The Flaw of Supply and Demand

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As a boy, I developed an absorbing interest in how things work, and every time a household gadget failed to work properly, I dismantled it, noting where each part went and what function it played in the device. In pursuing this interest, I discovered that many devices were engineered in ways that made them not only fail prematurely but impossible to repair which led me to develop a robust skepticism of the honesty of American business. (See my piece, "America on the Dulling Edge.") Decades later, when I was a college student, I found that this method of learning how things work was also useful in acquiring an understanding of theories and commonly accepted doctrines. As a result, I found that many of these, upon analysis, had little if any significant content. The Law of Supply and Demand is one such doctrine.

The Law of Supply and Demand is usually presented in textbooks in association with a graph made up of two intersecting lines, but the graphs displayed are not identical. Some show straight lines with opposite slopes; some show curved lines, one being is some sort of inverse relationship to the other. One line represents supply, the other, demand, and the point of intersection, price. Readers are told to imagine moving one of the lines to the right or left and observe how the point of intersection changes. If the supply line is moved to the left (decreasing supply), the point of intersection (price) rises; if the supply line is moved to the right, (increasing supply), the point of intersection falls. Similar but opposite results are generated if the line of demand is similarly moved. Students are induced to conclude that as supply falls or demand rises, prices increase, and as supply rises or demand falls, prices fall. Essentially, that's all there is to this doctrine.

However, if one disassembles this doctrine, important things are revealed. The graphs sometimes show straight, sometimes curved lines. But any two intersecting lines produce the same result. The nature of the lines on the graphs is irrelevant. Since lines are made of sequences of data points, data is also irrelevant. Since the lines are arbitrary, no formula can be written that relates them to each other and, therefore, the doctrine doesn't allow anyone to make any calculations. That is, the price cannot be calculated by replacing the supply and demand variables with numbers. The supply cannot be calculated by replacing the price and demand variables with numbers, and the demand cannot be calculated by replacing the price and supply variables with numbers. Although the graph gives the impression that the relationship is mathematical, the doctrine has no mathematical applications.

I am surprised that no economist has found this curious, especially since mathematical modeling is so pervasive in today's orthodox theory. For instance, Dani Rodrik [http://rodrik.typepad.com/dani_rodriks_weblog/2009/03/the-sorry-state-of-macroeconomics.

html] has written, “The economics profession doesn’t take an argument seriously until the argument can be laid out with a well-specified model that respects accepted standards of modeling. . . .” But if a well-specified model that respects accepted standards of modeling is necessary for economics to take something seriously, the Law of Supply and Demand should have been jettisoned a long time ago.

Someone may object that I have not stated the doctrine precisely, and that’s true. So let’s examine its terms.

Supply seems to be the easiest to understand. Let’s say it means the number of units of a product available for sale, although I’m not certain that this definition is accurate. But the concept of demand is another matter altogether. First of all, using the word *demand* in this context is a linguistic howler. When a robber walks into a bank, points a gun at a teller, and says, “Give me the money!”, s/he is making a demand. Demands are expressed in imperatives. That’s not what happens in the marketplace. So what can demand mean in this context? One possibility is the number of people who need a product, as for example, the number of people who need a specific drug to maintain their lives. Another is the number of people who want a product, as for instance, the number of children who want a specific toy for Christmas. Still another is the number of people who can afford to purchase the product. But none of these is part of the doctrine as precisely stated. The precise definition of demand is the number of people who are willing to purchase a product at a specific price. But this definition destroys the doctrine, because if price alone determines the demand, supply is no longer relevant even though the supply may influence the vendor’s pricing. The doctrine becomes a mere empty tautology. Furthermore is willingness to buy synonymous with buys? Isn’t it possible for a person to say, “I was willing to buy it, but I was too busy to get around to it”? But the real weasel word is price.

The Law of Supply and Demand is perhaps the most frequently cited economic principle by the American press; it is cited every time an oil company raises gasoline prices. But the precise definition of price in the doctrine is “equilibrium price” which is a purely theoretical concept. What relation it has to the actual price is a mystery.

When an oil company or an economist claims that the price of gasoline is rising because of increased demand, it/he/she is weaseling. The precise claim should be that the equilibrium price is rising because of increased demand, but that is never claimed, and even if it were, it would have no relevance unless the relationship between the equilibrium price and the actual price were specified. All equilibrium price means is the price at which the number of units for sale is equal to the number of units consumers buy. But equilibrium is a fantasy. If it is ever attained in reality, the attainment is purely accidental. So the Law of Supply and Demand plays no place in the marketplace.

