PART **TWO**
The Market and Business

BUSINESS HAPPENS IN MARKETS. A BUSINESS BUYS SUPPLIES, RAW MATERIALS, AND MACHINERY IN INDUSTRIAL MARKETS; IT FINDS WORKERS IN LABOR MARKETS; IT SELLS ITS FINISHED PRODUCTS TO RETAILERS IN WHOLESALE MARKETS AND THE FINAL SALE TO CONSUMERS HAPPEN IN RETAIL MARKETS.

THE NEXT TWO CHAPTERS LOOK AT THE ETHICS OF MARKETS.

CHAPTER 3 DISCUSSES THE ETHICS OF THE MARKET SYSTEM AS A WHOLE: ITS MORAL JUSTIFICATIONS, STRENGTHS AND WEAKNESSES.

CHAPTER 4 LOOKS AT THE ETHICS OF PARTICULAR PRACTICES WITHIN THE MARKET SYSTEM, LIKE PRICE-FIXING, PREDATORY PRICING, BRIBERY, AND MARKET CONCENTRATION.

Chapter Three

The Business System: Government, Markets, and International Trade

Questions to be Answered:

- Why did John Locke say government has no right to take anyone's private property?
- Why did Adam Smith claim that government should not interfere with the free market?
- What benefits did David Ricardo attribute to free trade?
- What injustices did Karl Marx say were inherent in free market capitalism?

Economic System and Types of Economy

The system a society uses to provide the goods and services it needs to survive and flourish is called economy.

Economic System has four factors: 1-Means of Production (material things, land, labor, skills & services); 2-Production (agricultural, industrial, handicrafts & gems and minerals); 3-Distribution and 4-Consumption.

- **Tradition-Based:** Societies rely on traditional communal roles and customs to carry out basic economic tasks, like barter trade.
- **Command Economy**: economic system based primarily on a government authority making the economic decisions about what is to be produced, who will produce it, and who will get it, like socialist and communist economies.
- **Market Economy**: economic system based primarily on private individuals making the main economic decisions, about what is to be produced and who is to get it.

‘Free’ Markets and ‘Free Trade’

(Reaction to Feudalism, Landlordism, Imperialism and Monarchism,)

- **Free Markets** = each individual is able to voluntarily exchange goods with others and to decide what will be done with what he or she owns without interference from government.
- **Free Trade** = citizens may freely trade goods with the citizens of other nations without the interference of tariffs, quotas, or other government limits on the goods citizens may buy from or sell to foreign citizens.

Locke's State of Nature

According to John Locke (1632-1740), the champion of freedom and liberties, all human beings have a natural right to liberty to live with and he calls it "state of nature."

In this state of nature:

- All persons are free and equal.
- **Each person owns his body and labor, and whatever he mixes his own labor into.**
- People's enjoyment of life, liberty, and property are unsafe and insecure. So
- People agree to form a government **"only"** to protect and preserve their right to life, liberty, and property.

(Locke's views paved the way for the concepts of the "Free Markets" of Adam Smith and the "Free Trade" of David Ricardo)

Criticisms of Locke's View on Rights

- Locke does not demonstrate **how** and **to what extent** individuals have "**natural**" rights to life, liberty, and property.
- Locke's natural rights are "**negative rights**" and he does not show that these rights **override** conflicting "**positive rights**".
- Locke's rights imply that markets should be free, but **free markets can be unjust and can lead to inequalities**, and he did not touch this issue.
- Locke **wrongly assumes** that human beings are **atomistic** individuals. He ignored the fact that **every individual is locked in a web of relationships.**

1-Free Markets and Utility

- Adam Smith (1723-1790) in his work (*The Wealth of Nations*)
  - Market competition (**Invisible Hand**) ensures the pursuit of self-interest in markets, and as a "driving force" for individuals, advances the public's welfare. (A Utilitarian approach)
  - Government **interference** in markets lowers the public's welfare by creating shortages or surpluses, which ultimately harms consumers.
  - **Private ownership** leads to better care and use of resources than common ownership.
  - In a free economy all available resources are used and demand always expends to absorb the supply of commodities made from them (J. B. Say's law of market: "Aggregate production necessarily creates an equal quantity of aggregate demand." or "Supply always creates its own demand, " i.e. producer gets paid which raises his purchasing power.)
- Friedrich A. Hayek and Ludwig von Mises said (in Support of Adam Smith)
  - Governments should not interfere in markets because they cannot have enough information to allocate resources as efficiently as free markets do.

