FREE MARKET ECONOMICS

An Introduction for the General Reader

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Contents

Introduction

This is a book about the market economy.

A market economy is one in which overwhelmingly the largest part of economic activity is organized by private individuals, entrepreneurs, for personal profit. Such entrepreneurs are private citizens, not government employees. They make decisions for themselves on what to produce, who to hire, what inputs to buy, which machinery to install and what prices to charge.

There are, of course, in every nation state legislative barriers put in place by governments which limit every one of these decisions. No market is or ever has been even remotely laissez-faire. Entrepreneurial decisions are circumscribed by the laws, rules and regulations that surround each and every such decision.

And in every economy there are various areas of production undertaken by governments to a greater or lesser degree. There is no economy without government production of various kinds.

But in a market economy, although governments impose their will on the market process and engage in production themselves, it is the individual entrepreneurs who make the ultimate decisions on the largest part of what is produced, how it is produced and the prices that are to be paid.

It is from these activities that entrepreneurs earn their incomes. It is how they earn the money they spend. It is through their value adding activities that their own purchasing power is created, and not only their own but the purchasing power of their employees as well. Indeed, since governments live off tax revenues, a government's own ability to spend on what it buys is largely dependent on that same entrepreneurial success.

SHARING THE WEALTH

There are, of course, other ways of claiming a share of the output of an economy. Theft, charity, welfare, government grants of various kinds all provide an opportunity to receive some part of what has been produced.

But while each of these have economic consequences, they are not forms of market activity. Providing charity is an individual choice that will have as much, if not more, to do with the surrounding culture than it has to do with the nature of the economic system.

The provision of welfare by governments is a political decision that is generally unrelated to the economic system, except to the extent that welfare is more likely to be provided in strong economies than in weaker ones.

Government grants – the receipt of income through political decisions rather than through the market – is a major industry in itself. Governments are prevailed upon at every turn to hand out money; usually, but not always, with some stated social purpose attached.

Many such projects do not even achieve the social purposes that their advocates have promised, but whatever may be the outcome, the decision is made by those with political power for political reasons. Not all decisions to direct money in some particular direction are intended to strengthen the economy, and even where it is the intent, governments are often poor judges of the economic benefits of what they do.

But this at least can be said. The ability of governments to make such grants is ever-dependent on the underlying strength of the economy from which the expenditure must be funded. There is therefore always at least some interest in governments to see the community prosper. It is well that there is.

Because it is here that the market comes into its own. It is only in market activity that those who receive incomes give something back in return and, by the nature of the system, give back at least as much in value, if not more, than what was received. It is only through market activity that those who receive do so because they have also produced.

It is therefore only through the market that wealth and prosperity can be achieved. It is within the market-based exchange economy, one of the greatest social discoveries ever made, that our living standards depend.

THE NATURE OF MARKET ACTIVITY

Market activity is about earning an income of one's own by creating goods and services for others to buy. It is a natural part of human life in the complex societies in which we live.

But to speak of a market economy is to speak of an abstraction. By focusing on production, exchange and the enjoyment of the produce of economic activity, it seems to remove the processes involved in earning a living from the day-to-day lives of people. It seems to suggest that there is economic activity over here and then over there is something else which makes up the rest of life somewhere else.

One of the greatest English economists, Alfred Marshall, defined economics in this way. 'Political economy', he wrote on the very first page of his book first published in 1890, 'is a study of mankind in the ordinary business of life' (Marshall, [1920] 1947:1). There is a great deal of compartmentalization that often goes on when economics is discussed formally. There is a sealing off of economics from the everyday world when it is, in fact, seamlessly connected.

Contrasting economic activity with the study of economics is quite instructive. Economic activity is, as Marshall said, about getting on with life itself. The study of economics is about trying to understand the processes involved.

Economic activity is about people doing things that make them materially better off. The study of economics is about putting together formal analytical structures that neatly wall off such activities from everything else. Economic activity is about doing things. The study of economics is about explaining things.

What is important, therefore, in thinking about economics is that it is understood that outside the text and the theory are just people going about their lives, producing things for others and trying to earn incomes for themselves. In burying oneself in the formal study of economics, strangely enough it is possible to forget that for most people economics is just about getting on with the ordinary business of living.

There is also a notion that exists in some areas that the economics of the market and markets themselves ignore such problems as poverty, disadvantage or economic harm. That the attitude of a 'market' economist is to leave the economy to sort things out and let the chips fall where they may.

An economy is part of a community's political structure. There are innumerable ways that the political process will deal with various economic concerns.

