

THE FREE MARKET AND THE STANDARDS BY WHICH IT IS JUDGED

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ABSTRACT

To establish that “the free market” either succeeds or fails, one must appreciate what “the free market” is, determine what it does or would do, and compare this process or state to a validly established standard. As the galaxy of voluntary (rights-respecting) exchanges, the market is a philosophical concept. Endogenous standards are either invalid (a catallaxy has no goals of its own) or valid but unknowable (the goals of each individual can only be inferred from the very actions one is trying to judge). Exogenous standards arise either from unreasoned emotion (“Everyone should have X”) or from economists’ errors of crude utilitarianism and “pretence of knowledge.” Lacking both endogenous and exogenous standards for its outcomes, economics provides no means for judging the free market. Valid criticism or support of the free market must originate in the philosophical examination of its very nature.

INTRODUCTION⁽¹⁾

One need only turn to the pages of any newspaper for evidence that our times are plagued with a wide variety of economic problems. My purpose in this lecture is not to offer direct solutions to any of them, but to contribute indirectly by examining the process by which they are identified. In the simplest sense we can observe a state of the economy using only our senses (a man is sitting in his back yard on a weekday midafternoon), but to think about our sense data we must identify them with concepts (he is unemployed), and to label the resulting set of concepts "inadequate," "wrong," "unfair," or "inefficient" requires us to compare it to a standard against which it fails. We stand a reasonable chance of advocating beneficial policy only if we accurately identify what we observe, correctly use economic theory to trace its causes, and use the proper standard to determine that something is wrong.

Attempts to identify and solve economic problems often begin with the claim that "the market isn't working," or "the free market has failed." The practical effect of these phrases is to channel the search for solutions into government policy: taxation, subsidies, mandates, regulations, transfer payments, price restrictions, tariffs. To reach this conclusion, however, one must know what "the free market" has done, is doing, or would do, and one must compare that outcome unfavorably to a properly established standard. Errors on either score--misidentifying a state as the result of "the free market" or using an improper standard to determine failure or success--can lead to dangerous errors of economic policy.

The body of my lecture addresses these two issues. I'll consider what "the free market" is, and what its nature implies about our ability to specify what it would do. Then I'll look at various standards by which outcomes are judged to be either good or bad.

First, though, a brief digression to clear away an elementary error in the conceptual categorizing of the things we can observe. Economists are notorious for stating the obvious and making it sound erudite--at least to their own ears--so it is with some trepidation that I point out that one cannot identify the United States with "the free market." For various reasons, some well-intentioned and some not, the United States deviates substantially from a truly free market. Since governments are major players in many of the choices that individuals make, most of the economic things that we can observe are affected--for good or bad--by government policies. Certain of these outcomes might be identical to those a free market would produce, but we sure can't count on it.

A prerequisite for the accurate identification of the things we observe, therefore, is to recognize that they result from a hampered, not a truly free, market. It is this combination of freedom and controls that produces our observable unemployment, our growing and declining industries, our health care costs, our personal-computer prices, our male/female wage differentials.

Contrary to the popular slogan, neither these nor any other facts "speak for themselves." Only the intellectually lazy or untutored believe that facts or data can somehow be forced to cough up an explanation of their own causality. The markets of the United States are, in general, the freest in the world, but the hope that they permit us to simply observe what "the free market" would do is a short-cut that does not work. To understand why the data are what they are, why the observable end-state is what it is, one must trace out the causal process that produced it. And for

that, there is no way to avoid the intellectually arduous task of theorizing. To assert either that a situation is the result of free-market forces or of government restrictions, one must conceive what the free market would have done. That cannot be observed; it must be a mental construct, deduced using economic theory with an appropriate conception of what a free market is.

WHAT THE FREE MARKET IS

The word "free" is negative: it refers to the absence of something. Our car windshields are finally free of ice, the bathroom tile cleaner promises to make the task free of scrubbing, and while the ice cream isn't free of monetary cost your choice between vanilla and chocolate is. The fact that "free" is so general, properly used in so many ways, imposes an obligation: if we are to think clearly, we must be careful not to confuse its essence with non-essential implications that are unique to particular applications. In economics, for example, the question of "free entry" into an industry often arises. The economist must make clear whether he means "free of prohibitory legislation" or "free of monetary cost." I wish I could report that this distinction is always maintained.

