

Basics of Market Economics: Ten Principles and Seven Venues to Prosperity

Dr. Krassen Stanchev

(www.ime.bg, www.easibulgaria.org)

Introduction

The structure of the lecture is:

1. Country examples – Bulgaria and France,
2. Philosophic and moral backgrounds,
3. Principles of market economy,
4. Abstract rules, that could promote prosperity.

In explaining these I rely on and borrow from the following economists:

Adam Smith, Frederic Bastia, Augostino Balve, Friedrich von Hayek, Karl Popper, Henry Hazlitt, James Gwartney, Richard Stroup, Dwight Lee, Gordon Tullock, Mansur Olson, Thomas Sowell and some others as well as research by the Institute for Market Economics in Sofia.

Definition of central planning

- ❑ The idea of central economic planning is that the government (the state) shall take an active and decisive role in the economy: by own acts of enterprise and investment, by various controls (on prices, via inducements and restrictions) over the private sector and that the state should initiate and steer economic development. Often these efforts are coordinated and made explicit in plans. [Gunnar Myrdal]
- ❑ Often it is assumed that without central planning there will be chaos.
- ❑ In fact, **central planning means that the state over-rides other people's plans.**
- ❑ The talk between Mikhail Gorbachov and Margaret Thatcher.

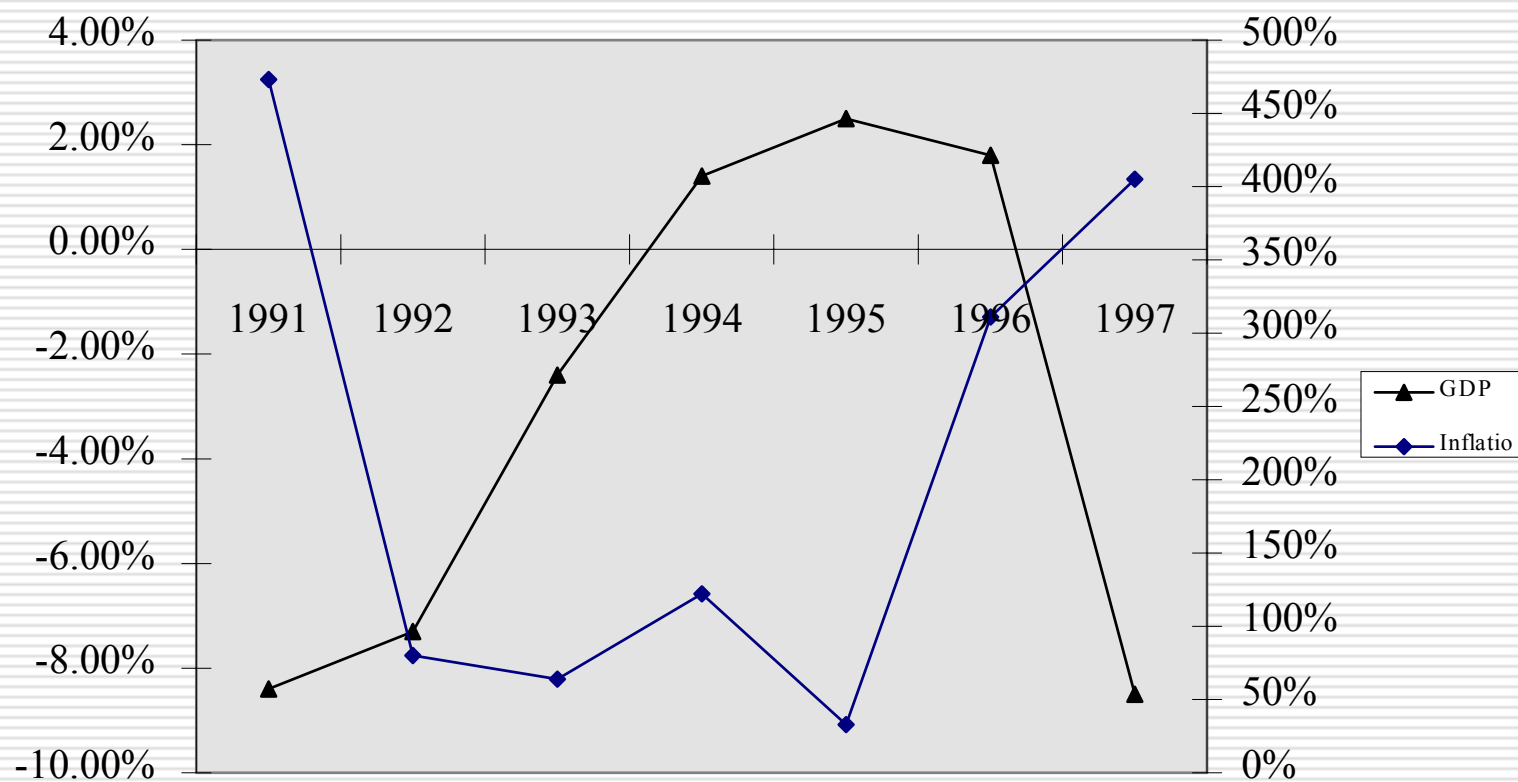
Summary of Bulgaria reforms

- ❑ Transition to a pluralistic democracy (1989-1991),
- ❑ Successful start of reforms in 1991,
- ❑ Followed by a **new “edition” of central planning (1993-1995),**
- ❑ And hyperinflation, banking and economic, and political crisis (1996-1997),
- ❑ Resolved via elections and a Currency Board (1997).
- ❑ Since 1997 - a new recovery with 4-5% average annual growth, finalized privatization of almost all enterprises and all banks (of which 85% foreign owned).
- ❑ In 2001, it is the first country to outvote its establishment that led reforms between 1989 and 2000. In 2001, for those who do not know, Bulgarians elected their former king's party to run the government, and became a prime minister (until 2005). Currently, the party that led the country into hyperinflation, is ruling again. There are chances not to repeat previous mistakes. This depend on how deep the basics of market economics has been understood by the public.

New “edition” of central planning (1993-1995): price controls

1991	14%
1992	13.4%
1993	16.5%
1994	18.9%
1995	49%
1996	52.4 %
1997	45%
1998	18.2 %
1999	20.7%
2000 and after	19.4%

Inflation /GDP Dynamics: February 1991 - February 1997

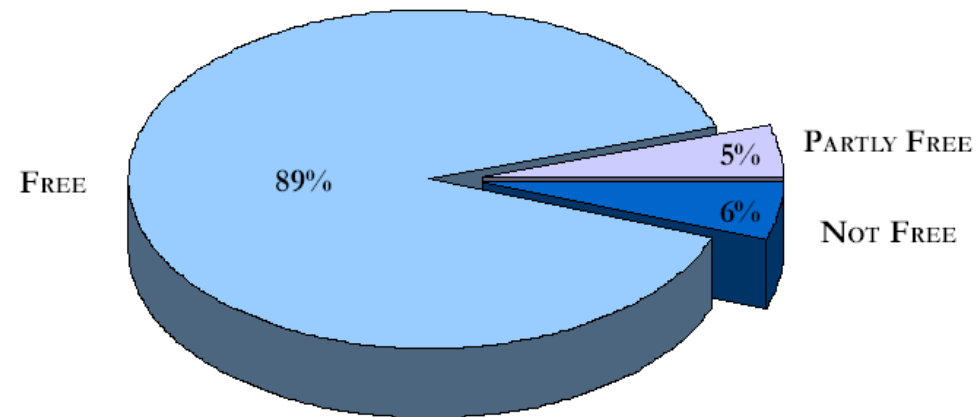


Access to Sound Money (example)

Main economic indicators for Bulgaria (15 years)

