

---

ECONOMICS AND SOCIAL INSTITUTIONS

---

*Volume II*

---

INTRODUCTION  
TO  
ECONOMIC  
ANALYSIS

---

*by*

---

ARCHIBALD MACDONALD McISAAC

AND

JAMES GERALD SMITH

*Department of Economics and Social Institutions,  
Princeton University*

---

BOSTON  
LITTLE, BROWN AND COMPANY

1937

---

*Copyright, 1936, 1937,*

BY LITTLE, BROWN AND COMPANY

---

*All rights reserved*

PRINTED IN THE UNITED STATES OF AMERICA

## PREFACE

---

THIS is the second volume in a six-book series designed to serve, in various combinations, as a text for an introductory course in Economics. The first volume, *Development of Economic Society*, gives the student a broad perspective of the development and operation of economic and social institutions. This book, in turn, acquaints him with the fundamental tools of economic analysis. The remaining four volumes in the series present a survey of the major problems of the modern economic system. In each of these books the emphasis is placed not merely on the description of economic problems, but also on the study of underlying economic and social processes.

Volume II, *Introduction to Economic Analysis*, is offered to teachers and students in elementary economics courses with the hope that it may help to close the gap that frequently appears to exist between economic theory and real economic life. This divergence of theory from reality is largely a consequence of the usual assumption, conventionally made for purposes of analysis, that conditions of pure competition prevail throughout the economic system. In the present volume the authors have avoided this unrealistic assumption and, instead, have recognized the existence of monopolistic elements throughout modern economic society.

The analysis of the operation of the entire price system has, therefore, been carefully related to the theory of price adjustment under conditions of monopoly or monopolistic competition. It is thus possible for the student to proceed directly to the study of the problems of price and production in actual industrial life, without making fundamental qualifications in the structure of theoretical analysis. This approach has been employed consistently throughout the analysis of the conditions affecting the prices of both consumers' goods and producers' goods. Explicit consideration is given to the influence of monopolistic conditions in the determination of wages, rent, interest, and profits.

Full use has also been made of the recent developments in marginal analysis that have appeared in the economic journals and monographic literature. Indeed, one of the chief objectives of the authors has been to make available to elementary students, in a systematic, concise, and simplified form, some of the important contributions to economic analysis that have been made in recent years. Marginal analysis, as developed in these recent contributions, has been adapted by the authors in such a manner as to make possible the presentation of a unified treatment of the entire price system.

In carrying out this project the authors have benefited greatly from the help, encouragement, and criticisms of many colleagues and friends. The authors gratefully acknowledge the many constructive criticisms and the friendly co-operation offered by the instructors in Economics A at Harvard University, where a preliminary edition of the text was used during 1936-1937. They

are also greatly indebted to the instructors and students of the course in Economics 201-202 at Princeton during 1936-1937, whose numerous suggestions and criticisms of the preliminary edition have guided the preparation of this book.

A special word of thanks and appreciation is voiced for the advice and suggestions of those who read and criticized parts or all of the manuscript, both of the preliminary edition and of the present text. Among these are Professor E. H. Chamberlin and Dr. J. P. Miller of Harvard University, Mr. R. F. Bryan of Yale University, and Dr. A. J. Duncan and Dr. E. S. Lynch of Princeton University.

JAMES G. SMITH

*Princeton, N. J.*  
*September 1937*

## CONTENTS

---

Preface, v

I · Nature and Purpose of Economic Analysis, 3

II · Production and Income in the Modern  
Economy, 16

III · The Mechanism of Exchange, 33

IV · Consumer Demand, 51

V · Analysis of Supply: Cost of Production, 85

VI · Current Price Adjustment: Competitive  
Conditions, 114

VII · Current Price Adjustment: Monopolistic  
Conditions, 128

VIII · Normal Tendencies in Price Adjustment, 163

IX · Supply and Price under Dynamic Conditions, 187

X · Producer's Demand, 224

XI · Wages and Rent, 260

XII · Capitalization, 295

XIII · Interest and Investment, 316

- XIV · Enterprise and Profit, 344
- XV · Economic Equilibrium, 358
- XVI · The Business Cycle, 392
- Index, 427

INTRODUCTION TO  
ECONOMIC ANALYSIS





## C H A P T E R I

# *Nature and Purpose of Economic Analysis*

---

### *ECONOMIC ACTIVITIES*

*Desires and Scarcity.* Despite the vaunted wonders of scientific progress and the miracles of the modern machine age, men do not yet live in an "economy of abundance." The vast majority of people, on the contrary, still find their capacity to lead the "full life" strictly limited by the lack of many things that are necessary to minister to their manifold needs or desires. Nor is there much likelihood that these limitations on the resources at man's command will ever be fully relaxed; no small share of his thought and effort will doubtless always be concerned with the provision for his ever-recurrent desires.