Economic theory does not pretend to provide answers for all of life's problems, not even for all of our economic problems. No matter how you run an economy, there will be differences of income, differences in wealth, differences in power and ultimately differences in outcomes.

But what economics does do is let you understand the trade-offs that are intrinsically involved in making decisions. You cannot have everything, economists point out. You have to choose, sometimes between two goods and sometimes between two bads to work out which is the least worst.

And no matter what you do, from time to time there will be recessions and unemployment. There will be disappointment and failure.

But as history has so amply shown, the one and only road to improving the living standards of a community is through putting in place institutional structures that encourage entrepreneurial activity, continuous innovation and market-driven change.

FREE MARKETS AND POLITICAL FREEDOM

And then there is this. The free market is the only economic system consistent with personal freedom. It thus not only provides the basis for the greatest improvement in living standards, it also provides the basis for remaining free of political control over our lives.

The only other way to organize an economy is through central control and centrally determined collective action. There is a belief held by many that it is only possible to coordinate the required actions of an economy through some form of government planning and direction. With no government to coordinate activity, it is said, there is no basis for individuals working together.

It is, in fact, the opposite which is true. It is the market, and market-based activity, that is irreplaceable as the means to foster cooperative action, to encourage people to work together. And it encourages such cooperative activity because it harnesses the self-directed interests of individuals.

But it is only where such individuals are free to make decisions on their own without reference to anything other than the law of the land – where the law is itself designed to allow individuals the widest scope for making such decisions on their own – that the most productive economic decisions are made that raise, over time, the living standards of all.

ECONOMICS IS POLITICAL ECONOMY

Economics is, moreover, a branch of politics. No economic decision is ever made by economists unless the authority to make that decision has been given by those who hold political power.

Economics is also a branch of philosophy, but it is political philosophy of which it is a sub-branch. Economists think about the good life and how to get it. There has never been an economics tract of any consequence that did not outline how its author believed the lives of individuals could be improved by organizing the economy in one way rather than another.

Economics is also by nature a guide to action. It sketches out the contours of the economic system, explains how the various bits and pieces are related to each other, and brings the lot together in such a way that those who make economic decisions are able to understand how to achieve the political ends they seek.

When all is said and done, it is those who hold the political levers of the state who decide about many, if not most, of what will determine the ability of a nation's economic system to perform to its potential. And overlaying all of the economic considerations will be the political demands placed upon an economy by those with political power who, in an ideal system, are responsive to the individuals in whose interests they govern.

The ancient name of economics was political economy. This was in many ways more accurate as a description of the subject matter of this area of study. Politics dominates. There is no economic system anywhere that is now or ever was that has not been profoundly shaped by the political world in which it is found.

It is why books on economics are so frequently designed as manuals for government.

But there are still many reasons for the rest of us to understand how economies work. We each have to make our own way in the world based on our own assessments of what is going on. Having an understanding of economic matters is amongst the most useful areas of knowledge one can have.

By studying the economy we can judge, assess and see the consequences of the many events that will affect our own lives. It helps explain the world we live in and can help in making decisions in the face of the uncertainties we face.

It is also useful to understand what governments are doing even when there is nothing we can do to change it. Government economic blunders of the most expensive kind are common. A knowledge of economics provides the necessary insight for a ringside seat in what is often the most intensely contested area of political debate. As with any sport, only if one knows the rules can one genuinely follow the game.

HOW THIS BOOK IS DIFFERENT

This book describes itself as being about free market economics. How, it might be wondered, does this approach differ from any other? There are a number of ways, but a few stand out.

To begin with, this book is about the entrepreneur. At the very centre of economic activity are those individuals who decide for themselves to earn their incomes by owning and running a business. Other texts seem to take a cosmic approach where things just happen without identifying the role that specific individuals have played. Ignoring the role of individuals ignores everything important about how a market economy works, indeed about how any economy works.

And then there is this. The book embeds uncertainty at every step. Much of economics is taught as if not knowing what the future will bring is just one of those things that have no effect on how economies are managed or on how economics should be taught. In reality, the fact that the future is unknown, that tomorrow may bring the most profound forms of change, means that economics and economic management must be approached in a very particular way. Uncertainty means that an economy can never be managed from the centre, that it must always be managed in as decentralized a way as possible.

To think that governments or public servants or any central body can know and understand anything other than the most minute part of what needs to be known is to be blind to the ultimate reality of economic life.

