Section 6 | The Basics of a Market Economy

6 The Basics of a Market Economy

We have spent most of our space in this booklet addressing how individuals can do a better job of building wealth. Now we would like focus on how nations can do a better job of building wealth.

Mystery nations

Ever wonder why the United States is a wealthy nation? To answer this question, let's play a short guessing game.

Imagine nation A.
This is a country that has a wide base of natural resources including major deposits of oil, natural gas, coal, many important minerals, and vast stocks of timber. In addition, this nation has a large population of more than 144 million people and a literacy rate of 98 percent. Would you expect this nation to be rich or poor? (Many would say rich. In fact, Nation A might be a wealthy nation like the United States.)

Now imagine nation B.
It is a tiny country — about 3.5 times larger than Washington D.C. It has almost no natural resources. It has no oil, gas, minerals, or forests. Its only natural resources are fish and deepwater ports. For such a small place, this nation has a large population of 4.5 million people. Its literacy rate (93.7 percent) is less than that of Nation A. Would you expect this nation to be rich or poor? (Many would say poor. In fact, Nation B might be a poor nation like Haiti.)

If you expected a trick, you were right. Nation A is Russia. In 2001, Russia's per capita income (the value of all the goods and services produced in a nation [Gross Domestic Product or GDP] divided by the population) was $8,300. Nation B is Singapore, a nation in southeastern Asia. In 2001, Singapore's per capita income was $24,700. Singapore is among the wealthiest nations of the world.

Natural resources paradox

We call this result the "natural resources paradox." There are nations with vast supplies of natural resources (like the United States and Germany) that are wealthy. But there are other nations with vast supplies of natural resources (like Russia and Nigeria) that are poor. In fact, there are nations with no natural resources (like Japan and Singapore) that are rich. Clearly, wealth is not solely a matter of natural resources.

Why is Singapore wealthier than Russia? It is for the same reason that Bill Clinton won the presidency — it's all about the economy. Individuals who have acquired wealth in the United States share many characteristics. They get a good education, live below their means, own a home, use credit cards sparingly, save regularly, and invest. Like individuals, nations that have achieved high levels of wealth share many characteristics. These characteristics have to do with their economic systems. Wealthy nations generally have economic systems that feature voluntary exchange, a price system, the profit motive, private ownership, and well-functioning financial institutions. Together, these characteristics are what economists call "market economies."

Market economies

Few Americans, rich or poor, spend much time wondering about the basic characteristics of our economic system. Almost certainly, they have more important things to do. Nonetheless, it might be worthwhile to pause for a few moments and consider why it is that nations such as the United States, Canada, and Great Britain, many of the nations of Western Europe, and parts of Asia have been economically successful while other nations including many in Africa and parts of the Middle East, Latin America, and Asia, have not.

All nations have to make decisions regarding how to distribute the goods and services they produce. Different nations have made different decisions. Back in the bad old days of communism in the Soviet Union (1917-1991), for example, Communist Party officials often had special access to stores that sold western goods. Distribution of western luxury goods — cheeses, wine, western clothes — depended, in part, on an individual's position in the Communist Party. Many other nations have similar distribution patterns. Goods and services are distributed based on who you are, not what you produce or earn. Members of a privileged class (royal family, family members and friends of dictators, and so forth) receive special access to goods, services, and opportunities to run monopoly-like businesses, while foreign competition is kept away.

The United States economy is a market economy. Market economies depend on prices to distribute goods and services. It is not who you know or what group you belong to. All that matters is a willingness to pay the price.

6 | The Basics of a Market Economy

Prices, like many things around us, often go unnoticed. We just accept them as part of the economic system. But the fact that prices are commonplace does not make them any less important. Let's explore why having a system of prices is so important to creating wealth.

Prices are signals

Prices are important because they encourage voluntary exchanges — for goods and services of all sorts. Prices convey complex information quickly and efficiently. They provide a basis for cooperation between strangers.

