# The Socialist Myth of the Greedy Banker and of Economic Monopoly

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Most people are convinced that private banks are responsible, or at least mostly responsible, for the current economic crisis. The truth is that the crisis is the outcome of the policies followed by the political systems of the U.S.A., the E.U. and China. But I describe the major causes of the crisis in my essay “The causes of the economic crisis”, and therefore the purpose of this document is not to explore them, but rather to explain in very simple words, why private banks are not at all responsible for the crisis, since they cannot “create” money. Even though I have postgraduate studies in economics I am not a specialist, and this document is the knowledge I gathered in an attempt to answer my own questions. Moreover English is not my first language and you will have to excuse my syntax.

To show that private banks cannot “create” money, is very important since excessive money creation in the U.S.A., the E.U. and China, was one of the main causes of the current crisis. Equally important is to explain why excessive money creation is always and everywhere a government act. What happened in reality is that excessive money creation was simply used to accommodate the unsustainable fiscal policies followed for years by many countries. Unfortunately it is much easier to notice the private banks credit expansion with the abundance of cheap credit, and the resulting bubbles, and much harder to realize that it was state policies and laws that dictated such expansions and led to bubble creation.

Since the average person is well aware of the credit expansion and the inflationary money of the pre-crisis era, it is not unreasonable for him to assume that the cause of the crisis is the “uncontrollable” and “unstable” private banking sector. But if a person is mistakenly convinced that the private banking sector is responsible for the crisis, a very reasonable response would be to ask for more government regulation. Wouldn’t that be the most natural response? I therefore believe that it is of great importance for the general public to realize that private banks cannot create inflationary money. Only governments can do so by introducing relevant laws as I explain below.

In order to do so, I use various economic examples to show that private banks cannot “create” money. First I use an example where private banks issue their own bank notes and there is no central bank. In the second example private banks still issue their own bank notes, but there is also central bank that only keeps the private banks’ gold at its vault, and clears their transaction. In the final example which is very realistic, there is a central bank that issues bank notes, which keeps at its vault all the gold, and that clears

the transactions between private banks. But the bank notes it creates are still backed by gold. I show that in all cases private banks cannot create money. Then I explain why it is only the government that can create money, and I show how and why it does so. At the final part of the document I explain why conspiracy theories about central banks are not true.

But first of all, what do we mean by “inflationary money”? What do we mean by “excessive money creation”? The best description in my opinion is the following: “Inflationary money refers to an increase in the supply of money that is not matched by an increase of equal value in production”. For example there is an economy with 2 tomatoes and 2 dollars, and each tomato costs 1 dollar. A third dollar is now created, that is not matched by the production of a third tomato. Therefore the price of each tomato increases to 1.5 dollars, which means that the new dollar was inflationary. This is actually a way for the issuer of the third dollar to tax the 2 existing tomatoes.

In my document “Central Banks for non-Economists Part 1: Inflation and Taxation”, I explain the relationship between money creation and taxation, and therefore in this document I will not elaborate on the relationship of inflation and taxation. I will only say what is necessary for the purpose of this essay. I will therefore show with this document that in a free market system, private bankers cannot create money and tax the current wealth. A free market banking system is exactly the opposite from the banking system we know. And I am not saying that when the state follows an aggressive monetary policy, private bankers do not make big profits. They do make big profits at such times. But this has nothing to do with the evil private banking sector. When there is lots of money around, they make big profits because their job is to buy and sell money. In the same way that someone who sells nails makes lots of money if huge amounts of nails are bought and sold. This does not change the fact, that paper money is the most important state monopoly. But before I explain why private banks can not create inflationary money in a free market economy, I would like to say a few words about why it is good for an economic system to have a form of “money” (a medium of exchange), and a banking sector. After all, this document is written for non economists.

In a barter economy without any generally accepted medium of exchange, that is without a good that everybody accepts as a means of payment, a person wishing to sell his tomatoes and buy oranges, would have to find someone who sells oranges and wants tomatoes. This can be a very difficult and time consuming task. On the other hand if everybody accepts a good as a means of payment, i.e. gold, olive oil, paper money etc, this problem ceases to exist. If I want to sell tomatoes I simply have to find someone looking for tomatoes, and with the medium of exchange that I will receive, I will buy the oranges I want. This is a much more efficient way to trade, and it leads to much higher levels of productivity and welfare.

Moreover, the orange producer needs a way to store the value of his production surpluses. If he needs 100 oranges per year but he produces 200 oranges, he must somehow store the value of his surplus i.e. the 100 oranges. He therefore needs a non perishable good, that everybody accepts as a medium of exchange, in order to store his surplus of 100

oranges. This can be a good that can last for a long time i.e. olive oil, but silver, golden and other metal coins, or paper money, are much more suited to serve as mediums of exchange. There are more reasons why an economy needs a medium of exchange, but the above will suffice for my purposes.

Now I want to say why an economy needs a banking system. The farmer of the previous example had a surplus of 100 oranges. There is another farmer that is willing to pay 110 oranges in a year's time if he borrows these 100 oranges today. But the other farmer is reluctant. He does not know if the borrower is capable of repaying the 100 oranges, and he does not want to risk his surplus. But if there is a specialist who can evaluate the borrowers' creditworthiness, this problem ceases to exist. This specialist is called a bank. It could be called a money merchant or anything else. But these experts are called banks. There is no difference between a real estate agent and a money agent. One is an intermediary in transactions involving property and the other is an intermediary in transactions involving money. The above explanations of the usefulness of a common medium of exchange and of a banking system are enough for this document. After all nobody disagrees.

My starting point will be an economy with no money and no banking system. There are only farmers producing oranges. Farmers producing more oranges than they consume, worry about their surpluses. They are afraid that someone might steal them when they are absent. There is therefore demand for places to deposit these surpluses for greater security. New companies are created then, with huge vaults, where farmers can store their oranges. Let's call these companies banks. Farmers store their surpluses in their vaults, and can go whenever they want to take oranges for personal consumption or commercial purposes. I assume for a minute that oranges do not perish, and therefore they can serve as a store of value.

When farmers deposit oranges at the banks, they receive paper receipts. An orange and the number "1" are stamped on each receipt. All receipts are identical, except that each one carries the name of the issuing bank. Gradually farmers start to use these receipts as money. They find it more convenient to do so, instead of carrying oranges around. We now have a monetary economy with a banking system. People do not exchange oranges but paper representing oranges. However citizens want a medium of exchange that is more convenient than oranges. They therefore start using gold, which is much better suited to serve as a medium of exchange than oranges. Now gold is not only used for jewellery but as a means of payment too. In the same way that some people work to produce oranges, some others work to extract and process gold. One should not confuse gold with paper money. Gold is a good like all other goods. Someone has to work hard to extract and polish it, and it has real value. Paper money on the other hand has no intrinsic value. Its value derives from a governmental law establishing as the legal and only means of payment.

The price of gold is affected by the same factors that affect the prices of all other goods in the economy i.e. its availability, demand and supply for gold, improvements in mining techniques, changes in tastes etc. Gold is a good **like all other goods** (oranges, wood,

wine etc). **It is not** like paper money that has no intrinsic value. Gold simply possesses some special characteristics that make its use as a medium of exchange ideal. Therefore economic agents trade their goods for gold, and deposit their gold at the bank, which in turn issues and gives them a paper ticket (bank note). Let's call these bank notes "1 gram of gold" notes. All bank notes are "1 gram of gold" notes, and the issuing bank's name is written on these notes. Banks are obliged to redeem these notes for 1 gram of gold, if the bearer wishes so.

These papers are exactly the same with 1 dollar notes, except that "1 gram of gold" is written on them instead of "1 dollar". Actually the main difference is that you cannot redeem dollars or euros for gold, while you can do so for the bank notes of my example. The bank notes of my example have real value. They do not derive their value from a law, but from the gram of gold that backs them (or from the oranges that backed them before I introduced gold into my example). And for simplicity I assume that there are only "1 gram of gold" bank notes, and the economy is only producing oranges and gold, and that oranges exchange for 1 gram of gold, and the price is fixed. All very unrealistic assumptions but they enhance intuition which is my aim.

## Why private banks cannot create inflationary money

Now I turn my attention to the private banker, to whom all socialists attribute the crisis. As expected, the private banker wants to sell as much of the medium of exchange as he can, whether the medium of exchange is olive oil, whether it is golden coins, or paper money or whatever, because this is his job. This is what he does. In the same way that someone selling nails wants to buy and sell as many nails as he can, the banker wants to buy and sell as much money as he can. The more he buys and sells the more profit he makes, exactly like the nails merchant. If the interest on deposits is 5% and interest on loans is 10%, and the private banker lends 100.000 dollars, he will make 5.000, if he lends 1.000.000 he will make 50.000 dollars, if he lends 10.000.000 dollars he will make 500.000. The same principle applies whether you buy and sell nails or money. The more you buy and sell the more profit you make, assuming of course that each sale carries a profit mark up. Therefore it is very normal and very healthy that the private banker wants to lend as much as he can, given of course his customers are creditworthy.

