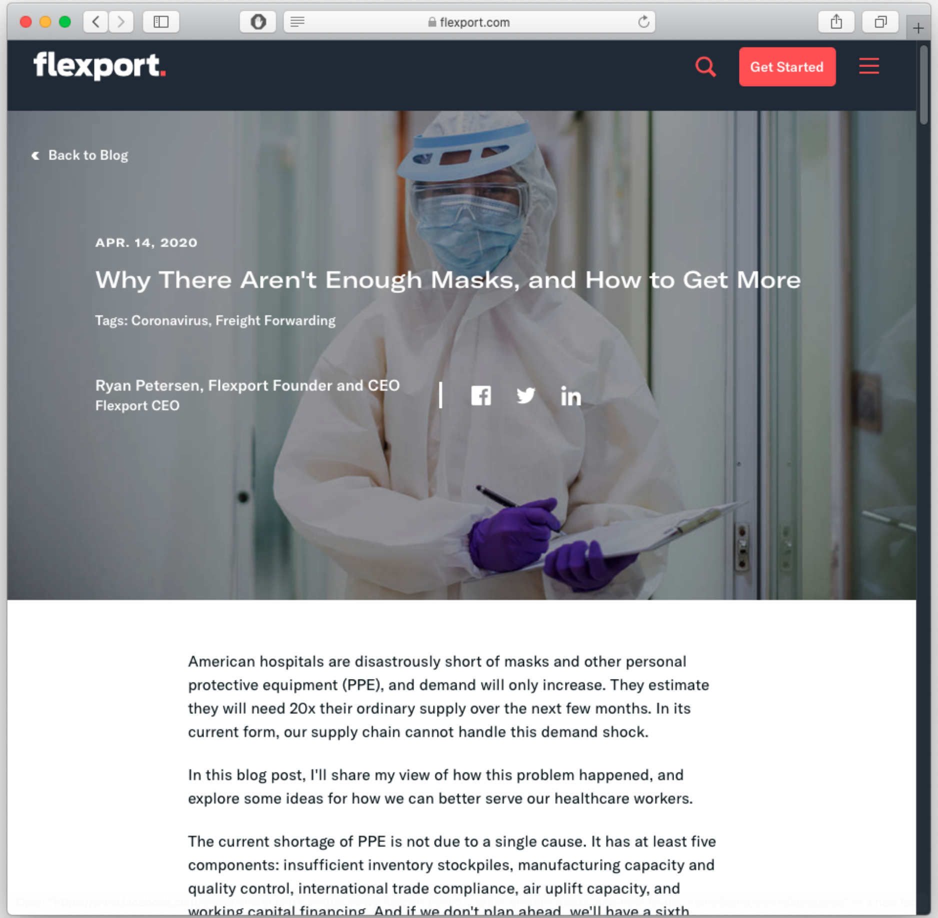

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Get Started

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APR. 14, 2020

Why There Aren't Enough Masks, and How to Get More

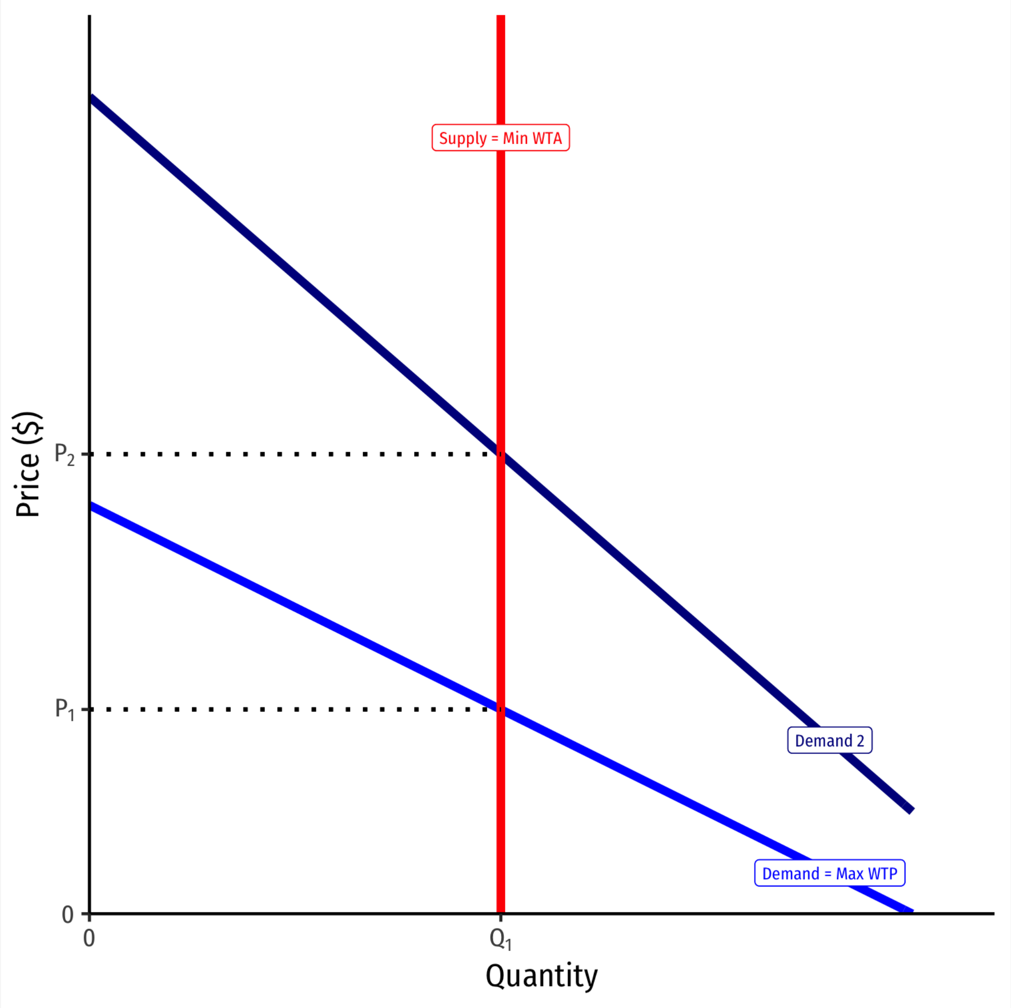
Tags: Coronavirus, Freight Forwarding

Ryan Petersen, Flexport Founder and CEO
Flexport CEO

American hospitals are disastrously short of masks and other personal protective equipment (PPE), and demand will only increase. They estimate they will need 20x their ordinary supply over the next few months. In its current form, our supply chain cannot handle this demand shock.

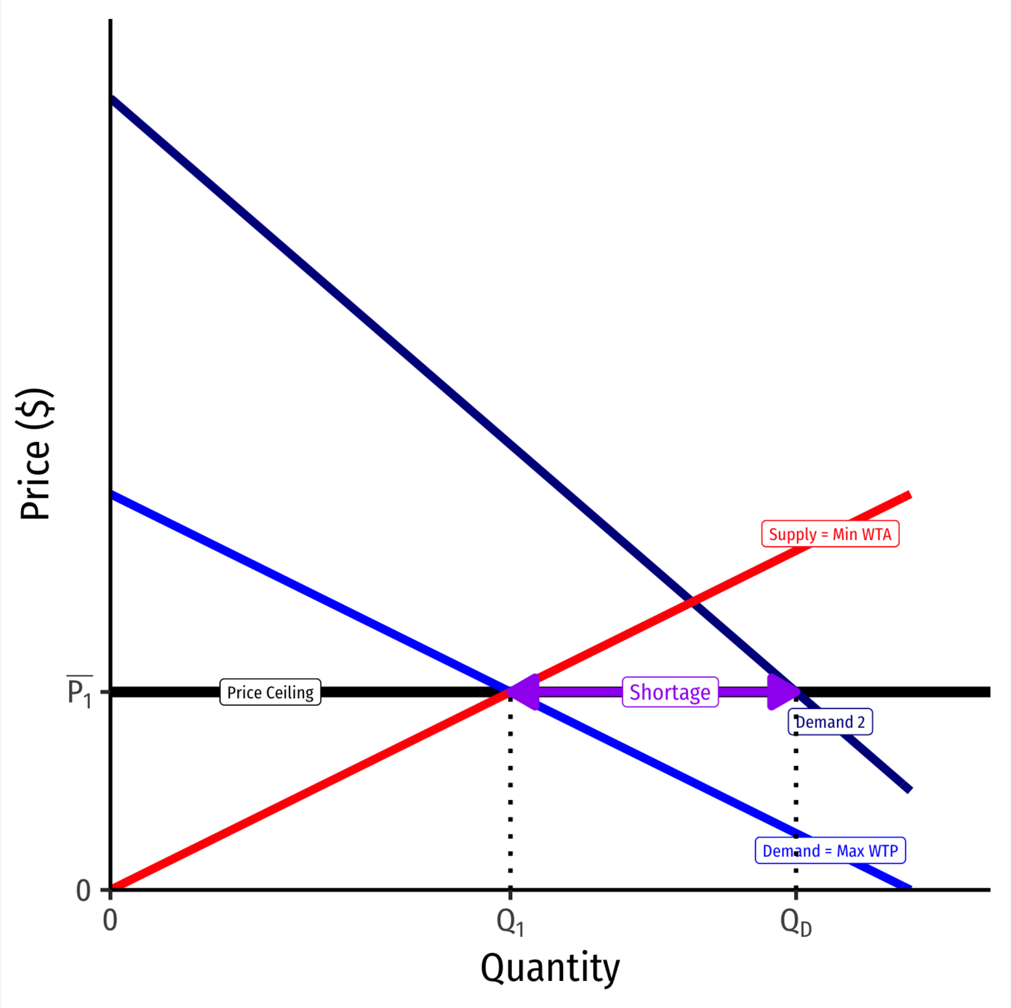
In this blog post, I'll share my view of how this problem happened, and explore some ideas for how we can better serve our healthcare workers.

The current shortage of PPE is not due to a single cause. It has at least five components: insufficient inventory stockpiles, manufacturing capacity and quality control, international trade compliance, air uplift capacity, and working capital financing. And if we don't plan ahead, we'll have a sixth



Price Gouging Laws

- Additionally, government has **anti-price-gouging laws**, a **price ceiling** at the original price, P_1
- $Q_d > Q_s$: **excess demand**, a **shortage**!
- Sellers will not supply more than Q_1 at price $\bar{P}_1$



