FAITH & FREEDOM

A Publication of the Institute for Faith & Freedom at Grove City College

THE INSTITUTE FOR
Faith & Freedom
GROVE CITY COLLEGE

EVERYDAY ECONOMIC ERRORS

MARKETS ARE UNREGULATED

LIFE OF THE MIND: GREAT LECTURES FROM THE GROVE

Everyday Economic Errors: Markets are Unregulated

DR. CALEB FULLER

This is a condensed version of the final lecture in "Everyday Economic Errors" from Grove City College's "Life of the Mind: Great Lectures from the Grove" series. For information on accessing the entire series, please reference page 10.

Some critics are suspicious of the supposedly unregulated exchange. What about considerations like fraud? What's to stop unscrupulous sellers from hoodwinking unsuspecting buyers? And what about discrimination? What prevents bigoted or racist employers from refusing to hire a member of a religious or racial group they dislike?

In short, trade might make some people better off. But isn't it also true that unregulated markets open the door to all sorts of other social ills?

Dr. Caleb Fuller

Lurking behind concerns like this is another everyday economic error. *This error holds that "free markets" are synonymous with "unregulated markets."*

I'll argue that there is no such thing as an "unregulated market." There never has been, and there never will be. **All markets are regulated**. Only perhaps not in the way you are thinking. And this regulation plays an important role in reducing the extent of fraud and discrimination.

Here's how economist Israel Kirzner puts it in his book, *Market Theory and the Price System*:

> *"To the casual observer, market activity seems to be a bewildering and uncoordinated mass of transactions. Each individual in the market society is free to buy what and when he pleases, to sell what and when he pleases, to produce or to consume what he pleases, or to refrain altogether from any or all of these activities."*

Now [look] carefully to what he says next:

> *"Economic analysis reveals that this seeming chaos in the activity of market participants is only apparent. In fact, analysis shows that the exchanges that take place are subject to definite forces at work in the market. These market forces guide the individuals participating in the market in their decisions."*

Okay, enough beating around the bush.

What are these "forces?"

How do they "regulate" market exchange?

How do they curtail fraud and discrimination?

Well, first, the regulations I have in mind are *profits* and *losses*.

It's true, most people don't think of "profits" and "losses" as "regulations"—but that's because they're not looking through the *opportunity cost* lens.

In fact, for many people, the word "profit" tends to be a dirty word!

Why then is it helpful to think of "profits" and "losses" as an under-appreciated method of regulating market activity? The reason this mental reframing is helpful is because it's the *lure* of profits and the *threat* of losses that regulate buyers' and sellers' behavior.

Why then is it helpful to think of "profits" and "losses" as an under-appreciated method of regulating market activity?

Let me offer a brief example.

iPlat

Suppose a world-famous entrepreneur, like the late Steve Jobs, had imagined that what consumers want is an iPhone made of solid platinum.

Based on this hunch, Jobs buys several tons of platinum, manufactures 10 million phones with it, and attempts to sell his new creations for fifty thousand dollars per phone. He chooses that price because at any lower price, he won't cover his costs of production.

I think it's safe to say that our hypothetical, harebrained Steve Jobs would earn losses in this scenario. Why? Well, hardly anyone wants to pay fifty thousand dollars for an iPhone. Even for an indestructible phone made of platinum.

If Jobs had gone through with this plan, his behavior would likely have been "punished" by consumers. They'd force him to earn losses by not buying his phone in sufficient numbers.

By forcing Jobs to earn losses, consumers would be rhetorically asking Jobs a question of sorts. They'd be asking him why he deprived them of the use of platinum in dental appliances and jewelry, two contexts where consumers *do* value platinum being used.

When Jobs uses the platinum for his phones, we can't use that same platinum in its other, more valuable uses, such as in dental appliances that make our lives more pleasant. And consumers like you and me would demonstrate our displeasure with that outcome by forcing losses on Jobs.

