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A Critical Appraisal

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Preface

From listening to my students and to people at cocktail parties talk about the free market system, I have come to realize that there is a great deal of misunderstanding about the free market argument. The world seems divided between people who see markets as the cure for all our problems and people who see markets as the cause of all problems.

This book takes the view that the truth lies somewhere in between. In it I attempt to apply the free market argument to a wide variety of social issues and, in doing so, to point out some of its contradictions. However, my aim is not so much to discount free market economics as to raise doubts about its validity as a solution for all social problems. The criticisms I present are immanent; that is, they do not challenge the assumptions upon which the free market argument is based but rather accept them and use them to demonstrate how they can lead to social outcomes unacceptable to a consistent free market advocate. I conclude that while markets do work in many situations, they are not panaceas, and for some problems non-market institutions may be preferable. These institutions should be organized and coordinated by the state because private incentives fail to create and control them.

This book is addressed to many audiences. First, it has been written as a supplement to the textbooks used in a number of economics courses taught at universities. Any course that uses competitive (free market) economics as its theoretical foundation would benefit from devoting time to the ideas presented here. Such courses include not only economic principles (both micro and macro) but also intermediate microeconomics and industrial organization. Other courses where this book may be useful are economics of public policy, welfare economics, and business school courses on the nature of the competitive process. Students—and, for that matter, professors—should be forced to stop and think about the subtleties of the economic arguments they use to buttress their classroom discussion and policy analysis. Few books are available that do this in a logical, non-polemical way, using modern economic ideas. This is what I attempt here.

In addition, I hope that this book will be read by intelligent laymen, policy makers, and political leaders willing to follow a logically rigorous, but generally non-mathematical, argument to its conclusion. I feel that the current social debate treats the theory of free markets in much too cavalier a manner, invoking it to justify policies without proving that such an invocation is appropriate. If there were a better understanding of the limitations of the free market argument, a more rational public policy debate might follow.

This book progresses from the general to the specific. In chapter 1, I describe the "free market economic argument," spelling out its basic assumptions and tracing their roots in the history of economic thought. Chapter 2 presents conventional criticisms of the argument, which, since few of them are immanent, are not pursued in the remainder of the book. In chapter 3 I give examples to demonstrate the benefit of organizing society along free market lines. Chapter 4 aims at pinpointing where the free market system can break down, showing how individual rationality—the cornerstone of the free market argument—is responsible for many of the system's failures. As an illustration, I review some new and some traditional instances of markets that fail to determine optimal social outcomes, reviewing work on markets with what are known as informational asymmetries, externalities, and public goods. Here the selfish individual rationality of the agents in the market destroys its results instead of leading, "as if by an invisible hand," to socially desirable outcomes. Chapter 5 then shifts us from the realm of theory to that of policy. It investigates such public-policy issues as crime, minimum wages, affirmative action, anti-discrimination laws, and educational vouchers. Chapter 6 presents a theory of justice that should be acceptable to people who subscribe to the free market ideals spelled out in chapter 1, but that may lead to outcomes that they would find undesirable. Chapter 7 looks at the most recent and the strongest assumption of rationality used in the free market argument—the assumption of rational expectations—and points out potential logical difficulties with it that, if true, would dramatically alter many of the recent macro-economic policy conclusions reached by the leaders of the rational expectations school. Chapter 8 offers reasons for the endurance of the free market system in America. Chapter 9 summarizes the discussion and offers conclusions. I hope that by the time the reader reaches this point, he will have gained a more detached and objective view of the pros and cons of free market economics.

Because there are many potential audiences for this book, there are many ways to read it. General readers interested in a quick overview of the book's argument should read chapters 1, 3, 4, 5, and 9. Professors planning to assign the book, however, should use a more sophisticated strategy geared to the course being taught and the background of the students. Chapters 3, 8, and 9 are the least difficult and require no background in economics. Chapters 1, 2, 4, 5, and 6 require exposure to introductory economics—for example, through the economic principles course. Chapter 7 calls for an intermediate amount of knowledge of economics and related disciplines. This chapter is by far the most difficult in the book and should only be assigned in more advanced undergraduate or beginning graduate courses. As for the material presented in the other chapters, however, I believe that any diligent undergraduate should have no difficulty in understanding it. Chapters 1, 2, and 3 should be read by all students, regardless of the course in which they are enrolled, while the other chapters can be selected according to the emphasis of a specific course. Except for Chapter 7, this book uses no mathematics whatsoever. Nevertheless, the analysis is still logically rigorous and possibly demanding at points. I have made it so in order to give beginning students something to strive for, while at the same time not insulting more advanced students.