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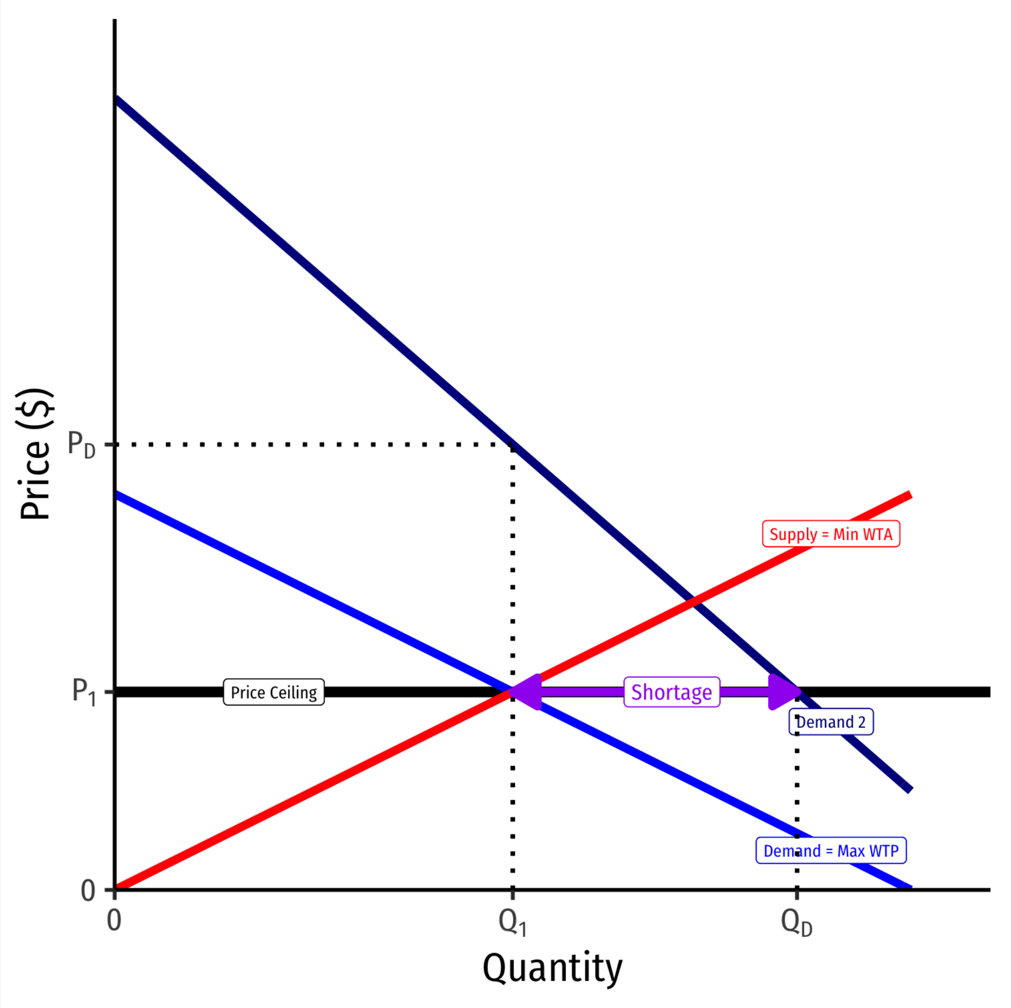
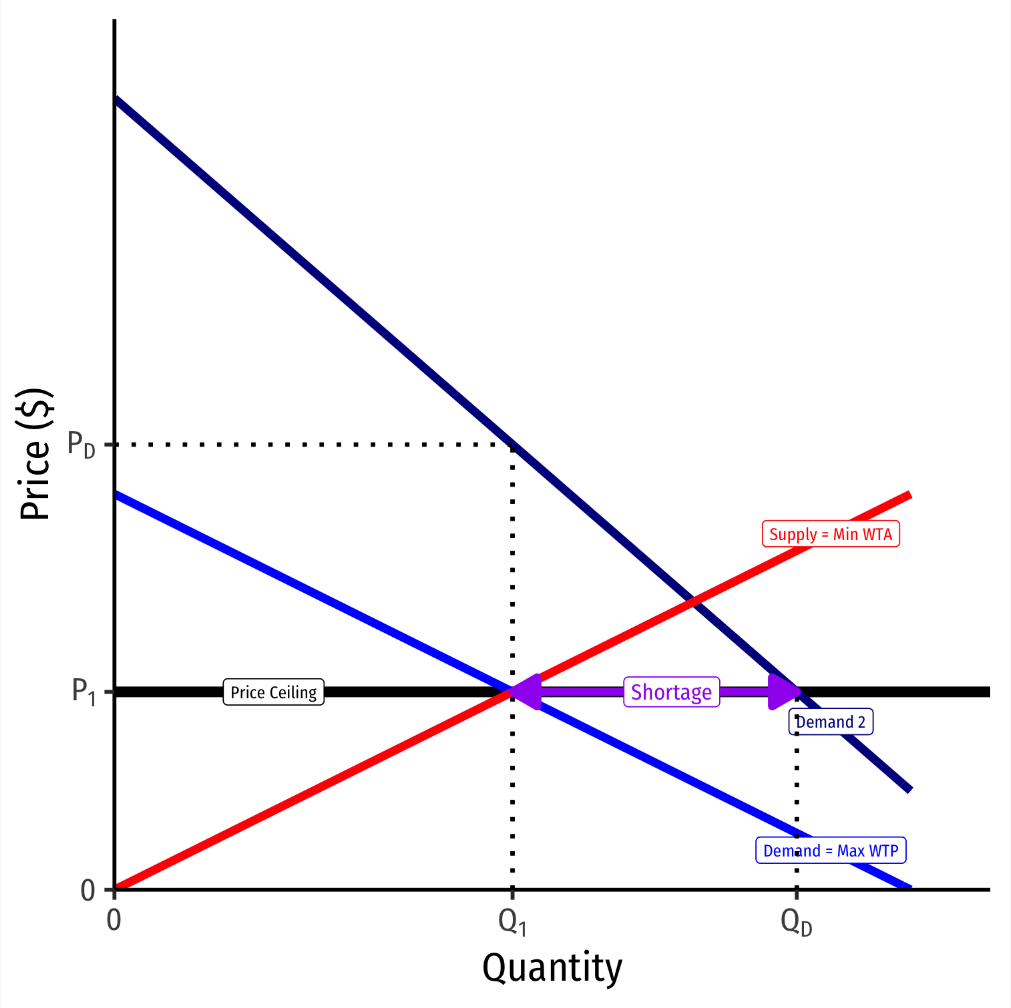
- For Q_1 units, buyers are willing to pay P_D!



