

# Does the Market Economy Make the Life Better for All?: An Alternative View

## Market Mechanism: The Background

Most economies in the world have adopted or in the process of adopting market mechanism with a view for economic prosperity through a faster economic growth. The supposition is that the market is the most efficient mechanism to allocate scarce resources among different sectors in the economy. The efficiency is achieved, from consumers' point of view, by providing the people with an opportunity to consume more goods and services and information at comparatively low prices. Goods and services and information at lower prices means more perceived benefits for consumers. From producers' point of view, market provides them with opportunities for profit making. They take the risk to combine resources in the most innovative manner to lower the cost of production of goods and services and information. The cost of production is important, because it determines the level of profit for producers. An opportunity is created in the market when the level of profit is greater than the risk involved for the producers. The tussle between risk and opportunity by producers on one hand and thriving for more perceived benefits by consumers on the other hand determine the market price for the product. This is popularly known as the competition between the market forces.

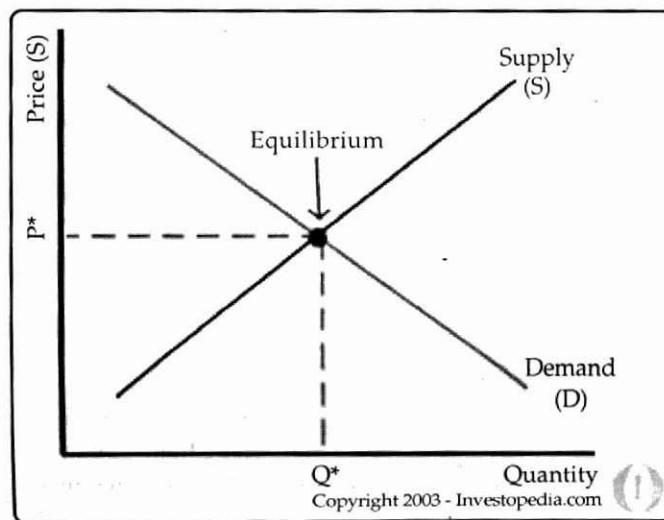
On the other hand, the market mechanism is complimentary to modern day democracy. Under the market mechanism, people in the society are able to exercise their democratic rights in consumption, production and distribution. In other words, as Freidman says, people enjoy economic freedom when production, consumption and distribution are

arranged in line with the market mechanism. To Freidman, economic freedom is the key for political freedom.

Smaller economies find it difficult to be indifferent to the forces of globalisation because it disseminates around the world very rapidly today. In this outset, market mechanism marches into the lives of people in countries with the pledge of economic prosperity. However, a careful look at countries which have achieved economic prosperity, largely through market mechanism, shows that the market mechanism does not only mean the competition between demand and supply forces, but also an array of institutions, procedures, social relations and infrastructure that guarantees a fair-play, that in turn facilitate exchange of goods and services and information in the most efficient manner.

## How Market Works: Theory and Practice

The market mechanism is explained by the following well-known graph.



In this graph y axis represents the price of the product and x axis is for quantity demanded and supplied. Market supply and demand curves are denoted as S and D respectively. At the intersection point of these curves, the equilibrium price ( $P^*$ ) is determined,

## Dr. Chandana Aluthge,

Senior Lecturer,  
Department of Economics,  
University of Colombo.

and at that price, the market clears, or in other words, the demand ( $Q_d$ ) equals the supply ( $Q_s$ ). Participants in the market are happy about the equilibrium price and thus what is supplied to the market is sold. Hence, market delivers the most efficient outcome.

However, it is important to look at this explanation in a different perspective to understand well the market dynamics in reality. The market demand curve is constructed by summing a large number of individual demand curves together. That means any given point on the market demand curve represents an individual consumer in the market and his/her preference on how much to buy at the preferred price. Given that, if market demand curve is divided into two at the intersection point, all consumers in the market will fall into those two groups. One group represents the upper segment of the demand curve from the intersection point and the other group represents the lower part of the demand curve from the intersection point. The group that represents the upper segment of the demand curve is better off because market equilibrium price is lower than to what they are willing to pay and thus they achieve the highest level of perceived benefits. For them, market mechanism brings economic prosperity.