Indicators (average)	1990-1997	1998-2004	2002-2004
Inflation (%)	210.1	7.5	4.8
Inflationary tax rate (%)	57.7	6.9	4.5
GDP growth (%)	- 4.7	4.4	5.0
GVA growth (%)	n.a.	4.0	4.9
Investment growth (%)	- 8.8	18.2	11.4
Budget deficit/surplus (% of GDP)	- 6.3	0.2	0.4
Government debt (% of GDP)	168	65.9	48.3
FDI (USD million, 1990-1996)	63.2	1,253.4	1,867.7
FDI (% of GDP)	0.8	7.4	9.1
Subsidies (% of GDP)	n.a.	2.1	2.5

GDP (in USD) in free, partly free and un-free countries according to Heritage / Wall Street Journal Index of Economic Freedom



Who pays taxes in Bulgaria: population above 15 years of age

	Million.	% of those above 15
Employed by the private sector	1.9	28
Employed in government owned but not subsidized industries	0.3	5
Employed in government financed activities	0.6	9
Unemployed, students, other	1.5	22
Pensioners	2.4	36
Total	6.7	100

Effects of “voting with the feet”: the myth of “educating” and “feeding” Bulgaria migrants

	2001	2002	2003
Remittances	472.5	531.7	613.0
As % of budget expenditures on			
Education	77.5	76.8	87.9
Healthcare	77.3	72.3	84.6

The myth...

- ❑ The illusion the “we feed (cure and educate) them but they emigrate” and impose costs on the home country (Bulgaria), on “us” is not justified even if we take into account unrecorded remittances and the “net”, shadow price of health and education.
- ❑ Trickle down effects are great: In 2003, in terms of human life benefits, remittances contribute to 340,000 annual average wages and “saved” 3,405 human life a year (calculated as value of the human life in life insurance patterns).

Background (philosophy) of markets

- Simple philosophy is that economic freedom equals prosperity, and that, to the extent this is understood, people will support the difficult process of economic reform.
- “The state is a humanly designed entity through which everyone is attempting to live at the expense of somebody else”. It often motivates plunder.
- “There are two ways of living better: producing and selling something that people need and plundering from others”.
- Plunder is introduction of force in the voluntary exchange and wealth creation in the sake of predation. - “When *plunder* has become a way of life for a group of people., they create for themselves... a legal system that authorizes it... and a moral code that glorifies it.” And... “it is rarely that the many plunder the few...”. [*Frederic Bastiat*]

Theoretical background of the clash between centrally planned and market economy

- ❑ Two types of economy: of production and of transfer. The latter reviewed well by Gordon Tullock.
- ❑ In the latter, individual mobilize resources (money, time and influence) in order to transfer income from quarters of society where it is produced. There are two ways to do so:
 - ❑ 1. attempts to expropriate the income of others
 - ❑ 2. attempts to prevent others producing and disposing the income they produced.
- ❑ Obviously, government plays a role in this, though centrally planning choices people make, substituting their decisions on their own resource. (Government does not produce anything, it redistributes what citizens and companies produce.)
- ❑ The secret is that everyone, in normal condition of mind and body, would prefer that all these happens to other.

Transfer Society in France (recent years, French sources)

According to the France Official statistics (INSEE) most recent figures, the ratio of public spending to GDP was 53.5% in 2004.

Contribuables Associés, the leading French taxpayers' association, presents this in following manner:

1. the taxpayer was "freed" every year on 16 July.
2. Before that date, the French worked an average:
 - 67 days for the central State, mostly thanks to VAT, income tax and corporate tax,
 - 37 days for local governments, mostly thanks to professional and residential taxes,
 - 80 days for social security,
 - 4 days for Europe and
 - 9 days to reimburse public debt.

The taxpayer would therefore have had to work entirely for the State from 1 January to 15 July inclusive.

