



Ec240: Limits of Markets

Maitreesh Ghatak

London School of Economics

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Motivation

- The narrow self-interest driven view of individuals in the economic domain has increasingly come under question.
- Recent work in economics has moved beyond stylized models of motivation based on a narrow view of *homo economicus* who cares about only money and leisure, and have embraced a wider perspective on motivation.

Motivation

- At the same time, the power of self-regulating markets to achieve the greatest good for the largest number is increasingly under question due to rising inequality and unemployment, unravelling of social norms, democratic institutions, and communities due to market forces, and environmental degradation.
- But what is the policy implication?
 - Government regulation?
 - Empowering communities and the third-sector?
 - Better provision of information and legal reforms to empower individuals?
 - Set of social norms and values to make self-regulation more powerful?
 - All of the above?

- In this research seminar, we will examine various aspects of this broad theme of Limits of Markets – their intrinsic limitations as mechanisms to allocate resources from the welfare point of view and the kind of limits that may be needed to be put in place to prevent them having corrosive effects on society.
- All course related material can be accessed at the following website:

http://personal.lse.ac.uk/ghatak/Ec_240_Ghatak_Lent_2019.htm

- The first lecture will look at how does motivation (whether due to moral values such as altruism and pro-sociality, reciprocity and fairness, social norms, reputational and identity concerns etc) interact with market forces – e.g., do market forces crowd out moral behaviour and should there be limits to markets?
- For example, should we legalise
 - Organ sales?
 - Recreational drugs?
 - Commercial sex?

- The remaining lectures will address questions like
 - Is Universal Basic Income an answer to the labour displacement by automation?
 - Should we use incentive pay to improve public service delivery or should we worry about pro-social motivation being crowded out if we do so?
 - How are social norms formed – is it an equilibrium that people coordinate on or does it affect people's preferences? How do social norms and market forces interact – e.g., can labour market or product market competition eliminate discrimination against some social group or can they reinforce them?

- Should we look beyond government vs market binary, and look at communities, the third-sector (non-profits, social enterprises)?
- How do these organisations work, in what way they are different from standard (for-profit) firms, and how they survive in a market economy?

Schedule

- The course will include lecture-seminars given by researchers from inside and outside LSE and will allow for the opportunity to interact and ask questions.
- Each term will consist of a series of biweekly lecture-seminars (5 x 90mins) and class-seminars (5 x 60mins).
- The class-seminars will discuss the *previous* lecture through specific questions on the topic that will be circulated after the lecture.
- Students are expected to be prepared for discussing the answers to these questions during the class.

Speakers

Lecture 1 - January 17

Maitreesh Ghatak. Department of Economics, and STICERD, LSE.

Topic: Limits of Markets - Should All Voluntary Exchanges be Legal?

Lecture 2 - January 31

Christopher Pissarides. Department of Economics and CFM, LSE

Topic: The Future of Labour Markets

Lecture 3 – February 14

[Oriana Bandiera](#). Department of Economics, and STICERD, LSE

Topic: Relaxing the *Homo Economicus* Assumption in the Design of Incentives

Lecture 4 - February 28

[Zaki Wahhaj](#). School of Economics, University of Kent.

Topic: Social Norms and Discrimination

Lecture 5 - March 14

[Stephan Chambers](#). The Marshall Institute, LSE.

Topic: Social Entrepreneurship

Eligibility

- This course is compulsory on the BSc in Philosophy, Politics and Economics.
- This course is not available as an outside option nor to General Course students.
- This course is only available to second year students on the BSc in Philosophy, Politics and Economics.

Assessment

- Students will be assessed throughout the course, through essays, and class participation.
- Students will be expected to produce one 2500-word **group** essay by the end of the LT.
- Groups of size three to four will be formed from within each section of the class-seminars.
- This essay will be due the last day of the Lent term – March 29, 2019. A 500 word proposal for the essay will be due on Friday, February 15 (Week 5).
- All essays and proposals should be sent by email (in pdf form) to m.ghatak@lse.ac.uk by 10PM of the day of the deadline.

- Groups will be invited to meet with the course convener in his office to discuss the proposal and receive feedback.
- Feedback on the essay proposal and essay will help prepare students for the final individual essay.
- The format of class participation will range from questions and comments during a lecture/class to more structured forms such as a mock panel or debate format.