The essence of "free" is the absence of something, and in the phrase "free market" what are absent are limitations on each individual's exercise of his natural rights to life and property. The term "free" thus refers to political liberty, nothing more and nothing less. Imagine a society in which individuals' natural rights are properly identified and enforced. It is not a logical necessity that free individuals would perceive the great benefits of specialization and exchange, but it is virtually an empirical certainty; if they do, the pattern of trades that emerges constitutes a free market.

This perception of benefit by specialization and trade is a form of entrepreneurship. Because it is individuals' noticing and acting upon opportunities for profit that not only creates new goods but drives existing markets toward equilibrium, Kirzner notes that "individual liberty... is the crucial circumstance which permits the market process to work." (Kirzner 1992, p. 52) His concern is an understanding of the role of entrepreneurship in the free market, so he emphasizes the necessary dependence of the exercise of entrepreneurship on the presence of individual liberty. Kirzner's argument that "individual liberty is not merely one element in the definition of a market economy" but rather "that ingredient in that definition upon which the success of the market process depends" [1992, p. 52] suggests that liberty derives its value from that of the market process. This is almost true. Philosophically, his entrepreneurship is the exercise of human reason, and that is the essential property of life as a human being.⁽²⁾ Liberty is a virtue because it necessary to the exercise of reason, to life as a human being; "the free market" is simply the pattern of exchanges that is likely to result from this freedom.

A full specification of the free market would require a complete understanding of individuals' rights, but their nature is the subject of continual debate among philosophers, their specific content may change over time (as, for example, the electromagnetic spectrum is discovered), and the difficulty of discerning exactly how they apply to particular "hard cases" is well known. Does a philosophically valid concept of natural rights subsume abortions, gun-toting, or your view of your neighbor's country estate? Thank goodness I don't feel obliged to tackle these matters here. Public controversies naturally focus on such marginal problems, just as in economics the taking

for granted of our many issues of agreement conveys to the public the false impression that economists agree on nothing. But each of us has a fairly accurate sense of what it means to own his shirt, coffee mug, car, and house. I would like the privilege of building on this common understanding to discuss some of what a free market would do.

Rights are philosophical concepts that must obey certain logical rules. They must be universalizable, for example, and they can't contradict each other. Rights are not granted by government, although it can enforce them or not and permit or actively participate in their violation, and the loud protesting by members of a group does not confer a right upon them. For the same reason that we cannot observe "the free market" in the United States, we cannot fully identify any actual legal system in history with the philosophically consistent concept of individual rights that would be needed to specify the free market. British common law gave rise to John Locke's famous discussion of property rights, which in turn supported the United States Constitution, but each deviates significantly from a complete and consistent system of individual rights.

As a consequence, then, not only must we theorize to understand the patterns of action that individuals choose under the system of rights that establishes the free market: we must theorize even to understand what the free market is. But note that my description of the free market has had little or nothing to do with economics. Economists are well equipped to understand how the free market works and what it does; the theorizing that tells us what it is, belongs to philosophy.

I am going to use the word "voluntary" to denote "not violating rights." There is a sense in which even the giving up of one's money to an armed robber is "voluntary," because one could have chosen to resist. But that would seem to make every non-reflexive human action voluntary and obliterate any meaning to the word. With this foundation of what the free market is--the pattern of exchanges that respect individuals' rights, or, in other words, the galaxy of voluntary exchanges--let us explore what the free market does.

WHAT THE FREE MARKET DOES

The essence of the "free" in the phrase "free market" is that no individuals' rights are violated. Any economist should be able to explain that this is a necessary but not sufficient condition for a free-market exchange: also required is the mutual perception of benefit. The buyer will buy only if he benefits, and the seller will sell only if he does. Although neither has to care that the other benefits, every voluntary exchange must be mutually beneficial. That, in turn, implies that the price at which they trade must exceed the seller's supply price, but fall short of the buyer's demand price: high enough for the seller to benefit, low enough for the buyer to benefit.

Each party has the right to evaluate the traded goods: the buyer to establish the highest price he would pay, the seller the lowest that he would benefit by accepting. Neither has an obligation to trade to his own detriment; if party A is unwilling or unable to offer terms that party B perceives as beneficial, party B's refusal to trade violates none of A's rights. Furthermore, since valuations are subjective judgments developed from the feelings and expectations of each individual trader, no third party can quarrel with either A's demand price or B's supply price. The quest for a "just price" was abandoned by most respectable economists centuries ago. If B refuses to sell for less than \$75, some third party (C) may suspect that he's engaging in bargaining

strategy and that he would really benefit by selling at a price as low as \$50. But C cannot truly know this without the ability to read B's mind, a skill associated perhaps with television psychics but not with economists. A properly subjective theory of value requires us to infer relative values from demonstrated action, and--whatever we may think about it--if he says \$75 and refuses to sell at \$74, his action demonstrates that he would benefit only with at least \$75.