We now have to think whether a private bank can "create" inflationary money if it wishes to do so. And the answer is of course no. Let's imagine a private bank, in which farmers have deposited 1.000 grams of gold, and which has issued 1.000 "1 gram of gold" notes, with its name on them. Therefore the issued bank notes are 100% covered by gold, which means that each bank note issued corresponds to 1 gram of gold in the bank's vault. This bank now wishes to issue another 9.000 bank notes in order to lend them and make more profit. But the bank does not have another 9.000 grams of gold. Therefore these new notes will be inflationary notes. They will be money creation from thin air. Can the bank do so? No, it cannot as I already said. If X Bank attempts to do so, it will go bankrupt very soon. And here is why.

Imagine that the bank issues another 9.000 bank notes, and lends them to some customers in order to charge interest. The customers that will receive the "fresh" notes will use them to finance their activities, thus giving them to other economic agents, who in turn will deposit them to their domestic or foreign banks. The domestic and foreign banks that will receive the new bank notes will send them to the issuing bank to redeem them for gold, as the issuing bank is obliged to do. And more specifically they will require 1 gram of gold for each bank note. But the issuing bank has only 1.000 grams of gold in its vault, and therefore will not be able to redeem the banknotes. Therefore the issuing bank will go bankrupt shortly after the credit expansion.

In the banking system I just described, banks have to send loads of gold to each other every day, in order to clear their customers' transactions. This is very inconvenient, and I will therefore introduce a central bank in my example. The private banks will continue to issue their own bank notes, and the central bank will simply hold their gold and clear their transactions. For instance when X Bank receives a bank note from Y Bank, it will send it to the central bank. The central bank will take a gram of gold from Y Bank's box, and put it in X Bank's box. Once the transfer of gold has taken place, the central bank will return the bank note to Y Bank, since the debt was fully paid. In a banking system like the one I describe, bank notes resemble bank checks, since the bank's names are written on them.

The inclusion of a central bank into my example does not change much though. The private banks cannot create money for the reasons I described before. If Y Bank has "created" inflationary money, which means it issued more bank notes than the grams of gold it has at the central bank's vault, it will go bankrupt. Assume farmers deposited 1.000 grams of gold at Y Bank, and Y Bank issued 1.000 bank notes of 1 gram of gold each. Now the bank issues another 9.000 bank notes not covered by gold i.e. inflationary money, and lends it to a customer. The customer buys something and the new bank notes end at X Bank. X Bank sends these bank notes to the central bank, and the central bank finds in the box of Y Bank only 1.000 grams of gold instead of 9.000 grams. The central bank therefore does not clear the transaction. Therefore the introduction of the central bank did not change anything.

Now let's examine what happens when the central bank not only holds the private banks gold and clears their transactions, but in addition is the issuer of the economy's paper money. But each bank note issued by the central bank issues is still covered by 1 gram of gold, as was the case in the previous examples. Can private banks now create inflationary money? No they cannot. For the central bank to issue a new bank note, someone will have to deposit in its vault 1 gram of gold, that someone being the government or a private bank (on its behalf or on behalf of a customer). Each private bank receives a bank note from the central bank, for each gram of gold it sells to the central bank. In other words, for each gram of gold that goes in the state's box of gold at the central bank. Not for each gram of gold that the private banks deposit in their own box at the central bank's vault. Bank notes are only issued when a gram of gold goes to the state's box of gold. Therefore the country's bank notes are real bank notes. For each one of these notes there

is one gram of gold (at least) in the state's box of gold at the central bank's vault. They are "golden" paper notes.

I will use a full transaction as an example. I sell 1 orange to a person that extracted 1 gram of gold. Remember that I assumed oranges sell for 1 gram of gold. I then deposit this gram of gold at X Bank. X Bank has two choices. One is to buy the gold for itself and send it to the central bank for the latter to deposit it in X bank's box of gold. Alternatively X Bank can send the gram to the central bank for sale. The central bank will then issue a "fresh" bank note, and send it to X Bank. The central bank will then put the gold in the state's box of gold (and not in X Bank's box). I, the seller of the orange, will take a bank note of 1 gram of gold in both cases. In the first case an existing bank note and in the second case a "fresh" one. I can give this bank note back to X Bank and open a deposit account or take it and leave. I use this example to emphasize that for a "fresh" bank note to be created someone has to put a gram of gold into the state's box of gold. This is very important. And it is a very reasonable, since each bank note created represents for the country a debt of 1 gram of gold, whether this bank note is held by a local or a foreign citizen. And in order for the country to be able to redeem all the bank notes issued for 1 gram of gold, there must be (at least) 1 gram of gold for each bank note issued, in the state's box of gold. That is why I call the banknotes "golden" notes. If these bank notes are not backed by gold they are not "golden", they are simply paper deriving their value from a relevant law. Issuing "golden" bank notes is very healthy, since they represent real production surpluses and savings and not inflationary paper.

So, can a private bank in this environment "create" money if it wishes to do so? The answer is again no. If X Bank issues new loans, and gives let's say bank checks to some customers (remember that now it is the central bank that issues the paper money), the customers will give these checks to other economic agents, these other economic agents will deposited these checks in foreign and domestic private banks, and eventually they will end up at the local central bank to be cleared. The central bank will not find enough gold in X bank's box, and it will not clear the transactions.

We therefore see that private banks cannot create inflationary money under any circumstances. I hope it is now clear why the document is titled "the myth of the greedy banker". Only the state through governmental laws, and through its monopoly as an issuer of paper money, can create inflationary money. Inflationary money is as I already said, money not covered by production surpluses. It is money that does not represent citizens' savings, but it is rather a new government claim on the citizens' savings. I must also say that a country does not have to produce gold. It can produce other goods and exchange some of them for gold. Gold is simply a good like all other goods.

## Creation of money by the government

I hope that it is clear by now that private banks cannot create inflationary money. The problem for a political system with a banking system as described is that the government cannot create money either. And governments have only 3 ways to finance their deficits. The first one is taxation, the second one is domestic and foreign borrowing, and the third

one is by printing new inflationary money. As I explain extensively in my other document, printing money is taxation through inflation. Inflation is a way of taxation that most governments very often prefer to use. Taxation is very unpopular, borrowing requires confidence on behalf of the lender that you will honor your obligations and carries the cost of interest, while printing money does not require a third party's confidence in the government's policies, it does not carry interest, and it is not as unpopular as taxation. Of course increasing the money supply increases inflation, but most people do not realize that inflation is taxation. Therefore taxation is more unpopular than inflation. If a government goes too far with the printing press though, it can cause very high levels of inflation, or even hyperinflation, with catastrophic consequences for the economy. But in the short run political parties tend to overlook the long run consequences.

I now want to describe the difficulties that a government faces under the gold standard, in its effort to finance deficits by printing money. To make things simpler, let's start from day 0. Citizens have no savings in gold or oranges yet. They now start producing oranges and gold. Some of them produce oranges and some produce gold, and it is gold that serves as a medium of exchange and a store of value. Producers of oranges, exchange their surpluses with gold, and deposit gold at the bank. Similarly, gold miners exchange their gold for oranges, and deposit whatever quantity of gold is left at the bank. Note that the deposited gold does not represent only the past surpluses-savings of gold in the economy. It represents the surpluses-savings of all goods and services in an economy. When I exchange my extra orange for 1 gram of gold, and I deposit that gold at the bank, that gold represents a surplus of 1 orange that was stored in gold. I mean that the deposited gold at the banks represents all surpluses, all savings in the economy. Surpluses in oranges, surpluses in haircuts, surpluses in gold, surpluses in cleaning services etc, that are all converted and stored in the common store of value, which in my example happens to be gold. In my example gold is the only way to store value, but in reality this is not the case.

The private banks now deposit the citizens' gold at the central bank, and the central bank issues new "1 gram of gold" bank notes. These notes could be called something else. They could be called dollar notes, or euro notes or whatever. I prefer to use the name "1 gram of gold" notes to emphasize that these notes are "made" of gold, they are backed by gold. Let's assume now that there is 1.000.000 grams of gold deposited at the state's box of gold in the central bank, and 1.000.000 "1 gram of gold" notes circulating in the economy.

