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PRICING, DISTRIBUTION,  
AND EMPLOYMENT  
Economics of an Enterprise System

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**PRICING, DISTRIBUTION,  
AND EMPLOYMENT**

**Economics of an Enterprise System**

To  
**BEA, JENNIFER, AND TERRY**

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## PREFACE

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This book is written primarily for use in the first collegiate upper-division course in economic theory. It presupposes that the student will have had some survey course in economics but not necessarily one which goes very far with formal economic analysis. As such, I suppose it might be characterized as either “elementary” or “intermediate” economic theory. Recognizing that the content of the prerequisite survey course varies from place to place, I have begun on a rather elementary level and carried the subject as far as seemed desirable for undergraduate teaching.

As the student is introduced to economic theory, there is initially a serious question as to what should be emphasized. From one standpoint economic theory may be viewed as a system of formal reasoning that supplies certain analytical tools which can be applied to the solution of numerous practical problems. Correspondingly, the basic theory offering has often been constructed primarily as a “tool-box” course, emphasizing a technical training for the future economist. But economic theory may more broadly be viewed as a system of thought which offers an explanation of how the economy works and an evaluation of the tendencies that this system of thought discovers. The subject material is construed in the latter sense in this volume. My primary purpose is to explain to the student in some detail what theory tells him of the working of his econ-

omy and of the reasons this economy behaves as it does. Since the bulk of undergraduate "majors" in economics or business administration are obviously not going to become professional economists, it seems appropriate thus to reduce the emphasis on formal training and to focus attention mainly on the meaningful propositions which economic theory has developed.

Because they have been written with this emphasis, the following chapters do not present an especially intensive or advanced treatment of the formal apparatus of economic theory. The basic concepts and solutions are presented and discussed, but mainly as a means of showing what economic theory has to say and in general how it arrives at its conclusions. On the other hand, the work may be somewhat more comprehensive of the content of economic theory and of its implications than some more strictly formal treatments. The discussion of pricing and distribution, for example, is not limited to a consideration of the firm and industry (the particular equilibrium) but extends to cover a number of aspects of the interrelated behavior of all sectors of the economy (the general equilibrium). Thus pricing is considered not only as an individual industry problem but as a general phenomenon affecting the level of employment and the allocation of resources among uses.

The content of the volume includes a theory of price, in particular and general equilibrium aspects, a theory of the distribution of income, and a theory of the level of income and employment. Some of these matters have perhaps been more thoroughly explored than others. For example, the theory of employment is given only a synoptic treatment in connection with the discussion of capital and interest, and a course devoted primarily to income and employment should certainly seek much additional reading material. In general, however, I have attempted to prepare a primer covering a good deal of the content of modern economic theory. Certain exceptions to this may be noted. The theory of consumer choice is not developed but only referred to as an explanation of the observed system of demands for goods. The theory of production is not treated in great detail but is brought into the discussion mainly in the explanation of varying costs and of the inter-substitution of factors by the firm. These omissions are deliberate; if the in-

structor desires to emphasize these matters, a great many standard treatments of them are available.

Little of the basic theoretical content of this volume is original. I have, however, felt free to apportion emphasis to various lines of analysis in accordance with their empirical relevance and their pedagogical value. Thus the analysis of price is dominantly an analysis of monopoly price and primarily of pricing in oligopolistic situations. This would seem appropriate in view of the current structure of the American economy. I have discussed oligopoly pricing at considerably greater length than is customary in theory textbooks, in the belief that we should emphasize the pricing situations of the real world. The treatment of income and employment runs entirely in terms of a sequence analysis; some Keynesian ideas are put forward in a period-analysis format in order to bring them perhaps a bit closer to experience.

The materials contained herein have been mostly covered in the first semester of a year's course on theory—that devoted to pricing and distribution—and have served as an introduction to a second semester on income and employment. With appropriate selection and supplementation, I hope that they may be useful under various curricular arrangements.

