Markets: The Right and The Responsibility To Compete

" . . . competition is important as a process of exploration in which prospectors search for unused opportunities that, when discovered, can also be used by others. . . . "

F.A. Hayek (1948).

"The modern business economy has as its basis human freedom exercised in the economic field. . . . We acknowledge the legitimate role of a profit, this means that the productive factors have been properly employed and corresponding human needs have been duly satisfied."

Pope John Paul II, *Centesimus annus*, 1991.

Owners normally use their private property rights in combination with the property and labour of others. Property rights can be combined (a) within an organisation, i.e. in a more or less durable arrangement to pursue a shared purpose under some form of leadership and direction, and (b) through markets. The purpose of this chapter is to outline how individual markets, as well as entire, interdependent systems of markets work. How property in capital, one's labour and knowledge is used within organisations, such as business firms, is the subject of organisation science. Although this is beyond the framework of the present essay, we note in passing that coordination by market and by organisation are often interchangeable. For example, some firms produce an input in-house and others subcontract the same input in the market, and your mother may have done the cooking in-house whereas you subcontract it to fast-food outlets.

The Market Process

A market is a meeting place. Intending buyers and sellers, each with limited knowledge, seek and find information about what uses of their property might be mutually advantageous to them. Intending buyers (on the demand side) and sellers (on the supply side) are engaged in ongoing, open-ended processes of knowledge search and exchange, in which new wants are explored and discovered, new resources and resource uses are uncovered

and tested, and unwanted resource uses, which are signalled by low profits or even losses, are discontinued. What happens in markets is therefore at the heart of the economic problem: discovering and satisfying changing wants with scarce resources and discovering new resources, in a process that has been called "catallaxy"[1] (Hayek, 1945, 1948, 1978; Mises, 1949, see Catallaxy in the "Glossary"). The market is a dynamic phenomenon—a "discovery procedure", as Hayek used to call it. Markets fulfil their function in tackling the economic problem well if they

- facilitate entrepreneurial exploration and discovery,
- spread useful knowledge around,
- bring about spontaneous correction of errors, and
- control concentration of economic power (monopoly).

All four functions add to economic growth.

How effective market competition is in advancing knowledge and living standards depends on the specific rules that guide the behaviour of market participants. Some rule sets do this obviously better than others. What matters here is not only what happens in one specific market, such as the local vegetable market in Delhi, but the entire system of interdependent markets, the incredibly complex, evolving network of interrelated processes which constitute the web of economic life.

The Costs of Using Property

How is useful knowledge discovered and tested in markets? To answer this question we have to acknowledge first that this is not a cost-free process. Indeed, market transactions—searching for new products and business partners, negotiating deals and monitoring them—absorb considerable resources. We have already noted that, in a modern economy with an intricate division of labour and specialist knowledge, about half of the economic effort is used to find knowledge and cope with other costs, of coordinating business and production, a fact that may possibly amaze the reader. Much work effort in firms is dedicated to organising resources and coordinating the activities of collaborators and outside contract partners (workers, lenders, borrowers, customers, suppliers of inputs, R&D and other such activities). Entire service industries have sprung up to expedite such coordination (trade, communications, finance, advisory services, etc.). In mature economies, the share of transaction services in GDP has probably doubled since the start of the 20th century, and it is rising rapidly in the developing countries. This is an inevitable consequence of the ever-more sophisticated division of labour

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[1] The term derives from the Greek word *katallatein*, "to exchange and thereby to turn strangers into friends". One can almost visualise merchants landing in a port, talking, trucking and bartering to obtain useful market information.

and knowledge and a natural concomitant of the process of economic growth.

The coordination costs in markets (which we call "transaction costs") fall into the following categories:

- *Exploration and information costs*: finding out what one wants and is able to aspire to, what sources of supply there are, as well as where, at what prices and qualities goods and services may be available, whether potential contract partners are reliable and similar information, as well as where and how to sell goods and services;
- *contract costs*: negotiating and concluding a contract takes time and resources, not least because one faces inevitable uncertainty and has to guard against eventualities and contingencies, and
- *monitoring, adjudication and enforcement costs*: keeping oneself informed whether the contract is being fulfilled as agreed; if not, settling misunderstandings and conflicts (adjudication) and enforcing contract compliance, possibly with the help of a third party, such as an arbitrator, the judiciary, the police and jailers.

We have already noted in Chapter 2 that the costs of exploring new concepts and finding information before one can even contemplate a deal in the market have a rather insidious quality. Before one has incurred sufficient exploration costs, one cannot know or evaluate whether or not it is worth one's while to incur these costs (Streit-Wegner, 1992). There is simply no way of assessing rationally whether the exploration effort will yield a return in terms of useful knowledge before the exploration has been done and the costs have been expended! It takes true entrepreneurial flair and a taste for risk taking to engage in this essential part of market activity. Many people feel intensely uncomfortable with the risks involved, in particular when knowledge search involves sizeable expenses. The general institutions surrounding markets therefore must inspire a degree of confidence. Exploration costs are the major reason why there are limits to finding new knowledge, why the division of labour has limits, and why scarcity persists.

