Economics Review

Unfettered Markets: An Intuitive Approach

This introductory section provides background information and an intuitive approach to free markets. The benchmark lessons that follow offer a more graphical analysis of market operations.

Economists tend to praise competitive markets because the rational and self-interested forces that characterize economic behavior lead not to a permanent state of chaos but to a harmony of interests. Adam Smith articulated this insight in 1776 in his book, *An Inquiry into the Nature and Causes of the Wealth of Nations*:

> Every individual necessarily labours to render the annual revenue of the society as great as he can. He generally, indeed neither intends to promote the public interest, nor knows how much he is promoting it. By preferring the support of domestic to that of foreign industry, he intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, as he is in this, as in many other cases, led by an invisible hand to promote an end which was not part of his intention. Nor is it always the worse for society that it was no part of it. By pursuing his own interest he frequently promotes that of society more effectively than when he really intends to promote it. I have never known much good done by those who affected to trade for the public good. (page 423)

Smith felt that the tendency of individuals to act in their own self-interest is a natural law and a natural right that precedes the existence of government. Exercising individual rights in a competitive market creates the greatest good for the greatest number in society. Smith's view, although regarded as a mainstream perspective on capitalism, has been amended to accommodate government provisions of goods when the market fails to provide them in sufficient quantities.

How does this work?

While nobody blames the thermostat (a measure of temperature) for a low temperature, prices (a measure of scarcity) are often blamed when people are not able to obtain a scarce resource. Scarcity is a relationship between desirability and availability—between demand and supply. In a society in which diamonds are highly desired but not available, diamonds are relatively scarce. In a society in which diamonds are not desired and also not available, they are still scarce. A good is scarce whenever people cannot obtain as much of it as they would like without being required to sacrifice something else of value.

If goods are scarce, they must be rationed. Some kind of criterion must be established for discriminating among the claimants as to who gets how much of the good. The criterion could be physical prowess, public esteem, age, willingness to pay money, or anything else. Under capitalism and a market-based economy, willingness to pay money usually determines who gets the good…but not always.

- Harvard University has many more applicants than it can take as freshmen, so it must ration its admissions. The university discriminates on the basis of high school grades, test scores, recommendations, etc.
- Although many individuals want to be President of the United States, only one person can serve at a given time. We have developed an elaborate election process to discriminate who becomes President.
- Physically attractive women frequently have several men clamoring for their attention. They must, therefore, ration their attentions. They could use athleticism, intelligence, looks, manners, or something else to discriminate between suitors.

Competition is the result of discriminating among the individuals vying for a good. For example, once Harvard announces its criteria for discriminating among applicants, individuals compete for admission to Harvard based on these criteria. *Competition results from scarcity*, and it can be eliminated only with the elimination of scarcity. It is not confined to capitalist societies or to societies that use money.

Whenever scarcity exists, rationing allocates the good according to some criteria for discrimination. Competition is merely what occurs when people strive to meet the criteria used to ration scarce goods.

Nonetheless, the criteria matter. If a society rations on the basis of physical strength, individuals will do strength-enhancing exercises. If a society rations on the basis of *willingness to pay money, individuals will work to earn that money, and those that are able and willing to pay the price will get the good*. Poor people will get less than rich people, which many consider to be unfair. However, with nonprice rationing (distributing goods by means other than price), businesses may sell to customers on the basis of age, sexual preference, personal habits, family size, letters of reference, pet ownership, race or ethnicity, etc. These allocations also may not seem fair, and it is hard to tell who will get goods without price as the rationing device.

Let's look at price as a distributional mechanism. What happens when a good, like gasoline, becomes more scarce? In an unfettered market (i.e., one without interferences), consumers will compete for the remaining gasoline by bidding up its price. If prices are not allowed to rise, rationing criteria other than price will be used. Potential purchasers of gasoline will attempt to discover the new criteria for discriminating among buyers, and they will compete against one another in trying to satisfy the new criteria. Their competition will raise the total price—monetary plus nonmonetary—and will continue raising it until the quantity demanded no longer exceeds the quantity supplied.

It is almost always in the interest of suppliers (i.e., producers) to raise the monetary price rather than use another rationing device. The owner of a gasoline station, for example, gains nothing if customers have to wait in line 20 minutes to buy gas. Thus, the increased costs to purchasers from nonprice rationing often are not benefits to the seller.

If suppliers cannot raise prices in the face of increasing shortages, they will look for alternative ways to turn the situation to their advantage. For example, gasoline retailers may reduce their daily hours of operation, since they can probably sell all of their supply in a shorter period of time. This may further increase the price—monetary plus nonmonetary costs—of gasoline to buyers. Gasoline retailers may also sell gasoline in an illegal (black) market, in which they can sell it at a higher price.

Price, therefore, serves as an important rationing device in market economies. This is not to say that it is the perfect means of coordinating the production and distribution of goods. Under some conditions monetary prices may not reflect people's preferences adequately. Ignorance, market power, collusive arrangements, disagreements about property rights, and inequalities in society all interfere with the "ideal" operation of the price system and can drive a wedge between price and people's preferences.

Consider other rationing mechanisms and their potential difficulties.

- ***Need.*** The idea of rationing according to need may be intuitively appealing, but the definition of need is vague, subjective, arbitrary, relative, uncertain, and subject to abuse.
- ***First come, first served.*** Standing in line increases the nonmonetary price paid for the good. This rationing device is appealing to those who have a relatively low opportunity cost of time, such as low-wage workers and retirees.
- ***Lottery, or equal shares for all.*** While this rationing scheme takes some of the arbitrariness out of rationing, it ignores the differences in individual needs for a good. Does everyone have an equal right to gasoline—even those who do not own a car, or those who are too young to drive?
- ***Merit.*** Rationing can be based on providing the good to those who deserve it. The problem arises in defining who deserves it. Should a prize be awarded to the person who tries the hardest to obtain it, or to the one who has performed the best?

Nonprice rationing mechanisms also ignore the problem of supply incentives. People produce goods because they want to be rewarded for their efforts. A system for rationing scarce goods that does not provide appropriate rewards for those who make the goods eventually will fail because most goods simply would not be produced if the producer were not compensated.

Finally, prices serve as a signal for economizing. Because people can use money to purchase a wide variety of goods and services, a rising price creates an incentive to economize on that good's consumption so other goods and services can be purchased. For example, the rising price of gasoline, in the face of increasing scarcity, signals individuals to economize. They begin looking for ways to reduce usage—through carpools, walking, public transportation, more efficient cars, etc. If the price of gasoline is kept low, say with price ceilings, individuals do not have an incentive to economize, and they will continue to use gasoline at levels consistent with less scarcity.