When an earlier version of this book, entitled "Capitalism and Corner Solutions: Some Problems with the Conservative Argument," was circulated among my friends and colleagues at New York University, they made me realize that what I was discussing in that somewhat polemical manuscript was not the conservative argument—which has distinct political, philosophical, and even religious overtones—but rather the more libertarian free market argument. Hence, I wish to thank Jess Benhabib, Clive Bull, Ray Canterbery, Roman Frydman, Lewis Kornhauser, Janusz Ordover, Peter Rappoport, Mark Schankerman, and Bernard Wasow for the frankness of their comments on that manuscript, a frankness that led me to make drastic changes in this book over the past two years. I would yet again like to thank Clive Bull and Lewis Kornhauser for their comments on selected chapters of the final manuscript. I want to acknowledge my debt to the work of Roman Frydman and Gerald O'Driscoll in the discussion of Newcomb's problem in chapter 7. Also, I wish to thank my editor, Michael Weber of St. Martin's Press, for his encouragement and patience and for providing me with some excellent (anonymous) referee reports that made my revisions easier. As with all of my work, this book was made possible in part by the support of the Office of Naval Research, Contract No. N00 14-78-C-0598. This support is gratefully acknowledged. Finally, I thank my wife, Anne Howland Schotter, for her careful stylistic editing.

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The Free Market Argument

It is important to point out at the beginning that what I call the "free market argument" differs from what has come to be known as the "conservative argument." This is because the latter is a composite of moral, economic, and political arguments that present a multi-faceted perspective on social issues. George Nash in *The Conservative Intellectual Movement in America Since 1945* divides conservatives into three groups—the "libertarians" or classical liberals, the "traditionalists," and the "evangelical anti-communists." He claims that a full characterization of the conservative argument must take all of these groups into account. My characterization of the free market argument is closest to the libertarian view, concentrating on the classical liberal value of individual rights and avoiding the emotional and moralistic concerns of the "traditionalists" and "evangelical anti-communists." I will separate the free market argument from the conservative argument and investigate it in isolation.

THE CHARACTERISTICS OF THE ARGUMENT

The free market argument is characterized by several attributes, not all of which are logically consistent. First, it is invariably individualistic, holding that all social action must be sanctioned by the will of the rational individuals composing society. Under this view society is nothing more than the aggregate of the individuals composing it. Normatively this implies that no external ethic should be applied to social decisions other than by the will of the people. Norms such as equality and equity are relevant to social debate only if invoked by all of the individuals in society. Such norms should not be imposed upon society by a government or a social planner who values them for their own sake. A concomitant of this individualistic philosophy is the Lockean idea that people have an inviolable right to keep what they have earned. According to this view, no external authority has the right to expropriate these earnings through taxes.

The free market argument assumes that economic and social agents are rational in that they are fully aware of their own preferences and capable of making all of the calculations necessary to pursue their interests efficiently. This assumption of rationality has recently been taken to extremes by the rational expectations school, whose work we will discuss in chapter 7. This assumption has two components—utility maximization and selfishness. Under the first component social and economic agents are seen to make decisions that bring them the greatest satisfaction. Under the second, social and economic agents view any social state (e.g., income distribution) in terms of their own allocation of goods without regard to the consequences that the state might have for other agents' allocations. Adam Smith claimed that nothing more than selfishness is necessary for society to achieve optimal social outcomes.

> It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages. Nobody but a beggar chooses to depend chiefly upon the benevolence of his fellow-citizens. Even a beggar does not depend upon it entirely. The charity of well-disposed people, indeed, supplies him with the whole fund of his subsistence. But though this principle ultimately provides him with all the necessaries of life which he has occasion for, it neither does

> nor can provide him with them as he has occasion for them. The greater part of his occasional wants are supplied in the same manner as those of other people, by treaty, by barter, and by purchase.[1]

The selfishness assumption does not deny the possibility of socially minded behavior among rational social agents.[2] This assumption only holds that such behavior is neither a necessary nor a sufficient condition for markets to maximize social welfare.

