

FOURTH
REVISED
EDITION

AN INTRODUCTION TO

ECONOMIC
R **REASONING**

ROBINSON
MORTON
CALDERWOOD

An Introduction to
ECONOMIC REASONING

BY

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FOURTH REVISED EDITION

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FOREWORD

This book on economic reasoning is an introduction to economics for laymen. It is for adults who have a fragmentary knowledge of economic affairs and who seek a framework for more systematic thinking about economic issues. Its purpose is to help the reader explore the meaning of economic events and acquire skills for thinking economic issues through to some conclusion. It is hoped that this treatment will show that economic analysis can assist those who wish to reason for themselves and can help them reach independent judgments respecting economic matters.

The book was originally prepared for the use of adult discussion groups. The topics covered and the length of the volume were dictated by the needs of these groups. In an effort to help them, the authors have attempted to strip economic analysis to its bare essentials. They do not wish to make economic analysis appear easier than it is. But they do believe that laymen with varied backgrounds and experience, who are far removed from college courses and have many demands on their time, need a way to get started on the subject—a way to get into it. They hope that this book will serve to encourage further study. Because of the growing public interest in economic affairs in recent years, the audience for the book has exceeded expectations, not only in the United States but abroad as well. Translations have appeared in eleven languages: Arabic, Bengali, Dutch, Farsi, Gujarati, Hindi, Japanese, Korean, Marathi, Portuguese, and Spanish. A special edition in-

corporating a supplement on the Australian economy was published by the Tudor Press.

For the fourth edition, new information has been added throughout the text to bring the statistics up to date and to reflect new developments. Essentially, however, the book follows its original plan: It is a *way of thinking* about economic issues rather than a full review of economics that is introduced here. The purpose is to show how to examine an economic question, rather than to display the warehouse of economic knowledge that experts might apply. Thus the approach is to present the essentials of fact and formal definition, and to hurry the reader on to a consideration of selected problems on which he may exercise his powers of analysis.

With each chapter there are suggestions for additional reading. The materials selected have been chosen for the purpose of helping the reader expand his general background. Therefore those interested in detailed analysis of specific problems will want to look beyond the selections listed. In the belief that an extensive bibliography frequently tends to discourage beginners by forcing them to make premature choices of what to read, these lists have been kept to a minimum. It is hoped, however, that with this beginning, readers will obtain the skill needed to select and read additional economic literature.

Three books that are especially recommended are listed below. References from them are given in most chapters.

1. *Economics—An Introductory Analysis*, by Paul A. Samuelson (New York: McGraw-Hill Book Co., Seventh edition, 1967). This is one of the most widely used books in the beginning college course in economics. The author has an easy style of writing. Technical sections that may be difficult have frequently been put in separate appendixes.

2. *Economics—An Introduction to Analysis and Policy*, by George L. Bach (Englewood Cliffs, N.J.: Prentice-Hall, Inc., Fifth edition, 1966). This book covers most of the same fields as the preceding one. It also presents an inter-

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esting section entitled "Straight Thinking in Economics," which will be helpful in examining economic issues.

3. *Readings in Economics*, edited by Paul A. Samuelson, John R. Coleman, and Felicity Skidmore (New York: McGraw-Hill Book Co., Fifth edition, 1967). This book contains a large number of short readings on a variety of economic subjects. Some of the selections are designed to present the views of different organizations on highly controversial topics. To get the full benefit of these selections, they should be read after developing some familiarity with the subject.

These books have been chosen as representative samples of introductory materials in economics. As most introductory books in economics tend to be rather long and cover considerable ground, an attempt has been made to select those that do not have to be read from cover to cover. Generally, the authors of these books notify the readers when certain sections must be read in sequence.

This volume, *An Introduction to Economic Reasoning*, has been prepared under the direction of Dr. Marshall A. Robinson, Officer in Charge of Higher Education and Research of the Ford Foundation, formerly Dean of the Graduate School of Business, University of Pittsburgh, and a member of the Senior Staff of The Brookings Institution. Co-authors were Dr. Herbert C. Morton, formerly of the Amos Tuck School, Dartmouth College, and now Director of Publications at Brookings, and Dr. James D. Calderwood, formerly of the Claremont Graduate School and now professor, School of Business Administration, University of Southern California.

