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On Free Markets, Their Benefits and Shortcomings, and How Competition Policy Operates in Such Markets

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People have strong feelings about the free market, and even more so about free-market capitalism. For the advocates, sometimes called *free marketeers*, market freedom is what has generated the economic growth and progress we have witnessed during the twentieth century. For them our planet would have been a different place without market freedom. It could never have hosted its actual seven billion inhabitants, and the satisfaction from life for those who would have lived would have been only a tiny fraction of what it actually is. The opponents of the free market, on the other hand, hold market freedom responsible for all the injustice and inequality we see around us everywhere.

I myself am a free marketeer, albeit a moderate one. I do believe that the world is a better place to live thanks to market freedom, but I admit it is no more than a belief, nothing really susceptible to scientific proof. I also believe that market freedom doesn't guarantee anything like a fair distribution of income and wealth, nor justice or equality. In my view, it is recommendable to temper free-market forces to some extent in exchange for more social justice. Apart from that, it should be noted that there is no genuine contradiction between the convictions of the advocates of the free market, on the one hand, and the opponents, on the other. Both may be right at the same time. That is, our economic progress may be a product of the same market freedom that stands in the way of a more equal distribution of income and wealth.

Yet, before commenting on the desirability of market freedom, I would like to share some thoughts with my readers on what it is that makes markets free. One may wonder why. Don't we all know what a free market is? The

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answer is that as a general rule we know, but when it comes to the details, there are many questions not so easy to answer. And as usual, the devil is in the details. That is why I want to address two questions. One is: What exactly are market participants free to do in a free market? The second question is: What kind of market freedoms are constrained by competition law and what kind of freedoms are supposed to remain untouched?

Moreover, there is substantial confusion about the concept. Some people, among them famous economists, think that markets are no longer free when they are concentrated: that is, when there is a limited number of suppliers or just one.[1] That way, they confound market freedom with the strength of competition, which are definitely related issues, but not the same. One of the first to complain about confounding the concept of what he calls the "perfect market" with that of competition was George Stigler. According to Stigler, "[t]he merging of the concepts of competition and the market was unfortunate, for each deserved a full and separate treatment. . . . A market may be perfect and monopolistic or imperfect and competitive."[2] As I explain below, monopolistic and concentrated markets can be perfectly free, whereas competitive markets are sometimes heavily regulated. Market freedom is not about the outcome of the game; it is about the rules.

Another common misperception about market freedom is that the motivating force of free-market capitalism would be greed and selfishness. This is a mistake. In a free society in general, and in a free-market system in particular, people are free to be selfish or greedy, but market freedom is about something else. Market freedom is about what people are free to do, not about what motivates them. It is about the rules of the game, not about what players pursue. When consumers buy only fair-trade products as a matter of principle, or when Bill Gates and Mark Zuckerberg are ready to share their fortunes with philanthropic causes, that doesn't make markets any less free. In a free market everyone is free to set his own goals, which may be selfish, altruistic, or whatever. What matters is that he is free to choose them, that nobody can tell him what his goals should be.

Most of what I bring up in this article is old stuff and has formed an integral part of the economic literature for at least half a century. Moreover, it is relatively uncontroversial; there is ample agreement on its validity. If there is something new in this article, it is in the way the presentation of the stuff is structured. My aim is to establish coherence between market freedom, economic efficiency, market failures, and the inequalities to which

1 For example, Milton Friedman observes that "natural monopoly . . . makes competition (and therefore thoroughly voluntary exchange) impossible." Milton Friedman, *The Role of Government in Education*, *in* Economics and the Public Interest 123, 124 (Robert A. Solo ed., Rutgers Univ. Press 1955). That monopoly doesn't go together with competition is clear, but that it doesn't go together with voluntary exchange is not. And what Friedman means by the addition of the adverb *thoroughly* is cryptic.

2 George J. Stigler, *Perfect Competition, Historically Contemplated*, 65 J. Pol. Econ. 1, 6 (1957).

free markets often give rise, and also to spell out what can and cannot be expected from competition policy in the whole setting.

In Part I, I set out the basic principles of the free market: that is, its premises and what exactly one is free to do in such a market. In Part II, I examine the benefits of market freedom, one of which is its purported economic efficiency. However, the allowance of decentralized decision making and information exchange is, in my view, at least as important. In Part III, I first review market failures and then comment on what I consider the main drawback of market freedom: the absence of any principle of fairness in the distribution of the proceeds of the market game. In Part IV, I have a look at competition policy and how it is supposed to work in a free-market system.