This is also true for the group of suppliers who represent the lower segment of the market supply curve from the intersection point. They possess the technical know-how to supply the product at lower prices than

the market equilibrium price offered to them. Since the market equilibrium price is higher than what they have expected, their level of profit is higher, bringing them economic prosperity. What about the suppliers who represent the upper section of the market supply curve from the intersection point? The price they offer is higher than the market price. That means they are not competitive enough to be in the market, and eventually will have to exit from the market. For suppliers, the market mechanism is reasonable, that is, only those who are competitive will prosper, and those who are not so will diminish to non-existence.

### Market Mechanism: Agony and Ecstasy

Coming back to consumers, what is interesting is to understand the state of the group who represents the lower segment of the demand curve from the intersection point. For them, the equilibrium price is higher than what they can pay for the product. This issue is quite important when the number of consumers in this group becomes larger. For example, take a situation where a significant proportion of the population of a country is in the lower segment of the demand curve. For all of them, the market price is unaffordable. This can be quite serious when the product in question becomes an important for life, like powdered milk for infants. Consumers are in a dilemma, as the product is essential, but cannot afford it. Eventually, they are forced to abandon the demand for the product. For them, the economic freedom is denied then. In this context, there is a strong need to question the outcome of the market mechanism.

Equilibrium price and clearing the market at that price may be an efficient outcome. But, when the equilibrium price is higher than the expectation of the majority of the consumers, whether it can still be accepted as an efficient outcome is a question to be discussed. Why does a certain section of the consumers cannot afford the equilibrium price? The answer may be their inadequate income, or the market price is higher than their expectation. It could also be a result of both these situations. First, consider the scenario of inadequate income. Why is their

income low? The answer to this lies in the cost of production issue that was discussed earlier. A control on cost of production is vital to maintain a reasonable level of profit for producers. Profit swells when cost goes down. Cost on labour is a significant part of the cost of production. Producers naturally take measures to keep the cost on labour or more specifically wages for workers as low as possible to maintain a healthy level of profit for their enterprises. This would result in very slow progress in wage increases, and thus low income for workers/consumers. Consumers with low income are unable to afford the price of the product determined according to market forces. Therefore, economic freedom by consuming more at a lower price becomes remote for the majority of consumers, if they are happened to represent the lower segment of the demand curve from the intersection point.

One of the important issues in this regard is the meaning of healthy or reasonable level of profit for enterprises. There is no clear-cut definition for reasonable level of profit given in the market mechanism theory. Of course, the "normal profit" explained in the market mechanism theory can be considered as the theoretical equivalent to reasonable level of profit. However, those who are familiar with this concept know better that, in practice, no enterprise will settle with normal profit. Naturally the enterprises thrive for more profits since profit is the driving force of business firms in a market environment. Therefore, excessive level of profit would be the most likely outcome in reality under market mechanism, and enterprises perceive it as for them to grow and expand business activities to contribute more to gross domestic product (GDP) and employment. In this regard, many would think that this behaviour by enterprises is justifiable.

As discussed previously, business enterprises in a market environment employ low-cost methods of production to maintain a higher level of profit. The substance called 'melamine' in infant milk provides a good contemporary real world example to understand how enterprises work for

higher profit by lowering production cost. Melamine enhances the protein content in milk. The production formula then would be more melamine in milk. Why? Because cost of melamine is comparatively low and more protein in milk is produced with less cost, and thus higher profit for enterprises. But, melamine is lethal for living beings. It shows the extent to which enterprises exert the low cost methods to enhance profit in a market environment. This example is a testimony on how business enterprises can gain at a huge social cost in a market setting.

The other issue that needs the consideration is the situation where the market price is higher than the expectation of the majority of consumers. It is true that at the equilibrium price the market clears. But at the same time, the market equilibrium price should be the just price too. Then only it is possible to declare that the market delivers the best outcome, paving the way for economic prosperity for majority of the consumers.

As previously discussed, the best market outcome is based on competitive behaviour in the market with zero social cost. On its own, the sort of competitive behaviour explained here may not be possible to achieve. In order to compel market participants to engage in the competitive behaviour with zero social cost, properly developed vital institutions, procedures, social relations, and infrastructure should be in place in the society to ensure fair-play. In other words, markets are required to operate within a carefully laid down system of institutions and infrastructure. To have all these essentials in place, social and political commitment is necessary. Only when the required atmosphere is created for fair-play, we can expect the market to produce the socially justifiable outcome that is conducive for economic freedom for the majority. Otherwise poverty, frustration, social disharmony and disintegration, etc. are inevitable consequences of the market mechanism. ■