Markets are institutions that evolved from human action in the past without initial conscious planning by anybody. As a result, there is a great deal about markets that we have tended to take for granted without being aware of what is involved. This we have learned from the attempts of the former centrally planned countries to create markets from scratch. The market is a highly useful economic instrument but idealizing it is not justified. While it is an effective instrument in helping societies generate wealth, it also favors manipulative (treating people as means) over ethical (treating people as ends) behavior. The market is not perfectly rational, its outcomes are not precisely governed by demand and supply, and, above all, it does not necessarily result in optimal outcomes or just rewards.

Modern neoclassical theory presents a model of the economy that depicts it as a series of competitive markets embracing the whole economy. Everything—commodities, services, factors of production—is included. The market for any of these is standard: the demand curve slopes downward, the supply curve slopes upward, and the point where they cross sets the market-clearing (equilibrium) price at which transactions take place. It is presumed that these markets are generally competitive.

Note that according to the rationality assumption all economic agents are successfully maximizing their self-interest in this process. Consequently, when the equilibrium price (the market-clearing price) is set by the intersection of the demand and supply curves, this is optimal for the economic agents concerned. This is a Pareto-optimum, but it is not optimum optimorum (the best of the best) since the unequal income distribution gives agents with the highest incomes more of what they desire while those with the lowest incomes may not be able to meet even their most vital needs. Francis Bator illustrates this point nicely:
In a two-person world of Adam and Eve, depending on the initial distribution of whatever, you can have an outcome where practically everything goes to Adam and nothing goes to Eve. This is still Pareto-efficient in the sense that you cannot reconfigure any of the inputs or the outputs or the distribution in such a way as to make Eve better off without making Adam worse off. (Bator 1998, 202)

This reservation is often overlooked, however, and the results of the market are regarded as beyond criticism, a kind of utopia or even heaven on earth. As Mancur Olson observed, it is a staple assumption that the rationality of individuals makes societies achieve their productive potential; we are already therefore in the most efficient of all possible worlds (1996, 3–5). Thus, the market, in a more credulous age, could even be regarded by market-idealists as another name for God.

The major, indispensable, true contribution of the market is as a means of collecting and disseminating information among its participants. This information is provided in the form of price signals or, if prices are not allowed to fluctuate freely, by the emergence of shortages or surpluses. The market is also a coordinating mechanism. As desires, technologies, and resources change, the market provides incentives to move resources to where they are needed and divert them from uses where they are not. This view of the market as a discovery and coordinating mechanism is of course the one that Hayek stressed for years and which most economists now accept.

As we have seen in chapters 3 and 4, the assumption that people always behave as rational maximizers of their own self-interest is faulty. This substantiates Hayek’s refusal to accept that the market provides a precise mathematical solution to the problem of resource allocation on the basis of exact known information or that the market necessarily leads to just outcomes.

The market economy, in truth, is a flawed, crude mechanism. Knowledge is fragmented, chaotic, and often unattainable. Participants act on the basis of their imperfect knowledge and understanding, and their influence on results is affected by their command of purchasing and market power. The future is uncertain and largely unpredictable. Learning by doing and technological innovation create profit opportunities, knowledge is limited and often ambiguous, and externalities in production and exchange are widespread.

The market, however, can be an effective tool for policy. Governments have learned that establishing a market for regulating pollution works. A maximum amount of pollution is set as a target, rights are assigned and distributed among firms, and trading is allowed in these rights.
Markets Are Social Institutions

One of the assumptions taken for granted is that the market simply exists. There is no concern for the specification of its institutional features, how it came into being, or what factors shape its development. But markets have a social and cultural history and are created or influenced in their evolution by the establishment and defense of property rights and the exercise of political power.

Most markets today are social institutions supported by a network of social practices, cultural behavior, and other institutions, including the government through regulations and laws. Living and working in a functioning market economy require public acceptance of a whole set of appropriate, conventional, and socially acceptable behaviors. The culture within which an economy is embedded has economic consequences. The market itself is both a cultural construct that influences how people behave and a system of social relations in which the participants interact.

Economic action takes place within a social context. It is usually embedded in ongoing networks of personal relationships—a regular set of relationships among individual or groups. For example, the Kamarck family has a black book listing the people we call on in times of need: the plumber, electrician, lawyer, mechanic, carpenter, and so on. We do not routinely try to find service at a lower price or even discuss price when we need help. In these ongoing relationships, each party expects and normally receives reasonable, friendly consideration from the other.

This behavior is both economic and social. It allows us to economize on the time and effort required to find the right person each time. But a social feature is present as well, for there is a perceived benefit from dealing with another human being when it is tacitly understood that neither is attempting to screw the last penny of gain out of the transaction. Similar determinants come into play between industrial firms and their suppliers and main customers. In Japanese firms, this connection is particularly intimate, but it exists elsewhere too. For example, “sticky prices” are due in part to companies not wanting to irritate their customers with frequent price changes.

Businessmen, like most people, often prefer to rely on a handshake to finalize a transaction rather than a contract that spells out the possible risks. Since it may be impossible to foresee the specific risk that needs to be guarded against, the handshake may provide more security than detailed small print. And people appreciate the fact that the other party is manifesting trust in them and showing faith that they will live up to the implicit understanding inherent in these ongoing relationships (Macaulay 1992).
People behave much the same way in consumer products markets. Most commodities are sold at prices set by their sellers. Customers have limited time in which to search for information, and once they decide to patronize a retail store they tend to continue to do so. The transaction costs for the customer of looking for a better price gives the firm some monopoly power, if only temporarily. But a sensible firm knows that to keep its customers its prices must be competitive enough to encourage new customers to sign on and to discourage its regular customers from deserting. The firm also tries to provide some incentive for loyalty by giving advance notice of sales to regular customers, facilitating purchases by them, and so on (Phelps 1981; Okun 1981).

