
20 Supply and demand

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If economics is the science of exchanges, in the tradition of Adam Smith, then supply and demand analysis is the core of economics. How should supply and demand analysis be conducted if the goal is to explain the operation of what Smith called 'a commercial society', a society in which the division of labor has become so thoroughly established that everyone 'lives by exchanging, or becomes in some measure a merchant' (Smith, 1776, p. 37)?

Austrian economists have objected persistently in recent years to the pre-occupation of contemporary economists with equilibrium states and the formal conditions for equilibrium, and their neglect of the processes generated by disequilibrium (Kirzner, 1980). Change and progress, along with almost everything else that is either puzzling or interesting about a commercial society, occur in response to disequilibrium situations. The contrasting ways in which contemporary economists engage in supply and demand analysis illustrate most of the matters at issue.

The equilibrium-obsessed approach to supply and demand assumes that a demand function and a supply function 'determine' a market-clearing price – the price at which the quantity people want to purchase is equal to the quantity people want to make available for purchase. If the quantity demanded is greater than the quantity supplied, the price will rise, causing the quantity demanded to decrease and the quantity supplied to increase, until the two quantities are equal. If the quantity supplied is greater than the quantity demanded, the price will fall to equate them. The analyst does not ask what decisions by real actors produce these changes in prices and quantities or how the decision makers obtain the information that prompts them to act as they do. Prices and quantities 'adjust themselves' to satisfy the conditions of 'equilibrium'.

Some versions of analysis in this mode introduce an auctioneer to bring about the equilibrium that the given demand and supply functions dictate; but the auctioneer is altogether imaginary. The auctioneer's presence in the analysis does nothing to illuminate the processes by which actual prices move towards market-clearing levels in the world of real exchanges or to suggest what will occur if these movements of prices and quantities are impeded. The auctioneer is a mere device that enables the analyst to proceed in disregard of the fact that no one knows the shape or position of actual demand and supply functions or the market-clearing prices with which they are consistent.

Actual processes of demanding, supplying and generating prices take place in a world of limited information where the pressing problem for market participants is not how to select the economical choice among given alternatives but rather how to locate alternatives and discover the terms on which they might be available. Once everything is known, the correct choice is a mere matter of logical or mathematical deduction. In a commercial society, however, everything is not known to any single actor or even any set of actors. The knowledge relevant to economic decisions is scattered among many people who characteristically do not realize that others are interested in the knowledge they possess, and who often do not even 'command' their own knowledge because it is tacit knowledge of which they have had no occasion to become consciously aware (Hayek, 1945).

The illusion that a modern economy could be centrally planned and directed was long sustained by the assumption that all knowledge relevant to economic decisions could be known to a single mind, a single coordinating intelligence. The equilibrium-obsessed approach to supply and demand analysis helped foster and maintain this illusion. Austrian economists insist that the acquisition and dissemination of knowledge is a fundamental problem in any commercial society, and that no explanation of the processes by which decisions are coordinated in such a society will be helpful if it assumes that all participants know everything that they need to know in order to make markets clear.

When the demand for a particular good suddenly and unexpectedly increases, what happens next? The Austrian economist has no standard answer and will be reluctant simply to say, 'The price rises.' What often occurs in such cases is that retail sellers find themselves running low on inventory, and so place larger orders with their suppliers who in turn place larger orders with their suppliers. At some point in this process more resources will ordinarily be demanded to expand production of the good for which consumer demand has increased. If larger quantities of these resources can be obtained without bidding up their price, the increase in consumer demand might well produce no change at all in the retail price. Consumers could instead find themselves faced with temporary shortages that take the form of waiting periods. The claim that sellers would profit from such a shortage by raising their prices and therefore would do so assumes without warrant that sellers know exactly what is going on and are, moreover, indifferent to such factors as the ill-will of valued customers that might result from a temporary price increase designed to exploit a temporary shortage.

Supply and demand is a process in which people pursue the diverse projects that interest them in substantial ignorance of the projects that happen to interest others. When property rights are reasonably clear and secure and participants are substantially free to exchange as they prefer, supply and

demand tends to become a process of mutual accommodation. When a good becomes more scarce, the process will tend to produce a higher money price for the good insofar as sellers who recognize conditions of excess demand find it in their interest to ask a higher price. This higher price will in turn persuade demanders to economize on their use of the now scarcer good and persuade suppliers to shift more of their resources into the provision of the good.