- The final summative grade will weigh the essay (80%) and class participation (20%) from all three terms (the essays will be weighted 25%, 25% and 50%, respectively).
- The overall grade the students will receive will be one of four: fail, pass, merit and distinction.
- EC240 and EC340 will be assessed in the same manner as LSE100. Marks of F, P, M, DI appear on the transcript but do not affect progression or the final degree classification

Administrative information

- My office is 3.08A in the third floor of 32LIF.
- My assistant is Lubala Chibwe (l.chibwe@lse.ac.uk), Ext 6674, 32 Lincoln Inn Fields, 3rd Floor, office 3.06.
- My office hours are Tuesdays 4 -5PM. You can sign up on this sheet for an appointment: <https://docs.google.com/spreadsheets/d/1NmdBhBGNXaPPwNWI7bKlfB0MFpEL1fkhO7dOICW7pRM/edit#gid=182403768>
- There are some extra appointment slots in the spreadsheet. Please email Lubala to book an appointment at a different time if the slots are all full or you cannot make them for some reason.

Reading List

There is a list of books that provide general background readings to the broad topic of Limits of Markets



- For each lecture there will be a 2-3 specific background readings to help you get an introduction to the core issues.
- There will be a number of additional readings for each topic if you want to pursue it in greater depth and/or find useful for the essay that you are required to write.

Lecture 1

Limits of Markets - Should All Voluntary Exchanges be Legal?

Maitreesh Ghatak

Market Transactions

- In most day-to-day commercial transactions that involve "willing" buyers and sellers, the state has little or no role to play.
- Three key assumptions
 - Individuals are rational and informed - they know what's good for them
 - There are legal institutions that make sure no one is robbed or cheated
 - There are no effects on third parties
- If consenting and informed adults engage in a transaction voluntarily and no one else is affected, what's the ground for preventing that?

- On the flip side are transactions where either the buyer or the seller is "unwilling".
- When one of them exerts pressure over the other or adopts dishonest means, it is naturally considered unlawful.

A Simple Schema

	Buyer Willing	Buyer Unwilling
Seller Willing	Most Market Transactions	Selling one's kidney
Seller Unwilling	Forcible Acquisition of Land	Robbery or fraud

- Academically economists are well aware of the limitations of the market due to
 - Absence of proper institutions of protection of property rights - can lead to coercion
 - Externalities on third parties - e.g., pollution, underprovision of public goods whose social returns exceed private returns
 - Asymmetric information and transactions costs - quality assurance & trust problem
 - Asymmetric bargaining power - can lead to exploitation
 - Paternalistic concerns - individuals may have self-control problems and other biases

- However, kidney sales or commercial surrogacy involve consenting adults who are voluntary participants in a transaction.
- Then what could be the arguments for banning it?
- One can well take the view that laws banning a specific market will be ineffective, or drive the activity underground, or make the problem worse
- Given the egregious failure of basic law enforcement at all levels in developing countries from child-trafficking to public safety, from mob violence to financial crimes, whether in preventing them or in bringing criminals to justice, no one can be faulted for having a pessimistic view about what can be accomplished by laws.

- However, it is instructive to think through arguments in favour of banning something from the point of view of **principle** as distinct from **practice**.

- What Sandel is putting on the table is “corruption” or “degradation”
 - Certain transactions are **repugnant**
- Consider the following examples
 - Kidney Sales
 - Commercial Surrogacy
 - Selling (as opposed to donating) blood
- He also refers to things such as friendship, honours, poems for wedding toasts and some people’s attempt to "buy" them

- That is indeed tacky, but clearly not a strong case for "banning" anything
- Other examples - eating horse & dog meat is illegal in California, dwarf-tossing (see Table 1 of Roth, 2007)
- Finally, he refers to the problem of markets crowding out community norms

Table 1

Markets In Which Some Transactions Are, or Were Once, Repugnant

Human remains

Cadavers for anatomical study, organ donation,
bone and tissue
Live donor organs (kidneys, livers)

Labor

Indentured servitude, slavery
Volunteer army, mercenary soldiers
Discrimination based on race, gender,
handicap, marital status, etc.