Of course, the reason Jobs never tried to give us the platinum iPhone—the iPlat—is because he anticipated he'd earn losses. In other words, the threat of loss was regulating, guiding, and even changing the actions he was taking!

Let's now see how profits and losses also regulate the impulse toward fraud and discrimination.

Fraud

Suppose you want a haircut. Once you're in the barber's seat, you describe what the finished product should look like. The barber nods as if he understands. Next, he picks up a razor and shaves you completely bald! You feel as if the whole experience is over before it even happened.

Then he politely says: “That’ll be 25 bucks! Thanks for your business. See you next month.” You’d be shocked at his gall after having so brazenly defrauded you!

We could imagine other, similar scenarios. You go to your favorite, exquisite seafood restaurant where you order an expensive lobster. An hour later, the waiter brings out a plate of “monkfish”—more commonly known as “poor man’s lobster.”

As you may know, monkfish is a very cheap lobster substitute that tastes and even looks like a lobster. Half an hour later, the waiter re-appears with the fifty-dollar bill. That’s fraud!

Both of these scenarios should seem a bit far-fetched—even though we’ve all occasionally had the lousy haircut or patronized the disappointing restaurant.

But why are my stories so far-fetched? After all, it seems like a barber’s profits would rise if he simply gave everyone a buzz cut. Perhaps he could service twenty customers a day instead of just six or seven.

At first glance, it might also seem like the restaurant’s profits would rise by serving the cheap monkfish while charging for the expensive lobster. Why isn’t virtually every seafood restaurant promising lobster and then serving monkfish?

What stops the barber or the restaurant from taking advantage of you? Is it because they know you have your lawyer on speed-dial?

Of course not. The costs of using the court system far outweigh any damages the courts might award you for a fraudulent meal or haircut. What’s worse—the restaurant owner and barber know this, just as well as you and I.

So, what stops them from defrauding you every time you exchange with them? Conscience clearly constrains many sellers. They couldn’t look at themselves in the mirror if they lived their lives as frauds.

But what about those who don’t have such a tender conscience and are just out to make a quick buck? Doesn’t their profit-seeking cause them to want to defraud you? In what sense is profit going to curtail their impulse to deception? Wouldn’t it only pour gasoline on the fire?

One force that disciplines sellers’ fraudulent impulse is the threat of earning losses in the future.

After all, none of us buyers would patronize this barber or restaurant again if we received the buzzcut or the monkfish. If he defrauds us, the seller will lose all the future profits he could have made from cutting our hair or serving us meals.

And besides that, we’ll probably tell all our friends and post about our terrible experience on platforms like Yelp.

I like to think about it this way. The “shadow of the future” looms over every exchange like a specter threatening to take away future profits.

If the barber wants to keep earning profits into the future, he’ll “behave” in the present. The evaporation of future profits is the opportunity cost of misbehaving today. Of course, that fact won't be enough to discipline every barber, but it does raise the cost of fraud for every barber. And over time, fraudulent barbers simply won't last. Losses will weed them from the market system, just as a gardener plucks dandelions from his flower-bed.

But there's a way to make this logic even more robust.

A barber might tell you that he'll provide a high-quality haircut, but how do you know he places a high value on your future business? Just how serious is the threat of losing future profits to him? Some fly-by-night barbers might simply be out to make a quick buck. Those aren't the barbers you want to frequent.

This is an important problem because if buyers suspect that the barber won't follow through, they'll be suspicious and avoid him. This is true even if he's a high-quality, honest barber. As a result of the buyer's suspicion, neither party gets the benefits from trading that we discussed in the last two lectures.

To overcome buyer suspicions, sellers can offer so-called "*credible* commitments" to prospective buyers. These enable buyers and sellers to better enjoy the gains from trade.

What is a credible commitment? A credible commitment is anything that makes a promisor's word more believable.

It does this by raising the promisor's opportunity cost of acting contrary to the other party's best interest.

I realize that's a fairly abstract description—so what's an example?