When property rights are not clearly defined or are poorly protected, or when market participants are prevented by law, custom or social pressure from negotiating the terms of exchange that they find most satisfactory, the supply and demand process will tend to produce less mutual accommodation. It will more frequently generate costs for demanders that, unlike money prices, are not simultaneously benefits to suppliers. When, for example, the political authorities impose rent controls in response to an unanticipated increase in the demand for rental housing, the quantity of rental housing demanded will at first exceed the quantity supplied. With suppliers prevented by law from asking openly for higher money rents, some other component of the cost of acquiring rental space will inevitably rise. The quantity that demanders succeed in purchasing obviously cannot exceed the quantity supplied; some procedure will consequently evolve, with or without design, that allocates the available supply among those competing to acquire it. Frequently demanders will end up obtaining apartments by paying the legal maximum money price plus higher non-monetary costs, such as the costs of increased waiting and searching. Because these non-monetary costs provide no additional benefits to suppliers, the fact that they are rising will not ordinarily induce suppliers to discover and adopt procedures for more effectively satisfying the demands of consumers. In such circumstances, negative-sum games rather than positive-sum games will emerge from the processes of supply and demand (Cheung, 1974).

An economic analysis that largely assumes away the problem of acquiring and disseminating knowledge will give little attention to the social institutions that evolve to facilitate wealth-enhancing exchanges in a world of scarce knowledge. On the other hand, those who see the coordination of diverse projects in a situation of highly limited knowledge as the central problem of a commercial society are compelled to be students of institutions. They will recognize that the arrangement of satisfactory exchanges requires the acquisition of knowledge about the characteristics of both goods and people, and that innumerable institutions have evolved over time to reduce transaction costs by providing such information in a suitable form and a timely manner. The supply and demand process develops within the context of institutions that are themselves continuously evolving in response to that process. Economists who recognize this will be reluctant to take institutions

for granted; they will more likely regard institutions as part of the social reality that needs to be explained and understood (North, 1990). Such institutions include even the 'rules of the game'. While the process of supply and demand presupposes the property rights of the demanders and suppliers, along with established customs, principles and laws, all these 'rules of the game' are themselves the continually evolving outcome of supply and demand processes. As such, they are an appropriate object for research by those who want to use the tools of supply and demand to enhance the understanding of commercial society (Barzel, 1989).

The characteristic Austrian emphasis on the continuing processes of supply and demand rather than on the end states they produce fits comfortably with the unwillingness of most Austrian economists to construct comparative assessments of end states. Economists frequently argue that various forms of market intervention by government, such as price controls, produce 'inefficient' results by preventing resources from moving to their most highly valued uses. The thoroughgoing subjectivism of the Austrian perspective provides no criterion for comparing the goods or satisfactions realized under one set of institutional arrangements with those realized under another set. Economists may legitimately argue that price controls prevent resources from moving to those uses that yield the highest *monetary* valuations; but monetary valuations cannot be equated with valuations because different people value money differently. The implication of all this is that the economist's legitimate contributions to policy discussion will largely be limited to discovering the rationale of observed practices and tracing out the probable consequences of alternative policy proposals (Coase, 1988). There is no logical termination point in any direction for this kind of analysis. When supply and demand analysts have finished predicting or explaining the consequences of a particular scheme of price controls, they can use the same tools to talk about what might be expected in a world without any such controls, or to examine the political exchanges that produced the price controls, or to spell out the probable consequences of some alternative political scheme for dealing with whatever pressures prompted the imposition of price controls in the first place.

Another point about the Austrian understanding of supply and demand merits special notice in the context of Anglo-American economics, where Alfred Marshall managed to popularize the notion that supply and demand represent two sets of independent factors that jointly determine prices. From the Marshallian perspective that dominates most textbook presentations, demand reflects tastes and preferences, the subjective aspect of the situation, and supply reflects costs of production, the objective aspect. This account of the matter cannot be accepted by anyone who subscribes to the opportunity cost theory, which asserts that the costs affecting decisions to supply are the

value of forgone opportunities. Costs are not material facts dictated by physical reality but the outcome of social transactions. Costs are themselves the product of demand and supply, because the cost of producing any good will depend in part upon the demand for other goods that can be produced with the same resources. Marshall obscured this relationship with his doctrine of 'real costs', which he thought of as the 'efforts and sacrifices' of those whose exertions and abstinence provide respectively the labor and the capital for production (Marshall, 1890, pp. 338–9). Philip Wicksteed tried to straighten out the confusion in his presidential address to Section F of the British Association in 1913 (Wicksteed, 1914) but was not able to overcome what had by that time become the settled orthodoxy: a pair of scissors requires two blades to cut. In this misconception, supply and demand are the two independent blades that cut through the mysteries of price determination, and any attempt to explain supply by reference to subjective valuations is simply the opposite error to that of the classical economists who had tried to explain prices exclusively on the basis of costs.

The concepts of supply and demand provide a valuable pair of complementary tools because the factors that affect exchange transactions and resource allocation decisions can *usually* be *usefully* sorted into the two categories of those that influence supply and those that influence demand. The heuristic value of having two vises in which to hold our observations should not be allowed to obscure the fact that everything ultimately depends upon everything else.

See also:

Chapter 4: Market process; Chapter 22: The Austrian theory of price; Chapter 25: Prices and knowledge

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