What kinds of problems does a market economy create, and how should they be overcome?

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Economic thought can be traced back to antiquity. Aristotle was one of the first to engage in economic thinking when he distinguished between "natural and unnatural arts of acquisition." Furthermore, Plato wrote on the benefits of specialization within the Ideal state (Brue & Grant, 2012, p. 455). This later inspired Adam Smith to form his ideas of the division of labor. The classical school of economics initially proposed the concept of a market economy. There is a large degree of uncertainty when defining a market economy. In this assignment, a market economy has very minimal to no government intervention. It is equivalent to a free-market economy, referred to as the truest form of capitalism. Therefore, the term 'market economy' will be used interchangeably in this assignment with 'free-market economy' and 'capitalist system.' *This assignment will argue that a market economy imposes several problems, which can be overcome primarily through different degrees of government intervention.* The rise of classical economics will first be introduced through Adam Smith, as he often is looked at as the founder of free-market economics. Adam Smith, Karl Marx, and John Maynard Keynes will be the main thinkers discussed, followed by other economic thinkers, who will be referred to more briefly. These thinkers have been chosen because they show a wide range of opinions on free-market economics, providing a solid base for comparing their core ideas.

A reaction to mercantilism and the emergence of a market economy

Adam Smith was a Scottish philosopher that contributed significantly to the Scottish enlightenment. He is often considered the father of modern economics as he formed the basis for the theories of classical economics (Sharma, 2021). He wrote in response to what he coined the "mercantile system," which was a system that aimed to enrich a country by limiting its imports and maximizing its exports (LaHaye, 2017). Mercantilism dominated economic thought and policies in western Europe from the sixteenth to the late eighteenth century. These policies were implemented to establish a favorable balance of trade that would maintain domestic employment and bring gold and silver into the country (LaHaye, 2017). Mercantilism was a period in which policies were formulated to benefit the relationship between government and industries. The emphasis on the collective rather than individual wealth of mercantilism mainly separates it from the capitalist system (Nachbar, 2005, p. 1318). Smith refuted the mercantile system and argued that the collusion between government and industry to create monopolies was damaging (LaHaye, 2017). The mercantile system only served a small proportion of society, notably the interests of merchants and producers whose activities were protected by the state. The East India Company was one of the largest companies during Smith's time and served as a monopoly, subsidized by the government (LaHaye, 2017). Smith argued that the mercantile system was harmful to most of society and highlighted the benefits of a market economy and laissez-faire to enhance the welfare of the entire population (LaHaye, 2017). Adam Smith inspired several thinkers with his most famous work, *The Wealth of Nations*. In *The Wealth of Nations*, Smith discussed that free trade, the specialization of labor, and limited relations between government and industry, can increase growth and improve efficiency. Smith's book *The Theory of Moral Sentiments* pointed out the forces that drive the market economy, namely, supply and demand, self-correct through what he described as the invisible hand (Majaski, 2020).

Monopoly and limited government regulation to overcome market economic problems

Although Adam Smith supported a market economy with minimal government regulation, he was not for complete laissez-faire. He acknowledged several problems in market economies, which could only be resolved through government intervention. He foremost argued that natural liberty would not function without a system of justice provided by the government to control crime and protect property rights (Backhouse, 2002, p. 128). Smith argued that a legal system and armed forces were essential for a market economy to work, even though spending on it was unproductive. Although Smith was for a free market economy, he recognized that specific problems had to be government regulated. Smith believed that the most significant role of the sovereign was to maintain law and order. He was in favor of the Navigation act, which significantly restricted competition within shipping, but he supported it because it contributed to the strength of the Royal Navy (Backhouse, 2002, p. 128). Smith, therefore, recognized that the laissez-faire market economy does not secure justice and defense in a nation, which means that government intervention is needed as a tool to regulate these sectors of the economy.

