The Five Institutions of the Market Economy

Written by Henry Hazlitt.

Let us see what the basic institutions of the market economy are. We may subdivide them for convenience of discussion into (1) private property, (2) free markets, (3) competition, (4) division and combination of labor, and (5) social cooperation. As we shall see, these are not separate institutions. They are mutually dependent: each implies the other, and makes it possible.

Property

Let us begin with private property. It is neither a recent nor an arbitrary institution, as some socialist writers would have us believe. Its roots go as far back as human history itself. Every child reveals a sense of property with regard to his own toys. Scientists are just beginning to realize the astonishing extent to which some sense or system of property rights or territorial rights prevails even in the animal world.

The question that concerns us here, however, is not the antiquity of the institution, but its utility. When a man's property rights are protected, it means that he is able to retain and enjoy in peace the fruits of his labor. This security is his main incentive, if not his only incentive, to labor itself. If anyone were free to seize what the farmer had sown, cultivated, and raised, the farmer would no longer have any incentive to sow or to raise it. If anyone were free to seize your house after you had built it, you would not build it in the first place.

All production, all civilization, rests on recognition of and respect for property rights. A free enterprise system is impossible without security of property as well as security of life. Free enterprise is possible only within a framework of law and order and morality. This means that free enterprise presupposes morality; but, as we shall later see, it also helps to preserve and promote it.

Free Exchange

The second basic institution of a capitalist economy is the free market. The free market means the freedom of everybody to dispose of his property, to exchange it for other property or for money, or to employ it for further production, on whatever terms he finds acceptable. This freedom is of course a corollary of private property. Private property necessarily implies the right of use for consumption or for further production, and the right of free disposal or exchange.

It is important to insist that private property and free markets are not separable institutions. A number of socialists, for example, think they can duplicate the functions and efficiencies of the free market by imitating the free market in a socialist system—that is, in a system in which the means of production are in the hands of the State.

Such a view rests on mere confusion of thought. If I am a government commissar selling something I don't really own, and you are another commissar buying it with money that really isn't yours, then neither of us really cares what the price is. When, as in a socialist or communist country, the heads of mines and factories, of stores and collective farms, are mere salaried government bureaucrats, who buy foodstuffs or raw materials from other bureaucrats and sell their finished products to still other bureaucrats, the so-called prices at which they buy and sell are mere bookkeeping fictions. Such bureaucrats are merely playing an artificial game called "free market." They cannot make a socialist system work like a free-enterprise system merely by imitating the so-called free-market feature while ignoring private property.

This imitation of a free-price system actually exists, in fact, in Soviet Russia and in practically every other socialist or communist country. But insofar as this mock-market economy works—that is, insofar as it helps a socialist economy to function at all—it does so because its bureaucratic managers closely watch what commodities are selling for on free world markets, and artificially price their own in conformity. Whenever they find it difficult or impossible to do this, or neglect to do it, their plans begin to go more seriously wrong. Stalin himself once chided the managers of the Soviet economy because some of their artificially-fixed prices were out of line with those on the free world market.

I should like to emphasize that in referring to private property I am not referring merely to personal property in consumption goods, like a man's food, toothbrush, shirt, piano, home, or car. In the modern market economy private ownership of the means of production is no less fundamental. Such ownership is from one point of view a privilege; but it also imposes on the owners a heavy social responsibility. The private owners of the means of production cannot employ their property merely for their own satisfaction; they are forced to employ it in ways that will promote the best possible satisfaction of consumers. If they do this well, they are rewarded by profits, and a further increase in their ownership; if they are inept or inefficient, they are penalized by losses.

Their investments are never safe indefinitely. In a free-market economy the consumers, by their purchases or refusals to purchase, daily decide afresh who shall own productive property and how much he shall own. The owners of productive capital are compelled to employ it for the satisfaction of other people's wants. A privately owned railway is as much "dedicated to a public purpose" as a government-owned railway. It is likely in fact to achieve such a purpose far more successfully, not only because of the rewards it will receive for performing its task well, but even more because of the heavy penalties it will suffer if it fails to meet the needs of shippers or travelers at competitive costs and prices.