I. The Free Market

Certain premises underlie the notion of the free market. In any market, free or regulated, there are market players—if you wish, economic agents—performing market activities, such as producing, selling, buying, and consuming goods and services. Most market players produce and sell in one market, or in just a few, and buy and consume in a wide range of other markets. There are also intermediaries who buy and resell in the same market. Services cannot be stored and are usually consumed by the first buyer, but goods may change hands several times on their way from the producer to the consumer. Anyhow, the distinction between producers, consumers, sellers, and buyers is functional, not personal.

Another premise for there to be a market is that there are reasonably enforceable private property rights. As a matter of fact, the nature of a market system depends a good deal on the way property rights are structured and enforced. The question is: What tangible and intangible assets can be owned by market players? And also: What are those market players allowed to do with them? The abolition of slavery in the United States changed the nature of the market system. Likewise, what you are allowed do with a lot of land and what is meant by non-obvious inventions susceptible to being patented, determines to a large extent what a market system stands for. Particularly in the field of intellectual property and copyright law, property rights can be so strong as to strangle market freedom.[3]

What is produced is property of the producers, and in order for one to consume something, it must first be acquired as property. Properties are exchanged between market players through market transactions. That is precisely the purpose of markets: to be a scenario for the exchange of goods and services making all parties better off. In a free market, in which

[3] *See* Gary L. Reback, Free the Market!: Why Only Government Can Keep the Marketplace Competitive (Penguin 2009).

parties voluntarily engage in transactions, it is reasonable to assume that the transactions make all parties better off. Otherwise, the party being worse off wouldn't enter. Hence, in a free market, transactions are supposed to enhance social wellbeing.

Another prerequisite of any market system is that there is a means of payment that is sufficiently trusted by transaction parties to be accepted in exchange for property. In the absence of money, trade would be barter and transactions would be rare. It would be difficult to find a transaction partner interested in the goods offered, and the indivisibility of goods would be an enormous impediment. The existence of a means of payment is a condition not so much for markets to be free, but for there to be a market with a minimum turnover.

It should be noted that market freedom has little to do with the distinction between the haves and the have-nots. It is quite possible that someone has something in abundance that others badly need. Transaction freedom allows him to refuse to sell it; he is not obliged to sell what he doesn't want to sell. It is also possible that someone has nothing to sell and no money to buy what he badly needs. Once more, transaction freedom is of little help to the poor guy. Transaction freedom, and market freedom in general, are not about the availability of options; they are about the freedom to choose among the options that are available. This is the root of the misunderstanding of those who believe that concentrated markets are not free.[4]

Last but not least, it should be realized that in a free-market economy everybody stands on his own feet. He makes money by selling and spends money by buying, but it is up to him to make the ends meet. The importance of this principle can hardly be overstated; it is what makes decentralized decision making possible. It is what empowers everybody to decide for himself what to do and how to defend himself against actions of his fellow market players that may affect him. He sets his own goals and follows his instincts, and when he makes a mistake, it is his fault, not that of others. The premise that everybody is responsible for his own acts and that there is an absence of paternalism in the rules of the game is, for me, the key principle of market freedom, and it is the most important thing that is lost with market intervention.

A. Production and Consumption Freedom

In a free market, everybody is allowed to produce whatever he wants to produce in the way he wants to produce it, and nobody is obliged to produce what he doesn't want or in a way he doesn't want. Likewise, everybody is

[4] Market freedom is the freedom of individuals as conceived by Hayek. *See* Friedrich A. Hayek, The Constitution of Liberty ch. 1 (Univ. of Chicago Press 1960).

allowed to consume what is of his property in the way he wants to consume it, and nobody is obliged to consume what he doesn't want or in a way he doesn't want.

In most economies of the real world, there are many limitations on production freedom. For most productive activities, permits or licenses are required, and on top of that there is often a host of professional qualifications to be met. However, as long as the permits and licenses are granted in a transparent way and without discrimination, such limitations are deemed necessary to protect consumers and not considered a serious constraint on market freedom. Consumer freedom, on the other hand, is usually fully respected. With few exceptions, consumers are free to consume what they want and in the way they want.

B. Transaction Freedom

The most fundamental principle of the free market is freedom of transaction. That is, everybody is free to sell his property to whomever he wants at the price he wants. The other side of the coin is that nobody is obliged to sell his property at a price fixed by others or to someone to whom he doesn't want to sell. Likewise, everybody is free to buy what he wants at a price he wants and from the person of his choice, and nobody can be obliged to buy anything at a price he is not willing to pay or from a person from whom he does not want to buy. Market freedom implies that all transactions are voluntarily engaged in and that their parameters are the result of a free negotiation in which the parties can say no at any time. As far as I can see, the right to say no and voluntariness are one and the same thing

Transaction freedom applies not only to physical goods, but also to services. The difference is that a good is something tangible that can change ownership several times on its way from the producer to the consumer, whereas services are intangible and subject to a single transaction between the producer and the consumer. As a consequence, there is no exchange of property involved in services. Yet transaction freedom is defined in exactly the same way as in the case of goods. That is, the transactions and their parameters are the result of a free negotiation between the producer and the consumer.