Criticisms of Smith's Argument

- It rests on **unrealistic assumption** that there are no monopoly companies.
- **Falsely assumes** that all costs of manufacturing are paid by manufacturer, which ignores the costs of (e.g.) pollution and depletion of resources.
- **Falsely assumes** human beings are motivated only by a self-interested desire for profit, ignoring altogether altruism, benevolence and caring concerns for others.
- Unlike what Hayek and von Mises said in support of Smith, some government planning and regulation of markets is possible and desirable.

Keynes' Criticism of Smith

John Maynard Keynes (1883-1946) has strongly criticized Smiths Views saying:

- Smith **wrongly assumes** demand is always enough to absorb the supply of goods.
- If households forego spending, demand can be less than supply, leading to cutbacks, unemployment, and economic depression.
- Government spending can make up for such shortfalls in household spending, so government should intervene in markets.

Keynesian Economics

- The theory of John Maynard Keynes: **Free markets alone** are not necessarily the most efficient means for coordinating the use of society's resources.
- **Aggregate Demand:** According to Keynes, it is the sum of the demand of **three sectors** of the economy: **1) households, 2) business** and **3) government**.
- The government must meet **aggregate demand** of the three sectors by regulating **aggregate supply** of the goods and services to avoid unemployment and **inflation,** which will ultimately lead to **economic depression.**
- Keynes' views, however, were challenged when government spending did not cure high unemployment but created **inflation.**

2-Free Trade and Utility

Advocated by **David Ricardo** (1772-1823) in his major work (*On the Principles of Political Economy and Taxation*)

- Everyone prospers if nations specialize in making and exporting goods whose opportunity costs to them are lower than the opportunity costs other nations incur to make the same goods.
- **Absolute Advantage**: A situation where the **production costs** (costs in terms of the resources consumed in producing the goods) of making a commodity are lower for one country than for another.
- **Comparative Advantage**: A situation where the **opportunity cost** (costs in terms of other goods given up) of making a commodity are lower for one country than for another.

The arguments of Smith for "**Free Markets**" and Ricardo for "**Free Trade**" provide ample support for "**Globalization**".

Criticisms of “Free Trade” and Utility

- **Ignores** the easy movement of the resources used to produce goods (labor, equipment, machinery and even factories) by companies from one country to another one.
- Falsely assumes that a country’s **production costs are always constant.**
- **Falsely assumes** that workers can easily and without cost move from one industry to another.
- **Ignores** the influence of international rule setters (like WTO, IMF, World Bank).

Karl Marx (1818-1883): *(Das Kapital)*

Criticizing Markets and Free Trade

(Reaction to exploitative practices of Capitalists and miserable conditions of workers in 19th Century)

- **Capitalist** systems offer only two sources of income:
  1. Sale of one's own labor.
  2. Ownership of the **means of production** (i.e**. farms, mines, land, natural resources, buildings, machinery, raw materials, energy and technology** used in the production of goods).
- **Capitalism** and its private property system create **alienation** among workers.

Marx on Alienation

Alienation: In Marx's view, **the condition of being separated or estranged from one's true nature or true human self.**

- In capitalism, workers become alienated when they **lose control of their own life activities** and the ability to fulfill their true human needs.
- Capitalism alienates workers from:
  1. their own productive work,
  2. the products of their work,
  3. their relationships with each other, and
  4. from themselves.
- **Alienation** also occurs when the value of everything is seen in terms of its market price.

The Basic Structure of the Society

Two main components of a society, according to Marx are: 1) Economic Structure and, 2) Social Structure.

1. **Economic Structure**: The materials (land, labor, natural resources, machinery, technology etc. that are used as ***forces of production***) and social controls (the ***relations of production*** i.e. the social control by which the society organizes and controls its workers) a society uses to produce its economic good.
2. **Social Structure**: A society's government and its popular ideologies.

Marx's Historical Materialism

The Marxist view of history as determined by **changes in the economic methods** by which humanity produces the materials on which it must live and survive.

- The methods a society uses to produce its goods determine how that **society organizes its workers**.
- The way a society organizes its workers determines its social classes. (***Bourgeoisie*** i.e. the Ruling Elite and ***proletariat*** i.e. the serf class.
- A society's **ruling social class controls society's government and ideologies** and uses these to advance its own interests and control the working classes.