The general climate of confidence, which makes it easier for people to embark on exploring new knowledge of (yet uncertain) value, is largely determined by a society's institutions, their quality, content and reliability. Where pioneers, who wish to explore a new area, cannot trust that they will be able to keep the benefits of new knowledge, they will desist from incurring the costs of new ventures. And where political favouritism offers easy profits, entrepreneurs concentrate on lobbying rather than searching for productive knowledge and cost saving. It is therefore essential to provide trustworthy institutions that guarantee pioneers rewards for finding useful knowledge and for restraining political favouritism. In other words, the institutions must guarantee universal property rights. Failure to do so is the main reason why different societies vary greatly in their innovative dynamism and why economic growth rates differ.

One good example to show that this is a realistic way of looking at knowledge exploration and risk-taking is the oil industry: oil companies are on the alert for new information from geological surveys and similar sources, drawing on their own knowledge and flair, until they judge that they know enough to sink a hole in the ground. This is a costly exercise. Millions of dollars may have to be spent on successive drillings until the oil explorer knows whether he has struck a bonanza—or found nothing. Entrepreneurial guesses drive prospectors to incur enormous fixed costs for uncertain returns. Once a petroleum deposit has been proven, the past exploration costs are genuine sunk costs—pardon the pun! They have absolutely no bearing on the decision whether to develop oil well to commence production. This is solely determined by expected future costs and sales receipts.

The Spirit of Enterprise

Entrepreneurship is needed to find new opportunities in all walks of life. Thus, the real-estate developer may see an opportunity in a new location; the industrialist may respond to new technical opportunities and explore the commercial feasibility (profitability) of a new product or process; the young woman or man may be alert to the need for new skills and incur high costs in acquiring these skills; and the consumer may be alert to new products and be prepared to explore whether or not they will be as useful as expected. Lively, innovative markets require not only entrepreneurship on the supply-side, but also alert consumers on the demand side. In short, a dynamic market economy is a continuous invitation to buyers and sellers to incur knowledge-exploration costs for uncertain gains. The more market participants act in an entrepreneurial spirit, the more useful knowledge is likely to be discovered and used to advance living standards and life opportunities.

To be precise, entrepreneurship implies two qualities:

a) an alertness to scan the horizon for new opportunities, using one's own knowledge and inspiration to unearth new opportunities, sometimes turning liabilities into assets and often applying a creative mentality to imagine what no one else had visualised before (Kirzner, 1984, 1997; Gilder, 1984; Blandy, Kasper *et al.*, 1985; Berger, 1987), and

b) the willingness to incur the necessary transaction costs by pioneering new activities and products, which is always a risky business (Streit-Wegner, 1992; Streit-Kasper, 1998).

If the entrepreneur has guessed correctly, he or she will reap a profit. If not, a loss will be incurred; the business may even go bankrupt. Profit has the important social function of mobilising and rewarding entrepreneurial creativity and the risk-taking of costly knowledge search. A profit therefore is not the result of mere luck, as people who assume perfect knowledge tend to believe. Although luck does play a role in profitability, it is the result of constant alertness and preparedness to incur the transaction costs of

knowledge exploration. When people are poor, profits are highly taxed, invoke social opprobrium or are poorly protected by prevailing institutions, there will be less "creative curiosity" and less innovation (Maley *et al.*, 1983). Growth and job creation will be correspondingly slow.

How do enterprising market participants handle those insidious knowledge exploration costs? Typically, some follow their curiosity and their "animal instincts" and do not worry about the cost of "the hunt for information", at least for a while. Others will be guided by experience in deciding how much of their property to invest in search costs. Once entrepreneurs have a feeling that they are sufficiently informed, they will make a decision to buy or sell (Streit-Wegner, 1992). With hindsight, they may find either that they have spent too little or too much on the search. In the process, errors may have to be corrected and aspirations may have to be adjusted (bounded rationality). New information searches will be started in the never-ending process of knowledge-generating market activity, an open-ended, evolutionary process of discovery of new wants and new resources.

An example of what is involved is the Xerox company, a small office-products supplier at the time. After they discovered in the technical literature about bonding carbon particles to paper with the help of light, they had to incur enormous information and transaction costs until the first photocopier could be marketed. Establishing its technical feasibility (does it work?) was the lesser part of their problem. The commercial feasibility test (does it make a profit?) required much entrepreneurial knowledge search:

- From what raw materials and suppliers to get the inputs?
- How to coordinate suppliers?
- How to convince sceptical bankers to finance the effort?
- Where to build the factory?
- How to train all necessary skills?
- How to find customers? There was no ready-made market for photocopiers at the time!
- How to distribute the machines and where? How to handle possible breakdowns in this, as yet untested, new technology?

Such practical information problems require an entrepreneurial attitude and the backing by people with property to shoulder the exploration costs.

In a competitive system, people have a profit incentive to search for and test useful knowledge that their fellows welcome. Market competition therefore creates conditions in which people are most likely to learn how to improve their lot.