It is obvious that for many commodities consumer demand is motivated by fashions and fads and other social considerations that override rational consideration. Even such important decisions as mergers and takeovers of corporations are subject to surges of irrational emotion. Mergers and corporate acquisitions come in waves. A favorable environment may make them more economic in some years, but this cannot be the whole explanation.

During the 1960s, the building of conglomerates was all the rage. Companies in unrelated industries were bundled into a single firm. Beatrice, a food company, acquired Avis (a car rental company), Samsonite (a luggage manufacturer), and Playtex (an underwear maker). In the 1980s, it became the fad to unbundle the conglomerates. The separate parts of most of them, including Beatrice, were sold off to improve their profitability. Both conglomerate building and unbundling were spurred by the fact that investment bankers are paid a “success fee” if the deal they are advising is concluded. If the deal fails, the fee is much less.

Limits of Markets

Observing a society and seeing only market and exchange relationships is looking with tunnel vision. In agriculture, which comes close to the classical description of a market with many buyers and many sellers, farmers in the high-income industrialized countries receive on the average 40 percent of their income from producer support above market prices or direct government subsidies. Many human needs and activities are outside the market. Mediating institutions and organizations (such as churches, clubs, and associations) that are outside or beyond the market meet the needs that people have for community, the feeling of belonging, learning to live with the knowledge of mortality, and building character.
There are also moral limits—generally concurred on by all civilized peoples—to what can be traded in the market. As Arthur Okun reminded us, “Everyone but an economist knows without asking why money shouldn’t buy some things.” The buying and selling of human beings, the white slave trade, and assassination for hire are all outlawed. A modern taboo forbids the buying and selling of human organs. A person threatened with failure of the heart, lungs, or kidneys or threatened by blindness from a bad cornea may desperately desire the needed organ, but the supply of organs for transplants comes from voluntary donors. There is a moral revulsion against traffic in body parts. Indeed, if it were allowed criminals might murder people for their body parts, just as autos are stolen to be disassembled in “chop shops.”

There is not, however, universal agreement on the inclusion or exclusion of human sperm and embryos from the market. The Canadian Royal Commission of New Reproductive Technologies recommended in November 1993 a ban on the “commercialization of baby making.” The commission was critical of the United States for allowing brokers to find surrogate mothers and for allowing sperm to be sold: “It is fundamentally wrong for decisions about human reproduction to be determined by a profit motive” (Langan 1993).

The unfettered market is an inadequate instrument for coping with environmental problems, both internationally and domestically. The “wealth stock” of human-built capital (buildings, equipment, land improvements) can be measured by means of original or replacement cost, allowing for depreciation. There is no equivalent satisfactory accounting for the stock of natural resources, the quality of air and water, the absorptive and dilutive capacity of the environment, or the aesthetics of the ambiance in which we live.

There is no market in which the prices of environmental “goods” such as clean air, clean water, or beautiful beaches are quoted. Benefits and costs often run far into the future, affecting generations not yet born. Economics cannot cope with such long periods. The benefit-cost technique relies on discounting the future at an appropriate rate set by the present cost or return on capital. At a discount rate of 6 percent, a benefit of $1,000 fifty years hence is only worth $54 today (Jacobs 1991; Kamarck 1983, chap. 9; Norgaard 1992). The state can organize a market in which pollution rights are traded. While this is effective for reducing pollution, an arbitrary, non-market decision has to be taken on the magnitude of the problem.

There is a more fundamental problem: if monetary values are notionally assigned to environmental benefits and costs, the calculation is economically meaningless because if there were such monetary values attached
in reality people would take them into account in their behavior and the results would be quite different. One ethical constraint on our decisions on the efficient allocation and use of our generation’s stock of resources is that they must not irreparably harm future generations. The determination on the latter point has to be made on some other basis than straight discounting of the future back to the present.

**Market Failures**

The market cannot give accurate results in determining just compensation for a person’s life. Financial calculations are made of expected earnings or of other economic factors, and no other satisfactory approach has been discovered. But nearly everyone will confess to a feeling of unease that nothing better has been found—and juries often repudiate the calculus and put a higher value on a human life than the amount recommended.

But the failure of the market to set a price in this instance does not rule economics out completely from being useful in this field. Decisions as to the saving of human lives often have to be taken on the basis of a comparison of costs and benefits of alternative possibilities. If one set of regulations, say, costs $25,000 per life saved and the alternative costs $100,000, then clearly the first alternative is preferable.

*Externalities* (spillover or neighborhood effects), a well-known failure of markets, are a problem because normally there are no markets in external costs or gains. An externality imposes costs on or grants benefits to third parties from an economic action in which they were not directly involved. For example, the bees belonging to a beekeeper may pollinate neighboring farms and so increase their productivity or, in the opposite case, acid rain from coal-burning power plants may destroy neighboring forests.

Externalities represent market failure since they are not included in the cost or demand schedules that determine what is produced and at what price it is sold. In an economy driven by profit, it is obviously in every firm’s interest to externalize a cost whenever it can: dump waste into public water or air, get the government to build the infrastructure the firm needs, bully a city into building a stadium for a professional team, and so on. Passing labor input costs out of the firm is an omnipresent practice (note how much work a company forces you to do in paying a bill or trying to reach some entity within a firm by telephone). The market in these cases clearly does not determine what is the economically efficient amount of output at the economically efficient price. The market per se cannot cope with external-
ities without some special action being taken outside of the market in which they occur.

In the example of the beekeeper, if a farmer can accumulate enough land or organize a cooperative with his or her neighbors so that a hive of bees can do all its work within the boundaries of the client, a market can be created. There are migrant beekeepers in the United States who move their hives south to north during the spring and early summer under contract to fruit growers. In this case, an externality has been deliberately changed into an internality: all of the work of the bees is productive for their clients, so a price can be collected for their work.