The assumption of rationality, combined with the view that there are large numbers of economic agents, known as competitive assumption, presents the fiction of an economy composed of isolated individual agents pursuing their own self-interest without considering how their actions affect the lives of others. Such interdependencies will be seen to present problems for the workings of free markets and historically have been the basis of most of their criticism.

The free market argument is usually either utilitarian or what I shall call Paretian (after the nineteenth-century sociologist Vilfredo Pareto, who devised a well-known standard by which to judge the efficiency of social states) and efficiency-oriented in its calculations. If individualism dictates that only the preferences of individuals are allowed to count in making social decisions, then these preferences must be aggregated. For example, in a cost-benefit analysis a project's social costs and benefits are added to see if the project should be undertaken.

If a utilitarian standard is used, preference intensities (perhaps expressed in dollars) are simply added up. If a Paretian standard is used, only the alternative that is the unanimous choice of the entire society is chosen. For instance, if society must build a road through either a bird sanctuary or a suburban neighborhood, the decision should be determined by which interested group—naturalists or suburban residents—is willing to pay more to have the road's location changed. If the naturalists are willing to pay $1,000,000 to avoid the road and the suburban dwellers are willing to pay only $800,000, then it should be built in the suburbs. In being willing to pay only $800,000, the suburban dwellers in essence are admitting that they will accept the road in their neighborhood as long as a bribe of that size is offered to them. We know that the naturalists are willing to pay at least $1,000,000 for that purpose, and thus they could offer the suburbanites a sufficient bribe. Hence, building the road in the suburbs is deemed best for society, since the suburbanites can be compensated by the naturalists in such a way that both parties are better off. Notice that this calculation uses only the information of individual preference and therefore is consistent with the free market individualistic bias. No external ethic, such as "the environment should be preserved," is invoked. If the individuals involved want bird life destroyed, it should be destroyed.[3]

This problem points up an inherent tension between utilitarian and libertarian aspects of the free market argument. Building the road through the suburbs is bound to violate individual rights, especially if suburbanites have to be relocated. Consistent individualists should not be willing to do so just because of a utilitarian calculation. Rather, we should build the road there only if either *all* people agree voluntarily that it is best or they can be bribed to accept it. This is a more liberatarian or contractarian view of individualism, which we will later introduce the Pareto principle to justify.[4] In fact, this conflict is evident in the utilitarian motto "the greatest good for the greatest number." The social decision that maximizes the greatest good or the greatest sum of individual utilities may turn out to benefit a minority of the population that feels intensely about the decision under consideration. Hence we may maximize the greatest good but not for the greatest number.

The free market argument is what Robert Nozick calls a "process-oriented" argument, as opposed to an "end-state-oriented" argument.[5] Process orientation assumes that in judging the outcomes of social institutions, one should not concentrate on their ethical properties but on the institutional process through which these outcomes are determined. For example, unequal income distribution in the United States is not *prima facie* evidence that incomes should be redistributed as long as the process through which they were determined did not involve fraud or coercion and was otherwise fair. If the outcome was arrived at voluntarily by the mutual consent of all involved, it can be justified, since, given the individualistic bias of the free market argument, nothing that individuals enter into voluntarily can be bad.

Another assumption of the free market argument I call the "invisible-hand laissez-faire faith assumption." This assumption holds that if individuals are left alone and allowed to contract voluntarily, the welfare of society will be enhanced. Any intervention in this process is bound to make things worse.

The final assumption of the free market argument is the efficiency-equity tradeoff assumption. Advocates of free markets maintain that if society uses a nonindividualistic social ethic to define the equity of social outcomes, there is likely to be a dropoff in the efficiency of existing institutions. Society is forced to choose between an economic system that maximizes social output (the free market) and one that maximizes some nonindividualistic ethical objective, such as the socialist ethic of "from each according to his ability, to each according to his need" or the Rawlsian ethic of maxi-min justice.[6] The latter is named after the philosopher John Rawls, who, in his book *A Theory of Justice,* advocates an ethic according to which social decisions are made in a way to maximize the satisfaction of the worst-off person in society—the "maxi-min" criterion.

