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"Free Entry and Exit" from the Market:

Simplifying or Substantive Assumption?

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Abstraction and Economic Analysis

Economic theory, of necessity, presents an abstraction to the reader. Abstraction is required to achieve the perspective that allows for theory, that is to say, understanding and interpretation, to occur. If the abstraction is done well only inessential details are set aside -- details that would otherwise divert the theorist from grasping the essential or fundamental elements of the process under examination. For example a study of the mechanisms that cause a moving automobile to stop can reasonably abstract from the vehicle's color scheme.

For this process to be valid it is critical that the theorist distinguish between "simplifying" and "substantive" assumptions. The former clears away the inessential. The latter elevates or prioritizes the inessential -- thereby contributing to a distorted understanding. The difficulty is that distinguishing between simplifying and substantial assumptions remains, and will always remain, something of an art. Fifty years ago the siren of "Positive Economics" proposed that this critical distinction could be reliably made by adhering to a set of clear and simple rules. While some

economists and empirical psychologists maintain a nostalgic commitment to that eclipsed understanding of science, today most thinking practitioners are aware that such an epistemological stance, with its triumphant dismissal of the need for defensible assumptions, was naive -- even misguided.

Out of this epistemological vacuum economists have retreated to several crude "fixes" to guide their selection of abstractions. Occasional assertions to the contrary, these methods are conventions. Innocent of any knowledge of these issues, many economists instinctively deploy the abstractions used by their graduate advisor, or rely on those that most frequently appear in what are held to be the profession's premier journals. Economics, perhaps more than ever, is now defined by what economists do.

Ideally, the distinction between substantive and simplifying assumptions could be grounded in something more meaningful. Such a ground does exist -- it is called judgment. Unfortunately judgment, like "beauty" or "goodness," is difficult to define without invoking specific cases. The reason is that good judgment requires a sense of context. Context is most readily gained through direct experience, a study of history, or the comparative method. Once acquired, this knowledge enables the researcher to "compare and contrast" one situation with another, to learn from previous efforts to

interpret the subject at hand, or to benefit from multiple approaches to a single question.

In short, judgment requires the kind of broad-ranging knowledge that is largely absent, even disdained, in the training of the economists of our era ("training" is the appropriate term in this context -- to be contrasted with "education"). To appreciate the implications and importance of the distinction between "simplifying" and "substantive" assumptions, consider the conventional assumption of "Free Entry and Exit."

The "Free Entry and Exit" Assumption and the Implicit Denial of Bargaining Power

Free entry and exit is almost always presented as a "simplifying" assumption. Several generations of economics textbooks have repeatedly asserted that its value is in enabling students and researchers to grasp the essence of the market process by freeing them from the inessential distractions inherent in the particulars of time and place.

But is this assumption really an innocent simplification? Among the "inessential distractions" it abstracts from is bargaining power. For some markets, such as that for a slice of pizza in New York City, or an espresso coffee in the heart of Paris, we can confidently

ignore issues related to bargaining power. However, in most cases understanding the cause, extent, and implications of bargaining power is essential to a coherent theory of market dynamics. Stated simply, those with superior bargaining power enjoy a disproportionate influence over the price and ancillary conditions of the exchange (these latter include the time and place of the exchange, terms of delivery, means of payment, guarantees of quality, etc).

In its most elementary conception, bargaining power can be reduced to the relative ability of each party to an exchange to "walk away" (Prasch 1995). Free entry and exit simply finesses such considerations by positing that all parties to an exchange are absolutely equal, in the sense that they are free to enter and exit the market at no cost to themselves. In this manner relative bargaining power is removed from consideration. For many if not most markets and market phenomena, removing considerations of bargaining power represents a *substantive* rather than a *simplifying* assumption.

One reason that bargaining power is invisible to so many economists is that they have been taught, and instinctively draw upon, a uniquely limited understanding of coercion. This vision presumes that only physical force or the state's mandates can be coercive once the institutions of private property and "free" markets have been widely established. The proposition that private

economic power exists, or could have important or lasting effects, is ignored or even denied.

