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To the memory of my father

PREFACE TO THE REVISED EDITION

When revising a book written 20 years earlier, one may well be expected to write an altogether new book. This I have not done. The present edition is enlarged and I hope improved; but it still is the same book. The many improvements in the economist's tools and approach over these two decades left the subject matter of this book relatively unaffected. The greatest changes occurred in the theories of production and capital and in our treatment and understanding of the nature of public goods and externalities, inequalities, and consumer rationality. Many of these I tried to incorporate as part of a general attempt to improve and round out the book, by filling in gaps, carrying further arguments, introducing new concepts, correcting mistakes, and, in some cases, shifting emphasis. There is a new Part III, consisting of five new chapters, and many additional sections, notes, paragraphs, and sentences, especially in chapters 3, 6, 9, 16, 21, and 26. A few things have been omitted, others rewritten; but many parts and entire chapters are unchanged, as are the organization and general approach of the book.

A newly written book on this subject would be couched in mathematical terms and could be more rigorous, succinct, and elegant as a result. But the greater use of mathematics also carries the danger of a greater divorce of economic theory from economic life in unskilled hands and minds; also, there still seems to be a need for discussing the strengths and weaknesses of the market economy in plain English accessible to nonspecialist, nonmathematical readers, among them some future professional economists.

At long last, the American public is becoming aware of the tenuous relation between wealth and welfare, affluence and happiness. Economists ought to lead in awareness of this problem and its nature; this is why the student of economics ought to be made to face the basic questions of his discipline at an early stage, before he gets too immersed in technical detail and too fascinated with his technical competence to remember to ask them and seek answers to them. All too often it is the most highly trained and the technically most competent who lack the patience and humility for such simple questions as what does a rising national product mean, or what can and what cannot be accomplished by the market economy. Herein lies my reason for investing time and effort in revising a book whose simple language has been left behind by the more sophisticated student but whose concerns should not be by-passed by anyone.

Stanford, California
January, 1971

TIBOR SCITOVSKY

PREFACE TO THE FIRST EDITION

The aim of this book is to bring together price theory and welfare economics. Price theory as currently defined and interpreted comprises an elaborate technique but makes relatively little use of it. This is why so many students of the subject feel that the complexity of its technique is out of all proportion to the main use to which this technique is put: prediction. To predict how a change in costs will affect price, and how a change in price will influence demand, hardly requires a knowledge of indifference-map analysis or of the theory of the firm under pure competition. At the same time, price theory as presented today often fails even to consider the very problems to answer which it was originally developed, and which happen to be among the most essential economic problems of our time. Present-day economists teach the theory of how market prices are determined and how buyers and sellers respond to these prices, but they so often fail to take the further step of examining and appraising the economic organization that results from such behavior.

Many problems of economic policy in this country, the main economic problems of Great Britain and other socialist countries in Europe, as well as the major political issue of the world today—all raise the question of how efficient the market economy is and how its efficiency compares to that of the planned economy. This question and other questions of this type were uppermost in the minds of the classical economists who developed price theory; but the subsequent realization of the limitations of the theory in answering them has gradually led to a change in orientation and to the neglect of welfare economics, the branch of price theory specifically concerned with such questions.

The problem of efficiency, however, is so vital that we cannot ignore it merely because our answers to it are not complete. Welfare economics, despite its limitations, provides a partial answer; and I feel that to provide partial answers to vital problems is at least as important as it is to provide complete answers to lesser questions. This is why, in teaching introductory price theory to seniors and first-year graduate students at Stanford University, I tried to stress the welfare aspects of price theory and to apply each result of price theory to the problem of efficiency in economic organization. This approach proved intellectually statisfying to students and showed the relevance and full usefulness of price theory, but it presented the problem of finding adequate reading material. We possess an ample literature of pure and monopolistic competition at several levels of abstraction and sophistication; but welfare economics, except for a few difficult and highly condensed articles, has never progressed much beyond proving that perfect competition would produce the best of all possible worlds. It was to fill this gap that I tried, in the present volume, to bring together the theory of competition and welfare economics, and to use the latter not merely for stating the conditions of an efficient economic organization but also for appraising the efficiency of our imperfectly competitive economy. This required a more detailed discussion of the meaning and elements of efficiency than is usual. The very detailed exposition of Chapter 8, for example, may appear tedious; but it seemed essential as a springboard for the further analysis.