Asymmetric capabilities or information lead to less than optimal market results. In most transactions, there is asymmetric information: between buyer and seller of most commodities and services, between a company’s chief executive and its shareholders, or between employer and employee. If one party has better information, he or she can take advantage of this privileged position and strike a better bargain. Many services have unique characteristics that make it difficult or impossible for consumers to make informed decisions regarding their purchases. Health care, one of the largest economic activities in the modern world—accounting for 14 percent of GDP in the United States—appears to be one such example. Consumers are generally uninformed buyers and rely on the supplier medical profession for information on the quality and quantity of the service, there are restrictions on competition in the medical profession, payment is usually by third parties, and so on. It is not surprising that most high-income countries have a national health system.

Asymmetric information may even result in destroying a market altogether. If consumers cannot judge the quality of a commodity before they own it, sellers have an incentive to cut costs by producing an inferior product. This may result in a “race to the bottom” (with such a bad product that consumers stop buying it) or nonmarket mechanisms may have to be set up to prevent the self-destruction of the market (Akerlof 1984, 7–22).

There are similar difficulties when suppliers have imperfect or insufficient information. With imperfect information, a bank that raises its interest rates under the pressure of demand may fall victim to adverse selection, that is, it lends to high-risk customers who are willing to take on the higher rate. Insurance agencies, too, find that high premiums result in attracting customers who are most likely to file claims. In both cases, it is more sensible to keep rates below what the market would set and use administrative means to ration supply to demand (Grossman and Stiglitz 1980).

Some markets are prone to overshooting. In this case, instead of attaining and then resting at the point where demand and supply intersect,
supply shoots right on past. The classic “hog cycle” is a case in point. This seems also to be true in industries that require large capital investments and a long gestation period between the investment decision and date when the first product appears. Then, when supply greatly exceeds demand, it takes a long time before excess capacity can disappear. It may take up to a decade and require an investment of hundreds of millions of dollars before a major copper mine, for example, can come on line.

The commercial real estate market in most of the industrialized world provided another instance of this in the 1980s. Following low levels of commercial construction in the late 1970s, construction of office buildings took off in the mid-1980s, stayed at a very high level, and then crashed at the beginning of the 1990s. Investors during the 1980s saw the possibility of high profits and rushed into real estate lending. Because of the long lag between the planning and the completion of a building, the supply of real estate is relatively fixed in the short run. An increase in the demand for space pushes rents above the long-term sustainable price. Since rental agreements are made for a term of several years, new tenants do not compete for the space already under lease. The new tenants are all competing for a small portion of the supply. The result is a spike in rents, which may then be regarded as representing a permanent increase. Bankers and lenders make decisions to build new capacity on the basis of the short-term spike. This euphoria about the future feeds on itself, and the result is a true bubble, with large-scale overbuilding. Sanity sets in when lenders find themselves with “see-through” skyscrapers, that is, empty of tenants, and it may take years to fill the excess space (Browne and Rosengren 1992).

Whenever information is imperfect and/or markets are incomplete, markets are inefficient. This, plus all the other circumstances that hinder the efficiency of a market, leads one to suspect that market failure is not the exception but the rule.

How Markets Work in Theory

Neoclassical economic theory assumes that buyers and sellers are price takers, with prices being set by the market. But John Hicks has called attention to a major change in markets. Markets used to be mostly flex-price markets—unorganized markets with a large number of buyers and sellers with prices directly responsive to supply and demand. There were also some organized markets formed by groups of traders to deal with one another. These also were responsive to supply and demand. Today, the dominant markets are fixed price, with prices set by producers (or some
authority) and not immediately by supply and demand. Changes in costs and demand affect prices but not automatically. “Price decisions are made deliberately and are influenced by many other factors than just supply and demand” (Hicks 1977, x, xi).

When prices are set through administrative decisions, someone or some committee has to initiate action (e.g., note an unexpected piling up or depletion of inventory), consider, make a decision, and communicate it. And the decisions may be governed by some existing corporate tactical or strategic policy on how to treat a particular market or commodity and how great a change will be required before incurring the adjustment costs needed to alter a price.

In standard economics, in a market for a particular good there is a group of buyers and a group of sellers. The relationship between the quantities and prices at which purchasers are willing to buy is captured in a demand schedule. Similarly, the relationship between the quantities and prices at which suppliers are willing to sell is shown by the supply schedule. The intersection of the two curves sets the equilibrium price; the quantity demanded and the quantity supplied match at that price, and the market is cleared. And this is the largest possible quantity that can change hands at a price on which both buyers and sellers can agree.

A standard economics text, Mankiw’s Principles of Economics, presents the accepted version of how markets work (1998, 62–85): “For every good in the economy, the price ensures that supply and demand are in balance. The equilibrium price then determines how much of the good buyers choose to purchase and how much sellers choose to produce” (85). The discussion in the text focuses on a market for ice cream cones, with the demand and supply schedules shown in table 1.

The equilibrium—market-clearing price—at which demand and supply balance at seven cones demanded and offered is two dollars. Consec-

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<th>Price</th>
<th>Demand</th>
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<td></td>
<td>Catherine</td>
<td>Nicholas</td>
</tr>
<tr>
<td>$0.00</td>
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<tr>
<td>0.50</td>
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sequently, the theory runs, there will be a total of seven cones bought and
sold at the price of two dollars each. Of course, in real life the ice cream
sellers set a price and only sell at that price. But if the market were like this
textbook example, the scenario might rather go like this:

Catherine comes on the market and offers $1.00 for a cone and Ben
sells one cone for the price. Nicholas then offers $1.00 and there is no
supply, so he offers $1.50. Jerry sells him two cones, and Ben sells him
one (since he already has sold one cone at $1.00 and there are only two
that he was willing to sell at $1.50, one of which he was willing to sell
for less). Catherine has one cone but wants more. She now has to offer
$2.00, but she only wants to buy three since she already has one and she
only wants four at the price of $2.00 or less. Ben sells her the only cone
he has left to sell at that price. Jerry has only two left to sell. Catherine
buys them.

Nicholas has bought three cones at $1.50, and, while he would be
willing to pay $2.00 to get three cones, he now has no reason to buy any
at that price.

Consequently, seven cones have been sold but only three at the
market-clearing price: Catherine has bought four, one at $1.00 and three
at $2.00. Nicholas has bought three at $1.50.