Let's turn to the core of the matter. Consider the case of Red Delicious apples grown by hundreds of Washington State's apple growers. When you buy Red Delicious apples, you don't know who produced them. Religion, race, class, and nationality don't matter. The price on the apple tells you most of what you want to know. You hold the apple in your hand, you look at the price, you look at the apple, and you decide if you want to buy it today.

It is the much same for the apple growers in Washington State. They don't know you. Yet they spend millions of dollars each year trying to produce Red Delicious apples that you would like to buy. Your religion, race, class, and nationality don't matter to them. Growers concentrate their attention on the price for which they can sell Red Delicious apples. If the growers do it right, they will not only be able to pay for the costs of production, they might also be able to earn a profit.

The world's biggest instruction manual

It is a challenge, of course, for the apple growers to be sure that they get all aspects of production done right. Imagine the size and complexity of the instruction manual it would take to explain all the steps required to grow, pick, package, ship, and display Red Delicious apples neatly in your neighborhood grocery store. Sounds nearly impossible. But this is exactly what prices do. Prices are the world's best communicators. They encourage high levels of cooperation without the help of the world's biggest instruction manual.

Messing with prices causes big messes

What happens when prices are not allowed to work freely? The problems are severe, predictable, and all too familiar. Imagine what might happen if the government determined that Red Delicious apples were critical in the fight against cancer. Because the apples played a critical role in the fight against a deadly disease, the government determined further that Red Delicious apples could only be sold for $.10 each, well below the market price. What would happen?

Almost overnight, the market for Red Delicious apples would be destroyed.

There would be severe shortages of Red Delicious apples. Producers would not voluntarily produce Red Delicious apples at this low, government-set price. They could not make a profit or pay the costs of production if they did. Buyers, eager to acquire Red Delicious apples for their health benefits, would quickly buy them all up at the below-market price. The result would be empty store shelves.

As simple as this fantasy tale about apple shortages is, it is remarkable that many people in business and government ignore the fundamental principle of economics it illustrates. Market prices and voluntary exchange are important factors in enabling businesses to produce the goods and services that consumers want at low prices. If we want Red Delicious apples on store shelves, market systems require that the information expressed by the price be communicated to apple buyers and sellers. When price signals are ignored, shortages and surpluses result, depending on the action taken. The same principles about prices that work in the apple market apply to other markets as well. Think about the importance of price signals when you hear people demand rent controls for apartments, price controls for gasoline, heating fuel, pharmaceutical drugs, and limits on interest rates for credit cards.

Prices are incentives

Prices provide for highly efficient communication between buyers and sellers. They tell both parties what they need to know. Imagine, for example, that pests infest the Red Delicious apple orchards in Washington State. The supply of Red Delicious apples will be severely reduced. Will there be long lines at the grocery stores? Will apple eaters protest in the streets? Will grocers have to ration Red Delicious apples? No. People will calmly go about their everyday shopping. Why? Because market systems use prices to distribute products like Red Delicious apples.

Here is what will happen. The reduced supply of Red Delicious apples will cause an increase in the price. The increased price will provide an incentive to buyers to buy fewer Red Delicious apples. People who normally buy Red Delicious apples will take a sudden new interest in Granny Smiths, Braeburns, Fujis, and Galas. This reduced desire for Red Delicious apples is exactly the correct response to the problem. Consumers will buy less at the new high price. Not only that: most apple buyers will do this without any knowledge about the pest invasion in Washington State. The price simply and efficiently tells apple consumers what they wanted to know about the supply of Red Delicious apples.

The increased price of Red Delicious apples also provides an incentive, encouraging other growers to get into the Red Delicious apple market. The opportunities for profit will be enhanced if growers can figure out how to solve the pest problem and produce more apples. This increased interest in Red Delicious apples is exactly the correct response to the problem. The price simply and efficiently tells the growers what they wanted to know about the supply of Red Delicious apples

Voluntary exchange: The hair cut

Market systems depend on people voluntarily making exchanges with one another. Prices are critically important in allowing voluntary exchanges to take place smoothly.