Even though it makes no difference for my analysis, in order to be a bit more accurate, I have to add that the price of orange and gold would not be fixed in reality. The banknotes are indeed backed and redeemable for 1 gram of gold, but that does not mean that they will always buy 1 orange. The relative price of gold and oranges will vary according to weather, demand and supply, changes in tastes etc. In other words bank notes will always be redeemed for 1 gram of gold, but that gold might buy 1 orange, or 2 oranges, or half orange, depending on the prices prevailing at the market. But this should not be confused

with a general increase of the price level that arises as a result of inflationary money creation. Relative prices must change when market conditions change.

So, we have 1.000.000 grams of gold in the state's box at the central bank, and 1.000.000 "1 gram of gold" notes circulating in the economy. Let's suppose that the government wants to issue some more "1 gram of gold" notes, to finance its deficits and avoid taxing its citizens. Can the government do that? Well for a while it can. I assumed that the total gold of the economy is 1.000.000 grams, and let's say that 100.000 of these grams belong to the state. But the government decides to host the Olympic Games that cost 200.000 grams of gold. The treasury issues a check of 200.000 grams of gold, and gives it to the contractor. The contractor deposits the check at X Bank, in order for the latter to clear it. X Bank in turn sends the check to the central bank for the latter to clear it. The thing is that in reality, the gold is not kept in separate boxes with a bank name written on each box. It is placed all together at the central bank's vault, and the central bank holds electronic information about the owners of that gold.

Therefore when the central bank receives the check issued by the treasury, it sees that the state's gold of 100.000 grams is not enough to cover the expenses. However, contrary to what it would do for a private bank, it credits X Bank's account with 200.000 grams of gold and says that everything is ok. X Bank then credits the contractor's account, and the contractor starts preparations for the Olympics. The country now owes 100.000 grams of gold. In accounting terms this appears as a debt of the government to the central bank, but in reality it is a debt of the government to its citizens. Except that the citizens do not know that the just lent their government 100.000 grams of gold. Alternatively, instead of a check by the treasury, the government could have ordered the central bank to create 100.000 new notes. The central bank would create these notes pass them to the treasury, and write in the central bank's books a government debt of 100.000 "1 gram of gold" notes. The treasury would pay the contractor, who would deposit these notes at X bank. X bank would open a deposit in his name and send the bank notes to the central bank in order for the latter to transfer 100.000 grams of gold in its box. The central bank would credit X bank's gold account which would match the debt created by the government. I think the case with the check is better for illustration purposes. So you better think of this transaction in terms of the treasury check. But both cases are exactly the same. In both cases what happened is that the central bank owes a private bank 100.000 grams of gold, and the government owes the central bank 100.000 grams of gold. In reality, it is of course the government owing to its citizens 100.000 grams of gold, since the central bank is only a governmental institution.

The government just created money. But it did not created new wealth. It simply used its citizens' accumulated wealth to finance the Olympics. This will of course appear as a debt of 100.000 grams of gold when the government prepares its financial statements at year end, but who notices? Everybody is happy. Everybody got their money. And the government did not have to tax anybody, and did not have to borrow any money. Only inflation was affected. But who cares when inflation is low? The problem for the government under the gold standard is that this artificial money expansion increases demand, it increases the price level, the country becomes more expensive and starts

losing its competitiveness, imports start rising and exports start declining. The economic agents abroad that receive the country's bank notes as a payment for their sales send these bank notes through their central banks, to the domestic central bank, in order for the latter to redeem it for gold.

Therefore if the government is very active in creating inflationary money, the country's gold reserves will start declining. People will start doubting that the government will be able to redeem its bank notes for gold, and there will be a confidence crisis. Even domestic citizens might start redeeming their bank notes for gold. But there is not enough gold to pay for all bank notes in circulation, since the government used much of it for its expenditures. At some point the government will have to either abandon the gold standard all together i.e. stop redeeming the bank notes for gold, or change the exchange rate between bank notes and gold i.e. say that it will exchange each bank note for half instead of 1 gram of gold. Thus the gold standard imposes much more discipline on a government's fiscal policies. On the contrary if the government passes a law, as is the case in all countries, imposing its paper money as the legal means of payment without promising to redeem it in gold, there is no limitation on the creation of inflationary money.

Now the bank notes do not derive their value from gold but from the law, and the government can create as much money as it wants. Well, almost as much, because excessive use of inflationary money as a means of taxation can lead to catastrophic hyperinflation. The point is that the gold standard imposes much more discipline on a government, and it is no surprise that governments do not like such regimes. It is no surprise either, that socialists hate the gold standard and libertarians love it. Because it is socialists that like excessive taxation, and since direct taxation is unpopular, they prefer to use the indirect taxation of monetary expansion. Libertarians do not favor big public sector and excessive taxes and they therefore love the gold standard as a barrier to socialist policies.

**To make things simpler, think about it in the following. If society's savings are a pile of gold, and the government takes some of this gold without taxing, it will have to pay back with gold. But the government does not have gold. But if, as it happens in all countries, the government passes a law that imposes paper money as the legal and only means of payment it is in effect forcing its citizens to save their surpluses in paper money. Now if the government can take some of the savings without taxing the citizens. If the citizens ever ask for their money back, the government can always print new money and pay them. But this paper will buy much less than it used to. Of course it is possible to save in gold but it is not as convenient. And therefore most people will hold their savings in the form of paper money. The honest thing for a government would be to back paper money with gold.**

## The gold standard and budget surpluses

As I already said, the gold standard is a regime favored by libertarians and of proponents of small public sectors in general. This rule prevents politicians, or at least makes it much

harder for them, to follow policies based on budget deficits. There is another way however to prevent governments from creating deficits, and this is by passing a law requiring governments to have on average budget surpluses. Some political systems in developed countries do so, as a means of self discipline. In Sweden for instance, there is a law imposing budget surpluses of +1% on average. That means that deficits are allowed, but they will soon have to be reversed. But such laws are not welcome at all by socialists, since they are even stricter than the gold standard. Under the gold regime as I described above, at least temporarily, a government could finance a deficit by monetary expansion. The law of budget surpluses makes life for socialists even tougher since they can only use taxation to finance their projects. There is also a softer version of this rule that allows deficits but only if they relate to public investment i.e. road networks, harbors etc, with the hope that such investments will increase the country's GDP.

## Central banks and conspiracy theories

The main idea of this document is that there are no fat greedy bankers, but rather fat greedy governments and politicians. However there is one last issue which is the conspiracy theories about central banks. Such theories claim that central banks print money for themselves and this is the cause of the crises. In other words they claim that it is not that central banks are directly or indirectly at the mercy of their political systems but the other way round. The following link has a lot of information about conspiracy theories concerning the Federal Reserve Bank, which is the central bank of the U.S.A.

http://www.publiceye.org/conspire/flaherty/Federal_Reserve.html

Such conspiracy theories are everywhere and always supported by populists, or by people that are not very educated or intelligent, and they have a tendency to believe populists. Political systems in developed countries try to make their central banks as independent as possible, in order to protect their monetary policy from political cycles. They do so in order to put a barrier between politicians and the money machines. And they do so with laws that they pass in their own parliaments. For instance the board of the Fed, is appointed by the president of the United States of America and approved by the congress, but the president cannot terminate the chairman's tenure once he is appointed. They do so because they do not want the chairman of the central bank to be at the mercy of the president and the congress. They want the chairman to have some degree of independence in order to be able to resist pressures on behalf of the congress, to follow more expansionary policies. Because the truth is that politicians tend to focus on short rather than long term consequences.

The problem is that political systems do not provide enough independence to their central banks. For instance by law the Fed's goals are price stability and low unemployment. The same applied for the central banks of the socialist southern European countries. However this was not the case for Germany. Bundesbank's goal was set by law to be only price stability, and this partly explains the superiority of the German economy, since the political system had to be much more disciplined. Because when you include low unemployment as a goal of the central bank, the central banker is at the mercy of

politicians. Politicians know that if their irresponsible fiscal policies lead to high unemployment, the central bank will have to step in and give them a hand in the form of monetary expansion, since it is required by law to do so. But an increase in paper money can only have short run positive effects and will definitely has very strong long term negative effects. Therefore this commitment of the central bank to intervene in case of rising unemployment gives negative incentives to the political system. If on the other hand the goals of central banks were only price stability and the stability of the financial system, politicians would be much more cautious and disciplined.