This is a basic issue, so here's an example. Imagine a neighborhood kid offering to mow your lawn for \$20. You decline, because your lawn isn't all that big, you don't really mind mowing it anyway, and you're not rich, but you counteroffer \$15, which he declines. As he begins to walk away, third party C appears, declares that \$20 is a fair price, and forces you to hire him at that price. Or perhaps C declares that \$15 is fair and forces him to work for that, or that \$17.50 is fair and applies force to you both. In either case, C has violated rights--yours, the kid's, or both--and forced an involuntary exchange that would not have occurred on a free market.

An unfortunate terminological confusion has arisen, and I think it's because economists try a little too hard to stay away from philosophy. An exchange requires two parties, so it is voluntary only if each consents. But what do we call the outcome if party A wants the trade and party B doesn't? The trade won't happen, of course, and that's the outcome preferred by party B, but to A it may seem involuntarily forced upon him. Is a person's unemployment involuntary just because he wants a job and can't find one, or should we identify it as voluntary because no employer wishes to hire him? Keynes called it involuntary because he wanted to make the market system look as bad as possible; modern-day new-classical economists call it voluntary because they seem to think the unemployed consciously prefer leisure. I also consider it voluntary, though not for their absurd reason. My own conclusion is that because a voluntary exchange must benefit each party, if neither or only one would benefit it is the lack of exchange which is voluntary.⁽³⁾

Whatever we decide about this terminology, it is vital to appreciate that the simple fact that a person cannot afford something does not mean that he is the victim of force. If a person wants something that only another can provide, it is his obligation to make an offer that the provider considers beneficial. If he doesn't, then he goes without the good and none of his rights is violated.

The guiding principle that the free market consists simply of the galaxy of voluntary (that is, rights-respecting) exchanges has several other interesting implications. Consider first the inevitability, in modern society, of one's action having effects on others. Perhaps the kid has tentatively agreed to mow your lawn for \$12--nothing definite yet--when another neighbor offers him \$18, he accepts, and turns your offer down. The neighbor's offer has made you worse off, but since none of your rights was violated, you're no worse off than you were entitled to be or had a right to be.

These third-party effects, or externalities, are contrary to the free market if and only if they violate individuals' rights. Some do, of course, like some forms of pollution, and the actions that generate them would be proscribed. But many actions with external effects violate no rights, like the neighbor's superior offer to the mower of lawns, or my choosing to wear a tie that you don't like. An external effect violates the free market not if it makes some people worse off, but only if they have a right to its absence; the denial of an external effect confounds the market not if it would make some people better off, but only if they have a right to its presence. Since economists define externalities (costs or benefits) by their effects on others' welfare, not whether they violate rights, it follows that the presence of externalities is fully consistent with the existence of a free market.

Among the most fascinating implications of the voluntary-exchange conception of the free market are those regarding competition. In its general sense, competition is a natural and probably inevitable consequence of scarcity, so it is found in some form under any and all legal systems. To appreciate the relationship between competition and the free market, consider a simple example. There is one potential buyer of one widget, with a demand price of \$50, confronting one potential seller of one widget whose supply price is \$30. Mutually beneficial exchange can occur at any price between these; suppose that bargaining establishes it at \$43. If, however, we were to introduce into our example a second potential seller whose supply price is \$32, the two hopeful sellers would compete, each undercutting the other until exchange takes place at a price between \$30 and \$32.

The buyer has clearly benefitted from this competition between sellers. But that does not imply that the buyer has a right to it. Indeed, the very idea of such a "right" is absurd: it would impose upon others the positive obligation to produce and attempt to sell widgets even if they preferred other occupations. The competitive bidding and the purchase of the widget at, say, \$31 is a free-market exchange, but only because each competitor voluntarily chose to participate.