Finally, free markets have another important social role. Private property rights and autonomy in free markets not only support prosperity and economic freedom, but also enable us to enjoy wider civil and political liberties (Friedman, 1962, pp. 7–21; Kasper, 2001–02). Free markets—as Joseph Schumpeter once said—provide "many private fortresses" in which people

are free and from which they can defend their domain against the use of power by others and by the state. It is no coincidence that the new middle class in 19th century Europe and America fought for civil and political liberties, and that the new middle class in East Asia now does the same. Poor people can be dominated by dictators, but not citizens of property.

Private entrepreneurship is absolutely essential for economic development, which is nothing but the discovery of new resources, wants, knowledge and means of production to meet human wants. Centralised government entrepreneurship—the model of statist development—has rarely been very successful in development and has left many developing countries with a legacy of white elephants and depressing foreign debts. Politicians and civil servants lack the knowledge and the incentive to discover the right knowledge. Instead of meeting the demands of the people and informing them of what is possible, they tend to employ their energies to finding opportunities to line their own pockets or support their political power. By contrast, profit-chasing, competing private entrepreneurs tend to do what the market demands and adjust to evolving circumstances in the course of economic change (Kilby, 1971; Gilder, 1984; Blandy, Kasper *et al.*, 1985; Baumol, 1990). In this context, it is also worth thinking about foreign aid and easy revenues from resource exploitation, for example oil. Aid and oil revenues have often contributed to stifling independent entrepreneurship and have encouraged political regimes to curb economic freedom, whereas resource-poor countries, such as Switzerland and Scotland had to concentrate on developing human resources and institutional capital. Where economic freedom is given, economic growth normally occurs spontaneously and capital and knowledge are mobilised. The difference in the development performance between East Asia on the one hand, and South Asia on the other is explained primarily by the difference in reliance on private entrepreneurs on the one hand and on statist control on the other.

The mainstream of Indian literature on the economics of development has shown little understanding of the spontaneous forces of development in a free economy, and trust has been put since 1948 in development plans, import substitution, statist, socialised industry and heavy administration. Yet, there have been clear-sighted exceptions, most notably Professor B.R. Shenoy who saw the errors of planners long before others and who understood that free markets and secure property rights for all was the path to a prosperous and just India (Shah, 2001).

Tax and Compliance Costs

We have to mention two further types of cost in coordinating economic activities, namely tax and compliance costs. As we have seen, the internal institutions, which order most of our activities, sometimes require the back-up by government legislation, regulation, monitoring, and enforcement by

legitimated compulsion. This is a costly exercise, causing what economists call the "agency costs of government." These have to be financed by taxes and other fees. In addition, there are compliance costs which have to be borne by those who are monitored and governed. The agents of government often suffer major knowledge problems when trying to monitor what goes on. Therefore, they often impose considerable costs on citizens whom they oblige to keep records and accounts, report statistical data, conduct business in disadvantageous ways and desist from certain, probably lucrative actions. If governments are careless in imposing such compliance costs, they create a major hindrance to the active use of assets and talents.

Some jurisdictions try consciously to keep citizens' compliance costs to a minimum, even if that inconveniences the administrators. They will impose certain policy requirements, for example to protect health or the environment, but draw on the art of administration to cause the least cost and inconvenience on complying citizens. Interested foreign investors who want to set up shop in Singapore or Taiwan can turn to a "one-stop shop" to learn what is required to start business and to obtain all necessary permits. Often, the "one-stop shop" even goes around to obtain all necessary permits on behalf of the applicant, possibly within a fixed period (as is the case in Taiwan, for example). With such an institutional arrangement, most compliance costs for setting up new industrial ventures are shifted to a government agency. This has the additional advantage that government agents become aware of the compliance costs, regulatory inconsistencies and obstacles to business.

In other countries, it is not uncommon for a new business to run the bureaucratic gauntlet of obtaining some 20 or more permits from local, State and federal authorities. Often it is very difficult to find out how many permits are needed. Administrators sometimes seem to believe that industry and commerce are necessary evils, which have to be "domesticated" by strict and virtuous administrative supervision. In other places, officials consider permits to create jobs as items that have to be kept scarce, so it can be sold for their own private gain. Such conditions prevail in many developing and developed countries, so that small firms often operate illegally, and big enterprises stay away (de Soto, 1990, 2000).

While a user-friendly approach is fairly alien to many administrative traditions, a switch in the style of administration can do much to enhance growth and job creation. A first step in this direction is to depart from the model of perfect knowledge and to recognise the central fact that top-down coordination imposes considerable costs on business and citizens and that bureaucrats have no right whatsoever to extract bribes for expediting business applications. Where a corrupt administrative culture is deeply entrenched, it may even make sense to delegate approvals (within stipulated government guidelines) to private agencies who are then paid according to the number of jobs that are created or the number of successful approvals.

The costs of using property vary greatly from one community to another.

Where the internal and external institutions make sure there are few thieves, the costs of protecting property are low. Property is worth more. Where the government's enforcement of property titles is lax and haphazard, private exclusion costs sky-rocket and property loses some of its value. This has, for example, become evident in areas where crime against property has gone up.

