A Moderate Compromise: Economic Policy Choice in an Era of Globalization
(Excerpt) - by Steve Suranovic (Palgrave McMillan, 2010)

Chapter 8 - Voluntary Exchange and Competition

Mutually voluntary exchange is the best example of a win-win situation. Whenever a bilateral exchange occurs, both parties must profit, for if not, one party would simply have refused to trade. This basic result is sometimes used to argue that a free market economy, consisting of billions or trillions of bilateral voluntary exchanges, must therefore be to the benefit of everyone. In one sense this is true, but upon a more careful investigation, it is also misleading. To clarify the distinction, this chapter will explain in some detail how competitive markets are likely to work. However, the competitive process we need to understand is not the "perfect competition" described in standard economic models. Rather, we need to understand dynamic competition as described by Joseph Schumpeter (1942) when he talked about *creative destruction*. For Schumpeter, the crucial economic dynamic was one in which new businesses rise up in a creative process while existing businesses are simultaneously destroyed. Friedrich Hayek described this same dynamic competition when he discussed *competition as a discovery process* and the free market as a "*spontaneous economic order.*"[i]

This chapter provides a detailed description of dynamic competition in response to one commonly suggested policy change; trade liberalization. It demonstrates that when competition works without impediments or restraints, that is, when it works as envisioned, it is rife with ups and downs, winners and losers. The positives occur as creative, innovative businesses, new and old, improve quality, adjust product characteristics and reduce production costs ahead of their competition. The negatives occur for all who try, but fail, to realize these same outcomes. These firms are relatively

less creative, less innovative and less lucky than the winners. As a result jobs are lost and painful transitions occur.

Because of the rhetorical necessities described in Chapter 5, proponents of trade liberalization will typically emphasize the innovative aspects of competition, the likelihood of economic growth, the raising of "average" incomes and many other positive outcomes. They will also tend to minimize the real strains and pressures associated with well-functioning competitive systems. They even seem to suggest that these "problems" are merely transitory and will disappear in time. But such is not the case. A competitive market will be a continual swirl of changes – a kind of churning - that will regularly act to force some firms out of existence with their employees losing jobs and being forced to adjust and change.

This chapter will emphasize that the fear and anxiety created in the dynamic competitive process is critically important as a motivator for the creative, innovative process itself. This tension and anxiety are *necessary* stimulants to business experimentation and discovery. For this reason, trying to protect those who lose in the competitive process is counterproductive since it will act to stifle creativity and innovation. Thus, these kinds of losses must be accepted as an unfortunate, but necessary, by-product of competition.

Furthermore, suggestions by economists to compensate the losers from trade liberalization with gains from the winners is problematic since compensation will reduce anxieties faced by potentially uncompetitive firms and thereby reduce the overall effectiveness of the competitive process. Although compensation may be suggested as a means to induce political support, its cost is a weakening of the competitive system. As

such, compensation, when provided, is an example of objectionable involuntary transfers rather than voluntary exchange.

Free Market Competitive Responses to Trade Liberalization

Consider the impact of a policy change that inspires significant adjustments throughout an economy. The policy change chosen is trade liberalization, however, similar effects can be expected with any policy change that causes numerous prices to adjust. As such trade liberalization mimics the effects of policy changes more generally. Of course, admittedly, markets do not currently operate exactly as described below. This is largely because businesses and interest groups have managed to induce their governments to implement policies and regulations that act to impede free and open competition. Nevertheless, in many markets, especially in developed countries, numerous markets remain highly competitive, thus the adjustments described below do correspond to real world processes to a degree. I'll also imagine that firms respond to competition with competitive responses rather than reverting to involuntary transfer mechanisms to protect themselves. In this way, we can examine how a market would work in more ideal circumstances. It is worth noting that this more idealized market process is probably the way most economists imagine markets can and do work.

A trade liberalization policy change means a reduction of tariffs collected on imported goods. Trade liberalization can also involve the elimination of internal rules or restrictions that previously prevented foreign goods from being supplied freely and easily. In either case, trade liberalization will increase the degree of competition faced by domestic industries.

Import Country Effects

As trade liberalization reduces the prices of imported goods, domestic import competing industries will be forced to adjust. Consider the clothing industry. Domestic clothing consumers will now face a choice between buying lower priced imported clothing or the somewhat higher priced domestic clothing. If the products are seen as almost identical, a consumer will switch purchases to the cheaper imported product.

As long as some fraction of consumers shift purchases to the imported good, demand will fall for the US produced good. Reduced demand for the domestic product will result in lower revenues and an increase in inventory. The domestic firms can respond in several ways. First, to try to maintain sales volume, the firms can lower the price of its clothing. However even if market share is maintained, revenues will still fall since the same sales volume commands a lower price. Since production costs will remain the same initially, domestic firm profit will fall. Even with a lower price, some firms will not be able to maintain sales volume and will be forced to reduce output or deal with rising inventory. Perhaps the quickest way to respond to reduce costs and output is to lay off workers.

Job losses in import competing industries are the most noteworthy effect of trade liberalization. In the late 1990s, the US was eliminating quotas on textile and clothing products as a part of its WTO agreement. The increases in imports affected employment in the import-competing industry. Table 8.1 below shows the changes that occurred in three industry sectors - textile mills, textile products and apparel manufacturing - during a four-year period as quotas were being eliminated.

In the textile mill industry, imports rose by 8% while the value of US output fell by over 20% in four years. The industry reduced employment by over 25% during the period, eliminating almost 100,000 jobs. The situation was more severe in the apparel-manufacturing sector. As imports rose over 30%, output fell by about 20%. Employment was cut by over 35% as the sector shed over 250,000 jobs. In the textile products industry, output actually rose slightly while imports increased by a whopping 58%. Despite stable production, employment was nonetheless reduced by just over 10% shedding 25,000 jobs. The number of jobs lost in just this four-year period in only three US industry sectors was over 375,000.

Table 8.1
Effects of US Import Competition

		1997	2001	% change
Textile Mills NAICS 313	Output Value (billions)	$58.7	$45.7	- 22.1%
	Employment (thousands)	392	294	- 25.0%
	Imports (billions)	$6.3	$6.8	+ 7.9%
Textile Product Mills NAICS 314	Output Value (billions)	$31.1	$32.0	+ 2.9%
	Employment (thousands)	235	210	- 10.6%
	Imports (billions)	$4.8	$7.6	+ 58.3%
Apparel Mfg. NAICS 315	Output Value (billions)	$68.0	$54.6	- 19.7%
	Employment (thousands)	711	456	- 35.9%
	Imports (billions)	$47.1	$62.4	+ 32.5%

Source: U.S. Department of Commerce: Bureau of the Census; International Trade Administration (ITA), http://www.ita.doc.gov/td/industry/otea/industry_sector/tables_naics.htm (June, 2006)

From an even broader perspective, if we consider all the import-competing industries affected by increased import competition due to the WTO agreement and other free trade agreements, besides just textiles and apparel, we would likely discover job losses numbering in the millions because of the transitions. While this represents a relatively small fraction of the US workforce, it is nevertheless a very big deal especially for the workers who have lost their jobs.

If we expand the perspective and consider all import-competing industries *worldwide* affected by the increased competition due to bilateral and multilateral trade liberalization agreements, we will certainly be able to count total job losses in the hundreds of millions over several years. A reasonable question to ask is; what happens to these workers?