Now using this two-seller case as our starting point, suppose the second supplier decides, instead, to go fishing. His action takes us back to our bilateral monopoly, single seller and single buyer, and the price of \$43. The fisherman's choice would delight the original seller, but it would harm the buyer to the tune of a \$12 higher price caused by the absence of competition. Now, does the original seller's benefit impose upon the second seller the obligation to go fishing? Or does the harm that his choice brings to the buyer impose upon him the obligation not to go fishing? I hope this sounds as ridiculous to you as it does to me. The first seller is not entitled to the absence of competition, and the buyer is not entitled to the presence of it. That potential second seller has the right to either compete or fish, and neither other sellers nor potential buyers have a right to either of his choices.

Since it is inconceivable, in a society of individual liberty, that any persons could be forced to compete in a particular way contrary to their voluntary choices, there is no guarantee that particular markets might not be monopolistic, in the literal sense of "single seller." The simple fact that there is only one producer of a particular product, and even that he may be able to price far above cost, does not itself imply any violation of "free market" principles. If a clever entrepreneur, through a process of strictly voluntary exchange, establishes himself as the sole supplier of a highly valued good, it is fully his right to charge whatever he wishes for it. His customers and potential customers have no right to have the good provided at a particular price, or even to be provided with it at all. Economists can explain that he would select not the highest conceivable price, but that which equates marginal revenue to marginal cost, and that it is inversely related to the elasticity of demand. The more desperately valued the good is, and the fewer its substitutes, the higher that price is likely to be. But remember: the good is the property of its creator and owner, and it is his right to establish its supply price--and, indeed, even to decide whether to sell the good at all. Customers would, of course, be better off with a larger quantity and lower price, but they cannot properly claim this behavior by the seller as their right.

As an empirical but nonessential fact, these circumstances are unlikely to persist unless the single producer owns a uniquely productive asset. Other individuals will perceive the creative entrepreneur's success, and imitate it as closely as patent law and the availability of resources permits. This competition chops price rapidly down toward cost and provides the consumers with great benefit. But the competition arises if and only if some individuals perceive a profit

opportunity and, in their own self-interest, choose to act on it. Competition is therefore not an essential property, a defining characteristic, of "the free market." I first noticed this insight in a 1972 essay by Ayn Rand, who observed that in the phrase "competitive capitalism," "'competitive' is a definition by nonessentials..." (Rand 1972, p. 131) A properly conceived and fully enforced system of individual rights establishes the legal framework in which persons may compete by offering consumers a better deal if they choose to, but it does not and can not require them to do so. The good's consumers cannot claim, as their right, this pattern of actions by others.

A controversial implication is that collusion among either sellers or buyers constitutes no violation of any individuals' rights and is therefore entirely consistent with "the free market." Potential customers have no right to be provided with a good by several or many competing sellers; indeed, they have no right to be provided with the good at all. If a number of sellers agree to offer their goods only on common terms, such as price-fixing, that agreement probably will make the consumer worse off than if they had actively competed among themselves, but their action denies to the consumer nothing to which he was entitled, to which he had a right. Labor unions, buyers' cooperatives, explicit price-fixing by a cartel of widget-sellers or major airlines... none of these is at all inconsistent with the full operation of the free market. Unfortunately the history of business and labor are replete with cases in which violence has been used to coerce membership, to quell competition from non-members, or to force terms of a contract. Such actions are, of course, contrary to the requirements of the free market--not because they are collusive, but because they are coercive--that is, forceful violations of individuals' rights.

THE STANDARDS BY WHICH THE MARKET IS JUDGED

It is now time to address the question of failure or success. I have already cautioned against identifying the free market with the United States; since it cannot be observed, its outcomes must be developed by a process of reasoning, using economic theory, from the defining property of the free market. But there is a further, and truly basic, question: By what standard can the performance of the market properly be judged?

Potential standards may be classified as endogenous, arising from within the market itself, or exogenous, devised by some criterion that is external to the market system. An analogy might help to explain my meaning. When I was an addicted runner, I'd tackle my ten-mile loop even when I was feeling terrible, and I judged my success by a such continual and delicate metering of condition that I was able to hold a steady pace and arrive home in just the proper state of fatigue. That's an endogenous standard; only I could know how I felt and how close I came to my limit. If a neighbor had compared my time to yesterday's, or even worse to Bill Rodgers's, he would have judged my run a failure by these exogenous standards.⁽⁴⁾

Endogenous Standards: Desirable but Unattainable

For various reasons the endogenous standard is superior--a person's action is judged according to what he himself is trying to achieve. Whether he attains goals by which others measure his performance may have important implications, but he may not be interested in or trying to achieve them, and may not even be aware of them. I'll examine the important class of exogenous

standards shortly, but let's first consider the idea of an endogenous standard of market success or failure.

