

**Controversy:**

**Do Market Economies Allocate Resources Optimally?**

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**Introduction**

As we begin, let me offer some explanation of why I—someone who sees a market economy as a central institution within a free society—am not only willing, but eager, to oppose what is arguably the linchpin concept in free-market ideology: the claim that a market economy makes an “optimum allocation of resources.”

The first reason is purely intellectual: The concept is based on an elementary fallacy. The claim of optimum allocation has compelling rhetorical and ideological appeal, but, I believe, the theory underlying a free society should be based on the soundest possible foundation. Most supporters of free-market ideology do not see the fallacy in the claim. I do not doubt that their desire for a sound theoretical foundation is as great as my own, but we differ over what is required for a sound theory.

The second reason is functional in the context of competing ideologies. (There, the theory underlying global free trade is one of the more influential today.) I have become persuaded that the system of free-market thought as we know it—which is essentially a self-contained system that provides an answer to all possible objections—will rapidly become a liability to classical liberalism as an overall theory of a free society. The world is changing so fundamentally that it is becoming necessary to rethink virtually all aspects of social, political, and economic thought. The astonishing technology of computers, robotics, materials sciences, and biotechnology is such that the future offers the prospect of a near-utopia, while at the same time there will be a move to a near-workerless economy. Both aspects will shake societies to their core. When work is largely replaced as a source of income, a catastrophe will result in

less-developed economies, where income from work is almost the sole source of support. In the more-advanced economies, the high incomes of those who own or manage the technology and of those who possess high skills may be enough to provide auxiliary service employment for everyone else, but the level of inequality will become so great that a free society will not be able to accept it. Consequently, arising out of technology rather than from anyone's lack of market virtues, this inequality will not be the kind that free-market supporters have been willing to accept as a necessary concomitant to economic freedom.

The world is only a small fraction of the way into the new age. The "old economy" still prevails, for most practical purposes. But the vision of Jeremy Rifkin in *The End of Work* and *The Biotech Century* is real, and unfolding quickly. Those who do not begin to think in terms of it will find themselves holding positions that will not only be untenable but that may even become despised among the billions of people to whom the policies will be ill-suited.

In the following discussion, we shall analyze what is meant by the postulate that a market economy makes an optimum allocation of resources. Furthermore, we shall inquire into how this postulate serves as the linchpin to a self-contained theoretical system supporting a laissez-faire view of the market, including a brief excursus on how the concept is fallacious. Finally, before concluding, we shall describe briefly what sort of free-market theory may be called for by future conditions.

### **What the Claim of Optimum Allocation Means**

It is sometimes alleged that the claim of optimum allocation has a purely technical meaning in economics, and that it has nothing necessarily to do with a value judgment of good or best. That is not the way the concept is used, however, in the most common form of free-market, free-trade ideology. In that context, value judgment plays an essential role, and it is in that form that it is problematic.

A point is first made about consumer sovereignty as a description of how a market works. "Neither the entrepreneurs nor the farmers nor the capitalists determine what has to be produced," the great Austrian economist Ludwig von Mises wrote. "The consumers do that." "With every penny spent the consumers determine the direction of all production processes."<sup>1</sup> This is followed by a value judgment that declares the result to be good. Mises argued that "the social function of catallactic [market] competition ... is to safeguard the *best* satisfaction of consumers which they can attain under a given state of economic data." To this, he added that "to assign to everybody his *proper* place in society is the task of the consumers."<sup>2</sup> The same point was made a century ago

by Henry George: "On the whole, the ability of any industry to establish and sustain itself in a free field is the measure of its public utility, and that 'struggle for existence' which drives out unprofitable industries is the best means of determining what industries are needed under existing conditions and what are not."<sup>3</sup>

In his 1996 book published by the Foundation for Economic Education, John K. Williams argued that "profits simply show that people want [a certain thing].... Limited resources are being allocated in a people-serving, responsible way." In the same book, Garett Garrett included a quote from Adam Smith's *The Wealth of Nations* (1776): "Each individual ... generally ... neither intends to promote the public interest or knows how much he is promoting it ... [H]e intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was not part of his intention ... By pursuing his own interest he frequently promotes that of society."<sup>4</sup> Such statements show that the theory is advancing a value judgment favorable to a market economy's allocation of resources. It is not making some purely technical point.

### **How the Claim Serves As a Linchpin in Free-Market Theory**

The claim that market economies allocate resources optimally is no small argument. By adding a value judgment it transforms market analysis from a purely descriptive science into an ideology producing policy prescriptions, which, in turn, has social and political implications. The value judgment sweepingly validates the outcomes that arise from the laissez-faire market.

It is this value judgment that provides the basis for the argument that any deviation from unhampered free exchange, such as from free trade in international affairs, will "distort" the allocation of resources, introducing an "inefficiency," which produces a "sub-optimal" satisfaction of wants. That it might do so is treated as a definitive argument against the action. Nothing could better serve a theory of pure laissez-faire. It is, in effect, the key to the self-contained theoretical system, since it provides a compelling argument against anything that would deviate from unhampered exchange.

