The Market System, Freedom and Efficiency

EFFICIENCY, FREEDOM, THE MARKET AND GOVERNMENT INTERVENTION.

This essay intends to argue that, theoretically, the market system is conducive to efficiency and economic freedom, but, in practice, Government intervention is often required. I have thus divided the essay into two main sections: the first is a justification of the market system by showing that efficiency and freedom are better achieved through the free market than through its antithesis, government control (efficiency and freedom must first, of course, be shown to be desirable objectives themselves); the second is a justification of government control due to market failures and deficiencies. This section includes a provisory note on how intervention itself may not be carried out adequately. My conclusion draws the thesis and antithesis together and a synthesis is proposed.

SECTION 1: THE MARKET JUSTIFIED.

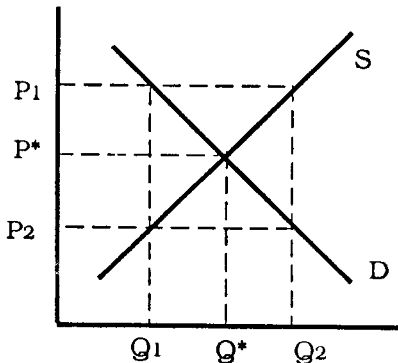
Pareto efficiency says that a situation is efficient if nobody in it can be made better off without reducing somebody else's welfare. If we make the following three (quite plausible) assumptions, we can see economic efficiency is desirable.

(i) the aim of policy makers is to maximise social welfare.

(ii) the social welfare depends positively on the welfare of the individuals in the society.

(iii) individuals' welfare depends on the goods and services they consume.

There are two categories of efficiency - efficiency in exchange and efficiency in production. If we make the fourth assumption that (iv) individuals are the best judges of their own welfare and act in their own self interest, we can show that a pareto efficient situation is achieved by the free market system.



It is through the price mechanism that the market achieves efficiency in output and exchange. If output Q1 is produced, consumers will be willing to pay more than the suppliers must be paid to produce Q1. From assumption (iv) it follows that (as profit maximisers) suppliers will increase production until the point where consumers are not willing to pay any more than that which is required for the producer to supply. At this Q* prices are equal to P* and none can be made better off without making someone else worse off by a change in output. Thus efficiency is achieved in production.

In the free market marginal rates of substitution are equal. If they were not, goods would be valued differently and so further trading would take place. We assume all goods in the competitive market are valued in monetary terms only. Thus if one person values a good at £4 and another at £5 trading will take place. Trading will stop when the marginal rates of substitution between all goods is equal to the ratio of their prices. But consumer theory tells us this is the optimal point for the consumer since it is the point where his budget line is tangential to his highest attainable indifference curve. Thus when MRS = ratio of prices each consumer is at his optimal point and nobody can be made better off by further trading without making someone else worse off.

Heald shows how production by the public sector is X-inefficient i.e. too many inputs are used because profit maximisation is not the primary concern of the individuals involved as employees. He also shows how free provision of

services is inefficient as the quantity demanded at this point exceeds the quantity at which MR = MC (profit maximising point). Thus the efficiency achieved through the free market system is not emulated by the public sector.

I shall now turn to issues of economic freedom, which, by definition implies individual choice. It is desirable because

(i) it allows for consumer sovereignty - in buying what he wishes at a certain price and leaving other products behind the consumer effectively controls what quantity of what good is produced(Galbraith, though denies this).

(ii) choice itself is a psychological benefit (challenged effectively by Mishan)

(iii) Economic freedom is a prerequisite for political freedom. This point is probably more topical now than ever. All over Eastern Europe, popular revolutions have occurred. A priority of the new leaders is to develop a free market system. Hayek has consistently argued that control of economic transactions is "the Road to Serfdom". He says that whoever controls the means also controls the ends and thus controls man's goals and thought and purpose in life. Any freedom requires economic freedom.

How does the market allow freedom? Economic freedom and the market are so closely linked that they are practically the same thing. Both of them mean that people can choose who to trade with, when to trade and how much to trade. The market is simply the title for the systematic working of economic freedom. However the market does have its imperfections and deficiencies. This leads us onto the second section.

SECTION 2: JUSTIFICATION OF GOVERNMENT INTERVENTION.

Government intervention is justified where there are market imperfections. There are four main imperfections.

(i) When externalities exist the social cost or benefit is not completely captured in the price of a good i.e. the cost or benefit is not measured in monetary terms. Externalities usually tend to be costs because the opportunities for increased profits due to benefits means that there is an incentive to internalise these. In ignoring social cost the market prices the goods involved at a lower price than that where real MC = MR. It does not produce at the optimal quantity and inefficiency results. It has long been recommended that government should impose a tax on such goods so that the extra cost will be reflected in monetary terms.

(ii) Public goods are goods which due to the jointness of their consumption are not provided for by the market. Public facilities such as parks or playgrounds are examples. If everyone had to pay for these in relation to the benefits each received from the facilities individuals would understate their benefits and so total welfare from the facilities would be underestimated. This would lead to decreased provision or perhaps non-provision of the good. Depuit's argument against toll bridges (an argument which applies to all goods which show a very small operating cost once they have been provided) shows how allocative efficiency can be improved by suppression of prices. Some industries, such as those supplying electricity or telephone communications networks, have such large capital requirements that only government could provide them. The private sector would be incapable of dealing with the rail-link between London and the Channel Tunnel and government has had to take over.

(iii) The market's assumption of perfect information is clearly unrealistic. Scitovsky compares the economy to a Chinese Menu - due to lack of expert knowledge or information we either choose the wrong dishes or the same old boring ones - this causes inefficiency.

(iv) Finally, perfect competition exist in reality and governments must intervene to reduce inefficiencies caused by monopoly power.

There are other faults of the market due to its deficiency in aiding primary policy objectives - which include instability in output and employment, the fact that the market is geared towards present allocation rather than future growth

and its tendency to intensify income inequality. There exists, therefore, a priori reasons for government intervention.

This must be qualified-intervention itself has its weaknesses. One of these lies in the difficulties involved in reflecting individual preferences in public decisions. Economic reasoning sees maximum social welfare as the independent addition of maximum individual welfares. It does not recognise that an individual's consumption is affected by the consumption of others. For example, my utility from driving to work is affected when everybody else decides to drive to work and I get caught in a traffic jam. The lack of collective choice mechanisms causes problems in public policy making.

There is also the problem of the "over-expanded" public sector. We cannot assume that politicians and civil servants are the only economic agents who do not try to maximise their utility i.e. votes in the case of the politician and budgets in the case of civil servants. This can lead to decisions being made simply to satisfy the demands of certain interest groups or to increase a department's budget for the sake of influence/prestige, rather than for efficiency reasons.

"Baumol's disease" is another problem with the "over-expanded" public sector. This occurs in sectors where output is qualitatively rather than quantitatively measured e.g. Health and Education. The image of the disease tries to reflect the problems involved when wages of the sector continue to increase (to keep up with the wages of the private sector) while output remains constant. Ireland's public sector has suffered much from this disease in the past twenty years.

CONCLUSION

The market is no doubt an excellent system - efficiency and freedom being two of its most desirable features. However there are cases where it is less than perfect and in these cases government is justified in intervening to increase welfare. But although market failure is a necessary condition for government intervention it is not a sufficient one as the intervention itself may also fail. Thus failures of the market must be balanced against failures of intervention and the right combination of each chosen so as to maximise welfare as constrained by policy objectives. The attempt to unite the advantages of the market system and those of government intervention has resulted in a synthesis of both, today's mixed economy.

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