My favorite example comes from Notre Dame economist and legal scholar Margaret Brinig.

In her 1990 paper, *Rings and Promises*, she compellingly argues that engagement rings served as credible commitments to marry in the United States during the mid-20th century.

Brinig notes that before 1935, American women could sue a fiancé who had broken his engagement promise. The courts would usually award monetary damages to the woman to compensate her for wedding preparation expenses and shame.

In 1935, Indiana struck down such "breach of promise" laws. By 1945, sixteen other states had followed Indiana's lead, with every other state eventually eliminating these provisions from the books.

However, at the time, there was a significant social stigma for a woman who experienced a broken engagement. Consequently, women still wanted a way to separate frivolous from serious suitors. A worst-case scenario for a woman was finding herself high and dry after an unserious man promised to marry her and then got cold feet.

What was the solution?

A credible commitment is anything that makes a promisor's word more believable.

Brinig argues that the practice of engagement ring-giving arose shortly after 1935 as a way for a man to demonstrate the credibility of his marriage offer.

After all, he'd just invested in a costly diamond ring that he'd forfeit if he broke his promise to marry. Giving a ring was a credible commitment to marry because men who weren't serious simply didn't offer them. Women now had a way of sifting the masculine wheat from the boyish chaff.

Here's another example. One of the most memorable scenes in all classic literature colorfully illustrates why people invest in credible commitments.

Take a look at this picture.

Here's Odysseus on his way home from the Trojan War, as described in *The Odyssey*.

You've probably heard the story. Odysseus knows that anyone who hears the Sirens' beautiful song will jump overboard and be devoured by these alluring, but ultimately ferocious creatures. He wants to listen to their music, so he binds his hands to the mast of his ship, rendering himself incapable of jumping overboard.

A credible commitment does the same thing. It ties a person's hands by raising the opportunity cost of specific actions that would be otherwise enticing.

Now, what does any of this have to do with disciplining fraud in markets?

Here's what: Sellers can "bind their hands to the mast"—in a manner of speaking—by offering credible commitments to behave honestly with buyers.

Advertising can serve this function. Have you ever wondered why firms spend so much money on celebrity endorsements?

Here's one noteworthy example. In 2014, Coca-Cola signed a 26-million-dollar contract with Taylor Swift to promote their products.

Now, are consumers more likely to grab a coke just because Taylor Swift films herself drinking one? And don't we all know she's only drinking one because Coca-Cola has paid her big bucks to do so?

The economic explanation for this curious phenomenon goes like this. Sellers aren't tricking weak-willed buyers by splashing celebrity images over their products. Instead, the celebrity endorsement is a costly investment that sellers only recoup if they uphold their commitment to quality.

When consumers see the catchy Taylor Swift ad, they know that the Coca-Cola Company has spent tens of millions on this endorsement. And what will happen to Coca-Cola if the company begins diluting its flagship product to cut costs? Customers will stop buying as much Coke. And if that happens, Coca-Cola will never recoup the tremendous investment they made in the Swift contract. They'll be out tens of millions of dollars.

In other words, these massive, sunk investments serve as credible commitments to maintain quality into the future. Coca-Cola just raised the opportunity cost of diluting its product.

Advertising is but one of many ways that sellers can offer credible commitments to buyers.

I'll mention just one more. Premium restaurant owners often locate in high-rent areas of their city. This locational decision functions as a signal to consumers. Restaurants will only recoup those high rents if they don't renege on their quality commitment.

If they do renege, buyers will "punish" the owners by refusing to patronize this restaurant. And if you're a restaurant owner who's paying a pretty penny for rent, losing patrons isn't something you can afford. So, you do what you can to keep your promise of serving high-quality cuisine. No monkfish here!

To sum up, the lure of profits often prompts sellers to invest in credible commitments. And then the threat of losses disciplines their temptation to defraud us.

None of this means that fraud never happens. Of course, it does. But the profit-and-loss system raises the cost of fraud and reduces its frequency. It's in this sense that "profits" and "losses" regulate market participants' behavior.