Adjustments to Job Losses

Industries can reduce their workforces in a variety of ways. One method is simply not to hire new employees to replace retiring workers. Thus, a small percentage of these workers are not suffering from their loss of job since they have merely retired from the workforce. Other workers may have independently decided to take a job in another industry. They too may not be replaced. All industries experience a natural attrition of workers for these reasons and thus can reduce their workforce modestly with very little negative impact since the separations are voluntary. Most industries try to do this whenever the reduction in labor needs is small or can be stretched out over a longer period.

However, many other workers, perhaps most, will lose their jobs quickly and unexpectedly. Some of these workers will find new jobs quickly. Others will remain unemployed for some time. In many countries, workers will receive unemployment compensation for a period of time, however, they will still suffer a loss of income together with the anxiety associated with job loss and job transition. An additional loss is the opportunity cost of lost production since these workers are idle during the transition. Some who find new jobs will not make as much income. Some may take several part-time jobs just to make ends meet. Others will be more successful, perhaps landing a better job in an expanding and prospering firm. In all cases and in all countries, the income effects will be mixed.

Export Country Effects

As markets are opened to international trade and competition, a completely different story emerges among the domestic industries that are able to expand exports. These firms face lower tariffs in markets abroad and can respond by reducing the price they charge without reducing the revenue they receive on foreign sales. The lower foreign price will increase demand allowing them to expand output. Output expansion in turn will require more resource inputs, including new workers. Salaries and wages of current employees may also rise as rising revenues are spread among stakeholders and as the expanding export firms try to attract and retain higher quality workers.

In the clothing industry example above, the jobs created in the industry are in the foreign countries that have been able to expand exports to the US market. Thus, the increases in imports correspond to new jobs somewhere else. One might conclude, then, that trade liberalization is good for them but bad for the US. However, this conclusion is

true only if we restrict our attention to the employment effects in the import competing industries. Remember, trade liberalization agreements will also lower the barriers that US firms face abroad, allowing them to lower their prices to foreign consumers and increase exports at the same time. Expanded exports of goods and services, brought about from trade liberalization, will create new jobs in many industries.

Net Effects of Trade Liberalization

International trade analysts sometimes evaluate the effects of a free trade agreement by calculating the net effect on jobs. The simplest way to do this is to calculate the number of jobs associated with every million dollars of imports and exports and then measure how exports and imports change after an FTA. In this way, one can estimate how many jobs are created in export industries and how many are lost in import industries. The Economic Policy Institute applied this method in 2003 to argue that the North American Free Trade Agreement (NAFTA) had led to a net loss in jobs in the US economy. According to their estimates, "between 1993 and 2002, NAFTA resulted in an increase in exports that created 794,194 jobs, but it displaced production that would have supported 1,673,454 jobs … Thus, the combined effect of changes in imports and exports as a result of NAFTA was a loss of 879,280 U.S. jobs."[ii] This, they conclude, is the real cost of free trade.

This analysis correctly shows some of the losses and gains in jobs due to free trade but it doesn't capture everything. There are many more effects of the FTA. One problem with this analysis is that it focuses on trade deficits. Since trade deficits grew larger after NAFTA, EPI concludes that jobs have been lost. It is certainly true that when a country runs a trade deficit, there is more money used to demand foreign goods (foreign

import demand) than the money that returns to demand US goods (US export demand). But what happens to the excess money that flows out? This study ignores it; effectively assuming it is lost. But that money, and the demand it generates, is not lost. The excess outflow of money comes right back in on the financial account side of the balance of payments. When the US runs a trade deficit, there is an inward financial flow, called a financial account surplus. This money doesn't just sit around. Instead it is lent to US banks, firms or the US government. In all cases, this financial inflow stimulates spending by someone in the US economy. That spending creates jobs; more than likely though, the jobs are not tied directly to trade, since those are already accounted for in the trade statistics. Instead these jobs will be in firms that produce for the domestic market, what economists call the non-traded sector. These jobs in the non-traded sectors would not exist except for the extra spending, which, in turn, would not exist without the borrowing financed by the financial surplus, which would not exist without the trade deficit. This means that by focusing on the trade deficit only, the analysis misses some of the jobs being created (and lost) in the economy. A more comprehensive approach is to focus on the total number of jobs gained and lost in all sectors of the economy after trade is liberalized.

Labor Market Churning

Free market economies are in continual flux, constantly changing. New businesses are opening, older businesses are closing every day. New jobs are advertised and filled, while workers in other jobs retire, or quit, or move, or are fired. When trade liberalization occurs, perhaps the most important effect is a quickening of the dynamic flux in an economy. The increase in competition with foreign businesses and the

expansion of market opportunities for export industries further stimulates the process Josef Schumpeter called "creative destruction."[iii] Another way to describe the process is as a kind of "churning," or stirring-up, of the market. Which businesses are operating, which workers work where, and who makes more or less income, all are more rapidly changing after trade liberalization.

One way to see the churning that takes place in an economy is to look at business startups and closures. Since the beginning of the worldwide recession in 2008, evidence of churning is less apparent since most industries have suffered losses and very few have experienced gains. Thus it is more instructive to use a prosperous period such as 2005 to illustrate the natural ups and downs of the economy.

In the US in 2005 there were about 672,000 new businesses (with employees) created. During the same period about 545,000 businesses shut their doors. The total number of businesses in the US with employees is about 5.8 million.[iv] This means about 10% of the business stock is refreshed each year with a small net gain being the norm.[v]

With each business closing, jobs are lost. Sometimes the layoffs make headlines: "IBM to layoff 8,000 to 12,000 workers;"[vi] Citigroup to layoff as many as 15,000 workers;[vii] Circuit City to cut more than 3500 store and IT jobs.[viii] However, it is very important to put these layoff stories in perspective. First, one should know how many layoffs occur in total in the economy in a typical month. Secondly, the more important trend is not how many occur in one industry, but whether the aggregate trend is significantly higher than usual. Finally, one should also look at the trend in job hires during the month. If job hires are rising as fast or faster then layoffs, then the economic effect is surely less severe.

When a company reports a significant layoff of workers, it is likely to be spread over several months or even a year. Compared to the total changes taking place economy-wide, these reported layoffs are typically a very small share. But, even if it were a large share, this only means that labor market churning has hit one particular sector or firm very hard in this period.

Every month the US Labor Department reports the aggregate employment changes by industry.[ix] In the January 2007 report we learned that employment fell in many industries: motor vehicles and parts lost 23,000 jobs, furniture and textile mills both lost 4,000 jobs and computer and peripheral equipment lost 6,000 jobs. However, in the same one month period health care employment rose by 18,000 jobs, professional and business services was up 25,000 jobs, while food services employment rose by 21,000 jobs. The net effect for the month was a gain of 111,000 jobs. This follows a net increase in December 2006 of 206,000 jobs. The total number of payroll jobs in the US economy is 137.3 million.[x]

The point here is that the typical churning of job gains and losses in the entire economy dwarfs most layoff stories. Nevertheless concern about job losses is one of the most powerful and convincing arguments used by opponents of trade liberalization. And, almost certainly, trade liberalization will cause in increase in the number of job dislocations.

In international trade models, labor market adjustments occur smoothly and easily. Workers who lose their jobs in the contracting import-competing industries immediately find better jobs in the expanding export industries. However, in the real world, while it may work out well for some people sometimes, for many others the skills

of the newly unemployed - such as textile and sewing machine operators, sewers and seamstresses - will not match the demands for computer programmers, financial and systems analysts, or health care professionals in the expanding sectors. Thus, these workers will remain, at least temporarily, unemployed. In most periods though, expanding trade does not correspond to a rising aggregate unemployment rate. This means that many of the displaced workers are indeed finding new jobs.