Smith furthermore argued that market economies require a limited level of taxation. He emphasized that taxes were necessary for the sovereign to "erect and maintain public institutions and public works" (Backhouse, 2002, p. 128). Smith argued that certain institutions are highly advantageous to society. Still, their profit could never repay the expense of any individual investing in them. Therefore, it cannot be expected that any individual in a market economy would create or maintain such institutions. Transportation, such as bridges, roads, and canals, as well as primary education, are some of Smith's prominent examples, in which he argued the case for government intervention (Backhouse, 2002, p. 128-129). We can see that Smith notices that within a market economy, one or more individuals would never be incentivized to restore or create institutions for the greater public. Smith acknowledges that this problem can be overcome using taxation for the government to provide these goods and services to society.

Smith believed that the economic policies of mercantilism were absurd and hindered the potential for real wealth ("Constitutional Rights Foundation," n.d.). He is known to have opposed monopolies, which in his time were usually the results of privileges granted to industries by the government (Backhouse, 2002, p. 128). Although Smith was skeptical of monopolies, he was aware that temporary monopolies could further social aims that a free-market economy would not be able to (Salvadori & Signorino, 2014, p. 14). Smith argued that government intervention was often necessary to incentivize individuals to invest in innovative projects. He recognized that in some instances such as with patents and copyrights the grant of a monopoly was vital (Salvadori & Signorino, 2014, p. 14). Granting a monopoly ensured that individuals had an incentive to induce the required inflow of capital into innovative but hazardous and costly enterprises (Salvadori & Signorino, 2014, p. 14). Market economies could not always guarantee that individuals would invest in innovative projects. Therefore, government intervention could overcome this problem by granting temporary monopolies to certain industries through copyrights and patents.

Karl Marx and the rise of communism

While Smith published the *Wealth of Nations*, the Industrial Revolution began to take off ("Constitutional Rights Foundation," 2007). Industrialization had significant impacts on societies, as it transformed economic systems throughout Europe into market economies dominated by capitalism. While Smith was for a free market economy with a passive state, Karl Marx had a different vision and made a case for a prominent state in a planned economy. Capitalism had become the most prominent ideology at the beginning of the 19th century, which Marx heavily opposed. Marx published *Das Kapital* between 1867 and 1894, which emphasized his frustration with the economic system at the time (Backhouse, 2002, p. 158). He was dissatisfied with much of the capitalist system, but he was especially opposed to the exploitation of the working class, which he argued lay at the heart of capitalism (Backhouse, 2002, p. 159). Through his theory of surplus-value, Marx argued that the exploitation of workers in the capitalist system was the main problem with a market economy. He explained that capitalists could only exploit workers because they owned the means of production. Workers were forced to sell their labor power to capitalists because they could not undertake production themselves (Backhouse, 2002, p. 159).

Furthermore, he pointed out that when the demand for a product falls, at least one component of prices (profits, rent, or wages) must fall below its natural rate. He argued that Smith's theory of the division of labor meant that workers had more difficulty changing to a new profession because they had become specialized. This meant that when prices fell, workers were unable to change occupation, and therefore, they suffered from lower wages when their incomes were reduced below the natural rate (Backhouse, 2002, p. 157). This occurred because capitalists wanted to keep the competitive price to maintain their profits; however, it led to the exploitation of the working class.

Communism as a solution to market economic problems

Karl Marx noticed several problems with the capitalist-centered competitive market economy. The poor get poorer as the rich get richer; there is periodic underemployment and constant exploitation of the working class, were some of his observations. He noted that this, in turn, led to revolution, socialism, and finally, communism (Lund, 2021). To correct the injustice and achieve true freedom from the capitalist system, Marx argued that the working class must first overthrow the capitalist system of private property. The workers could then replace capitalism with a communist system, in which they would own property in common and share the wealth that they produced.

In 1848 Karl Marx and Friedrich Engels published *The Communist Manifesto*, which described three phases that moved society from capitalism to communism ("Constitutional Rights Foundation," 2003). Marx argued that the exploitation of workers would enhance a new class struggle, ending with a "violent overthrow" of the bourgeoisie by the proletariat (Marx & Engels, 2001, p. 24). The proletariat would lead a revolution to take control of the government. Then the new proletariat government, would during the socialist phase of the revolution, use its political supremacy to confiscate all capitalist private property from the bourgeoisie and centralize all production in the hands of the state (Marx & Engels, 2001, p. 36). The government would manage these enterprises for the benefit of the workers. During the final phase, or what Marx called the "communist phase," all classes would cease, and class struggle would come to an end

("Constitutional Rights Foundation," 2003). Marx argued that communism was the only way to overcome a market economy's problems and that a move towards communism would happen naturally. Marx believed that revolution was inevitable to the progress of human society because exploitation was inherent in the fundamental relationship of the capitalist system. Marx argued that market economic problems would fundamentally solve themselves as society moves towards revolution, and in turn communism, and away from a capitalist system.