Competition

The foregoing discussion already implies the third integral institution in the capitalist system—competition. Every competitor in a private-enterprise system must meet the market price. He must keep his unit production costs below this market price if he is to survive. The further he can keep his costs below the market price the greater his profit margin. The greater his profit margin the more he will be able to expand his business and his output. If he is faced with losses for more than a short period he cannot survive. The effect of competition, therefore, is to take production constantly out of the hands of the less competent managers and put it more and more into the hands of the more efficient managers. Putting the matter in another way, free competition constantly promotes more and more efficient methods of production: it tends constantly to reduce production costs. As the lowest-cost producers expand their output they cause a reduction of prices and so force the highest-cost producers to sell their product at a lower price, and ultimately either to reduce their costs or to transfer their activities to other lines.

But capitalistic or free-market competition is seldom merely competition in lowering the cost of producing a homogeneous product. It is almost always competition in improving a specific product. And in the last century it has been competition in introducing and perfecting entirely new products or means of production—the railroad, the dynamo, the electric light, the motor car, the airplane, the telegraph, the telephone, the phonograph, the camera, motion pictures, radio, television, refrigerators, air conditioning, an endless variety of plastics, synthetics, and other new materials. The effect has been enormously to increase the amenities of life and the material welfare of the masses.

Capitalistic competition, in brief, is the great spur to improvement and innovation, the chief stimulant to research, the principal incentive to cost reduction, to the development of new and better products, and to improved efficiency of every kind. It has conferred incalculable blessings on mankind.

And yet, in the last century, capitalistic competition has been under constant attack by socialists and anti-capitalists. It has been denounced as savage, selfish, cutthroat, and cruel. Some writers, of whom Bertrand Russell is typical, constantly talk of business competition as if it were a form of “warfare,” and practically the same thing as the competition of war. Nothing could be more false or absurd—unless we think it reasonable to compare competition in mutual slaughter with competition in providing consumers with new or better goods and services at cheaper prices.

The critics of business competition not only shed tears over the penalties it imposes on inefficient producers but are indignant at the “excessive” profits it grants to the most successful and efficient. This weeping and resentment exist because the critics either do not understand or refuse to understand the function that competition performs for the consumer and therefore for the national welfare. Of course there are isolated instances in which competition seems to work unjustly. It sometimes penalizes amiable or cultivated people and rewards churlish or vulgar ones. No matter how good our system of rules and laws, isolated cases of injustice can never be entirely eliminated. But the beneficence or harmfulness, the justice or injustice, of institutions must be judged by their effect in the great majority of cases—by their over-all result.

What those who indiscriminately deplore “competition” overlook is that everything depends upon what the competition is in, and the nature of the means it employs. Competition per se is neither moral nor immoral. It is neither necessarily beneficial nor necessarily harmful. Competition in swindling or in mutual slaughter is one thing; but competition in philanthropy or in excellence—the competition between a Leonardo da Vinci and a Michelangelo, between a Shakespeare and a Ben Jonson, a Haydn and a Mozart, a Verdi and a Wagner, a Newton and a Leibnitz, is quite another. Competition does not necessarily imply relations of enmity, but relations of rivalry, of mutual emulation and mutual stimulation. Beneficial competition is indirectly a form of cooperation.

Now what the critics of economic competition overlook is that—when it is conducted under a good system of laws and a high standard of morals—it is itself a form of economic cooperation, or rather, that it is an integral and necessary part of a system of economic cooperation. If we look at competition in isolation, this statement may seem paradoxical, but it becomes evident when we step back and look at it in its wider setting. General Motors and Ford are not cooperating directly with each other; but each is trying to cooperate with the consumer, with the potential car buyer. Each is trying to convince him that it can offer him a better car than its competitor, or as good a car at a lower price. Each is “compelling” the other—or, to state it more accurately, each is stimulating the other—to reduce its production costs and to improve its car. Each, in other words, is “compelling” the other to cooperate more effectively with the buying public. And so, indirectly,—triangularly, so to speak—General Motors and Ford cooperate. Each makes the other more efficient.

Of course this is true of all competition, even the grim competition of war. As Edmund Burke put it: “He that wrestles with us strengthens our nerves and sharpens our skill. Our antagonist is our helper.” But in free-market competition, this mutual help is also beneficial to the whole community.

For those who still think this conclusion paradoxical, it is merely necessary to consider the artificial competition of games and sport. Bridge is a competitive card game, but it requires the cooperation of four people in consenting to play with each other; a man who refuses to sit in to make a fourth is considered non-cooperative rather than noncompetitive. To have a football game requires the cooperation not only of eleven men on each side but the cooperation of each side with the other—in agreeing to play, in agreeing on a given date, hour, and place, in agreeing on a referee, and in agreeing to abide by a common set of rules.