Nevertheless, even though trade liberalization may simply add to the already sizeable number of job losses and gains without affecting the overall unemployment rate, the connection between increased trade and job losses will be obvious, especially to those who lose their jobs because of trade. This is why it is especially difficult to argue in support of free trade to the owners of businesses and their employees who expect to suffer these dislocations.

The politically astute supporters of free trade often dismiss these concerns by arguing that they will be temporary and that these same individuals will be better off eventually. Unfortunately the reality is very different. This implies that an honest argument supporting free trade must come to terms with these painful and unfortunate outcomes that will become more and more commonplace if the world continues its push towards freer trade. A more appropriate way to respond to the realities of labor market churning is to argue, as we will below, that first, churning is a very important and necessary process to achieve rising standards of living, and second, that the process is more fair and just than any plausible interventions would be. Let's consider why.

Positive Incentive Effects of Fear

Labor market fears, worries, and anxieties are rarely mentioned by supporters of freer trade, and never measured in empirical assessments. Nonetheless, these effects are clearly a major cause for concern among those workers whose jobs are threatened and a prime reason to oppose free trade.

An excellent description of the extreme anxiety the churning process of trade liberalization will sometimes cause can be found in a New Yorker article from 2004 titled, "The Churn: Creative Destruction in a Border Town."[xi] This article describes what adjustment to open international markets will be like from the perspective of the people living through the process. Here's a passage describing the aftermath of the closing of a Fruit of the Loom factory.

> Fruit of the Loom had chosen a few veteran laborers to go, briefly, to Honduras to train the cheaper workers who would replace them. Some of the others would board the meat- and poultry-industry buses that idled outside the county employment office, luring those sufficiently desperate to take short-term slaughterhouse jobs in the Ozarks. But, as Fruit of the Loom's cutting machines and bleaching vats were cranked up on pallet jacks, loaded onto flatbeds, and hauled to the Port of Brownsville, many of the company's workers pocketed a month's severance and filed into Mario's van. They applied for unemployment assistance equal to roughly half their former wages, took aptitude tests, and studied the twenty training brochures that were taped to the van's walls. And thus they joined the Rio Grande Valley's eight thousand other former inseam, watch-pocket, and waistband experts in what economists call capitalism's necessary churn.

However, despite the fear and anxiety that comes with free trade, the increase in competition also has a very important effect upon incentives. This is because fear can affect behavior; fear motivates action. In a separate context, it is fear of a midterm or final examination that motivates students to study and learn; it is fear of embarrassment

that motivates a dancer to practice before a performance. In a similar way, it is fear of losses and economic failure that can incite owners, managers and workers to action. Two types of responses may occur: one a competitive response, the other an anti-competitive response. The anti-competitive response involves attempts to profit, or to prevent losses, via special government protections. These actions were described as types of involuntary transfers in Chapter 7.

The alternative is the competitive response. If firms respond competitively, they must accomplish a few basic tasks: they must lower their costs of production, improve the desirability of their product and preferably, do both simultaneously. Unfortunately, these tasks are not always easy to achieve. Even more importantly, to be successful, a firm must do both of these faster and more effectively than other firms competing for the same consumers.

Faced with falling profit due to foreign competition, managers will seek out all conceivable ways to lower their costs of production. This may mean purchasing more technologically advanced equipment; it may mean laying off the least productive workers; it may mean outsourcing some processes to a more efficient (cheaper) external company, maybe in another country.

But, not all of these steps will necessarily be effective. New technology may be expensive and it will be difficult to decide whether to incur a larger cost, or borrow to purchase equipment whose effectiveness will be uncertain until tested. Firing workers immediately reduces cost, but also requires a readjustment of assignments of the remaining workers. Finally, although outsourcing, or offshoring, may reduce cost, it too may be significantly less effective. If the effectiveness, or productivity, of inputs falls by

more than the cost is reduced, the attempts at cost saving will actually make the company less competitive.

Businesses can also raise their competitiveness by improving the desirability and quality of their product. This may involve changing the colors and design, or adjusting the materials used in production. It may mean devoting more resources to quality control. It may mean hiring a more effective sales team or expanding efforts to place their products in more retails outlets. The firm may also work to enhance their market demand through advertising. Advertising will communicate information about the product to a larger group of consumers, and improve the image and reputation of their product vis-à-vis their competitors.

These adjustments will also be difficult to make. For example, how much more should be spent on design, on quality control, on advertising? What will the return be in terms of increased sales revenue? Should all three be done, or is one approach more likely to be effective than another?

These questions will not have easy answers. Successful adjustment will depend on the creativity and effort of managers and workers. It will also depend somewhat on luck. Because there are so many ways to respond to the increased competition, each firm will respond somewhat differently. Some will reduce their workforce more, and devote resources to advertising. Others will switch to cheaper input sources and adjust the quality and design of their products. Some firms will adjust the mix of products they produce. Each firm's objective is the same; to remain competitive and maintain, or even improve, profit.

Not all firms will be successful though. Some will see their sales plummet and will be unable to cut costs fast enough. These firms will close, ultimately firing their entire workforce. Other firms will struggle; sales may fall, then rise, then fall again. Some firms will struggle for a long time, but continue to barely cover production costs and so will remain in business. These firms may wind up with a much smaller workforce.

Worker Responses to Competition

One of the major concerns people have about the competitive process is the effect on workers. When companies adjust to competition they often release workers to improve efficiency. We might ask what the firm's responsibility is to the workers? And how should workers respond to the churning in the market?

First of all, a business consists of a group of owners who put together a plan to produce a product they believe is demanded by consumers. If they do this effectively, they will profit. To produce the product and distribute it they need to hire workers for a variety of tasks in the production process. To attract effective workers, firms must offer terms that are agreeable; afterall workers have the right to refuse. At the same time, when markets are free, firms have the power not to hire someone or to fire a worker if the worker has become ineffective.

Keep in mind that in a dynamic competitive market, consumer demands and the most effective production process are both quite likely to be in constant flux. That means that demands for worker skills will change over the weeks and months and years. To remain as flexible as possible a firm must be able to hire and fire workers as needed to maintain the best service to their customers. Restrictions on that flexibility will

automatically reduce the firm's ability to satisfy their customers' demands and will reduce its ability to compete effectively; that is, unless all other firms are required to face the same constraints.

Some restrictions may be mutually voluntary. For example, a firm may recognize that it can hire more competent workers if it commits itself to a one-year labor contract. In this case, the contract constrains the actions of the firm, but the firm may do so willingly to attract better workers. In contrast, the implementation of a national minimum wage law constrains the terms of an allowable labor contract. The law means that some freely voluntary exchanges are now prohibited, which in turn may impede the ability of some firms to provide the best product to its customers. It may also prevent some firms from offering jobs that might have been offered otherwise. When all firms in a country must face the same constraint, the minimum wage law might not reduce competitiveness vis-à-vis other local firms since everyone must conform to the same constraint. However, when different countries have different minimum wages, the more highly constrained firms may suffer a loss of competitiveness.

Suppose firms could freely hire and fire workers whenever they desired. How would workers respond? They would likely respond by changing their expectations and their behavior. A worker in a competitive economy would know that the firm has no obligation to provide a job under any conditions different from the terms of the employment contract. For example, a worker who knows she can be fired tomorrow, or at the end of the year, has a much stronger incentive to strive to be as individually productive as possible. A worker will want her boss to know she is a hard worker, that

she contributes to the firm's goals, because to do so makes it less likely she will be the one fired if an adjustment occurs.

