

THE DYNAMICS OF THE MARKET ECONOMY



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An isolated person living in a primitive environment, faced with the task of deciding how to make the best of his situation, would be able effectively to manage only a limited amount of material resources and could make comparatively few plans about directing their use. Because of the simplicity of his range of choice, calculations in terms of physical output would suffice because his resources would not be highly diversified or, for him, particularly versatile. Such a person would be unable to manufacture anything but the most rudimentary tools and his most versatile factors of production would be his own labour and ingenuity. Moreover, since he would be producing for his own satisfaction, his own scale of values would be the sole determinant of which goods among those produceable should be chosen. His decisions therefore as to what economic action he should take would be based on calculations in kind. However, over the course of human history virtually all people have chosen social co-operation instead of self-sufficiency, and as all men have different skills and talents, specialisation and the division of labour have created an enormous increase in human productive ability. The basic economic problem however is one of scarcity: human desires exceed the means or resources for their satisfaction.

In an advanced economy, with the immense variety of consumer goods and services that can be produced and the infinite array of steps that can be taken towards their production, the more economic or fruitful choices cannot be made simply by reviewing calculations in terms of physical output. Resources and factors of production cannot be allocated without some basis for comparison of the results.

Money, which permits the widespread exchange of goods and services, provides a calculational means by which the myriad of physically different resources and outputs can be translated into a common denominator. The analysis of costs and benefits is crucial to the allocation of scarce resources and productive factors.

The other basic economic problem is one of co-ordination and knowledge. Hayek has highlighted the problem of the “division of knowledge” which underlies the problem of the division of labour. The knowledge that underlies human economic action, which is dispersed in fragments throughout millions of minds, is grossly imperfect, for it comprises to a significant degree suppositions about the future decisions and actions of other market participants. Each individual has unique information regarding his particular cir-

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cumstances of time and place and particular talents and skills. The co-ordination of potentially conflicting individual plans and the allocation of scarce resources can only take place in a system of social co-operation and market prices. The relative importance of the various consumer goods and resources is translated into common terms by money prices. Money prices are exchange ratios which reflect the ranking of the subjective valuations placed upon increments of goods at a given moment by market participants. Money prices are subject to continuous change because of the changeability of people's desires and valuations and because of changes in the supply of particular goods and services.

The co-ordinating function performed by the price system can be illustrated by assuming a sudden shortage of some resource. The price of a unit of that resource will increase as those who use it for the generation of products promising the higher return outbid those producers who plan to use it in less remunerative products. The higher price results in the curtailment of the employment of the resource in its marginal, i.e. less remunerative, uses.

Hayek, in *Individualism and Economic Order*, described how the price system produces a sort of order as a result of human action rather than design:

The marvel is that in a case like that of a scarcity of one raw material, without an order being issued, without more than perhaps a handful of people knowing the cause, tens of thousands of people whose identity could not be ascertained by months of investigation are made to use the material or its products more sparingly. [This mechanism] ... is not the product of human design and ... the people guided by it usually do not know why they are made to do what they do.

Another tendency of the market is towards resource conservation and resource discovery. As the price of scarce resources rises, people are induced to search for more of them. It thus becomes more economic to mine marginal reserves or to use or develop substitutes. Thus, as resources become more scarce, more supplies can be established and the number of years of reserves of a given resource such as oil or coal increases. Resource owners moreover tend to dole units of resources out onto the market as slowly as possible, as they often have an eye on the possibility of selling their remaining units of the resource in the future at a higher price per unit.

THE ADVANCED ECONOMY

The underlying purpose of all productive effort in an advanced, market economy is the generation of goods and services for consumption. Wealth (and thus spending) must come out of production. i.e. the creative application of men's minds, and not the other way round.

The level of employment in an economy will also be determined by the relationship between millions of costs and prices. In an economy where markets are allowed to work without hindrance, changes in prices bring about a balance between the supply and demand for goods and services, including labour. As a result, the price mechanism tends to iron out surpluses and shortages throughout the economy, provided always that prices are allowed to prevail freely and not distorted by government intervention or certain restrictive practices. Attempts by governments or trade unions with legal immunities to interfere with the price mechanism, e.g. through minimum wages legislation, will create unavoidable surpluses and shortages. In the case of labour, this means that unemployment will ensue. The market is essentially a continuous *discovery* process, with millions of rising and falling prices providing information to entrepreneurs about potential surpluses and shortages. Money prices enable people, as we have seen, to make economic calculations, because money is the common medium of exchange.