Transaction freedom implies that everybody is free to choose how aggressively he wants to compete. He can go for market share, by charging low prices or improving the quality of his products, or he can settle for a quiet life, reaping profits as they come. If he goes for market share, he knows that his rivals won't lean back to see it happen, so he anticipates their responses to his moves. If he anticipates that his rivals will meet his price cuts, he may

well decide to take it easy. Nobody can oblige him to compete fiercely. It is up to him.

In most market economies there are certain limits to transaction freedom. Some of them are relatively soft, others much more severe. To give some examples, obligations to deal on nondiscriminatory terms are among the soft ones, but direct price controls and more outspoken obligations to deliver may affect the incentives of the market players severely, such that much of the benefits of market freedom may be lost. Most limitations to transaction freedom imposed by competition law are of the soft type.

C. Freedom of Association

Association freedom is an integral part of market freedom. It implies that market players are allowed to join efforts with their fellow market players and form new entities that operate as a single market player. The new entity earns its own income, which is divided among the associates according to some agreed-upon rules, and it has separate liabilities. Such associations can give rise to enormous efficiency gains. They allow for greater specialization among associates and for an enhanced exploitation of complementarities, and they may achieve substantial savings in transaction costs between otherwise separate market players.

At the same time, particularly when the association is between competitors, it may give rise to a loss of competition—which is why horizontal mergers are not *a priori* allowed in most jurisdictions with a competition regime. In such cases, the idea is to strike a proper balance between possible efficiency gains, on the one hand, and the loss of competition, on the other. Anyhow, merger control is an important limitation of market freedom and should be carried out with great care.

D. Freedom of Contract

Contract freedom means that market players are allowed to commit themselves mutually to future market transactions and their parameters. As a general rule, contracts imply that the parties voluntarily give up specific market freedoms, such as the right to say no or the freedom to set prices at will, in exchange for similar commitments on behalf of other parties to the transaction. Such waivers of market freedoms are not considered a limitation of market freedom in general, provided that the contracts be celebrated voluntarily.[5] That is, market freedom implies not only certain freedoms, but also the freedom to voluntarily waive them. It is like Ulysses, who voluntarily had himself tied up to the mast to enjoy the song of the sirens.

[5] To "celebrate" a contract, I mean to enter into a new contract.

Most contracts pave the way for welfare-enhancing transactions that would otherwise not occur due to the possibility of opportunistic behavior of one or some of the parties. The purpose of contracts is precisely to exclude such possibilities. Because practically all contracts limit competition in some way or another, they are looked upon with skepticism by competition authorities. Competition authorities prefer *arm's-length* transactions—that is, transactions that do not give rise to any commitments between the parties in the future. Unfortunately, in most concrete cases the choice is not between arm's-length transactions and transactions under contract; the choice is between transactions under contract and no transactions at all.[6]

The parties to a contract are usually the same as the parties to the transactions subject to the contract, but there are also contracts limiting the freedom to negotiate with third parties. Examples are contracts of exclusive dealing or resale price maintenance between parties at different levels of a distribution chain, and contracts of price fixing between competitors. Because the latter type of contract is forbidden in most jurisdictions with competition laws, such contracts are mostly not enforceable. Yet, it is an example of how competition law limits market freedom.

For market players, the celebration of contracts is somewhere between remaining fully independent and forming a new entity by association. In an association, market players integrate by joining efforts, dividing tasks, and sharing both risks and rewards in all of their business; with a contract they do so, but in a part of their business. Celebrating contracts is a much more flexible form of cooperation than association. It is not a marriage; it is living apart together.

E. *Privacy of Information*

A last pillar of the free market is privacy of information. There are usually many producers, sellers, buyers, and consumers around. None of them is obliged to disclose the parameters of his transactions, the nature of his production process, or his preferences as a consumer to third persons. He may wish to do so, and there may be good reasons to do so, but he cannot be forced. There may also be good reasons not to disclose information—for example, a seller who doesn't want a prospective buyer to know the price at

[6] Robert Bork's criticism of antitrust is essentially that it prohibits contracts for their clauses that limit competition tomorrow, when they are necessary for doing business today. Robert H. Bork, The Antitrust Paradox: A Policy at War with Itself (Free Press 2d ed. 1993). The most eloquent way in which I have seen this idea expressed was by Joseph Schumpeter in the 1940s. He compared such anticompetitive clauses of contracts with brakes in a car. They are not there to drive slower; they are there to enable you to drive faster. Joseph A. Schumpeter, Capitalism, Socialism, and Democracy 88 (Harper & Bros. 3d ed. 1950).

which he sold the same product to other buyers, or a producer who doesn't want his competitors to know the details of his production processes.