But even when low unemployment is one of the central bank's goals, the economists from the academia that that run them, are a significant obstacle to the political system since they do not have to worry about political cycles. And this is the reason that socialists and statists want central banks to be at the absolute control of the political system. And they circulate conspiracy theories about central banks, in order to convince ignorant people that central banks should be stripped from any form of independence. They want the money machine under their complete control. When politicians have the money machine under their control, they can do the following. Suppose there is a 3 people economy, the president and two citizens. The president wants to take a dollar from John and give it to Nick. He can print 3 dollars give 2 dollars to John, and 1 dollar to Nick. If you take into account inflation, the net effect was to give 1 dollar to Nick. But John is happy too. He got a dollar. He did not realize that 1 dollar was taken from him. He thinks 1 dollar was given to him. He only notices inflation. This is the reason that politicians do not want economists running central banks. In less developed countries the money machines are indeed at the mercy of the political system, in the way that statists and conspiracy theorists want them to be. Only in the developed word central banks enjoy some degree of independence.

The Fed has indeed shares which are held by all the private banks operating in the U.S.A. But banks are required by law to hold the Fed's shares. And by the same law they have to keep a part of their funds with the Fed. But private banks do not have a saying on the conduct of monetary policy which is determined by a board appointed by the president and approved by the congress. Moreover all the interest earned by the Fed is returned to the treasury at the end of each year (for more details see the link I provided above).

I will therefore conclude by saying that contrary to what conspiracy theorists suggest, the problem with central banks is that they do not have enough independence and they have to accommodate irresponsible fiscal policies. The most famous case is of the northern and southern European countries. The northern European countries provided much more independence to their central banks and they always outperformed the southern countries in economic terms.

# PART B

# THE SOCIALIST MYTH OF ECONOMIC MONOPOLY

## Introduction

Economic monopoly is a major issue in economic and political discussions and I want to make a small contribution on the subject. Even though I have postgraduate studies in economics I am not a specialist, and this document is a common sense rather than an academic approach on the subject, and it is written for the general reader with no economic knowledge. English is not my first language and you will have to excuse my syntax.

The essay is mainly a critique to both the traditional Marxist approach on monopolies, and to the more modern academic approach, the so called "neoclassical theory of competition and monopoly". According to the traditional Marxist approach, capitalism leads to economic monopolies. Poor people become poorer, and capital is concentrated in fewer and fewer hands, and at the end of this process capital ends up in the hands of a small group of capitalists. The modern academic approach does not claim that. It examines whether government has to ensure that companies do not acquire excessive market power and use this power to charge consumers with "unfair" prices.

The two approaches are not irrelevant of course, but rather one is the continuation of the other. You cannot afford to ignore either of them, since they are both used to this very day. The Marxist approach is mainly used in the form of propaganda to convince the public that capitalism is bad and socialism is the solution, while the neoclassical approach examines whether government intervention is required in order to protect consumers from large companies.

My impression is that non economists tend to believe the Marxist propaganda which postulates that capitalism i.e. the free market, does indeed lead to monopoly. I think they believe so because they have been exposed to a lot of Marxist propaganda. The size of the huge corporate champions of the business world tends to enforce such beliefs. Socialists have convinced them that the large corporate size is equivalent to economic monopoly, which is actually something very wrong. Think of a small island where the government has issued only one taxi license. Is this taxi a monopoly? Of course it is, since it is the only provider of a particular service. Therefore the relationship between company size and monopoly is not as simple as it seems.

Since large corporations have been the victims of such intensive socialist propaganda, there is no point in examining the issue of monopoly, if we don't first examine large corporations irrespective of ownership. That is without examining if they privately or publicly run. After all under both forms of ownership the aim is to produce as much wealth as possible. After I examine company size, I turn my attention to the issue of ownership and monopoly. So what is it that determines the size of corporations? Which is the right size? Is it better for a company to be small, medium or large? After all a bakery wants to produce as much bread as possible whether it is publicly or privately run. Therefore the most important issue is how more bread can be produced. Is it better for the consumer if one or many small companies exist? How many bakeries should exist in a

market? What should the optimal market structure be? By market structure I mean the number and size of companies in a specific market.

## Factors that lead to large corporate sizes

It is better to think about the factors that lead to large corporate sizes in a communist economy, in order not to confuse company size with capitalism.

### Economies of scale

Economies of scale refer to a decrease in the average production cost with increasing levels of production. For instance a production unit costs 100 euros when 1.000 units are produced, 98 euros when 2.000 units are produced, 40 euros when 20.000 units are produced and so forth. There are many reasons why increasing levels of production lead to a decrease in average cost. Specialization is a good example. Imagine a company in a communist country that is producing 1.000 units of a product. This production level might allow for only one administrative employee. This employee must be both and accountant and a secretary. A production level of 2.000 units though, could possibly allow the company to operate with two administrative employees, one secretary and one accountant. These specialized employees could be far more productive. There are many other reasons why increasing levels of production lead to lower costs. Economies of scale are a very common and a generally accepted concept in economics.

Many non economists though, tend to think that economies of scale are present during all levels of production i.e. the more a company is producing the lower the average cost is. But this is of course nonsense. At some level of production economies of scale turn to diseconomies of scale, and this is accepted by all economists.

### Diseconomies of scale

Diseconomies of scale refer to rising average costs for higher levels of production. This can occur for many reasons, for instance due to bureaucracy. The larger a company becomes the more people are required to monitor its operations, and the harder it is for decisions to be taken, since it is impossible to have managers who know everything about the company. There are many other reasons why diseconomies of scale appear at some production levels. Moreover it is very difficult for very big companies to adjust to changes in consumers' tastes. Imagine a company in a communist country that produces 100 thousands units and another that produces 10 million units. It is much harder and costlier for the larger company to change its product.

If economies of scale persisted for all levels of production, Marx's prediction about capitalism and monopoly would have been realized, at least for standardized products i.e. salt. But as we observe this is not the case. It would actually be very nice if average costs continued to fall for all levels of production. At the limit unlimited amounts could be

produced with almost zero average cost. Unfortunately this is not what happens. But non economists tend to focus on the advantages of being large and forget the disadvantages of being large. Economists are of course fully aware of diseconomies of scale.

**Transaction Costs Economics TCE**

"Transaction cost" economics is a totally different approach to explain the size of companies. Economies of scale refer to production costs. Transaction costs refer to a very different category of costs. It is easier to understand "transaction cost" theory, when production costs are assumed to be known and given for everybody i.e. anybody can manufacture an iphone given he has the required capital. This is very unrealistic but it enhances illustration of what transaction costs are.

Let me give an example of a transaction cost. I have a business and I need someone providing cleaning services for 8 hours a day. Let's say that the market daily wage for such a service is 25 euros. This is not a transaction cost but a production cost (I use the term production costs to also refer to administrative, financial costs etc for greater simplicity). I will pay this production cost (25 euro) whether I hire this person as an employee or whether I use his services as a separate business entity. The price of 25 euros for this service is something determined by the market i.e. how many people are offering cleaning services and how many people are looking for such services.

The question is whether it is better for me to hire such a person or him in the form of an external cleaning service provider. In both cases there is a production cost of 25 euros. What is best for my company? To answer this question one needs to take into account transaction costs. If I use that person as an external associate, a contract must be written. And the contract must clearly specify what he will do and how he will do it, and many other details. And if the person providing the cleaning service does not honor the contract's terms I would have to go to the court. If I hire him on the other hand, we would only need to agree that he will clean for 8 hours a day in the way he will be instructed to, which is much simpler. On the other hand an external cleaner might be more motivated because he knows that I can try somebody else at any time, while an internal employee might not possess this kind of motivation and need supervision. But then again I can train my employee to do things in exactly the way I want things to be done. So what is better for my company? Well there is not a clear cut answer. It depends on transaction costs. There are both benefits and costs when a company integrates more operations.

And this is not only true in a capitalist economy. Transaction costs have nothing to do with capitalism. Imagine that I am the manager of a company producing ice cream in a communist economy. People in communist economies eat ice cream too you know. And companies in communist economies have managers too. I am therefore the manager. Let's assume that there is no money. We count costs in terms of working hours. There are other public companies producing ice cream in the country. The communist leadership evaluates my efficiency in terms of how many working hours it takes for my ice cream to be produced and how good this ice cream is. I therefore need to be at least in the same

position in terms of cost and quality i.e. 5th costlier and 5th in quality. If I am 5th costlier and 6th in quality I am inefficient and if I am 5th costlier and 4th in quality I am efficient.

I must therefore improve the company's performance to impress the communist elite, otherwise they will demote me. Let's further assume for simplicity that I only use milk to produce ice cream, and I take this milk from any public milk company I want. Assume that milk costs 1 working hour per liter, and that the production of 1 kilo of ice cream only requires 1 liter of milk. Therefore if it takes me 1.5 working hours to convert 1 liter of milk to 1 kilo of ice cream, my ice cream costs 2.5 working hours per kilo. But I want to do better than that in order to impress the communist elite. Would it be better for me to run a milk company too? Remember I assumed that production costs are given and known, which means that I can also produce 1 liter of milk per working hour if the communist elite allows me to run a milk company. What would be better for my final product i.e. my ice cream? Well, it depends again on transaction costs.