Thirdly, this book more than just dispenses with an innovation introduced into economic theory in 1936, which is the concept of aggregate demand; it attempts to demonstrate at every turn just how fallacious and misguided this concept is. There is now virtually no text on the economics of output, employment and growth that does not start from the notion that variations in the level of demand are needed to account for variations in the level of activity. It is the argument of this work that this is not just a poor way of thinking about such issues, it is positively wrong and guaranteed to mislead.

But because aggregate demand is now the bedrock foundation of the branch of economic theory dealing with the economy as a whole, the theory of aggregate demand is explained in this book in exactly the same way it might be found in any normal work of economics. It is essential to understand the frame of reference in which decision makers are making their decisions.

The largest revolution in economic theory during the twentieth century was brought about by the English economist John Maynard Keynes, who published his *General Theory of Employment, Interest and Money* in 1936. It was he who introduced aggregate demand into economics by rejecting a principle that had until then been part of the very foundations of economic theory.

That principle, known as Say's Law, denied in absolute terms the validity of the theory of aggregate demand. No discussion of economic theory in general since 1936 has attempted to return Say's Law to the central position it had previously held. This book does.

The full name of Say's Law was Say's Law of Markets. It is the essence of market-based economics. Without the clarity that the Law of Markets brings, economic theory has lost its moorings and the irreplaceable value of leaving things to the market in directing economic activity cannot be understood.

And because this book looks back at economic theories that had flourished before Keynes wrote his *General Theory*, it presents the classical theory of the business cycle which, since 1936, has all but disappeared from economic discourse. The theory of the cycle, however, has the ability to penetrate the darkness left by Keynesian theory in understanding the causes of recession and the steps that are needed to bring recovery about.

Finally, the book looks at the nature of the money market and uses pre-Keynesian forms of analysis to understand the nature of the inflationary process. No one can promise to settle for all time the theory of money and inflation, but what this book at least does is examine and explain theories of inflation that were common before Keynesian economics swept the field. These are market-based theories that still make logical, coherent sense and shed light on what remains one of the most difficult areas of economic thought.

1. The axioms and underlying principles of a free market economy

Before taking a single step into the formalities of economic theory, there are some things that have to be understood about the nature of the world if one is to understand how market economies work. Call these the basic axioms of the market mechanism.

- Nobody knows the future.
- Everything is always in the process of change.
- Commercially useful knowledge is diffused everywhere across an economy.
- Without market prices no one can tell what anything costs.
- In the commercial world, everyone does what is best for themselves.

What we have here are statements about the world that are the bedrock foundations for understanding why a free market economy is the only kind of economy that can deal with the world as it actually is. The opposite of each of these cannot be entertained. No one can genuinely argue any of the following:

- that the future is known and knowable;
- that change either never happens or takes place so slowly it makes no difference;
- that there is someone or some group who knows everything about the economy that needs to be known;
- that it is possible to tell what something costs without prices that reflect relative scarcity or the intensity of demand;
- that individuals within an economic environment can realistically be expected to act in the best interests of total strangers rather than themselves.

Because these axioms are true statements about the nature of the world, we need an economic system able to cope with things as they actually are. Let's look at these axioms one by one.

NOBODY KNOWS THE FUTURE

If the future were known, or even knowable, there would hardly be a need for economics. It is because the future is invisible, except as inferences from what we see in the present and what we have learned from the past, that economic decision making is so difficult. The possibility of error is always present in every decision, and the farther into the future a return is expected, the greater is the risk of loss.

This is the most basic fact about economies: all decisions are made about the future before the future becomes known. There is therefore a need to find institutional arrangements that reward good decisions and punish those decisions which turn out to have been wrong. No one may be at fault, but unless those who run a business understand that it is their own responsibility to make that business succeed, the kinds of incentive to get things as right as possible just will not occur.

And the reason that some decisions are rewarded while others are punished is because only in this way can we guide the economy in the direction of creating more net value than is used up in production. Bad decisions are wasteful. They take an economy in the wrong direction. They cause the production of things for which others do not wish to pay the full costs of production. People end up less wealthy and less prosperous. Their living standards are lower. The aim of setting up our institutions as best we can is to limit as much as humanly possible the damage that such bad decisions can cause.

And because the future is invisible, it is amongst the most difficult tasks to decide, in the present, which forms of investment made today will produce a profitable outcome. For every successful enterprise there are many others which have fallen by the way.

There are, in fact, no guarantees of success.

Because all economic decisions aside from the most trivial are about the future, economic decisions are built around individuals in the present trying to work out what the future will be like. And because the future is always different from how it was imagined, economic decisions often turn out to have been mistaken.