Voluntary exchanges take place because both parties see themselves as being better off as a result. A man goes to his favorite barber for a haircut. The barber cuts his hair and says, "that will be $15.00 please." The customer looks in the mirror, nods his satisfaction, and hands over the $15.00. The barber says, "Thank you, and please come back again." The customer says, "Thank you. I'll see you in a few weeks." This is a voluntary exchange. Voluntary exchanges take place millions and millions of times each day. Both sides gain. That's why we always seem to be thanking one another.

Why the big deal about voluntary exchange? Think about how it could be different. What if people were *forced* to provide goods and services? Consider America's tragic history of slavery. Slavery was a denial of voluntary exchange. People ordinarily "own" their capacity for labor. It is their most important resource. If they choose to use it on behalf of others, they expect to get something in return. They expect to get paid.

But slavery created a legal system that sanctioned stealing labor from one person and giving it to another. This system of legalized theft violated a principle of private ownership: the principle that people own their own capacity for labor. It was not a market system based on voluntary exchange. It was a system that depended on non-voluntary exchanges, coercively enforced.

It has taken the United States generations to overcome slavery. One would think that the world's leaders would have learned by now of all the evil that stems from non-voluntary exchange. Russia in 1917 had not learned. Neither had China in 1949 or Cuba in 1959. It will take Russia generations to overcome its violations of private ownership. And systems of non-voluntary exchange still exist in many parts of the world.

Why do people make what they make?

Understanding the importance of prices and voluntary exchange can also help to explain why some people earn more money than others. But prices and voluntary exchange are not the first things most people think about when they think about income. Let's examine the relationships more closely.

Nearly everyone thinks they are worth more than they are paid. Just ask them. Economists approach the subject differently. They begin with a focus on the market for labor. To work correctly, markets depend on prices. And the prices in labor markets are wages and salaries.

The income people earn depends on the productive resources they own and the amount of money those resources can fetch in the market place. For business owners, their income is the difference between how much money they receive from customer sales and how much they spend in producing goods and services. For most of us, our income depends on wages and salaries. The wage or salary paid to a worker is a reflection of the market price for his or her labor. It reflects how much businesses are willing and able to offer for that labor. It also reflects how much workers are willing to accept.

Labor markets

In order to compete successfully in labor markets, individuals have to have something of value to offer businesses. Most people increase the skills they can offer to business by increasing their levels of education and training. Economists call investments in education and training improvements in human capital.

6 The Basics of a Market Economy

How can individuals increase their value to business? Education is the simple and most powerful answer. In general, it is a lack of education and training that results in low-paying jobs. Gary Becker, recipient of the 1992 Nobel Memorial Prize in Economics, has explained that gaining a high school and college education raises a person's income even after allowing for the direct costs (e.g., tuition and books) and indirect costs (e.g., income that people could have earned while they were in school) of getting an education. High school and college education raises a persons' income regardless of intelligence or family wealth.

Other factors, of course, also influence labor markets and people's income.

- People with more skills and more experience, and those who work harder, are more valuable to employers and are more likely to receive higher wages and salaries.
- People who are middle-aged tend to earn more income than people who are young. Older workers generally have more knowledge, skills, and experience.
- Some people are luckier than others. Natural abilities such as strength, good looks, coordination, intelligence, and so on are all factors that have some bearing on income. Some people inherit money. Others can throw fastballs 90 miles per hour.
- Many studies of discrimination conclude that discrimination does account for some of the differences in pay between men and women, and between whites and non-whites. However, higher earnings for men or whites can be explained in part by job experience and education, not by race or gender alone.

Like other markets, markets for labor change. For example, demand for software engineers is likely to increase faster in the near future than the demand for other workers. Demand for machinists is likely to decrease, compared to demand for other workers. Similarly, the supply of workers influences the market price of labor. The supply of carpenters is likely to decrease because many potential workers prefer more comfortable working conditions. Wages (the price of labor) are also likely to change along with these changes in demand and supply.

Mystery neighborhoods

Imagine two neighborhoods. In Neighborhood A, life is often mean and dangerous. People worry about their personal safety. Property of any sort is not safe. Theft is common. Buildings are neglected and often abandoned. Vacant lots multiply. There is little legal commerce. People can't trust one another. It is hard to do business with strangers. Strangers might steal from you or charge high prices for shoddy merchandise. In these difficult circumstances, people depend on a network of family members and close friends to get the things they need. The future looks bleak.

