

Thing 1

There is no such thing as a free market

What they tell you

Markets need to be free. When the government interferes to dictate what market participants can or cannot do, resources cannot flow to their most efficient use. If people cannot do the things that they find most profitable, they lose the incentive to invest and innovate. Thus, if the government puts a cap on house rents, landlords lose the incentive to maintain their properties or build new ones. Or, if the government restricts the kinds of financial products that can be sold, two contracting parties that may both have benefited from innovative transactions that fulfil their idiosyncratic needs cannot reap the potential gains of free contract. People must be left 'free to choose', as the title of free-market visionary Milton Friedman's famous book goes.

What they don't tell you

The free market doesn't exist. Every market has some rules and boundaries that restrict freedom of choice. A market looks free only because we so unconditionally accept its underlying restrictions that we fail to see them. How 'free' a market is cannot be objectively defined. It is a political definition. The usual claim by free-market economists that they are trying to defend the market from politically motivated interference by the government is false. Government is always involved and those free-marketeers are as politically motivated as anyone. Overcoming the myth that there

is such a thing as an objectively defined 'free market' is the first step towards understanding capitalism.

Labour ought to be free

In 1819 new legislation to regulate child labour, the Cotton Factories Regulation Act, was tabled in the British Parliament. The proposed regulation was incredibly 'light touch' by modern standards. It would ban the employment of young children – that is, those under the age of nine. Older children (aged between ten and sixteen) would still be allowed to work, but with their working hours restricted to twelve per day (yes, they were really going soft on those kids). The new rules applied only to cotton factories, which were recognized to be exceptionally hazardous to workers' health.

The proposal caused huge controversy. Opponents saw it as undermining the sanctity of freedom of contract and thus destroying the very foundation of the free market. In debating this legislation, some members of the House of Lords objected to it on the grounds that 'labour ought to be free'. Their argument said: the children want (and need) to work, and the factory owners want to employ them; what is the problem?

Today, even the most ardent free-market proponents in Britain or other rich countries would not think of bringing child labour back as part of the market liberalization package that they so want. However, until the late nineteenth or the early twentieth century, when the first serious child labour regulations were introduced in Europe and North America, many respectable people judged child labour regulation to be against the principles of the free market.

Thus seen, the 'freedom' of a market is, like beauty, in the eyes of the beholder. If you believe that the right of children not to

have to work is more important than the right of factory owners to be able to hire whoever they find most profitable, you will not see a ban on child labour as an infringement on the freedom of the labour market. If you believe the opposite, you will see an 'unfree' market, shackled by a misguided government regulation.

We don't have to go back two centuries to see regulations we take for granted (and accept as the 'ambient noise' within the free market) that were seriously challenged as undermining the free market, when first introduced. When environmental regulations (e.g., regulations on car and factory emissions) appeared a few decades ago, they were opposed by many as serious infringements on our freedom to choose. Their opponents asked: if people want to drive in more polluting cars or if factories find more polluting production methods more profitable, why should the government prevent them from making such choices? Today, most people accept these regulations as 'natural'. They believe that actions that harm others, however unintentionally (such as pollution), need to be restricted. They also understand that it is sensible to make careful use of our energy resources, when many of them are non-renewable. They may believe that reducing human impact on climate change makes sense too.

If the same market can be perceived to have varying degrees of freedom by different people, there is really no objective way to define how free that market is. In other words, the free market is an illusion. If some markets *look* free, it is only because we so totally accept the regulations that are propping them up that they become invisible.

Piano wires and kungfu masters

Like many people, as a child I was fascinated by all those gravity-defying kungfu masters in Hong Kong movies. Like many kids,

I suspect, I was bitterly disappointed when I learned that those masters were actually hanging on piano wires.

The free market is a bit like that. We accept the legitimacy of certain regulations so totally that we don't see them. More carefully examined, markets are revealed to be propped up by rules – and many of them.

To begin with, there is a huge range of restrictions on what can be traded; and not just bans on 'obvious' things such as narcotic drugs or human organs. Electoral votes, government jobs and legal decisions are not for sale, at least openly, in modern economies, although they were in most countries in the past. University places may not usually be sold, although in some nations money can buy them – either through (illegally) paying the selectors or (legally) donating money to the university. Many countries ban trading in firearms or alcohol. Usually medicines have to be explicitly licensed by the government, upon the proof of their safety, before they can be marketed. All these regulations are potentially controversial – just as the ban on selling human beings (the slave trade) was one and a half centuries ago.