The authors and The Brookings Institution are grateful to many members of the economics profession and to the leaders and participants of test groups who generously provided suggestions for the improvement of the book. A special debt is owed to the following people who read and criticized an early draft of the volume: Sumner H. Slichter, G. L. Bach, Horace Taylor, R. A. Gordon, Arthur Upgren, Walter Salant, John G. Gurley, L. H. Kimmel, and Sylvia

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Stone. The authors' view of the requirements of this type of book prevented them from accepting some of the suggestions that were offered; thus the authors alone are responsible for the final result. The authors are indebted to Edna Birkel, who prepared the manuscript, to Evelyn Breck, who edited the manuscript, and to Ynid Robinson, who indexed the volume.

The suggestion that a volume of this sort be written came originally from Mr. C. Scott Fletcher of the Fund for Adult Education. Mr. Robert D. Calkins, President of The Brookings Institution, proposed the approach followed in this treatment. The Institution is indebted to the Fund for Adult Education for providing financial support for this project. To the authors who have labored to prepare successive editions of this introduction to economic reasoning, the Institution is especially grateful.

Kermit Gordon
President

The Brookings Institution
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Chapter 1

PROBLEMS AND GOALS

Economic problems are everybody's business because they are part of everybody's life. We read in our newspapers about taxes, foreign aid, strikes, farm price-support programs, poverty and unemployment, inflation, urban renewal, the impact of technological advances, the balance of payments, Medicare, the national debt, and many other things. We read of economic problems confronting the community, the state, the nation, and the world. We are urged to vote, to serve on committees, and to be for or against particular proposals that affect economic life. In fact, we are overwhelmed by information, interpretations, appeals, arguments, and advice.

To form opinions on current issues and to make judgments on public problems under these conditions, we all need the help of economic analysis. We need methods by which explanations may be found and alternative courses of action may be evaluated. This is what a study of economics can provide. Economics does not offer explanations and solutions ready-made. Instead, it offers the tools and methods for the analysis of economic problems. It leaves to the individual the task of applying these tools and methods to the problems he wishes to solve.

This book concerns a method of analyzing economic problems. It does not cover the entire subject of economics, but deals only with certain aspects of our own economy. It stresses problems of economic policy and explores them from the standpoint of (1) their effects on the growth and

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stability of our national income and (2) their effects on the structure of our economic system. It concentrates on such problems and their background in order to illustrate the way that economic analysis can help the citizen.

WHAT IS ECONOMICS ABOUT?

Economics is generally described as the study of how society produces and distributes the goods and services it wants. More specifically, it examines the activities that people carry on—producing, saving, spending, paying taxes, and so on—for the purpose of satisfying their basic wants for food and shelter, their added wants for modern conveniences and comforts, and their collective wants for such things as national defense and education.

Economics also includes the study of various systems that people organize in order to satisfy their wants. These systems include not only the American system but also communism, socialism, the peasant village system of rural India, and the tribal arrangements of the Amazonian Indians.

Every society needs a system of production and distribution because the things people want are not provided free by nature. Goods and services must be produced, and the means of production—natural resources, human labor, machines and other forms of capital—are scarce in relation to the demand for them. Therefore, people cannot have everything they want. They have to make *choices*. They have to decide what to produce now and what to produce later, how to use their scarce resources most efficiently, and how to distribute goods and services among the people. They must also consider whether these choices are to be made by the government, by a free price system, or by a mixture of both.

As a first step to understanding how these choices are made in our society, let us look at our objectives. What do we want our economy to do? What do we want it to be?

THE GOALS OF OUR ECONOMY

The goals of a free society are the goals of its people. The American citizen is free, within wide limits, to direct his economic affairs so as to serve his personal and social interests. He may save, join a union, buy a car, run a store, and make a variety of other voluntary decisions. Political democracy also gives him a voice in determining the role that government shall play. He may vote directly for new schools or highways. Indirectly, he may influence governmental policies by electing representatives who pass legislation on taxes, foreign aid, control of utilities, the size of the public debt, or other governmental activities. Thus a predominantly free economy and a democratic government give the American citizen freedom to determine his personal economic goals and the broader goals that society shall pursue.

Some of these goals are objectives of certain groups; some are objectives for the whole society; and some are objectives that conflict with others. Some are transitory objectives designed to deal with particular problems without reference to the long-run goals of the public.

A few of the more familiar economic objectives are shown in the following list.