Governments who set or alter the external institutions frequently disregard the transaction and compliance costs, which they impose. Indeed, many in the judiciary or politics (especially in countries with a British administrative tradition) scorn the thought that they should take these compliance costs into account when they pursue justice or similar goals, however defined.

Communities enjoy low transaction costs also when the internal institutions of society favour spontaneous honesty, punctuality and readiness to compromise in solving conflicts, and when the laws are universal and the courts operate expediently. More opportunities can then be explored and tested, and more valuable knowledge is discovered and utilised. Big trading centres—such as Florence, Venice and Amsterdam in earlier ages, and New York, Zurich, London, Hong Kong, and Singapore nowadays—flourished because the coordination costs of merchants and innovators were kept low by the conscious cultivation of market-friendly institutions. And many locations remain economically and culturally underdeveloped, because the attitudes of the people and the heavy, visible hand of government hinder commercial creativity and confident competition.

Market Participants Compete by Incurring Transaction Costs

The uncomfortable business of competing is driven by the rivalry with others on the same side of the market place. Thus, the—typically few—suppliers in a market are in perennial rivalry with each other for the favours of the buyers. To position themselves favourably for deals with buyers, producers incur high costs of research and development to improve their product, to advertise, and to offer better or cheaper new models. This rivalry drives ceaseless product innovation—in the case of motor cars, for example, progress has been enormous, from Mr. Benz's rickety, sputtering cart to today's sleek limousines. The rivalry among suppliers may be uncomfortable for them, but it is the motive force behind most of the technical and material progress of modern industry (see Insert below). By contrast, one only has to look at countries where suppliers were protected from incurring knowledge-exploration costs by their government. In India, for example, the heavily protected car industry produced the rachitic 1948 model of the Morris Minor into the 1970s; and in East Germany, the industrially most advanced country in the socialist bloc, they produced the miserable *Trabant* car year-in, year-out!

Rivalry in the market always creates uncertainties. You never know what your rivals might do next and whether their initiatives will eat into your market

share. As long as suppliers cannot be sure how secure their market niche is, they will strive to control their costs. As long as their market position and profitability are perceived as temporary, producers will invest resources in knowledge search to find out cost-saving production processes (cost control by process innovation, see *Insert* below). The rivalry between suppliers is therefore essential not only to make firms bear the costs of product innovation, but also for them to incur the costs of process innovation. Private cartels and government-sponsored protection from their rivals (such as tariffs and industry licensing) automatically reduce the intensity of an industry's rivalry and hence the willingness to incur innovation costs. As a result of government intervention, the economy displays less of what economists call "catallactic or dynamic efficiency". In other words, entrepreneurs generate and utilise few useful new ideas.

It is not surprising that long-protected manufacturers, who enjoy government-made certainties, are poor innovators and tolerate high cost levels. They do not have to live with "creative unease". The flip-side of such "welfare policies for big business" is always an industrial malaise, poor economic growth and limited competitiveness. Once government-made protection gives way to limited, partial trade liberalisation and globalisation, as was the case in many countries from the late 1970s into the 1990s, the adjustment pains are great. Like someone rising from a sick bed, manufacturers have to relearn how to incur search costs and to compete. To the extent that they do, they begin to offer the buyers more advantageous products, often at lower prices. Where import protection is removed, locally made cars, for example, have without exception, become more reliable, and are better designed and cheaper. But industry has to face the discomfort of those insidious information-search costs. This induces many suppliers (firms and their previously featherbedded workers) to become politically active to regain a degree of political protection in exchange for offering government their political and material support. In many countries this has given rise to a certain backlash against the regulatory reforms of the 1980s and 1990s.

It needs to be mentioned here that not all people consider competition—incurring transaction costs to discover new things—a burden. For many people, discovery is a worthwhile pursuit in its own right. Especially the young and the curious experiment and explore; they derive satisfaction from venturing into the unknown and from solving problems, which others have found overwhelming. This exploratory curiosity is an integral feature of human nature. Where it is suppressed by too much regiementation and control, it seeks forbidden outlets: The young experiment with drugs or engage in street demonstrations, thrilling criminal or gang activities and "dares" that appear foolhardy. In Africa, Indonesia and Latin America, many young, who lack better opportunities to explore the world, join militias to exploit and monopolise precious natural resources. Traders go into black market activities. Repressed minorities emigrate or take on the oppressors. Overtaxed producers

pursue tax evasion and go into the underground economy.

Although the transaction costs of entrepreneurial discovery are real and substantial, it would be one-sided to assume that they are a mere burden, which everyone tries to shirk. The energies and the entrepreneurship of many people could probably be channelled into economically creative pursuits, if the institutions guarantee them other, more constructive outlets. Rule systems that ensure a high degree of economic freedom and that avoid being excessively prescriptive promote economic development because the creative energy of entrepreneurial people is mobilised and because rent-seeking, unenterprising people are encouraged to risk their assets in discovery ventures in the market place.

