Markets, Efficiency, and Price Signals: Crash Course Economics #19

Crash Course: Economics
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Adriene: Hi, I'm Adriene Hill.

Jacob: And I'm Jacob Clifford, and this is Crash Course Economics. Today we're gonna talk about a lot of stuff.

Adriene: Everything from blundering planned economies to heartless free markets from price gougers to indolent apparatchiks. But it's not all bad news. We're going to learn that price signals indicate skinny jeans are on the way out.

(Intro)

Adriene: We've talked about the different between free market economies, where supply and demand determine what gets produced, and centrally planned economies, where government agencies decide what gets produced. Today we're gonna expand on that, and discuss why competitive markets have been more successful at providing most of the things people want.
Central planning has some upsides. Everyone who wants a job has a job, and production aims to meet an idealized version of society's collective goals. But the reality of it has been less ideal for consumers in those societies.

In the Soviet Union, central planners were focused on producing heavy equipment and military hardware. There were shortages of consumer goods, like soap, sugar and electronics. It turns out that people care more about smartphones and good coffee than they care about tractors. And so countries like China and Cuba have moved away from large-scale central planning.

Jacob: The problem with central planning is that it's inefficient. Now, when economists talk about efficiency, they're talking about a couple different types of efficiency that's different than the efficiency that you might know.

The first is productive efficiency: the idea that products are being made at their lowest possible cost. This means that there are no wasted resources and that raw materials, workers, and machines are being used to their fullest potential.

Central planners in general, aren't that focused on cost. But in the free market an individual business owner has an incentive not to be wasteful because they want to maximize profit. In the words of Milton Friedman; "Nobody spends somebody else's money as carefully as he spends his own."

The second type of efficiency is called allocative efficiency This means that the things we're producing are the things that consumers actually want. In other words, our scarce resources are being allocated towards the things we value.

Let's say a company is producing only skinny jeans, now if they're not hiring too many workers and if they're not ending up with a bunch of extra materials they're producing at the lowest possible cost and that's productively efficient. The problem is they only make skinny jeans. Even though the company might be productively efficient they're probably not allocatively efficient. Consumers don't want only skinny jeans some want boot cuts. Central planners are less likely to be allocatively efficient because they have a harder feedback about what people want.

Adriene: Free market producers of consumer goods collect a lot of data about consumer preferences through stuff like market research. But they can also learn a lot about consumer's wants by looking at prices. Economists call these price signals. Let's go to the Thought Bubble.

Okay, if people are paying high prices for skinny jeans, it tells producers "Society wants more skinny jeans, start making them." If no one wants skinny jeans, producers start making something else instead.

Here's another example: tablet computers weren't really popular until apple introduced the iPad. After that, boom! The market exploded. In fact, I know about 11% of you are watching this video on a tablet right now. Because I can see you. And I can't believe you're still wearing skinny jeans.

When Google, Samsung, and Microsoft saw Apple selling millions of iPads at $500 and up, they had an incentive to jump into the market. Price signals not only tell producers what to make, but they also help distribute tablets to the people that value them the most.

For example: if someone's grandma doesn't really want a tablet and she was only willing to pay $20 for one, she doesn't get it. Unless her grandkids drag her into the 21st century, by giving her one for Christmas. Some economists love price signals so much that they argue against the tradition of giving gifts. This argument was popularized by economist Joel Waldfogel who argued that gift giving is inefficient. From a macroeconomic point of view, holiday shopping boosts consumer spending, GDP, and employment. But, if too many people are purchasing items that the end consumers don't value, then resources are being wasted.

Of course, this analysis doesn't factor in other implicit benefits of gift giving Like fostering love and affection among family and friends. But the fact remains: The ideal gift in terms of efficiency is cash. Heart-warming cash.

Thanks Thought Bubble. Theoretically, in a free market, producers cannot make themselves better off without making consumers better off. If a company makes too many units of a product or just undesirable stuff, They'll have to adapt quickly, or else it will go out of business. Competition between businesses keeps prices and quality up. This is our old buddy Adam Smith's invisible hand.

It's important to take a step back here and point out that we're not saying that free markets are always good and that government involvement is always bad. Most economists recognize that markets aren't perfect and they often fail to meet society's needs. In these cases, economists encourage the government to either regulate or take direct control of markets to improve social welfare.

