MacIntosh School
Built Environment Level 1

ECONOMIC CONCEPTS 3:
Why Karl Marx was an Economist...
The Failure of Markets and the Crisis of Capitalism

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Aims and Learning Objectives:

Aim:

- To introduce students to the theory of market failure and the case for intervention/planned allocation

Learning Objectives:

By the end of this lecture students should be able to:

- understand what is meant by market failure;
- know the main areas of market failure;
- know the main ways that the state can intervene

In what sense was Karl Marx an Economist?
Where did he get it wrong?
And where did he get it right?

Plan:

- (1) Market Failures

- (2) Methods of State Intervention

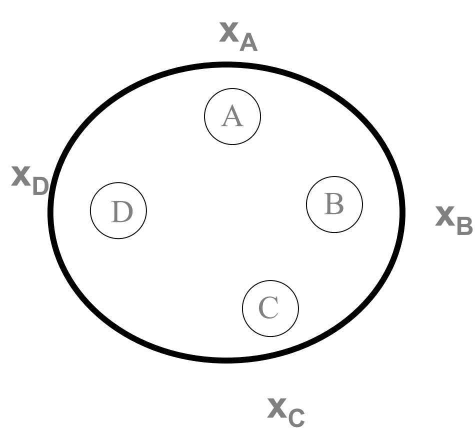
(1) Market Failures

- i) Failure of Competition
  - barriers to entry restrict resources from gravitating towards their optimal use and cause monopolies
    - Monopolies which restrict output below optimum level for consumers in order to max profits
    - <u>Entry barriers:</u> start up costs (car industry); training (architects); increasing returns to scale (railways); transport costs (local monopolies--Aberdeen); speculative stock piling of key resources (land banking => 1 land-owner all the key land)

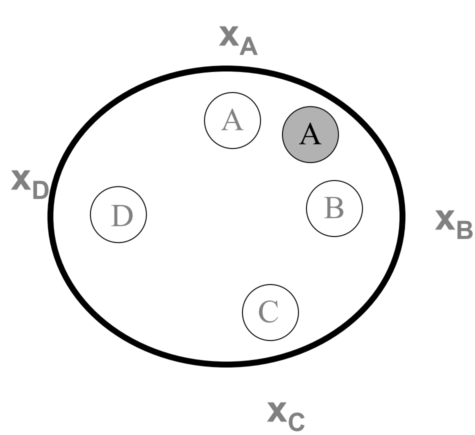
- ii) Public Goods and Externalities
  - Pub gds tend to have the following qualities:
    - <u>non-excludable</u>: not possible to prevent consumption by those who haven't paid.
      - E.g. nice gardens; street lighting; defence; police; National Parks
      - Problem of the commons (communal housing facilities)

E.g. Problem of the Commons:

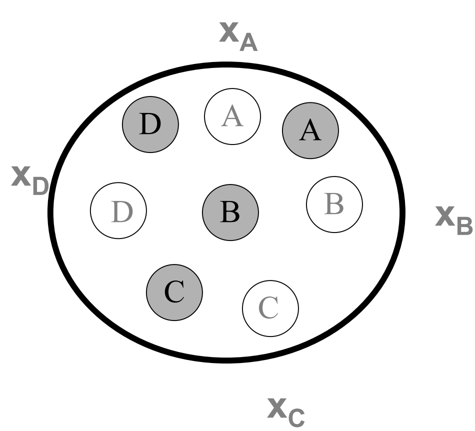
- 4 farmers, graze 1 cow each:
  - => Milk output per cow = 10 gallons
  - => Total milk for community = 40 gallons
  - => Market shares = 25% each



- Farmer A grazes 2 cows to ↑his mkt share:
  - => Milk output per cow = 8 gallons
  - => Total milk for community = 40 gallons
  - => Mkt shares: A has $^{16}/_{40}$ = 40%
    B,C,D have $^{8}/_{40}$= 20% each



- Farmers B,C,D also graze 2 cows to restore their mkt shares:
  - => Milk output per cow = 4 gallons
  - => Total milk for community = 32 gallons
  - => Mkt shares = $2x^4/_{32}$ = 25% each



- **So, competition and self interest have returned market shares to initial values resulted in lower milk output overall.**
- Moreover, self-interest will induce further rounds of competition until no grass left!
- Is this parable applicable to any other contexts?

- ***'Externalities'***
  - arise when an individual's production or consumption decision directly affects the production or consumption of others, other than through market prices.

Other qualities of Public Goods:

- <u>non-rejectable:</u> not possible to prevent one's own consumption, even if it yields negative utility, or no compensation for inconvenience of avoiding consumption
  - E.g. aesthetic pollution: agony of monstrous carbuncles; environm[l] effects of pollution & energy consumption
- <u>Non-rival Consumption</u>
  - i.e. consumption by one user does not prevent or inhibit the consumption of the same good by another.
  - cost of providing to one extra user is zero
    - e.g. street lighting, recreation facilities, public amenities (although the non-rivalry has its limits!)

