The great strength of the market is that it is a decentralised means of resource illocation

Aleksandr Solodovnikov

Abstract: In this essay a decentralised means of resource allocation is going to be discussed as a strength or weakness of the market. In order to get a broad picture on this issue, we are going to bring examples of resource allocation in both market and planned economies. First, the most important authors concerned with this matter are going to be evaluated. Thus, we will review the opinions of authors like Adam Smith and Friedrich Hayek. While evaluating different positive and negative sides of the market economy, we will particularly focus on the matter raised in the question: what are the strong and weak sides of the market economy in terms of resource allocation. Finally, we will examine a particular case in order to get an understanding of how failure in resource allocation will affect centralised and free market systems.

Keywords: market and planned economies, resource allocation

Many of the philosophers of 17th century regarded human nature to be driven by egotism and selfishness, whereas freedom was treated as the means for the achievement of selfish ends. Thus, Thomas Hobbes stated that the competition of two persons for the same aims brings conflicts and results in the state of war (Leviathan 1994, p. 77). Therefore, he advocated sovereign rule which can resolve these conflicts.

Adam Smith was one of the first to recognise that the main motive of human action is self-interest: «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 self-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» (2005, p. 19). In his regard, a person is only capable of pursuing their interests by offering their goods and services for exchange with the others. And therefore, the natural tendency of people to improve their welfare is so powerful a stimulus, that it is capable of leading society to prosperity. The concepts of self-interest and non-intervention policy gave foundation for the notion of 'natural liberty' (Smith, 2005, p. 265). Thus, if the economic activity of each individual is eventually good for society, it should not be restricted. Adam Smith has outlined one of the biggest advantages of market economy: the market relies not on altruistic motives, but on the natural quality of human beings - self-interest.

After collapses of markets in the first half of 20th century and the rise of Keynesian ideas, Friedrich Hayek was one of the strongest advocates of the market economy. He sees the market not as a human invention, and not as a mechanism for the implementation of justice and optimal allocation (he is generally the enemy of goal-setting and has always been a bitter opponent of the reconstruction of society on a pre-engineered ideal model), but as a spontaneous economic order. Hayek outlines a clear difference between the market and planned economy: in a planned economy all resources are allocated in accordance to some 'reasonable' plan and set of values in order to achieve specific goals. Whereas the market functions in a principally different way. The market does not guarantee fulfilling everyone's needs and does not scale them in accordance to their importance (Hayek 1988, p. 14). In the market economy no one knows the needs and opportunities of every single person, but everyone shares the information about their opportunities and goals, when engaging in voluntary exchange. Thus, every participant of the market economy shares and gains information and according to this information every participant gets their own idea of the best ways of allocating their resources.

Hayek pays a lot of attention to the mechanism of competition in the context of resource allocation. Unlike Keynesians who would regard competition to be a highly imperfect mechanism, Hayek saw competition as a 'discovery procedure', which allows new products and services that would never exist without competition. He argued that cooperation is only possible when a group of people substantially agree on some presupposed ends, therefore it is not useful when adapting to unknown circumstances (Hayek, 1988 p. 19). This is the competition that forces the entrepreneur to search for new products and new markets of raw materials in order to maximise their profits. Thus, competition stimulates the dynamic development of the economic system. Having the opportunities to express themselves, entrepreneurs find innovative solutions, which make the resource allocation even more effective.

Hayek's concept of individualism in the economy emphasises the creative aspirations of man, the desire for innovation and the will to fulfil demand. Thus, there is a connection between freedom and progress. Here lies another argument against the planned economy: since the production of a product that does not exist cannot be planned, the system of directive planning falls into reproducing the existing structure of social production. Therefore, competition is valuable precisely because its results are unpredictable.

Hayek dedicates a lot of time to the discourse of whether the resource allocation would be more effective in a socialist system rather than in a market economy. He debates, that even if we could achieve the same level of effectiveness in the allocation of the already discovered resources in a socialist system as we have in a market economy, it would not be enough to justify the transition to socialism. The main reason for it, is that the market does not only deal with resources and technologies that are already engaged in the economic processes; on the contrary, one of the main advantages of the market is that it involves a certain degree of ignorance (Hayek 1988, p 70). Unlike other neoclassical economists, Hayek does not see the market as a social institution with a known and limited volume of resources. He argues that 'a distribution of resources is effected by an impersonal process in which individuals, acting for their own ends, literally do not and cannot know what will be the net result of their interactions' (Hayek 1988, p. 71). If the problem of allocation only concerned discovered resources, then this sort of task could be done by men. However, the market has such an advantage that it is able to efficiently allocate resources that have not been and could not be taken into consideration for economic purposes; resources that have not been and could not be detected. Thus, the market is superior to the centralized system due to its ability to deal with a certain degree of ignorance.