*Definition of Economics.* It is with this phase of human life that economics is concerned, and especially with the activities and relationships that bear upon the efforts of people to make provision for their desires. To

be sure, not all human desires are dependent, for their satisfaction, on the possession of goods or claims upon the services of other people. The expression of religious feeling, the satisfaction of the interest in play or sport, the pleasures of friendship and of the family circle, do not always make direct demands upon the material environment. Thus, not all desires are of economic significance, although there are few phases of life that are not dependent, at least indirectly, upon economic activities.

The study of economics is, basically, a study of the problems of scarcity. Whether it is defined as the "science of wealth", as "the study of man earning a living", or as "the study of the allocation of scarce means to human ends", economics is concerned with problems that result from the scarcity of the means of satisfying desires. The twin factors, human desire and scarcity, constitute the foundations of economic life.

*Significance of Production.* Economic activities reflect the efforts of individuals and groups to extend their command over the goods and services they must have in order to meet their desires. The progress of civilization from primitive times represents, in large part, the gradual increase in the ability of men to convert the objects of the natural environment into forms that are more capable of satisfying desires. Primitive man depended on the wild fruits of nature for his scanty fare. With the fashioning of the first crude weapons, and with the first tilling of the soil, began the long march of technical progress in the conversion of nature's riches to the meeting of human needs.

Those processes by which human effort is expended

in order to increase the sum of goods and services capable of satisfying the desires of men constitute *production*. Most of the complications of modern economic life arise out of the fact that, with the progress of civilization, production has come to be carried on as a social process. The individual is no longer limited by the meagerness of his own powers, but can combine his strength and abilities with those of his fellows to gain a more abundant product. At the same time, the economic and social relationships among the people making up the community have become much more intricate. They are interconnected by a maze of rights, duties, obligations, and claims against each other and against the common product of their combined efforts. The definition, regulation, and enforcement of these relationships become matters of social custom or formal law. The special task of the economist is to analyze the operation of the system by which the common interest in production is served.

### *ECONOMICS AS A SOCIAL SCIENCE*

*Relation to Other Social Sciences.* Economics belongs in the general classification of the social sciences because it is concerned with human activities, relationships, and institutions. It differs from other social sciences in that it concentrates attention on those activities, relationships, and institutions that play a part in the *economic* life of people. It differs from the other social studies, also, in that it accepts as facts, in the background of economic life, some things that are the direct object of investigation in other sciences.

From the standpoint of the economist, for example,

it is possible and reasonable to assume that people have desires, without stopping to consider what desire is, or why it exists. The latter problems fall within the domain of the psychologist and the philosopher. Likewise, the economist takes for granted the tendency of people to form social groups or organizations for the attainment of purposes that they have in common, without attempting to duplicate the work of the sociologist or anthropologist, who is specifically concerned with exploring the forces that produce social cohesion in group life.

Obviously, there is a great deal of common ground to be covered by the social sciences, each from its own special point of view, and each one has much to contribute to the other sciences. The economist, for example, is interested in history, because it helps to explain the development of the institutions through which economic life functions. He is interested in the conditions leading to the formation of certain types of social groups, whether they be business organizations, trade unions, or other forms of association, because such groups tend to modify the direction and pressure of economic forces. He is increasingly interested in the theories and practices of political organizations because modern societies are tending to bring many phases of economic life under organized social control. But in each case the economist's interest in allied sciences arises from their contribution to the study in which he is primarily interested; namely, the understanding and evaluation of the processes, relationships, and problems of the modern economic world.

*Social Institutions.* In the social sciences the term "institution" is applied to any sort of organized arrangement under which the people in a social group live and conduct their affairs. These arrangements exist by the sanction of social custom and may also enjoy the support of law, which is itself a social institution. For example, family relationships, taken collectively, constitute the institution of the family. In the same way, marriage, as an arrangement enjoying social sanction, is regarded as a social institution.