There are also restrictions on who can participate in markets. Child labour regulation now bans the entry of children into the labour market. Licences are required for professions that have significant impacts on human life, such as medical doctors or lawyers (which may sometimes be issued by professional associations rather than by the government). Many countries allow only companies with more than a certain amount of capital to set up banks. Even the stock market, whose under-regulation has been a cause of the 2008 global recession, has regulations on who can trade. You can't just turn up in the New York Stock Exchange (NYSE) with a bag of shares and sell them. Companies must fulfil listing requirements, meeting stringent auditing standards over a certain number of years, before they can offer their shares for trading. Trading of shares is only conducted by licensed brokers and traders.

Conditions of trade are specified too. One of the things that surprised me when I first moved to Britain in the mid 1980s was that one could demand a full refund for a product one didn't like, even if it wasn't faulty. At the time, you just couldn't do that in Korea, except in the most exclusive department stores. In Britain, the consumer's right to change her mind was considered more important than the right of the seller to avoid the cost involved in returning unwanted (yet functional) products to the manufacturer. There are many other rules regulating various aspects of the exchange process: product liability, failure in delivery, loan default, and so on. In many countries, there are also necessary permissions for the location of sales outlets – such as restrictions on street-vending or zoning laws that ban commercial activities in residential areas.

Then there are price regulations. I am not talking here just about those highly visible phenomena such as rent controls or minimum wages that free-market economists love to hate.

Wages in rich countries are determined more by immigration control than anything else, including any minimum wage legislation. How is the immigration maximum determined? Not by the 'free' labour market, which, if left alone, will end up replacing 80–90 per cent of native workers with cheaper, and often more productive, immigrants. Immigration is largely settled by politics. So, if you have any residual doubt about the massive role that the government plays in the economy's free market, then pause to reflect that all our wages are, at root, politically determined (*see Thing 3*).

Following the 2008 financial crisis, the prices of loans (if you can get one or if you already have a variable rate loan) have become a lot lower in many countries thanks to the continuous slashing of interest rates. Was that because suddenly people didn't want loans and the banks needed to lower their prices to shift them? No, it was the result of political decisions to boost demand

by cutting interest rates. Even in normal times, interest rates are set in most countries by the central bank, which means that political considerations creep in. In other words, interest rates are also determined by politics.

If wages and interest rates are (to a significant extent) politically determined, then all the other prices are politically determined, as they affect all other prices.

Is free trade fair?

We see a regulation when we don't endorse the moral values behind it. The nineteenth-century high-tariff restriction on free trade by the US federal government outraged slave-owners, who at the same time saw nothing wrong with trading people in a free market. To those who believed that people can be owned, banning trade in slaves was objectionable in the same way as restricting trade in manufactured goods. Korean shopkeepers of the 1980s would probably have thought the requirement for 'unconditional return' to be an unfairly burdensome government regulation restricting market freedom.

This clash of values also lies behind the contemporary debate on free trade vs. fair trade. Many Americans believe that China is engaged in international trade that may be free but is not fair. In their view, by paying workers unacceptably low wages and making them work in inhumane conditions, China competes unfairly. The Chinese, in turn, can riposte that it is unacceptable that rich countries, while advocating free trade, try to impose artificial barriers to China's exports by attempting to restrict the import of 'sweatshop' products. They find it unjust to be prevented from exploiting the only resource they have in greatest abundance – cheap labour.

Of course, the difficulty here is that there is no objective way

to define ‘unacceptably low wages’ or ‘inhumane working conditions’. With the huge international gaps that exist in the level of economic development and living standards, it is natural that what is a starvation wage in the US is a handsome wage in China (the average being 10 per cent that of the US) and a fortune in India (the average being 2 per cent that of the US). Indeed, most fair-trade-minded Americans would not have bought things made by their own grandfathers, who worked extremely long hours under inhumane conditions. Until the beginning of the twentieth century, the average work week in the US was around sixty hours. At the time (in 1905, to be more precise), it was a country in which the Supreme Court declared unconstitutional a New York state law limiting the working days of bakers to ten hours, on the grounds that it ‘deprived the baker of the liberty of working as long as he wished’.

Thus seen, the debate about fair trade is essentially about moral values and political decisions, and not economics in the usual sense. Even though it is about an economic issue, it is not something economists with their technical tool kits are particularly well equipped to rule on.

