Such "spread the wealth" programs are to be encouraged for a variety of reasons; property gives people a sense of security and independence which is very desirable in our over-wrought, urbanized civilization, property ownership gives people a stake in the society and aversion to violent change which certainly should be welcome in America, and finally, wealth earns income and thus a more equal distribution of wealth automatically results in a more equal distribution of income.

In addition, much greater effort must be made to redistribute income directly through tax reform, more generous family assistance and other programs. I am convinced that such policies are indeed compatible with both a high level of economic incentives and with a free society—but that is a whole new essay. □

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In Defense of the Free Market

David E. Lindsey

THE EXTENSION of state regulations and controls in the last several decades has reduced the role of the free market in guiding the economic activity of Western countries. This trend has strengthened the common presumption among intellectuals that the case for free markets is fundamentally invalid. They often simply assume that increased state intervention was necessitated by the failures of the free market. The verdict of history concerning free markets is rarely questioned by intellectuals (least of all, ironically, by the reformers who most strongly challenge the *status quo*, which is, after all, the most recent verdict of history). Accordingly, the defender of the free market is a disadvantaged participant in the "marketplace of ideas," while the "speculator," who envisions beneficial results from new anti-market reforms, enjoys substantial returns.

I believe that the attitudes underlying this situation are mistaken. The case for free market competitive capitalism deserves reconsideration; the historical causes of the retreat from free markets deserve re-examination. Presumptions are too often poor substitutes for analysis.

Free market, competitive, capitalism can be usefully defined as the economic system in which factors of production and commodities are privately owned and in which transactions among economic units are made voluntarily, on terms agreeable to all transactors. Rights to the ownership of property are invested in individuals and households, although managers of other economic units, like firms or unions, may intermediate some transactions among these ultimate owners. Competition ensures that an agreement to exchange (or rent) a factor of production or commodity is voluntary rather than coerced because competitors provide alternatives to any particular transaction. Markets are free in that first, neither buyers nor sellers are excluded from entry by law, thereby promoting competition, and second, no legal restrictions are placed on the terms of the transactions regarding price, quantity, or quality, thereby enhancing the range of voluntary agreement.

The functions assigned to the state by advocates of the free market system generally lie in the classical liberal tradition of limited government and the rule of law. An arbitrary list follows: (a) to operate a legal system which prohibits initiated violence, theft and fraud, defines property rights, enforces contracts, adjudicates disputes, guarantees liberty and disperses just punishment to convicted criminals; (b) to provide for the common defense; (c) to maintain a stable monetary standard; (d) to reduce involuntary exchanges caused by "neighborhood effects," like air pollution; (e) to care for the insane and the infirm; and (f) to prevent private monopoly and collusion which restrains competition. Of course, private or market alternatives to many of these state functions have been occasionally suggested, as have additional governmental responsibilities. Essentially, the state's proper role is viewed as that of rule maker, umpire and nightwatchman.

The case for free markets is difficult to summarize. Its advocates have offered a variety of justifications for their views; their arguments fall into three rather indistinct categories: (a) economic, (b) pragmatic and (c) libertarian. The economic arguments emphasize that free markets generally allocate resources efficiently in response to the material wants of consumers. The pragmatic arguments are that direct state interventions to correct real or alleged market imperfections have been (and will always be) generally counter-productive. The libertarian position is that the free market is the system of economic organization which permits maximum individual liberty.

The justifications for the free market which I label "economic" naturally derive from standard economic analysis. The basic economic problem is the scarcity of available resources relative to unlimited human wants. To put it awkwardly, *how* scarce resources to be used with *what* techniques to produce *which* commodities to be distributed *to whom?*

A moment's reflection reveals the staggering proportions of this problem in a world populated by billions of people. An additional moment's reflection may also suggest that a decentralized mechanism which deals with this problem by relying upon the voluntary decisions of every individual could not avoid total chaos. This initial reaction, though understandable, departs surprisingly from the truth, because free markets in fact provide a remarkably efficient device for the rational allocation of resources and distribution of commodities. That is, in terms of every individual's own preferences, there is little scope for altering the outcome of the free market in a way that could make everyone better off, even hypothetically. If there were no way to make one person better off without hurting someone else, then an economist would say the economy was fully efficient and resources were rationally allocated.