### **How the Claim of Optimum Allocation Is Fallacious**

The claim of optimum allocation is thought to follow from the argument that consumers are sovereign, since it is their demand that entrepreneurs must respond to if they are to make a profit. To avoid misunderstanding, we should differentiate this position from the view that I have long considered sound (even though it will not continue to be so under future conditions). This

viewpoint accepts the allocation of resources and of social position that comes from consumer choices but does not assert that the allocation is necessarily the best possible one. Whether it is best or not, as a classical liberal, I have supported what the market does because it allocates resources on the basis of a voluntary nexus of contractually determined exchanges. I have not favored individual liberty and the act of voluntary exchange because they produce the best allocation of resources but because this allocation is produced by a free process.

When a market theorist insists that consumer sovereignty produces an optimum allocation of resources, he is making a holistic argument. Ludwig von Mises himself argued persuasively against holistic concepts. Chapter VIII of his monumental *Human Action* contains a section with the heading "A Critique of the Holistic and Metaphysical View of Society." Mises talks about the imputation of distinct existence to "society" as a collective whole separate from the individuals who make it up:

The individual lives and acts within society. But society is nothing but the combination of individuals for cooperative effort. It exists nowhere else than in the actions of individual men. It is a delusion to search for it outside the actions of individuals. To speak of a society's autonomous and independent existence, of its life, its soul, and its actions is a metaphor which can easily lead to crass errors.<sup>5</sup>

Such a concept as society is useful in many ways, but it contains what we might call *the fallacy of wrongly imputed consciousness*, if it is used in a way that attributes consciousness and decision-making power to the abstraction as an aggregate. A society can make decisions through individuals who are its selected representatives, but the aggregate itself is not a conscious being. To talk about it in this manner is to treat it holistically, asserting that the sum is different from the parts. (Interestingly, a human being *is* a validly holistic creature, since a person *does* have consciousness and is in that way more than simply the cells that compose the person. But it is a metaphor to speak of society as having its own consciousness.) The concept of the consumer is the same. Consumers, taken as an aggregate, do not possess a consciousness; only consumers as individuals do. It is odd that Mises did not see this, since he saw it so powerfully in other aspects.

But now, we must inquire, from whence can value judgments come? The answer is: only from a conscious being. Inanimate objects such as rocks, water, clouds, and sky do not make value judgments. Nothing is good or bad, desirable or undesirable, to a rock. A divine being, in most concepts of God, *is* a consciousness, and so can decide what is good and bad, what is to be preferred

and what is not. But here we notice an essential point: that between the consciousness of a divine being and of individual people, there is no mediate consciousness. This is a point largely ignored by those who seek a metaphysical imprimatur to validate a given outlook. The source of the holistic fallacy and of all metaphysical claims is that many thinkers (in a secular age) do not want to base their value judgments on the proscriptions of a divine being but feel uncomfortable about attributing them to no more solid basis than individual minds and the preferences to which they give rise. They search for some source of values below God but above individuals. All efforts of this kind entail attributing consciousness to some metaphorical entity or process that does not possess consciousness.

Can consumers, taken holistically, make a value judgment? Are they collectively a consciousness that can decide that something is best? Of course not. Considered by itself, the aggregate does not have a mind but is the sum of countless individual consumers, each making decisions about what is best for the person in question.

From the perspective of each of these individual consumers, the person may or may not regard the allocation of resources flowing from the total economy as the best one possible. In fact, this person would almost certainly prefer an allocation that would bestow a greater amount of resources upon himself personally. Actually, in spending his own money, he has not given the slightest thought to the economy's total allocation; he has only paid attention to his own self-interest.

Next, think of each individual in his role as *philosopher* or *social observer*. Will he then think, as he looks out upon the results of the sum total of market transactions, that what he sees is entirely in accord with his philosophy, whatever it may be? Probably no one, including Mises himself, would be completely satisfied from this perspective. There are many things consumed, such as excessive alcohol, dope, pornography, or what-have-you, that hardly square with anyone's idea of what is best, even from the point of view of those engaging in the consumption (if asked in their sober moments). More profoundly, people from competing philosophies and cultures bring very different preferences to bear on what they would like to see happen.

If consumers as a metaphor cannot judge, and individuals as consumers are not judging, and individuals as philosophers find aspects over which to take issue, and we are not premising the whole optimum allocation claim on a judgment made by God, what is there to the claim that a market economy makes the best possible allocation of resources? Nothing. The most we can justifiably say is, as was said earlier, that "I will accept the allocation, with a few exceptions

as provided by law, since it is what results from a free process.” The seeming deficiency in this, and the reason the closed system of market theory has so eagerly embraced the optimum allocation argument instead, is that it has no metaphysical pretensions and, hence, less compelling polemical power.

Socialists, of course, have never accepted that the allocation of resources effected by a market economy is ideal. They consistently urge a different set of priorities. Given that difference, one would think they would have raised the criticism made here, pointing to the conceptual flaw. That they have not is probably due to the fact that most people really do not pay all that much attention to what people who differ from them are saying.