Property and Coercion

Institutionalists have long argued that such a perspective on coercion is as naive as it is erroneous. Among other objections, they have argued that private property is itself, by design and intent, coercive. Indeed the point, as opposed to an accidental effect, of property law is for the state to grant and protect a right of exclusive disposal over some object, service, or privilege to a particular person or entity.

For illustration, consider a situation in which some people have neither savings nor a source of income and all objects, services, and privileges (hereafter collectively termed "goods"), are privately owned. No goods, not even the roads or parks, are held in common. In such a case, property-less persons can do nothing, including meet their most basic survival needs, without first receiving, after agreeing to terms, means of payment from some property owner. This will, in most instances, require providing some service in return. Should this requirement be ignored, its violator is subject to arrest by the state's officers for trespass or

theft. Thus, in the absence of a commons, each of us must already own the goods we need, or come to terms with someone if we are not to perish. This condition represents, almost trivially, a form of sovereignty (Cohen 1978).

In every short period it is evident that for most of us private property places limits on our ability to have, to do, and to be. For survival, to say nothing of achieving our several ends in life, those without wealth must first come to terms with an owner of property to acquire means of payment. By contrast to feudalism, the propertyless are formally "free" in the sense that the persons with whom they must negotiate are not identified by previously existing social arrangements. Moreover those persons with whom the propertyless must bargain to obtain means of payment may be in varying degrees of competition with each other. Nevertheless, the *principle* that some autonomy must be surrendered remains. What is unknown and remains to be determined are the precise conditions and terms.

Now most social theorists agree, as an abstract proposition, that just and justly applied laws of property promote a greater good for one and all even if

they diminish our ability to do certain things at any given moment in time.[1]

> To protect a consumer's liberty from annihilation at the hands of other consumers, the law curtails it in a more methodical and less drastic way, by forbidding the use of goods without the consent of the owner. In practice this means that the liberty to consume is conditioned on the payment of the market price (Hale 1943, 626).

Since our ability to consume is conditioned on our access to means of payment, it follows that the laws of property are differently experienced according to our wealth. To a person of substantial wealth, a world where everything is private property presents itself as one where they are, as the neoclassical economists like to say, "free to choose." If one's wealth is great enough, and the persons with whom one is interacting in a given market have limited opportunities and substantial unmet needs, such a regime can become one of license. Instances of great social dislocation, such as those of a

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[1]What constitutes "just and justly applied" laws of property is, of course, the interesting and lasting issue.

famine, reveal an endless number of striking examples to illustrate this point. When our freedom -- that is to say our relative ability to have, to do, and to be -- depends upon wealth, then those who enjoy substantial wealth also enjoy a greater degree of freedom.

To a person without access to means of payment, a world where everything is private property presents a strikingly different picture. If all goods, including necessities, are rationed by income they will have access to very little.[2] As such, the impecunious person's day-to-day experience will be one of continuous adaptation to constraints and prohibitions. Their "freedom to choose," while formally protected by law, is effectively nullified in practice.

> The employer's power to induce people to work for him depends largely on the fact that the law previously restricts the liberty of these people to consume, while he has the power, through the payment of wages, to release them to some extent

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[2]Economists present a false dichotomy when they contrast "markets" with "rationing." Markets, it should be obvious, ration goods according to the ability and willingness to spend. While this is different from rationing according to need, political influence, or priority in line, it remains a form of rationing.

> from these restrictions. He has little power over those whose freedom to consume is relatively unrestricted, because they have large independent means, or who can secure freedom to consume from other employers, because of their ability to render services of a sort that is scarce and in great demand (Hale 1943, 627).

If propertyless individuals cannot sell their labor or even their persons for a price greater than the cost of their needs, then the restrictions inherent in a pure private property regime are a cause of distress, even death, unless some form of extra-market subsistence is extended in a timely manner. That this is not a speculative result was affirmed by the great famines of nineteenth century Ireland and India. In each instance British colonial officials depended upon the free market to feed masses of starving people who had nothing to sell. Predictably, tens of millions died. Again, it must be emphasized that the British Empire, as part of its "civilizing mission," guaranteed that every one of the millions of people who died had an *absolute right* to purchase food -- all they lacked was the *means* to do so.