Why does the free market come as close to attaining economic efficiency as it does when consumers are mainly interested in their own wellbeing and producers are interested in maximizing their profits? Adam Smith first provided the answer in the *Wealth of Nations* in 1776:

Every individual. . .generally neither intends to promote the public interest, nor knows how much he is promoting it. He intends only his own security, only his own gain. And he is led by an invisible hand *to promote an end which was no part of his intention. By pursuing his own interest he frequently promotes that of society more effectively than when he really intends to promote it.*

The principles underlying demand, supply and the price mechanism explain why the "invisible hand" works so well. Flexible prices automatically adjust to clear markets, thereby eliminating surpluses and shortages. Given these market prices, consumers spend their available income on various goods so as to attain the greatest satisfaction. In a given period of time, a consumer buys just enough of a good to bring his subjective valuation of the last unit down to equality with its market price. At that point he buys no additional units; another unit is worth less than its price to him. Thus, a free market price is a (relative) measure of the subjective benefits consumers receive from the last unit of a good they buy.

Consider the owner of capital who wants to maximize the return on his investment, i.e., his profits. He is induced to invest in the industry where expected profits are the highest. High profits act as an effective signal to expand output in this industry. This effect is desirable, because high profits mean that the cost of production per unit is less than the market price—a measure, remember, of the benefits consumers receive from the last unit purchased. The economy clearly becomes more efficient when it increases the output of a good which has a value to consumers in excess of the production cost.

Capital as well as other factors of production flow into the high-profit industry and are allocated efficiently by suppliers who try to reduce costs as much as possible. Production continues to rise until the increased supply drives down the market price enough to eliminate abnormal profits, i.e., until the cost per unit of output, including a normal profit, just equals its market price. In this way the producers' desire to maximize profits causes the free market to automatically approximate the following condition for economic efficiency: the economic cost of the last unit of goods produced must equal their subjective benefit to consumers.

Just as high profits signal that output should be increased, losses signal the opposite. The free market possesses an automatic feedback mechanism which discourages a firm that fails to satisfy consumers' demand at appropriate costs from staying in business. This responsiveness of producers to consumer demand is why free market competitive capitalism has been termed a system of consumer sovereignty.

Efficiency does not necessarily imply equity in the distribution of commodities, however, because views about equity differ widely. Some opponents of free markets argue that a distribution of income according to what a person and the resources he owns add to the value of production — the principle of distribution in the free market — is inequitable. But it does not follow from this view that free markets ought to be dispensed with, because income can be redistributed by taxation and transfers outside the market, e.g., by a negative income tax. The hidden costs of this proposal, though, are the inefficiencies introduced as a result of both the reduced incentives to work for rich and poor alike and the decline in savings and capital formation.

Most economists concede that free markets in actuality will not achieve complete economic efficiency because perfect competition will not always exist and because the market price will not reflect all the economic costs and consumer benefits of a good in the presence of external "neighborhood effects." Is it reasonable to expect state intervention to mitigate these inefficiencies? George Stigler expresses the spirit of the "pragmatic" arguments for *laissez-faire*: "Any economist who wants the government to act whenever the market falls short of perfection is like a judge in a singing contest who awards the prize to the second singer merely on the basis of having heard the first."

In fact, the record of governmental economic programs is poor; even the government's performance of its basic functions has been very spotty. Most unfortunately the failures of governmental activity have been commonly attributed to the free market and have in turn given rise to additional state programs. Improper monetary management has contributed to both depressions and inflations. Minimum wage laws and urban renewal programs have reduced the employment and housing opportunities of the disadvantaged. Tariffs and patent laws have lessened competition. The failure to extend private property rights to commonly owned resources has worsened the environmental problem, as have the activities of several governmental agencies, such as the Army Corps of Engineers. These are but a few of many examples.