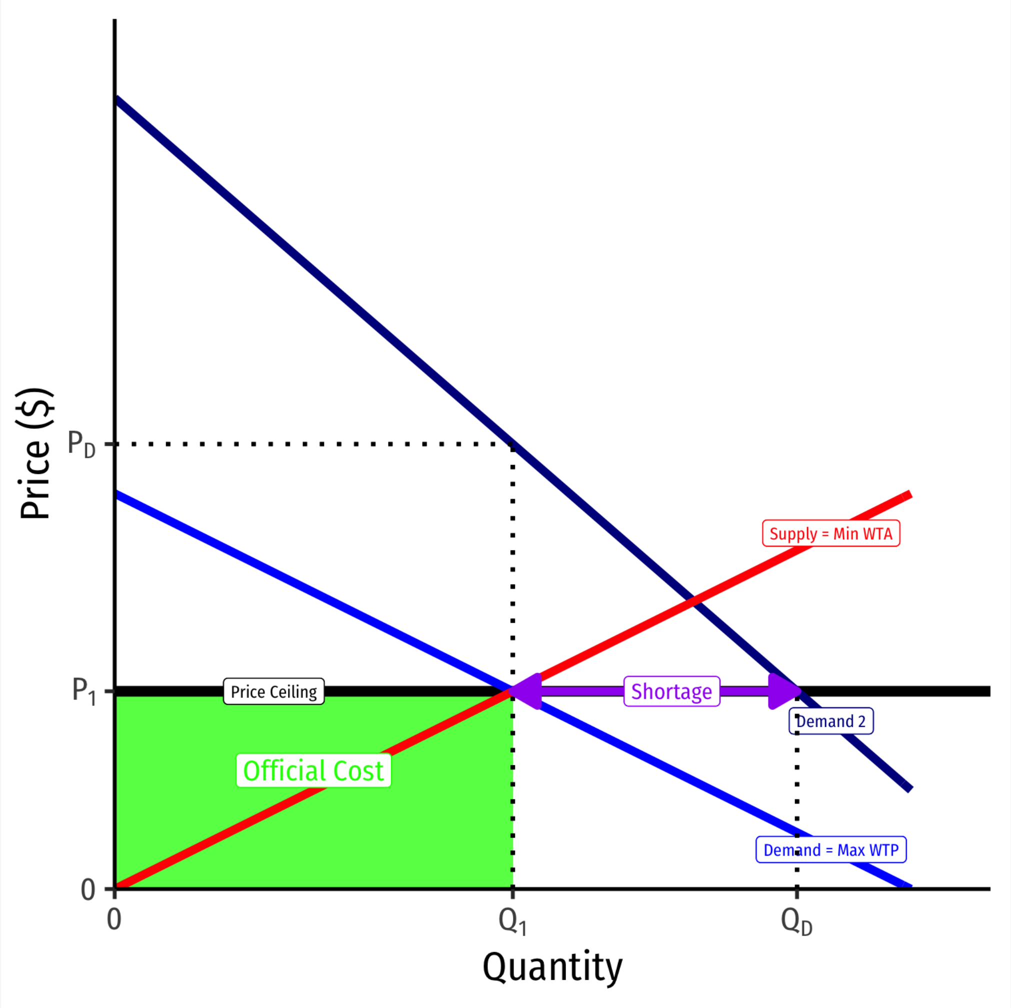
Price Gouging Laws

- **If prices were allowed to adjust**: buyers would bid higher prices to get the scarce Q_s goods
- Sellers would respond to rising willingness to pay, and produce and sell more
- **But the price is not allowed to rise above $\bar{P}_1$!**