It is true, of course, that retailers sometimes lower prices during “sales” to rid themselves of excess products. But they do not raise prices when the number of items available decreases. The products are sold at the fixed price until they are gone or are restocked. Even oil companies function this way at the retail level. After a supply of gasoline is delivered to a filling station, the price is set and even if a long line of automobiles forms at the station, the proprietor does not dash out and increase the price to get some of the people lined up to drive away. The same is true of toy makers at Christmas. Often one new toy becomes very popular with children whose parents attempt to buy it. But toy stores do not increase the price when they notice the unexpected demand; they merely sell the toy first come, first acquired until the toy is sold out. So the Law of Supply and Demand is a principle without a practice.

Pricing is not the only method of distributing products. In times of crisis, such as wartime, products are often merely rationed. Everyone who needs a product gets a share of those available. The manufacturer makes a profit and consumers get at least some of what they need. Another distribution method is the method described in the previous paragraph. Products are distributed to consumers first come. Again the manufacturers make a profit and those consumers who get to the retailer soon enough get what they want, those who do not get none. But what would happen if the Law of Supply and Demand were applied in the market place? The vendor would raise the price as the supply diminished, the consumers who managed to acquire the product would pay more for it than they would otherwise, and the other consumers would get none no matter how essential getting some was. This scenario is identical to the previous one except that the vendor makes a larger profit at the expense of the consumer. It is merely a method of transferring wealth from consumers to vendors without providing consumers with an additional benefit. In other words, it transfers wealth from the neediest to the needless.

This, of course, raises an important question: Why would economists advocate a method of distribution that enriches vendors at the expense of consumers? Why would they advocate an economic principle that reduces the wealth of consumers to advantage vendors? Exactly for whom does the economy exist? After all, increasing the wealth of the wealthy few at the expense of the many violates every ethical, moral, and humanistic principle ever proclaimed. Why would any decent human being advocate such a system?

The Law of Supply and Demand is an empty, tautological doctrine that is not supported by observations of the marketplace and merely serves as an excuse used by some producers to increase prices to the detriment of consumers. It is not an economic law; it is an economic flaw. It is not even a legitimate idea; it is a mere notion. So are orthodox economists who advocate this "law" merely bad people? Perhaps not; perhaps another explanation exists.

Consider this analogy. Recently I accompanied my wife to a Sunday school class. The text of the day was Acts 2 where the claim is made that Peter preached and three thousand were converted. While driving home, I said to my wife, "I wonder what kind of sound system Peter used." She quickly saw the passage's absurdity and replied by saying, "I never thought of looking at it that way." The point is that once a person adopts an ideology, questioning it rarely occurs to him/her. If such a person can be persuaded to question it, the foolishness quickly becomes evident. The fault, of course, lies in educating people in ways that do not encourage questioning orthodoxy. Yet knowledge only advances in a culture of iconoclasm. Hal R. Varian has written, "Indeed, when pressed, most economic theorists admit that they do economics because it is fun." [http://people.ischool.berkeley.edu/~hal/Papers/theory.pdf] Games are played for fun; serious thinking is not, and game playing is not iconoclastic. No one who plays a game questions its rules. Questioning the rules never even occurs to game players, just as it rarely occurs to ideological true believers. The lack of an iconoclastic culture in classical economics is its Achilles heel.

I have often thought that classical economics is some variation of the game named Monopoly. The data used, faulty as it often is, can be likened to the sum of the dots shown after the dice are thrown, and the fiat money they measure value by is exactly like Monopoly money since it has no intrinsic value. The wealth that economists claim is created often vanishes in an orgy of destruction. And while these economists are having fun, people suffer and often die.

John Kozy is a retired professor of philosophy and logic who blogs on social, political, and economic issues. After serving in the U.S. Army during the Korean War, he spent 20 years as a university professor and another 20 years working as a writer. He has published a textbook in formal logic commercially, in academic journals and a small number of commercial magazines, and has written a number of guest editorials for newspapers. His on-line pieces can be found on http://www.jkozy.com/ and he can be emailed from that site's homepage.

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