Privacy of information is important. Whether a transaction materializes—and, if so, at what price—is the result of negotiation between the parties, and information is a crucial input into any negotiation. Sellers may want buyers to believe that their competitors offer inferior products, and buyers may want sellers to believe that they have more options than they actually have. Reputation building and bluffing, often made possible by asymmetries in information, play a crucial role in determining the negotiation power of the parties. The free market is not a nudist beach where everyone shows everything to everyone. Bikinis and more extensive bathing suits are allowed to make life more exciting.

Evidently, keeping information private is the responsibility of the persons themselves. If you do not want your picture to be taken in public, you better stay home. Privacy of information also implies that nobody can be forced to disclose the parameters of his transactions to third persons—that is, to persons not party to the transaction. If you want to give your favorite client a special price, you better ask him not to tell it to anybody. If he does so anyhow, it is a pity and it will be difficult to punish him for that. It is part of the game. In brief, with privacy of information, everybody is free to tell anybody what he wishes to tell, but nobody can be obliged to tell something he doesn't want to tell or to somebody to whom he doesn't want to tell it.

II. The Benefits

Let us now consider the two principal benefits of market freedom: economic efficiency and decentralized decision making.

A. Economic Efficiency

The presumed benefit of market freedom is that it would lead to economic efficiency. What exactly is meant by economic efficiency is not always clear, and it must be admitted that different scholars have different ideas about it; but when it is about the efficiency arising from market freedom, what one usually has in mind is *Pareto efficiency*. (It is not my intention to comment on these issues here. For a more detailed discussion of economic efficiency, see my separate essay on the subject.[7] But a few observations seem to be in order.)

[7] Adriaan ten Kate Sr., Economic Efficiency as the Ultimate Goal of Competition Policy (Mar. 1, 2016), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2740523.

An outcome of a market system is Pareto-efficient when any additional transaction would make at least one of the market players worse off.[8] That is, with Pareto efficiency there is no transaction left making at least someone better off without making anyone else worse off. The latter type of transaction is considered *welfare-enhancing*. If there were such transactions left, those who would be better off could share a tiny fraction of their gains with the other parties to the transaction. As a result, every party would be better off, and with market freedom one may reasonably expect such transactions to be celebrated. In other words, a Pareto-inefficient situation cannot be the final outcome of the process.

There are several flaws in these arguments, but this is the line of reasoning underlying the belief that market freedom leads to economic efficiency. The flaws go under the name of *market failures*. One category of flaws is that market freedom does not ensure that all welfare-enhancing transactions are carried through; still, the mere knowledge that all the transactions that take place do enhance welfare is of great comfort. That knowledge implies that market freedom drives us at least in the right direction, though perhaps not until the end of the road. I will comment on market failures below, but first I would like to discuss another advantage of market freedom, which is in my view at least as important.

B. *Decentralized Decision Making*

For me, the single foremost advantage of market freedom is the decentralized character of decision making and information exchange. With market freedom everybody stands on his own feet and is responsible for his own acts. Everyone has his budget and decides for himself what to do with the income he generates. He decides for himself what to produce and what to consume, what to buy and what to sell, and at what prices. There is no authority telling anybody what to do or not to do. When someone makes a bad decision, it is his fault, not that of others.

Moreover, everybody does so with the information available to him. This information is often far from perfect, but producers learn about the preferences of the consumers from the sales they realize in the market, and consumers learn about product characteristics from past acquisitions and from the supply they face in the market. Nobody has to go any further than that. No producer has to break his mind on what exactly consumers do with

[8] In its original version, Pareto efficiency applies to a division of a basket of goods among individuals with certain preferences. There, it is not about transactions, but about exchanges of the goods between the individuals. In a market system it is preferable to speak about transactions, but interpreted in a broad sense. When I speak about transactions, they are supposed to include the productive activities preceding the transactions. So when I say that there is no welfare-enhancing transaction left, such welfare-enhancing transactions may be meant to include the preceding productive activity.

the products they acquire from him, and no consumer has to know the details of how the products of his choice are made. Transactions in a free market are a process of trial and error, and when market players are disappointed about what they did, they themselves are to blame.[9]

The importance of this advantage can hardly be overstated. The opposite of market freedom is market intervention. But for market intervention to be efficient, the authorities must have detailed knowledge of production processes and consumer preferences—knowledge not readily available to them and often difficult to get hold of. The information is no longer coming from the market itself, and what does come from the market is then distorted. With market intervention, the authorities pretend to outperform the market as a vehicle for information exchange. Those authorities must know what consumers want better than the consumers themselves and must know what producers can produce better than the producers themselves. Market freedom, on the other hand, implies the absence of any state paternalism; it is the ultimate expression of the bottom-up approach.