The free market is the galaxy of voluntary exchanges, interrelated in complex patterns that are continually changing in response to consumer demands and entrepreneurship. Viewed with special goggles from some distance out in space the pattern might appear as a living being, always in motion on the molecular level and usually moving about on a larger scale. The German Historicists viewed society as such an organic being, growing and changing according to laws distinct from those governing the individual. This is a really interesting analogy, but it is just an analogy, and to treat society or its pattern of economic exchanges as if it had a life of its own, as if it were in essence a super-individual, impedes understanding of what markets actually accomplish. This is why the great Austrian economist and Nobel Laureate Friedrich Hayek wrote often about the distinction between economy and catallaxy.⁽⁵⁾

The term economy, rooted in the Greek for "household management," refers to goal-directed actions, chosen by one mind with particular plans or ends to be achieved. The individual consumer choosing between a second box of Cheerios and a first box of Granola according to his own tastes, or a business production manager deciding whether to substitute a little titanium for a lot of iron, exemplify economy. There is one plan, one goal, one objective function, and actions are chosen by consulting it.

Any market exchange, however, constitutes an interaction between individuals each of whom has his own goals. Each party views the other as a means to his own ends, but neither knows nor has any particular reason to care about the specific goals that the other is seeking. The system of markets is the catallaxy, and the science of exchanges is called catallactics. (This term, I think also from the Greek, was used by Richard Whately in 1831, and by John Stuart Mill.) Catallactics differs from economics (narrowly viewed as the study of individual decisionmaking) in that the results of market interactions cannot legitimately be considered the deliberate choice of any one planning agent. At this level the Historicists' view of society as an organic whole breaks down, and we must recognize the superiority of the British Classical School. Adam Smith never considered his famous "invisible hand" to be more than metaphor, and the strong message of his best-known work was that "the wealth of nations" grew most rapidly when, within a legal system guided by Lockean individual property rights, "the butcher, the brewer, and the baker"--and every other individual--were free to pursue their own plans.

The significance of this unplanned nature of the catallaxy--I use the term "unplanned" advisedly, because there is obviously a lot of planning going on at the individual level--was widely recognized in early 18th-century Britain. Bernard Mandeville set forth the idea in 1723, and it was a dominant feature of Hume's political philosophy.⁽⁶⁾ Perhaps its most terse expression is the 1767 phrase of the Scottish political philosopher Adam Ferguson: "the result of human action, but not the execution of any human design."⁽⁷⁾

Although patterns of economic activity are obviously determined somehow in our society, it is imprudent to suggest that "society chooses them." This is why I disapprove of the Principles textbooks' habit of introducing the student to economics with a social production possibilities curve that illustrates "society's choice" between guns and butter. The fact that Adam Smith knew better, more than two centuries ago, illustrates that--in the social sciences, at least--it is actually possible for knowledge to be lost.

But the application of the concepts of success or failure to the catallaxy commits precisely this error. Put simply, the catallaxy--the free market--is not attempting to achieve anything. It has no

goals, no purpose of its own, no objective function that "it" maximizes subject to constraints.⁽⁸⁾ The very concepts of success or failure presuppose goal-directed action, and while that is not only appropriate but essential for the individual, it does not apply to the catallaxy.

This is the fundamental reason that I consider judgments that "the market fails" or that "the market succeeds" to be dangerously misleading. They deny the distinction between the goal-directed behavior of economy and the unplanned outcomes of the catallaxy. It is a small step from the error that the catallactic "results of human action" can be treated as if they were the economic "execution of human design," to the proposition that deliberate design should be imposed on them.

The quest for the simplest endogenous standard for judging the market, namely the goal that the free market is attempting to achieve, fails because there is no such goal. A more sophisticated endogenous standard is just the set of goals of the individual market participants themselves. Perhaps the standard for market success should be whether the pattern of individuals' voluntary actions best achieves their separate goals. But to presume that we could know what those goals are commits what Hayek (1974) called "the pretence of knowledge," requiring the mind-reading I referred to earlier. If we try to escape this problem by inferring the individuals' goals from their observable free-market choices, we're working in a circle, using the free market as the standard of itself.