The extreme example of famine affirms that in an unregulated market individual property owners, backed by the full authority of the state, may set the conditions and terms by which others may acquire ownership or use of

their goods. Of course, the terms that owners may demand for the use of their property is moderated by the specific qualities of the goods in question and the degree of competition in the market. These conditions may, or may not, represent an adequate check on their bargaining power. It certainly does not do so if the population is starving and mainstream economists are able to convince themselves and the authorities that everyone will be fine in their favored period: *The Long Run*. Unfortunately, history has repeatedly demonstrated that needy persons may have to surrender their dignity, their children, and even their lives while they await the arrival of this legendary non-period.

Today, the coercive aspect of property becomes most evident when a good that was formally part of the commons is privatized. Suddenly confronted with a demand for payment to continue in a course of action that was previously free, the coercive nature of property becomes transparent and is resisted. Prominent examples include the recording industry's strenuous efforts to prevent the sharing of recorded music among young Americans, or the ending of free access to potable water in those unfortunate Third World cities that have been unable to stave off the World Bank's privatization mandates.

The Contours of Bargaining Power

As we have seen the coercive aspect of private property conditions, and at times limits, people's ability to meet their needs. It follows that an analysis that begins by assuming free entry and exit may be an inadequate ground for understanding the system of exchange conventionally termed a "market society" if property and bargaining power are unevenly distributed -- as is generally the case.

My right to what is designated my private property, from a legal and economic standpoint, empowers me to deny you access to my goods unless you can induce me to change my mind. "This power of property in itself, the power to withhold, seen in these extreme cases, is but an enlargement of that power which exists in all property as the source of value-in-exchange and which may be distinguished as *waiting-power*, the power to hold back until the opposite party consents to the bargain (Commons 1924, 54, italics in the original). In a market system, consent is most reliably achieved through the provision of a payment. In a property-based market society the issue is not the principle, but rather the size, of this payment. This, in turn, is determined by our bargaining power.

To understand the place of property in the formation of relative bargaining power it is essential to know the context. Considerations will include the specific

qualities of the good, the unmet needs of each party to the exchange, and the structure of the market. Do you "need" or do you "want" the particular goods that I possess? Do you have access to acceptable alternatives? Are you categorically unable to access certain markets or large segments of these markets? How viable, then, are your options? What are the transaction and direct costs of these options? The answer to each of these questions determines your capacity to "walk away" from any given exchange. If it is the case that I will suffer a greater loss than you in the event that we fail to consummate a given exchange, then your greater ability to walk away enables you to effectively demand a lower price or more favorable terms from me (Prasch 1995; 1999; Levine 1988, Ch. 1).

It is now evident that the "Free entry and exit" assumption presupposes that the good in question: (1) Is not a necessity. (2) Has many perfect or near-perfect substitutes. (3) Can be acquired with negligible transaction and direct costs. Each of these conditions implies that one can readily get along without achieving any specific exchange. This last proposition implies that a failure to agree to an exchange at a reasonable price will leave each party in a condition identical to the one in which they initially entered the market.

Let us return to the above example of pizza. Few New Yorkers really "need" a slice of pizza from any

specific vendor. While it may contribute to their overall happiness, it is likely that they would soon recover if they failed to acquire a specific slice of pizza from a specific vendor at a reasonable price. Throughout New York City pizza is available from numerous competing venders and the "transaction cost" of going from one to another is not, typically, prohibitive. Such a commodity, we can surmise, is not a necessity, is relatively inexpensive, and features a variety of acceptable substitutes and near-substitutes -- such as a falafel or a hot dog. It follows that one may plausibly consider the market for a slice of pizza in New York City to be characterized by free entry and exit. But can these qualities be said to hold for electricity? The market for home loans, or what is dubiously labeled "executive talent"?

Bargaining power, by contrast to the conventional presentations of economic theory, is an important consideration in a wide variety of markets. Yet assuming free entry and exit remains the pedagogical and research norm. Too often this *substantive* assumption is made under the guise of *simplifying* the analysis. Unfortunately this substantive assumption has had a lasting impact on what passes for our "understanding" of many markets. This error, in turn, has implications for the boundaries between what are considered "acceptable," "unacceptable," and "irresponsible" policies. In short,

assumptions matter.

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