Price Gouging Laws

- Official price is $\bar{P}_1$, sellers gain monetary revenues



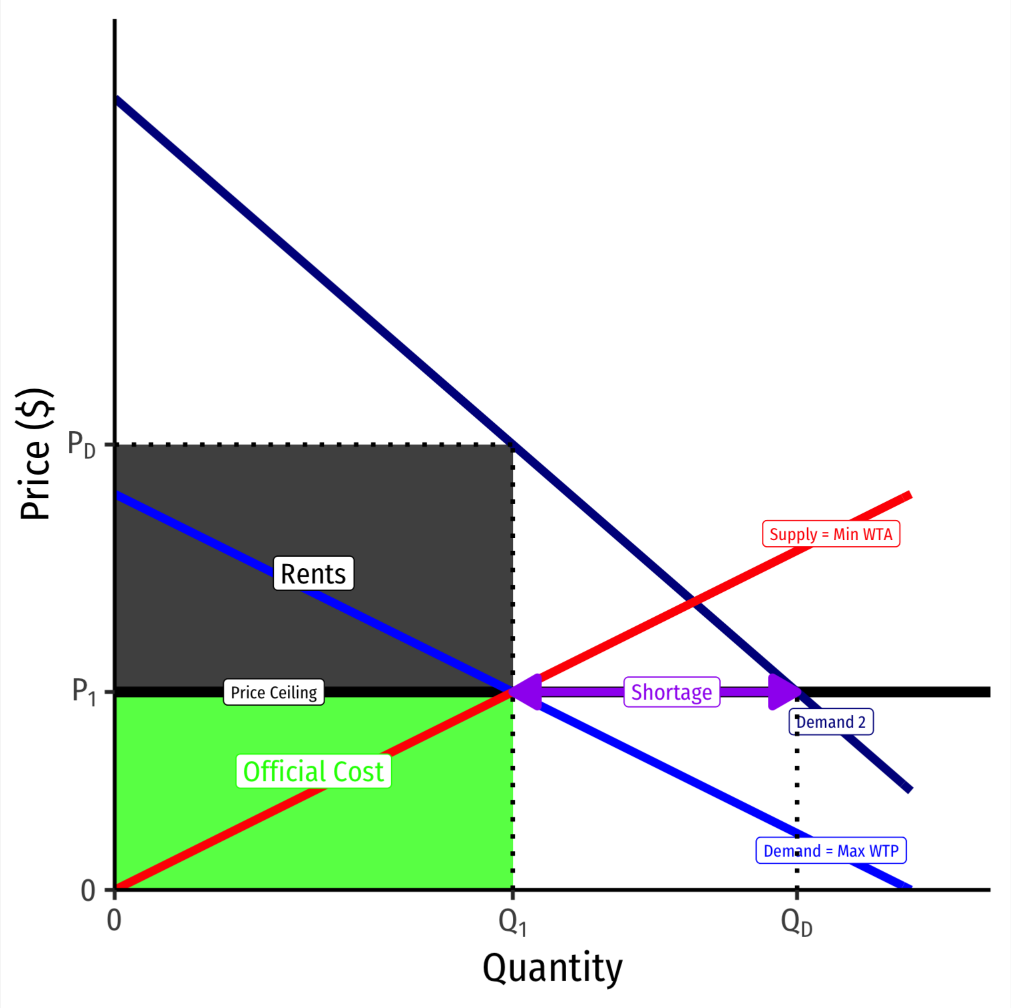
Price Gouging Laws

- Official price is $\bar{P}$, sellers gain monetary revenues

- Competition exists between buyers to obtain scarce Q_s goods
    - Buyers willing to pay P_D *unofficially*

- Goods are distributed by non-market means:
    - Queuing
    - Black markets
    - Political connections, favors, corruption

- **Economic rents**: excess resturns (above cost) go to those who own & distribute the scarce goods



Forms of Rents

(Temporarily) Raising Prices Can Solve the Shortage

A relatively high price:

- **Conveys information**: good is relatively scarce
- **Creates incentives for**:
  - **Buyers**: conserve use of this good, seek substitites
  - **Sellers**: produce more of this good
  - **Entrepreneurs**: find substitutes and innovations to satisfy this unmet need

(Temporarily) Raising Prices Can Solve the Shortage

(Temporarily) Raising Prices Can Solve the Shortage

BIЯGΣЯ
@Birger_s

A supermarket in Denmark got tired of people hoarding hand sanitizer, so came up with their own way of stopping it.

1 bottle kr40 (€5.50)
2 bottles kr1000 (€134.00) each bottle.

Hoarding stopped!

#COVID19 #Hoarding pic.twitter.com/eKTabEjScc (via @_schuermann) cc @svenseele

2:28 AM · Mar 18, 2020

4.1K   See the latest COVID-19 information on Twitter

Forcing Low Prices Doesn't Solve the Shortage

Russell Roberts
@EconTalker

Shopper: Your chicken is too expensive. The butcher across the street is only $1/lb.
Butcher: So buy from the butcher across the street.
Shopper: But he's out of chicken.
Butcher: Yeah, when I'm out I charge $1/lb, too.

10:15 AM · Apr 13, 2020

1.5K 25 Copy link to Tweet

Supply-Side Restrictions & Regulatory Burden

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Making Fair Comparisons

Two Fundamental Problems of Political Economy

- All societies face two fundamental problems, which institutions emerge (or are created) to address:

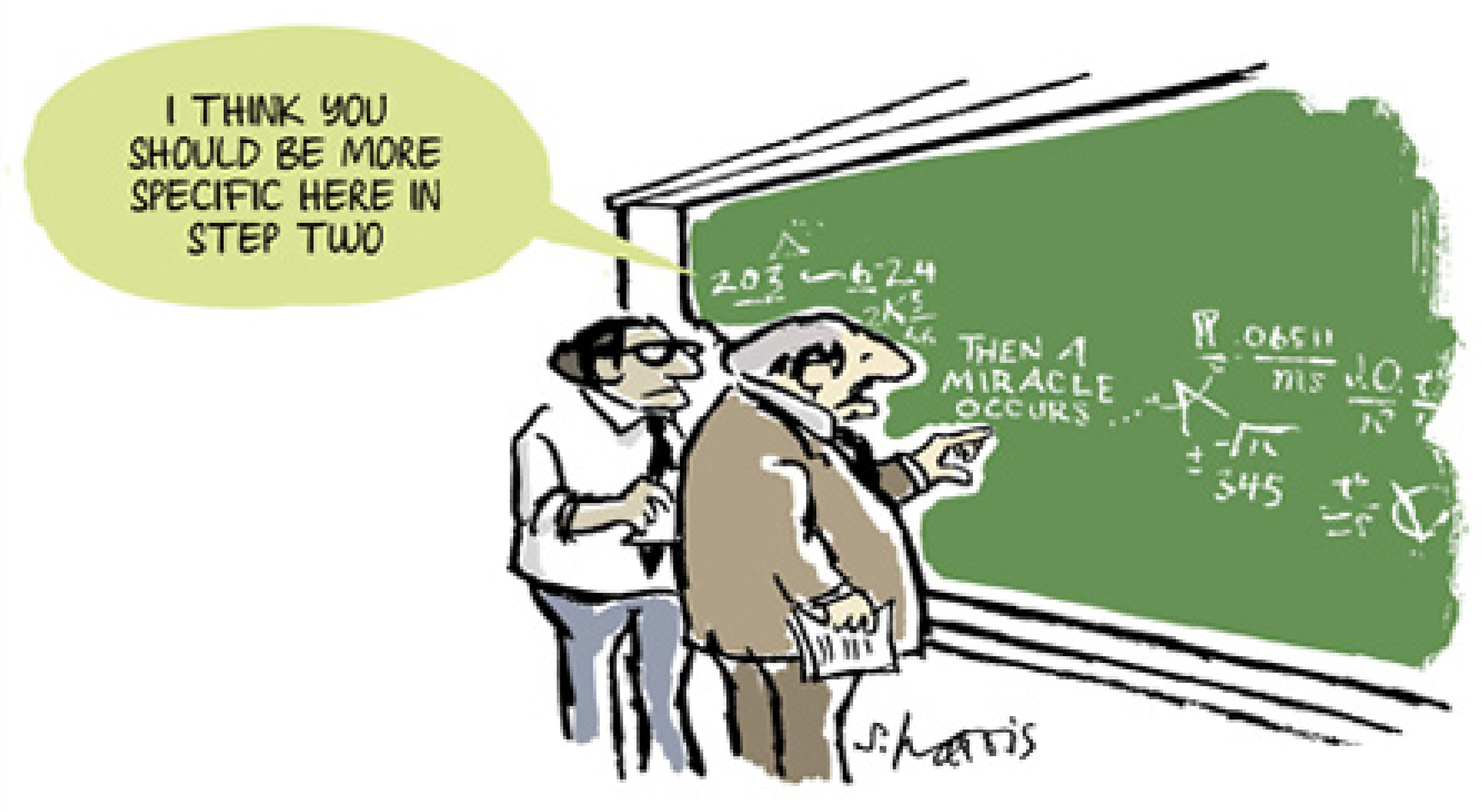
The Knowledge Problem: How to coordinate the *tacit*, *fragmented* knowledge of opportunities and conditions *dispersed* across millions of individuals (and accessible to none in total) in order to maximize the ability of individuals to achieve their goals

