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**Legitimization of the free market from two aspects:**

**Hayek: Competition as a discovery procedure**

**vs.**

**Coase: The Problem of Social Cost**

**Introduction**

In the following paper I will introduce two main theories about the market procedure. The first one will be the „Competition as a discovery procedure” by Friedrich August von Hayek, economist and social scientist of the Austrian School, noted for his defense of liberal democracy and free-market capitalism against a rising tide of socialist and collectivist thought in the mid-20th century. The second will be “The problem of social cost” by Ronald Coase which suggests that well defined property rights could overcome the problems of externalities on the market. At the end I will summarize the main contradictory and common points in their works.

**Hayek - Competition as a self-exploring procedure**

**The false assumptions of information lead to a false evaluation of competition.**

The false assumption that the actors of the market have perfect information is misleading from the point of the evaluation of the market procedure. We can assume, that if all actors would have perfect information, all consequences of market procedure could be predicted, moreover there wouldn't be a need for such a demanding procedure, because a simple information center could optimize the demands and supplies. According to this perception of knowledge the free market is hardly defensible against the central planning, since the central planner as every actor could have the sufficient information to satisfy all needs. So competition should be defined – as it is – as a discovery procedure, in which actors always

adapt to unpredicted circumstances, as a constant dynamic mechanism that always combine the segments of information by meeting new challenges.

**The false definition of competition is devaluating the market procedure.**

In classical economics competition is defined as an optimization procedure of scant sources. However competition is a procedure that defines sources and scantiness, because it is not a static data which sources should be used and which are scant.

**The “fragmented knowledge” can only be utilized by competition**

This derives from the nature of that knowledge: This knowledge is not information or data that could be reported, but the ability to find out a competitive strategy on the market. Every single actor has its own fragment of knowledge and with that can take part in the competition, and prices inform the actors to what extent the market needs their services.

**The major mistake is that the result of market order is considered to be economy**

The result of market order is not economy (in the sense of national economy), but catallaxy. National economy is defined as system of institutions with certain and common aims of society, so it assigns sources to ends. On the other hand catallaxy is a system where all individuals have their own aims and they can follow it freely. Each actor assigns sources and ends individually.

**Socialist regime was an attempt to replace catallaxy by national economy.**

Replacing catallaxy by national economy meant the centralization of the decision procedure. This was far more inefficient utilization of information as the catallaxy, since only the information of central agent could be utilized and others were excluded, even more the sea of aims had to be unified in one common social aim.

Catallaxy could utilize information or knowledge much easier and more efficient, however it is hard to evaluate, since the satisfaction of individual aims can hardly be measured on a common scale. The only measure of a catallaxy can be the extent to which people's expectations come true, in other words the rate of integration.

**The regulation of market in the name of the so called “social justice” is oppressive.**

If we define competition as before, incomes and prices are tunnels of information, that show which activity is demanded and which is not. In this sense competition does not evaluate the

quality of the service, but legitimize its existence. Although it sounds justice to compensate the losers of competition, since it is a zero sum game it causes at the same time the restriction of newcomers on the market. Compensation in the name of macroeconomic stabilization is also not verified, since the trial and error of competitors will only lead to a microeconomic fluctuation, but not a macroeconomic instability.

### **Competition has an invaluable importance in developing countries.**

Since competition is the most efficient way of discovering the new possibilities and in a developing economy there are tremendous possibilities of new discoveries, competition have to be supported in these regions. On the other hand the freedom of competition is the most important here, because the few new entrepreneurs are easily restricted by other actors in favor of traditional methods. Freedom of competition can be prevailed through proper regulation of private property and liberal law framework.

## **Coase - The Problem of Social Cost**

### **The reciprocal nature of the problem**

Most of the externalities on the market occur in a zero sum game, so as a consequence if we decide to settle the rights to one side the other side will lose in any case. The further task is only to decide which side should have the rights or how can we decide about that?

### **The Pricing system with liability for damage leads to optimum allocation.**

The article takes the example of a farmer and a cattle-raiser. First let's assume, that the cattle-raiser would have to pay if he damaged the crop field of the farmer. If "the pricing system works smoothly" and the cost of compensation is lower than the profit the damaging production will be continued, moreover if the cost of protection is even lower than the compensation, the cattle-raiser will provide the protection to the farmer. Following this logic if the damage is bigger on the farmer side than his profit, and there is the possibility of a bargain between the actors, farmer will stop production and will merely rely on compensation.