Economic institutions include those social relationships or arrangements among the people of a community that constitute the social setting within which the economic processes of life are carried on. The institution of private property, for example, is a social arrangement that permits the individual to assert exclusive rights to control and dispose of certain objects or services. More highly organized arrangements for the conduct of economic life include the complex organizations by which production, marketing, financial activities, and business generally are carried on. The term "institution" thus covers a great diversity of relationships, all of which, however, are alike in that they serve, in one way or another, to express the *group* aspects of life and to define the positions of the individual in each of the important groups of which he is a part.

The classification of institutions as social, economic, financial, political, or religious, does not mean that these groups are mutually exclusive. On the contrary, almost all human institutions have economic aspects

and economic significance. Taken as a whole they constitute the institutional setting of economic life.

*INSTITUTIONAL SETTING OF ECONOMIC  
LIFE*

To be realistic, economic analysis must concern itself, not with isolated individuals, but with people living in a world in which their behavior, choices, and modes of thought and action are actually molded and influenced by a heritage of customs, conventions, and institutions built up through the centuries. Some parts of this social, intellectual, and economic environment may seem poorly adapted to the conditions of the present day, yet their importance cannot for that reason be ignored. At the same time, there is a continuing struggle to adjust social institutions to current needs, or to develop new organizations, institutions, and modes of action, to meet these needs. This is at once apparent if one considers how the gradual development of the present forms of organization of industry and commerce has changed the conditions under which the individual lives, works, and spends his income. It has altered his outlook, his opportunities, and his whole behavior.

Business activity, for example, is now carried on chiefly by corporate organizations rather than by individual business proprietors, and much of the production of raw materials, heavy machinery, and other producers' goods, and of consumers' goods as well, is in the hands of large-scale enterprises. At the same time, a considerable part of the population has come to be

employed on a wage or salary basis, and incomes derived from different forms of economic activity vary tremendously in size among individuals.

The preservation of historical perspective in studying economic relationships is especially important, because many of the economic and business institutions now taken for granted, and often considered immutable, are in fact the product of less than three quarters of a century of growth. This is true, especially, of the business corporation. It is true also of certain rights of individuals and business organizations that, within the past fifty years, have been recognized by the courts as "property."<sup>1</sup>

### OBJECTIVES OF ECONOMIC ANALYSIS

*Explanation of the Functioning of the Economic System.* The economist undertakes the task of economic analysis with two important objectives in view. The first of these objectives is to obtain an understanding of the operation of economic forces, and a picture of the economic relationships that constitute collectively the framework within which economic life is carried on.<sup>2</sup> The primary function of economic analysis is to provide this understanding.

<sup>1</sup> For example, the right of access to a market, or the right "to do business."

<sup>2</sup> An *economic force* is a condition that tends to motivate economic action. Human desires are elemental economic forces, inasmuch as they constitute the fundamental urge for economic activity. In a complex economic structure, changes in population, in techniques, in tastes, and in choices are constantly occurring. These, with many other circumstances, including even the hopes and fears people have, give rise to an ebb and flow in economic life, to which people are constantly attempting to adapt themselves and their undertakings.



Some people seek this understanding because of scientific curiosity, or the desire to know, for the sake of knowledge, the causal order in the occurrence of economic events. Others seek knowledge for the help that it may render in planning business undertakings or in formulating the economic policies of states and nations. Still others are interested in the study of the economic system because they feel that its operation now falls short of fully satisfactory results. If the causes of its failure can be discovered, it may be possible to devise and apply remedies that will make possible a fuller measure of social well-being. If the force and direction of changes that are occurring can be ascertained and clearly understood, a basis for formulating plans of action for the future may also be attained.

*Evaluation of the Operation of the System.* The second major objective of economic analysis is to evaluate the operation of the economic system in terms of its capacity to promote economic welfare. The term "economic welfare" is narrower in its scope than the general social welfare. Anything that operates to increase the sum total of goods and services capable of satisfying desires contributes to economic welfare. Admittedly, from a broad social point of view, some desires should better go unsatisfied; admittedly, also, the true level of social well-being is not to be measured in purely material terms. It is, however, chiefly with the problems of material well-being that economic activities are concerned, and it is therefore to them that the attention of the economist is primarily directed.

Having gained some insight into the character of