UNDERSTANDING THE MARKET ECONOMY

ARNE JON ISACHSEN
CARL B. HAMILTON
THORVALDUR GYLFASON

Understanding the Market Economy

ARNE JON ISACHSEN, CARL B. HAMILTON,
and THORVALDUR GYLFASON

OXFORD UNIVERSITY PRESS

1992

Oxford University Press, Walton Street, Oxford OX2 6DP
Oxford New York Toronto
Delhi Bombay Calcutta Madras Karachi
Petaling Jaya Singapore Hong Kong Tokyo
Nairobi Dar es Salaam Cape Town
Melbourne Auckland
and associated companies in
Berlin Ibadan

Oxford is a trade mark of Oxford University Press

Published in the United States
by Oxford University Press, New York

British Library Cataloguing in Publication Data
Data available

Library of Congress Cataloging in Publication Data
Isachsen, Arne J.
Understanding the market economy / Arne J. Isachsen, Thorvaldur Gylfason, and Carl B. Hamilton.
p. cm.
Includes bibliographical references and index.
1. Economics. 2. Comparative economics. 3. Capitalism.
I. Þorvaldur Gylfason, 1951– . II. Hamilton, Carl. III. Title.
HB171.5.I78 1992 330.12'2—dc20 92–24790

ISBN 0–19–877356–0
ISBN 0–19–877357–9 (Pbk)

Set by Hope Services (Abingdon) Ltd
Printed in Great Britain by
Biddles Ltd., Guildford and King's Lynn

To
Jannike and Elisabeth
Mette, Christoffer, and Tobias
Jóhanna and Bjarni

Preface

THE inspiration to write this book came to us during the conference 'The Baltic Family' held in Kaunas, the old capital of Lithuania, in October 1990. Realizing the enormous challenges facing Lithuania in its transition from plan to market, we decided to try our hands at a book explaining the workings of a market economy. A modest contribution to such an understanding is the purpose of this book.

In the course of writing this book, the Centre for Baltic Business Development has been established at the Norwegian School of Management. The present book is the first contribution in the Learning Library Programme of that centre.

Originally, the book was intended for beginners' courses in economics and business administration. However, since we rely on simple examples rather than mathematical equations, the book should be accessible to a much wider audience than a standard textbook in economics. Through circulating earlier drafts of the manuscript among Scandinavian readers, we have indeed learned that people from different walks of life have got a good grasp of economics from reading it. This makes us believe that business people, academics in other fields, politicians, public servants, and enlightened laymen in general could benefit from reading the book.

We thankfully acknowledge useful comments on earlier drafts of the manuscript from Olav Bjerke, Ole Bjørn Fausa, Harry Flam, Knut Isachsen, Gerson Komissar, Preben Munthe, Reidar Nilsen, Øystein Noreng, Mats Persson, Geir-Helge Sjøtrø, Jan Arild Snoen, Øystein Thøgersen, Jens Jonathan Wilhelmsen, and Anders Åslund. Tore Rokstad and Nils Haugland have provided able research assistance. In addition, they patiently updated the manuscript based on three authors rewriting the text.

John Christian Langli, Ph. D. student at the Norwegian School of Management, wrote a draft of a chapter on accounting. With minor modifications this appears as Chapter 17 in the present book. We owe him our gratitude.

Finally, we would like to thank the Department of Foreign Affairs in Norway, the Swedish International Development Agency (SIDA), and the Nordic Economic Research Council for financial support.

The Danish physicist Niels Bohr once remarked that physics is not about the real world because the world is too complicated for that; no, he said, physics is about what can be said about the world. We take the same view of our subject: economics is about what can be said about economic life.

Furthermore, to a large extent, economics is concerned with marginal changes. How much will the demand for shoes decline in response to a 10 per cent increase in the price of shoes? What will be the effects of a 5 per cent devaluation of the currency? How will increased taxation of production that causes pollution accompanied by a commensurate decrease in income tax affect the economy?

However, the economic challenges now facing the nations of Central and Eastern Europe are anything but marginal. When considering these challenges, economists therefore have reason to be modest about what they have to say. We do not claim to present unequivocal or simple solutions to the serious problems that we discuss in this book. Our objective is more modest: to present an intelligible account of basic economic mechanisms and relationships and to consider how they can be brought to bear on the transition from plan to market.

Many people consider economics a difficult field. Precisely for that reason, we have endeavoured to keep the text as simple as possible, without, of course, losing rigour. The extent to which we succeed in conveying a basic understanding of economics is for you to decide, after having studied the chapters that follow. We now put our pens to rest and wish you a happy journey.

A.J.I.
C.B.H.
T.G.

Oslo, Stockholm, and Reykjavík
December 1991

Contents

PART III: PUBLIC FINANCE, MONEY, CAPITAL, LABOUR, AND INTERNATIONAL TRADE

List of Figures

List of Tables

List of Supplements

1

Introduction

Whether you like it or not, history is on our side. We will bury you.

Nikita Khrushchev

IN 1960 Nikita Khrushchev claimed that in the course of the next twenty years the Soviet Union would have caught up with and surpassed the United States in terms of material standard of living. Add on ten years, and you will find an economic system in a state of dissolution: the Soviet system.