If I have my own milk company I will always have my milk on time, and there will be no more delays. Moreover I will make sure that the milk is always very fresh, while the current manager might give me milk that is not very fresh to squeeze his costs and impress the communist elite. I will also save the time I spent on checking the quality of the milk. On the other hand if I run a milk company too, I have to run a bigger company and it will be harder to control everything and I will have to rely on other people which might affect the quality of my decisions etc.

I hope the above provides in a simple way the "transaction cost" economics approach in explaining company size.

**Technological Progress**

Imagine two factories in the same town both producing nails, and assume that consumers need 2.000 nails per month. Both factories have equipment that produces 1.000 nails per month at full capacity. But due to technological progress a new machine comes out which can produce 2.000 nails per month. For the technological progress to lead to lower prices one of the two companies must go. If both companies buy the new machine, and continue to produce 1.000 nails each, prices cannot go down since costs will have increased (new equipment) while sales have stayed at the same level. Actually prices have to increase if both companies buy the new equipment.

But if only one company is left, prices can fall. There are various ways for one of the companies to go. There might be a consolidation, one of the companies might go bankrupt etc. But no matter how this comes about, it is obvious that there is only space for one company. The example could involve 100 companies and technological progress could have wiped out 60 of them. The question is do we want cheaper nails or not? If we are not sellers and we are consumers we should prefer cheaper to expensive nails. If we sell nails we might prefer expensive nails of course.

**The Development of Capital Markets**

Large corporations involve investments that are far beyond the limits of even the biggest capitalists. The gradual development of capital markets made possible the pool of resources and allowed large projects to be realized. The more sophisticated the capital markets become the larger the companies can become.

**Taxation and company size**

It might sound strange, but the socialist way of taxation led to larger company sizes. One of the principles of socialist taxation was to tax companies in two levels. That is to first tax the company's profits at a certain tax rate, and then impose an additional tax for the profits distributed to shareholders in the form of dividends. The purpose of this form of taxation is to offer incentives to companies to reinvest and not distribute profits.

Assume that a company makes 100 euros of profit. Let's say the tax rate is 30%. The company pays 30 euros in taxes and there is another 70 euros left. If these 70 euros are not distributed to shareholders, socialists do not impose further taxes. If on the other hand they are distributed as dividends, there is an additional tax of 20% on the 70 euros that are distributed (random numbers). Thus the owners have an incentive not to take their profits, hoping that these profits will be reinvested and generate further profits, which will be reflected in a higher share price. And they can then sell their shares receiving their profits in the form of capital gains which are usually taxed with very low rates. At least they were taxed with very low rates in the past to enforce this socialist incentive scheme for reinvestement. Such policies are of course wrong. Company size should only reflect economic factors and not tax incentives.

Moreover profitable companies have an incentive to buy other companies that have accumulated large losses in the past, in order to use them for tax purposes. The highest the tax rates are, the higher the incentive to do so.

## The Ideal Company Size

All the above factors i.e. economies of scale, transaction costs, technological progress and taxation affect company size. They are by no means the only factors affecting size. They are only some obvious considerations. After examining the above factors one has to wonder what is the optimal company size. According to Murray Rothbard there is no optimal company size. Each entrepreneur has to decide what the optimal size of his company is. On a theoretical basis one can only makes some basic assumptions about the optimal company size. For example economies and diseconomies of scale dictate some boundaries within which optimal size should be.

If for instance market conditions (technology, prices of raw materials, human capital, consumer tastes) in the automobile industry, lead to decreasing average costs until the production of 200.000 units, then the minimum company size involves production of 200.000 units. In the same way the other factors I examined dictate boundaries for company size. But the actual size can only be determined by the specific entrepreneur.

The optimal size for Apple is different if it can sell 100.000, 200.000 or 100 million iphones. But we could say that economies of scale and transaction costs play a more important role in determining company size in markets for homogeneous products (i.e. salt), and a bit less important role in markets for products with great differentiation where the role of entrepreneur is more significant.

We could say that the optimal company size is determined by consumer preferences (quantities and quality required), from the ability of the economy (technology, availability of resources, human capital etc) to satisfy these needs, and from the ability of the specific entrepreneurs to detect and satisfy consumer needs by using scarce resources (highest possible quality at the lowest possible cost). The entrepreneur is a bridge between consumer preferences and scarce economic resources. And of course a charismatic entrepreneur will better satisfy consumers, will attract more clients, and employ more resources, and will end up with a larger company than a less charismatic entrepreneur facing the same conditions. In the place of the capitalist entrepreneur could be a manager in a communist economy without changing my discussion until now. I am not yet talking about capitalism or socialism, but instead for production units stripped from ideologies.

Therefore there is no optimal company size, but only boundaries within which a company's size must be. What is unambiguous is that if the minimum possible price of salt is 50 cents per kilogram, and each production unit needs to produce at least 100 thousands tons to achieve this price, then the smallest company should produce at least 100 thousand tons of salt, both in capitalism and socialism. A useful concept for the discussion is that of "minimum efficient scale" of production (MES). Minimum efficient scale refers to a level of production at which it is not possible to increase production and achieve further economies of scale. Whether constant economies or diseconomies of scale appear after economies of scale depends on whether we consider the average cost curves to be L or U shaped, but this is beyond the scope of my document which is not a microeconomics document but a common sense approach to the issue of monopolies.

## Company Size and Socialism

To show that the large company size has nothing to do with capitalism, I would like to use the example of the Soviet Union and Sweden. The first was a communist economy and the second is very often used by socialists as a proof of the superiority of socialism over capitalism. It is actually a myth that Sweden's success has anything to do with socialism, as I explain in my document "The Swedish Economic Model: A socialist or a free market success", but nonetheless socialists very often use Sweden as an example. In both these countries the market was dominated by a small number of large companies.

### Sweden & the Soviet Union

Sweden is considered as the country of multinationals. The following link

http://www.forbes.com/lists/2006/18/Sweden_Rank_1.html

mentions 26 Swedish multinationals that are in Forbe's list with the 2.000 biggest companies in the world. Total revenues of these 26 largest companies amount to 230 billion dollars. In other words the revenue of the 26 largest companies of "socialist" Sweden's is almost equal to the GDP of Greece (they both have approximately 11 million inhabitants). Socialists use Sweden as a proof of socialism's superiority, and at the same time socialists blame everything on "greedy multinationals". And the funny thing is that the success of the "socialist" Sweden has always been based on her very successful multinational. This is a very inconsistent socialist rhetoric. In the following link

http://www.scanmagazine.co.uk/2010/08/sweden-small-country-with-big-companies/

Sweden's minister of commerce (2010) proudly explains how Sweden managed to become "the small country with the big companies".

M. Henrekson and S. Davis of the universities of Stockholm and Chicago respectively, in their article "Explaining National Differences in the Size and Industry Distribution of Employment", examined the reasons that led to large enterprise sizes in Sweden compared to the rest of the world. In page 6 of their article, they mention research conducted by the Swedish government in 1992, according to which Swedish companies with at least 500 employees employed 60% of the Swedish workforce, while the European average was 30.4%. On the other hand companies with less than 10 employees, employed less than 10% of the workforce in Sweden while the European average was more than double that figure.

The Soviet Union was another example of a market dominated by few and very large companies. In page 3 of their article "The Myth of Monopoly: A New View of Industrial Structure in Russia", three academics from the university of Pennsylvania, explain that it was generally accepted in the Soviet Union that very large production units would lead to decreasing costs, and they provide further evidence. But I do not actually think that anybody claims this was not the case in the Soviet Union.

Since both in capitalist and socialist economies there is a tendency for companies to grow larger, one must conclude that large company size is not an attribute of capitalism or socialism, but rather a result of economic factors. And since both capitalism and socialism want as much wealth as possible to be produced, they must use large production units if the latter lead to more wealth creation.

I hope the discussion up to this point has persuaded the reader that large company size is not necessarily something negative, and that it is not an attribute of capitalism. And it is finally time to turn to the issue of "monopoly".

## The two theories of monopoly

There are as expected two theories of monopoly, the socialist one and the libertarian. The socialist theory believes in "**economic monopolies**", and the libertarian theory believes in "**political monopolies**". When I say socialist theory I mean both the traditional Marxist

approach to monopolies, and the more modern theory of monopolistic competition. And I discuss them separately. According to the libertarian theory, monopolies are always created by **governmental laws**. They are therefore political monopolies. This can take the form of a public company which is by law the only company in the market, or it can take the form of very few private companies that enjoy government protection and support. They are private in the sense that they are not owned by the state, but they are still protected by the political system and in return they offer political and financial support to politicians either legally or in the forms of bribes.