This is the way of the economic world in which, by the nature of circumstance, we will always be forced to live. It is therefore imperative that the economic system provide as much incentive as possible for decision makers to get it right and that we remove from the control of businesses as quickly as possible those decision makers whose judgements are, for whatever reason, habitually wrong.

EVERYTHING IS ALWAYS IN THE PROCESS OF CHANGE

In an economy, as with just about everything else, the processes of change never come to a halt. Some of these changes are visible to all and some are virtually invisible. Indeed, some changes are unknown to anyone at all although they will ultimately affect everyone; think of an impending natural disaster such as an earthquake or an invention that will be made one year from today.

There are major economic and political events that no one can predict. Economies expand and contract. New regulations are regularly introduced. Governments come and go. Wars are declared and peace resumes.

There are new products, new technologies, new ways of doing things, and many of these have commercial possibilities that will completely upset the best laid plans of those who are already in the market.

Amongst the most important features of an economy is that it be designed to cope with change. The phrase 'creative destruction' captures the way a modern economy adjusts. The new does not arrive and then live side by side with the old. The old is instead driven from the field, and unless adjustments are made, what was there before ceases to exist.

There was a time when the only way to cross the oceans was to go by sea, but now virtually no one does. The businesses who built and sailed the world's ocean liners were some of the largest businesses of their times. These businesses have now almost entirely disappeared and have been replaced by aircraft and airlines.

But there are also many changes that are quite trivial except in the particular workplaces they affect. A change in the price of an important input, or in the prices charged by some competitor, can come as a bolt from the blue but with devastating consequences.

The cancellation of orders from a major customer or an illness for one of the key personnel in an enterprise can create major difficulties impossible to accommodate.

This business about change being a constant has all the force of any old cliché, except that like many clichés, it expresses one of the profound truths about the economic world.

No economic system, nor the businesses contained within it, can survive without the means of accommodating change. The better they are at adapting themselves to new circumstances as they arrive, the more successful they will be.

KNOWLEDGE IS DIFFUSED EVERYWHERE ACROSS AN ECONOMY

The knowledge needed to run an economy is dispersed everywhere. No one has anything other than an infinitesimal amount of the knowledge required to keep an economy working.

Useful knowledge is contained within actual people, embedded within the individuals of whom the society is composed. This is not knowledge contained in books, but the active knowledge held by actual people who are personally capable of applying that knowledge in a real world workplace.

No one knows everything commercially useful to know. Virtually everyone has specialist knowledge that is economically useful, some with knowledge more valuable than the knowledge held by others but each with something to contribute towards a final outcome. One of the major purposes in structuring an economy is to put that knowledge to work as efficiently as possible.

Even the most knowledgeable people have only a smattering of the relevant knowledge in any society. Most commercially useful knowledge is of quite a basic character (Where are the paint brushes usually kept? What is the quickest way to get to Major Street?) yet it is essential for making an economy work efficiently.

Getting the knowledge that is at hand into the most commercially useful places is among the great and difficult tasks an economy is forced to perform.

Beyond that, the sum total of all the knowledge in existence is continually growing and changing shape. Things that were known on one day (where the brushes are kept) may be different the day after. A price that was charged on one day may be different a day later. A new innovation or invention may have just been released on the market or an old product removed.

Relevant knowledge is scattered everywhere. How to increase the knowledge base of a society and then coordinate and focus such knowledge towards economically useful and productive ends is the single greatest challenge an economy must face. How well or poorly it is done will determine the prosperity of an entire community.

WITHOUT MARKET PRICES NO ONE CAN TELL WHAT ANYTHING COSTS

Think of costs as representing a proportion of the totality of productive resources available within a community. Therefore, the more any particular product costs, the less of everything else that can be produced. Some mechanism is therefore needed in any complex society to allow consumers and producers to work out how to satisfy their wants at the lowest possible cost.

The centre, the absolute centre, of a properly functioning market economy is therefore based around the price mechanism. It is almost impossible to emphasize enough just how important to an economy the generation of *market* prices is.

Market prices reflect the intensity of demand on the one side and the relative scarcity of the good or service on the other. Prices instruct economic agents (that is buyers and sellers) on how to economize.

In very simple terms, the price mechanism identifies which products, services or resources are the least abundant relative to demand. Prices therefore guide producers to use relatively more abundant resources and smaller amounts of relatively less abundant resources.

Without prices set in the market no business can make economically rational decisions on what to produce, since there is no actual information available to producers about what others want to buy. (They want shirts, you say – then tell me what colour, what size or what style?)