Quite apart from the assertion that the allocation within a market is optimal, a free play of supply and demand *does* serve important functional needs within a market system. It provides an ongoing adjustment to the effective demand that exists, so that neither gluts nor shortages come into being. The price mechanism serves as a guide, keeping everyone informed of the current situation. The entrepreneurial function involves people’s looking ahead to future conditions, making a profit from being ready for them at an appropriate time. The idea of a market as a self-automating mechanism that can workably substitute for a command system is conceptually elegant and lies at the heart of any overall acceptance of a market economy.

### **What Those Who Endorse the Values of a Classically Liberal Free Society Will Need to Consider for the Future**

Even if no revolutionary changes were underway to recast world conditions, supporters of a laissez-faire free market would need to restate the justifications for their social and economic model if they wish to be intellectually sound. I believe, however, that whether they wish it or not, events will force a change in their social model. This is because in a near-workerless world the market economy, as we have known it, will not work for everybody; in fact, hundreds of millions, even billions, of people will find themselves either totally displaced or standing on the margin.

My free-market friends who champion the unhampered market are accustomed to denying that this is possible. “Human wants are without limit, and if prices and wages are left free to adjust, there will always be a demand for everyone’s services.” What this fails to appreciate is the extent to which modern technology is beginning to minimize the need for human effort *in virtually every area*, including services. We are still far removed, however, from the situation of a near-workerless world, so that employment in the United States has even continued to grow, for example, in building construction. But the

technology is changing rapidly before our very eyes. Even those who do not grasp the implications need to begin the process of rethinking the set-piece theories of the past and present. A future economy based on immensely high productivity and little demand for labor essentially will pose two main questions: (1) What will be needed to nourish the innovation and high productivity? and (2) What system of distribution should be adopted to see to it that people in general obtain the benefit from that productivity?

The consensus that exists among many people in the world today that a competitive market system, combined with science, is the most dynamic engine for innovation and productivity is sound. An implication of this is that a competitive global economy will remain invaluable. This much, at least, is congenial to free-market advocates.

In a near-workerless economy, however, problems of distribution and of inequality raise issues that classical liberals have always associated with socialism. It is only with the greatest reluctance that they will embrace a non-market distribution. And yet, if they do not (in some form, at least), those who are displaced will come to hate them and all they stand for, with the probable effect that the market economy itself and the free society of which it is an integral part will both be washed away.

It would appear that there is a way to combine a market economy with a broad-based distribution of the economic product. It is time to begin thinking about a shared market economy. This is one in which there is a fully competitive market system, driving toward low-cost production on a world scale, but with each citizen of a country owning a part of the enterprises through accounts that would hold shares in "index mutual funds" (i.e., funds that would hold securities broadly representative of the market). Instead of deriving income from work, most people would receive income from the earnings of their portfolios. It would be something akin to a guaranteed annual wage, but based on how well the competitive market does. The fund holdings would be purchased by government and dispersed to people according to pre-established legal criteria. This would be a non-market distribution, made necessary by the demise of the wage system.

The aspect that would keep the world competitive market going is that individuals and firms would remain free to earn more (subject to such limits as a given culture may find necessary) than the income that would come from the distributed shares, so that the profit motive would not be missing. A business could still have \$100,000,000 in capital, for example, and could compete for profit—or perhaps fail. The only difference to the business would be that a

substantial portion of its capital would have come from money paid to it for the purchase of its shares to distribute to the citizens' accounts.

There are many sources from which the money can come for governments to purchase shares to place in citizen accounts, which could be built up over time. For instance, funds could come from all of the money now going into welfare and Social Security, and the billions of dollars the Federal Reserve's Open Market Committee creates each year as a normal part of the desired expansion of the money supply.

As a classical liberal, it hurts me to say it, but it is true: Impending technology is about to bring conditions that actually replicate much of what Socialist thought has been saying (with far less justification) for over a century, namely, that distribution amid plenty will be the central problem. The question for classical liberals will be how they can retain all of the central features of a free society while at the same time addressing the problem of distribution. (Since income-without-work will inevitably bring vast lifestyle and moral repercussions, and thus will do more than simply address the crisis of distribution, almost all aspects of social, political, and moral philosophy will need rethinking.)

### The Importance of Civil Dialogue

My long-time friend, Dr. Walter Block, supports the position that the optimum allocation of resources will occur naturally through market mechanisms. I look forward eagerly to what he will say. In the period of radical change that is almost upon us, the most important concern is not that we all agree with each other, because it is predictable that we will not, but that the discussion proceed with civility. For that to happen, the sooner the discussion begins, the better. Once vast numbers of people are hurting, civility will be a gem much to be cherished but nearly impossible to attain.

### Notes

1. Ludwig von Mises, *Human Action* (New Haven: Yale University Press, 1949), 270. Emphasis added.

2. *Ibid.*, 276, 275.

3. Henry George, *Protection or Free Trade* (New York: Robert Schalkenbach Foundation, 1966), 96.

4. Mark W. Hendrickson, ed., *The Morality of Capitalism* (Irvington-on-Hudson, N.Y.: Foundation for Economic Education, Inc., 1996), 34, 71.

5. Mises, *Human Action*, 143.