Funding the Future

Pricing

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I wrote about supply and demand curves here yesterday. I said that the ideas implicit within them are total nonsense, as the claims in the basic model - the only one anyone ever recalls - are based on economic functions.

Then it was suggested in a comment that:

There are serious teachers and lecturers on the supply and demand curve with examples of when they don't meet, when the meeting point moves around, how they can be made to move around and then going onto teach the interesting variations from their initial 'rule'. It's taught in business studies too although possibly not very well.

Anyways, my query is this – are all these teachers genuine in their beliefs that the model is a useful approximation to some of reality as a starting point, so they are at least sincere, or are they in the direct or indirect pay of big oil?

Let me offer four answers:

* If they are genuine in their belief, they have no clue how the real world works.

* If they are genuine, but then believe they have to offer a whole range of excuses for why the model does not work in practice, why don't they go out and find out what really happens and teach that instead?

* Many are not genuine; they are just teaching what the syllabus demands and can't be bothered to argue in the interests of an easy life, and don't care what the student ends up thinking, even if it is wrong.

* I do not know where Big Oil comes into this.

To put it another way, they're stupid, they lack inquisitiveness, or they're lazy. The good ones teach something else, or do another job altogether.

What really happens?

So, the real question is what those talking about pricing by business should actually be talking about. This is something I know about from a great deal of practice and no small amount of accounting theory.

The important thing to note is that, almost entirely contrary to what the economic theory of supply and demand curves suggests, the vast majority of prices in the real economy are chosen rather than imposed. That is because, contrary to the assumptions of microeconomics;

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No one knows everything. In fact, most people retain remarkably little price information about the things they buy, even when they buy them quite often. I know there are exceptions, especially when money is very tight, but my observation is true of most people, for most products, most of the time.

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Very few goods are identical, almost anywhere. Even the same product (think of a branded box of tea, as an example) in two supermarkets half a mile apart is not the same. They are not just in different locations, but few people buy tea in isolation, so the price of a box of tea is not independent of the price of other products in each store.

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There aren't countless sellers of anything, and since most vendors still serve small geographic areas, there aren't limitless buyers either.

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The consequence of these facts means that most vendors of almost any product have some degree of market power: they can choose prices, at least within the limits of what they know about their markets, although it should be noted that their own knowledge of that will definitely be incomplete.

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There are both fixed and external costs for any institution that they will always want to cover: they do not, almost ever, think in marginal terms, contrary to what economists suggest.

There is no invisible hand

As a result, almost no firm will ever wait for an invisible hand to tell them what to charge. Instead, they set prices. To do so, they use cost accounting, desired profit margins, and corporate strategy to direct their decision-making.

The consequence of all that is that supermarkets, builders, manufacturers, airlines and many other sectors use targeted mark-up pricing based on the estimated costs of supplying a product plus a desired profit percentage, and stick to that price until competitive or regulatory pressures force a change. Even when they adjust, it is usually to protect margins rather than to find a mythical equilibrium.

What is more, administered or regulated prices are everywhere, including utilities, pharmaceuticals, telecoms, and transport. Governments themselves set prices in sectors such as energy, rail, and student education, whilst central banks fix the most important price of all, the cost of money.

Prices reflect power

Prices are not, in that case, neutral signals of scarcity; they are the outcomes of bargaining power and institutional design.

Employers suppress wages because labour markets are not competitive.

Landlords can raise rents because tenants have nowhere else to go.

Global corporations can charge what they like because we have allowed markets to consolidate into oligopolies.

Price setting, in other words, is not an issue determined by markets, but is instead a political process. It expresses who has the ability to impose their preferred outcome on others.

Expectations and stories shape the rest

The exception to this "normal" process of price setting for goods and services is to be found in financial and speculative markets, where prices bear almost no relationship to underlying cost. The price of oil rises because traders expect war, not because there are fewer barrels available. Stock markets move on belief, not the real value of companies. House prices rise because people believe they will keep growing, until they don’t.

Prices in these cases reflect what might be best called the momentum of the underlying narrative. The tidy intersection of curves on a graph tells us nothing about this behaviour.

Money matters

In a monetary economy, the ultimate constraint on prices is not physical scarcity but purchasing power, but even this is not determined by markets. If governments inject more money through spending or banks expand credit, more money chases the same goods. When the state withdraws money through taxation or banks tighten lending, demand falls.

Fiscal and monetary policy, therefore, frame the entire pricing system. Pretending that the market sets prices without acknowledging the monetary environment is a category error; it confuses outcome with context.

What follows from this?

If prices are not imposed by market power, or discovered by businesses and consumers as a consequence, but are instead chosen or administered and are shaped as much by power, government policy and the availability of credit rather than supply and demand, then the task of economic policy is to manage the institutions with most influence on this process, and not to chase imaginary microeconomic equilibria.

That means:

* Regulating monopolies and oligopolies properly.
* Supporting unions and wage bargaining to rebalance power.
* Using fiscal and monetary policy together to stabilise prices and incomes.
* Accepting that price stability is a social goal, not a mathematical accident.

The fact is that prices are social constructs. They tell us less about scarcity than about who decides. And the neat intersection of supply and demand curves, which has misled generations of economists, probably deliberately hides the real lesson, which is that every price is a reflection of power. If we want fairer prices, we need more equitable power. That is the economics that Funding the Future is about.

This post will be included in the Funding the Future glossary under the heading pricing.

It is also being included in the economics myths series.

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