The free market argument, then, is based on the rights of the individual, uses only his preferences in making its utilitarian or Paretian calculations, and, assuming the rationality of individuals, has faith in the ability of the unbridled free enterprise system to maximize the sum of these preferences.

THE INTELLECTUAL ROOTS OF THE FREE MARKET ARGUMENT

A brief examination of the historical development of the preceding assumptions will cast light on the strengths and weaknesses of the contemporary free market argument.

Individualism

Though individualism can mean many things to many people, I will distinguish only two meanings here. In one sense used by Hayek, individualism is primarily a theory of society and of social institutions. It explains the nature, evolution, and function of such institutions in terms of the unplanned and unintended action of free individual agents.[7] This emphasis on the unplanned aspect of institutions contrasts with a study of their creation or design by some centrally controlled planner.[8] Hayek states:

> It is the contention that, by tracing the combined effects of individual actions, we discover that many of the institutions on which human achievements rest have arisen and are functioning without a designing and directing mind; that, as Adam Ferguson expressed it, "nations stumble upon establishments which are indeed the result of human action but not the result of human design;" and that the spontaneous collaboration of free men often creates things which are greater than their individual minds can fully comprehend.[9]

Individualism for Hayek is intimately connected with the invisible-hand laissez-faire faith assumption. Both beliefs sanctify individuals and trust in their ability to create spontaneously and unconsciously social institutions that further society's aims better than institutions consciously designed by the same people.[10] It is in the generation of what Hayek calls a "spontaneous order"—superior in terms of social welfare to any planned social order—that the free individual is so necessary.

I will expand on this theoretical conception of individualism later in connection with the invisible-hand laissez-faire faith assumption. A second meaning of individualism is derived from a political philosophy that looks to the individual as the ultimate reservoir for all rights and obligations in society. This view is seen clearly in John Locke's famous analysis of how the political state emerges from a "state of nature." Locke views humanity in the state of nature as totally free and endowed with its full set of natural rights.[11] The political state is created at the will of the individuals existing in the state of nature solely to maintain their rights and property. If this purpose is not served, the people have the right to revolt and change their government.

> Wherever law ends, tyranny begins, if the law be transgressed to another's harm. And whosoever in authority exceeds the power given him by the law, and makes use of the force he has under his command, to compass that upon the subject, which the law allows not, ceases in that to be a magistrate, and acting without authority, may be opposed, as any other man, who by force invades the right of another.[12]

Hence, once created, neither the state nor society has rights of its own but must be the servant of the individuals that create it.

What consequences does this Lockean notion of individualism have for social policy? It implies that the state has no right to judge or alter a social outcome determined by freely contracting individuals as long as it was reached in a manner that violated no one's rights. This is true because that outcome reflects the collective will of the individuals composing society and is the equilibrium result of the "natural order" that results from free individuals. According to Locke, individuals have the right to keep anything that they mix with their labor:

> Though the earth, and all inferior creatures be common to all men, yet every man has a property in his own person. This nobody has any right to but himself. The labor of his body, and the work of his hands, we may say, are properly his. Whatsoever then he removes out of the state that nature hath provided, and left it in, he hath mixed his labor with, and joined to it something that is his own, and thereby makes it his property.[13]

As we will see later, the notion of property rights discussed here is a central characteristic of the free market argument.

Utilitarianism and the Pareto Criterion

If the individual is to be the sanctified atom of social life from which all social molecules are constructed, then it becomes necessary to create some calculus that will permit us to know when society, defined as the aggregate of individuals, is made better or worse off by a certain policy. As Jeremy Bentham wrote,

> The happiness of the individuals of whom a community is composed, that is, their pleasure and their security, is the end and the sole end which the legislator ought to have in view: the sole standard, in conformity to which each individual ought, as far as depends upon the legislator, to be made to fashion his behavior.[14]