Yes, there's a sense in which sellers can "do whatever they want." But they won't be around for long if they do.

Discrimination

Let's now see how the profit-and-loss system also raises employers' costs of practicing discrimination.

Imagine a job that pays forty thousand dollars a year. Imagine further that the employer dislikes people with blue eyes. He simply can't stand them.

To make the example easy, let's suppose that there are just two applicants for this job. One has green eyes and will contribute forty-five thousand dollars annually to the employer's bottom line. The other has the dreaded blue eyes—but he'll contribute fifty thousand dollars to the employer's bottom line. The blue-eyed worker is simply more skilled.

Can the employer indulge his prejudice by hiring the green-eyed worker simply because his eyes are green? Of course he can. We're talking about a voluntary exchange here.

But this decision will cost the employer. It will cost him five thousand dollars every year that he indulges his bigotry. The question then becomes: Is the employer willing to pay five thousand dollars annually just to satisfy his vile tastes? Is he willing to incur that opportunity cost?

And suppose he does decide to enjoy his bigotry at the expense of the more productive worker. That just means there's a profit opportunity for an unbigoted rival to hire the more productive worker, and begin outcompeting the bigoted employer.

In other words, the rivalry between employers exerts competitive pressure to eliminate discriminatory hiring practices.

I want you to notice something else that is implicit in this logic. We should expect *less* instances of discrimination the more costly it becomes. This means that we'll tend to encounter less discrimination at higher salary rates. Hiring custodial staff based on prejudice will only cost pennies out of the employer's profit.

But now imagine hiring a CEO based on eye color, skin color, sex, religious creed, or any other characteristics that are irrelevant to skillfully directing a company. In this case, the results could be catastrophic. Hiring the wrong person could mean millions of dollars in foregone profits or even the company's eventual bankruptcy.

In short, the more it cuts into a company's profits, the less discrimination we should expect.

There's good empirical evidence for the ideas we've just been discussing.

In 1962, Armen Alchian, who had some of the clearest and furthest-seeing economic eyeglasses in history, partnered with coauthor Reuben Kessel to publish a paper that empirically explored the logic we've been discussing.

They began their analysis by noting that firms in some industries are prohibited by law from keeping all their profits.

The significance of this fact is that, when firms can't keep all their profits, the opportunity cost of discrimination necessarily falls!

Think back to the example from a few moments ago. We said that the employer could make five thousand dollars in additional profit if he hired the disliked blue-eyed worker.

But suppose that the government confiscated every last penny of that five thousand dollars. If that were the case, there'd no longer be any advantage in selecting the blue-eyed worker over the favored green-eyed worker.

So, the question becomes: In what industries are firms legally blocked from keeping all their profits?

Well, for starters, public utilities like water, gas, and electricity companies. In these areas, enterprises are subject to profit regulations so that the rate of return can never rise above some government-stipulated minimum.

Similar considerations apply to railroads, busses, airlines, and taxis.

Here's what Alchian and Kessel say about firms in these industries:

> *"If [these firms] are able to earn more than the permissible pecuniary rate of return, then 'inefficiency' is a free good, because the alternative to inefficiency is the same pecuniary income and no 'inefficiency.'"*

Unfortunately, so-called "inefficiency" may include indulging one's racial preferences. And that's what Alchian and Kessel find empirically.

Economics shows us that the freer the profit-and-loss system is, the less fraud and discrimination we'll have.

They examine employment data in different US industries. Specifically, they look at the proportion of Jewish employees across sectors during the first part of the 20th century—a time when Jews were often discriminated against in the United States.

To examine Jewish employment, they compare the share of Jewish to non-Jewish Harvard Business School grads employed across a variety of fields.

What they learn is consistent with the logic I've been discussing.

First, they find that the relative share of Jewish to non-Jewish grads is 36% overall in the ten industries they examine.