The scenario might play out differently on different occasions. If
Nicholas had made the initial purchase offering $1.50, he could have
bought two cones from Ben and two from Jerry, satisfying his demand.
When Catherine offers to buy, there are no cones available below $2.00
and only three at $2.00. She then has to pay $2.50 to get the fourth cone
she wants. In this case, eight cones are sold: Nicholas has four at $1.50
and Catherine has three at $2.00 and one at $2.50.

If it happens, for example, that the initial transaction begins at the
high end of the price scale, Nicholas could wind up with one cone at
$3.00 and two at $2.50 while Catherine might have paid $2.50 for two
cones and $2.00 for another two. Seven cones will have been sold, but
Ben and Jerry in this case will make out better than the “market-clearing
price” would indicate.

Any of these scenarios is plausible. What is not plausible is the silent
assumption in conventional theory that if Catherine buys a cone at $1.50 or
Ben sells one at $3.00 they will cancel their favorable bargains in order to
do business at $2.00, the notional equilibrium price.

As the Austrian school of economics points out, the conventional the-
ory ignores the necessary process by which the theoretical equilibrium mar-
ket-clearing point is supposed to be reached. Once this is taken into account, it becomes evident the equilibrium does not exist in reality.

William Squire has pointed out (personal communication, 1984) that there is a fundamental flaw in the concept of the usual demand and supply curves, that is, its disregard for time or history. For example, the amount demanded at any price is influenced by what the price was previously. If the price is rising, demand may increase to avoid a higher price tomorrow. If the price is dropping, demand may hold off in the hopes of a lower price. In other words, demand and supply are history-dependent properties.

Commodities are produced before they come to market. Producers have to hope that they can move the goods, for if they are wrong they will end up with unwanted inventories. Expectations and uncertainty are central. If the market is competitive, suppliers, driven by the profit motive, will follow the strategy of (1) constantly striving to cut the cost of their products, changing their products, or offering new products; or (2) trying to minimize uncertainty through acquiring market power by absorbing, combining, or colluding with competitors. In either case, whatever the ruling price in the market happens to be at any moment in time, the dynamic of the system operates to change it. It is the exact opposite of what the concept of equilibrium signifies. In an equilibrium system, any movement away from equilibrium instantly evokes forces that restore the position.

Behavior in a market is influenced by expectations that derive from both objective and subjective factors: information and misinformation, facts and illusions, hopes and fears, optimism and pessimism, and facts and beliefs about future economic and technological trends and tendencies. The Austrian school of economics recognizes that people in the market have incomplete, and possibly wrong, knowledge and may not even be aware of what they do and do not know. Activity in the marketplace is a social learning process by means of which the participants learn and discover imperfect but useful knowledge. An important function of competition, for instance, is providing the means through which imperfectly informed firms learn about what consumers will buy. Entrepreneurs are not seeking an equilibrium position but are aggressive searchers for opportunities and weaknesses in their competitors (Horwitz 1995).

**Market Power**

The most efficient way to earn profits is to gain market power, ideally as close to a monopoly as possible. Neoclassical economics postulates the
absence of market power (no single buyer or seller can move the price of a commodity). This is highly unrealistic for most of the economy. There is a great deal of empirical research that has found market power in the supply of many commodities (see Silvestre 1993). Competition is usually “imperfect”; market power is pervasive. The long-established norm of modern market structure and behavior has been that of imperfect competition and oligopoly (Herman 1981, 1). Robert Solow agrees that generally we should assume that firms have some market power and monopolistic competition is the norm. “In any recession, it is all too obvious that most business firms would be happy to produce and sell more than they are currently able to sell at the current price. Evidently, then, price exceeds marginal cost. Why do firms not quote lower prices to increase sales?” (1998, 1). While there are many possible satisfactory answers to this question, they all involve the fact that firms must have some degree of market power (Mankiw 2000a, 427).

General Electric (GE) is the world’s most successful corporation from the point of view of a shareholder, having increased its market value from $12 billion in 1981 to around $500 billion by 2000. It centers its corporate strategy on market power. It abandons any sector in which it is not now, or does not believe it can become, number 1 or number 2 in sales. This strategy is not unique to GE; it is followed or aspired to by Johnson and Johnson and many other large corporations.

Results Not Necessarily Optimal or Socially Just

For perfectly competitive markets (in those few cases in which one could argue that they exist) to be truly optimal, everyone taking part in the market should have the same perfect knowledge, the same purchasing power, and the same freedom of choice. If there is inequality in economic resources, in knowledge and skills, or even in the right skin color needed to act freely in the market, then the results of the market cannot be truly optimal. Because of imbalances in the wealth of individuals in the marketplace, the desperate need of a very poor person for a particular commodity may go unsatisfied because a wealthy person may bid more merely to satisfy a passing whim. There are large numbers of people (the disabled, the helpless, the unschooled, or other involuntary victims of society) who, through no fault of their own, do not have the money to participate on an equal footing in the market. Adam Smith perceived the inequality of power in the labor market between employer and worker even before the rise of the corporation:
The workmen desire to get as much, the masters to give as little as possible.

It is not, however, difficult to foresee which of the two parties must upon all ordinary occasions, have the advantage in the dispute, and force the other into compliance with their terms, ... In all such disputes the masters can hold out much longer. ... Many workmen could not subsist a week, few could subsist a month, and scarce any a year without employment. In the long run, the workman may be as necessary to his master as his master is to him, but the necessity is not so immediate. ... Masters are always and everywhere in a sort of tacit, but constant and uniform combination not to raise the wages of labour above their actual rate. (1776, 66–67)

The market can fail or divert resources to socially undesirable ends, as in the “winner take all” or “Hollywood effect” markets.

