Issues concerning The Market

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The concept of the market has been central to economics since the time of Adam Smith, and this essay deals with what advocates of the market claim are its chief advantages, namely efficiency and freedom, and also asks how (if at all) this theoretical debate is of relevance to an actual economy.

Economics is defined as a science which studies how the scarce resources of the world are distributed, and it is perhaps the major claim of the market that it facilitates the attainment of efficiency in this regard. The case linking the market and efficiency has evolved over the years and can be summarised as follows:

The Italian economist, Vilfredo Pareto defined efficiency as a situation where to make anyone better off, someone must be made worse off, i.e. no person's economic welfare can improve without a fall in somebody else's. Pareto also showed that in a free market, which obeyed certain assumptions, this type of efficiency would be achieved (optimality). This 'perfectly competitive' market causes:

- Productive efficiency to be maximised, i.e. no waste occurs, becuase producers must always produce at the lowest cost level.
- Consumption efficiency to be maximised, because it can be shown, using indifference analysis, that consumption takes place where utility is tangent to the production possibility frontier, i.e. where utility is maximised.

The most important assumptions of Perfect Competition are that many buyers and sellers exist, that firms have free entry to, and exit from, the industry, and that buyers and sellers have full information about both the present and future states of the market. Pareto's criteria were later modified by Hicks and Kaldor who allowed for the possibility of compensation. This means that if welfare changes such that the people who gain can compensate those who lose, and still have some 'left over', then this is an improvement. This gets rid of the absurd notion that a decrease in welfare of one person, no matter how small and no matter how great the corresponding gain for society, is never an improvement. It is intuitively more desirable also, in that an improvement in national income will always count as an improvement in National Welfare. Finally, compensation has the technical advantage that it is a far more decisive criterion: given a choice between two patterns of income it will always prefer one over the other, unless they add up to the same total. The Pareto criterion, on the other hand, is indifferent to all those pairs in which there are losers as well as winners; so it has nothing to say in just those cases where policy-makers need most guidance.

Besides Pareto efficiency there is another type of efficiency which is also maximised by the market, i.e. diachronic efficiency. This is efficiency which will exist in the long-run due to the process itself, and can be sub-divided under two headings:

- Production Efficiencies. Under a perfectly competitive system, factor price equalisation will occur over time. In the short-run capital (for example) may be fixed in quantity, but in the long-run all factors are variable, so the producer will move to the point where MPK = MPL. This is aided by the incentives in competition to improve productivity, to invest in new machinery etc. Of course, when one firm engages in these processes, all firms must, due to the process of 'tatonnement', i.e. if one firm does not it will be pushed out of the market.

- Exchange Efficiencies. Again, the idea is the same; in the longer term, transport costs fall, more branches are set up and distribution costs minimised. Another vital efficiency is that of information, the costs of which are far less in the free(ish) markets of the world than in centralised economics. It is argued that the 'informations revolution' is a diachronic efficiency of the market system. Again, tatonnement takes place and costs fall.

This is a basic outline of the 'efficiency argument' for markets. The second claimed advantage of the market is the attainment of economic freedom. This, I feel, is an argument of far less strength than the efficiency argument, since in effect it depends on one's definition of freedom.

Economic freedom tends to be defined as the general absence of economic constraints.(*1) The absence of economic constraints leads to the following:

- Consumer Sovereignty: This is the principle that whatever people want will be reflected in the production process due to perfect information, and a desire to maximise profits. In other words, what people want matters, and is listened to. Some examples of consumer choice in action would be the rejections of Guinness Light and the new 'sweeter' Coca Cola, or more positively the shift to health foods in the 1980s.
- Freedom of choice: It is also argued that the choice the market system entails is a good thing in itself. This, as a philosophical point, is unproveable.

There are solid arguments against the idea of the market entailing freedom. On an overall level, the definition is hotly disputed, a recent manifestation being Hattersley's "Choose Freedom, the future for democratic socialism". Funnily enough, he uses the same concepts as Hicks and Kaldor did, arguing that a government should restrict one group's freedom (apply restraints) if the sum of liberty in the population is increased. However, even acceptance of Friedman's definition does not mean that economic freedom exists. It is argued, by Galbraith among others, that manipulation of consumer wants is widespread, and that the marketing industry exists solely for this purpose. On the other hand, it can be argued that freedom ought to be, but is not, divorced from economic considerations. Mr Thomas Jefferson may have written noble words about liberty, which are universal in their application. But if one had happened to be a black working in Jefferson's fields, one might well have found his sentiments of purely academic interest and his reiteration of them insensitive and irritating.

The final section of this article will look at whether the type of theoretical issues outlined above have any practical applications to an actual economy. The following points are equally valid for a study of the Irish economy.

The uses of this type of theoretical discussion are

- a value base underpins all economic systems, whether overtly or hidden. In Keynes' much qoted words, 'Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist.' The first argument for theory would be that it is much wiser to discuss these values openly

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*1 According to Milton Friedman, 'Liberty means the Liberty to shape one's own life.'

than to drift along with no logical, worked out system in operation.

- while the Pareto system is theoretically sound, it is unanimously accepted that it has failings in practice. These consequently require some sort of policy (even if it is no response). To decide on policy, a model of a theoretical nature is vital to reduce the economic system to where policy can be clearly decided for theoretical reasons, and not on the basis of what is 'smooth and flowery' in the short term.

There are, of course, arguments claiming that the theory of the market is of no relevance to real economies:

- the theory of second best , developed by Lipsey and Lancaster, states that a distortion in one market may mean it is not optimal to have perfect competition in any other market.
- the assumptions involved are totally unreal, and render the model and its findings useless.
- cynicism, i.e. Pareto's model has existed for 80 years now, and gross inefficiencies abound. Theories, schools, debates and personalities have contributed to the theory of the market, but decisions are still made due to pressure groups, politics etc. In other words, economics is meant to be a social science, affecting peoples lives, but often seems to be simply another branch of mathematics.

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