In the United States, which is often mistaken for a free market economy, it turns out just about everything is regulated. For example, FDA regulations reject any wheat that contains nine milligrams or more rodent excreta pellets and/or pellet fragments per kilogram. And the government directly controls the markets for national defense and public education. The field of public economics analyzes this very thing.

Now I love rodent excrement and public education as much as the next girl But let's get back to markets and the role that prices play in determining how we use our limited resources. So price signals help us use our resources efficiently, but that doesn't mean that everyone agrees that they are always right or just. Take price gouging.

Price gouging happens when sellers raise prices for essential items like food, water, or gasoline. When there's something like an emergency. Some argue that this practice exploits consumers and as an example of the cruelty of markets. In the US, anti-price gouging laws have been enacted in 34 states. But many economists say that these laws promote inefficiency and actually make the problem worse. They argue that allowing prices to increase in times of crisis encourages others outside the disaster zone to haul in and sell essential goods.

If prices aren't allowed to increase, then there's less of an incentive to bring this stuff in. Furthermore, higher prices for things like batteries, sleeping bags, and generators mean that people who don't really need them won't buy them, making them more available to people who do. Now it might not always be government laws that limit price gouging. It may be the desire to earn profit that actually keeps prices down.

It's clear that businesses can earn a ton of profit in the short run by price gouging, but what happens in the long run? Consumers are likely to remember how they were treated. This is part of the reason some businesses like Walmart has an emergency operation center and an in-house meteorologist to interpret weather patterns. This allows them to have goods like water and batteries and stock when they're needed.

Not only is this profitable, it's also a pretty good public relations move. In fact, in some cases like Hurricane Katrina in 2005, private businesses were quicker to provide disaster relief than government agencies. A different example of how the price system is perceived as unjust is below-cost pricing. Sometimes called predatory pricing. This is the idea that a business can drive out competitors by charging lower prices even at a short term loss. Competitors that can't sustain such low prices will be forced out of the market, giving the surviving businesses market share and the ability to raise prices.

Let's talk about Walmart again. Walmart has been the target of numerous predatory pricing lawsuits. Their size allows them to squeeze distributors and sell products at very low prices. Although lots of consumers like these low prices, it's bad for competitors. Especially small mom and pop stores, who are sometimes pushed out of the market. But is it predatory pricing?

In the US, the courts have said it's not. the federal trade commission's website states, "Although the FTC examines claims of predatory pricing carefully, courts, including the Supreme Court, have been skeptical of such claims." So predatory pricing lawsuits are common, but very rarely successful in the US. In Germany, Walmart faced the same sort of accusations in 2000 and was ordered to raise some of its prices. The company ended up leaving Germany in 2006.

Predatory pricing is difficult and risky. When a business successfully eliminates their competitors by selling products at a loss, they're eventually gonna need to increase their prices above the market price to make up for those losses. In the short run, consumers would have to pay more. But eventually, other businesses would be attracted by the higher prices and enter the market. The end result is that there's no guarantee that predatory pricing is worth it in the long run.

Jacob: There's tons of examples of corporate greed, inequality, and disregard for the environment that make people wonder if markets are evil. And they are. Thanks for watching! We'll see you next week! [endscreen music plays, stops] Now, there are some examples of socially conscious companies that make an effort to protect the environment and help the disadvantaged.

Capitalism, with its focus on prices rather than fairness is often characterized as the opposite of altruism. But the two can, and do coexist. But here's the big takeaway: Capitalism, with its system of price signals, is basically crowdfunding. We collectively choose what we want and how we want it made when we spend our money. After all, companies can't force you to buy their stuff, they have to earn your money. Now if you want to see real changes in the world, don't just complain that corporations are greedy; expect more from them.

You also need to expect more from ourselves. If you disagree with the way a retailer treats its workers, then don't buy from them. Even if they do have the lowest prices and convenient delivery options

Adriene: If we as consumers want our purchases to have a positive impact, it's on us to seek out companies that try to improve the world. This might mean paying more for the stuff we buy or it might mean buying less stuff. A market based society still has shared social goals. They just don't come from a central planner. Sure, some of our social priorities come from governments, but they also come from each of us and the decisions we make about how to spend our time, and energy, and money.

It's also worth remembering that it's a luxury to have these discussions. For many, many people around the world who live in poverty and have trouble affording the basic necessities of life, paying a higher price, based on conscience isn't an option. Thanks for watching! We'll see you next week.

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