The Incentives Problem: How to structure incentives that individuals face in a way that maximizes cooperative behavior (voluntary exchange and association) and minimizes non-cooperative behavior (cheating, opportunism, exploitation, violence, rent-seeking)

Robust Political Economy

- No system is perfect
- We need to find arrangements that are **robust** to knowledge & incentive problems
- Easy (unpersuasive) case: perfect information & pure benevolence
  - every system works *in theory!*
- Hard (persuasive) case: uncertainty & selfish behavior
  - what works best *in practice*?
- Treat people as they are: sometimes good, bad, smart, stupid, opportunistic, altruistic,

Robust Political Economy



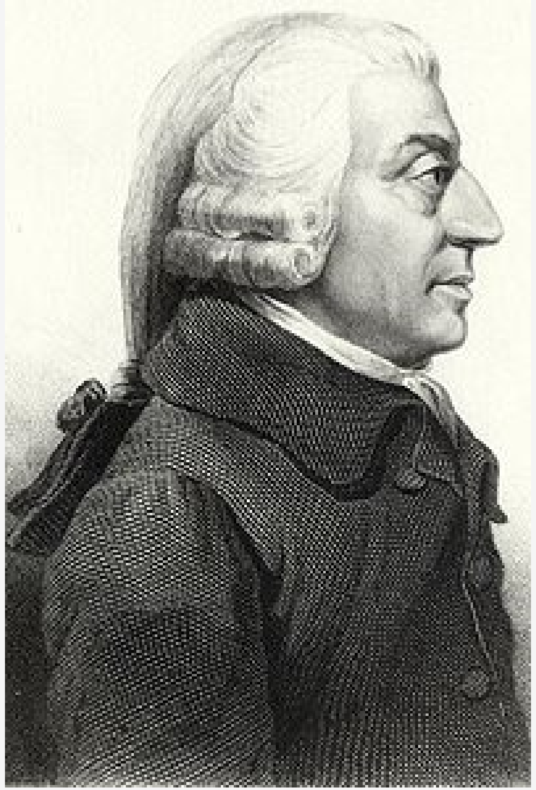
Robust Political Economy

- People often recommend optimal policies as if they could be installed by a **benevolent dictator**
    - A dispassionate ruler with **total control**, **perfect information**, and **selfless incentives** to implement optimal policy
    - A "1st-best solution"
- In reality, 1st-best policies are distorted by the knowledge problem, the incentives problem, and politics
    - Real world: 2nd-to-n^{th}-best outcomes

Comparative Institutional Analysis

- Compare imperfections of *feasible* and *relevant alternative* systems
    - **The "Nirvana Fallacy"**: comparing an imperfect system in reality with an ideal system in theory
- Economics: *think on the margin!*
    - One system's "failure" does not automatically imply another will be "successful"!
    - Real world requires **tradeoffs**
    - "economics puts parameters on people's utopias"
    - "compared to what?"