I have taken a very long time in writing this book, and so had ample opportunity to ask for and receive the advice of many friends. (What have now become) chapters 2, 17, 18, 20, 23, and the Note to Chapter 7 were written almost ten years ago and formed part of an unpublished monograph on the behavior of the firm under monopolistic competition. This was read and criticized by Mrs. Joan Robinson and Professor Abba P. Lerner, and I owe much to their comments. In fact, the welfare orientation of this book is partly due to Mrs. Robinson's criticism that the original monograph merely presented a new tool of analysis, which would have to be applied and proved superior in use if it was to be adopted.

In writing the present version of the book, I have had the benefit of help from my colleagues and students at Stanford. I want especially to thank Professors Paul A. Baran, Melvin W. Reder, and Lorie Tarshis for much useful advice. Of the final draft, fourteen chapters were read by Professor Kenneth E. Boulding; and I want to thank him for his valuable comments. The entire manuscript was read by Professor Bernard F. Haley, and his detailed and painstaking criticism and constructive advice made for a great improvement of every aspect of the entire book. I owe him not only a great debt of gratitude but also an apology for having disturbed his sabbatical leave by pursuing him with manuscript throughout his European trip.

Finally, I want to thank my (former) wife (Anne A. Scitovsky), with whom I discussed every problem that arose in the writing of this book as well as most of its arguments and conclusions, and who also read most of the manuscript. I owe to her a great improvement in the organization, clarity, and logical rigor of the argument. The exposition of (the present) Chapters 8, 16, and 17 is largely her work. I also want to thank Miss Hazel M. Scott for an excellent typing job, and Mr Richard D. Irwin and his staff for their patience and help in preparing the manuscript for publication.

STANFORD UNIVERSITY — TIBOR SCITOVSKY
August, 1951

CONTENTS

PART I

Introduction

Chapter 1 THE SUBJECT MATTER OF ECONOMICS

Economics is a social science concerned with the administration of scarce resources. Resources are objects and services that are capable of satisfying human wants either directly or indirectly by helping to produce other objects and services whose use satisfies human wants. The administration of resources does not always create economic problems. Some resources are so plentiful that they are more than sufficient to satisfy completely all the human wants which depend on them. Air, for example, is such a resource. These resources are called free resources; and there is no need for organizing their use, because any waste or inefficiency in their utilization can be made good from their excess supply and need not abridge the satisfaction of human wants.

By contrast, scarce resources are those that are insufficient to fill completely all the wants they cater to; these wants therefore can only be satisfied partially. This raises problems of administration which are the subject matter of economics.[1] To begin with, one problem of administration is to insure the full utilization of scarce resources, because their incomplete utilization would result in a loss of human satisfaction. Second, when scarce resources are fully utilized, there is the further administrative problem of properly allocating these resources among their different uses and to the satisfaction of different wants. For when scarce resources are fully utilized, the fuller satisfaction of any one want can only be achieved at the cost of the lesser satisfaction of some alternative want or wants. Third, yet another problem of administration is the proper distribution among consumers of these resources or of the goods and services produced with their aid.

Most of these problems would present themselves even to an isolated and completely self-sufficient person. Such a person, to fill his needs, would have to rely on his limited capacity to work and would face the problem of how best to husband his energy and divide his time between leisure and different types of work. This is a problem of administering the scarce resources of his time and energy; but it is his private problem, which he may be left to solve as best he can, because its solution has no repercus-

[1] The term "administration" is used here in its broadest possible sense and is not restricted to mean only administration by a central authority.

sions on other people's welfare. Only when several people cooperate for the purpose of satisfying their wants do one man's actions affect other people's welfare. Only in this case does the use and allocation of scarce resources and the distribution of their products raise problems of social organization; and it is only these problems that are of interest to the economist.