At the same time the firm knows that any worker can walk away from his or her job at anytime, again also subject to the terms of the labor contract. This a reason why firms have incentives to provide decent working conditions to its workers. Better treatment can motivate higher productivities. If workers feel mistreated, or if they expect that changes in the market may result in the loss of their job, then they are free to look elsewhere for employment. In order to find employment elsewhere though, the worker will need to be able to demonstrate his effectiveness. To remain constantly in demand then, the worker should continually improve and expand his skill set.

Thus, workers freedom to move and firms ability to fire, motivates both better worker treatment on the part of firms and better efforts on the part of workers. Adding labor market constraints reduces firm and worker flexibility and reduces the ability of firms and workers to compete in a dynamic market.

Competitive Experimentation and Discovery

The firms that succeed will be the ones that choose the right competitive response. However, identifying what the right response should be is almost impossible to know beforehand. Even the owners and managers of the firms themselves won't know whether the adjustments they are making will ultimately succeed or fail. This is one reason competition creates such a high level of anxiety for owners, managers and workers. There is always an enormous amount of uncertainty and risk.

Economic models typically assume that firms have good, even perfect (!) information about the market and their costs of production. When imperfect information

is introduced, models often assume one agent has perfect information and the other doesn't (asymmetric info), or, if the information is unknown to all, then the agent at least knows the probability distribution of that information. However, all of these assumptions are unlikely to be satisfied in the real world. It is true that firms know a lot about their own market, but they don't know everything, and they especially don't know what market conditions will be like in the future.

Nevertheless, competitive markets represent an extremely effective way to resolve this uncertainty. The resolution comes through experimentation; through trial and error. In a competitive market, every business enterprise represents an experiment taking place every day as producers offer their products and services for sale and hope that consumers will come along and buy freely and voluntarily. Consumers will consider the price, design, functionality and quality of the good or service and will buy only if they believe the product fulfills their needs or desires.

Each firm's objective is to fulfill a sufficiently large number of consumer desires, so as to cover their costs of production and return a reasonable profit. In textbook models, the choice problem is simple; simply set output so that marginal revenue equals marginal cost. In real world businesses though, the decision process is much more complex, especially for large companies.

Every product that makes it to the marketplace has a multitude of individual decisions behind it. Consider a simple product like a can of soup. The producer had to decide the recipe, where to buy the ingredients, the equipment and labor resources needed to make the soup, the type of can to use, who would produce the can, the color and design of the label, which retailers would stock the product, how much to spend on advertising

in newspapers, radio, TV and the internet and, finally, what price to charge. In the background the producer also had to decide what type of health care and retirement plans to offer workers, implement quality control procedures to assure product safety, adhere to government regulations concerning worker safety, manage the payroll, hire new workers to replace recent retirees, fire some workers who were habitually late for work, and throw one of the administrative assistants a birthday party. Decisions like these, and many more, affect the price and the quality of the product for sale, whether it's soup, or bread, or watches or life insurance.

Firms will succeed when they can consistently manage the production process in a way that provides a product consumers desire, while also covering the costs of production plus an adequate profit. Unfortunately though, in many instances businesses can't rest even after they've discovered a production process that works. That's because consumer demands are never fixed and immutable. Instead, demands change as incomes, tastes, trends, and availability of alternative products changes. This means that the best business strategy will quite likely be one that continually changes and adjusts as well. It is as if businesses are shooting at a moving target. And, to make matters worse, as trade is liberalized, the target moves even faster.

Friedrich Hayek (2002) wrote that, "The difference between economic competition and the successful procedure of science is that the former exhibits a method of discovering particular temporary circumstances, while science seeks to discover something often known as 'general facts,' … " Market demand is the *particular temporary circumstance* that is constantly changing and changing ever more rapidly with globalization.

Since no individual firm (and surely no government) really knows what the most effective product and production process really is, the best way to deal with this uncertainty from a systemic perspective is to have many, many firms simultaneously attempting to hit the moving target and satisfy demand.[xii] To understand why, consider the alternative for a moment.

Suppose only one or two firms try to satisfy consumer demand for, say, bicycles. With only a couple of firms, consumers will not have many choices. As long as both firms can produce an adequate bicycle, consumers will have no choice but to buy from one of them. The two firms might split the market almost equally and if the firms earn a comfortable profit, possibly neither one would have a strong incentive to change very much.

Next imagine what happens as three, four or ten new bicycle firms are added. The incumbent firms, and all the others, would now have a much lower chance of survival because the expansion of consumer choices may lead all consumers to choose something else. Firms would now need to pay much more attention to their potential customers' needs and desires. Some firms might decide to specialize in certain niche products, for example, expensive racing bikes or children's bikes. Other firms might decide to produce a range of bicycle styles to satisfy many consumer types. Some firms may spend more on advertising attempting to attract new consumers into the market, or persuade consumers to switch to their brand. Other firms may provide better service agreements by offering buyers regular bicycle tune-ups and repairs. Whatever a firm does, it will remain in business in a competitive market only if it satisfies some segment of consumer demand. No single firm may know exactly what is best, but they will all

have the incentive to continue to investigate and learn from their customers and the market. This is what Hayek meant when he described competition as a discovery process.

The Objective of Competition

In main objective in competitive markets is the satisfaction of consumer desires. Consumer demands are the primary source of well being in an economic system. These demands are satisfied through the pursuit of profit. Profit is the extra benefit one obtains above the cost of producing or acquiring something. Producers profit whenever they satisfy consumers demands, which in turn enables them to purchase goods and services for themselves to satisfy their own consumer demand. But, production activity is not the goal; jobs are not the goal; even profit is not the ultimate goal; production, work and profit are merely the means to an end, the end being consumer demands.

Unfortunately, popular discussion and public policy making is dominated by excessive focus and concern for producer outcomes. This is largely because of the functioning of political markets. Mancur Olson (1965) argued that smaller groups who stand to enjoy relatively larger benefits from an government policy will be able to organize and influence political decisions much more effectively than large groups who have little to lose individually. Even though the net losses to the large groups (consumers) may overwhelm the benefits earned by the small group (producers), the small group often wins. In democratic governments it is interesting to note how many new policies tend to substantially benefit a small group, paid for with small incremental costs to a very large group (consumers or taxpayers).

Furthermore, in many instances government interference in markets tends to reduce the benefits received by consumers. This is largely because of imperfect information. If governments knew how to satisfy consumer demands more effectively than the firms in the marketplace, then they could design policies that would prevent entry by firms with the bad ideas while guaranteeing the markets for the champion firms. This would eliminate all those costs associated with unnecessary market experiments that the government knows will fail. However, if government does not have better information than firms about consumer desires, then market interventions will almost surely inhibit the competitive experimental process. This means consumers will not have as many choices before them. Furthermore, unless the government is lucky enough to inhibit only the least effective firms, consumers will also, almost surely, be made worse off.

Government is also at a disadvantage because the individuals most closely involved in the production process will have better information about consumer demands than the government workers, who are more distant. Thus, when firms compete, managers and workers within the firms themselves will be able to analyze their own sales data, negotiate prices with intermediate input suppliers and survey their own customers about their desires. They will use all this information to make decisions about which type of product will be most successful to produce. Thus, with free competition, the most relevant and available information is used to make decisions to satisfy consumers.