Institutions: Operationalizing Adam Smith



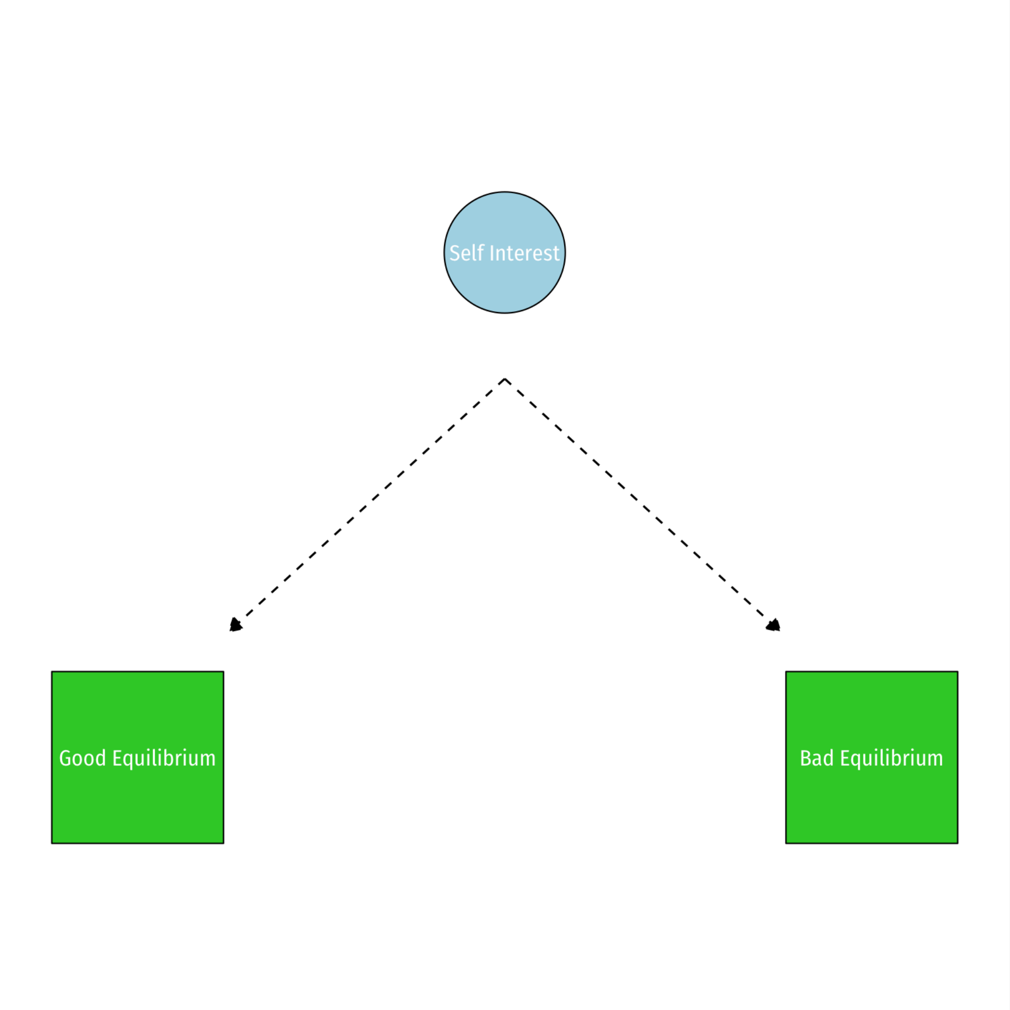
Adam Smith

1723-1790

> “[Though] he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention...By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it,” (Book IV, Chapter 2.9).

Smith, Adam, 1776, *An Enquiry into the Nature and Causes of the Wealth of Nations*

Institutions: Operationalizing Adam Smith



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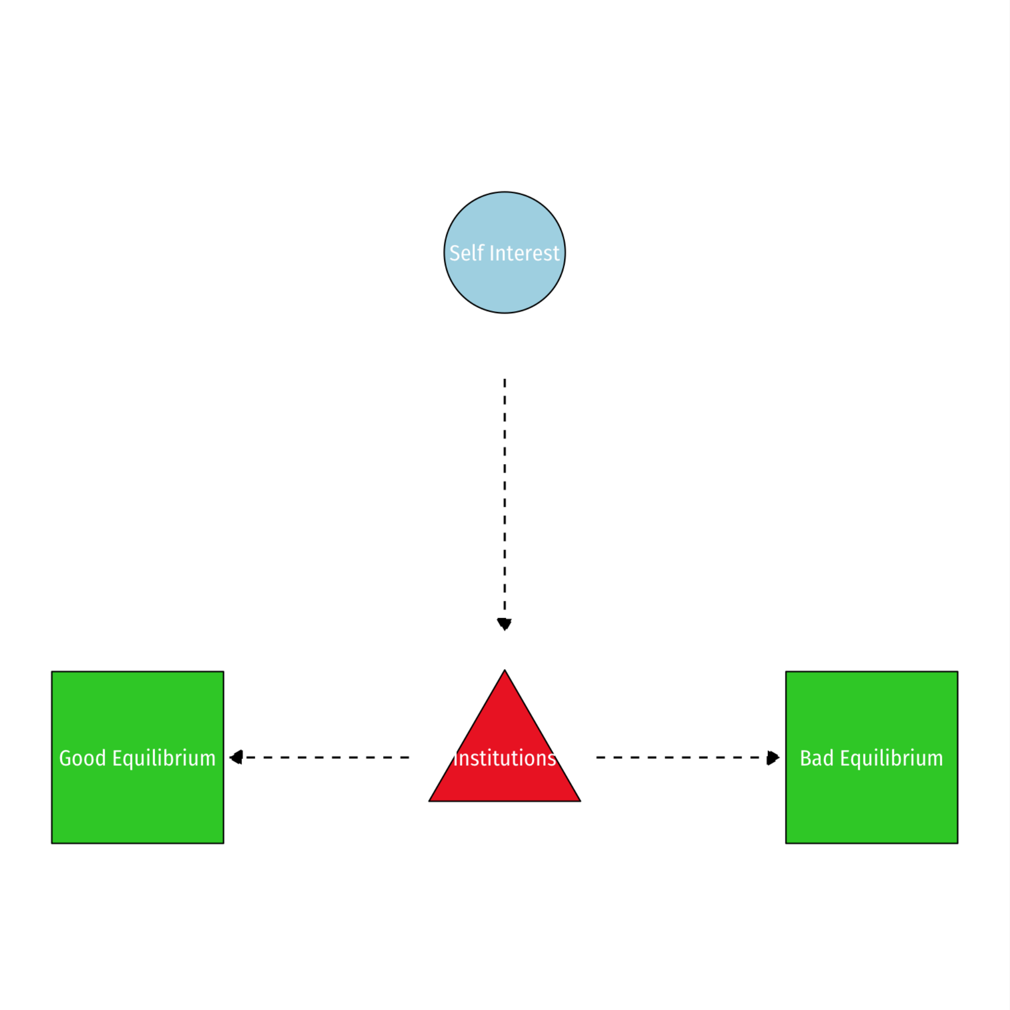

