

Markets and Economic Theory

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Economists see markets as the primary institutional site for bilateral exchange. Market exchange is normatively significant because parties to exchange are both made better off in expected terms; and because exchange permits the separation of production and consumption activities. The first aspect allows individuals to benefit from natural differences in tastes and talents and (in the case of international trade) differences in climate and institutional arrangements. The second aspect allows individuals to take advantage of the productivity increases that specialization creates – increases that, according to Adam Smith, are the main source of human progress. In this sense, markets are first and foremost an institutional device for mobilizing the benefits of human cooperation. Cooperation rather than competition is the central feature of the market order.

Because market exchange is essentially voluntary, within the bounds set by an initial assignment of rights and rules of contract (rules against fraud, for example), markets are also seen by some philosophers as instantiations of free interactions – though most economists value liberty so understood for its consequences for material well-being rather than intrinsically.

A well-functioning free market performs three functions: it allocates the available supply of goods among individual demanders according to the intensity of their effective demands (their willingness to pay); it ensures that aggregate supply is distributed among suppliers so that demanders are supplied at minimal cost; and it connects demand to supply by providing both the information and the incentive that suppliers require in order to meet the prevailing demand. Non-market mechanisms for the allocation of goods (such as queuing, or rationing) will routinely fail in one or other of the three mentioned functions. Queuing, for example, may allow demanders to express their demand by waiting in line and allow suppliers to assess demand by examining the length of the queue. But in non-market institutions, the waiting time given up by queuers does not translate into any benefit to suppliers, so suppliers have no incentive to adjust supply in the light of demand conditions: the critical link between demand and supply that a market would provide is severed.

The informational and incentive features of markets are worth special (and separate) emphasis. Within the free market system, prices constitute signals as to the value that others place on alternative activities that potential suppliers might engage in. Prices operate as a kind of gauge for measuring the effect that my choices have on the well-being of others (as they themselves assess it). In the absence of market prices, such information would be unavailable—a point mobilized against those who might look to socialist planning to simulate the beneficial effects of markets. Further, in the market system, each player has an incentive to act in the way that others most prefer: the beneficial effects of markets emerge invisibly—that is, without those beneficial effects being the central intention of any of the participants. Put another way, the benefits of human cooperation are reaped with only a minimal claim on the players' dispositions to act cooperatively. Achieving the beneficial effects of markets does require that participants refrain from fraud and deception—but, to some extent, markets themselves provide rewards for individuals who so refrain. A reputation for reliably good service is an asset in market transactions, especially for products whose quality is not easy to assess on inspection.

Although markets work broadly in the public interest for ordinary private goods like apples and houses, they often fail to work well in the case of so-called public goods. Public goods are goods that all members of a relevant community consume in common, in such a way that none can be excluded from the benefits. More specifically, public goods have two properties: they are *non-rival* in the sense that each consumer enjoys full use of the good without diminishing the amount available for other users (as in the case of a concert performance, where an encore for one consumer means an encore for all others); and they are *non-excludable*, in the sense that individuals who do not pay cannot be prevented from consuming what is available. Both non-rivalry and non-excludability can come in degrees; and either can be present without the other. Economists often associate public goods with “market failure,” since rational actors in a market will fail to produce goods for which there is potential demand when they lack the ability to charge consumers.

Market failure is typically identified as providing scope for government intervention in markets. To be sure, many of the standard activities of governments – the provision of a legal system, with enforcement of rights; provision of national defense; certain kinds of public health provision (including pollution control and vaccination programs) – fit the public goods categorization. But many others (such as private health provision and public housing subsidies) appear to exemplify the public

goods category much less well. In these latter cases, the standard results about market success and market failure do not support government intervention.

But nor do those results in themselves argue *against* government intervention. Any case, for or against such intervention (in relation to public or private goods) requires a corresponding examination of the normative properties of the relevant institutional alternative. Such examination involves a specification of the incentives of agents operating in democratic political settings and an investigation of the ways in which public supply can be expected to respond to citizen demand. Undertaking this exercise has been the motivation for the development of public choice theory.

The general point here is that no discussion of the normative properties of any institutional arrangement – including markets – can be undertaken without an answer to the “compared to what?” question. Claims about market success and market failure only have normative bite when the analogous analysis of alternatives (primarily government action) has been completed. Markets are often criticized – even by those who accept their many advantages – on the grounds that they give rise to distributions of income that are unjust. We do not here explore this line of criticism. We note however that, even here, the normative exercise is ultimately a comparative one: if the market fails to provide a distribution of income that meets all normative standards, it remains to be shown that the distributional modifications that emerge under alternative political institutions will predictably improve things.

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FURTHER READINGS

Hayek, Friedrich (1945). “The Use of Knowledge in Society.” *American Economic Review*, 35 (4) pp. 519-30.

Smith, Adam. (2010). *The Wealth of Nations*. New York: The Modern Library.
Originally published 1776.