Adam Smith noted the peculiarity of the great divergence in remuneration between the few winners and the runners-up in the profession of law (Smith 1776, 106). In today’s professional sports, the few top players often receive incomes of millions of dollars a year while players rated below them sometimes have trouble eking out a living. The top rated college quarterback, on graduation, is offered a fabulous amount—millions of dollars—just to sign a contract to play. Other quarterbacks, who may be just as good but had the misfortune to play for a school with a weak offensive line, may not get any offers at all. The most popular singers are paid millions while others—nearly as good or even better but perhaps less well managed or lucky—are paid little. The same results may be observed in book publishing, investment banking, and corporate management.

In all of these cases, it is impossible to argue that the market distributes its rewards consistently with the distribution of talents. Worse, the market, because it drops huge fortunes on a fortunate few, attracts far too many others into these occupations. The sad stories of the young people who go to Hollywood hoping to become stars are commonplace. Similarly, there are thousands wasting their lives practicing basketball for every one who makes it into the professional ranks. The efficiency of the whole economy suffers from this misallocation of resources (Frank 1994).

Even if the market system did distribute its rewards according to talent, this would not make it a just system. The ability to sing like Pavarotti or Domingo or to crush opposing football linemen is largely due to inherited good fortune not earned desserts. An attractive face or body or an appealing personality is rewarded in the marketplace. Handsome men and beautiful women are paid more than those who are plain (Hamermesh and Biddle 1994; Averett and Korenman 1994). Nor is it just when one’s occupation suddenly becomes obsolete and income vanishes. When overseas air travel became possible, every plane had to carry a flight engineer. When jets
replaced propeller planes, the remunerative flight engineering jobs vanished.

Fervent believers, however, accept that whatever a market decides is optimal. Heretics are outside the pale. Harvard economics professor Robert J. Barro, in dismissing the need for legislation to require employers to allow workers to take leave for family emergencies, stated flatly:

Most economists (and all respectable [sic] economists) would agree that the amount of family leave and the trade-off between leaves and wages would be satisfactorily determined by voluntary interactions between workers and firms in our competitive labor markets. . . . there is no reason to think that the unfettered labor market generates "too little" or "too much" family leave. (1992, A13)

From 1993, when the U.S. Congress, contrary to Professor Barro’s advice, passed the Family and Medical Leave Act, to 1999, around 20 million workers, both male and female, took unpaid time off for the birth of a baby or to care for a sick member of the family. Both employers and workers have been content with the law (Bernstein 1999, 42).

Professor Barro’s Panglossian conclusion that the market makes optimum provision for the family concerns of workers is in stark contrast to reality. Around three-fourths of American employed mothers have children under eighteen. The first nationwide comprehensive study by researchers at Harvard’s Graduate School of Education found that “The market is failing to equitably distribute affordable child care services across regions of the country, and among rich, working-class and poor communities” (Harvard Gazette 1993, 1, 7). In Massachusetts in March 1998, It was easier to get a child into college than into an excellent child care facility (Kornblut 1998, B8).

Inadequate child care is not a trivial matter. Poor, unstimulating environments have lasting negative effects on children’s intelligence. A sick child recovers faster when cared for by a parent. A study of nine European countries from 1969 to 1994 found that “more generous leave rights reduce the death rates of infants and young children. The magnitudes of the estimated effects are substantial” (Ruhm 1998, 27). Good child care at home or at day care centers is an investment in human capital. It is absurd to argue that the market makes available just the right amount of parental leave needed by children (Sharpe 1994).

**Capital Markets**

Securities markets are as close as any to being perfectly competitive. Hidden in the general belief of the beneficent result of free markets is the
assumption that the motives of the participants are in tune with the social purpose of the particular market. Keynes warned against the capital development of a country becoming the by-product of the activities of a casino. The proper social purpose of the financial markets is to direct new investment into the most profitable channels in terms of social yield. But this is not what occupies many of the brightest brains in Wall Street or the City of London (Keynes 1936,159). The biggest rewards—in the tens or even hundreds of millions of dollars—often go to the most successful financial manipulators.

The stock market is taken to be a prime example of an “efficient market.” That is, all the pertinent information about a company (e.g., its earnings, dividends, competitive position, and future performance) is always reflected in its share price. Investors are assumed to be rational, well-informed actors who absorb the available information and make objective decisions as to which shares to buy. Those investors who make decisions irrationally either learn to behave rationally or are eliminated from the market by losing all their money. The “efficient market” assumption, while comforting, unfortunately is contradicted by the real world.

The stock market is moved by emotion and fads as well as by reason. According to Warren Buffett, probably the most successful stock investor of all time, “The game is being played by the gullible, the self-hypnotized and the cynical.” The very fact that his success is rare illustrates that few investors qualify as rational calculators (Lowenstein 1995a).

In Buffett’s words, “market prices are frequently nonsensical.” A large number of share owners have no real knowledge of the company or industry in question. Day-to-day news and rumors of ephemeral value have an excessive impact on price fluctuations while the real value of the corporation remains unchanged. If stocks were always rationally priced, stock quotations would change only when there was some reason to do so, that is, rarely. In reality, most bounce around almost constantly.

This can also be true of the whole market. On October 19, 1987, the Dow Jones Industrial Index dropped by 23 percent—almost double the drop of October 23, 1929, which heralded the Great Depression. The next day, the Dow went up by 5.9 percent, and the great bull market of the 1990s began. In October 1997, because of troubles in Southeast Asia, markets plummeted in Bonn, Paris, London, and New York. The Dow dropped a record 554 points (7.2 percent) on October 27 and then rebounded with a record 337 point gain the next day. Is this rational behavior?

Professional investors and speculators, with a few exceptions, are concerned with foreseeing at what level the market will value a security under
the influence of mass psychology. The trick is to jump the gun and outwit
the other fellow. This is, in fact, the theme of Gerald M. Loeb’s enduring

The financial press is full of reports by “experts” pontificating on the
future of the current bull or bear market. The very concept of bull and bear
markets implies that the market is being affected by widespread sentiment.