A point that could be put forward in the defence of socialism, is its ability to gather information through cooperation. And indeed, how could a small entrepreneur compete with the Politburo in terms of information gathering? It could be supposed that central planning allows all aspects to be taken into consideration before making the best decision on how to allocate resources. Just imagine the Soviet Union with thousands of Universities and Scientific centres providing sufficient reports to decision-makers on local and central levels on how to deal with a particular issue. From the first sight it may look like private companies would never have enough informational resources in order to compete with a solid structure like that. However, Hayek argues that the most significant information that we need for decision-making could only be elicitted while undertaking some particular task (1988, p. 77). So, when information is gathered throughout all these institutions in the Soviet Union, most of it would be irrelevant for the purposes of the task and it will be almost impossible to outline the really important aspects. Another problem is that in most cases of resource allocation we do not need scientific or factual knowledge: individuals base their judgements on 'dispersed knowledge' that can hardly be transferred to another individual. This knowledge does not require a virtuous foundation and is not based on ideology, it is 'essentially dispersed, and cannot possibly be gathered together and conveyed to an authority charged with the task of deliberately creating order' (Hayek 1988, p. 77). There is a significant difference between knowledge and skill; when an individual is basing their actions on some kind of knowledge, they would not be able to foresee all the effects of their actions, whereas skill presupposes a complete predictability of the outcomes.

Another problem of the planned economy is its vulnerability to the mistakes that can be made in the process of decision-making. The planned economy, according to Hayek, is deprived of the mechanism of compensation that acts in the market economy. In the market economy every subject of the market is engaged in the decision-making, which helps to compensate for the mistakes of some by the right decision of others. Whereas an error in the planned economy can only be solved after the economy has already suffered irreparable damage. It can be quite a significant factor in terms of resource allocation. Imagine that the central government in a socialist state "A" plans to create a new product of consumption for the population, which is for instance winter boots. This sort of product would be essential for the population of most parts of "A" with its severe winters. After considering different proposals, the Politburo makes a decision to start using a new artificial material instead of leather, because one Constructive Buro has scientifically proved that their material keeps warmth better than standard leather, is more durable and it is cheaper to produce. So, taking that into consideration the Politburo decides to start an experiment for the use of these boots throughout the country. They order new factories to be built that produce this material in industrial quantities and to re-build some of the current shoe factories in order to use material. Finally, in October of the next year these shoes are delivered to the shops throughout the country, taking the place of the many leather shoes that used to be produced in those factories. The Politburo announces through the media that they have come up with a new victory for consumers: winter boots that in all aspects are better than similar boots in the free market state of "B". However, this is not the most inspiring factor to persuade consumers to buy this new type of shoes, they are left with less choice, considering the fact that this product partly replaced leather ones. Let's say this product really became as useful as was predicted by the scientists. Then, almost all the winter supply of the shoes is turned to be based on this innovative material. The government announces that this is a global victory, which demonstrates that A's Society is way more innovative and animal-friendly, because they do not use leather for the production of shoes.

This may seem to be a victory of the planned economy in this case. However, if we take other economic factors into consideration it may not be so obvious. When replacing leather as the new material, many leather factories had to be re-build or shut and their experienced workers instead of just being fired had to be re-trained or transferred to other types of production. Most of these workers exceed their thirties and have been selected for this job straight after professional school. So, after being re-trained to participate in other industries you could expect a dramatic decrease in their performance. This results in negative effects on other industries. Another side of this is issue is leather that is being left after the decrease in a demand for it: most of the leather that is used for the production of shoes is obtained from the food industry. So far, we can see that resources of skills (workers) and materials (leather) are used less efficiently that they used to be.

Let's imagine that after six years of exploitation these shoes doctors discover the new toxic nature of this material which is related to a serious increase in deep vein thrombosis among the population. The Ministry of Public Health of A receives this information in December and transfers it to the Politburo. They make a decision to postpone the public announcements until spring to avoid a panic, because leather shoes are no longer available in the shops, meanwhile making a decision to urgently re-build the industry to its previous state. It is quite easy to imagine what colossal costs this sort of mistake would have cost to a planned economy.

Would it be such a massive issue for the economy of free market state B if one of the entrepreneurs had introduced this product? It definitely would not be a global issue for their economy, even if consumers would have liked this product, because it would never make this company a monopoly in the shoe market. Therefore, after discovering that this product is toxic it would only damage the company, which would give up its market share to its rivals and it would not cause massive shocks for consumers and the market.

This example may seem to be unrealistic: you may argue that a complete switch to this new material would be impossible. You may be right and this is not a real example. However, very similar cases happened in the USSR quite a few times. It is enough to remember the case when N. Khrushchev decided to start mass cultivation of maize in the areas where wheat was cultivated. As a result, the corn harvest was lost and the USSR ended up importing grain for many of the following years. These examples demonstrate that in the planned economy mechanisms of compensation do not function as well as in the market economy.

In this essay the issue of resource allocation in market and planned economies has been addressed. We have figured out that the market economy has certain benefits in terms of resource allocation. First of all the market provides more efficient ways for sharing information between the participants of the market. Resource allocation in the market economy is not based on beliefs or values. We have figured out that competition in the market economy brings more efficiency in terms of resource allocation and that the market economy has an effective mechanism for the discovery of new resources that have not been engaged before in the economy. The market allows people to make better use of their tacit knowledge. Finally, we have discovered in the example explained the importance of the mechanism of compensation for the stable functioning of the economy.

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Aleksandr Solodovnikov
King`s College University of London
BA International Politics/FD International Studies