In contrast, when governments make policy decisions, the information they have about the market has to be worse, not better, than the individual firms. What's more, if the government attempts to acquire market info to assist it in making better decisions the

best source of that info is the firms themselves. However, the firms have the incentive to provide biased info to the government. Firms prefer to inhibit competition with other firms; ideally they would prefer to be a monopoly. Thus the info they provide government policy makers will often help mold policy decisions to favor their own interests. This kind of lobbying is surely the norm, rather than the exception. Firms have every reason to protect their own interests even if it means tilting the debate in a favorable direction. These actions are also the reason many people are extremely suspicious of, especially large, firm motivations.

Opportunity and Incentives

In a well-functioning free market economy the fear of losses from international competition should inspire owners, managers and workers to perform with greater effort and skill to increase output, reduce cost, and increase the quality of the product. So, we might ask next, whether these reactions by businesses to the fear of competition will guarantee successful transition of these businesses in the new global economy. Alas, the real answer is a great big, emphatic, NO!!!!

A competitive economic system is NOT a system in which everyone benefits. This is the unpleasant and rarely spoken reality. A competitive system is one that, by its nature, raises fears and anxieties. As the world globalizes and as competition extends its reach to include more markets, there will be an increase in this fear and anxiety in all countries. This is precisely what we are seeing today and it is a primary motivating factor for the renewed resistance to globalization.

Alan Greenspan (2007, p.268) explains, "The problem is that the dynamic that defines capitalism, that of unforgiving market competition, clashes with the human desire

for stability and certainty. Even more important, a large segment of society feels a growing sense of injustice about the allocation of capitalism's rewards. Competition, capitalism's greatest force, creates anxiety in all of us. One major source of it is the chronic fear of job loss. Another, more deeply felt angst stems from competition's perpetual disturbance of the status quo and style of living, good or bad, from which most people derive comfort."

The fight to preserve the status quo will initially involve pointing fingers and laying blame on others. This is especially easy to do when the blame can be directed at foreigners. People seem to have a natural inclination to look to external sources to explain their own misfortune. Perhaps this is why competition from domestic sources is not looked at in the same way.

However, despite the continual swirl producing winners and losers, a competitive system is one in which is best suited to satisfy the ever changing and amorphous consumer demands and provide individuals with the best chance to reach their maximum potential. It is a system that provides opportunity. The beauty of the system lies not in the misguided promise that "all good will come to all people." Rather, the beauty lies in the incentive structure that motivates (indeed forces) all individuals to achieve their very best. If you don't, you will fall further and further behind. The system's incentives reward those who work hard and have natural skills and abilities and sometimes those who are simply lucky. It rewards those who succeed in producing that which other people want the system to produce. At the same time the competitive system withholds rewards from those who are lazy, are less fortunate in terms of their natural endowments and in

many cases are simply unlucky: it withholds awards from those who produce what consumers don't want.[xiii]

The longer-term impact of a competitive system will be the provision of goods and services that consumers most want, at the lowest economic and resource cost at the moment. The size of the economic pie will rise over time if the system is allowed to work. This will mean a higher average standard of living for people in all countries, as it is usually measured. However, the distribution of those gains may be quite different from what they would be in a system rife with intervention. Thus, it is not accurate to say that everyone would eventually benefit in a competitive system. This is the reason many people would still prefer a system with government "protections," which as the term implies, *protects* the benefits of some groups.

Costs of Free Competition

Although there are many efficiency advantages in the operation of free voluntary exchange and competitive markets, there are also costs. Some costs have already been mentioned. Many producers and their workers will lose in the competition to other firms who produce a more desirable product. Consumers of the losing firm's product may also lose somewhat. For example, a small number of consumers may feel that the failing firm's product is ideal for them relative to the alternatives. However, if that consumer group is too small, it may not be cost effective to for a firm to serve them. When the firm fails due to insufficient demand, these consumers will have to switch to a slightly less desirable product.

Experimentation

Additional inefficiencies arise in a dynamic market because of the wasted experimentation. As mentioned above, failed market experiments represent costs that are not recouped. In an ideal world, with perfect information about consumer desires, only those firms that can succeed would produce, thereby saving unnecessary duplicative efforts. Unfortunately though, this represents an unrealizable ideal. Suggestions to fix these problems assume that market participants have accurate information about production costs and consumer demands before beginning production. However, as explained earlier, since market conditions are constantly changing, it is difficult even for firms most engaged in the market to anticipate future changes in supply possibilities and demand potentials. The most effective and direct way to learn is through the competitive process itself.

Winner-Take-All Markets

One other important source of inefficiencies in the competitive process is the presence of winner-take-all markets as described in Frank (1995). He describes situations in which many individuals or firms compete in a market in which there can be only one or several winners, each of whom will realize extravagant profit. Examples include the markets for professional athletes, movie actors, musical artists, and corporate CEOs. Earnings for a small group of people in these markets easily reaches the multimillion dollar levels. Think only of Tiger Woods, Michael Jordan, Julia Roberts, Tom Cruise, Britney Spears, Madonna, Michael Eisner, and Warren Buffett, to name just a few.

The inefficiencies in these cases arise *not* because the high salaries are unwarranted. These salaries arise because the added value by these individuals in their respective occupations really does amount to multimillions of dollars. Indeed, it is valid to say that the multimillion dollar salaries of athletes and performers are matched by at least that much surplus value created among the large group of consumers who enjoy their performances.

Rather, the inefficiencies occur because the high salaries attract many people to the competition for these positions, almost all of who will ultimately be unsuccessful. Frank shows that even if people have perfect information about their low chances of winning the big prize, many more people than is optimal will enter the competition. The inefficiency is the lost opportunity of alternative production; that is, the value of the output these individuals could have produced had they not devoted their time to playing basketball, or to voice lessons, or to MBA and law school study.[xiv]

This example is one of many prisoner dilemma problems in which individual desires to profit and a lack of cooperation can result in aggregate inefficiencies. Another classic example is the nuclear arms race. The first country to develop one nuclear missile that can cause catastrophic damage to a foreign country gains a security advantage over that country, hence there is an individual desire to do so. The rival, however, now has an incentive to develop two nuclear missiles weapons. The first could destroy its opponent's weapon in a first strike and it would have one more extra giving it extra security against its rival. Of course, once the rival builds two missiles, the first country has an incentive to build three to take back the advantage. And so it can go, and did go, on and on during

the cold war era as the US and the Soviet Union wasted billions of dollars building weapons that, thankfully, were never used.

The solution to a problem like this normally involves cooperation. In the case of the nuclear arms race, the US and the Soviet Union eventually agreed to a strategic arms limitation treaty (SALT) in which both countries agreed to reduce their nuclear arsenals. The fear that either side would cheat on the agreement necessitated a complex system of verification to maintain the trust that the agreement would indeed be implemented.

Drawing on this example, Frank refers to this kind of agreement in all contexts as a positional arms control agreement. For example, sports franchises, like Major League Baseball, have cooperated to prevent any one team from dominating a league and to prevent excessively high salaries by agreeing to limit the total amount each team can spend on player's salaries. Similarly, ivy league universities and MIT *colluded* in the late 1980s with an agreement not to use financial aid as a method to attract the brightest students. The purpose was to stop a positional arms race in which financial aid was being offered even to students whose families were financially able to pay in order to attract them. The cost was that less financial aid was available to excellent students who could not afford the tuition. These are two instances in which collusion to restrain competition can actually have a positive effect.[xv]

Innovation and Competition Policy

Another important issue is the relationship between competition and innovation. In the competition story above it is blithely assumed that competition will inspire fear of losses and automatically induce the discovery process. Discovery may or may not involve innovation of new product or process technologies and it may or may not occur.