There is a whole profession of well paid “technical experts” who pre-
dict what the market is going to do simply by charting what the price
indices did. Their well-developed jargon includes such terms as *resistance*
point (the place on the chart where the rise in the index previously stopped)
and *support level* (the place where a previous decline halted). Even an
investor who tries to make decisions based on fundamentals has to take
into account the sentiment in the market. It may not affect which stock he
or she buys or sells, but it will affect the timing of the decision: buying
when a bear market has driven prices low or selling when the bull market
has raised prices.

One result of all this is that assets markets are subject to “bubbles,”
that is, market prices that differ widely from their fundamental values for a
time before suddenly bursting. The seventeenth-century Dutch tulip
mania, the English South Sea bubble and the French Mississippi bubble
(both of which burst in 1720), and the New York stock market crash of the
late 1920s are all classic examples. Even prudent investors may participate
in driving up prices while the bubble is growing. They hope to ride the
market up and get out just before the bubble bursts. This is the “greater
fool” theory, that is, purchasing an overvalued stock in the hope that a still
greater fool will buy it at an even higher price.

It takes a lot of practice in refusing to use common sense to believe, in
light of all these considerations, that the securities markets always and
invariably result in optimum results or that the results are deterministic and
single valued.

To perform their socially necessary role in investing their depositors’
savings, banks need to be able to pick the most economically productive
projects and make their decisions on purely economic grounds. Both of
these criteria are not invariably met. From direct observation in a number
of less developed countries, I can testify that often banks are not up to the
task of making the best economic decisions. And we know from the savings
and loan scandal in the United States that when government regulation
was weakened, bank officials frequently took the opportunity to divert
money into fraudulent investments or projects desirable only as a means of
pleasing friends, relatives, or cronies.
In addition to the securities markets and banks, managers are important investors of corporate retained earnings. Their investment decisions are not necessarily optimal in terms of the whole economy.

**Labor Markets**

Labor is the most important market, for nearly everyone is involved. It is fairly widely—though not yet universally—accepted that conventional theory is inadequate for understanding the labor market. Conventional economics assumes that labor is a factor of production, just like capital, ignoring the fact that workers are human beings and there is therefore a social aspect to work relationships. Workers are not usually hired for a single transaction but for an extended period, establishing a relationship between employer and employee. This brings in a social dynamic often with the kind of outcomes shown in repeated games. When a worker is hired for a job, there is usually an explicit or implicit understanding of the minimum standard of performance that the worker must meet. The actual performance is affected by many factors. For example, studies have shown that the determinant of the actual performance of a worker in any group is the norm set by the group. This may be higher than the employer’s minimum if the workers acquire a sense of loyalty to the company and feel that they are respected by it. A highly productive laborer may restrict his or her output out of solidarity with fellow workers. Many aspects of the employment relationship are strongly affected by social considerations (Akerlof 1984, 145–74).

The economic assumption that work is a disutility for which income and leisure are the rewards is simplistic and inadequate. Reality is much more complex. People are motivated to work by plural motives. Work per se often has intrinsic value. Many find pleasure in work. What we do is a large part of who we are. In countries with a strong work ethic, jobs provide not only income but meaning. New retirees often discover that with the loss of their work they have lost interest in life. If fired after years with a firm, the worker often feels like a piece of worn-out machinery. Unemployment increases the incidence of suicide, drunkenness, and family and personal psychological problems.

There is an underlying duality in the concept of “work” or “labor”—something we like and something we dislike. Hannah Arendt noted that every European language, ancient or modern, has two words, etymologically unrelated, for the same activity: *Work, labor; Werk, Arbeit; oeuvre, travail;* (Latin) *laborare, facere, or fabricare;* (Greek) *ponein, ergazesthai* (1978,
80). The first word in each pair insinuates an activity that is more pleasant, more prestigious. We speak of a work of art, a philanthropist engaged in good works, an *oeuvre littéraire*, or an *oeuvre de bienfaisance*.

Nonacquisitive drives affect effort and productivity. Recognition, pride, and satisfaction in accomplishment, freedom to make decisions, and the opportunity to make a difference or contribute something of value all matter, as do advancement within a hierarchy, pleasure in working with respected colleagues, team spirit, and a supervisor who respects the worker, listens, and cares.

There are many forces that affect wages and productivity within a modern enterprise in addition to the attempt by a rational firm to maximize profits. The history and current state of labor-management relationships within the firm have an enormous influence on the quality of labor effort, the level of work intensity, the creativity of worker suggestions, and the receptivity of management. These “social” or “sociological” factors, while they not treated in conventional theory, must be included in any analysis if we are to gain a proper understanding of the labor market and how enterprises function.

In conventional theory, all labor is equally in supply and available. The conventional assumption of “homogeneous” labor eliminates most of the important characteristics of actual labor markets. In reality, all workers are either insiders (employed workers) or outsiders (unemployed). Even without unions, employers will hesitate to replace insiders with outsiders. Not only are there costs of hiring and training but there are costs of firing (morale) and therefore productivity of the whole work force may suffer. Such action may offend notions of fairness.

In the workplace, where workers are in close personal contact, concern for fairness is an important emotional force. Workers who consider themselves unfairly treated are unlikely to want to work hard. Workers tend to feel that as long as all employees put in a “fair day’s work” each should get a “fair day’s pay”—in other words, equity should override sharp economic computation.

What lower paid workers consider to be fair wages in comparison with those of more highly skilled workers in the same workshop is not likely to coincide with the lower level of “market-clearing wages.” The result is that if the enterprise wishes to be sure that workers do not shirk it will pay skilled workers at least as much as the market-clearing wages of the external market and will pay higher than market-clearing wages to the less skilled. In Japanese enterprises, as we know, wage compression extends throughout whole enterprises from top management down.

