

ECONOMICS:

Principles and Problems

REVISED EDITION

VOLUMES 1 AND 2

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VOLUME 1



HARPER & BROTHERS PUBLISHERS

New York and London

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PART I

THE BACKGROUND FOR ECONOMIC STUDY



CHAPTER I

ECONOMIC SCIENCE AND ITS USES

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*Economics is the social science that describes man's efforts to satisfy his wants by utilizing the scarce means provided by nature.* It deals with the trying situation that arises when a society faces, at one and the same time, a scarcity of goods and a multiplicity of human wants. The subject of economics undertakes to describe, analyze, and appraise the activities by means of which man tries to increase the quantity and quality of goods at his disposal, hoping in this way to reduce to a minimum the disparity between the things he wants and the things he can have.

**Two Methods of Approach.**—Some writers on economics find it convenient to divide the subject into two general groups of items, the first consisting of economic principles and the second of economic problems. For certain purposes, this separation of principles and problems is very useful. However, there is no clean-cut line of demarcation between the two in actual economic life; and in the present work we shall deal with both phases of economics. But it will be well to bear in mind, throughout our study, that economic principles aim to describe the workings of our economic system, whereas economic problems deal with the maladjustments of economic life. Indeed, the purpose of this introductory chapter is to make clear the differences between these two methods of approach, and to point out some of the practical advantages of studying economic principles and problems.

#### ECONOMIC PRINCIPLES

**The Meaning of Economic Principles.**—We first note the fact that economic principles are sometimes referred to as economic laws, and again as economic theories. These three terms may be used interchangeably, for an economic *principle*, or *law*, or *theory* is always a statement of a relationship that exists in the world of economic affairs. Thus, we have such laws as the Law of Diminishing Returns, the Law of Supply and Demand, and the Law of Comparative Advantage, each of which tells how we may expect certain economic forces to work, under certain stipulated conditions.

**A Comparison with Other Sciences.**—The laws of economics are comparable to the laws of other social sciences, and of the physical sciences



as well, in that they are generalizations which apply only when the conditions set forth have been realized. They describe, therefore, the way our economic system *tends* to operate, and not the way it operates in a specific instance.

In the physical sciences there are some laws which actually "work out" in the laboratory, but not elsewhere, since only in the laboratory are found the precise conditions specified in these laws. For example, the perfect vacuum which is needed for the faultless operation of certain laws of physics does not exist outside the physics laboratory; and, in like manner, the perfect competition assumed in the economist's treatment of supply and demand is never more than approximately realized in actual economic life.

**Theory and Practice.**—This point may well be emphasized, for a good many people seem disposed to think of the laws of economics—and of other sciences—as being "good in theory, but poor in practice." They point out that, in this case and that, a particular law did not "work." Of course, a law which fails to work is a very bad law indeed. However, an investigation of the good-theory-but-poor-practice criticism usually reveals the fact that the critics have not grasped the full meaning of the theory which they attack—that they have *read into* a given economic law something which in reality was not there, or have overlooked an essential part of the statement. It is scarcely fair to condemn a law for not working out in practice if the conditions definitely specified in the law have not been met. The theory that a combination of red and yellow makes orange is not disproved when one mixes red and white and shows that the mixture is not orange but pink—for this latter combination fails to meet the conditions stated in the theory. Nor is an economic law disproved until it is shown that it fails to work out under the *exact* conditions set forth in the statement of the law.

Economic theories sometimes appear to be artificial, for the reason that the conditions of economic life vary widely and are ever-changing. The point is well illustrated in the economist's frequent assumption of perfect competition. We have already said that this condition is never more than approximately realized in actual economic life. It is probable that there are, in the world of business, conditions which range all the way from perfect competition to complete monopoly. But since it is out of the question to devise a statement that will describe all of these varied conditions, the economist ordinarily states in his theory what may be expected to happen under conditions of *perfect competition* or *complete monopoly*.<sup>1</sup> In doing this, he assumes, of course, that those who at-

<sup>1</sup> We are not overlooking the fact that writers on economics sometimes undertake to analyze economic relationships under conditions of *imperfect competition*. Examples of such analysis, as applied to the determination of individual prices, will be found in chap. 16.

tempt to apply the theory to specific instances will make due allowance for whatever deviations there may be from the stipulated conditions.

