

Economics in One Lesson

by Henry Hazlitt

The Lesson Applied

HOW THE PRICE SYSTEM WORKS

Section 2

Let us now turn to such a society. How is the problem of alternative applications of labor and capital, to meet thousands of different needs and wants of different urgencies, solved in such a society? It is solved precisely through the price system. It is solved through the constantly changing interrelationships of costs of production, prices and profits.

Prices are fixed through the relationship of supply and demand and in turn affect supply and demand. When people want more of an article, they offer more for it. The price goes up. This increases the profits of those who make the article. Because it is now more profitable to make that article than others, the people already in the business expand their production of it, and more people are attracted to the business. This increased supply then reduces the price and reduces the profit margin, until the profit margin on that article once more falls to the general level of profits (relative risks considered) in other industries. Or the demand for that article may fall; or the supply of it may be increased to such a point that its price drops to a level where there is less profit in making it than in making other articles; or perhaps there is an actual loss in making it. In this case the "marginal" producers, that is, the producers who are least efficient, or whose costs of production are highest, will be driven out of business altogether. The product will now be made only by the more efficient producers who operate on lower costs. The supply of that commodity will also drop, or will at least cease to expand.

This process is the origin of the belief that prices are determined by costs of production. The doctrine, stated in this form, is not true. Prices are determined by supply and demand, and demand is determined by how intensely people want a commodity and what they have to offer in exchange for it. It is true that supply is in part determined by costs of production. What a commodity *has* cost to produce in the past cannot determine its value. That will depend on the *present* relationship of supply and demand. But the expectations of businessmen concerning what a commodity *will* cost to produce in the future, and what its future price will be, will determine how much of it will be made. This will affect future supply. There is therefore a constant tendency for the price of a commodity and its marginal cost of production to *equal* each other, but not because that marginal cost of production directly determines the price.

The private enterprise system, then, might be compared to thousands of machines, each regulated by its own quasi-automatic governor, yet with these machines and their governors all interconnected and influencing each other, so that they act in effect like one great machine. Most

of us must have noticed the automatic governor” on a steam engine. It usually consists of two balls or weights which work by centrifugal force. As the speed of the engine increases, these balls fly away from the rod to which they are attached and so automatically narrow or close off a throttle valve which regulates the intake of steam and thus slows down the engine. If the engine goes too slowly, on the other hand, the balls drop, widen the throttle valve, and increase the engine’s speed. Thus every departure from the desired speed itself sets in motion the forces that tend to correct that departure.

It is precisely in this way that the relative supply of thousands of different commodities is regulated under the system of competitive private enterprise. When people want more of a commodity, their competitive bidding raises its price. This increases the profits of the producers who make that product. This stimulates them to increase their production. It leads others to stop making some of the products they previously made, and turn to making the product that offers them the better return. But this increases the supply of that commodity at the same time that it reduces the supply of some other commodities. The price of that product therefore falls in relation to the price of other products, and the stimulus to the relative increase in its production disappears.

In the same way, if the demand falls off for some product, its price and the profit in making it go lower, and its production declines.

It is this last development that scandalizes those who do not understand the “price system” they denounce. They accuse it of creating scarcity. Why, they ask indignantly, should manufacturers cut off the production of shoes at the point where it becomes unprofitable to produce any more? Why should they be guided merely by their own profits? Why should they be guided by the market? Why do they not produce shoes to the “full capacity of modern technical processes”? The price system and private enterprise, conclude the “production-for-use” philosophers, are merely a form of “scarcity economics.”

These questions and conclusions stem from the fallacy of looking at one industry in isolation, of looking at the tree and ignoring the forest. Up to a certain point it is necessary to produce shoes. But it is also necessary to produce coats, shirts, trousers, homes, plows, shovels, factories, bridges, milk and bread. It would be idiotic to go on piling up mountains of surplus shoes, simply because we could do it, while hundreds of more urgent needs went unfilled.

Now, in an economy in equilibrium, a given industry can expand *only at the expense of other industries*. For at any moment the factors of production are limited. One industry can be expanded only by *diverting* to it labor, land and capital that would otherwise be employed in other industries. And when a given industry shrinks, or stops expanding its output, it does not necessarily mean that there has been any *net* decline in aggregate production. The shrinkage at that point may have merely *released* labor and capital to *permit the expansion of other industries*. It is erroneous to conclude, therefore, that a shrinkage of production in one line necessarily means a shrinkage in *total* production.

Everything, in short, is produced at the expense of forgoing something else. Costs of production themselves, in fact, might be defined as the things that are given up (the leisure and pleasures, the raw materials with alternative potential uses) in order to create the thing that is made.

It follows that it is just as essential for the health of a dynamic economy that dying industries should be allowed to die as that growing industries should be allowed to grow. For the dying industries absorb labor and capital that should be released for the growing industries. It is only the much vilified price system that solves the enormously complicated problem of deciding precisely how much of tens of thousands of different commodities and services should be produced in relation to each other. These otherwise bewildering equations are solved quasi-automatically by the system of prices, profits and costs. They are solved by this system incomparably better than any group of bureaucrats could solve them. For they are solved by a system under which each consumer makes his own demand and casts a fresh vote, or a dozen fresh votes, every day; whereas bureaucrats would try to solve it by having made for the consumers, not what the consumers themselves wanted, but what the bureaucrats decided was good for them. Yet though the bureaucrats do not understand the quasi-automatic system of the market, they are always disturbed by it. They are always trying to improve it or correct it, usually in the interests of some wailing pressure group. What some of the results of their intervention are, we shall examine in succeeding chapters.