### **The Pricing system with no liability for damage leads to optimum allocation.**

Let's assume again that "the pricing system works smoothly". In this case the damage is not compensated by the cattle-raiser, but paid by the farmer. With a similar argumentation we can see that the allocation of resources would be the same finally.

**Institutional background plays the most important role.**

It is necessary to know whether the damaging -business is liable or not for damage caused since without the establishment of this initial delimitation of rights there can be no marked transactions to transfer and recombine them. But the ultimate result (which maximizes the value of production) is independent of the legal position if the pricing system is assumed to work without cost. The assumption mentioned above is unrealistic. If actors of the market interact with each other, they have to use institutions: legal framework, information platforms, negotiation platforms, control systems. The mechanism of these institutions is not costless. So market interactions are not costless.

**In these conditions the initial delimitation of legal rights does have an effect on the efficiency with which the economic system operates.**

With this assumption one arrangement of rights can cause different outcome of the transactions than the other arrangements. Moreover there can be arrangement of rights where the optimum can be reached because the transaction cost would be higher than the profit from changing the positions. As a conclusion there are some legal systems and administrative institutions that make absolute optimum possible some do not.

**There are some alternative economic organizations that can be more efficient than the market.**

Apart from single actors on the market there can be some other actors, like firms on the market that can reduce transaction cost by integrating some transaction inside the firm. According to the former theory of Coase the optimal size of the firm depends on this ability of reducing transaction cost. However according to this theory not only firms can control transactions at a lower cost but state administration. Economist should decide whether the market or the state administration has higher transaction cost.

**Alternative cost should be considered.**

Policy makers usually tend to correct the failures of the by direct intervention without considering all the consequences of an intervention – an implementation of a new transaction cost.

**A better approach would seem to be to start our analysis with a situation approximating that which actually exists**

When answering the question of state intervention, the alternatives of choice are never clear. Usually it is the choice between an ideal world and the state of laissez faire; however it is not described in details containing the legal and administrative background of these choices. So to form the question whether the state of laissez faire is better or an ideal world is weightless. The answer is obvious. The question should focus on the current state of affairs and the consequences of changes from these conditions to other conditions. What is the arrangement of the transaction costs now, and how could it be improved.

**Discussion on the market system**

**What is competition?**

Coase follows the path of neoclassical economist in using the term of competition. Through competition all actors maximize utility within the scant resources. Competition by Hayek is a procedure, that discovers the factors of market, defines these factors and their scantiness.

**What is the aim of competition?**

In short Coase describes a material aim of competition, while Hayek only a formal aim. Following the Coase's definition on market if there were some externalities on the market – some actors cause harm to other actors – market procedure through bargains could solve the problem, so the economy could reach its absolute optimum, on the supposition that market works smoothly. However this assumption is not valid and the market cannot reach its optimum. So the aim of competition is to maximize the utility within some limits caused by the transaction costs of institutions. Whereas by Hayek there exists no optimum production or output. The one measure of the system's efficiency is the satisfaction of expectations. The more people's expectations come true the better the economy works.

**What is the role of state regulation?**

Both works stress the reciprocal nature of state regulation. It means by Hayek if in the name of social justice some economic procedures are regulated these can be only oppressive. The regulations on one hand try to help the losers of competition but on the other hand regulations exclude the newcomers. Coase also warn us to pay attention on the reciprocal nature of regulation, he says that giving right to an actor to protect itself means a restriction in others' rights.

### **How do they defend the market system?**

In the end they both come to the conclusion that to decide market is better than state management we shall not identify market with state of laissez affair but with a state where property rights are well defined and the legislative system is consequent.

Since Coase defines market as an institution that can work well when the transaction cost inside the institution is the lowest. Economic systems are only stable when they reach the minimum of sum transaction cost. This is perfectly applicable theory for companies like he explained in his work *The nature of the firms*. The alternatives of state control and market system has different transaction cost. To defend the market we shall prove that it has lower cost than administration. Coase compared to Hayek has only a weak argument on that. Since the government can avoid competition altogether, if some activities are integrated it there is no pressure – not like in the firms – to minimize the cost of managing.

But this argument is not enough to defend the market system against over all state control, since it still let one question unanswered: If there was a central planner, who could manage the whole economy and collect all the information without any transaction cost would it be better than the market? Considering Coase's theory we cannot say no.

Hayek gives a stronger argument to defend. According to Hayek the market system – catallaxy – is the only way of utilizing information what is fragmented in the society. This can lead to an optimal situation where most individual aims and expectations come true. This procedure is the only one that can bring development and innovation, through the permanent pressure on actors to utilize the fragments of information.