Immiseration of Workers

- According to Marx, **combined effects of** increased concentration of global industrial powers, cyclic crises of economic down turns, rising unemployment, and declining relative compensation make the workers' conditions all the more miserable.
- In capitalism
  - Industrial power is concentrated in the hands of a few who organize workers for mass production.
  - Mass production in the hands of a few leads to surplus which causes economic depression.
  - Factory owners replace workers with machines which create unemployment; they keep wages low to increase profits.
- The only solution is a revolution that **establishes a classless society** where everyone owns the means of production.

Criticism of Marx

Marx’s critics claim that:

- Marx’s claims that capitalism is unjust are unprovable. Marx wrongly assumes that justice means either equality or distribution according to need.
- Justice requires free markets, where distributive justice is determined in the terms of effort and ability or on the principle of **“distribution according to contribution”.**
- The benefits of private property and free markets are more important than equality.
- **Free markets** can encourage community instead of causing **alienation** as claimed by Marx.
- **Immiseration** of workers has not occurred; instead their condition has improved.

Mixed Economy

- An economy that **retains** a free market and private property system, but **relies heavily** on government policies to remedy their deficiencies.
- By ensuring minimum wages, social services, welfare payments for workers and needy, introducing safety laws and union laws, imposition of income taxes on rich, elimination of monopolies, regulating oligopolies, through the government's effective and high level performance, countries like Sweden, Norway, France, Ireland and Switzerland have achieved the **status of a welfare state** and their citizens are reaping the benefits of the MIXED ECONOMY.

Private property and Intellectual Property Rights

Intellectual property is defined as: "**Nonphysical** property that consists of knowledge or information, such as formulas, plans, music, stories, texts, software etc."

- An **idea** cannot become a private property and remains a common property unless it is **expressed.** After an idea has been expressed through any **tangible and physical means** it can become a private property, either through "**copyright**" or a "**patent**".
- **Copyright:** A grant indicating that a particular expression of an idea is the private property of an individual or a company. Copyrights need not to be registered and are held for a certain period (90-120 years) after which the property becomes a common property.
- **Patent:** The exclusive right to make, use, or sell an invention for a specific period (14-20 years) granted by the federal government to the inventor if the device is novel, useful, and non-obvious. **Patents need registration** by the inventor; otherwise they will not constitute any proprietary right.

Chapter Four
Ethics in the Marketplace

Questions to be Answered:

- **Why is a perfectly competitive free market said to be so desirable from an ethical point of view?**
- **What is monopoly market and why are such markets seen as ethically questionable?**
- **How do oligopoly markets provide opportunities for anticompetitive behaviors that are ethically questionable?**
- **Can we do anything to remedy the ethical shortcomings of monopolies and oligopolies?**

Definition of Market and
Three Models of Market Competition

Definition: **A forum in which people come together to exchange ownership of goods; a place where goods or services are bought and sold.**

- ❁ التاجر الصدوق الأمين مع النبيين والصديقين والشهداء. (الحديث)

((A truthful and honest businessman will be with the prophets, the righteous ones and the martyrs.))

1. **Pure Monopoly:** A market in which a **single firm is the only seller in the market** and which new sellers are barred from entering.
2. **Oligopoly:** A market shared by a relatively **small number of large firms** that together can exercise some influence on prices.
3. **Perfect Competition Market:** A free market in which **no buyer or seller has the power to significantly affect the prices** at which goods are being exchanged.

1-Perfect Competition

- A perfectly competitive free market is one in which **no buyer or seller has the power to significantly affect the prices** at which goods are being exchanged.
- Perfectly competitive free markets are characterized by **Seven Defining Features:**

1. There are **numerous buyers and sellers**, and none of them has a substantial share of the market.
2. All buyers and sellers can **freely and immediately enter or leave** the market.
3. Every buyer and seller has **full and perfect knowledge** of what every other buyer and seller is doing, including **knowledge of the prices, quantities, and quality** of all goods being bought and sold