What has been said so far about rivalry by incurring transaction costs among suppliers also applies to the demand side of markets. Buyers rival with each other by incurring information costs to find advantageous purchases. Housewives shop around in the market place for the best deal. Sometimes their cost of exploration is even compensated by the pleasure of shopping around. Consumers read magazines and make inquiries. The market for computer software, for example, would not have flourished with such breath-taking innovative vigour without the young computer buffs perusing the computer magazines and the internet for product reviews, and their readiness to try out new software packages. By acting entrepreneurially, consumers thus enhance the intensity and quality of the competition. We get the best deals where we mix with discerning and critical buyers. This is why one can buy elegant men's suits in Italy and eat excellent restaurant meals in France. Discerning buyers are indeed crucial. Customers, who are too lazy to complain about poor products and who tolerate bad service, deserve no better!

The fact that buyers rival with each other may not always be evident at first sight in markets with shelves full of stock. It is, however, evident when buyers rival for particular pieces of real estate or art. There, one's alertness and readiness to incur search costs may decide whether one is a successful bidder or not. In markets for industrial inputs, the rivalry of buyers plays a big role in driving innovation and quality performance. Car companies, for example, invest in R&D, as well as in information and contracting expenses into obtaining the most advantageous car components, and supermarket chains rival with each other to obtain fresh supplies.

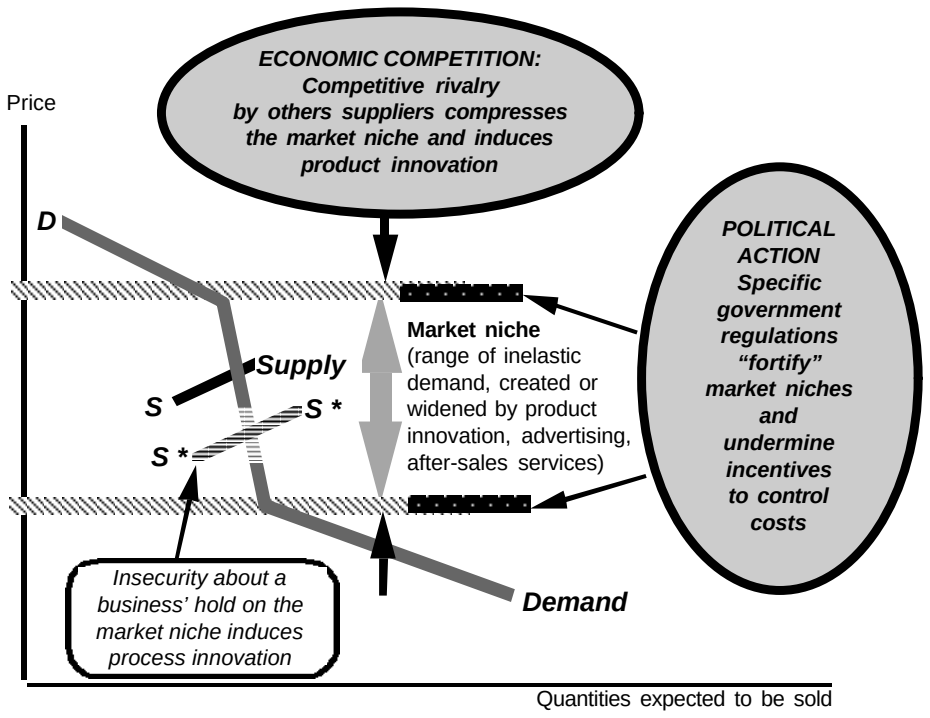
Insert

How Producer Rivalry Drives the Innovation of Products and Processes

To understand how competitive rivalry motivates producers to take on the burdens of transaction costs, we can take a snapshot from the dynamic competitive process. Let us take a car producer, for example. The producer will know that small price variations will not lead to much change in the quantity of vehicles he can expect to sell, because there are brand loyalties and frictions in the market. Indeed, he will see great advantage in widening the price band

over which demand is—as economists would say—inelastic. This range of inelastic demand is called "market niche". To create such a niche, a car producer will develop new car models (product innovation), advertise the merits of his cars and offer better after-sales services (for example, guaranteed spare part supplies, free three-year warranties, or free road-side assistance). Such non-price competition is costly, but it positions the car producer well in the market. His rivals, typically a limited number, will incur similar costs in the hope to compress his market niche and gain a bigger part of the action (Graph 7).

Graph 7: A Producer's Market Niche
A Snapshot from a Dynamic Process



The market niche is thus subject to a continuing tug of war; it is never certain, never reliable, always in need of fostering by investment in new transaction costs.

The uncertainty of the market niche keeps producers in "creative unease". This prevents them from driving up prices or resting on their laurels. It also impels them to control their costs or even bring costs down by process innovation (which is reflected in a lower supply schedule S* in Graph 7). Innovations cause expenses and often force producers to scrap old equipment to upgrade their production methods ("creative destruction" of old, but serviceable capital stock). Managers are forced by competition for market share to streamline their procedures, take risks, control their subordinates, and eradicate avoidable costs

and on-the-job consumption. All this is good for the wealth of nations. It is not welcomed by managers and workers who prefer a long tea break, a lunch at the club, or a leisurely overseas trip (principal-agent problem).