III. Shortcomings

Let us now consider the two principal shortcomings of market freedom: market failures and the distribution of proceeds.

A. Market Failures

Unfortunately, free markets are usually far from perfect. Most of them are plagued by so-called *market failures*, impeding an efficient functioning. Broadly speaking, there are two reasons why free markets may lead to inefficient outcomes. One is that market freedom does not guarantee that all transactions that are celebrated enhance welfare. The other is that market freedom does not ensure that all welfare-enhancing transactions are actually carried out. That is, market freedom may fall short of leading us to the end of the road.

1. Negative External Effects

Negative external effects belong to the first category of market failures. The problem is that many transactions have effects not only on the parties to the transaction, but also on third persons. In that case there is no guarantee anymore that transactions voluntarily engaged in by the parties won't make third persons worse off. When the affected third persons are included in the

[9] Sellers must make sure that they are paid before handing out the merchandise, and for buyers there is the *caveat emptor* principle.

transaction, such external effects are internalized, but the original parties to the transaction may be unwilling to include the affected persons when they are not explicitly obliged to do so. Moreover, there may be so many affected persons that including them all would be impractical.

Classical examples of negative external effects are productive activities causing pollution, but there are many other examples. What about someone opening a gasoline station next door? What about buying a car in a city plagued with traffic jams? It would be virtually impossible to include all the affected persons in buying the car. And imagine the kind of negotiation it would give rise to.

2. *Incomplete Information*

In the second category, we've got the welfare-enhancing transactions that never come into being. The most common cause is that people are simply unaware of them. They are potentially there, but they must first be discovered, and even when they are discovered, it remains to be seen if sellers are sufficiently informed about consumer preferences to be willing to make the necessary investments. Likewise, for transactions to take place, sellers and buyers must be brought together and must have confidence that prices are reasonable. Transactions are the result of negotiations, and when the parties are not well informed, such negotiations are less likely to arrive at an agreement.

In my view, the lack of information is by far the most important market failure of all. Both authorities and private people can do something about it—for example, by market-making efforts, advertisements, and so on—but it will always remain a matter of trial and error, and it is unlikely that we'll ever get close to what is sometimes called the *Pareto frontier*. Even stronger, we'll never know how close we actually are to that frontier. Evidently, the Internet and e-commerce meant an enormous leap forward, but rather than giving us an idea of how close we are now, it provides us with a lower bound on how far away we were before.

3. *Positive External Effects*

With negative externalities, unwanted welfare-decreasing transactions may be realized. With positive externalities, it is the other way round: welfare-enhancing transactions may be missed. This happens when the overall benefits are sufficient to make a transaction welfare-enhancing, but due to leakage of those benefits to third persons not party to the transaction, they are insufficient to make it attractive to the parties. The prominent example is that of network externalities where existing subscribers benefit from entrance

by new subscribers but cannot be charged for it. As soon as critical mass is reached, the problem is solved, but that may take time or never happen.[10]

4. *Transaction Costs and Negotiation Failures*

Transaction costs, including negotiation failures, is another factor that stands in the way of welfare-enhancing transactions. When the costs of the transactions are higher than their benefits, one might say that the transaction is no longer welfare-enhancing, but there is often disagreement about the division of the pie that causes negotiations to fail. When it is a sales transaction between one seller and one buyer, it is relatively simple, but when the number of parties increases, it becomes progressively more complicated.

A good example is that of public goods. In principle, such goods could well be provided by private undertakings, but the transaction costs that must be incurred to charge multiple users may be prohibitive. Highways can be toll roads, but how about public illumination and security services? It is amply accepted that in a free-market system such goods and services cannot be expected to be provided by private undertakings and that there is a role for a central government.

5. *Other People's Money*

Since we've got banks and insurance companies, we don't have to save our money under the mattress anymore, and it is not just goods and services that change ownership in market transactions: it is also claims and liabilities, or securities. Securities are not tangible goods; one may consider them services, but they are rather contracts with a time dimension and an element of risk, particularly when they are conditional upon certain things happening. Moreover, as opposed to normal services, securities can change hands many times during their lifetime.