When it doesn't involve innovation, discovery can mean finding the cheapest and most reliable input suppliers, or learning how to incorporate known technologies, such as internet service provision, into one's business operations. These represent static efficiency effects from competition – in other words, improvements in the allocation and uses of resources that are already available. However, in many industries discovery involves creation of whole new products or services to satisfy a consumer demand that had never been satisfied before. Discovery can also mean designing new machinery that enables the firm to improve product quality or reduce cost. In these cases, discovery involves new innovation. These are known as Schumpeterian growth effects because the innovation in new technology may induce a more rapid growth of the industry and the economy.

Aghion and Griffith (2005) provide a good overview of the issues, stating:

> "But are we so sure that competition always favors innovation in developed economies? In fact we often hear the opposite view being advocated by prominent innovators – for example, by Microsoft over the past five years – namely, that tough competition discourages innovation and inhibits productivity growth by reducing the expected rents from innovation. … If, as an entrepreneur, I anticipate future antitrust action, or future liberalization of entry in my market, why should I invest so much in new innovations if the rents from these are to be destroyed by new entrants or potential competitors? On the other hand, antitrust practitioners and competition authorities argue that competition is a necessary input into innovation, both because it encourages new entry and because it keeps incumbent firms on their toes and forces them to innovate in order to survive competition." (p. 2)

In part this describes a conflict between antitrust policy and intellectual property policy. Intellectual property protections include, patents on new inventions, trademarks for original labels and designs, and copyrights for literary and artistic work. These protections confer monopoly rights for some firms and individuals in certain prescribed

situations, normally for items in which the cost of producing the first unit of these goods (i.e., the fixed costs) is high, whereas the cost of every additional unit (the marginal costs) is very low.

The best example is for a new pharmaceutical drug. The cost to identify a drug that alleviates a particular ailment, can often run into the billions of dollars. However, once it is known what the drug can do, it is easy for others to identify the chemical composition and produce it at a very low unit cost. If an imitator is allowed to reverse engineer the drug, then the imitator can produce and sell it at a very low cost to the consumer. Hence patent protection enables the innovator to recoup its high fixed cost with monopoly profit by preventing competition from imitators at least for some period of time. Without the patent protection, or intellectual property protections, more generally, innovations and, subsequently, economic growth might be decidedly lower.

Achion and Griffith carefully examine both the theoretical and empirical literature in this area and ask whether one can turn to economists for an answer to the question: does competition inspire innovation. Their answer is no.

> "While competition features prominently in the history of economic thought, it is fair to say that economists still have a limited and sometimes contradictory understanding of its economic effects and, in particular, of the relationship between competition and growth. What we have accumulated so far are only bits and pieces: … From this a deep feeling of confusion arises."

Overview of the Costs of Competition

It is important to recognize that support of free markets and competition cannot be justified with some sort of *proof* that it will always lead to the most efficient outcome. Researchers have identified numerous examples of inefficiencies when markets are

completely free, including the winner-take-all markets, other prisoner dilemma situations, incentives for innovation and the presence of other kinds of market imperfections described in Chapter 2. The key problems in every attempt to correct for these inefficiencies are the lack of sufficient information and the problem of capture by the political system. As discussed in Chapters 2 and 3 it is enormously difficult to measure the full impact of policy changes and to determine precisely the right policy lever and policy strength to use to improve economic efficiency. Consequently, policy actions to correct for distortions or imperfections will surely change economic outcomes and the distribution of income, but it will remain *impossible* to know whether these outcomes are *better,* in some clearly defined way, than what would have happened without the corrections.

Also, once the opportunity to correct perceived problems is available in the political system, parties have incentives to propose policies beneficial to themselves and to cobble together efficiency or fairness arguments to justify them. Unfortunately, we have no idea whether this piecemeal approach to policy making improves overall outcomes relative to free competitive markets.

Compensation

Economists, cognizant of the fact that trade liberalization will cause harm to some groups in the economy, often argue that compensation be provided to those who would lose. This would essentially entail a system of monetary transfers from the winners to the losers. In the event the actual winners cannot be identified, the practical solution is to fund the transfers from general tax revenues. Compensation is also supported for

political reasons: if the potential losers from trade liberalization are vocal enough, compensation can be used to quiet the opposition.

The nature of effective competition, though, provides an argument **against** compensation. Since trade liberalization will increase the competitive churning in product and labor markets, many of the weaker industries and the workers whose skills are least in demand will be the ones that lose from trade liberalization. If compensation is provided, these firms and workers will lose the incentive to change and adjust. And, if adjustment is incomplete, consumer demands will not be fully satisfied.

Distributional Effects of Trade Liberalization

Competition inspires creative behavior but it does not guarantee success. In fact, in a truly competitive economy, despite noble efforts on the part of some firms and their workers, many will still fail to compete; other firms will produce better products at lower prices. Perhaps this will come because other firms have cheaper, more reliant sources of input supply, perhaps, because other firms introduced more efficient management procedures. Maybe other firms hired a more competent average workforce, or maybe they were lucky enough to choose the style and design for their product that more people wanted this season. For many reasons, some the fault of the management and workers, some just dumb luck, businesses will fail. These failures will cause income losses for employees and will cause anxiety-filled adjustments to other jobs. Once again, the truth about competition is that it is a difficult process for many of the participants.

We might ask whether these adjustment costs will be borne by all people at one time or another. In other words, how will these costs likely be distributed? Unfortunately, here too the answer is unlikely to appeal to those in search of fairness and

justice. The cost will almost surely be borne disproportionately by those who are less skilled, less educated and generally poorer. The reasons should be obvious.

Those workers who are most skilled will be in the greatest demand by many different firms. Every firm would like to have the best managers, the most creative researchers, the most prudent accountants, etc. Those individuals who rise to the top in their profession will face fewer difficulties, first because they will likely be one of the last people fired in a declining industry and second because they will have more alternative opportunities in other industries if they are forced, or decide, to leave a firm. The way firms identify the most-able, the best educated, the shining stars, is by noting their previous achievements relative to others. Thus, those who attend the most elite schools will be identified as having the greatest likelihood of being among the best and brightest. Also, those who have more money or whose families have money will be better able to leverage that to achieve better academic outcomes and will also likely have better connections with people who make hiring decisions.

Fairness and Voluntary Exchange

Voluntary exchange involves the simultaneous, voluntary transfer of goods and services between two individuals. Each person gives away something willingly in order to receive something else that the other person also gives away willingly. If both are free not to trade, then the very fact that a trade occurs must mean that both traders expect to profit from the transaction. This simple exchange process happens whenever a person buys food at the market, when someone pays their electric bill and when a firm pays wages to an employee.

The exchange process requires acceptance of private ownership. We presume that an individual "owns" his own labor services, that the money he uses in a transaction is rightfully his, and that the goods a firm sells are not claimed by another. If no one owns the means of production and the returns to it, or if the state owns it, then the free voluntary exchange process is compromised.[xvi],[xvii]

Thus, two things are needed to define a free market economy; free voluntary exchange and ownership. Competition arises in this environment whenever a group of sellers with similar products is matched with a group of buyers with similar demands. If all exchange is left free, then competition automatically arises.

Competition is a catalyst that can motivate people to achieve their very best, because to be successful requires that the products you are trying to sell are more desired than the similar products others are selling. This makes competition a process in which, on average, individuals that are smarter and work harder will achieve more economic success than others. Thus, a competitive system with free voluntary exchange will operate as a meritocracy. However, not all outcomes need be based on skill and effort; luck will also play a role. Sometimes a business will sell more items than competitors simply because it guessed correctly what consumers' preferences would be this year.