According to the libertarian theory, as long as there is no barrier to entry in the form of regulation, there is no monopoly irrespective of the number and size of companies in a particular market i.e. the market structure. The only condition of this theory is that anybody having the capital and will to enter into a market must be allowed to do so. Therefore this view of monopoly does not relate the concept of monopoly to the size and number of companies, but rather to **an absence of pressure for decreasing costs and improving quality**.

On the other hand, the socialist theory of monopoly, which is by far the more widely spread and accepted, claims that monopolies are created by the free market, and therefore they are economic monopolies. According to this theory the state has to intervene to protect its citizens from the free market. What is crucial for this school of thought is the **number** and **size** of companies in a market.

The libertarian theory claims that monopolies are the result of government laws, which is quite straight forward, and therefore I will not discuss this theory any further. I will focus instead on the issue of economic monopolies and I will examine both the Marxist and the neoclassical theory of monopoly.

## Marxism and Monopoly

Marxists in a way believe in the capitalist equivalent of "Chuck Norris". They believe that capitalism leads to a capitalist that will beat all other capitalists, and employ and exploit all of us. And they therefore argue that capitalism leads to monopoly, and the only difference with socialism is that in capitalism the monopoly is run by a private tyrant that exploits everyone, while in socialism monopoly is run by righteous state employees that use their monopoly power for the benefit of their people.

In essence Marxists cannot distinguish between Microsoft and a state company. They do not see much difference between Microsoft, which derives its power from its ability to satisfy consumers, and a state monopoly which derives its power from the parliament. Actually Microsoft is a very good example, because it keeps improving its products and prices, without facing significant competition all these years. And the reason is that if Microsoft does not improve its products and lower its prices, one can keep using Microsoft XP and not upgrade to Windows 7. And if that happens profits will fall and the people that run the company will be fired. In other words Microsoft faces so much pressure without significant competition, simply by the threat of falling profits or the

appearance of a potential competitor. Imagine if all these years there were another 5-6 companies seriously competing with Microsoft.

And the funny thing is that Google appeared out of the blue, and introduced the android operating system. And if tablets end up dominating the electronics industry as many people predict, the android system might threatens Microsoft's windows. And this is not Linux or Mac, but Android which until very recently did not even exist. But that's how capitalism works. And the truth is that Android did not appear out of the blue, but they were brought forward by another giant, namely Google. And this is where most people get it wrong. Because they think that since the small computer shop in their neighborhood cannot compete with Microsoft, no one can. But they forget that there are other giants in other sectors of the economy, that if they see profit opportunities in a market they can easily enter. They have the capital. The issue is whether there is enough profit to cover their investment. People tend to think that it is difficult to find the capital to compete with Microsoft. But they are wrong the issue is whether there is enough profit the costs. All free market companies are at the mercy of competition and consumers. And all consumers are at the mercy of political monopolies, which are immune from competition.

Private companies can indeed acquire monopoly power at some point of their economic life. But what is this monopoly power? If Samsung creates a new smart phone which we all want to buy, she will sure obtain some monopoly power. But what is this monopoly power? Isn't this monopoly power exactly the same with consumers' preference? For a private company monopoly power is nothing else than consumers' loyalty. And government regulation is the monopoly power of political monopolies. But consumer loyalty and government regulation are very different forms of monopoly power. Samsung, or any corporate giant, cannot permanently enjoy the same consumer loyalty, since it is impossible to be always the first to understand what consumers want, and always be the best in finding the most cost efficient way to provide them with what they want. It is impossible for a management team to constantly come up with the best solutions, in the same way that it is impossible for a football team to always win the championship. And we should not forget that management teams have an expiry date. People die or they go to work for other companies. They leave Samsung for Apple and vice versa.

But even if a private company is always first in satisfying consumers, why should there be any problem? It means that this company is constantly improving quality and prices. On the other hand, if the government provides only one taxi license in a small island, the taxi driver has no motive to improve services and prices, because he has monopoly power. His taxi is a monopoly but not in the sense of large profits, but in the sense of no pressure for increasing quality i.e. buying a new car or reducing prices. Only political monopolies have the privilege to ignore the pressure for better services and lower prices. And therefore in the libertarian way of thinking the taxi is a monopoly and Microsoft is not.

And Marxists should answer a crucial question. Why capitalism did not lead to economic monopolies? Marx predicted so when he published "Capital" in 1867. Marx predicted in

1867 that the poor would become poorer and the rich richer, and that capitalism would end up with a small group of capitalists owning all the means of production and would exploit everybody else (for a discussion on the socialist myth of the poor who are getting poorer, see my document "Are the rich getting richer and the poor getting poorer? Another socialist myth"). The average worker is much richer today than the average worker of 1867, and there are still plenty of companies producing salt in each country. How many centuries does it take for the markets of homogeneous products like salt, to become monopolized? Why there are still so many companies producing salt, chocolate, alcohol etc?

## Concentration of Capital and Markets

"Market concentration" usually refers to the market share of the 4-5 biggest companies of a particular market. The question however is whether companies become larger in the Marxist sense i.e. that one capitalist eats the other and wealth is constantly concentrating in fewer and fewer hands, with the poor becoming poorer an the rich richer, or whether they became larger due to cost factors, in order for lower prices to be achieved thus making more and more products available for everybody, including the poor. Because it is not enough to say that there are fewer and bigger companies in a sector than they were some years ago, to prove that the Marxist analysis is correct. If socialists are right, the fewer and larger companies in a market must have caused the production of lower quality and more expensive goods. If on the other hand increasing concentration led to higher quality and lower prices for goods, the Marxist analysis must be wrong, and there must be other factors i.e. cost factors, that led to increasing concentration. So what do you think? What has happened to the quality and pricing of products since 1867 when Marx's "Capital" was published? Do workers today have access to more and higher quality or less and lower quality products than they had almost two centuries ago?

Therefore if socialists want to prove that Marx was right about capitalism, they have to prove that increasing market concentration leads to products that are of lower quality and higher prices (actually Marx was very wrong and most economists today agree on that, and I provide a simple explanation of why this is so, in my document "Why Marx was wrong"). Steven Lustgarten, in his article "Productivity and Prices: The Consequences of Industrial Concentration" showed that for the period 1947-1972, price increases were lower in industries with the highest increase in concentration, and in industries with the highest decrease in concentration, as compared to price increases in industries with relatively stable levels of concentration over time. He claims that changes in industry concentration were due to technological development which caused changes in the market structure and increased productivity, thus putting downward pressure on prices. While he claims that in industries that did not experience significant technological progress, concentration and prices tended to remain stable over time.

There is a lot of research on whether higher industry concentration leads to higher or lower prices. You should know that for every academic article that claims that higher market concentration leads to price increases, there is another paper showing the

opposite. You just need to google expressions like “benefits of industrial concentration, benefits of market concentration, cost reductions-industrial concentration, why market concentration is good, which is the optimal market structure, benefits of mergers and acquisitions, prices and industrial concentration, innovation and industrial concentration” and you will find plenty of evidence.

People also tend to forget that large corporations are the sums of a huge number of capitalists. Millions of small, medium and large capitalists hold the shares of large corporations. And this was actually the reason that the institution of the stock market was invented i.e. to make huge projects feasible. Assume that there are 1.000 businessmen producing a particular product. And they then form a new company in which they all hold shares. Is there an increase in concentration? Well there is but isn’t this a pool of resources in a common effort to exploit economies of scale? In reality of course, not all of the 1.000 businessmen will hold shares in the new company, but some will go bankrupt instead. But there is an inherent risk in the business world and bankruptcy is a possibility for both a small grocery shop and a large corporation.

And to have an idea of the dispersion of ownership in large corporations, I provide the following links from yahoo finance. The following link states the largest shareholders of Microsoft

http://finance.yahoo.com/q/mh?s=MSFT+Major+Holders

And this link states the largest shareholders of Apple

http://finance.yahoo.com/q/mh?s=AAPL+Major+Holders

The largest individual shareholder of Microsoft is Bill Gates with 357 million shares, which represent less than 5% of ownership. And this man is the founder of Microsoft. The next biggest individual shareholder is Kevin Brian Turner with 1.5 million shares, which represent a bit more than 0% of ownership. The largest institutional shareholder of Microsoft is Vanguard Group with 366 million shares worth 12 billion dollars, representing less than 5% of ownership. And then there are few other institutional investors with a bit more than 1% ownership.

For Apple the largest shareholder is Arthur Levinson, with 162 thousands shares, which represent ownership of a bit more than 0%. The largest institutional investor is again the Vanguard Group with less than 5% of ownership. And it must be noted that Vanguard Group is a company investing for millions of smaller investors. Consequently the ownership of large corporations like Microsoft and Apple is widely spread. **Note** that the data are not recent and my aim is not to provide up to date data, but rather to demonstrate the dispersion of ownership in big corporations.