**The Development of Scientific Laws.**—The principles of economics are developed in much the same way as the laws of physics, chemistry, astronomy, and other sciences are developed; that is, they evolve through a process of *observation, statement, and repeated retesting*. Physicists, chemists, and astronomers do not lean back in easy chairs, go off into trances, and in this way arrive at the theories we find in works on these subjects. Instead, they make observations, using for the purpose whatever scientific tools they have been able to develop, and after a careful study of the facts they have observed they finally arrive at conclusions which are known as theories, principles, or laws.

In like manner, the economist examines the facts of economic life. He notes that a given set of conditions appears to bring certain results. Having made this observation several times, he begins to suspect that there is a causal relationship between the conditions observed and the consequences that follow. He may even feel justified in drawing up a tentative statement, setting forth the idea that a given set of conditions may be expected to lead to a given result. However, he will not be content with this statement, or be likely to make it public, until he has extended his investigations and found that in a large number of instances—and not once only, or a few times—the conditions described bring about the consequences which his earlier experiments had led him to expect.

Thus, by observation and statement and repeated retesting, an economic theory is evolved. It is fair to say that most economic theories of the present day have undergone very considerable modification before arriving at their current stage of evolution. When a theory is made public by an economist, it immediately becomes the target at which other economists are likely to begin shooting. This, indeed, is a fortunate situation. Not only does the probability of criticism lead economic thinkers to make sure of their ground before making their theories public, but the attacks upon and defense of economic theories have the effect of refining the original statements. Through a free and open discussion of this kind the statements usually are either discarded as unsatisfactory or reworded so as to be generally acceptable to a large number of economic thinkers. When economic statements such as these have stood the test of years, holding up under the attacks of those who propose contrary theories, they are commonly referred to as economic theories, principles, or laws.

**Practical Uses for Theory.**—An economic theory is usually a brief statement, and yet many pages of print may be required to explain it clearly. This indicates that a theory is simply a sort of shorthand statement of what is often a very complicated situation. It must be re-

membered, however, that it is a statement of a relationship which has been found to work out in practice under the stated conditions.

From what we have just said, it should be clear that economic principles or laws may have practical significance, and that a knowledge of economic theory may be useful, just as a knowledge of the laws of physics, chemistry, astronomy, music, or painting may be useful. One of the valuable features of theories is the fact that they represent relationships which have been arrived at (as we have already seen) through the scientific process of observation and repeated retesting. By accepting theories as *established facts*, we may use them as "starting points" and then proceed to build upon them.

An excellent illustration of building upon established facts may be found in a fascinating volume which tells of man's search for information about microbes.<sup>2</sup> In this book the author traces the process through which we have acquired the knowledge which now enables us to control, to a large extent, the activities of harmful microbes. There was, first of all, the scientific discovery of the existence of these animal organisms. This was followed by the work of another scientist who learned the method by which microbes are propagated. Building upon this knowledge came the labor of many scientists who isolated specific microbes and discovered the particular human ailments for which these microbes were responsible. And still later followed the investigations of others who, by careful observation sometimes extended over a period of many years, learned how to destroy these parasites without at the same time injuring their human hosts. The work of these later scientists, which has been of the utmost significance in stamping out certain dread diseases, would have been impossible without the pioneer work done by those earlier microbe hunters, who not only made careful investigations but set down the results of their investigations in the form of principles.

Another example of building upon the work of others is found in the development of the earth-inductor compass, which Charles A. Lindbergh carried with him in his memorable transatlantic flight, and which he said made possible this remarkable non-stop trip across the ocean. This compass, which enabled the flyer to pursue his course even though he was out of sight of land, is an instrument built by two scientists who employed in its construction certain previously discovered and stated laws of physics.

Finally, it may be mentioned in this connection that Beethoven was stone-deaf when he wrote some of his most delightful compositions. At first thought, it might seem absurd that a man should be able to compose music that would thrill later generations, without himself being

<sup>2</sup> Paul de Kruif, *Microbe Hunters*, New York, Harcourt, Brace & Company, Inc., 1926.

able to hear a single note. But Beethoven's deafness was not enough to stop his career as a great composer. For he knew the theory of musical composition, and, armed with this knowledge, he found it possible to write some of his greatest works, including his famous Ninth Symphony, after he had suffered the total loss of physical hearing.