As there are millions of producers and consumers in an advanced economy, operating according to their own independent plans, having differing skills and abilities, possessed of different fragments of knowledge and guided by their own independent judgments and desires, it is impossible for any state planner to have all the necessary information about people's preferences and the consequences of given courses of action.

Because there can be no such thing as certainty in an advanced economy and there is always the risk of error, the more that economic activity is planned by the state and the more that resources are allocated according to the dictates of politicians as opposed to the ultimate preferences of consumers, the greater the likelihood of disastrous economic miscalculation and the greater the damage that will result.

It is thus vital that economic planning of any sort be left to the individual actors in the economic process. We have seen that as risk is inherent in economic activity, freely prevailing rising and falling prices provide a means of co-ordinating economic information. As a result of profit or loss experiences entrepreneurs learn to assess consumer wants more accurately. This encourages the more efficient allocation of resources to the benefit of both parties. Freely prevailing prices induce competition and efficiency, enabling prices to be cut and an advantage over competitors to be gained.

Although the future is always uncertain, freely prevailing past prices form a useful starting point for predicting the future prices that consumers will be willing to pay. In this way, infinitely more information about people's changing wishes and desires can

be handled in a market economy than in a socialist or “mixed” economy.

SUPPLY AND DEMAND - THE CONSUMER IS SOVEREIGN

Once goods have been produced, the past costs of production are irrelevant in deciding how to use them. As economic activity is *prospective*. The object of the supplier is to make the best of his position, in the light of his possessing a given quantity of goods. The price at which the seller is willing to sell a unit of a good or service depends on his subjective valuation of the good or service in its next best alternative use of either direct use or future sale at a (hopefully) higher price. For him, then the exchange value of the good (if he does not have any direct use for it) will be based on the greatest satisfaction that he can derive by giving it up for something else. If, as is usual, he gives the good up for money, he is concerned with the benefits that he can expect to obtain by receiving the money in return for the good.

However, it must be borne in mind that this exchange value derives from the subjective evaluations of those who are to receive the good in exchange and who will willingly pay money for it. As consumers will ultimately be using the good and when buying a good clearly value it at the time of purchase more than the money spent on it, the valuations of consumers are obviously pre-eminent. The seller sells the good when he values the benefits which he can expect to obtain from the money he receives for the unit of the good more than a unit of the good itself in terms of direct use or future sale. We can thus perceive that voluntary exchanges occur only when there are differences in the subjective valuations of a unit of the good on the part of the parties thereto. Thus, in an exchange, both parties gain according to their own judgements - neither “loses” as a result of the transaction and thus the process is equal and non-exploitative. This same analysis applies to the exchange of one’s labour for remuneration as much as to the sale of finished goods.

Socialists often accuse private business of showing no concern for the safety of the consumer and of putting “profits before people”. But the market does not work like that. Private business wants satisfied customers who will come back again. A reputation for unsafe products or poor services is not good for business. Moreover, competition between suppliers doesn’t simply induce them to produce cheaper goods and services, but better goods and services. For example, there is no such thing as a market price for cars in general, but a market price for a certain kind of car. Purchasers of, e.g., motor vehicles are concerned to get value for money and will be influenced by such matters as mileage per gallon, performance reliability, safety and comfort as well as by price. Different consumers may place different valuations on

different things. The point is that profits cannot be put “before people” but can only be earned by *serv-ing* people and satisfying their wants.

THE COSTS OF PRODUCTION

We have already seen that once goods have been produced, the past costs of production are irrelevant to the seller’s decision as to their use. The money costs of production come under the producer’s consideration when he is planning the undertaking of production. He will think: “Could I use these resources or this money for ends which will be better for me? Will what I produce be worthwhile?” Or, put another way “Will the prices that I expect to be able to charge and the profits I hope to make mean that spending my money on production of this good or the provision of these services will be worthwhile?”

It is essential to note that final product prices determine factor and resource prices, including wages. All means derive their importance from the ends that they effect. The prevailing price for given resources or factors is set by the competitive bidding in a market economy of a variety of producers for their application towards the production of more important final products or ends. Underlying such bidding is the value of the anticipated contribution of a unit of each factor or resource to the value of the final product, as envisioned by the various producers. The value of such resources or factors is subject to a discount on the part of producers on the basis that the value of the *future* contribution of each productive factor to the productive process must be discounted to its present value. The basic principle is simple: people value future goods less in the present than present goods, and people who invest in productive undertakings forego the enjoyment of present consumption goods which they could instead have obtained. When they acquire units of productive factors in the anticipation that they will obtain enhanced future purchasing power, they provide the former owners of productive resources with a means to acquire present goods.