This explains why producers often demand political intervention to protect their market niches. Thus, car producers will invest effort and resources in lobbying politicians, bureaucrats and the public for protection from foreign competitors. The car producers will tell the industry minister and the bureaucrats that their duty is to provide support and regulation. Politicians and bureaucrats can then easily lose sight of the fact that they are only the agents of all citizens, who want cheaper and better cars, and that their loyalty is to the citizens, not special interest groups! Lobbyists will argue that protected market niches are essential for job security and investment—conveniently confusing the job security and investment in one specific industry, which protection featherbeds, with the nation-wide employment and investment level, which is undermined by industry-specific measures, such as tariffs.

Often, it is of advantage for rivals on one side of the market to reduce the transaction costs of those on the other side. Thus, competing suppliers often incur advertising costs. This has the advantage for buyers that they are better and more cheaply informed. Social critics of advertising tacitly assume "perfect knowledge" and conclude that advertising is a waste. In reality, potential buyers frequently face a costly information problem. To ease the information problem of the buyers, sellers compete by a number of (costly) strategies. They advertise. They offer trial runs (for example, with new cars or nightclubs, where guests are invited to enter for a few minutes before they have to pay the entrance fee). They offer free samples. Another important strategy to reduce the search costs of the buyers is to build up a reputation as a quality supplier, and then ensure that the costly investment in one's reputation is not quickly lost. Reputed sellers offer themselves—as it is called in the literature—as hostages to make their promises more credible. This reduces the information costs of the buyers. Another method is to offer warranties or money-back guarantees.

Another method of reducing information costs is to network or enter open-ended, more or less permanent contractual relationships. Dealing with the same stockbroker or the same tax accountant affords me cost-saving knowledge. All these examples incidentally serve to demonstrate how important information and other transaction costs are in real life. As a result, the market is far from faceless and anonymous. Frequently it takes place amongst long-term friends and business partners who stick to shared rules of honesty, courtesy and reliability as a transaction-cost-saving strategy to beat the competition (see also Desai, 1998).

The Role of Middlemen

When community-wide institutions are ineffective and transaction costs high,

as is typical of underdeveloped countries, there is often a place for intermediaries. Buyers may prefer to deal with a trader with whom they have regular business and who has a reputation to lose, rather than dealing directly with the many different producers of particular products. Sometimes, intermediaries confine themselves to conveying information, as is the case with stockbrokers. In other instances, they become intermediary contract partners, as is the case in wholesale trade and with banks who contract separately with savers and borrowers. The banks offer borrowers, who wish to invest long term, credible long-term loans (a knowledge-cost saving device). At the same time, they offer depositors short-term contracts and the possibility of early withdrawal. They also bundle small savings into big loans. In the process, financial intermediaries solve numerous information problems.

Intermediaries are often unpopular, not only with people who assume that transaction costs do not, or should not, exist. The Jews, the Chinese and the Indian traders of East Africa form groups of middlemen who are of great service to their host communities. They convey knowledge and open new opportunities. Yet, they suffer persecution (Sowell, 1990). One possible explanation—not an excuse—is that these groups make themselves exclusive, engaging in monopolistic behaviour that gives the primary buyers and sellers the feeling that they are at the mercy of the middlemen. However, the problem is not solved by persecuting the middlemen. Then, the trade breaks down altogether, and buyers and sellers are worse off. In some South Asian agricultural industries, middlemen in agricultural produce have been replaced by government agencies, frequently to the detriment of the farmers. The solution is to create and enforce better general institutions which facilitate information search and equal market access for everyone so that middlemen have to compete or become redundant.

How Knowledge is Signalled to Others

Only after intending buyers and sellers have incurred sufficient search costs, will they strike a deal with someone on the other side of the market. They will enter a voluntary contract, choosing among substitute offers and agreeing on a price and other contract conditions. Such deals—in turn—signal valuable information to other market participants. When a buyer and a seller enter into a contract, they do so voluntarily and on the basis of (necessarily imperfect) knowledge. The question now is: How is this knowledge signalled to others who may find it useful, and how are inevitable errors corrected?

The key signalling device in the market is the price. It conveys complex knowledge in condensed, coded form. If prices rise, this makes it profitable for suppliers to offer more of a certain product. The high valuation of that product by the buyers is signalled to other potential suppliers. As long as suppliers are allowed to appropriate the gains, they will have an incentive to provide more of what the buyers want. If suppliers discover an idea that is

particularly highly valued by buyers, they will reap a “pioneer profit”. At least initially, the return will be high. But a profitable price will also induce imitators to offer more of what is highly valued, or at least to offer close substitutes. This will bring the price down again and spread the advantage of the new idea to customers and the public.

Earlier, we considered what it took to launch the photocopier. Once Xerox sales took off, because buyers welcomed the new product, the company became highly profitable, and its shares became the blue-chip stock of the 1960s. But the pioneer profits were temporary. Potential rivals got the signal and tried to emulate Xerox’s commercial success, despite technical obstacles and patent protections. In the process, they discovered additional knowledge and applied it, making better copiers and bringing prices down. The competition enhanced the product, gave buyers a cheaper product and led to an unimaginable growth of the use of photocopiers. The talents and knowledge of thousands of people were drawn upon in the effort to expand human knowledge. This was a true contribution to economic growth.