The Olympic games would not be possible without the cooperation of the participating nations. There have been some very dubious analogies in the economic literature of recent years between economic life and “the theory of games”; but the analogy which recognizes that in both fields competition exists within a larger setting of cooperation (and that desirable results follow), is valid and instructive.

The Division of Labor

I come now to the fourth institution I have mentioned as part of the capitalist system—the division and combination of labor. The necessity and beneficence of this was sufficiently emphasized by the founder of political economy, Adam Smith, who made it the subject of the first chapter of his great work, The Wealth of Nations. In the very first sentence of that great work, indeed, we find Adam Smith declaring: “The greatest improvement in the productive powers of labor, and the greater part of the skill, dexterity, and judgment with which it is anywhere directed or applied, seem to have been the effects of the division of labor.”

Smith goes on to explain how the division and subdivision of labor leads to improved dexterity on the part of individual workers, in the saving of time commonly lost in passing from one sort of work to another, and in the invention and application of specialized machinery. “It is the great multiplication of the productions of all the different arts, in consequence of the division of labor,” he concludes, “which occasions, in a well-governed society, that universal opulence which extends itself to the lowest ranks of the people.”

Nearly two centuries of economic study have only intensified this recognition. “The division of labor extends by the realization that the more labor is divided the more productive it is.”

“The fundamental facts that brought about cooperation, society, and civilization and transformed the animal man into a human being are the facts that work performed under the division of labor is more productive than isolated work and that man’s reason is capable of recognizing this truth.”

Social Cooperation

Though I have put division of labor ahead of social cooperation, it is obvious that they cannot be considered apart. Each implies the other. No can can specialize if he lives alone and must provide for all his own needs. Division and combination of labor already imply social cooperation. They imply that each exchanges part of the special product of his labor for the special product of the labor of others. But division of labor, in turn, increases and intensifies social cooperation. As Adam Smith put it: “The most dissimilar geniuses are of use to one another; the different produces of their respective talents, by the general disposition to truck, barter, and exchange, being brought, as it were, into a common stock, where every man may purchase whatever part of the produce of other men's talents he has occasion for."

Modern economists make the interdependence of division of labor and social cooperation more explicit: "Society is concerted action, cooperation. . . . It substitutes collaboration for the—at least conceivable—isolated life of individuals. Society is division of labor and combination of labor. . . . Society is nothing but the combination of individuals for cooperative effort."[9]

Adam Smith also recognized this clearly:

> *In civilized society [Man] stands at all times in need of the co-operation and assistance of great multitudes, while his whole life is scarce sufficient to gain the friendship of a few persons. . . . Man has almost constant occasion for the help of his brethren, and it is in vain for him to expect it from their benevolence only. He will be more likely to prevail if he can interest their self-love in his favor, and show them it is for their own advantage to do for him what he requires of them. Whoever offers to another a bargain of any kind, proposes to do this: Give me that which I want, and you shall have this which you want, is the meaning of every such offer; and it is in this manner that we obtain from one another the far greater part of those good offices which we stand in need of. It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages.*[10]

What Adam Smith was pointing out in this and other passages is that the market economy is as successful as it is because it takes advantage of self-love and self-interest and harnesses them to production and exchange. In an even more famous passage, Smith pressed the point further:

> *The annual revenue of every society is always precisely equal to the*

> *exchangeable value of the whole annual produce of the industry, or rather is precisely the same thing with that exchangeable value. As every individual, therefore, endeavors as much as he can both to employ his capital in the support of domestic industry, and so to direct that industry that its produce may be of the greatest value; every individual necessarily labors to render the annual revenue of the society as great as he can. He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it. By preferring the support of domestic to that of foreign industry, he intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for the society that it was no part of it. By pursuing his own interest he frequently promotes that of the society more efficiently than when he really intends to promote it*

This passage has become almost too famous for Smith's own good. Scores of writers who have heard nothing but the metaphor "an invisible hand" have misinterpreted or perverted its meaning. They have taken it (though he used it only once) as the essence of the whole doctrine of The Wealth of Nations. They have interpreted it as meaning that Adam Smith, as a Deist, believed that the Almighty interfered in some mysterious way to insure that all self-regarding actions would lead to socially beneficial ends. This is clearly a misinterpretation. "The fact that the market provides for the welfare of each individual participating in it is a conclusion based on scientific analysis, not an assumption upon which the analysis is based."