Functioning Market and functioning Solidarity

- A market functions (see “functioning market economy” in the Euro-speak) if and only if the buyer pays less than expected and the seller gets more than originally believed, provided transaction is voluntarily executed.
- One may tell Peter to give Peter one of his two shirts to his brother. This could be understood either as an order or as an advice. In the former case, the solidarity (giving away the shirt) is forced in the latter – it is natural, at will.
- Adolf Hitler is told to have said: “The order is the most profound essence of every human action and every human thought”. This statement highlights a certain vision of the human nature.
- Adam Smith’s view viewed human nature differently: that people would prefer to choose for themselves, that they are inclined to “truck and barter” and would produce more if allowed to keep more for themselves than forced give to others unwillingly.

PRINCIPLES OF THE MARKET ECONOMY: I. Incentives are key

- ❑ The cost and benefit of different choices and decisions people make change the incentives and the way people behave.
- ❑ If buyers want to purchase more or something that seller can provide, the price of that something will rise. As prices rise, sellers will be more willing to provide that good or service. At some point – other things equal – the supply by the sellers will offer more of this something than demanded, the competitors will discover valuable substitutes, and the price would eventually come down.
- ❑ Prices bear the information in the society, there is no human or government mind that could envisage all circumstances in social life. But prices do not act automatically: it takes time for people to adjust and the instrument of this adjustment is incentives.

II. “There is no such thing as a free lunch”

- The fundamental axiom of human life is that resources are limited while the needs (for goods and services) are virtually unlimited.
- Because people cannot have as much of everything as they would wish, they are forced to choose among alternatives.
- The cost of a good helps counterbalancing unlimited desires to use it, if it is at all wanted .

III. Decision are made on the margins

- Weighting cost and benefits is essential for individuals, business and society, and is made billions of times every minute.
- Choices of the sort “either all or nothing” are extremely rare. One cannot fully substitute the need for clothes for the need for food and eat without dress. The choice is between having a little more of one or the other.
- Most choices are made on the margins, in and about additions and subtractions in certain condition.

IV. Trade promotes progress

- ❑ If we now go back to our description of the functioning market, we will see that the foundation of exchange (trade) is the mutual gain.
- ❑ It moves goods from those who value them less to those who value them more.
- ❑ It allows us to specialize at things we do best thus enhancing output and allowing others to consume more.
- ❑ It makes possible achieving lower costs of producing units of things we specialize on and invent new modes of production.

V. Transaction costs are obstacles to trade

- The voluntary exchange enhances cooperation and helps us get more of what we want.
- But this has its costs: takes time, effort to search resources, partners, to negotiate, close the deal, resolve disputes, etc. Resources are spent to achieve all these.
- These constitute obstacles to the creation of wealth. They might be natural and artificial and because they exist there is a demand for services that reduce these costs. Such services are supplied by middle men who are often and wrongly believed to be increasing the price.

VI. Profits direct resources to activities that increase wealth

- If the sale of the products exceeds the costs of resources require to produce them (because the products are demanded, valued), a profit is being made. The value of the product is measured by the price the buying is willing to pay.
- If this happens, the producer or the seller would be expected to reallocate resources from alternative uses to satisfy the willingness to pay.
- If the use of resources is not directed to things and activities demanded, the costs would exceed the price and a loss occurs.
- The loss is a penalty for not using resources for something that is valuable. The responsibility for the losses is the mechanism that helps channeling resource to their valuable use and direct them to wealth creating projects.

VII. People earn income from helping others

- Those who earn more do so because they provide others with services and things they value. If this is not the case, consumers would not pay them so willingly.
- In other words: if one wants a larger income, he or she should figure out how to help others satisfying their needs.
- This does not necessarily mean that all should strive to “improve the world”, just the opposite: even when people pursue desire for high income they help others.