However—and crucially—in the industries subject to the strictest profit regulation, they discover that the share of Jewish to non-Jewish employment drops to 18%.

That sort of difference is what we'd expect because limiting a firm's ability to earn profits lowers the opportunity cost of discrimination. If you can't keep your extra profits, it doesn't make sense to hire the best worker. You might as well hire a worker based on racial preference.

Profits and losses regulate the behavior of market participants. Of course, the argument has never been that the profit-and-loss system *eliminates* fraud or discrimination.

But remember back to our barber and monkfish examples from earlier. The real question is: Why isn't there more fraud and discrimination in the world?

Economics shows us that the freer the profit-and-loss system is, the less fraud and discrimination we'll have.

Markets certainly don't eliminate every last instance of discrimination, but contrast their performance with public efforts. In lecture three, we explored a public policy that is aimed at reducing discrimination, but in fact, only exacerbates discrimination in hiring practices.

This short course, "Everyday Economic Errors," demonstrates just how far you can get with a single, straightforward economic principle: *opportunity cost*. If all you know about economics is the concept of "opportunity cost," you know enough to see through many, everyday economic errors. Understanding this simple, yet profound, concept is one reason why economists tend to agree on a broad number of issues.

Using this concept, you won't fall for the misunderstanding that war—any war—boosts the economy or that rent control is a free lunch for tenants. You'll be wary of well-intentioned public policies because now you're thinking about how they change the costs and the benefits people face. You can identify the mutual benefit in exchange, as well as some of the self-regulating properties of the profit-and-loss system.

THE INSTITUTE FOR
Faith & Freedom
GROVE CITY COLLEGE

UPCOMING EVENTS*

FOUNDATIONS OF AMERICAN LEADERSHIP SERIES
RIVERS CLUB – PITTSBURGH, PA

September 8	**"Let's Roll:" The High Price of American Freedom** with Grove City College President, the Honorable Paul McNulty '80
December 7	**"December 1941: 30 Days That Changed America and Saved the World"** with Craig Shirley, Founder & Chairman of Shirley & McVicker Public Affairs, bestselling author, and historian
March 22, 2022	**Indianapolis: The Story of the Worst Sea Disaster in U.S. Naval History** with naval historian Lynn Vincent

*We have begun in-person events at the Rivers Club in June. We will follow the recommendations of the CDC, federal, state, and local government to ensure everyone's safety

To learn more about the Institute's events, please visit:
www.faithandfreedom.com

THE INSTITUTE FOR
Faith & Freedom
GROVE CITY COLLEGE

The mission of the Institute for Faith & Freedom is to promote the principles of faith and freedom to the next generation of American leaders, and to share those principles with the wider world.

Grove City College equips students to pursue their unique callings through an academically excellent and Christ-centered learning and living experience distinguished by a commitment to affordability and its promotion of the Christian worldview, the foundations of free society, and the love of neighbor.

The Institute's work is entirely supported by the financial contributions of individuals, companies, and philanthropic foundations. Should you desire to support the Institute's work, please visit faithandfreedom.com.

SUBSCRIBE TO THE INSTITUTE'S E-PUBLICATIONS NOW!

The Institute offers free email subscriptions to all of our friends, supporters, and colleagues. Your inbox could receive periodic event notifications, scholarly white papers, published opinion editorials, and more.

Subscribe by calling 724-458-2606, or visit www.faithandfreedom.com/email.

TAKE THE FREE ONLINE COURSE

THE LEGACY OF RONALD REAGAN

The most comprehensive online classes about #40—President Ronald Reagan. In this course you will meet *NY Times* best-selling author, world-renown Reagan scholar, and professor of political science Dr. Paul Kengor. Paul will also appear in all of the videos in this class and has written many of the required readings. Enjoy!

www.academy.faithandfreedom.com

THE INSTITUTE FOR
Faith & Freedom
GROVE CITY COLLEGE

100 Campus Drive
Grove City, Pennsylvania 16127
www.faithandfreedom.com