My sincere thanks go to Professor William Fellner for his extremely helpful advice and criticism on many points throughout the manuscript. And I am deeply indebted to a number of my colleagues who have used a mimeographed version of the first nine chapters in teaching and have made many useful suggestions.

J. S. B.

University of California, Berkeley  
February 10, 1948

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## THE FUNCTION OF ECONOMIC THEORY

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Theoretical economics, with which this book is concerned, should explain how an economy works—what sort of results it gives, and why it behaves as it does. An “economy,” of course, is essentially a society of people engaged in their main occupation of making a living. People throughout the world are organized for the purpose of producing and distributing the things they want to use. All the persons in any country, or in the world, make up a sort of army constituted to accomplish the cooperative task of providing output for useful consumption. Their “economy” embraces organized effort in agriculture, mining, manufacture, transportation, marketing, merchandising, the service trades, and so on, as well as individual efforts in the arts and professions. The existence of an economy as a unified organization with a central purpose is especially clear in a fully socialized country. But it must also be recognized in a private-enterprise society like our own, where the pattern of economic effort emerges without central planning from the uncoordinated actions of a large number of people who are guided mainly by their pursuit of individual gain. The main difference is that in a fully socialized economy the ultimate economic accomplishment of the populace is largely premeditated, whereas in a free-enterprise economy it emerges as it will, automatically or by accident, and controlled mainly by the force of competition.

Whatever its form of organization, however, any economy performs in some measurable way, and its effectiveness may be appraised. There are several dimensions of the over-all accomplishment of an economy with which we are always closely concerned:

1. The amount of goods it produces, in the aggregate or per capita, each year or other time interval; in short, its *productivity* and, inferentially, its ability to employ available labor and resources.

2. The costs, in terms of human effort and physical resources used, which it incurs per unit of useful output it produces; roughly, its *efficiency*.

3. The way it distributes the goods it produces among its population; its *pattern of income distribution*.

4. The proportions in which it produces the various goods it makes, relative to consumer needs or desires for them—the *pattern of allocation of resources among alternative uses*.

5. The rapidity with which on the average the economy's output increases over time; its *progressiveness*.

6. The degree to which the output of the economy fluctuates over time; in short, the *stability* of the economy.

These are the principal dimensions of the material performance of any economy taken as a whole. With respect to each dimension, moreover, most people have an idea of what constitutes desirable performance. Large output and employment are preferred to small, at least up to some margin of overwork. (Substantial unemployment is almost uniformly disliked.) People also generally want low real costs<sup>1</sup> per unit of output, a composition of total output congruent with the pattern of consumer needs, and freedom from excessive economic instability. Although there may be more difference of opinion on the best sort of income distribution and the optimum degree of progressiveness, some majority sentiment on these matters can be established.

How a given economy behaves in each of the preceding respects—how close it comes to “ideal” or desirable behavior—

<sup>1</sup> By low “real costs” is meant a low expenditure of labor and resources per unit of output—low costs in terms of labor hours, machine hours, and materials used.

determines the level of material welfare of the people who are a part of it and depend upon it. It also determines whether public action will be considered necessary to improve the welfare-creating capacity of the economy. For these reasons, and also in the interest of better understanding of our society, it is important (1) to measure the performance of an economy in each of the several dimensions referred to, and (2) to explain why the economy gives the results that it does.

The measurement of the performance of the economy is essentially one of statistical enumeration and compilation, and is undertaken by many private and governmental agencies in our own society. Thus we have available manifold statistics of production, employment, cost, composition of output, and income distribution. From these statistics we can get an idea of how satisfactorily our economy has performed and where improvement might be desired. But measurement is not sufficient. If we are to appraise the significance of our findings or, more important, to consider means of improving observed results, it is essential that we understand their causes. We must know "what makes the economy tick" and why it behaves as it does. Only in this way can we learn whether the observed results, whether ideal or intolerable, are inevitable, accidental, or subject to modification with a modicum of effort.