I also want to give an example to show that market concentration is not necessarily something negative. Imagine an island where only cars and nothing else is produced. And there are let’s say 10 companies producing cars. After 10 years there are only 4

companies manufacturing cars but there is also a computer industry. Cars account for 40% of the island's economy and computers for 60%. Has market concentration in the automobile industry increased? Well it did, but is this something negative? It is not because new companies appeared in other sectors. Isn't that what we want? To produce what we already produced with less resources, in order to have resources for the production of new stuff?

Imagine 10 fishermen living in an island. In the beginning they are all fishing. Isn't it a good thing if after some years, due to technology improvements, only 2 people are catching the same or even a larger amount of fish than before, and the other 8 people are producing something else? Doesn't that make the island as a whole richer? If in 1950 there were 100 automobile industries employing 100.000 employees, and now there are only 40 companies employing only 50.000 employees, but at the same time these 50.000 employees are producing a larger quantity of higher quality automobiles than in 1950, it means that 50.000 people are freed from the automobile industry and can spent their time producing computers. That is what wealth creation is about.

## The price mechanism

Non economists have a tendency to confuse the workings of the price mechanism with monopoly. And before explaining what I mean, I want to say a few words about the price mechanism. One of the strongest arguments against the Marxist model is that it does not allow the price mechanism i.e. the law of demand and supply, to allocate scarce economic resources. Without the price mechanism, the state has to decide how resources must be allocated. For instance the bureaucrats will decide that 100 oranges and 100 lemons will be produced without considering consumer preferences. Therefore if consumers prefer 150 oranges and 50 lemons they will not be able to manifest their preferences through the price mechanism.

In a capitalist economy on the other hand, excess demand for oranges and excess supply of lemons, would push orange and lemon prices upwards and downwards respectively, increasing and squeezing at the same time profitability for oranges and lemons. This would create new jobs in the orange market and a loss of jobs in the lemon market. The result would be a transfer of labour and capital from the lemon to the orange market. This process would stop when the market would reach a production level which would be in accordance with consumer preferences i.e. 150 oranges and 50 lemons. It is therefore this mechanism that signals that a transfer of resources must take place.

If Nokia manufactures a very good smart phone that we all want to buy, she will indeed be able for a while to charge high prices, since consumers will not consider smart phones sold by other companies as close substitutes, and they will have a strong preference towards the Nokia smart phone. Some companies might even go bankrupt, but you cannot blame Nokia for coming up with a better product. It is the price mechanism that will drive these companies out of business. The price mechanism will signal that the market needs more Nokia style smart phones, and it will manifest that through increased profits for Nokia and reduced profits for her competitors. Because that is what the price

mechanism does. It shows through profit fluctuation where and how scarce economic resources should be allocated. And what is the price mechanism or the law of demand and supply? It is the needs of consumers on one side (demand), and the ability of the economy to satisfy these needs on the other side (supply). There is therefore nothing wrong with increasing profits in some sectors and decreasing profits in some others. That is of course if the market is left to operate freely. If on the other hand the government intervenes excessively, increasing and decreasing profits might also show the relative power of interest groups that put pressure on government in order to gain privileges.

Moreover the libertarian competition model is based on what is called "innovation and imitation". Companies struggle for a market share, and some of them manage to introduce new products and make large profits. The other companies will try to imitate the innovative companies, until they manage themselves to come up with something new. How easy it is for other companies to imitate depends on how sophisticated the product is. If for instance a company made large profits because it understood consumers' need for more tomatoes, very quickly the other companies will increase production of tomatoes. If profits are due to a highly sophisticated and technologically advanced product, it will take some time for other companies to imitate or come up with something better. It might also be possible that the new product is protected by a patent and therefore the other companies have to wait some time before they are allowed to produce the product themselves. Patents should not be confused with government intervention. Patents must be protected in the same way that our home is protected otherwise businesses will not have a motive to invest on research and development of new products.

There is also the issue of "excess profits". What do we mean by "excess profits"? There is no such thing as "excess profits". By penalizing profits we also penalize the price mechanism which is the foundation of capitalism. And we should not confuse the cost of entering into a market with the profit opportunities that the market offers. If indeed a market offers profit opportunities new companies will enter. For instance if Samsung needs 1 billion euros to enter the automobile industry, she can find the capital to do so. Capital is not the issue for Samsung. The issue is whether the automobile industry has enough profits for one more player, or whether Samsung can come up with something better or cheaper than the products already produced in this market.

## The free market anti-monopoly self defense

There are many mechanisms that protect the free market from monopoly policies. These mechanisms ensure that there will be a continuous improvement in quality and a continuous reduction in costs and prices.

**a) Substitutes** For almost all products there are substitutes i.e. motorbikes, bicycles, public transportation are all substitutes for cars.

**b) Potential Competition** Even if there is only one company in a market, there is always the chance that new competition will appear. This company has a motive to continually improve its products and prices to discourage potential competitors. Microsoft's windows

and Google's android is a good example. Only by government regulations can a company become immune to competition.

**c) Demand Elasticity** Demand for goods is never perfectly inelastic. For instance a dramatic increase in the price of cigarettes might lead consumers to quit smoking (actually taxes account for most part of the price of cigarettes). Or consumers can reduce the quantity they purchase or stop buying the new products of the company. For instance if Microsoft charges very high prices, consumers might decide to stay with windows XP and not buy windows 7.

**d) Competition from all goods in the market** People tend to think that a product only competes with similar products, which is not true. For instance a Fujitsu laptop does not only compete with an HP laptop. In reality all products compete with all products, because consumers' income is limited and given. Therefore Fujitsu has to persuade a consumer to buy a new Fujitsu laptop and not a new bicycle or a new dvd player or take a short holiday instead. All companies compete with all companies in a free market.

**e) Free International Trade** As Milton Friedman said, the best defense against monopoly practices is to open the country to international competition. That is guaranteed to bring the lowest possible prices for consumers. And free international trade cannot lead to unemployment as I explain in my document "Free Trade or Protectionism? A Case for Free Trade".

**f) Division of labor and specialization.** One of the main reasons capitalism managed to create this tremendous wealth in only 3 centuries, is the division of labor and specialization. Before capitalism that is before the market economy, every small society was organized as a self sufficient economic unit. Even families were organized as small self sufficient economic units. Each family would produce almost everything it needed. The market economy introduced the division of labor and specialization. Great businessmen became great because they had a specific talent. Bill Gates managed to create Microsoft, but that does not mean that he could be a successful businessman in the automobile industry, or that he could have made Microsoft what it is, without the help of millions of others i.e. employees, shareholders, scientists etc. I mean that Bill Gates is nothing on his own. He was clever in something, he had luck, but he is too insignificant on his own to control the world as Marx predicted, even with the help of some other mean capitalist friends.

## The neoclassical theory of monopolistic competition

The Marxist theory of monopoly has long been discredited and it is rarely mentioned in academia. It is mainly used as a means of propaganda, as a means of convincing people that they need more government. In academia the neoclassical theory of monopolistic competition is taught, and even though it is a wrong theory, it is much more serious than its Marxist counterpart. Even though it is not probably correct to say that one wrong theory is more serious than another wrong theory, but anyway. The neoclassical theory of monopolistic competition can be found in most microeconomic textbooks if not all, and is taught in the best universities of the western world.

This theory is very strongly related to the supposedly superiority of equality over freedom. In the same way that we are taught that all people must be equal, we are taught that all companies must be equal. People that have studied economics will recognize egalitarianism as the basis of the neoclassical theory of **perfect competition** and **monopolistic competition**. Contrary to the Marxist approach this theory is in favor of a market economy but it recognizes as the PERFECT (and therefore ideal) form of competition, an economic environment where: a) There is a very large number of small firms b) The products produced are almost identical c) All consumers and producers have complete knowledge of the market d) There are no barriers to enter and exit the market e) Companies cannot affect prices i.e. they are price takers.

It is clear from the above that the philosophical base of perfect competition is equality (egalitarianism). In the same way that all people must be equal, all companies must be equal. After all, companies are simply an extension of people. Therefore to accept the above form of competition as perfect, is to indirectly also accept that the opposite i.e. a market with a few large companies that sell differenciated products, which have some control over their prices, and which have established some forms of barriers of entry i.e. successful brand names, is an inferior and problematic form of competition.