Reproduction and sex

Adoption
Surrogate mothers, egg and sperm donation,
abortion, birth control
Prostitution, pornography
Brideprice, dowry
Polygamy, gay marriage, incest

Words, ideas, and art

Obscenity, profanity, and blasphemy
Cultural treasures, art, and antiquities

Risk

Life insurance for adults, children, and
strangers
Gambling
Prediction markets

Finance

Short selling, currency speculation
Interest on loans

Pollution markets

Tradable emissions entitlements
Dirty industries in less developed countries

"Price gouging"

After natural disasters
Ticket scalping

Religion/Sports

Sale of indulgences and ecclesiastical
offices ("simony")
Endorsements/payments for amateur
versus pro athletes
Drugs and sports

Food, drink, and drugs

Horse and dog meat
Alcohol (Prohibition)
Marijuana and narcotics

Vote selling and bribery

Dwarf-tossing

How To Draw Limits on Markets

- In economics, we evaluate everything in terms of three main criteria:
 - Efficiency
 - Equity
 - Individual freedom.

- Following Sandel we may add
 - Repugnance

- Advocates of the free market usually prioritise efficiency and individual freedom, while those leaning left emphasise equity.
- The underlying assumption is that there are institutional safeguards that prevent certain obvious premises of voluntary trade
 - Coercion (property rights respected, some alternative options available to both buyers & sellers)
 - Deception

- If the transacted commodity, be it agricultural land or one's kidney, is more valuable to the seller than to the buyer, then the transaction generates greater economic efficiency.
- But if poverty and deprivation are among the reasons for selling (as in the case of a poor farmer selling land, or his kidney), then, the efficiency argument notwithstanding, the transaction becomes problematic from the point of view of equity.
- The criterion of individual freedom dictates that no one can interfere in the decision to sell or not to sell things that are our own, such as our labour or our land, or, according to some, our kidneys.

- Coercive land acquisition by the government using eminent domain laws or human trafficking are clearly examples of activities that cannot be supported on any of these grounds.

- However, the problem with the equity argument is that there is no dearth of inequitable transactions around us (for example, child labour).
- Some market transactions make inequity more apparent and shocking — such as a poor person selling his kidney— than others, such as a poor farmer selling his land, which we have gotten used to.
- But this is clearly somewhat subjective.
- Also, it is not as though equity would be restored if all these markets were eliminated altogether.

- Would the desperate circumstances that might drive a poor person to sell his kidney on the black market be alleviated by a crackdown on organ trade?
- The only way to deal with the problem of inequity is poverty alleviation, and not shutting down markets arbitrarily.

- Besides equity, two other arguments are usually advanced to restrict voluntary transactions in the marketplace
 - Externalities
 - Paternalism

- Externalities

- For kidney or blood sales, it is not clear that there is any indirect effect on third parties
- There might be aesthetic or moral objections to any exchange (e.g., prostitution or gambling), but it is difficult to use them to legally forbid a transaction, because they are almost always subjective.

- Paternalism

- Another case for regulating voluntary exchanges could be made when there are questions about the judgement of the seller or the buyer.
- Is she/he equipped to weigh the pros and cons of his decision?
- Does she/he possess complete information about the risks involved?
- Reasonable concerns but apply to many other contexts (e.g., taking a loan, making a risky investment, gambling, smoking, drinking etc) - call for suitable regulations and information campaigns, it is hard to justify banning all such activity.

Coercive Transactions - Land Acquisition

- My first real world experience of the failure standard market logic was when I interviewed farmers in India on the issue of land acquisition.
- Eminent domain or land acquisition or compulsory purchase or resumption is the power of a state, provincial, or national government to take private property for public use.
- Some of the farmers I met said they were not ready to sell their land, whatever be the price offered.

- Other, more affluent farmers claimed that the returns from farming were small, and so they would not mind selling their land if they got a suitable price.
- On the face of it, land acquisition and legalisation of the trade in human kidneys seem to have little in common.
- But one can indeed draw a parallel between the two if one thinks in terms of the legal and ethical limits of economic transactions.
- Most day-to-day market transactions involve 'willing' buyers and sellers. Barring taxation and quality control, the state has little or no role to play in them.

- On the flip side are transactions where either the buyer or the seller is 'unwilling'.
- When one of them exerts pressure over the other or adopts dishonest means, it is naturally considered unlawful.
- But the act of buying and selling human kidneys is unacceptable in the eyes of the law even when both the buyer and seller are willing.