**Economic Principles in Business Practice.**—In the field of business, also, a knowledge of principles may have practical value, both to the individual enterpriser and to society as a whole. Its value to the business man is illustrated in the application of *industrial management*. Industrial management is a modern attempt to substitute definite knowledge, based upon careful investigation and repeated tests, for the "rule-of-thumb" methods, or guesswork, upon which many business men have relied in the past. And just as the use of these scientific principles has proved profitable to individual business men, so also the knowledge and use of economic principles by groups of people—say, by nations—may pay large dividends in the form of high standards of living. That country which gives due attention to the principle of specialization, the principles of money and banking, and the principles of international trade—to mention but a few phases of economic theory which we shall examine—will unquestionably find itself better off than other countries, similarly situated as regards economic advantages, which persist in ignoring the established laws of economics.

### ECONOMIC PROBLEMS

The rise of the factory system, which introduced the use of large quantities of capital and the application of mechanical power into industrial processes, dates from the last quarter of the eighteenth century. "Other times, other customs," runs the proverb; and there can be no question that the "other times" in which we live today have brought with them decidedly "other customs," so far as economic life is concerned. Among other things, we have moved from a simple economic system into one that is most complex. The hand process has become the machine process, industrial occupations have become highly specialized, and the independent artisan who was once his own master is now likely to be a factory worker directed by a foreman, who takes orders from a superintendent, who is responsible to a general manager, who, in turn, is under the control of the board of directors and ultimately of a group of stockholders.

In economic life, as in other forms of human activity, changes that are made in the name of progress are often opposed by those who see in the proposed changes a threat to their individual self-interest or to social welfare. The introduction of the power loom was effected only by beating down the objections, and in some cases the persons, of the hand

weavers. The movement for free public schools had to overcome the opposition of owners of private schools who feared competition, and of taxpayers who disliked the increased levies necessitated by this social project. Anti-trust legislation has been championed by those who regard great combinations as a menace to the public good, and condemned by the champions of *laissez faire*<sup>3</sup> and those who stand to benefit through monopoly control.

Changes in the economic world almost inevitably bring gains to some persons and losses to others, and, consequently, economic changes give rise to what we call economic problems. Since changes are continually occurring in a growing economic society, we are faced, year by year, with economic problems old and new—the old ones returning from temporary retirement to plague us, and the new arising out of fresh combinations of circumstances and challenging us to solve them if we can.

**The Nature of Economic Problems.**—The existence of an economic problem means the existence of conditions in which the interests of some persons are being affected adversely. Since, in the study of economics, we look at matters from the social point of view, we may define an economic problem as a maladjustment in economic conditions which results in loss to a considerable number of members of society. No one who is informed on events of the day will question that such maladjustments do exist, and that they often lead to serious consequences. Violent fluctuations in the general level of prices, involuntary idleness on the part of some millions of workers, the failure of banks to which thousands of persons have intrusted their life savings; the wasteful exploitation of our coal and petroleum resources—these are a few of the major maladjustments of twentieth-century economic life that still await solution. They are taken from the long list of economic problems that confront us and that bring to some members of society a sense of economic injustice and insecurity as well as standards of living lower than need be if only we disposed effectively of these maladjustments.

We have referred to the fact that, as students of economics, we examine conditions from the social rather than the individual point of view. We are interested in studying our economic relationships with the primary purpose of determining their effects upon society, and not upon isolated individuals only. Because economists adopt the social outlook, the study of economics is rightly classified as a social science. And we shall find that many of the problems that we examine are not economic problems pure and simple, but are related, in greater or lesser degree, to other social sciences as well. The problem of population, for example, is an economic problem, by reason of the relationship between

<sup>3</sup> The meaning of this term, as it is used in the literature of economics, will be explained in chap. 4.

population and wages; but it is also a problem in sociology, because of the relationship of population to the family, which is a social institution; and, finally, it is a political problem as well, through its connection with immigration. Few persons would dispute the statement that the tariff problem is both economic and political, or that the problem of poverty may be said to fall within the province of economics, sociology, and political science, and not within the scope of only one of these fields.