But they forget something very important. From all 5 characteristics of perfect competition, the element of competition is absent. The large number of small companies ignores the struggle of companies to grow larger in order to exploit economies of scale and become more efficient than their competitors. The assumption of identical products forgets that companies have to differentiate their products in order to make them more attractive to consumers, than their competitors' products. The absence of barriers of entry means that companies should not establish successful brand names, or obtain high capitalization to exploit economies of scale. The assumption of perfect information forgets that one factor that separates successful from unsuccesful businessmen is the ability to communicate with customers. Finally to consider companies as price takers, is to ignore that companies must always struggle to find more cost efficient ways of production to obtain an advantage over their competitors.

Therefore the whole idea of perfect competition is totally incompatible with the notion of competition and perfectly compatible with egalitarianism. The economic environment it refers to is a business environment of zero competition and of equal business opportunities. It is clearly a socialist idea. And it is the idea of perfect competition that leads to the arbitrary assumption that a market with few large companies is not competitive. But this is not true. Large companies are the result of severe competition and of consumers' pressure for better products and prices and not the result of monopolistic or oligopolistic competition.

## The basic argument of monopolistic competition

I will now present the basic argument of monopolistic competition by giving an example. It might look silly to someone that never took a microeconomic course, and yet it is on

this silly idea that monopolistic theory is based. And the idea that the government should intervene to protect consumers from monopolies, is based on the theory of monopolistic competition, and therefore this silly idea that I will present have very important repercussions. It is actually a silly which is taught at all western universities.

Assume that there is a manufacturer of tables. He buys wood and produces tables. The more tables that he produces the lower their selling price will be. The latter follows from the law of demand and supply which says that a higher supply leads to lower prices (ceteris paribus). This is a theoretical model and therefore prices are supposed to be know for different level of production i.e. the producer knows what the price of a table will be if he produces 100, 1.000 or 100.000 tables. He knows prices before even producing a single table. This is not realistic but this is only a theoretical model and not real life.

Let's assume that he can sell each table for 10 euros if he produces 1.000 tables and 9.95 euros if he produces 1.001 tables. We see that the increase in quantity supplied generates a small fall in price from 10 to 9.95 euros or 0.05 cents. The thing is that the price fall does not only involve the last piece but all production i.e. each one of the 1.001 tables will be now sold for 9.95 and not 10 euros. And this is what makes the difference. Assume that marginal cost i.e. the cost of producing one more table, from 1.000 to 1.001, is 4 euros (fixed costs do not change with production). What would the producer do? Well by producing the 1.001th unit, he would incur a variable cost of 4 euros, would receive and additional 9.95 euros, and lose 0.05 for all the previous 1.000 units i.e. 1.000 times 0.05 =50 euros. Therefore the effect on his profits from the production of the 1.001th unit would be -50-4+9.95= -55.55 euros, and therefore he would not produce the 1.001th unit.

If on the other hand the company was operating in an environment such as the one described by perfect competition, the producer would be a price taker, and therefore he would go ahead with the production of the 1.001th unit. Because he would be a price taker, and therefore his production would not affect costs or selling prices. Therefore the situation would be the following. He would pay an additional cost of 4 euros, he would receive 10 euros for the 1.001th unit, since his increased production would not affect prices, and he would therefore increase his profits by 10-4=6 euros. He will then continue to produce until his marginal cost equals price i.e. MC=P. For those that have taken a course in microeconomics, what I am saying is that a monopoly produces until marginal cost equals marginal revenue i.e. MC=MR, while a perfectly competitive company produces until marginal cost equals price i.e. MC=P.

Therefore the dominant model of the neoclassical competition theory claims that the government should intervene to prevent companies obtaining significant market power, because significant market power will lead to higher prices and lower number of units produced, and therefore lower employment. Therefore the basic argument of monopolistic competition, and therefore of government intervention is that the "non-perfectly" competitive producer will take into account the effect that his production will

have on the prices of his product, while the "perfectly" competitive producer will not take this into account.

And it is this model that determines government policies and not the Marxist nonsense. The Marxist monopoly nonsense is simply used to develop a corporate phobia to the public. Because it is much easier to say to the public that the poor are getting poorer and the rich are getting richer and that capital is increasingly concentrated in a few hands and bla bla bla, and that capitalism leads to monopoly, than explaining the neoclassical theory of competition. The Marxist approach is much more convenient for propaganda purposes. But policy makers in the Western world do not consider the Marxist nonsense at all. Policies are rather based on the neoclassical theory of competition.

## Criticism to the model of monopolistic competition

My criticism to the Marxist view of monopoly applies to the model of monopolistic competition too, and therefore I will not repeat it here. I will simply add a few things. As I already said, the key argument of the monopolistic theory is that big companies have some control over their prices, while small companies are price takers. But this is not a realistic assumption, since in reality all companies have some control over their prices, even the small ones. Moreover to penalize increased market concentration, is to give wrong incentives. Imagine a market with 4 big companies, where one of them has come up with a more efficient way of production. And the company wants to pass the reduction in cost to prices i.e. sell at lower prices. But if the company does so, it might increase its market share and drive some companies out of the market, thus making the state's competition commission to take action against it. And therefore the company might decide to keep prices at the current level.

The other problem is that the government has to decide which price is low, reasonable or high. But how can a government decide that? If one invents a new vehicle that can fly and can substitute cars, how much should he charge for it? What should determine its price until competition comes up with something similar or even better? Should the price be determined by its cost, by the inventor's intelligence, by its utility to consumers, a combination of these factors or something else? Why not let consumers decide what they are willing to pay for it? Is there really a better way to determine the right price? For an excellent criticism to the theory of monopolistic competition see chapter 2 of Dominick Armentano "Antitrust and Monopoly: Anatomy of a policy failure", Brian Simpson "Markets don't fail", and Brian Simpson's super article "Two theories of monopoly and competition", which you can find at the following link

http://na-businesspress.homestead.com/JABE/Jabe112/SimpsonWeb.pdf

## The rhetoric of economic monopoly

Politicians very often attack large corporations and multinationals because there is a huge dispersion of ownership and nobody pays much attention. People that hold significant

numbers of shares are very few and they represent a very small number of votes. And politicians care about votes. Only with large number of votes they can remain in their office. And voters do not perceive attacking multinationals as an attack on their own interests, even when they hold some shares. But they should care because these companies are very important to them. And they are important not because they might hold a few shares, but because of the great products that these companies manufacture. But there is so much propaganda about big companies that people tend to be very suspicious towards them.

The truth is that the rhetoric of monopoly is always put forward by small less competitive units, in order to protect themselves from competition from larger and much more efficient producers. Small production units i.e. farmers, always represent more votes than big companies, and they therefore can exert much more political pressure. But people tend to think the opposite. That is they believe that the 50-100 largest companies of the country, actually run the country. But this is very wrong. Sure the political system can have and almost always have linkages to these companies, and might receive financial support or even bribes in corrupted countries, but it is always the large number of voters that keep politicians in place. And politicians care much more about gaining the support of strong guilds than the support of multinationals. Multinationals cannot keep politicians in office, but strong guilds and syndicates can. It is always and everywhere true, that the rhetoric of monopoly is in reality used to protect less efficient production units from competition and leads to higher and not to lower prices for consumers as politicians claim all the time.

I mean that the rhetoric of monopolies is used to cause corporate phobia to the public, and thus justify the introduction of regulations which are supposed to protect consumers from higher prices, but which are in reality meant to protect small inefficient producers that represent significant voting power i.e. farmers, or to protect large domestic producers from more efficient foreign competitors. In either case the result is higher prices for consumers.

## Conclusion

If after reading this document one agrees that large companies and high market concentration is not necessarily something negative, one has to also realize that it is not possible to have very large numbers of very big corporations. Germany cannot have hundreds of automobile companies, because such economic sizes require huge amounts of capital to operate. And the economy does not only need automobiles, but it also needs medicines, food, houses, computers etc, and therefore there must be some champions in all economic sectors. The more the German economy grows the more automobile companies she can have, if that is what German people want.

What I mean is that there are few large corporations in the automobile industries because large economic size is required to produce better and cheaper cars, and there are not hundreds of such companies because an economy cannot afford to have many such companies, and not because capitalism leads to monopoly. An economy can only afford

to have a few giants producing something. Some countries cannot afford to have any such companies actually. Therefore if we want highly sophisticated products at good prices, we have to see large companies as something positive, and at the same time we should not expect to see hundreds of them. The question then is what do socialists want? Do they want many small automobile, computer, airplanes companies to be happy and stop saying that capitalism leads to monopoly? Do they want each city to produce its own cars and airplanes in the same way it produces its own bread?

The wise thing to do before calling a market monopolistic is to observe whether there is pressure on the company or companies in this market to improve quality and prices. In my opinion the problem with these big companies is that they are under so much pressure to satisfy their clients and generate profits that they might sometimes do things they should not do. But I do not worry at all that they take consumers as granted and charge unreasonable prices.