The foregoing makes it obvious how important the distinction between free and scarce resources is. That distinction however depends on the quantitative relation between human wants and the supply of resources available to satisfy them; and this relation is always changing. Free resources can become scarce and scarce ones free with the passage of time, as wants and resource availabilities change. For example, the population explosion and our increased affluence are rapidly turning parking space from a free into a scarce resource; the same is happening, and for much the same reasons, to fresh air in the cities and to fresh water everywhere. The opposite change, once-scarce resources becoming free, is exemplified by the thousands of abandoned cars, appliances, plumbing fixtures, empty bottles, etc., that dot the American countryside, most of which would be considered valuable (i.e., scarce) in less affluent societies. If these examples also point to some of the more intractable problems of our time, the reason is new problems are always harder to resolve than routine ones. Society finds it especially difficult to recognize and deal with a problem where none existed before or to treat as valuable and learn to budget resources that, within memory, could be considered free and ignored with impunity.

People cooperate in the use of their scarce resources even in the most primitive societies, because specialization improves their efficiency and the division of labor increases their total product. The more specialization and division of labor there is among the members of a society, the better use they can make of their limited resources for the satisfaction of human wants. Most economic progress consists in increasing these potentialities; and, from the economist's point of view, almost every innovation and technical invention is merely a new and more efficient method of specializing and dividing up the task of catering to human wants.

The blessings of economic progress however are gained at the cost of the increasing complexity of economic organization. The more division of labor there is among the members of a society, the more they lose their economic self-sufficiency and become dependent on each other. Economic interdependence is not a bad thing; but it turns the administration of scarce resources into a social problem. Means must be found whereby different members of society can exchange their respective products, whereby they can be induced to work and to produce different goods in the proportions wanted by society; and when a good embodies the contributions of several people, these must be brought together, their work coordinated, and the fruit of their joint effort shared among them. The organization that this requires may be efficient or inefficient, equitable or unjust; it may function smoothly or be subject to occasional breakdowns. The farther the division of labor is pushed, the more intricate does economic organization become, and the greater is the likelihood of something going wrong with it. The task of economics is to study economic organization, to appraise its efficiency and equity, and to suggest ways and means whereby its imperfections can be lessened or eliminated.

To appraise the efficiency of economic organization, a standard of perfection is, if not always essential, at least very desirable. In the natural sciences such standards are easily established. A perfect locomotive, for example, would be one that transforms all the heat energy of its fuel into traction; and the efficiency of an actual locomotive can be measured by the percentage of energy so transformed. In the social sciences the establishment of standards of perfection is usually very difficult and constitutes one of the main problems. The function of economic institutions is to organize economic life in conformity with the community's wishes; and to find out how well they fulfill this function, one must first ascertain the community's wishes. Sometimes these are expressed through the politically appointed organs of the community. For example, the community's wish to assure a minimum income to the old and to the unemployed may be expressed by a legislative body when it enacts laws providing old-age assistance and unemployment relief. It is even conceivable that all the wishes of the community might be expressed collectively through its politically appointed organs. This is more or less the case in the communist state. In such a state, appraising the efficiency of economic organization is very simple and consists of little else than ascertaining the extent to which and the speed with which the central production plan has been fulfilled—assuming, of course, that this plan is a true expression of the community's wishes.

In a democratic society, most of the community's wishes are not expressed collectively but must be found out by ascertaining the wishes of each member of the community. In some cases, this is relatively simple. For example, an approximate indication of the community's desire to work is found in the individual actions of its members who accept employment or register with employment exchanges. A comparison of the total number of people who have thus expressed their willingness to work with the number actually employed gives a rough measure of the economic system's efficiency in providing employment.

As a rule, however, to ascertain the community's wishes in a democratic society is a difficult problem; and a large part of this book will be taken up with it. We shall have to ascertain the way in which the market reflects people's preferences between different consumers' goods, between different types of work, and between leisure and the income to be earned by work; for the efficiency of economic organization will to a large extent be judged by its conformity to the community's preferences in these matters.