Market theory assumes that the unemployed are actively available out-
side the factory gates. But people who have been unemployed for a long period of time become demoralized, cease to look for work actively, and find ways of surviving from day to day. On the demand side, firms do not like to hire someone who has been long unemployed: skills have deteriorated and work habits become poor. The result is that the external market may have a large supply of unemployed labor with no impact on market-clearing wages (Blanchard and Summers 1988; Lindbeck and Snower 1988; Blanchard and Muet 1993). As the quotation from Adam Smith illustrates, employers usually have more power in bargaining than individual workers do. Karl Marx argued that capitalism required the existence of an army of unemployed to keep wages low. Shapiro and Stiglitz (1984) have shown that equilibrium unemployment acts as a discipline device to induce employed workers to exert more effort.

Large firms with market power and some fat in their costs set their “efficiency wages” high enough to persuade their superior workers that they are being fairly treated and to attract a queue of applicants. The result can be perfectly stable with continued existing unemployment (Blinder 1988).

Some workers get paid directly for their productive contribution: sales personnel on commission, waiters and waitresses paid through tips, the self-employed, and so on. But most workers are employees in corporations and—as Marx pointed out—are paid for their labor power not for the products of their labor. The connection between their performance and their pay is not inflexible. As the office worker, “Born Loser,” in Art Sansom’s comic strip explains: “There’s a fine art to completing assignments at work—too late gets you fired, but too early only gets you more assignments!”

The success of an economy is related to the quantity and quality of maintaining and reproducing its labor force. Some of the costs of this are borne by individuals and families, but many are social. In addition to the provision of education through government, low-income people are often subsidized through child tax credits, child payments, earned income tax credits, and so on. The degree to which work forces are unionized affects how the social costs of labor are borne.

Most workers in the industrialized economies now work in services. When workers are producing services directly for consumers, it may be difficult to monitor productivity and quality of the service. It becomes important to motivate workers to do their best. Thus, employers may try to persuade workers that their interests and those of the firm coincide by promising lifetime tenure. There is a similar problem in firms in fields such as research and high tech, which depend on the creativity of employees.
Particularly valued employees, as in the classic case of Steinmetz at General Electric, may even be given complete freedom to choose what they do, when they work, and how much they work (Warsh 1989).

In a country’s transition to industrialization, another set of forces different from today’s was in play. Urban incomes and incomes in the industrialized sector are greater than incomes in the subsistence countryside. People migrate to the cities and become unemployed. These migrants, as urban unemployed, secure incomes from useful petty trade and backyard industry as well as from begging or selling unwanted services (e.g., watching your parked auto—if you refuse, your tires may be slashed). This income, plus the probability of finding regular employment, entices a continuous supply of “unemployed” to the city during the process of development. In Italy, for three or four decades after World War II the economy was growing well and putting more and more people to work but unemployment remained stubbornly constant at around two million. It was only when the Italian countryside was largely depopulated that Italian unemployment dropped (Kamarck 1965).

Markets in Land

An efficient market for land depends on the acceptance of a general belief that property rights in land stem from title rather than use. But in many parts of the world such a belief is not accepted as natural.

In Kenya, for example, the legal system, which was instituted by the British, recognizes property rights in land as passing with title, but this runs counter to traditional beliefs and practices. Farmers with holdings of less than half a hectare are the poorest but also most productive because of intensive cultivation. Efficiency would increase and poverty diminish if the small farmers could lease land from the large landlords. But these, who are mostly absentee owners, fear that leased land will be lost for good. The old tradition is still strong that farmers derive their land rights from use. The large absentee farmers could hire labor to get more intensive cultivation, but supervised, hired, multipurpose labor is not productive in Kenya for historical and cultural reasons.

Kenyan small farmers are also unable to get credit to buy land because banks worry about their ability to repossess land from a cultivator. In sum, the markets for land, capital, and labor in the rural regions of Kenya do not work according to the economic texts and rural poverty continues (Collier and Lal 1986).
In neoclassical economics, the role of the state is minimal. It comes into the picture to remedy market failures that arise out of externalities but only if people cannot solve the problem of externalities privately through bargaining. The state also is there to provide or arrange for the provision of public goods—goods that are “nonrival” (one person’s use does not diminish another person’s) and “nonexcludable” (people cannot be prevented from using them). The transition to a market economy in the European former centrally planned countries has provided the graphic lesson that the state has a much greater role vis-à-vis the market than neoclassical economics has acknowledged. The great patron saint of the market, Adam Smith, recognized that the market needed the sovereign to maintain peace and justice, provide the physical and social infrastructure, and enforce contracts. That is, the state is essential to the market.

Competitive markets are the product of centuries of legal development of property rights, standardization of commodities and services, and evolution of nomenclature for these. Well-functioning markets need an independent legal system: a code of private property rights; bankruptcy and contract law; and a government that defines, protects, and enforces contract and property rights; a good monetary regime, developed financial markets and a good banking system; good communications; and generally observed standards and ethics. The World Bank from its experience in the European transition economies learned that the state had to establish these prerequisites for a modern market-based economy (Chhibber 1997; Gray 1997; Levy 1997; Pradhan 1997).

For markets to function well, this special set of conditions is necessary. The attempts of the former communist-ruled countries to institute a free market system have painfully demonstrated how much is demanded of government and the rest of society for such a system to function. The outcomes were remarkably different in practice. The European Bank for Reconstruction and Development found that this was primarily due to “national differences in institutional underpinnings and, in particular, to differences in legal systems and in the adherence, or lack thereof, to the rule of law” (Pistor and Sachs 1998, 2).

Property rights are not divinely established. They are set and defined by the state, established through legal action in the courts, affected by regulatory agencies, and subject to power struggles in these and other arenas. The value of a share of stock is determined not only in the marketplace but by what the management and the board of directors do in controlling the distribution of benefits from the operations of the corporation.
Investors have learned from bitter experience that government supervision is needed if a stock exchange is to prevent ramping, insider trading, and other distortions from affecting share prices. The financial crises in Asia in 1997–98 and the billions of dollars lost in the 1998 failure of the Long-Term Capital Management hedge fund led the leading American business periodical, *Business Week*, to draw this lesson:

Expanding government oversight is critical. . . . The idea that free markets exist in a vacuum has been shattered. Without rules and regulations, they can create anarchy. Enforcing accountability and transparency is government’s job. This is as true for the U.S. as for Asia. (1998a, 162)

The history of each country makes each business environment unique to that country. When the European Community embarked on its policy of creating a single internal market among its twelve members, it had to be laboriously constructed. Nearly three hundred specific subjects had to be harmonized by changing the existing laws, rules, and procedures. Product health and safety standards (what constitutes a sausage, how beer is brewed, and so on) and rules for the treatment of intellectual property and the service sector all had to be negotiated.