Other writers have interpreted the "invisible hand" passage as a defense of selfishness, and still others as a confession that a free-market economy is not only built on selfishness but rewards selfishness alone. And Smith was at least partly to blame for this latter interpretation. He failed to make explicit that only insofar as people earned their livings in legal and moral ways did they promote the general interest. People who try to improve their own fortunes by chicanery, swindling, robbery, blackmail, or murder do not increase the national income. Producers increase the national welfare by competing to satisfy the needs of consumers at the cheapest price. A free economy can function properly only within an appropriate legal and moral framework.

And it is a profound mistake to regard the actions and motivations of people in a market economy as necessarily and narrowly selfish. Though Adam Smith's exposition was brilliant, it could easily be misinterpreted. Fortunately, at least a few modern economists have further clarified the process and the motivation: "The economic life . . . consists of all that complex of relations into which we enter with other people, and lend ourselves or our resources to the furtherance of their purposes, as an indirect means of furthering our own." Our own purposes are necessarily our own; but they are not necessarily purely selfish purposes. "The economic relation . . . or business nexus, is necessary alike for carrying on the life of the peasant and the prince, of the saint and the sinner, of the apostle and the shepherd, of the most altruistic and the most egoistic of men. . . . Our complex system of economic relations puts us in command of the co-operation necessary to accomplish our purposes."

"The specific characteristic of an economic relation," according to Wicksteed, "is not its 'egoism,' but its 'non-tuism.' " He explains:

> *If you and I are conducting a transaction which on my side is purely economic, I am furthering your purposes, partly or wholly perhaps for my own sake, perhaps entirely for the sake of others, but certainly not for your sake. What makes it an economic transaction is that I am not considering you except as a link in the chain, or considering your desires except as the means by which I may gratify those of some one else—not necessarily myself. The economic relation does not exclude from my mind everyone but me, it potentially includes every one but you*

There is a certain element of arbitrariness in making "non-tuism" the essence of "the economic relation." The element of truth in this position is merely that a "strictly economic" relation is by definition an "impersonal" relation. But one of Wicksteed's great contributions was to dispose of the persistent idea that economic activity is exclusively egoistic or self-regarding. The real basis of all economic activity is cooperation. As Mises has put it:

> *Within the frame of social cooperation there can emerge between members of society feelings of sympathy and friendship and a sense of belonging together. These feelings are the source of man's most delightful and most sublime experiences. . . . However, they are not,*

as some have asserted, the agents that have brought about social relationships. They are fruits of social cooperation, they thrive only within its frame; they did not precede the establishment of social relations and are not the seed from which they spring. . . .

The characteristic feature of human society is purposeful cooperation. . . . Human society . . . is the outcome of a purposeful utilization of a universal law determining cosmic becoming, viz., the higher productivity of the division of labor. . . .

Every step by which an individual substitutes concerted action for isolated action results in an immediate and recognizable improvement in his conditions. The advantages derived from peaceful cooperation and division of labor are universal. They immediately benefit every generation, and not only later descendants. For what the individual must sacrifice for the sake of society he is amply compensated by greater advantages. His sacrifice is only apparent and temporary; he foregoes a smaller gain in order to reap a greater one later. . . . When social cooperation is intensified by enlarging the field in which there is division of labor or when legal protection and the safeguarding of peace are strengthened, the incentive is the desire of all those concerned to improve their own conditions. In striving after his own—rightly understood—interests the individual works toward an intensification of social cooperation and peaceful intercourse. . . .

The historical role of the theory of the division of labor as elaborated by British political economy from Hume to Ricardo consisted in the complete demolition of all metaphysical doctrines concerning the origin and operation of social cooperation. It consummated the spiritual, moral and intellectual emancipation of mankind inaugurated by the philosophy of Epicureanism. It substituted an autonomous rational morality for the heteronomous and intuitionist ethics of older *days. Law and legality, the moral code and social institutions are no longer revered as unfathomable decrees of Heaven. They are of human origin, and the only yardstick that must be applied to them is that of expediency with regard to human welfare. The utilitarian economist does not say: Fiat justitia, pereat mundus. He says: Fiat justitia, ne pereat mundus. He does not ask a man to renounce his well-being for the benefit of society. He advises him to recognize what his rightly understood interest are.*