Economic theory is largely concerned with explaining how an economy works and why it works as it does. In so doing it must explain certain basic forces which influence any economic activity, such as the character of consumers' desires for goods and the nature of productive techniques. It must also show the importance of the institutions or forms of organization through which economic activity is conducted—of the social planning authorities of a socialized economy or of the manifold institutions of a free-enterprise economy like our own.

The economic theory with which we are concerned here deals with the nature and behavior of a capitalist economy, with particular reference to the economy of the United States. It attempts to explain how a capitalist economy behaves, what sort of results it tends to give, and why it gives these results. As such it is in part pure scientific inquiry, but it is also an indispensable tool of our public policy.

The analysis of a free-enterprise economy, like any economic analysis, must begin with a consideration of the nature of human wants and the character of production techniques. To understand the functioning of any economy we must first establish the governing pattern of consumer desires for a variety of goods, and the basic relations of effort expended to output secured in producing various goods. The basic psychological and physical laws influencing all economies must be established. But our free-enterprise analysis must reflect with equal clarity the institutional characteristics of the modern capitalist economy which determine the sort of performance this economy gives.

The salient characteristic of modern capitalism is that it rests on a political system which recognizes a substantially universal exercise of the private ownership and operation of land, resources, and the physical equipment for production. Private individuals are thus able to own and control productive organizations of every type and to guide their operations in such a fashion as to enhance their individual gains. Such owners can secure the human labor necessary for production by hiring it at a wage, under a general system of free contract for human services. As a result, the activity of a capitalist economy is carried on mainly by a rather large number of private individual owners, or organizations of such owners in private business firms or corporations.

The activity of such private organizations is not directly guided by any central social responsibility to produce more or less, or this instead of that. Private enterprises in our system are expected to, and do, guide their courses of action in such a way as to make the largest possible individual profits<sup>2</sup>—they are profit-seeking enterprises. It follows that in our economy the prime decisions as to what to produce, how much to produce, how much labor and resources to employ, and what to charge the public are made by individual firms, and turn mainly on their effects on enterprise profits. Furthermore it is apparent that there is no central agency for coordinating individual profit-

<sup>2</sup> This is a good first approximation to the objective of enterprise activity; more extended consideration may cast doubt on the precise meaning of profit *maximization* and on whether firms always want the *largest* profit.

seeking decisions—they become coordinated only indirectly through the complicated mechanisms of markets for goods.

In our economy, moreover, individuals and firms do not produce primarily for use or for barter, but to sell for money. Individuals sell their labor for a money wage, and productive firms buy materials, equipment, and labor for money and sell their outputs for money. The pursuit of profit is precisely a pursuit of monetary profit—of a maximum difference between ultimate money expenditure and money income. Ours is a monetary exchange economy, where activity is immediately related to the flows of money expenditure seeking to purchase various goods and services.

In deciding, with an eye to profit, what and how much to produce and how many to employ, private business firms are guided by the general volume of money expenditure seeking goods, and by the tendency of this flow to seek specific goods and services. Production follows the aggregate money demand for goods and the composition of this demand. Similarly, individuals decide whether to work or not, where, and for how long at least partly in terms of the flow of money demands for the productive services they can supply.

As a result of the large number of independent decisions relating production or work to money demand, and as a result of the interactions of these decisions in the markets for goods and services (and for money itself), the over-all accomplishment of the capitalist economy emerges.

This is a brief description of the framework of action in a capitalist or free-enterprise economy. The task of economic theory is to explain what course this action takes and what results it ordinarily tends to have. This task, as economists are approaching it today, falls into two principal parts which, though related, are for expository purposes reasonably divisible.

One part of the work of theory is to explain what determines the size and course through time of the aggregate flow of money expenditure, production, and employment. In a money exchange economy like ours, productive activity and employment are elicited by the presence of effective money demand; the rate of output and employment at any time depends on the relation of