Implication of Public Goods:

- goods with these qualities will be either under or over produced by the market: not Pareto Efft
  - environmental pollution: over produced (non-rejectable)
  - infastructure, educ, health care : under produced (non-excludable)
- 'The important thing for Government is not to do things which individuals are doing already, and to do them a little better or a little worse; but to do those things which at present are not done at all'(Keynes, End of Laissez Faire, 1926, p. 4)

iii) Incomplete Markets

- mkts fail to provide good or service even though the cost of providing the good < what individuals are willing to pay
- e.g. Insurance
  - insurers not willing to insure certain risks even though borrowers willing to pay because:
    - insurance can affect behaviour (moral hazard)
    - insurance may attract high risks (adverse selection)

iv) Information Failures

- consumers & producers < perfectly informed re p, q
- ⇒ perverse incentives (e.g. **doctors***; workers shirk; unsafe work environments; firms pollute)
- ⇒ incomplete markets (credit rationing; insurance rationing)

" Highest quality surgery at the lowest prices …
all our surgeons have at least 6 months training …"

*Perverse Incentives in Market Provision of Health Care…**

"That any sane nation, having observed that you could provide for the supply of bread by giving bakers a pecuniary interest in baking for you, should go on to give a surgeon a pecuniary interest in cutting off your leg, is enough to make one despair of political humanity"

(*George Bernard Shaw*, 1911)

- v) Macro Instability
  - Collectively, markets may not behave in quite the same way as individual markets
  - Adjustment lags and distortions in one market may affect other markets.
  - Demand for all goods connected to supply via employment:
    - fall in aggregate demand $\Rightarrow$ fall in supply $\Rightarrow$ fall in employment $\Rightarrow$ further fall in aggregate demand $\Rightarrow$ downward spirals, booms & busts
    - what Marx called a "realisation crisis"

- More fundamental macro instability may arise from the socially divisive effects of capitalism:
  - (a) Market allocation exploits workers
    - because labour is seen as an "input" to the production process (a process the capitalist seeks to cost minimise) workers will be paid the minimum amount possible.
    - Also, the urge for profit tends to result in the use of mass production => specialisation & div. of labour
      - Adam Smith's pin factory
      - => "complex jobs have been incessantly broken down into minute tasks" (Braverman, 1974)

      - termed "Taylorism" after a major exponent of this method
      - Taylorist process of separating conception from execution (I.e. "mindless work") is like a "hidden spirit" revealing the inexorable deterioration of work (Braverman)
      - *reflected in architecture*: uniform factory vs grand HQ
    - worker alienation and exploitation cause social detachment, divisions to emerge which threaten macro stability
      - organised labour take strike action etc., revolutions, crisis of capitalism…

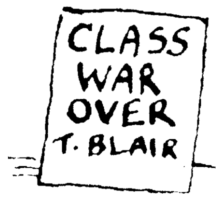
- but markets are adept at adapting:
  - human relations school of management etc.
- But new exploitations & control mechanisms?
  - hot-desking, CCTV, email & web use surveillance etc.

- Unemployment & Industrial Reserve Army:
  - Marx argued that capitalists deliberately maintained a pool of unemployed workers (IRA) to maintain their bargaining power:
    - => maintain low wages and poor working conditions.
  - “Unemployment is an acceptable price to pay for low inflation” (recent Chancellor):
    - eg of state serving the interests of capital: low infl. benefits capitalists by protecting the value of monetary assets.

- (b) Markets Result in Class reproduction
  - success of previous generation affects the probability of success of current generation through:
    - bequested wealth & land
    - education (funds for private schooling; passing on of knowledge)
    - cultural capital
    - access to social and economic networks
  - in 1881,
    - 99.5% of the land belonged to only twenty seven per cent of the population, and 87.1% of the land belonged to less than four per cent of the population
    - not much different today

- Inequality and class divisions may be seen as:
  - ***inevitable***: the outcome of nature/divine intervention
  - ***a positive thing***: motivates people to work and better themselves
- but may also be divisive and destabilising:
  - if not result in revolution, may result in more violent society, more extreme views and interest groups
    - miner’s strikes; Nazi Germany; US crime rates
  - Worse if class divns fall along racial/religous lines:
    - c.f. recent riots in Bradford etc.

Of course, Tone has put an end to all this by declaring that the class war is over….



But the question is…

(c) Markets result in Regional Inequalities

- although free markets should self-adjust across space, agglomeration economies may mean that they don't (at least within any reasonable time frame):
  - e.g. London vs North East: wage and land costs much lower in North East
  - Q/ why aren't grand architectures being constructed in Newcastle?
  - A/ benefits of spatial contiguity: pooled labour, nearness to market, existing buildings, cultural centres
- => outward migration of skilled labour from depressed regions => vicious circle of decline & congestion.

- But regional divisions can be politically and socially divisive and economically destabilising:
  - => congestion => economic inefficiency & fall in competitiveness (bec of high house prices => high wage rates)
  - => concentration of social deprivation (crime, violence, unemployment, drugs, dysfunctional families) => beyond redemption
  - => political fragmentation (costs of devolution?)
  - => civil wars
  - migration economically and socially costly:
    - adjustment & relocation costs
    - fragmentation of extended family => no safety net for elderly etc.

The *real* Invisible Hand of the Market?

(2) Methods of State Intervention

- Legislation: encourage competition, establish property rights, est. compensation system for -ive externalities
- Direct Provision: build council houses, roads, street lights
- Transfer Payments: redistribute wealth, maintain social stability
- Tax/Subsidise: redistribute income, encourage consumption of certain goods which have broader social benefits (housing, health, education)

Summary

- Markets fail through:
  - lack of competition
  - imperfect information
  - externalities and public goods
  - incomplete markets
  - macro instability
- The state can intervene by:
  - legislating, direct provision, tax/sub, welfare.

Reading

- Chapters 1 & 7 of Pennington, M. (2000) "*Planning and the Political Market*", The Athlone Press, London, ISBN 0 485 00606 5 PB
- Hardin, G. (1968) "The Tragedy of the Commons," *Science*, 162:1243-1248. http://dieoff.org/page95.htm