Stable prices

High wages

A better return on investments

Free trade among nations

Protection from the competition of foreign producers

Closer economic ties with our allies

Conservation of natural resources

Freedom from government restrictions

Increased consumption of goods and services

Increased leisure

Stability of income and employment

Technological advancement

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Co-operation among economic groups

Increased competition

Government aids for various economic groups

The full meaning of these objectives may not be clear at this point, but the list will give an indication of the diverse, and often conflicting, objectives of the American people. How do we go about reconciling such divergent interests? This is not an easy task, and we shall offer only a tentative answer at this point. We may begin by looking for a common goal that seems to underlie all the individual and group objectives stated above. What is the broadest economic goal on which we can all agree?

The broad economic objective of the American people appears to be the achievement of high and rising levels of income and consumption under conditions that afford opportunity for individual advancement and free choice. Of course, we could debate whether having more goods and services will bring greater happiness or greater welfare, but in economics the amount of goods and services produced and consumed is generally regarded as one suitable measure of economic welfare. This does not mean that economists believe that material goals are more important than other—moral, spiritual, or cultural—goals. But they usually proceed on the assumption that each of us is the best judge of what will best serve his own welfare. They assume that our actions indicate how we seek our goals.

In general, therefore, the economist assumes that income and consumption can be used as one measure of human welfare because man has shown that he is usually willing to use his effort and ingenuity to produce things for his material satisfaction. But in every society there are economic, cultural, and moral limits to man's desire for more income and consumption. In this book, we shall concentrate on the economic conditions of welfare, leaving to others the larger task of defining what constitutes "the good life."

PROBLEMS AND GOALS

Greater income and consumption are only the first ingredients of "economic welfare." A number of other requirements must eventually be added to arrive at a full definition of this goal.

How are goods and services to be shared by the people in the society? Should everyone receive an equal share or should 1 per cent of the people get 1 per cent, 50 per cent, or 95 per cent of the goods?

A complete definition of economic welfare must also include some concept of how much people should work. Should people have to work 6 or 8 or 14 hours a day? And who should make that effort? Should everyone, including children and the aged, have to work or should certain groups receive income without working?

The definition of economic welfare must also include some notion of what kinds of goods should be produced. Should production be limited to munitions and nutritious food or should a variety of things be produced? If so, what? Should some production be prohibited? If so, what?

The decisions involved in defining "economic welfare" are the basic economic decisions confronting every society. What goods and services should we produce and how should we produce and distribute them so that we will get the maximum yield from our efforts? In the Soviet Union and in France (or any other country), these decisions are made differently than in the United States. And in the United States, they are made differently today than they were made a century ago or even several years ago. The reasons for these differences will be explored in subsequent chapters, but now it will be useful to obtain a general idea of how these decisions are made in the United States.

HOW DOES OUR ECONOMY PURSUE ITS GOALS?

One of the important characteristics of the American economy is its strong reliance on individual economic decisions. For this reason, it is frequently given the name

“private enterprise system.” This term implies that an individual can usually choose his way of earning a living; he can save or consume as he sees fit; and he can pursue his personal goals even when they do not conform with those of society as a whole—as long as they do not unduly hinder important social goals or the freedom of others.

How this unplanned and unregulated economy might function successfully was first explored systematically more than 150 years ago by a Scottish philosopher, Adam Smith. In his *Wealth of Nations*, Smith argued that most people are primarily concerned with their own interests (that is, they want things for themselves, their families, or their communities). He also noted that if people will specialize in their work and exchange the fruits of their labor with one another, everyone will be better off. He argued that the individual could best help himself by producing the things that other people want. Thus with individuals free to show what they want by the prices they are willing to pay, producers would tend to supply the things demanded by the public. Free competition, together with a price system that reflected the desires of consumers and the capabilities of producers, would, he argued, bring order and efficiency to an economic system.

Smith recognized that a free economy needs “rules of the game”—and the government must be the umpire. When individuals combine forces to get the better of someone else, or when other private restraints are put on individual competition, the self-interest of one individual may actually harm the rest of society. Hence he argued that one of the necessary functions of the government in a private enterprise system is to control restraints on competition. With the passage of time, these and other “rules” have multiplied; they have multiplied because the economy today is much more complicated than it was in the time of Adam Smith.

As the American economy has grown, each part has become more dependent on the functioning of the other parts. Consider, for instance, the number of people and