7 Defining Features of a perfectly Competitive Free Market (Continued)

4. The goods being sold in the market are so **similar to each other** that no one cares from whom each buys or sells. (Applicable only to **Fungibles e.g. white sugar, salt, exactly identical industrial products etc.**)
5. The costs and benefits of producing or using the goods being exchanged are borne entirely by those buying or selling the goods and not by any other external parties. (i.e. **No Subsidies**)

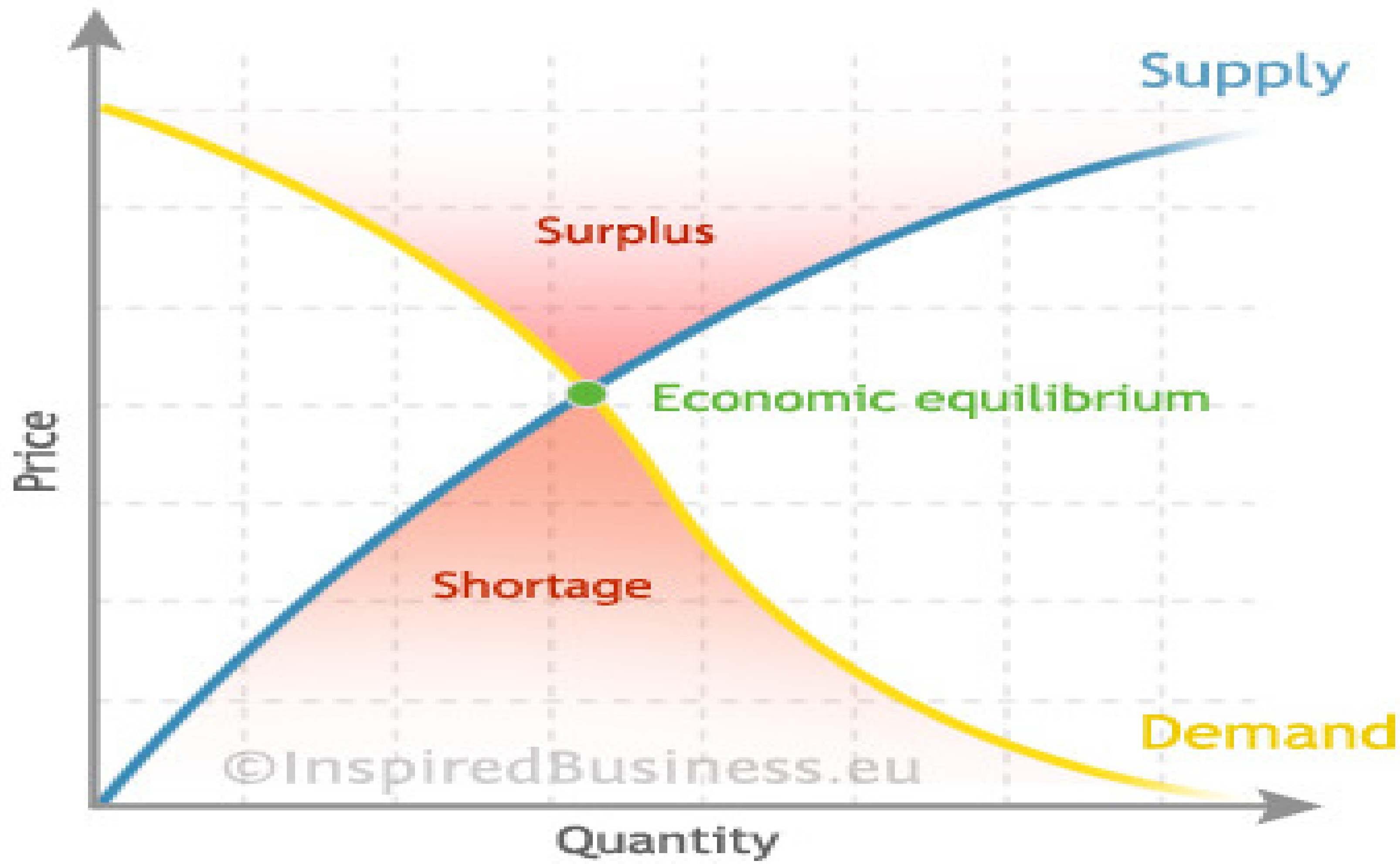
7 Defining Features of a perfectly Competitive Free Market (Continued)

6. All buyers and sellers are **utility / benefit maximizers**. Each tries to get as much as possible for as little as possible. (i.e. there are **no discounts** for some only)
7. No external parties (such as the government) regulate the price, quantity, or quality of any of the goods being bought and sold in the market.

