

Getting the balance of the economic system right

Understanding #1

The Economic System has to provide answers to the key issues of:

1. What and how much to produce	2. For whom to produce
3. How to produce	4. How to ensure use of resources is efficient

Understanding #2

Efficiency is maximized in free markets when the price of the product:

1. reflects the value or benefit of the product to the consumer.
2. reflects the costs* of making the product.

Note 1: Cost includes 'normal profit' – the minimum level of profit needed by the supplier to stay in business.

Note 2: Costs include private and social costs (that is costs for the producer and imposed on others) and value or benefit includes private and social benefit (that is benefit to the buyer directly and also those that spin-off to others as well).

Understanding #3

Free markets may not operate efficiently for four key reasons.

<p>Scarcity (monopoly) power Scarcity power is high in a market where consumers can't switch to:</p> <ol style="list-style-type: none"> 1. alternative products 2. alternative suppliers <p>A supplier with 'scarcity power' can push up prices and earn 'monopoly profit' because they don't have to worry too much about consumers taking their business elsewhere.</p> <p>The price they charge exceeds the costs of production that leads to inefficiency.</p>	<p>Bystanders or Externalities Choices are normally made in free markets on the basis of private costs and private benefit (the direct opportunity costs for the buyer and the direct benefit received by the buyer.</p> <p>However, bystanders or third parties may be affected through the creation of spill-over costs and benefits (for example non-smokers may be forced to become 'passive smokers' if people are allowed to smoke in confined spaces.</p> <p>If the spill-over effects from private economic choices are ignored prices don't accurately reflect total or community value or costs and the market operates inefficiently.</p>
<p>Information gaps or asymmetry Economic agents can only make rational or logical decisions if they have access to all the relevant facts.</p> <p>In some markets information may be unavailable (for example, in the insurance or second hand car industry), and in others information may be asymmetric or one-sided (for example, when going to the doctor or when buying a complex product). Asymmetric information gives the person with the knowledge power over those without the knowledge.</p> <p>Information gaps make markets inefficient.</p>	<p>Collective wants Free markets work well if the 'exclusion principle' applied to products traded in the market. The purchasers are the owners and they have control over what happens to their property.</p> <p>However, the exclusion principle does not apply to all products. The owner of, say, a lighthouse finds it difficult to stop people benefitting (or free-riding) from the service whether they have paid or not.</p> <p>Free-riders may make it unprofitable to provide the product and the absence of the market creates inefficiency.</p>

Activity

Select three markets of your choice. The selected markets may be any type of market, such as product, resource or financial markets. It will be easier to analyse each market if you are quite specific about each market, for example you might look at 'coffee beans in Australian supermarkets' rather than just coffee in general or 'police constables' or 'hospital nurses' rather than state employees or public servants in general.

Step 1

For each of your selected markets estimate (on a scale of 0 to 5 with 5 the highest level) the level of:

- Scarcity, market or monopoly power of the supplier over the consumer (0 = no monopoly power, 5 = significant monopoly power)
- The level of externalities or impact on bystanders, both good and bad (0 = no externalities, 5 = significant externalities)
- Problems with access to information for the buyer (0 = no information gaps, 5 = big information gaps)
- Extent of issues of free-riders or shared consumption (0 = no issues, 5 = significant issues)

Step 2

- Add up the score for each market.
- Is there a correlation (statistical relationship) between the score and the amount of government intervention evident in this market? If so, what is it?
- State if you would expect there to be a correlation and why this correlation might exist.

Step 3

- Estimate (using a 5 point scale again) the extent to which each of your chosen markets would operate efficiently without any government intervention at all (5 = very efficient, 0 = very inefficient).
- Estimate (using a 5 point scale again) the extent to which each of your chosen markets would operate fairly without any government intervention at all (5 = very fair, 0 = very unfair).
- Analyse the extent to which the inefficiency and unfairness is due to:
 - Prices not fully reflecting individual and community valuation of the product
 - Prices not accurately reflecting the cost of producing the product

Case Study #1 - On tap, but bottled for millions

Bottled water has become a global social phenomenon. Thirty years ago the market barely existed. Now it sells about 180b litres a year around the world with a value of more than \$45b. But it is increasingly under attack and not just from environmentalists. Australians reportedly spend \$385m a year buying some 250m litres of bottled water, but this is a drop in the ocean compared to North Americans who spend some \$30b a year and import it from as far afield as Fiji. Americans spend more on bottled water than on iPods or movie tickets.