Such a calculus, called the "felicific calculus," was proposed by the utilitarian philosophers of the eighteenth and nineteenth centuries—Jeremy Bentham (1748–1832), James Mill (1773–1836), and John Stuart Mill (1806–1873). Although utilitarianism today is looked upon as a philosophical apology for the status quo, it was quite radical when first proposed and in fact was used by Bentham as a weapon to press for legal reforms. It opposed the more libertarian view held by Locke, Adam Smith, and other individualists that God created a natural order that generally should not be interfered with by government. For Bentham and the utilitarians, the status quo is not sacred, since government intervention to increase the happiness of society is justifiable. But how is society's happiness to be measured? Bentham answers:

> The community is a fictitious body, composed of individual persons who are considered as constituting as it was its members. The interest of the community then is what?—the sum of the interests of the several members who compose it.[15]

But this answer has been unsatisfactory to twentieth century economists, since it has not been clear to them how one *measures* the interests of an individual. The solution given by the early neoclassical economists Jevons, Edgeworth, and

Marshall was to construct a utility function for each individual that would explain the satisfaction he or she got from each good or combination of goods he consumed. Such a function was calibrated in units of satisfaction called "utils." Later the economists John Hicks and R. G. D. Allen recognized that absolute utility measurement may not be possible and offered a more relative, ordinal function. Hence the utilitarian creed, "the greatest happiness for the greatest number," means arranging the laws and institutions in society so that the sum of the utilities of individuals is maximized.

However, utilitarian calculations involve a major technical problem: they assume that the levels of satisfaction of individuals can be compared. For instance, in our earlier example of the road to be built through a bird sanctuary or a suburb, we needed an operational method of making comparisons between the utility lost by one group and that gained by the other. The method proposed was simply to build the road where the willingness to pay to have it built elsewhere was smallest—in this case in the suburbs. But if income is not "optimally" distributed and if the naturalists are rich and the suburbanites are poor, a dollar would mean less to the former than to the latter. As a result, the "cheap-utility" dollars offered as bribes by the naturalists would not be comparable to the "expensive-utility" dollars offered as bribes by the suburbanites. We would have to make interpersonal comparisons of the utility of dollars.

One way out of this impasse was offered by Vilfredo Pareto, who proposed the Pareto criterion that allows us to rank social outcomes and the decisions that determine them without making interpersonal comparisons of utility. This criterion can be illustrated with the following example. Consider a world with two people, A and B, and two commodities, apples and oranges. A loves oranges and hates apples, and B loves apples and hates oranges. We are contemplating two allocations, one in which all oranges are given to A (the orange lover) and all apples are given to B (the apple lover), and one involving the opposite allocation. Clearly we can say unambiguously that the first allocation is preferable to the second because all agents in society unanimously prefer it: the apple lover gets the apples and the orange lover gets the oranges. No interpersonal comparison of utility is needed because of this unanimity. The social state that results from a particular allocation or decision is called "Pareto optimal" if no other state is unanimously preferred to it. The outcome is efficient because of the unanimity of opinion supporting it. This criterion is the one most consistent with the individualism implicit in the free market libertarian argument. If all people prefer state 1, no one has the right to deny it to them.

While the Pareto criterion is a great advance in the treatment of such problems, it comes at a cost, since it cannot be applied to all comparisons of social states. Because the criterion can only rank those states that society can unanimously decide upon, some social states are left in an ambiguous position. To get around this problem, economists have used what is called the compensation principle.[16] According to this principle, social state X is superior to social state Y if, in moving from Y to X, the people who gain can compensate the people who lose. This criterion has several characteristics. First, it does not solve the problem of interpersonal comparison of utility, since it again forces us to compare the utility gains of gainers with the utility losses of losers.[17] Second, the compensations called for under this principle need not actually be paid—the losers may remain losers. All that is required is that the gainers be able to compensate them.

The compensation principle typically infuriates modern-day liberals because it strikes them as unfair. Consider a rent-controlled apartment building occupied by elderly people. The owner decides that, because of low rental income and high oil prices, it is no longer worthwhile to keep the building and converts it into a cooperative. Should social policy allow such an action? Supporters of the compensation principle would suggest that we ask the prospective apartment owners (the gainers) how much they would be willing to pay for their apartments. We should also ask the present occupants how much they would be willing to pay to keep their apartments (this would reflect both their income and their cost of moving elsewhere). If the price that the prospective cooperative owners are willing to pay is greater than