Equilibrium in Perfectly Competitive Markets

- **Equilibrium point:** In a market, the point at which the quantity buyers want to buy equals the quantity sellers want to sell, and at which the highest price buyers are willing to pay equals the lowest price sellers are willing to take.
- Price and quantity move to equilibrium in a perfectly competitive market because:
  - **If price rises above equilibrium, surplus appears and drives price down to equilibrium**
  - **If price falls below equilibrium, shortage appears and drives price up to equilibrium**
  - **If quantity is less than equilibrium, profits rise, attracting sellers who increase quantity to equilibrium**
  - **If quantity is more than equilibrium, prices fall, driving sellers out which lowers quantity to equilibrium.**

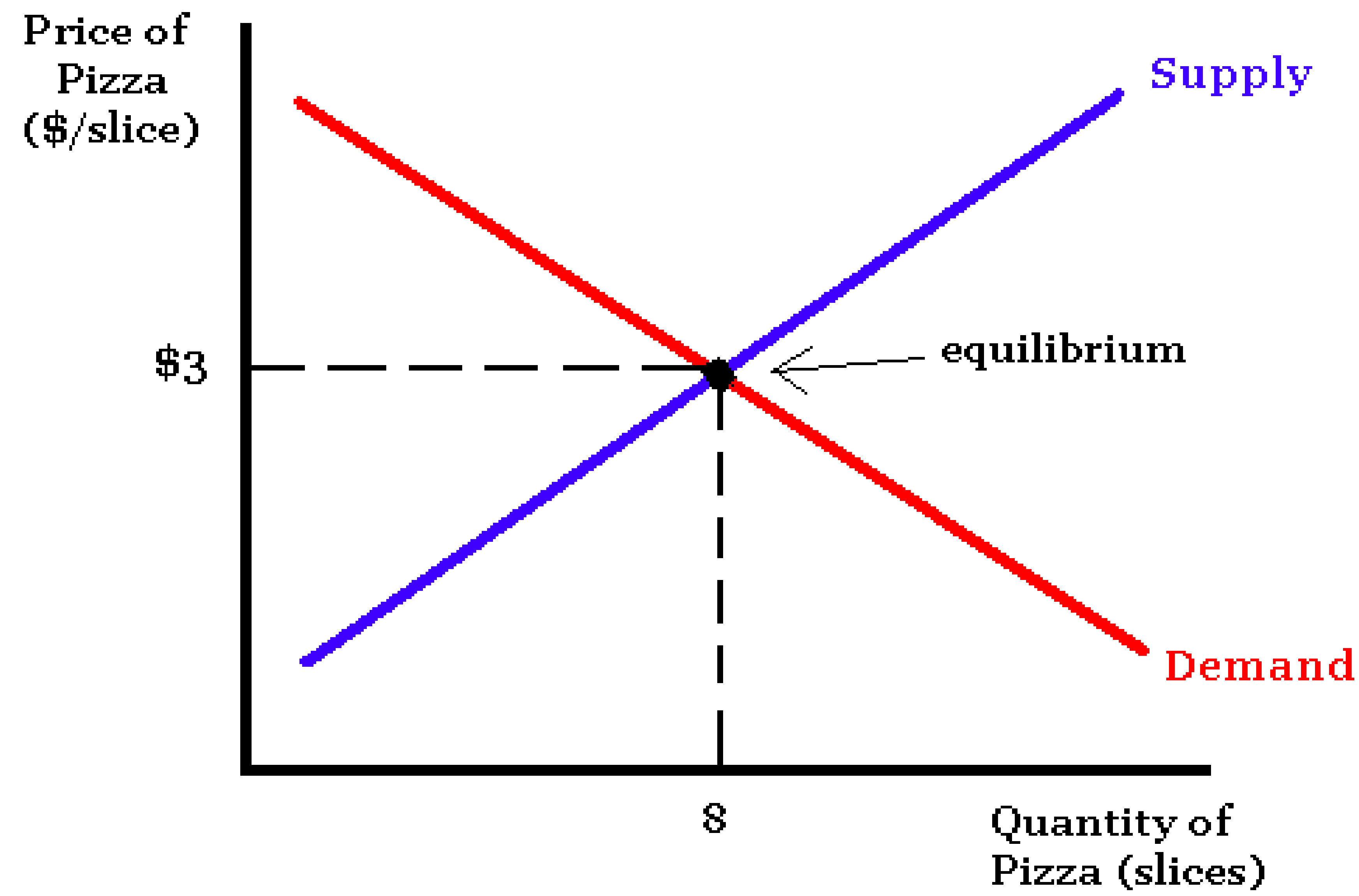
Equilibrium in Perfectly Competitive Markets