VIII. Economic progress come primarily from trade, investment, better ways of doing things, and sound institutions

- ❑ Investment (refrain from consumption) in productive assets and skills enhances the ability to produce goods and services.
- ❑ Improvements in technology (discovering resources, processes, organizational tools and less costly modes of production) enhances the ability of wealth creation.
- ❑ Improving economic organization promotes growth; these are ways the human activities are organized and rule under which they operate. Improving generally means reducing the costs of transactions.

IX. Market prices direct buyers and sellers towards activities that promote the general welfare

- Above we confronted the views of Hitler and Smith on the human nature. According to Smith, the individual “intends only own gain” but he is directed by the “invisible hand” of the market to promote the goals of the others, which leads to greater prosperity.
- This occurs because market prices coordinate the actions of self-interested individuals when private property and freedom of exchange are present.

X. Too often long-term consequences of an action are ignored

- All human actions have unintended consequences. This fact has been mentioned by many economists, Frederic Bastiat, Karl Popper (who believed it is a regularity), Ludwig von Mises (who called it uncertainty), Henry Hazlitt – to name just a few.
- It comes from the fact that no one possesses the whole knowledge of the chain of events and circumstances necessitated by human choices.

XI. Major sources of economic progress
(as described by Gwartney, Stroup and Lee, Common Sense Economics, NY, 2005; the first edition is available at: www.easibulgaria.org)

- 1. **Legal system that protects privately owned property and enforces contracts in an even-handed manner.** Private ownership:
 - gives wise stewardship
 - encourages people to use their property in a productive manner
 - creates incentives to develop things people own in ways that benefit others
 - Saves resources for the future.

XI.2. Competition promotes the efficient use of resources and provides incentives for innovation improvements

- Competition:
- Pressurizes to operate efficiently and serve consumers
- Creates incentives to develop better products and discover low costs production modes
- Enhances the organizational structure
- Keeps the costs low
- It is not pro-business, it is pro-consumer and presses the profits down and forces redirection of resources to more profitable use.

XI.3. Regulations that reduce trade hamper economic progress

- Such are:
- Regulations that limit entry into various markets, businesses and occupations,
- Regulation that substitute political authority for the rule of law and freedom of contract, thus undermining gains from trade,
- Regulations that introduce price controls,
- Regulations that hamper exit and responsibility for failures.

XI.4. Efficient capital markets

There are ways to raise capital:

1. Directly, by asking people (call investors because they delay immediate consumption) to support an idea,
2. Indirectly, by taking credit (other people's money kept a bank, savings) against a reward, payment (interest) for borrowing other people's money.

If there is no such market or if it is hampered by regulations, there is no mechanism to channel capital (resources) toward wealth-creating projects.

XI.5. Monetary stability

- Stable money simplifies the exchange and makes prices stable. This means that the exact time of purchasing/buying is limited factor in the choices and transactions made. Therefore less effort is needed to figure out what would be the purchasing power of a given unit of exchange (be it Bulgarian Lev or US Dollar).
- Money is also an accounting unit, something which that expresses prices. In other words, they bear information on choices and help planning future action and transaction. The more stable the money, the more reliable the plans.
- Unsound and unstable money bring about inflation. Slides 6 and 7 demonstrated what were the effects of high inflation in Bulgaria in the period between 1990 and mid-1997 on production and disposable income. Particularly harmful was the inflation tax of almost 60 stotinki of every Bulgarian Lev (inflation tax measures the money printed to finance government activities). This also means that unstable money fuels poverty and inequality (because those who get first access to newly printed banknotes have time advantage on the market).

XI.6. People will produce more when they are permitted to keep more of what they earn

High taxes:

- discourage work effort and reduce the productivity of labor,
- Reduce the level and efficiency of capital formation,
- Encourage people to consume goods that are deductible, thus hampering allocation of resources to otherwise more needed goods and services.

XI.7. Free trade acts as wealth promoter

- It helps producing things that could be effectively sold and buy things that would be costly to produce under given circumstances,
- It enlarges the markets and provides for benefits from the economies of scale,
- It promotes domestic competition.