Discussion: Were Marx's ideas effective in overcoming market economic problems?

Karl Marx developed a detailed course of events for the proletariat to rise against the bourgeoisie to bring about communism and abolish the capitalist system. However, he had failed to anticipate the implementation of specific reforms. Reforms such as the elimination of child labor, social security, and the right of workers to participate in unions caused workers in capitalist societies to focus on improving their working conditions and bettering their wages rather than participating in a revolution (Menand, 2016). Although Marx believed that there were significant problems with the market economic system, and he argued that communism was the solution, it did not work as effectively as he had anticipated.

In between communism and capitalism: John Maynard Keynes

John Maynard Keynes was neither a socialist nor a liberalist. He believed that governments could smooth out the peaks and troughs to which all economies seemed fatefully prone through reasonable injection of money and judicious regulation. Keynesian economics addressed a pressing problem of its day, namely depression and unemployment. The Keynesian school of economics began when *The General Theory of Employment, Interest, and Money* was published in 1936 as a reaction to the Great Depression (Brue & Grant, 2012, p. 455). Classical economics dominated economic thought at the beginning of the 20th century. Keynes argued that classical economics, based on a market economy, would not benefit society in the short run. The classical model assumes that the market will self-correct when wages are higher than what employers can afford. The supply and demand of labor will naturally come into equilibrium and ensure full employment. However, during the Great Depression, there were significantly high levels of unemployment. Keynes argued that the self-correction process to create an equilibrium between the supply and demand for labor might simply take too long, which he meant by the phrase "in the long run, we are all dead."

Keynes pointed out that within classical economics, a nation's economy was managed like a household, in which the government would increase savings in times of crisis. Keynes pointed out that aggregate demand will fall if people save their money as they did during the Great Depression. This meant that business profits would decline and, in turn, force employers to lay off employees. As more people got fired, they could spend less, and demand fell, even more, leading to a downwards spiral. Keynes, therefore, proposed a set of economic ideas that could resolve these market economic problems. During the 20th century, worldwide depressions, world wars, and the expanding complexities of modern life deteriorated the concept of laissez-faire (Brue & Grant, 2012, p. 458). There was increasing support for government intervention to regulate business fluctuations. Keynes argued that there should be a much larger focus on demand and spending, as these were low during a recession. He believed that increases in demand could resolve high levels of unemployment.

Implementing fiscal and monetary policy to overcome market economic problems

Keynes explained the business cycle fluctuations and established a program to mitigate them (Brue & Grant, 2012, p. 458). Keynesian economists argued that the government should intervene in the market through fiscal and monetary policy (Brue & Grant, 2012, p. 457). This would promote price stability, economic growth, and full employment. During a recession, the government should increase its spending and lower its taxes to boost private consumption spending. Furthermore, the interest rates should be reduced by increasing the money supply to further increase investment spending (Brue & Grant, 2012, p. 457). Keynes' theory of the multiplier effect showed that the net effect of government spending is much larger than the actual dollar amount spent (Beattie, 2021). The injection of fiscal and monetary policy would help overcome problems such as high levels of unemployment during a recession.

In contrast, if a market economy were experiencing high levels of inflation, Keynes advocated for a reduction in government spending and increases in taxation, as well as rises in interest rates to hinder high levels of excessive investment spending (Brue & Grant, 2012, p. 457). He showed that both contractionary and expansionary monetary and fiscal policy is useful. Keynes' thinking went against the existing classical market economic policies of laissez-faire and minimal government intervention. The free-market economy posed problems that were not always regulated in the short run. He argued that governments had to regulate demand and spending to overcome market economic problems. This could be through increased or decreased spending, depending on whether a nation was experiencing unemployment or inflation.