Evaluating Different Transactions

	Kidney Sale	Land Sale (poor farmer)	Land Sale (rich farmer)	Land Acquisition
Efficiency	✓	✓	✓	✗
Equity	✗	✗	~	✓ or ✗
Liberty	✓	✓	✓	✗

Use of Prices and the Crowding out of Intrinsic Motivation

- In his seminal 1970 book, *The Gift Relationship*, Richard Titmuss argued that monetary compensation for donating blood might crowd out the supply of blood donors.
- Argued that the US where blood-donors are paid had lower quality blood supplied than UK where it was based on voluntary donation
- This is referred to as crowding out - presumably use of money crowds out the voluntary donors, leaving only who do it out of financial need
- Does money "contaminates" certain relationships and so the price mechanism fails?

- Arrow (1972) and Solow (1971) in their surveys of Titmuss thought that doing something for money simply expands the choice set - how can that hurt?
- If you derive intrinsic motivation, and get paid, just add them up
- Also, can donate the money back to your favorite charity
- Can we explain this using standard the economic framework?

- To test this claim Mellström and Johannesson (Journal of the European Economic Association, 2008) carried out a field experiment with three different treatments.
 - In the first treatment subjects were given the opportunity to become blood donors without any compensation.
 - In the second treatment subjects received a payment of SEK 50 (about \$7) for becoming blood donors
 - In the third treatment subjects could choose between a SEK 50 payment and donating SEK 50 to charity.
- For the overall sample the supply of blood donors decreases from 43% to 33% when a payment is introduced, consistent with a crowding-out effect, but the effect is not statistically significant.

- Therefore cannot reject the null hypothesis of zero crowding out at conventional significance levels.
- The introduction of a charity option increases the supply of blood donors from 33% to 44%, but also in this case they cannot statistically reject the null hypothesis of no effect.
- However, the results differ markedly between men and women.
- For men the supply of blood donors is not significantly different among the three experimental groups.
- For women there is a significant crowding-out effect - the supply of blood donors decreases by almost half when a monetary payment is introduced.

- There is also a significant effect of allowing individuals to donate the payment to charity, and this effect fully counteracts the crowding-out
- Titmuss's original conjecture was silent about the effect of gender, but our results suggest that his conjecture holds for women but not for men.
- According to the authors, in terms of the signaling model of crowding out of Bénabou and Tirole (2006), the difference between men and women can be interpreted as " ..women being more concerned with social esteem than men"