Principle of diminishing marginal utility

- Generally each additional unit of a good a person consumes is less satisfying than each of the earlier units the person consumed. The more we consume the less utility or satisfaction we get from consuming more.
- For a thirsty fellow, first glass of water is more satisfying than the second one and second glass of water is less satisfying than the first one but more satisfying than the third glass of water, until there is no more demand for quenching his thirst.
- First piece of pizza might seem more delicious to a hungry man than the second one he eats, and the third one might be substantially less satisfying but the fourth one might even be disgusting.

Principle of diminishing marginal utility



Principle of increasing marginal costs

- After a certain point, each additional unit a seller produces costs more to produce than earlier units.
- Due to limited resources of production a seller might be forced to buy material at a higher price to meet the demand, thus raising the production cost.

Principle of increasing marginal costs and "Opportunity Cost"

- The cost of production also includes the profits sellers must make, to motivate them to invest in producing this product and **"forgo the profits they could have made by investing in other products."**
- This phenomenon is called **"Opportunity Cost"** which is defined as **"the best alternate forgone."**

Ethics and Perfectly Competitive Markets

Perfectly Competitive Free markets:

1. **Achieve capitalist justice**, but not other kinds of justice like justice based on need.
2. **Satisfies a certain version of utilitarianism** (by maximizing utility of market participants but not of all society)
3. **Respects some moral rights** (negative rights but often not positive rights)

BUT on the other hands:

1. Can lead to **ignoring the demands of caring and value of human relationships.**
2. Can **encourage vices of greed and self-seeking** and discourage virtues of kindness and caring
3. Can be said to **embody justice, utility, and rights only if seven defining features are present, which is a rare phenomenon.**

Ethics and Perfectly Competitive Markets

1-Justice in Perfectly Competitive Markets:

- Perfectly competitive markets **move price to equilibrium point** which is on both supply and demand curves and so is just for both buyer and sellers.
  - **For sellers prices are just (capitalist justice) only on the supply curve.**
  - **For buyers prices are just (capitalist justice) only on the demand curve.**

Ethics and Perfectly Competitive Markets

2-Utility in Perfectly Competitive Markets:

- Prices in the system of perfectly competitive markets attract resources when demand is high and drives them away when demand is low, so resources are allocated efficiently.
- Perfectly competitive markets encourage firms to use resources efficiently to keep costs low and profits high
- Perfectly competitive markets let consumers buy the most satisfying bundle of goods, so they distribute goods in way that maximizes utility.

Ethics and Perfectly Competitive Markets

3-Rights in Perfectly Competitive Markets:

- Perfectly competitive markets respect the right to freely choose the business one enters.
- In perfectly competitive markets, exchanges are voluntary, and respect the right of free choice.
- In perfectly competitive markets, no seller exerts coercion by dictating prices, quantities, or kinds of goods consumers must buy.

2-Monopoly Competition: (الاحتكار)

- لا يحتكر الا الخاطىء (الحديث) ● الجالب مرزوق والمحتكر محروم (الحديث)

  ((**No one hoards but a sinner. The one who brings his commodities to the market is blessed (by Allah) with profits and the one who withholds them from people is deprived of the blessings**.))
- **Monopoly** is a market situation in which a single dominant firm controls all or virtually the entire product in the market and where new sellers cannot enter, or have great difficulty entering because of "**barriers to enter**".
- In monopoly two of the seven conditions of a perfectly competitive free market are missing, i.e.
  1. **Instead of "numerous sellers none of whom has a substantial share of the market", in a monopoly market there is only one dominant seller, and who has a substantial share of the market**
  2. **Instead of sellers (or companies) being able "to freely inter or leave the market", sellers (companies) cannot enter or it is very difficult for them to enter due to "barriers to entry".**

Types of Barriers in a Monopoly Market

1-There are many **legal barriers** such as copyrights, patents, licenses, tariffs, quotas, and grants.