Marx, in his exploitation theory, maintained that capitalists exploited the workers by paying them less than the value of their products: however this argument was demolished by Böhm-Bawerk, who showed that the emergence of a surplus value was not due to exploitation but partly due to the result of a natural phenomenon - that of interest, whereby people are entitled to expect compensation for exchanging present goods for future goods.

As a result of the process of competitive bidding for factors of production, which we have discussed, certain producers will find that if they continue to use the same productive processes they will make a loss. If it is feasible, such producers will seek to innovate and use more efficient means of production. This, together with the incentive to provide better products

than one's competitors, creates a demand for more advanced technology. There are many socialist and Luddite myths about technology and in particular its impact on employment. Technophobes often argue that "machines will replace men" and that as a society becomes more technologically advanced, more and more people will become unemployed in the medium and long term. This argument is based on a very old fallacy and indeed was the basis of the Luddite opposition to the Industrial Revolution. In fact, technology increases the demand for skilled labour relative to unskilled labour. It enhances the individual's productive capacity and enables, if properly applied, more goods to be produced at less cost per unit and with consequently greater scope for price cutting and competition.

Any workers who do become unemployed as a result of the introduction of new technology or more efficient productive processes are in fact released for other economic or market activities. For example, employment in manufacturing has been falling, but not output. Instead, more people are in the (more labour intensive) service industries, such as tourism, sport, fashion and leisure. More people are now employed in communications, media and information processing. Technology increases workers' output and productivity and gives them extra wealth to spend and more leisure with which to enjoy it.

THE SOCIAL ROLE OF THE RICH

Socialists often complain that some services, if left to the market, would be "cornered" by the rich, leaving the "masses" with second best. However, the demand pressure of the more affluent members of society improves the quality of goods and services for everyone. In fact, the high prices which may be obtainable for certain goods and services will encourage people to contribute to their supply. Such extra production or supply of more "expensive" goods and services enables them to be brought within the range of more people. Colour television sets were initially a luxury for the wealthy, but are now found in most households. Concentrations of wealth perform a valuable social function. Not only do they create pools of capital which are available for investment in production (and thus the creation of jobs and goods), but the wealthy create a demand for goods and services by their spending. They also provide a market for new products and services which ultimately will come within the financial reach of more and more people. Through inequalities of wealth being allowed, people are given an incentive to put their skills and assets to work. In a free market, wealth is the reward for successfully anticipating consumer wants and supplying goods and services that people wish to buy. The greater the extent to which the state enforces redistribution of wealth, the less incentive there is to engage in entrepreneurial activity.

THE IMPOSSIBILITY OF STATE PLANNING

It should be clear by now that the free market mechanism, if it is left unhindered by governmental intervention, produces a spontaneous order with social co-operation and rational resource allocation as its fruits.

The price-signalling mechanism induces men to adapt to facts or changes in circumstances of which they may know little if anything. We have seen how knowledge is dispersed in small fragments throughout millions of human minds, and how individuals have differing tastes, needs and desires, of which they alone can be the judge. Planning has to be predicated upon knowledge and no bureaucrat or politician can even hope to acquire all the knowledge necessary to function successfully. Statistical analysis of the sort favoured by socialist macro-economists is useless as a tool of economic analysis, prediction or control. Statistical analysis of the sort used in actuarial science is based on the determination of classes of homogeneous events. Each class consists of a large number of past similar events which upon analysis will reveal the percentage of instances a given event has transpired. However, the bulk of the entrepreneur's dealings are with concerns that are of such a comparatively rare nature and situations that are unique, so that the grouping of these concerns into classes for the purposes of computing class probabilities is impossible. The situation which exists at any moment in time in the market economy is unique. It is in a state of constant flux and change and what is the situation now (looking at the market as a whole) will not be repeated in the future.

Not only do people's tastes change, but the availability of resources changes, as does technology. At the heart of the market process is the human *animus* of its participants.

The uncertain future that pervades all economic activity in the advanced economy is primarily due to the *dynamic subjectivism* of its participants, whose wishes and plans are in a constant state of change, and whose knowledge is constantly being updated. Because human beings are *subjects* and not *objects*, the outcome of human activity is not *predetermined*. Accordingly, the kind of statistical analysis of past events which may be appropriate in the physical sciences offers a would-be state planner no proper guide to action.

The free market however can be seen as a *process* whose *pattern* we can predict if not its particular outcome, and which can take advantage of infinitely more information than a sluggish and unresponsive centrally directed economy. The incentives provided by the profit opportunity stimulate the production and supply of more and better goods and services than any planned economy could ever produce.