In Neighborhood B, life is generally friendly and safe. People feel safe in their homes and on the streets. Property is safe. Theft is rare. New businesses are springing up. New homes are being built and old homes are being fixed up. People hunt for vacant lots in search of places to build new homes and start new businesses. Commerce is commonplace. Shops and businesses offer goods and services of all sorts to customers. People almost always conduct business with strangers. Strangers provide good service at low prices. The future is looks bright.

Where is Neighborhood A? It could be located in nearly any large American city. It could also be one of many such neighborhoods in the old Soviet Union, Eastern Europe, and North Korea.

Where is Neighborhood B? It could be one of countless neighborhoods in many cities, suburbs, and small towns in the United States, Western Europe, South Korea, Singapore, Hong Kong, or Canada.

What explains the fundamental differences between these two neighborhoods? Opinions would vary, of course. However, from an economic perspective, we would view communities like Neighborhood A as having failed due largely to the absence of an active market economy.

Entrepreneurship and private ownership

What lessons could people living in Neighborhood A learn that might help them make progress in becoming more like Neighborhood B? In addition to having a system of voluntary exchange, prices, and open labor markets, healthy market economies depend on widespread private property ownership to release the energy of entrepreneurs. Every community has talented entrepreneurs. Entrepreneurs are willing to take the risks necessary to go into business and try to offer people things they are willing to buy.

Widespread public ownership kills entrepreneurship. Private ownership is the key. Private ownership means that individuals are allowed to benefit from the ownership of their possessions without interference from others. If people can't be sure that their businesses and homes — their private property — are safe, then they won't voluntarily engage in enterprise. Lawlessness and theft destroy business.

Respect for private ownership begins with the individual. Each person owns him- or herself. Murder and rape violate private ownership (ownership of one's own self) in the same way that theft violates private property. Since it is unlawful and wrong in well-functioning market systems to take or destroy the property of another without his or her permission, individuals must figure out how to obtain the goods and services they desire by gaining the cooperation of others. This has to happen through voluntary exchange. To do this, people must offer something of value — their labor or business skill — to obtain the things they desire.

The profit motive: The greatest invention of all time

What motivates entrepreneurs to offer us the goods and services that we want? Entrepreneurs often have a love for their business, their employees, their customers, or all three. They might love to tinker with computer software, invent new children's toys, experiment with new recipes for a catering business, learn the best way to give chemotherapy to a cancer patient, experiment with new ways to teach addition and subtraction, or figure out how to prevent pipes from freezing when the heat goes out.

Also high on the list of the sources of motivation for most entrepreneurs is the desire to earn a profit. Profits are the rewards market systems provide to individuals who produce the goods and services we desire.

To entrepreneurs, profit is one of the greatest inventions of all time. Entrepreneurs do good things for others. They provide the goods and services consumers want and they provide jobs so that others can earn incomes as well. Entrepreneurs also do good things for themselves and their families. By running successful businesses (earning a profit), they can buy that new home, put the children through college, or take care of others who are less fortunate.

Private ownership helps in other ways that may be less obvious. Economists often say, "there is no such thing as a free lunch." By this they mean that all of us (individuals, families, cities, nations) face scarcity. We desire more goods and services than our time, entrepreneurial skill, labor, capital, and natural resources permit us to obtain.

By allowing most resources to be owned privately, we provide an incentive for people to use them in the most efficient way. By being efficient, we are able to get the most out our resources so that we can achieve as much as possible. Not only can businesses be built, so can homes, apartments, schools, parks, hospitals, roads, and churches. Not only can we take care of our own families, we can have resources left over to address other important goals — defending our nation from attack, improving the environment, building better transportation systems, and so on.