In the thirty years that have passed, the system of economic planning has shown itself unable to deliver what its leaders promised. Recognition of this fact has led to the desire to replace that system now. The market economy is generally regarded as the timely solution.

There is scarcely any doubt that the market economy has shown itself superior to the planned economy as far as economic growth is concerned. The material standard of living in Finland today is four times higher than in the Baltic states, despite the fact that at the start of the Second World War national income per head was about the same in all of these countries. In 1940 the economic situation of Hungary was about the same as that of Austria and the standard of living in Czechoslovakia was higher than in Austria. Today, however, the standard of living for the average Austrian is at least twice as high as for the average Hungarian or Czechoslovakian.

A similar story can be told about other continents. In 1960 the material standard of living in South Korea was certainly not significantly higher than in Tanzania; in 1988, however, the average annual purchasing power of income per inhabitant in Tanzania was $US355, compared with $US3,056 in South Korea, i.e. more than eight times as high. Compared with North Korea, which at the end of the Korean War some forty years ago was the richer part of the Korean peninsula, South Korea's income per inhabitant today is at least five times as high.

Although development of the material standard of living is difficult to compare from country to country, the conclusion remains: the market economy has shown itself to be vastly superior to the planned economy when it comes to economic growth. And the revolution in Eastern and Central Europe in 1989–90 could not be easily understood without reference to the stagnating standard of living in these countries.

Amidst the enthusiasm surrounding liberation from the command economy's tight bonds, and the eagerness to start using 'the new system', it might be opportune to focus on the questions that the introduction of a market economy must raise, as well as pointing to the demands and challenges that society, and individual members of society, will face if the new system is to have a chance of functioning reasonably satisfactorily.

To put it in slightly simpler terms, one could say that the two major problems an economic system must solve are to ensure an effective utilization of resources in the short and long term, and a just distribution of the resultant income from production. In any economic system, the state will inevitably play an important part in solving these problems.

1.1. Efficiency

Efficient use of resources means that everyone who wishes to work will have a job. Full employment is an important objective. In the sense that virtually everyone does have a job in planned economies, economic planning has been more successful than the market system in that regard. However, with respect to how efficiently labour is utilized, the market system is clearly superior. This is due among other things to the fact that in a planned economy an unreasonable amount of working time is spent in idleness on the job and in queues outside shops.

Being idle on the job is a way of wasting resources. In a market economy the capital owner receives the *profit*, namely what is left of income after all other costs have been covered; thus, the owner of capital is given a strong incentive to prevent wastage of labour and other resources.

In the longer term, however, full employment is not merely a question of keeping people in work and ensuring that working hours are utilized effectively. At least as important is what they are working at and how. And here the market system has shown itself to be vastly superior to economic planning. This is because the market adapts itself to changes in technology and preferences.

When new methods of production of well-known products are launched, those enterprises that do not adjust to developments will have problems in selling their goods; quite simply, they risk pricing themselves out of the market. In the short term this may lead to the closure of enterprises and higher unemployment. In the longer term, however, it ensures a great degree of flexibility for the system viewed as a whole.

In a market economy enterprises compete in selling their goods and services. Their main concern is to serve the interests of consumers. This encourages the production of new commodities which better satisfy customers' demands. Innovative enterprises that succeed in this will capture a larger part of the market. Enterprises that are unable to improve the quality of the goods they produce will have to reduce their activity. Despite the fact that the East German Trabant was the cheapest car when East and West Germany were united in 1990, such a poor-quality product was no longer in demand when other cars became available in the eastern part of the country. When the production of poor-quality products falls or ceases, resources are released for expanding enterprises and industries.

If, over a period of time, customers' tastes change, enterprises must quickly make note of this and make every effort to restructure production in the appropriate direction. One of the reasons why Japanese car producers experienced such a great increase in their market share in the United States after the quadrupling of oil prices in 1973–4 was that Japanese manufacturers were much better than their American competitors at meeting people's demands for more fuel-efficient cars. The American car manufacturers needed much more time to adapt to more expensive petrol. Luckily for consumers, there were alternatives to the large American cars in the small cars that were imported from Japan (and also from Europe).

In the long term, then, the market has a built-in mechanism which ensures that the structure of production changes in line with technological progress and with changes in preference among customers.

In a planned economy, production is directed by a central planning body. In principle, this body should be continually revising its plans, on the basis of technological innovations in production and changing tastes of consumers. In practice, it does not work that way. First, the manager of the individual enterprise has little incentive to take the risks involved in introducing new technology. There is no owner or group of owners that harvests the profits of increased productivity. Second, the planned economy is notoriously characterized by queues: the prices of most goods and services are far too low in relation to the demand. This makes it difficult for the planning authority to know how the existing resources can be optimally utilized, in other words what goods and services customers are most interested in obtaining more of.

In practice, economic planning has become a system where realization of the plan *as such* is a prime concern, rather than the satisfaction of customers' demands. Whereas a market economy is consumer-oriented, a planned economy is producer-oriented.

When economic planning managed neither to encourage innovation nor, over a period, to adjust itself to changes in preference among customers, the result was stagnation in economic growth.