Although an endogenous standard would be best, it is invalid to attribute a goal to the market itself and we have no way of knowing--other than inference from what we're trying to judge--the goals of the separate individuals. We cannot develop a standard for judging market outcomes from the nature of the market itself, so any standard that is used to establish its success or failure is necessarily some presumption of the judge: some result that the critic believes other individuals' voluntary actions should attain. To discuss those, we must turn our search to exogenous standards, imposed upon market outcomes from the outside.

Exogenous Standards: Attainable but Undesirable

If the catallaxy is not properly considered a person, perhaps the proper analogy is an inanimate object like a car. It too has no goal or purpose of its own, yet we impose upon it a standard by which we judge its success. Why should any problem arise with so judging the catallaxy?

But the catallaxy is like neither an individual human being nor an inanimate object such as a rock or car. As--again--Hayek has most clearly discussed (see, for example, Hayek 1973 pp. 20-1), it is a third class of entity, an evolved social institution neither "natural" nor "artificial"--that is, neither found in nature nor deliberately designed and created by man. Like the car, the catallaxy has no goals of its own, but unlike the component parts of the car--camshafts and pistons--which also have no goals of their own, the catallaxy is comprised of individual human beings each of whom engages in purposeful action. Adam Smith, in his 1759 Theory of Moral Sentiments, had a few words for those who treat this distinction lightly:

The man of system...is apt to be very wise in his own conceit... He... seems to imagine that he can arrange the different members of a great society with as much ease as the hand arranges the different pieces upon a chess-board; he does not consider that the pieces upon the chess-board have no other principle of motion besides that which the hand impresses upon them; but that, in the great chess-board of human society, every single piece has a principle of motion of its

own, altogether different from that which the legislature might choose to impress upon it. If those two principles coincide and act in the same direction, the game of human society will go on easily and harmoniously... If they are opposite or different, the game will go on miserably, and the society must be at all times in the highest degree of disorder. [pp. 380-1]

There are a great many such "men of system" in today's society, prepared to devise and impose their own standards by which to judge whether other individuals should be permitted certain freedoms. I separate these exogenously imposed standards into two categories: those that appear to have some economic reasoning behind them, and those with little or no such pretense. I call the latter the "feel good" standard, because it seems often to arise from unreasoned emotions.

Anyone who needs an example of the "feel good" standard can turn on any news show or read any newspaper. A medical student who recently introduced Mrs. Clinton at Johns Hopkins University mentioned that her own home town, population 12,000, had only three doctors, and identified this as a "maldistribution of health care resources." The only standard that I could discern for calling it "maldistribution" was that she thought it would be nice if there were more. For another medically-related example, it is of course tragic for a person to have an incurable illness, and it would be nice if someone else would voluntarily pay for his treatment. But if his only skill is pushing boxes on the loading dock, would anyone be surprised if he could locate no employer who would voluntarily purchase those services at a price of the minimum wage plus his future medical expenses?

The reason that such outcomes would probably be found even in a truly free market is that a voluntary exchange must make each party better off. If only one of the parties would benefit, the exchange will not occur and it is that which is voluntary. But by our feel-good standard, that somehow there should be fewer plastic surgeons in Beverly Hills and more general practitioners in Mississippi, or that individuals with absolutely certain sky-high medical costs should have no trouble getting insurance, "the free market has failed."

There are distressingly many well-educated individuals, including policy-makers, who seem prepared to employ this standard of their own feelings to justify violence to others' lives and property, using the power of the state to redirect it toward their own goals. Their own emotional stake may be so great, and their respect for others' lives and property so small, that they see nothing whatsoever wrong with using their own emotions and personal desires as the standard against which to judge others' rights to voluntary exchange. Any of us may find ourselves in such a position, regarding ones that we love, but the future of the free society requires that cooler heads prevail.

Perhaps I should take these feel-good exogenous standards more seriously, because it seems part of the anti-intellectual spirit of our age that feelings are tools of cognition, at least as trustworthy as reason, and that individual liberty is an archaic superstition. But less easy to dismiss, and surely more interesting to the scientific economist, are the exogenous standards that seem to have the support of economic theory.

Adam Smith's The Wealth of Nations explained how individuals' self-interested actions resulted in a spontaneous order that was the conscious goal of no one of them. But the very demonstration that a society of liberty promoted economic growth may have suggested to some that this was its justification. If property rights are justified by their contribution to measurable economic growth, legislation violating them could be justified by a demonstration of greater growth. In the early 19th century economists' attention turned partly to welfare, but that wasn't

much of an improvement because Bentham's utilitarianism suggested that welfare or utility could be measured and calculated just like physical production.