Securities interfere with one of the most important premises of the free-market system: that everybody stands on his own feet. Securities allow some people to play with other people's money, to run excessive risks and not be held responsible for the outcome. When it turns out fine, they take their share; when it turns out the wrong way, they are so sorry and wish the claimant better luck next time. In the economics literature, such opportunism goes under the name *moral hazard*. Whether moral hazard should be conceived as a separate market failure or just a combination of information asymmetries and transaction costs is open to discussion, but there is hardly any doubt that it can give rise to enormous inefficiencies and market instability. The

[10] In spite of the name, network externalities are not confined to network industries, but are present in many different settings.

financial crisis of 2008 will probably enter history as the prime example of risk mismanagement in a wagering world.

6. *Industrial Concentration*

The last market failure I want to discuss here is what is known as industrial concentration—that is, that the supply in a market is controlled by one or just a few firms. Industrial concentration may give rise to a loss of welfare-enhancing opportunities due to the interdependence of transactions in a market. Suppose there is a sole producer able to produce the product at a cost of $20 and a consumer willing to pay $21 for it. So there is a welfare-enhancing transaction to make: both can be made better off without making anyone else worse off. However, the sole producer sells the same product to other consumers at $25, so he prefers not to cannibalize his other sales and does not enter the deal.[11]

Industrial concentration is the market failure addressed by competition law and policy. The policy controls mergers and acquisitions, particularly horizontal mergers between firms producing close substitutes to avoid concentration. It forbids exclusionary conduct by powerful firms aimed at working smaller but equally efficient firms out of the market. Generally speaking, competition policy is there to ensure that markets remain competitive for the purpose of economic efficiency with the industrial-concentration market failure in mind.

B. *Distribution of the Proceeds*

So we know that, in the absence of market failures, market freedom leads us to a Pareto-efficient outcome. That sounds great, but is it really great? A first question to ask is: How many such Pareto-efficient outcomes are there? To those unfamiliar with the subject matter, the answer is equally astonishing as it is revealing. As a general rule, there are as many Pareto-efficient outcomes of the market game as there are ways to divide a fixed amount of money among the market participants. When there are N participants, there is an $(N-1)$-dimensional continuum of Pareto-efficient outcomes.

The immediately following question is then: Where is market freedom going to drop us off among this huge amount of possibilities? The answer is: No idea. It may leave us in a situation in which a single market player gets everything and the others nothing. That is by definition a Pareto-efficient outcome because any possible transaction would at least take something

[11] The problem is the interdependence of transactions. The potential sale at $21 would stand in the way of the sales at $25. The possibility of resale at a lower price frustrates the welfare-enhancing deal at $21 and keeps the solution away from the Pareto frontier.

away from the lucky one and make him worse off.[12] It may also leave us in a situation in which some other market player gets everything, which is equally Pareto-efficient. Or it may leave us in a situation with a more equitable distribution of the proceeds. It is entirely arbitrary. All depends on the circumstances.

On what circumstances? Generally speaking, what market players get back from the game (their performance) depends on four factors: endowments, effort, sharpness, and luck. When performance is the result of effort, it is considered fair; working hard gives a right to get more after all. When it is based on sharpness, it is still acceptable, though somewhat less. It is not your fault if you are born untalented. But when it comes from endowments, it gets worse. There is little merit in being born rich or in getting whatever in exchange for nothing. And worst of all is luck; luck is dumb.

Altogether, there is little hope that market freedom would bring us anywhere close to a situation perceived as fair. The distribution of endowments is quite unequal as a rule, that of sharpness perhaps even more so, and luck is a case apart. Thus, as long as everybody is entitled to keep the proceeds of his efforts for himself, as is supposed to be the case in a free-market system, it is unlikely that market freedom would lead us to a socially acceptable outcome. In my view, this is the most important shortcoming of the free-market system, more important than any of the market failures discussed above.

One aspect that, to my knowledge, has received little attention in the economics literature is the relation between property rights and inequality. That there is such a relation is quite plausible. As long as collective property is more evenly distributed than private property, there is a case for maintaining property in the collective sphere. The stronger private property rights and their enforcement, the greater will be the inequality in endowments and, thus, in the distribution of income and wealth. Although private property rights are necessary to preserve the healthy incentives of the free-market system, one should keep in mind that there is a tradeoff.

In my view, free-market capitalism, the way it works in modern times, suffers from over-shooting the benefits from the privacy of property rights. I believe that somewhat more reservation in granting patents, together with a shorter life, would affect innovation only moderately, bring enormous savings in administration and litigation costs, and lead to a significant reduction in inequality in the distribution of income and wealth. I also believe that many developing countries have shot themselves in the foot by subscribing to the World Trade Organization's Trade Related Aspects of Intellectual Property Rights (TRIPS) and similar agreements on intellectual property protection

[12] This holds true under the usual assumption of insatiability of consumer preferences: the assumption that more is always better.

in bilateral free-trade agreements. Having substantial comparative disadvantages in innovation, most developing countries should not encourage innovation at home, but imitate innovation abroad, following the successful examples of some East Asian countries.