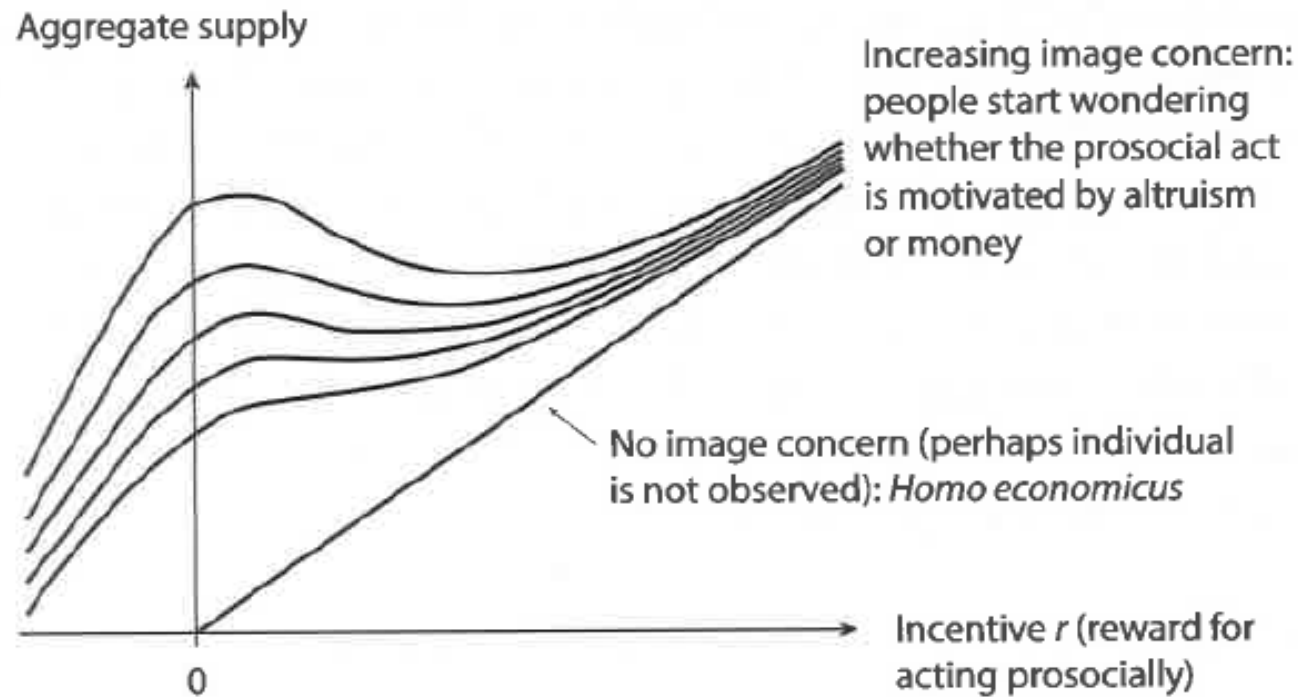


Figure 5.5. Intrinsic motivation and extrinsic motivation. Supply of public good in relation to a monetary incentive r ; the different curves correspond to different levels of the individual's attachment to the image of himself that he projects (a higher curve corresponds to a greater importance accorded by the individual to his image). When the image becomes sufficiently important for the individual, an interval appears in which an increase in the reward has a counter-productive effect.

Jean Tirole (2017): "The Moral Limits of the Market", Chapter 5 in *Economics for the Common Good*

- There is a more recent paper on this by Lacetera, Macis, and Slonim (2012, American Economic Journal: Economic Policy): "Will There Be Blood? Incentives and Displacement Effects in Pro-social Behavior"
- Presents evidence from nearly 14,000 American Red Cross blood drives and from a natural field experiment showing that economic incentives have a positive effect on blood donations without increasing the fraction of donors who are ineligible to donate.
- The effect increases with the incentive's economic value.
- However, a substantial proportion of the increase in donations is explained by donors leaving neighboring drives without incentives to attend drives with incentives; this displacement also increases with the economic value of the incentive.

- They conclude that extrinsic incentives stimulate pro-social behavior, but unless displacement effects are considered, the effect may be overestimated.

- There have been similar studies of crowding out in other contexts
- In a field experiment on day-care centers in Israel, Gneezy and Rustichini (2000b) furthermore found that introducing a fine increased the number of late-coming parents.
- Consistent with this finding, several recent laboratory experiments suggest that the introduction of fines or minimum performance requirements can reduce performance (Fehr and Gächter 2002; Fehr and Rockenbach 2003; Fehr and List 2004; Falk and Kosfeld 2006).
- Subsequent experiments (surveyed by Frey and Jergen, 2000 and Fehr and Gächter, 2001) that provides evidence for crowding out

Conclusion

- Where to draw the line as to which markets are considered repugnant?
- A very useful framework provided by Kanbur (2001)
- Depends on
 - Extremity of outcome (irreversible & potentially dangerous consequence)
 - Limited Agency (behavioural biases are likely to be large)
 - Inequality (desperation, not free choice)

Table 1**Each Obnoxious Market is Obnoxious in its Own Way**

	Extremity	Agency	Inequality
Arms	+	+	-
Hard Drugs	+	+	-
Soft Drugs	-	-	-
Toxic Waste	+	+	+
Blood	-	-	+
Body Parts	+	+	+
Child Prostitution	+	+	+
International Debt	+	+	-
Speculative Capital	+	+	-

Note: A “+” denotes a relatively high score while a “-” denotes a relatively low score. A “-” does not indicate that there is no problem along this dimension.

- It seems most potent they are combined
 - Only extremity of outcome would rule out dangerous sports
 - Only limited agency would require regulating lots of activities including eating unhealthy food
 - Only inequality would pretty much shut down the labour market in developing countries given the shortage of jobs & the poor job term and conditions
- When all three are combined, one can clearly see the grounds for repugnance
- Selling one's hair or even blood seems ok, but kidney is harder to accept, & heart seems unacceptable

- Even if we agree a market is repugnant, banning or regulation is not costless
- There are implementation issues and could lead to worse outcomes
- In the end, it depends on
 - In principle, which factor we put most weight on - liberty, equality, efficiency, or minimizing repugnant transactions
 - In practice, implementation considerations given the institutional realities