In addition to creating and monitoring the legal and social structures essential to the market, the state is needed to create the physical infrastructure for a successful market economy. Adam Smith recognized that the state had to create those infrastructures the productivity of which cannot be properly recognized during the too short horizon of private entrepreneurs. The canal and railroad building that was financed or subsidized by the government in the nineteenth century created the American national market. Publicly financed research in agriculture has been a large contributor to the enormous increase in productivity on farms. Public investment in feeder roads and irrigation has yielded high returns in many cases, and investment in health research has stimulated the biotechnology industry.

In modern times, in addition to the need to rely on the government to see to the provision of certain types of physical infrastructure, government investment in human beings has also been necessary. Educated, healthy workers and consumers underpin the market. There is no way that the pure market system could have eradicated the scourge of smallpox.

When a competitive market does exist, external authority (the state, strong custom, etc.) may be needed to keep it so. Profits can be won through superior efficiency or market power. Market power can be exerted on suppliers or buyers. The Standard Oil Trust not only secured lower rates than its competitors on the railways, but it forced the railways to give it a kickback on all the payments made by its competitors. Microsoft forced
computer manufacturers to pay it a fee even on computers they produced that did not use MS-DOS, Microsoft’s operating system at the time.

In a modern democratic society, it is necessary to guard against a highly skewed distribution of income. There is nothing preventing the market system from creating such an undesirable distribution. Great disparities in income and wealth may threaten the successful functioning of a democracy. A democratic government appears to be a necessary condition for the long-term survival of a market economy. It is quite possible, of course, for governments to change the distribution of wealth without interfering with the effectiveness of markets. A progressive income or expenditure tax at the top and a negative income tax at the bottom, generous provision of financing for students in higher education, technical training, and so on are all ways of offsetting wide disparities in income.

With the increasing complexity of modern life and higher population densities, government regulation of the social conduct of firms has become pervasive. This includes regulation of the health and safety of work places and products, the accuracy of the information that firms disseminate about their products, and the noise and other pollution that the firm produces. The economic conduct of firms—pricing, methods of distribution of products, control of entry and exit, and so on—is also commonly regulated.

Finally, a modern market economy needs wise economic management to mitigate economic cycles and maximize economic growth potentials. A poorly managed public sector or ill-advised government intervention can cause substantial damage to the market economy.

The market and academia

Adam Smith said that in universities where the teacher receives a salary and is prohibited from receiving any fee from his pupils his interest is set as directly in opposition to his duty as it is possible to set it: the teacher will either neglect his job altogether or perform it in as careless and slovenly manner as he can get away with. In the university of Oxford, the greater part of the public professors have, for these many years, given up altogether even the pretense of teaching (716–18).

Many present-day economics professors are avid advocates of market forces to be used to decide issues from agriculture to government policies but refrain from advocating the creation of an academic market for themselves—abolishing tenure and fixed salaries and compensating professors out of the fees paid by the students they attract. In such a case, there would be no need to concoct an imaginary market to illustrate the way demand
and supply work, since fees would vary according to them. If a fee-based system were regarded as too much of a good thing, there are other market conditions that could be allowed: when job benefit of tenure is granted, in such a market an offsetting cut in salary might be appropriate. Younger economists could be allowed to bid for positions—allowing the senior members, of course, to defend their jobs if necessary by offering to take salary cuts.

Free market ideology does have its limits, however, and this is one. Tenure protects freedom of inquiry. Abuses can be avoided through the nonmarket ethos of professionalism. As professionals, economists in academia expend their energy in pursuits that fall outside the impersonal market: acting as gatekeepers to professional acceptance; judging, mentoring, and recommending students; refereeing manuscripts and reviewing books; and conferring, voting, and politicking over the choice of new members in their departments and the awarding of tenure.

Concluding Remarks

The market is an important, vital institution in our enterprise system. It is better than any other instrument human beings have been able to devise to mobilize the scattered partial bits of information possessed by buyers and sellers to set prices, organize the exchange of goods, and indicate where resources should be utilized. But the market is not a god to whom unquestioning obeisance is due. It was made to serve us, not vice-versa.

The market has severe limitations. It works, but it works imperfectly. It is not a precise, deterministic instrument. Market outcomes, particularly in the most important market, the one for labor, are affected and sometimes even determined by nonmarket factors. The defects, shortcomings, and failures of the market are sufficiently great and widespread that one cannot legitimately claim that the results of the market lead to just social rewards. Actual rewards to participants in the market depend on an unforeseeable combination of ability, effort, chance, market power, and just plain luck.

The market is a social construct, a product of social evolution. To work well, it requires state management and a suitable framework of laws, rules, habits, and informal accepted norms. As Ronald Coase famously remarked, “Without appropriate institutions no market economy of any significance is possible.”

The intervention of the state or other public authorities in the market, or in creating or structuring it, cannot be counted on to always act wisely to
make the market work more ideally. Yet nonintervention is also a policy, and it is certain to have imperfect results. In developing countries and restructuring economies such as those of the former communist nations, if the government sits back and waits for market institutions to evolve from the bottom up it may take generations, just as it did in Western Europe. And in the meantime, as in Russia, the initial results can be crime, corruption, chaos, and a mortality crisis resulting in huge losses of men and women at their most active and productive period of life. Guided by good economic analysis, public intervention can set up the institutions, provide the necessary laws, and codify the informal rules that can result in improved markets and market results. The contrast between those capital markets (the heart of market capitalism) that are well regulated and those that are badly regulated or not regulated at all is a graphic proof of this claim.