Voluntary exchange, and the free market competition that arises from its application, is fair with respect to several fairness conceptions described in Chapter 4. First, voluntary exchange is fair with respect to privacy fairness, which states that individuals should be left alone when their actions do no harm to others. With exchange both parties to the transaction agree to exchange voluntarily and the process does not cause harm to either party directly involved in the trade. However, voluntary trades by

some people may cause harm to others if a person shifts his exchanges from one person to another. Thus if one week a person buys California wine instead of French wine, the French wine seller will be harmed. However, although harm occurs, attempts to prevent that harm would inhibit voluntary transactions and violate privacy fairness itself. It would also force buyers into trades with some sellers over others, thus violating non-discrimination fairness.[xviii]

Voluntary exchange is also fair with respect to positive reciprocity fairness; indeed it may be more than fair. Positive reciprocity says that positive benefits given to another should be reciprocated with equal benefits in return. I do something for you with value x, and you should return the favor and do something else for me also with value x. However, when voluntary exchange occurs, each party receives a benefit that is *greater* than the value of what is given up; surplus value is created as both sides in a trade profit. Thus, we might claim that voluntary exchange is not just reciprocity fair; it's reciprocity-plus fair, or even better than reciprocity.

By similar logic voluntary exchange would also tend to satisfy maximum benefit fairness, because there is a surplus created for both parties to a trade. However, it is conceivable that the perceived losses that accrue to parties left out of the exchange (for example the French wine sellers) may be larger than the surplus benefits accruing to the two traders. In this case maximum benefit fairness is violated. This result is in line with the more general point raised earlier, namely that free trade, and hence free exchange, does not guarantee that all people will benefit, nor that the sum of the benefits, measured broadly, will exceed the sum of the losses.

Voluntary exchange is fair with respect to golden rule fairness. The golden rule requires that each person take actions that they themselves would encourage others to take. With reciprocal trade, the parties to the trade can surely not object to the behavior of the other. Sometimes rules or laws are implemented that restrict voluntary trades. For example, the US prohibits sales of supercomputers to certain countries deemed potentially unfriendly to the US. If a firm violates this rule and trades voluntarily with a restricted country, one could argue that the voluntary trade, by breaking a law, violates golden rule fairness. However, the unfairness in this case applies strictly to the rule, not to the exchange itself. Nonetheless this example shows the application of the fairness criteria is sometimes ambiguous, or at the least, subject to multiple interpretations.

In terms of non-discrimination fairness, as long as all of the policies, procedures and institutions used to encourage voluntary exchange apply equally to all, then nondiscrimination fairness is realized. If, in contrast, some transactions are restricted, perhaps to guarantee continued profitable trading by another market participant, then these restrictions would violate non-discrimination fairness.

By itself, voluntary exchange has very little or nothing to do with negative reciprocity, which states that a negative effect caused by someone can be reciprocated with a similarly valued negative response. With voluntary exchange, both sides of the transaction are positive.

Finally, one can also argue that voluntary exchange can sometimes result in unfair outcomes, most notably with respect to distributional fairness. Distributional fairness involves perceptions of the equality of outcomes such as the realizations of income and wealth of individuals. As suggested by Nozick (1974), if thousands of individuals agree

to pay, say $5, to see Wilt Chamberlain play basketball, then Chamberlain's income increases significantly whereas each of the sports enthusiasts' wealth falls slightly. The resulting distribution of wealth becomes more unequal as a result of numerous voluntary exchanges.[xix] If we only accept movements in the direction of income equality as our measure of fairness, then voluntary exchange is potentially unfair with respect to this fairness conception.

In summary, voluntary exchange is consistent with privacy fairness, reciprocity fairness, golden rule fairness, and nondiscrimination fairness. It may or may not be consistent with maximum benefit fairness and is unlikely to be consistent with distributional fairness. Thus, although we cannot claim voluntary exchange is always fair regardless of how one classifies fairness, we can argue that it satisfies many of the fairness criteria and thus might be deemed "mostly fair."

Table 8.2 offers a summary of the fairness characteristics of voluntary exchange. Note that voluntary exchange is mostly fair with the exception of distributional fairness and the non-applicable case of negative reciprocity.

Table 8.2
Consistency of Voluntary Exchange
with Fairness Principles

Distributional	No
Nondiscrimination	Yes
Golden Rule	Yes
Positive Reciprocity	Yes
Negative Reciprocity	n.a.
Privacy	Yes
Maximum Benefit	Yes

Conclusion

People engage in voluntary exchange because they seek to profit. They wish to improve their own well-being, to make themselves happier. To be ready to trade, one must have something other people want. Generally these items do not come to us like manna from heaven; instead we must work at it, we must make it, create it. One thing we all can give is our labor services. However, if we wish to exchange our time and hard work with an employer, we must have skills an employer will demand. If we wish to sell a product instead, then we must produce that product first. Production may require our own effort as well as the effort of other workers. Production will also require the input of capital and natural resources. An owner's task is to purchase those inputs, manage their activities and produce a product that can be sold to willing buyers at a price that covers the costs of production. If that entire process is managed successfully, the owner will profit.

This kind of profit is laudable. When we match this process to the fairness criteria it is straightforward to show that voluntary exchange is mostly fair and just. Indeed, as suggested in Chapter 6, trading something of value to another can even be viewed as altruistic since part of every transaction involves giving something that another person values or desires. Successful trading requires one to discover peoples' wants and needs and to satisfy them through your own efforts. If a person or business can do so, they will also benefit themselves, thus trade has both an altruistic and an egoistic aspect combined.

The desire to benefit oneself - to profit - is natural. When profit arises by benefiting others, that is when it is matched with the altruistic component, then we should

support and promote that activity. Indeed, it is accurate to say that those who profit the most in a free market are those who have given the most to others. In contrast, when profit is obtained via involuntary transfers from others, as discussed in Chapter 7, then profit is not so laudable. In the case of transfers, there is no altruistic giving, only taking. Profit from involuntary transfers is what gives profit seeking a bad name.

The key to a new understanding is to separate these two ways to obtain profit. When we do so it becomes clear why some view profit making so negatively. Many people believe that businesses will do whatever is necessary to make more money. When they see businesses achieve that profit by cheating its customers, promulgating misinformation, by selling dangerous products, exploiting or mistreating its workers or by using its power and influence in government to restrict competition, then they are reacting to a clearly objectionable type of profit via involuntary transfers. Thus, these negative reactions to profit are all reasonable since all profit is not good profit.

Another source of confusion is that the sources of profit, even for a particular firm, are confounded. Some firms produce products that are desired by their customers but at the same time obtain special regulations from government giving them a competitive edge. Some firms produce products that are desired, like car repair, but pilfer a little extra income with a small dose of dishonesty. Some firms produce products that people want, but at the same time mistreat or even imprison their workers to reduce their costs and raise their own profit. What a person believes about the profit incentive will depend on what part of a business activity seems more prominent. Those who look favorably upon profit tend to see more of the market activity, while those who view profit negatively tend to see more of the involuntary transfers.

Friedman (2002: p112-113) makes this same argument about the confusion over profit and tries to clarify by distinguishing between two types of harm; positive harm (involuntary transfers) and negative harm (voluntary exchange induced).