2-There are many **other barriers** such as high start up costs of production, high fixed cost, high costs of "brand name" advertising and high research and development costs, long-term contracts and enduring loyalties.

3-Seller has the power to set quantity and price of its product on the market.

4-Seller can extract monopoly profit by producing less than equilibrium quantity and setting price below demand curve but high above supply curve.

5-High entry barriers keep other competitors from bringing more products to the market.

Monopoly Competition vs. Justice, Utility, and Rights

Ethical Weaknesses of Monopoly as it:

- **Violates capitalist justice**, by charging more for products than producer knows they are worth.
- **Violates utilitarianism** by keeping resources out of monopoly market where shortages show more are needed, and diverting them to markets without such shortages; and by removing incentives to use resources efficiently.
- **Violates negative rights** by forcing other companies to stay out of the market; by letting monopolist force buyers to purchase goods they do not want, and by letting monopolist make price and quantity decisions that consumer is forced to accept.

Monopoly Market's Characteristics

- A monopoly market, then, is one that
  - **Can, and generally will, deviate from the ideals of capitalist justice, economic utility and negative rights;**
  - **Instead of establishing a just equilibrium, a monopoly seller can impose high prices on the buyers;**
  - **Instead of increasing efficiency monopoly market provide sellers incentives for wastage and misallocation of resources;**
  - **Instead of protecting the negative right of freedom, monopoly markets create an inequality of power that allows the monopoly firm to dictate terms to the consumers.**

3-Oligopolistic Competition

Oligopoly Markets: Definition

- Oligopolistic markets are "imperfectly competitive markets" because they lie between the two extremes of the perfectly competitive market with numerous sellers and monopoly market with one dominant seller.
- **Highly concentrated markets:** Oligopoly markets that are dominated by a few (e.g. three to eight large firms. Major industrial markets are dominated by only a few firms.
- **Horizontal Merger:** A merger occurring between companies in the same industry. Horizontal merger is a business consolidation that occurs between firms who operate in the same space, often as competitors offering the same good or service.

Unethical Practices in Oligopolistic Markets

- **Price Fixing**: An agreement between firms to set their prices at artificially high levels. ❁**The Prophet refused to fix the prices: التسعير**
- **Manipulation of Supply**: When firms in an oligopoly industry **agree to limit their production** so that prices rise to levels higher than those that would result from free competition.
- **Market Allocation**: When companies in an oligopoly divide up the market among themselves and **agree to sell only to customer in their part of the market.**
- **Bid Rigging:** A prior agreement that a **specific party will get a contract** even though all parties will submit bids for the contract.
- **Exclusive Dealing:** When a firm sells to a retailer on condition that **the retailer will not purchase any products from other companies** and/or will not sell outside of a certain geographical area.

Unethical Practices in Oligopolistic Markets

- **Tying Arrangements:** When a firm sells a buyer a certain good only on condition that the buyer agrees to purchase certain other goods from the firm.
- **Retail Price Maintenance agreement:** Occurs when a manufacturer sells to a retailer only on condition that the retailer agrees to charge the same set retail prices for its goods
- **Price Discrimination:** To **charge different prices to different buyers** for identical goods or services.
- **Predatory Price Discrimination:** Price discrimination aimed at running a competitor out of business.
- **Tacit Agreement:** Implicit agreement between the firms of an industry for price setting. • All firms define a price leader which will have to set the prices.

Fraud Triangle: Incentives, Opportunities, Rationalizations

Why Instead of competing honestly by working to lower their costs or improve the quality of their products and services, the managers and employees of oligopolistic markets engage in wrongful behaviors?

According to **Donald Cressey**, they tend to engage in "white collar" crimes when **fraud triangle** of "incentives & Pressures; Opportunities; Rationalizations, is present."

- **Incentives & Pressures:** The pressure or strong incentives to do wrong, such as organizational pressure, peer pressure, company needs, personal incentives.
- **Opportunities:** The opportunity to wrong, which includes the ability to carry out the wrongdoing, being presented with circumstances that allow it, low risk detection.
- **Rationalizations:** The ability to rationalize one's action by framing it as morally justified.

The price of greatness is “ETHICAL” responsibility.

Dr. A. R. Ashraf Baluch
Rawalpindi

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