Either variable--physical output like real Gross Domestic Product or some notion of social welfare--seemed to provide economists with the standard they sought for judging the performance of the free market. All they had to do was to determine whether the system of philosophically proper individual rights would maximize real growth or social utility. If not, the free market could be considered as having "failed" and intervention was justified.

Several related trends converged to deceive economists that they were capable of such judgments. First was utilitarianism itself, an outgrowth of the empiricism of British philosophy, which suggested that the individual's utility could be measured and compared with that of others. Sums of money were used as objective proxies for utility as early as the 1840s, and continue to be today. Second, and opening the field for crude utilitarianism, was the failure of post-Lockean philosophers to develop a thorough and sound support for individual rights. This left the early capitalism of the Industrial Revolution with no coherent philosophical base, to be reluctantly tolerated only for its spectacular contribution to wealth, and has left the free market with an undeserved moral taint ever since. Third was the methodological error that Hayek has called scientism, the conviction that whatever methods of investigation were proven successful in the physical sciences must, therefore, be employed in the social sciences. Among its implications is a fascination with mathematical symbolism, in which economic variables are squeezed into continuous and differentiable functions--even if they aren't, indeed even if they are ordinal rather than cardinal.

The peculiar utilitarian standards which economists have extracted from this philosophical mish-mash find the free market coming up short on two general counts: it contains less than infinite competition, and people don't always consider the effects of their actions on everyone else.

This fascination with mathematical symbolism seems largely responsible for the rise of the concept of "perfect competition," a state with so many identical suppliers of a product that price is driven down to cost and the scope for bargaining is zero. Generally lacking a philosophical commitment to rights and buying into the utilitarian goal of maximizing social utility, economists in many respects have adopted as the standard by which the free market succeeds or fails the outcomes which would be produced under "perfect competition."

The result has been a fascinating confluence of errors. The more extreme identify any deviation of real-world behavior from the perfectly competitive model as "market failure." Asymmetric information, product differentiation, non-price competition... this list goes on and on. The most prevalent and important error, however, is that of the "welfare-loss triangle" that supposedly plagues any market that lacks perfect price discrimination and perfect competition. A monopolist would produce less and charge more than if the product were produced in a perfectly competitive market, making the consumers worse off. First, though, it's "worse off" compared to perfect competition, and that is not a valid standard. Second, the consumers are worse off, but the monopolist is better off. How can we conclude that welfare is lost? The economists' graphs really show that the sum of consumers' and producers' surplus is reduced, and to identify lost surplus with lost welfare one must objectify welfare by identifying it with sums of money, committing the utilitarian error of interpersonal utility comparison. Finally, as my examination of the nature of the free market noted, the simple fact that the consumers preferred the previous state does not establish their right to it; in fact, the monopolist--if his position was achieved and is maintained

by voluntary exchange--does have the right to assert the higher price and lower quantity.

It is the second general class of supposed market failures that sharply clarifies the utilitarian basis of modern economic thinking. This is the existence of externalities. If an action has net beneficial effects on society but the actor considers only the benefits to himself, he takes too little of the action. Of course he takes exactly that amount that best achieves his own goals, but the utilitarian standard is social welfare. When others--people he doesn't even know--are affected positively or negatively by his action, the choice that maximizes his own utility will be "too little" or "too much" for maximum social welfare. The free market is defined by rights, not by welfare, so unless those affected strangers have rights to the presence or absence of the action, the galaxy of voluntary exchanges will probably fail to maximize social welfare.

The ethical implication that each individual must devote himself to the collective, of which he is a part but of no greater significance than total strangers, seems to have escaped most economists, but their own reasoning implies tacit acceptance. This is the ethic of socialism, and no one who has thought about and values liberty could grant it. Even if we did, though, there remains the problem of knowledge. When Joe buys a car battery for \$60, he demonstrates--for all to see--that he values the battery more than he values the best other use of his \$60. But external effects, benefits or costs, involve no action or choice by the affected parties, no observable demonstration of the effects' significance. Evaluating them, and sometimes even determining whether they are benefits or harms, requires the economist-cum-utilitarian to be able to read their minds. Many economists, drawing their social benefit and cost curves, seem prepared to pretend this talent; none of them can actually pull it off.