Mises expounded the same point of view in his earlier book, Socialism. Here also, and in contradiction to the Kantian thesis that it is wrong ever to treat others merely as means, he emphasizes the same theme that we have seen in Wicksteed:

Liberal social theory proves that each single man sees in all others, first of all, only means to the realization of his purposes, while he himself is to all others a means to the realization of their purposes; that finally, by this reciprocal action, in which each is simultaneously means and end, the highest aim of social life is attained—the achievement of a better existence for everyone. As society is only possible if everyone, while living his own life, at the same time helps others to live, if every individual is simultaneously means and end; if each individual's well-being is simultaneously the condition necessary to the well-being of the others, it is evident that the contrast between I and thou, means and end, automatically is overcome

Once we have recognized the fundamental principle of social cooperation, we find the true reconcilation of "egoism" and "altruism." Even if we assume that everyone lives and wishes to live primarily for himself, we can see that this does not disturb social life but promotes it, because the higher fulfilment of the individual's life is possible only in and through society. In this sense egoism could be accepted as the basic law of society. But the basic fallacy is that of assuming a necessary incompatibility between "egoistic" and "altruistic" motives, or even of insisting on a sharp distinction between them. As Mises puts it:

> *This attempt to contrast egoistic and altruistic action springs from a misconception of the social interdependence of individuals. The power to choose whether my actions and conduct shall serve myself or my fellow beings is not given to me—which perhaps may be regarded as fortunate. If it were, human society would not be possible. In the society based on division of labor and co-operation, the interests of all members are in harmony, and it follows from this basic fact of social life that ultimately action in the interests of myself and action in the interests of others do not conflict, since the interests of individuals come together in the end. Thus the famous scientific dispute as to the possibility of deriving the altruistic from the egoistic motives of action may be regarded as definitely disposed of.*
>
> *There is no contrast between moral duty and selfish interests. What the individual gives to society to preserve it as society, he gives, not for the sake of aims alien to himself, but in his own interest.*

This social cooperation runs throughout the free-market system. It exists between producer and consumer, buyer and seller. Both gain from the transaction, and that is why they make it. The consumer gets the bread he needs; the baker gets the monetary profit which is both his stimulus to bake the bread and the necessary means to enable him to bake more. In spite of the enormous labor-union and socialist propaganda to the contrary, the relation of employer and employed is basically a cooperative relation. Each needs the other. The more efficient the employer, the more workers he can hire and the more he can offer them. The more efficient the workers, the more each can earn, and the more successful the employer. It is in the interest of the employer that his workers should be healthy and vigorous, well fed and well housed, that they should feel they are being justly treated, that they will be rewarded in proportion to their efficiency and that they will therefore strive to be efficient. It is in the interest of the worker that the firm for which he works can do so at a profit, and preferably at a profit that both encourages and enables it to expand.

On the “microeconomic” scale, every firm is a cooperative enterprise. A magazine or a newspaper (and as one who has been associated with newspapers and magazines all his working life I can speak with immediate knowledge of this) is a great cooperative organization in which every reporter, every editorial writer, every advertising solicitor, every printer, every delivery-truck driver, every newsdealer, cooperates to play his assigned part, in the same way as an orchestra is a great cooperative enterprise in which each player cooperates in an exact way with his particular instrument to produce the final harmony.

A great industrial company, such as General Motors, or the U.S. Steel Corporation, or General Electric—or, for that matter, any of a thousand others—is a marvel of continuous cooperation. And on a "macroeconomic" scale, the whole free world is bound together in a system of international cooperation through mutual trade, in which each nation supplies the needs of others cheaper and better than the others could supply their own needs acting in isolation. And this cooperation takes place, both on the smallest and on the widest scale, because each of us finds that forwarding the purposes of others is (though indirectly) the most effective of all means for achieving his own.

Thus, though we may call the chief drive "egoism," we certainly cannot call this a purely egoistic or "selfish" system. It is the system by which each of us tries to achieve his purposes whether those purposes are "egoistic" or "altruistic." The system certainly cannot be called dominantly "altruistic," because each of us is cooperating with others, not primarily to forward the purposes of those others, but primarily to forward his own. The system might most appropriately be called "mutualistic." In any case its primary requirement is cooperation.

Originally published at FEE.org