> "(there is) a serious confusion about two very different kinds of harm. One kind is the positive harm that one individual does another by physical force, or by forcing him to enter into a contract without his consent. An obvious example is the man who hits another over the head with a blackjack. A less obvious example is stream pollution discussed in chapter ii. The second kind is the negative harm that occurs when two individuals are unable to find mutually acceptable contracts, as when I am unwilling to buy something that someone wants to sell me and therefore make him worse off than he would be if I bought the item. … There is a strong case for using government to prevent one person from imposing positive harm, which is to say, to prevent coercion. There is no case whatsoever for using government to avoid the negative kind of "harm." On the contrary such government intervention reduces freedom and limits voluntary co-operation."

Thus, we should not disparage profit, per se, or believe that all negative outcomes indicate examples of involuntary transfers. Instead we need to disentangle the actions of businesses and individuals to identify the method used to acquire profit. A moderate compromise seeks policies that accept and promote profit via voluntary exchange while restricting or prohibiting profit via involuntary transfers.

This is especially important because not only is the desire to profit natural, but it is an absolutely necessary motivating factor for voluntary exchange. Voluntary exchange, in turn, is absolutely necessary to enable the division of labor, which is needed to achieve the kinds of increases in productivity that the human race has realized over the past 4000+ years. As will be argued in the next chapter, the absence of profit seeking could relegate our fate to a much lower average standard of living, especially if the alternative is a society motivated by primarily by altruism.

Although the promotion of voluntary exchange has many positive features, this chapter has also emphasized that a free competitive market consisting of a myriad of voluntary exchanges will be fraught with ups and downs for its participants. While proponents of free markets often try to put a positive spin on the process by suggesting that eventually all people will benefit, the actual experience of market participants will be quite different. In a nutshell, that's because competition is hard. It is very difficult to adequately satisfy the needs of a group of consumers, especially when there are other businesses trying to do the same thing.

Successful firms must first discover what people want. Even this may be difficult since consumer demands will continually change as incomes, tastes, and knowledge about alternative products changes. But even if a firm correctly identifies consumer desires for the moment, it must also be able to satisfy those desires more effectively than its competitors. When it does so it will profit. But those profits may be fleeting since profit making by one firm will attract other firms to step in and try to grab some of that profit away. The result is a competitive system replete with fear and anxiety.

In all cases, success today may disappear tomorrow. Firm owners will worry their profit will dissipate; workers will fear being fired. However, this fear and anxiety can actually be a good thing IF it motivates the correct behavior; namely the positive responses to competition. The positive response is when firms react to the pressure by continually adjusting its product features and production process to better satisfy its consumers' needs. Workers must react by continually preparing themselves for adjustment. That can involve everything from showing up to work on time and working

hard (i.e., prove to your employer that you are valuable), to investment in new up-to-date skills (perhaps to prepare for another job).

Unfortunately though, many firms and workers will respond to the fear and anxiety by seeking involuntary transfers instead. Firms don't like to compete and regularly and actively attempt to reduce competition either independently (e.g. with mergers) or with government intervention. Workers also resist competition by demanding unionization and pressuring companies not to adjust to competitive pressures by laying off workers. Along the way the company – seeking profit – is sometimes demonized. Suggestions for compensation are also widespread, especially when groups lose because of changes in government policy, as with a reduction of trade barriers. These responses, however, all represent calls for involuntary transfers to improve the well being of losing groups by transferring money from others.

An additional problem arises because in pursuing involuntary transfers, firms must devote resources (employee time and energy) that are diverted away from product improvements. This process of rent-seeking is a directly unproductive activity; the more resources devoted to rent-seeking, the poorer a society will be (all else equal).

But what is society to do about the hardships caused by competition? This chapter does not suggest, like many people do, that the hardships will be small and temporary. Instead, it is argued the hardships may sometimes be severe, persistent and somewhat arbitrary. On average, especially if good and bad luck is equally distributed, those individuals who are physically less capable, have fewer skills, or suffer from other impediments, such as poor health or disabilities, are more likely to suffer hardships in a competitive system. Concerns about outcomes like this are one reason supporters of free

markets are typically lambasted for being heartless and uncompassionate on the mild side, to being downright evil at the extreme. In the midst of these kinds of attacks, it can explain why free market supporters also tend to underemphasize the extent of the negative effects.

An honest argument supporting free competitive markets cannot ignore these negative effects or act as if they are unimportant. Fortunately there is a solution; it is possible to respond to these negative outcomes in competitive markets in a compassionate way. However, the solution is not the one typically provided by those suspicious of free markets. Policies that tax the rich and redistribute to the poor, although well intentioned, are nonetheless applying involuntary transfers to correct for these problems. A more equitable and reasonable solution can be found in another type of transfer, namely, *voluntary transfers*. Examples are discussed in the next chapter.

[i] Include reference to Road to Serfdom

[ii] See "NAFTA-related job losses have piled up since 1993" Economic Snapshots, Economic Policy Institute, December 10, 2003, http://www.epinet.org/content.cfm/webfeatures_snapshots_archive_12102003

[iii] Schumpeter (1942).

[iv] Of the 5.8 million US businesses, 99.9% of them are classified as small, having fewer than 500 employees. Only 17,000 US businesses have more than 500 employees.

[v] See for example this US Small Business Administration FAQ at http://www.sba.gov/advo/stats/sbfaq.pdf

[vi] See http://news.postbulletin.com/newsmanager/templates/localnews_story.asp?a=294216&z=7

[vii] http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20070326/REG/70326022

[viii] http://biz.yahoo.com/ap/070328/circuit_city_layoffs.html

[ix] See http://www.bls.gov/news.release/empsit.nr0.htm

[x] Even these statistics don't report all of the churning taking place within an industry. Every industry loses many workers each month and immediately replaces them with new hires. These numbers only report the net effect in each industry.

[xi] http://www.newyorker.com/archive/2004/03/29/040329fa_fact

[xii] Friedman (2002; p118) wrote, "… it is desirable to let men follow the bent of their own interests because there is no way of predicting where they will come out."

[xiii] Hayek (2002) p. 17 "In a constantly changing world, merely maintaining a given level of welfare requires constant adjustments in how the efforts of many individuals are directed; and these will only occur when the relative compensation of these activities changes. Under relatively stationary conditions, however, these adjustments—which are needed simply to maintain the income stream at its previous level—will not generate a surplus that could be used to compensate those who are disadvantaged by the price changes. Only in a rapidly growing economy can we hope to prevent an absolute decline in the material level of particular groups."

[xiv] If MBA study, or law school, were judged to be the best route to become a highly-paid CEO, then more people would enter those professions than would otherwise be optimal from a social perspective.

[xv] See Frank (1995) for many more examples.

[xvi] Rothbard (1974) argues that "for an economist to say that X and Y should be free to trade Good A for Good B unmolested by third parties, he must also say that X legitimately and properly owns Good A and
that Y legitimately owns Good B. But this means that the free market economist must have some sort of theory of justice in property rights; he can scarcely say that X properly owns Good A without asserting some sort of theory of justice on behalf of such ownership." (p. 90) Accessed online on April 22, 2008 at www.mises.org

[xvii] Robert Nozick (1974) indicated that for mutually voluntary trades to be fair, individuals must have acquired the object traded legally. Thus, if someone steals an object and then proceeds to exchange it for something else with someone else, the second exchange may not be deemed as fair acquisition.

[xviii] Richard Epstein (2003a) regards this as "one of those easy cases that is absolutely vital to get correct: there must be no compensation or protection against economic losses sustained through the operation of competitive markets. It is a principle that is widely acknowledged and violated in practice." (p 36)

[xix] Nozick, Robert, (1974), Anarchy, State and Utopia, Basic Books, New York.