Both of these two general standards--competition and externalities--commit what Hayek's Nobel Lecture of 1974 called "the pretense of knowledge": economists' pretense that they can know what patterns of economic activity would maximize social welfare. But economists cannot read individuals' minds, and the only clear knowledge anyone can attain about others' values must be derived from the observation of their voluntarily chosen actions. This implies that economists have no way to construct a valid social-utility-maximizing standard against which to compare the outcomes of the free market.

Although neither endogenous nor exogenous standards are legitimate for judging the outcomes of the free market, the very nature of the relationship between voluntary exchange and utility does permit us to say something. A voluntary exchange benefits both parties, and does not violate the rights of anyone else. Although there may be external welfare effects, they are irrelevant to the free market. As a consequence, because the free market maximizes the scope for voluntary exchanges it can be said to maximize social utility; not in the false sense of maximizing an aggregate, but by offering each person the greatest scope for voluntary actions which maximize his own utility. If we wish to conclude that "the market succeeds," we should note that any free-market outcome would have to be considered success, and that this success is inherent in the very nature of the free market. Anything is successful at conforming to its own nature.

CONCLUSION

Since it is nearly time for me to conclude this lecture, I would like to summarize my key points. "The free market" is the galaxy of voluntary exchanges, nothing more and nothing less. Economic theory is necessary to understand it, but its essence is philosophical, to be found in the

nature of individual rights. Since the catallaxy itself has no goal and those of its component individuals cannot be known, an endogenous standard is not feasible; as for exogenous standards, they seem to be either unconvincingly grounded in emotion--like "everybody should have medical insurance"--or to have the imprimatur of sophisticated economic theory but to be grounded in error.

Obviously I have been a little harsh with my own subject, but I would not wish to leave the wrong impression. The problem is only with certain of its nonessentials: a lingering attachment to crude utilitarianism, and the over-reliance on physical-science methods, especially mathematics. Economic theory, which I define as the science of choice, is essential to an understanding of how markets--free or not--function, to appreciating the complex interrelations among costs and prices, interest rates and asset values, land rents and entrepreneurial profits. Despite its beauty and power, it has its limitations: it provides no standard by which we can properly judge freedom.

Since both the endogenous and the exogenous standards are either invalid or unknowable, there really is no valid standard by which the performance of the free market can be judged. If one accepts the philosophical premises that make the market what it is, one cannot judge what it does. I have been fairly nonspecific about the nature of the rights that define the free market, allowing for the possibility of change over time, with technology or with population density.

But if one could develop a reasoned argument for the invalidity of any system of rights that could reasonably be identified with "free markets," then they could be said to have failed--not because of what they do, but because of what they are. (This, you might note, amounts to putting some logic and reason behind what I called the "feel good" standard.) Perhaps individuals have no legitimate right to own property, or perhaps trades outside certain logically determinable price ranges violate some kind of right of which we are currently unaware. (In other words, maybe there really is a "just price.") Perhaps one individual's need really does impose a valid, though unchosen, moral claim on the life and property of a total stranger.

To establish that the market fails because of what it is, rather than what it does, the critic must develop a logical, reasoned case that the proper standard for interpersonal conduct is a system of rights or obligations that is radically inconsistent with any set of individual rights that could reasonably be identified with the free market. Frankly, I don't think it can be done.

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NOTES

1. This paper, before modest revision, was presented as a University Lecture at Towson State University on March 24, 1994. Its audience was the University community at large, not specifically economists. Because it addresses issues about which he has long been concerned, the paper is humbly offered to this volume in honor of my mentor and friend Israel M. Kirzner.
2. This identification of reason with life that is distinctively human is a keystone of Ayn Rand's philosophy. See, for example, the early pages of Galt's speech in Atlas Shrugged (Rand 1957, pp. 1012-1018).
3. See Nozick (1974, pp. 262-5) on "Voluntary Exchange."
4. Rodgers was a top marathoner during the late 1970s and early 1980s.
5. See, especially, Hayek 1976, pp. 107-132.
6. On Mandeville, see Hayek 1966; on Hume, see Hayek 1963, Hume 1970.
7. This phrase is quoted from Hayek 1967b, p. 96.

8. "To transfer this important concept of individual allocative choice to society as a whole is, at best, to engage in metaphor. Society, as such, neither possesses goals of its own nor deliberately engages in allocative choice." Kirzner 1992, p. 183.