All this does *not* mean that we need to take a relativist position and fail to criticize anyone because anything goes. We can (and I do) have a view on the acceptability of prevailing labour standards in China (or any other country, for that matter) and try to do something about it, without believing that those who have a different view are wrong in some absolute sense. Even though China cannot afford American wages or Swedish working conditions, it certainly can improve the wages and the working conditions of its workers. Indeed, many Chinese don’t accept the prevailing conditions and demand tougher regulations. But economic theory (at least free-market economics) cannot tell us what the ‘right’ wages and working conditions should be in China.

I don't think we are in France any more

In July 2008, with the country's financial system in meltdown, the US government poured \$200 billion into Fannie Mae and Freddie Mac, the mortgage lenders, and nationalized them. On witnessing this, the Republican Senator Jim Bunning of Kentucky famously denounced the action as something that could only happen in a 'socialist' country like France.

France was bad enough, but on 19 September 2008, Senator Bunning's beloved country was turned into the Evil Empire itself by his own party leader. According to the plan announced that day by President George W. Bush and subsequently named TARP (Troubled Asset Relief Program), the US government was to use at least \$700 billion of taxpayers' money to buy up the 'toxic assets' choking up the financial system.

President Bush, however, did not see things quite that way. He argued that, rather than being 'socialist', the plan was simply a continuation of the American system of free enterprise, which 'rests on the conviction that the federal government should interfere in the market place only when necessary'. Only that, in his view, nationalizing a huge chunk of the financial sector was just one of those necessary things.

Mr Bush's statement is, of course, an ultimate example of political double-speak – one of the biggest state interventions in human history is dressed up as another workaday market process. However, through these words Mr Bush exposed the flimsy foundation on which the myth of the free market stands. As the statement so clearly reveals, what is a necessary state intervention consistent with free-market capitalism is really a matter of opinion. There is no scientifically defined boundary for free market.

If there is nothing sacred about any particular market boundaries that happen to exist, an attempt to change them is as

legitimate as the attempt to defend them. Indeed, the history of capitalism has been a constant struggle over the boundaries of the market.

A lot of the things that are outside the market today have been removed by political decision, rather than the market process itself – human beings, government jobs, electoral votes, legal decisions, university places or uncertified medicines. There are still attempts to buy at least some of these things illegally (bribing government officials, judges or voters) or legally (using expensive lawyers to win a lawsuit, donations to political parties, etc.), but, even though there have been movements in both directions, the trend has been towards less marketization.

For goods that are still traded, more regulations have been introduced over time. Compared even to a few decades ago, now we have much more stringent regulations on who can produce what (e.g., certificates for organic or fair-trade producers), how they can be produced (e.g., restrictions on pollution or carbon emissions), and how they can be sold (e.g., rules on product labelling and on refunds).

Furthermore, reflecting its political nature, the process of re-drawing the boundaries of the market has sometimes been marked by violent conflicts. The Americans fought a civil war over free trade in slaves (although free trade in goods – or the tariffs issue – was also an important issue).¹ The British government fought the Opium War against China to realize a free trade in opium. Regulations on free market in child labour were implemented only because of the struggles by social reformers, as I discussed earlier. Making free markets in government jobs or votes illegal has been met with stiff resistance by political parties who bought votes and dished out government jobs to reward loyalists. These practices came to an end only through a combination of political activism, electoral reforms and changes in the rules regarding government hiring.

Recognizing that the boundaries of the market are ambiguous and cannot be determined in an objective way lets us realize that economics is not a science like physics or chemistry, but a political exercise. Free-market economists may want you to believe that the correct boundaries of the market can be scientifically determined, but this is incorrect. If the boundaries of what you are studying cannot be scientifically determined, what you are doing is not a science.

Thus seen, opposing a new regulation is saying that the status quo, however unjust from some people's point of view, should not be changed. Saying that an existing regulation should be abolished is saying that the domain of the market should be expanded, which means that those who have money should be given more power in that area, as the market is run on one-dollar-one-vote principle.

So, when free-market economists say that a certain regulation should not be introduced because it would restrict the 'freedom' of a certain market, they are merely expressing a political opinion that they reject the rights that are to be defended by the proposed law. Their ideological cloak is to pretend that their politics is not really political, but rather is an objective economic truth, while other people's politics *is* political. However, they are as politically motivated as their opponents.

Breaking away from the illusion of market objectivity is the first step towards understanding capitalism.