Government ownership, while necessary for some purposes, often does not produce benefits of the sort we find produced in the private sector. Many examples exist. Ever try to renew a driver's license at the Department of Motor Vehicles? How long could a business survive if it required customers to pull numbers, wait in long lines, complete meaningless forms, and plead with grumpy clerks? Urban public schools, government-run hospitals, the post office, public parks, and the Internal Revenue Service are all examples of the frequent failure of government-run operations to provide the sort of services we expect and prices we can afford.

Profits and greed

To some people, *profit* is a dirty word. To these folks, the quest for profits is little more than an expression of greed. And it is no secret that some people are, indeed, greedy. But selfish behavior is not found only among profit-seeking business people. Selfishness and greed are traits we sometimes find in lawyers, teachers, scientists, ministers, and elected officials. Business people have no "lock" on greed. It is a common human trait.

How do market economies address the potential of business people to act in greedy ways? Why don't all business people simply "rip off" their customers in order to earn profits? In part it is because businesses are regulated by laws against fraud, price-fixing, and other illegal practices. But fear of the law is not the only reason. Business people must always think about their competitors. Any business that treats its customers poorly runs the risk of losing business to competing firms. If its products are shoddy, its prices out of line, and it becomes known for poor customer service, the company in question will eventually get beaten in the marketplace by its competitors. Competition for the business of customers is the tool market systems use to reduce problems of greed and sharp dealing. A key role for government, accordingly, is to make sure that there is plenty of competition (or opportunities for competition) throughout the many different parts of the economy.

Financial institutions: Helping yourself while helping others

The vast majority of people who become wealthy in the United States do so because they have decided to accept the opportunities offered by the private sector. One of the most important ways to start building wealth is to establish a relationship with a financial institution. Simply by establishing a connection to a bank, for example, individuals, like entrepreneurs, can help themselves while helping others.

The United States provides its people with a system of stable and well-regulated financial institutions. Let's focus on banks for a moment. By enabling people to place some of their earnings into savings accounts, banks reward saving. Individuals benefit from saving, obviously. But there is more to the story. Money saved by individuals is used, in turn, to provide loans others. Loans are often made to business owners. These loans can be used to expand existing businesses or open new ones. Loans are also used to build new homes and purchase other goods and services that many people want. As the money circulates, getting put to new uses, it results in new jobs and new opportunities for others.

Are markets good for the poor?

Market systems produce wealth. Prices, voluntary exchange, private ownership, competition, and financial institutions all work together to provide incentives for people to be highly productive. Productivity generates wealth and opportunity. This wealth, in turn, can be used to improve the lives of families, neighborhoods, and communities.

Nations and neighborhoods that persist in hanging on to non-market systems will fail. Non-market systems produce and distribute poverty. They reduce incentives to be productive, they reward spending over saving, they reduce private ownership, and they make it difficult to start new businesses.

Non-market systems in the extreme, such as the one that finally fell apart in the old Soviet Union, depend on coercion and even terror to get people to produce goods and services according to somebody else's plan. In such systems, it is cooperation with the government that opens doors to schools, apartments, opportunities for travel, and access to consumer goods. Failure to be cooperative means limited opportunities, demotion, threats, exile, or even death.

Conclusion

Understanding and participating in the market economy offers the greatest chance for people of low and moderate income levels to succeed. Admirers and critics agree that market systems create wealth. One reason for their success is that market systems are congruent with human nature. Over time, they provide private rewards and, at the same time, produce many public benefits. To succeed economically, nations and neighborhoods require the following:

- Widespread private ownership and use of the profit motive to reward enterprise, self-reliance, and responsibility.
- Active competition to impose discipline on business owners and make them efficient and productive.
- A widespread system of free market prices and voluntary exchange to promote cooperation among people.
- Competitive labor markets to encourage hiring of the best and most productive people, with rewards for those who attain higher levels of education and training.
- Financial institutions that encourage thrift by offering opportunities to save and invest.
- Financial institutions that use customers' deposits to help businesses expand, create new jobs, and produce new goods and services.

To the extent that these conditions are in place, people see improvements in their standard of living. Conditions are never perfect, of course. But overall we haven't been able to come up with a better system than the one these conditions create. It only took economists 300 years to figure this out!