IV. Competition Policy in a Free-Market System

The main, if not the sole, objective of competition law and policy is to enhance economic efficiency by promoting competition in a free-market environment. Being such, there is a certain tension between aims and means. On the one hand, competition policy interferes with the functioning of free markets; on the other hand, it attempts to do so without throwing overboard the main advantages of the free-market economy, particularly the decentralized character of decision making and information exchange. Competition policy, as opposed to economic regulation, does not intervene directly in the transactions of the market players, but sets some restrictions on their conduct. It is a policy somewhere in between hands-off and hands-on.

With regard to the different market freedoms, let us consider them one by one. There is no doubt that competition policy favors production freedom. When production freedom is limited by permits or concessions, it is the state authorities that exercise the control and the competition agencies that usually advocate for an ample, transparent, and nondiscriminatory granting of the permits and concessions. Likewise, competition policy favors transaction freedom. It rarely intervenes directly, but it sets some limitations on the conduct of powerful firms—for example, by prohibiting discriminatory treatment and below-cost pricing. It is contract freedom where competition policy becomes more interventionist. The outright prohibition of price fixing and market segmentation between competitors and the ban on exclusive dealing in contracts between powerful manufacturers and their distributors are some examples. However, it is particularly the freedom of association where competition law enforcement is most interventionist. The outstanding example is horizontal mergers, which in many jurisdictions require the green light of the authorities to be carried through.

Even so, competition policy hardly affects the basic market freedoms, and that is precisely the idea. With the exception of mergers, most practices are challenged *ex post*, and even though firms must be aware of their potential wrongdoing, as a general rule they can do their normal business. This stands in sharp contrast with economic regulation, which intervenes *ex ante* in sales transactions by imposing prices, obligations to deliver, and so forth. For economic regulation to be efficient, regulators must have detailed knowledge of market conditions, information for which they often depend on the

regulated entities themselves. This gives rise to incentive distortions that are at odds with the typical free-market incentives of supplying the best product at the lowest price. For that reason, economic regulation is often considered a necessary evil for hopeless markets that do not lend themselves at all to competition. Competition policy tries to keep away from that and to leave the normal incentives of the free-market system intact.

A. Competition Policy and Industrial Concentration

It should be noted that, out of the multiple market failures examined above, competition policy addresses only one of them—that of industrial concentration. Regarding the others competition itself is of little help, so that promoting competition cannot be expected to resolve inefficiencies. Positive and negative external effects require a different kind of intervention and are not removed by more competition. The same holds true for the market failure of incomplete information and transaction costs. There, competition policy may even be counterproductive—for example, when market-making information exchange is suspect for its potential as a device for monitoring cartel behavior, or when firms are vertically separated to allow for competition in downstream industries, which usually gives rise to huge transaction costs between the separated entities. Likewise, competition policy has no role to play in problems of moral hazard.

Apart from that, competition policy is not the only policy that tackles the market failure of industrial concentration. It does so only in industries in which competition can be expected to work. Industries characterized by pervasive economies of scale do not qualify. In such industries, more competition goes directly against productive efficiency, and there is no remedy other than regulation. The bad news for competition policy is that industries without or with minor economies of scale are an endangered species. Particularly in high-tech, information and communications technology (ICT) industries, the market games are often of the winner-takes-all kind, and marginal production costs are usually close to zero. Even in many traditional sectors, such as alcoholic drinks or funeral services, there are strong trends towards consolidation, perhaps not even due to economies of scale in the productive process, but in marketing, in the logistics of distribution, in brand loyalty building, and so forth. Nowadays there are few industries in which competition can be expected to deliver the conventional textbook benefits. As a consequence, as long as competition policy remains inspired by those textbook benefits for a lack of something better, the policy increasingly resembles playing marbles in the age of videogames.

Given (1) that competition policy addresses only one out of several market failures, (2) that it is not the only policy, nor the most important

policy, addressing that market failure, (3) that it works only in industries in which a proper functioning of competition is not impeded by strong economies of scale, and (4) that such industries are progressively difficult to find, somewhat more modesty on behalf of the competition community with respect to the expectations from their favorite policy seems to be in order.

B. Competition Policy and Redistribution

A completely different question is whether competition policy has a role to play in the redistribution of the proceeds of the free-market system. It is often suggested it has. With more competition, prices of goods and services go down, so there is a transfer of income from the producers, particularly from monopolists and powerful firms, to consumers and, as long as monopolists are rich and evil and consumers poor and forlorn—since time immemorial they have been—such redistribution is considered a good thing.