**Interrelationships of Social Problems.**—Since many of the problems of today are related to several fields of social science, it is sometimes possible to find a remedy for one phase of a given problem while other phases go unsolved. The Negro problem, for example, was solved in part by the freeing of the American slaves. But the abolition of slavery in this country did not solve the Negro problem in its entirety. Its economic phase was not remedied by this step. Indeed, freedom increased rather than decreased the economic difficulties of the Negro; and so serious is the present economic maladjustment of the American Negro that large numbers of our colored population are living under conditions which cannot, with any degree of reasonableness, be considered an "American standard of living." The emancipation of the slaves introduced, moreover, a brand new political phase of the Negro problem; for with freedom came the question of the political status of this large group of citizens, which now comprises about one-tenth of our total population. This, then, is another phase of the Negro problem that remains unsolved.

Yet another illustration of the complications of present-day social problems is to be found in the much discussed question of prohibition. Whatever one may think of the wisdom or unwisdom of attempting to discourage the use of alcoholic beverages through legislative measures, one cannot fail to see that the 18th Amendment and the Volstead Act brought upon us fresh social problems. The sudden closing of breweries and distilleries rendered practically worthless some millions of dollars' worth of highly specialized capital, threw out of employment thousands of workers whose industrial lives had been spent in the liquor business, and destroyed the market for an appreciable part of certain grain crops. The political aspects of the problem are evident to everyone who followed the presidential campaigns of 1928 and 1932, and the local elections of more recent years. Other serious problems that arose, in part at least, from our attempts to solve the liquor problem by legislation, were a loss of health and even life resulting from drinking poisonous "bootleg" liquors, and a growth in strength (in both numbers and influence) of the metropolitan gangs that prospered from the illicit manufacture and sale of alcoholic beverages. We are not here considering the merits or demerits of either Negro slavery or prohibition,

but merely indicating that out of an attempt to remedy a specific social problem maladjustments of other kinds often crop up.

#### THE IMPORTANCE OF STUDYING ECONOMIC PROBLEMS

It seems most unlikely that anyone who has kept track of current events during the past few decades could doubt that economic considerations have been playing a leading rôle in local, national, and world affairs, or that they are destined to occupy center stage for many years to come. Are there wars and rumors of war? Then they are more likely than not to have an economic basis, and are certain in most instances to have far-reaching economic consequences. And if happily the paths that we follow are the paths of peace, even then we do not escape the necessity of dealing with economic problems, for business depression, economic inequality, financial inflation or deflation, and many other types of economic maladjustment thrust themselves upon us from time to time. In these days of economic interdependence, he is indeed a *rara avis* whose lot is not affected by economic changes. We should be able, then, to assume an interest in economic problems on the part of all members of society. It will be worth our while, however, to indicate briefly several specific reasons for undertaking the study of this branch of economics.

**Economic Problems and the Business Man.**—The interest of the business man in economic problems is very often based upon self-interest. When an enterpriser is threatened by changes that would interfere with securing the land, labor, or capital needed in his business, with converting raw materials into finished products, with marketing his goods, or with retaining for himself whatever income he is able to make his business yield, he is faced with the problem of combating these changes or adjusting himself to them once they have come upon him. That such changes do come must be clear to all who read the newspapers. We need not go far back in history to find instances of governmental restrictions being placed upon the supply of certain kinds of capital, such as raw rubber or tin; of minimum wage rates and maximum hours of labor being laid down and enforced by federal action; of "interference" in marketing, with Better Business Bureaus and similar organizations insisting that goods must measure up to the claims made for them; and of large percentages of profits and managerial wages being taken by the government, through excess profits taxes and income taxes. There can be no question that business men need to know the "ins and outs" of economic problems that relate to their particular enterprises.