I can suggest several possible reasons why the results of governmental programs continue to fall far short of their objectives while at the same time the economic role of the state continues to increase. The politician who promises a rapid governmental solution to a pressing problem has an advantage in a campaign. If his program, when enacted, fails to work, it nevertheless becomes entrenched. The political process does not possess an effective negative feedback mechanism to eliminate programs that fail. Oftentimes the results of the program are not carefully examined, and its less obvious faults are not discovered. Furthermore, the lobbying system matches the powerfully represented special interests of producer and worker organizations against the weakly represented common interest of all consumers. Perhaps the most significant reason, however, is that the values of the electorate are changing. People seem to be ever more willing to sacrifice economic freedom in order to realize an apparent gain in income, security or equality.

The libertarian refuses to make this sacrifice. For him liberty is the primary political value; initiated coercion is a repugnant means to any end, even economic efficiency. Voluntary transactions in the free market represent relationships among free men. Economic power is decentralized and, most importantly, is not in the hands of the state, which has historically represented the primary threat to liberty. His views are certainly unfashionable. Those who scoff at him today may wish in years to come that they had listened to him while there was still time. □

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A New Verdict on Welfare

Ralph Harris and Arthur Seldon

FOR MORE THAN twenty-five years since the inauguration of the Butler-Beveridge regime of universal government provision, intellectual debate on the British welfare state has been inhibited by the undemonstrated objection that radical reform is "politically impossible." This obstruction did not silence academics who felt drawn to examine alternative "models" of financing welfare. Indeed, provoked by the complacency of sociologists and political commentators, independent economists associated with The Institute of Economic Affairs have, since its foundation in 1957, persisted in asking unpalatable questions. The essence of their liberal critique was whether a monolith dependent on taxation could raise standards in welfare to match the affluence generated by competition and choice in free markets.

Alternative welfare arrangements are plainly feasible. No other country has gone so far as Britain in discouraging fees, charges and insurance by supplying medical care and education without direct charge to those families who could pay. All systems fall short of perfection, but the emerging challenge for students of the welfare state was how to mingle the equity of public finance with the efficiency of private payment.

The critical flaw in Britain's National Health Service "model" is that when a service is provided "free" it embodies no mechanism to sort out priorities and ensure economy by suppliers and users. It denies kidney machines to save life but removes tattoo marks to save pride. Practice confirms what economic theory predicts: when pricing is suppressed, scarce resources are wasted and urgent needs denied. The result is mounting pressure to improve service combined with stiffening resistance from taxpayers to government expenditures.

It was two Labour Ministers for the Social Services, Mr. Douglas Houghton and Mr. Richard Crossman, who most bluntly voiced the commonsense view that people will expend more money in direct payment for better welfare than they will pay in taxes unrelated to the services they receive. Hence far from proposing that state welfare be replaced by wholly private provision that would jeopardize the minority least able to care for themselves, liberal economists have refined policies that would permit choice between public and private suppliers: minimum standards, contracting-out, tax refunds to encourage self-help, acting directly on low income, vouchers to enable everyone to pay for a choice.

As these academic innovators developed more sophisticated alternatives to the crisis-prone state system, the skepticism and cynicism of those who dismissed the liberal innovations as "politically impossible" seemed increasingly perverse. How could they be sure that spending ten billion pounds —not eight billion or twelve billion—a year on state welfare was what the public preferred? Election results prove nothing, so long as all parties offer much the same welfare *table d'hote*. Political "leaders" should have learned something from the Britain

Unfortunately...

our essay on socialism by Tom Milstein of the Young People's Socialist League was lost in the postal system — an inauspicious circumstance for any essay proposing extended government services — and will be featured in our April number. Mr. Milstein is a first-rate advocate. We are confident his essay is well worth waiting for.

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