Criticism of Keynesian economics as a tool to regulate market economic problems

The Chicago school of economics strongly opposed the entire Keynesian line of reasoning. The Chicago school began in 1946 when Milton Friedman joined the faculty at the University of Chicago (Brue & Grant, 2012, p. 529). They disagreed with Keynesian economists, who argued that the government was the only tool for breaking the cruel cycle of unemployment. The Chicago School argued that severe recessions and depressions resulted from inappropriate monetary policy rather than from changes in spending. In contrast to Keynes, they believed that the government is inherently inefficient at achieving goals that can be satisfied through private exchange (Brue & Grant, 2012, p. 531). Governments are mainly focused on optimizing their own objective instead of diverting their resources to the benefit of taxpayers. The Chicago school of economics became popular in the 1970s due to rapid inflation, which led to stagflation. Although Keynes could solve certain market economic issues, his ideas became discredited during the 1970s as his ideas could not explain the causes of stagflation. This paved the way for the Chicago school of economics, up until the 2008 financial crisis, when Keynesian policies became popular once again. Keynesian economics can solve certain market economic problems; however, it cannot address the causes and problems of stagflation.

Inefficient healthcare in a market economy: Paul Krugman

Paul Krugman criticizes the lack of universal healthcare in the United States and credits it to the free-market economy. He argues that health care cannot be relied upon by the market economy and cannot be marketed like bread or a TV (Krugman, 2009). He argued that people don't always know when they need healthcare and that it is costly when they finally do. Krugman implies that private health care insurers cannot be fully trusted in a market economic system because they do not always work in the consumer’s best interest. Private health insurers are profit-maximizing firms. From the insurer’s point of view, payments for health care are a cost, and they will therefore try to deny as many claims as possible (Krugman, 2009). Krugman believes that the simplest way to ensure that people have access to essential health care is for the government to pay their bills directly (Goodman, 2017). A market economy may not benefit all sectors, and government intervention is necessary to provide certain welfare benefits such as healthcare.

Discussion and conclusion:

Smith, Marx, Keynes, and Krugman agree that government intervention is necessary to solve specific market economic problems. However, their opinions on the degree to which the government should intervene are dramatically different. Krugman argues for a free-market economic welfare state with government intervention primarily in the health sector. In contrast, Keynes is focused on government intervention to eliminate high levels of unemployment. Although they have different priorities, they agree that government intervention is vital.

Smith agrees with Krugman on government regulation in certain industries. Smith acknowledges the benefits of the government provision of healthcare, defense, justice, and education and certain monopolistic benefits to entrepreneurs that invest in innovative projects. Smith and Keynes, however, have strongly diverging opinions. Smith is a classical economist who believes that a market will self-regulate through the mechanisms of supply and demand. When there are high levels of unemployment, employees will lower their expectations and accept lower wages to find a balance between the supply and demand of labor. Nonetheless, Keynes strongly disagrees, in which he suggested that this process can take a long time and that the government should interfere in the market to lower unemployment levels in the short run.

Smith is often referred to as the father of classical economics and a strong advocate of a free market. Smith argued that a free-market economy was beneficial to all of the population, whereas Marx strongly disagreed in which he suggested that a market economy only benefitted capitalists. Marx advocated for the maximum level of government regulation, namely communism. While

Keynes and Krugman both emphasize the importance of government regulation, they are far from Marx's solutions.

This assignment has argued that varying levels of government intervention are essential to overcome market economic problems. Problems such as high levels of unemployment or the exploitation of the working class, and the need for government grants to encourage research and development are necessary for market economies. This assignment has used a range of diverging opinions from Adam Smith to Karl Marx to show the contrasts and similarities between economic thinkers throughout history. To grasp the question entirely, certain counterarguments to Marx's and Keynes' ideas have also been addressed. To this day, market economies still pose problems if they are highly unregulated. The United States and China, the two largest economies globally, both experience government intervention, although to varying degrees. Government regulation can work as a tool to overcome certain market economic problems and therefore, it is often used in most modern economies.

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