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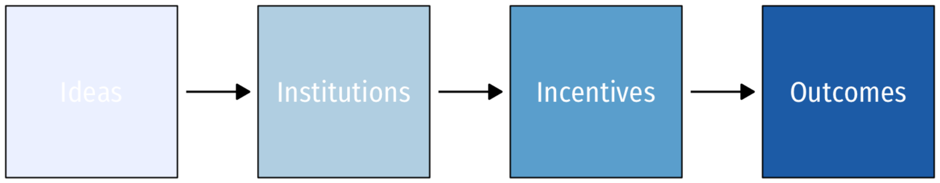
A Logical Framework for Political Economy



- **Outcomes**:
  - relative level of wealth or poverty
  - relative level of equality or inequality
  - stability of politics, finance, macroeconomy

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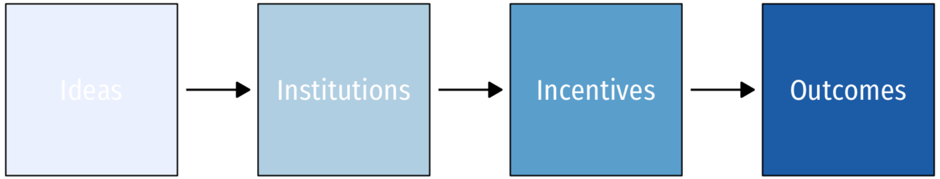

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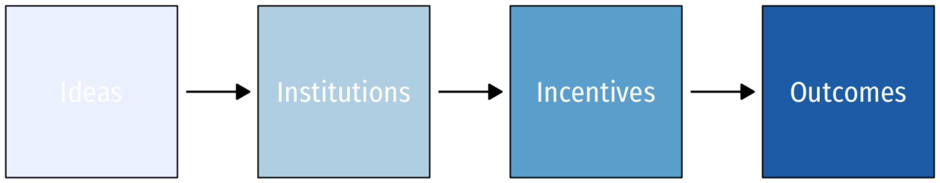

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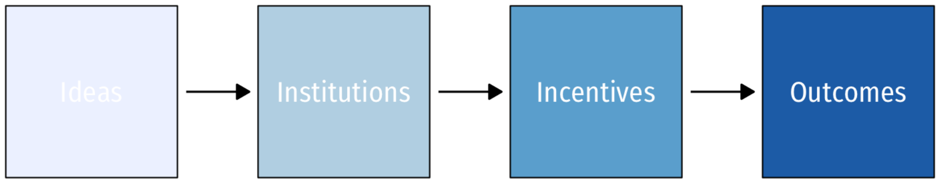

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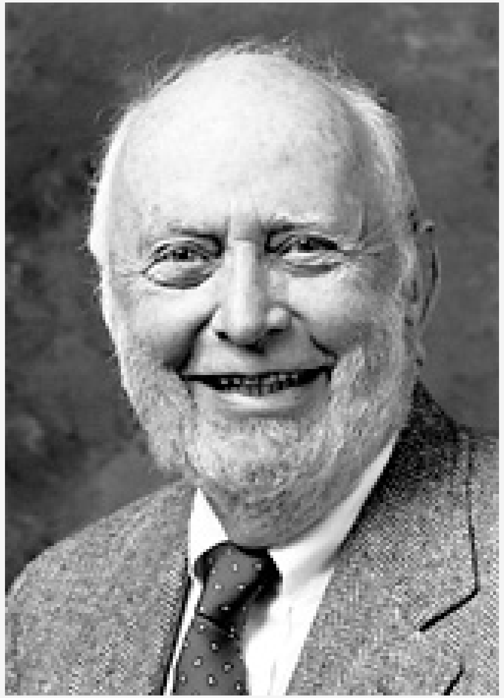
- ...are determined by **Ideas**:
  - political and social worldview -"isms"
  - which groups (should) have status

What are Institutions?



Douglass C. North

1920-2015

Economics Nobel 1993

> "Institutions are the humanly devised constraints that structure political economic and social interaction. They consist of both informal constraints (sanctions, taboos, customs, traditions, and codes of conduct), and formal rules (constitutions, laws, property rights)," (p.10)
>
> "Institutions are the rules of the game in a society," (p.1).

North, Douglass C, (1991), "Institutions," *Journal of Economic Perspectives* 5(1): 97-112.

North, Douglass C, (1990), *Institutions, Institutional Change, and Economic Performance*

Incentives are Structured by Institutions

> “Who needs this nail?”
>
> “Don't worry about it! The main thing is that we immediately fulfilled the plan for nails!”

Incentives are Structured by Institutions

> "Dear customer, in the leather goods department of our store, a shipment of 500 imported womens' purses has been recieved. Four hundred and fifty of them have been bought by employees of the store. Fourty-nine are under the counter and have been ordered in advance for friends. One purse is in the display window. We invite you to visit the leather department to buy this purse!" (p.38).

White, Lawrence H, 2012, *The Clash of Economic Ideas*, pp.38-9