Considerations of this kind pop up with a certain regularity in competition cases. For example, horizontal mergers are challenged, or even explicitly forbidden, when they are expected to substantially lessen competition, but when they are likely to generate cost savings, they may get the green light of the authorities. Such an efficiency defense has been in place for a long time, but more recently it often comes with the additional condition: provided that a substantial part of the resulting cost savings be passed on to the consumers.

Another example can be found in the partial-equilibrium approach commonly used in competition analysis. There, the objective is not Pareto efficiency, but maximum welfare, the latter conceived as the sum of consumer and producer surpluses.[13] Lately, the zeal to positively discriminate in favor of the consumers has led competition officials to propose that the sum should not be the simple sum but a weighted sum, with a greater weight for the consumer surplus. This in spite of the fact that in partial-equilibrium models competition as such maximizes the simple sum. By demanding this weighted sum instead, the officials add an additional goal beyond that of promoting competition.

In my view and in that of many others, competition policy should not pursue any goals other than economic efficiency. Nor is it well equipped to do so. Occasionally, competition redistributes income in favor of those who most need it, but there are many instances in which it is precisely the other way round. Particularly in dynamic and innovative industries competition often disrupts the existing patterns and may concentrate the benefits in the hands of a few. That is exactly what happened with the industrial revolution in the nineteenth century and with the emergence of the supermarkets in

[13] *See* ten Kate, Sr., *supra* note 7.

the twentieth. Should competition authorities in such cases act in favor of the guilds or the mom-'n-pop stores? I don't believe so.

V. Final Observations

What most opponents of the free-market system fail to recognize is that such a system is not a construct of human intelligence. Nobody invented it and put it to work. The free market simply emerged from two instincts: an animal instinct and a human instinct. The animal instinct is that of private property, and the human instinct is that of exchange of property to get better off.[14] The free-market system emerges as a spontaneous order that installs itself when you do nothing.[15] There is no such thing as a switch from market freedom to market intervention. When you favor intervention, you must specify what kind of intervention to apply. Moreover, if you intervene in one market, all other markets remain free. So, you must specify the intervention for each market. That is, market freedom saves you a lot of trouble.

To make myself clear, one can be against competition policy without specifying what one would like to have instead. You remove it from your toolkit of economic governance and that's it. The zero option is clearly defined in this case. But one cannot be against the free-market system without putting something else in its place. If you put nothing in its place, the system reinstalls itself without asking your permission. Quite often, the opponents of the free market are actually concerned about the privileges of the *status quo* being threatened by the disruptive forces of the free market.

Market freedom is like a weed; when you try to get rid of it, it pops up where you expect it least. To give an example, there is a famine. People starve. You ration the supply of rice to one kilo per person a week. That sounds reasonable, but how do you get the rice to the hungry? How do you make sure that beneficiaries are not coming twice for their ration? How do you make sure that nothing is kept back by those who hand it out? Not everybody is an angel after all. A black market emerges. The poor starve and the rich pay a bit more than usual. That is the way it works in off-textbook economics and how market freedom may reinstall itself even in the presence of intervention. The market just changes color like a chameleon, but from white to black. Ask Al Capone, ask the dollar-hungry Venezuelans! Taming the free market is a hard task.

There is little doubt that the free-market system does not guarantee anything like a fair distribution of the proceeds of all the efforts, but a different question is whether market freedom can be held responsible

[14] I am sure there is also some barter exchange between animals. For example, food for shelter or protection for sex. But it is definitely much more limited and less sophisticated.

[15] Friedrich A. Hayek, The Fatal Conceit: The Errors of Socialism (Univ. of Chicago Press 1991).

for the inequality of the outcomes. Even though market freedom does not make it any better, it is rather the inequality in the underlying factors that produces the inequality of the outcomes, and it would not be fair to blame the free-market system for not solving a problem it did not create.

However, to do something about the inequalities is hardly possible without affecting the fundamentals of the free-market system, particularly the premise that everybody may keep the proceeds of his efforts for himself. Progressive taxation of income, wealth, and inheritance, combined with the provision of social security and other public services, such as health care, education, and perhaps housing at accessible rates, together with outright redistribution are the most frequently used instruments. All these instruments distort the typical incentives of the free-market system, but there is hardly any nation that does not apply a vast array of them. The art is to do it in such a way as to minimize the distortion of incentives.

Altogether, even though the free-market system cannot be blamed for the inequalities we see around us, at least not as their main cause, in my view its failure to produce anything close to a socially acceptable outcome is more transcendental than all the inefficiencies derived from market failures, out of which competition policy addresses just one. I must admit that this is my personal appreciation and that there is no way to estimate the magnitude of such inefficiencies with any degree of accuracy. Yet, it is good to bear this in mind as a possibility, albeit only to temper the expectations from competition policy to an adequate level of modesty.