Market analysts say people buy bottled water because they think it:

- is safer than tap water
- is more healthy than soft drinks

despite the fact that:

- it is typically over 250 times more expensive than tap water (cost of a litre of tap water = 1 cent) and costs more than complaining motorists pay for a



litre of petrol

- d) there is little supporting scientific evidence that bottled water is safer than tap water in developed economies

Other experts point to a number of spill-over effects connected to production and consumption of bottled water.

- a) 20m barrels of oil a year are needed to make the plastic bottles for the US level of consumption.
- b) 50m barrels of oil a year are needed to provide the energy for pumping, processing, transporting and refrigerating US bottled water.
- c) bottled water does not contain tooth-protecting fluoride
- d) carelessly discarded plastic bottles create litter
- e) with under 25% of bottles recycled, most water bottles ends up in landfill
- f) there are ethical and social justice issues – spending money on bottled water is a ‘superfluous luxury’ when two billion people in the world lack access to clean drinking water

Questions for discussion

1. Is the allocation of economic resources in the free-market capitalist economic system to the production of bottled water efficient and fair?
2. In what ways could the government intervene in the bottled water market to increase efficiency and fairness?

Case Study #2 – Desalination is suddenly a sweet solution

17% of Perth’s drinking water comes from Australia’s first desalination plant at Kwinana. This will rise to over 30% when a second plant, north of Perth, is opened in 2011. The 45 gigalitres of water the plant produces each year reaches about 1.6m people in the south of the State. West Australia’s Water Corporation is a

State-owned enterprise.

Desalination has now become the favoured way of dealing with the shortage of water linked with

the long-term decline in rainfall because of improvements in technology has reduced production costs. However, it is still about ten times more expensive to produce water from desalination than from harvesting rainwater.

The biggest economic problem with desalination is its enormous thirst for electric power – it takes 24 megawatts of electricity per annum (enough for 30,000 households) to power the desalination plant at Kwinana. The Water Corporation claims to have offset



this by purchasing the equivalent amount of renewable energy from a purpose built wind farm at Emu Farms near Cervantes, north of Perth.

The water produced at Kwinana has meant that Perth households have not had to face the type of water restrictions imposed in the Eastern States and that water can be 'banked' in the Canning Dam for future use in times of heavy demand. Access to sufficient water is vital for the future viability of Perth as a major urban centre. The UWA Centre for Water Research is satisfied the plant is not doing any harm to the environment and to marine life.

Questions for discussion

1. What measures can the government or Water Corporation take to ensure water is supplied efficiently and fairly in the south of Western Australia?
2. Does the government have to be involved? What problems might arise if the government left the responsibility for water supply to private enterprise and the free-market?

Case Study #3 – Cricket comes poor second when millionaires play for money

The Indian Premier League (IPL), a Twenty20 Cricket competition, opened for business by allowing the eight participating franchises to bid for the services of the star international standard players that were to make up the core of their teams. Each franchise spent about \$6m on star players having already paid close to \$100m for the franchise itself.

For the 44 days of the competition the services of Mahindra Singh Dhoni, India's current limited-over captain, were secured by the Chennai franchise owned by India Cements for \$1.64m. They also signed up Matthew Hayden (Australia), Mike Hussey (Australia), Muttiah Muralidaren (Sri Lanka) and Makhaya Ntini (South Africa).

The IPL has been launched as a celebration of money. The sport itself has come a poor second. The International Cricket Council (ICC) endorsed the competition when it realized it had little alternative but to go along with the powerful financially motivated, interest groups in India.

The Twenty20 cricket revolution is seen by some as a market-led way of keeping the game afloat. It is suggested that even the Chinese and Americans will be attracted to a form of cricket that is all over in 3 hours and has action almost every ball that is bowled. Purists worry that the sport will morph into baseball and that culture and tradition will be lost.

At a more abstract level there is concern that sport is not an inherently commercial activity. Simon Barnes writing in *The Times* writes that 'sport can exist perfectly well when money is second on the priority list, but as soon as money become first priority, sport begins to die. Sport without the love of the game for its own sake, played purely for commercial reasons, lacks something, something that matters deeply to those who watch. If the IPL is about money first, it will fail. It will be up to the players and the viewing public to find out what has survived the auction of players. Sport must matter for itself, it is worth nothing: neither morally, spiritually nor commercially'.

Questions for discussion



1. Suggest two other methods that could have been used to allocate the scarce cricketing resources to the eight IPL cricket teams efficiently and fairly. Analyse the strengths and weaknesses of each option.
2. What problems might if sport operates on a free-enterprise, free-market basis? List some examples of rules or regulations used in particular sports that modify or control the impact of money on the way sport operates.