Profit thus has an important dual function: to signal knowledge and to serve as an incentive to improve valued human knowledge.

Alas, entrepreneurs frequently have to discover that their new product is not appreciated by sufficient “rupee votes” to make a profit. Likewise, they may find that a process innovation—a new production technology or a reorganisation of the firm—does not produce sufficient cost savings. The resulting “signal of red ink” makes the error obvious. As this reduces the value of someone’s property, it also creates a powerful incentive to abandon the unwanted line of production or the failed process. The market economy thus not only gives incentives to search for and exploit knowledge, but also to abandon errors spontaneously. Products which citizens do not want sufficiently to justify their costs, are scrapped and disappear. The profit-loss mechanism is not anonymous, faceless and devoid of the will of the people, as it is sometimes portrayed. Rather, it reflects the informed, careful private choices of the many buyers (consumer sovereignty) and a continuing process, which we might call “the rupee democracy of the market”.

Price changes (as well as corresponding profits and losses) constitute the “radio signals” that coordinate the complex, evolving market economy. They coordinate thousands of diverse people who typically do not even know each other, but whose coordinated efforts are needed to satisfy our diverse and complex material wants. If governments interfere with the “radio signals” by fixing prices or by allowing the “static” of inflation to overlay the price signals, they pave the way for inefficiencies. Less knowledge is used, fewer wants are satisfied, and fewer choices are available. Market interventions may become even more disruptive when they trigger social upheaval, for example when increases in administered prices lead to street riots.

To illustrate the practical relevance of the competitive system and its

marvellous effectiveness in communicating knowledge, we may look at the famous "oil crisis" of 30 years ago: In 1973–74, the OPEC oil cartel quadrupled the price of crude. This raised the income of the oil producers in the short run, but reduced it over the long term. People around the world began to drive less, and—in the longer run—replaced their gas guzzlers by petrol misers. Industries switched from petroleum to natural gas and coal. Researchers explored new sources of power (ranging from oil shale and tar sands to wind and solar energy). Exploration for new oil, new technologies to crack petroleum and many other costly knowledge-search processes to cope with the problem were set in motion. The efforts of millions of people in all corners of the world were triggered by one signal—the higher oil price. The price increase also served an important motivational role. With time lags, higher prices mobilised new supplies of oil and curbed demand. Eventually, the real petroleum price (adjusted for inflation) came down again. The Jeremiahs who had predicted the end of modern civilisation and the regulators who tried to stop the price increases by direct intervention were proven wrong. US President Jimmy Carter tried to protect the American people from foreign-made petrol price increases. He caused unexpected shortages and queues at gas stations, and was thrown out of office by the voters. The economists who had counselled the public to trust the power of the market were again proven right!

This episode illustrates a further point. The people whose actions solved the problem did not have to waste time on analysing what caused the petroleum crisis—whether it was a war in the Middle East, the OPEC cartel, long-term technological trends, or whatever? The simple-to-interpret price signal did the trick! The market thus economised on everyone's knowledge problem.

Let us sum up this part of the argument. Intense competition in the market economy has three important social functions:

a) It gives the incentive to be on the alert and to incur the costs of searching for valuable knowledge (the function of stimulating product and process innovation).
b) It signals success to others, leading to imitations and the diffusion of successful technology, at the same time eroding initial pioneer gains and passing lower prices to customers (signalling function).
c) It signals failures through "red ink" and induces the spontaneous, automatic abandonment of those property uses which are not sufficiently highly valued (control function).

The Responsibility to Compete

We saw that most people are naturally reluctant to compete, ie. to incur those insidious knowledge-exploration costs and that the mental obstacles to intense rivalry and knowledge search on both sides of the market are considerable.

Yet, it is important that these obstacles are overcome. Otherwise, there would be little prosperity and freedom of choice. Owners of property are of course free not to compete. But those who refuse to compete must anticipate that their property will lose value, as rivals capture market share. Owners who refuse to accept the challenge of competition thus have to accept the consequences in the form of possible losses of their property values and a possible reduction in their socio-economic position.

In the interest of well-functioning markets, such people must not be allowed to run to the government or conspire among themselves to avoid such losses. In a dynamic economy, positions must be revalidated by competing, time and again. It is absolutely essential for prosperity and the functioning of the capitalist system that the stimulus of competition is kept alive. As was said in the previous chapter, property rights not only establish claims to benefits, but also responsibilities. Governments who intervene to avert the impact of losses destroy an essential mechanism of coordination. If opportunistic parliamentary parties, ministers, civil servants and judges protect or compensate unwilling competitors, they directly undermine the constitution of capitalism and detract from our freedom, security, prosperity and justice (Berger, 1987).