And even if businesses knew in detail which final products to produce for consumers, which they never would, there would be no means whatsoever to determine how to find out which inputs would keep costs to a minimum.

A business would never know, without market prices to tell them, whether it was using scarce inputs which were relatively hard to find and expensive to produce. It would be impossible to determine what proportion of the entire productive potential of an economy was being used up to produce any particular array of goods and services.

Without prices to guide them, businesses could not know what forms of production would earn a profit since they could not know how much each input cost. Without a realistic set of prices to indicate the relative scarcity of inputs, no business would have the foggiest notion about which set of factors of production would keep their costs to a minimum.

Prices also connect the present to the future, at least to the limited extent we can ever know the future. What we know we know today, and part of what we know in the present is what is *believed* about the future. Market prices therefore adjust as assessments about the future shift.

Change in the economy is also automatically reflected in movements in market prices. Irrespective of what happens, if it comes to the attention either of those who sell and set prices or to those who wish to buy, forces are commenced which move prices in the direction to reflect either increased or diminished scarcity or an increased or diminished willingness to buy the product.

The thread that connects all of the parts of the economy is the price mechanism. It allows what could never otherwise be done by bringing together inputs from all over the world to produce goods and services sold all over the world; it allows activities to be coordinated which could not be coordinated in any other way.

The crucial point is this. Without the information provided by market prices, no complex economic decision could ever be made.

IN THE COMMERCIAL WORLD, EVERYONE DOES WHAT IS BEST FOR THEMSELVES

The way this is traditionally stated in economics is to say that individuals act in their own self-interest.

Since everyone has their own perspective on the world, everyone acts in the way they think is best based on their own morality, background and personal circumstance. Everyone does what they believe will be, given their own perspective, the 'best' thing to do.

Moreover, everyone acts as a moral agent in trying to do what they see is the right thing to do, but the only perspective from which anyone can see the world is from their own. To point out that we all do what is best for ourselves does not mean we necessarily act in selfish ways. It means that even when we try to help others, we are acting in this way because we personally believe that is the right thing to do.

A mother looking after her children, someone giving money to a charity, others doing what they can to help the poor, are all examples of acting in ways that each of these people believe will be best.

But moving away from such intense personal circumstances, virtually all economic activity is undertaken between strangers, frequently between people who live in different countries and often on entirely different continents.

Market-based activity is not a personal relationship between people. The different individuals who go into the making of an item of clothing, for example, whether harvesting the cotton, spinning the yarn, weaving the cloth or cutting and sewing the fabric, are undertaken far from the person who will eventually buy the shirt.

Producing goods and services that others wish to buy should therefore be seen as actions intended to serve consumers by allowing sellers to achieve ends of their own. People undertake the various productive activities for a variety of reasons, but to believe that the reasons are ever independent of their own personal interests will make understanding the nature of the economic world impossible.

There are personal relationships and then there are commercial relationships, and sometimes, but not very often, they are the same. An economy is run on self-interest, in which the central aim for all, whether the owner of the firm, the workers employed or the lenders from whom funds are borrowed, is to earn an income.

The greatest protection for a buyer is that the self-interest of firms which intend to stay in business lies in producing quality products at the lowest possible price. In a commercial competitive environment, self-interest works for customers and not against them.

THE BASIC RULES OF A MARKET ECONOMY

These are the basic axioms, not of a market economy but of any economy. If even only one of these axioms were true, the need for a market would be proven. That all five are true and obviously true makes market-based economies an imperative.

From the above axioms are derived the basic rules of a free market economy. They are also almost entirely invisible. Yet they are the fundamental background principles one needs to know to have an understanding of the economics of the industrialized world.

Anyone trying to understand the operation of such an economy must always bear these principles in mind.

These principles are also important because they are not always followed. And where they are not followed, where any of these principles is not permitted to be the operating principle in the management of an economy, that economy will experience slower growth and lower incomes than it would otherwise have achieved.

1. No One Runs a Free Enterprise Economy: It Runs Itself

The structures of a free enterprise economy are designed so that the personal decisions of producers and consumers shape the economic environment in which they live. Laws and regulations determine the decisions that can legally be made. But within the law, the decisions made are personal and private.

The shape and structure of the economy has been designed by no one. It is just the outcome of millions upon millions of individual decisions.

The driving force on the production side is profit. The driving force on the consumption side is personal satisfaction, often referred to as 'utility' by economists. Businesses make decisions that are expected to bring them the greatest excess of revenue over cost which they can only do by providing buyers with the goods and services they want.