It was a problem of this kind that confronted the United States Steel Corporation in 1921, when the United States first enacted legislation definitely restricting the volume of immigration to this country. The late Judge Gary, who was then president of the Steel Corporation, an-

nounced publicly and in no uncertain terms that the erection of immigration barriers would interfere greatly with the operations of his company, by excluding from admission to the United States large numbers of southern and southeastern Europeans, upon whom the steel companies of America depended for their supply of unskilled labor. According to Mr. Gary, a reduction in the number of laborers available for employment in the steel works of the country would inevitably result in higher wages, and, as a consequence, in higher prices for steel. A further possibility, not mentioned by Mr. Gary, was that of having to take smaller profits in the event that conditions of demand for steel should not make it feasible to increase the selling price of this product. In any case, there can be no doubt that Mr. Gary was genuinely interested in the problem of immigration.

Similarly, a prominent manufacturer of woolen goods was much interested in an economic problem during the presidential campaign of 1928, and, indeed, was fearful that, through the election of a Democratic President and Democratic House and Senate, he would suffer serious economic loss. He contended that the success of his business hinged upon the continuance of a high tariff on manufactured woolen goods, and that the Democrats, if they got into power, might indulge in so violent a downward revision of tariff rates that he would be unable to manufacture his product in competition with the foreign makers of similar goods. As matters developed, his fears proved to be without foundation; for the Democratic presidential candidate, before the close of the campaign, not only promised publicly not to tinker with the tariff in the event of his election, but also secured similar pledges from the Democratic members of Congress. The fact remains, however, that this manufacturer is typical of thousands of enterprisers whose attention has been directed to specific economic problems because these problems have threatened the successful operation of their respective businesses.

Of a different sort was the interest manifested by a Philadelphia merchant in the problem of low wages. Though not much given to reading about social conditions, he one day learned from a magazine article that the minimum income on which a family of average size could at that time live comfortably in Philadelphia was \$2000. Upon consulting his payroll, he found that some of his own employees, who were the sole breadwinners of families even larger than the hypothetical family of 4.3 persons, were drawing annual wages as low as \$1300. Genuinely concerned over the discrepancy between the wages he was paying and the minimum estimates of budgeteers, he sought out specialists in the field of industrial economics in the hope of discovering a remedy for what he considered a very undesirable situation. Unfortunately, there appeared to be no satisfactory solution of this particular problem in an



economic order based upon competition. The incident shows, nevertheless, that an understanding of economic problems is of significance to socially-minded business men—business men whose interest in economic processes is not limited to the possibility of extracting large profits from the operation of their enterprises.

**Economic Problems and Intelligent Citizenship.**—But the need for a working knowledge of economic problems is by no means confined to business men. In these days of large-scale collective action, the average citizen is called upon, time and again, to vote, directly or indirectly, on matters of the greatest economic significance.

An economic problem affecting large numbers of people is that of the United States Treasury deficits, such as the huge annual deficits that piled up during the post-1929 depression period, and the still larger ones that our program for national defense made unavoidable. Shall shortages of this kind be met by the imposition of excess profits taxes and by sharp increases in the rates of taxation on large incomes, or would it be wiser to raise the necessary revenue at least partly by the use of a general sales tax? The decision is of vital importance, since the imposition of a sales tax would mean a levy upon those of very meager incomes, whereas the excess profits tax and high income tax would place the burden chiefly upon the wealthy.

During the past two decades, American citizens have had many chances to advise their representatives on economic matters. These economic questions have related to the payment of bonuses to veterans of the World War, the adoption of reciprocal trade treaties with foreign nations, the provision of financial aid to needy corporations through the Reconstruction Finance Corporation and to farmers through the Farm Credit Administration, the construction of giant public works such as those built under the Tennessee Valley Authority, the restrictions placed upon the marketing of securities by the federal Securities Exchange Act of 1934, and so on.

If it should be said that these are exceptional cases, the point may be granted cheerfully, but with the comment that we are being called upon continually to elect men to represent us in deciding important economic matters, and that we have some responsibility in seeing to it that we are properly represented. We have the privilege of advising our lawmakers from time to time, and of repudiating them when they come up for reelection if they have failed to do our bidding. But this privilege, if it is to be exercised, carries with it the obligation to offer sound advice or none at all, and the ability to advise intelligently rests upon an understanding of the issues under consideration. Shall we change the tariff, and, if so, shall we have an upward or downward revision? Shall we nationalize the railroads, as many nations have done, or leave them in the hands of private enterprisers? Shall we continue to tolerate wild