Property owners, including the owners of labour, who shirk the costs of knowledge search, will of course resent their losses. They will try to obtain political patronage. Thus, the guilds of the Medieval cities of Europe mobilised political action to ensure that no outsiders could compete with them. The result was stagnation and decline, not only materially, but also intellectually, culturally and militarily. Economic nationalism—by means of trade protection, control of foreign investment, "Buy National" campaigns, agitation against foreign investment—falls into the same category of harmful defence against the challenge of competition. Another example of an opportunistic reluctance to compete is the refusal by well-organised trade unions to face open competition, defending the closed shop and privileges that could not be maintained in a competitive labour market. The third world is full of examples where protected unions have de facto taken over an industry and exploit the rest of the citizens, often sharing their ill-gotten advantages with political leaders.

Competition and Equity

The responsibility of asset owners to compete, if they wish to maintain the value of what they own, influences the distribution of incomes and wealth. Positions of relative income and wealth evolve continually. In a truly competitive economy, there is no such thing as a permanently rich and a permanently poor class of people—unless political power play interferes! In competitive open economies, such as the American economy, few of the top 500 richest stay on top for generations. Innovators challenge them ceaselessly.

No one's creative ideas flow ceaselessly. Established property owners will therefore often seek collective action to freeze their socio-economic positions. If they are successful in obtaining discriminatory political protection, this will impede the opportunities of newcomers, the young, new ventures, new industries, the unemployed and new industrial countries. Many observed "social injustices" are the consequence of such political interventions and their unintended side effects. Thus, the tariff protection of privileged industrial jobs by governments goes always inordinately at the expense of the poor. Most monopolies survive only because of government support (Friedman, 1962).

Of course, one can find numerous intellectual and administrative critics of a system of secure property rights and free competition, who admit that such a system is good for efficiency and economic growth. But they fear that it leads to unjust and inequitable outcomes. The mantra that the "rich are getting richer, and the poor are getting poorer" has been repeated so often that it is widely and uncritically accepted—despite the fact that most in the developed world nowadays belong to a middle class and that there is constant turnover amongst the rich.

There can of course be no doubt that any economy is at any one moment typified by rich and poor people (inequality of outcomes), as well as by great differences in opportunities (iniquity of opportunity). Not all suppliers of products, ideas, capital and labour are "rewarded" equally. Some respond to diverse and changing demands more successfully than others, either because of their entrepreneurial alertness and their readiness to shoulder transaction costs or because of their luck. Some may not have the wherewithal to incur transaction costs and therefore remain mired in a less advantageous competitive position. Others may be less well-endowed by nature (most regrettably, this author has not been able to compete with Naomi Campbell in the modelling market . . .).

However, such inequalities are normally temporary, unless artificial obstacles to competition are set up by corrupt governments. Inexperienced, low-skilled or handicapped people cannot easily compete in the labour market because of minimum wage laws. The minimum wage, closed shops, import controls, a Byzantine structure of industrial relations, labour cartels and administrative practices are the source of much inequality of incomes. In the welfare states of the West, ready access to welfare and a progressive income tax combine to keep many people from doing their best to help themselves and to deny them the satisfaction of self-responsibility. Numerous interventions in product markets—from building codes and industrial regulations to tariffs—are adding to the inequalities of outcomes. Governments thus often deny citizens more equal opportunities. Those who are well organised tend to obtain political protection from open competition at the expense of the unorganised. Positions of relative economic power are translated into artificial political protection from the responsibility to compete

at the expense of newcomers and outsiders. As we shall see in the following chapter, public choice has often displaced private competition, and political discrimination replaces the equality of opportunity.

One can, therefore, not criticise the competitive property rights system as discussed here with examples of iniquities in a highly distorted economic system. A glance at more competitive market systems overseas may suffice to demonstrate that genuine, open competition and the protection of private property can yield a high degree of income equality and economic growth. Taiwan, for example, figures at or near the top of all international tables on equality of income and wealth despite—or because of —a near-total absence of public welfare and coercive income redistribution! And the liberalisation of the New Zealand economy has opened many new opportunities to previously disadvantaged groups, as is shown by disproportionately large drops in the unemployment rates of Maoris, women and the long-term unemployed. It is also worth looking at the evidence about economic growth, poverty eradication and inequality, which we reported in Chapter 1.

Once one takes a dynamic-evolutionary view of the market process, one is likely to favour institutions and a style of governance that increase the material opportunities for everyone in the community over a redistribution of a given economic cake.

Competition is a Public Good

In the final analysis, the debate harks back to one's conception of the economy and of modern economics, as discussed in Chapter 1: Do we deal with the rationing of scarcity (economising), or are we involved in the enterprise of discovering new wants and new resources (catallaxy)?

The genius of competition facilitates innovation, freedom and self-realisation, as well as making for a cooperative rather than politically divisive social climate. A climate of competition and enterprise in all parts of the economy is a public good. The benefits of competition spread far beyond those directly involved in competing in a market. The institutions that make for genuine, open competition therefore deserve protection by government. This means that collective action should protect the universal institutions of private property and freedom of contract for *all* citizens and desist from discriminating between citizens by licensing, subsidies, specific taxes and other such corrupting interventions in market processes.