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Understanding Microeconomics

third edition

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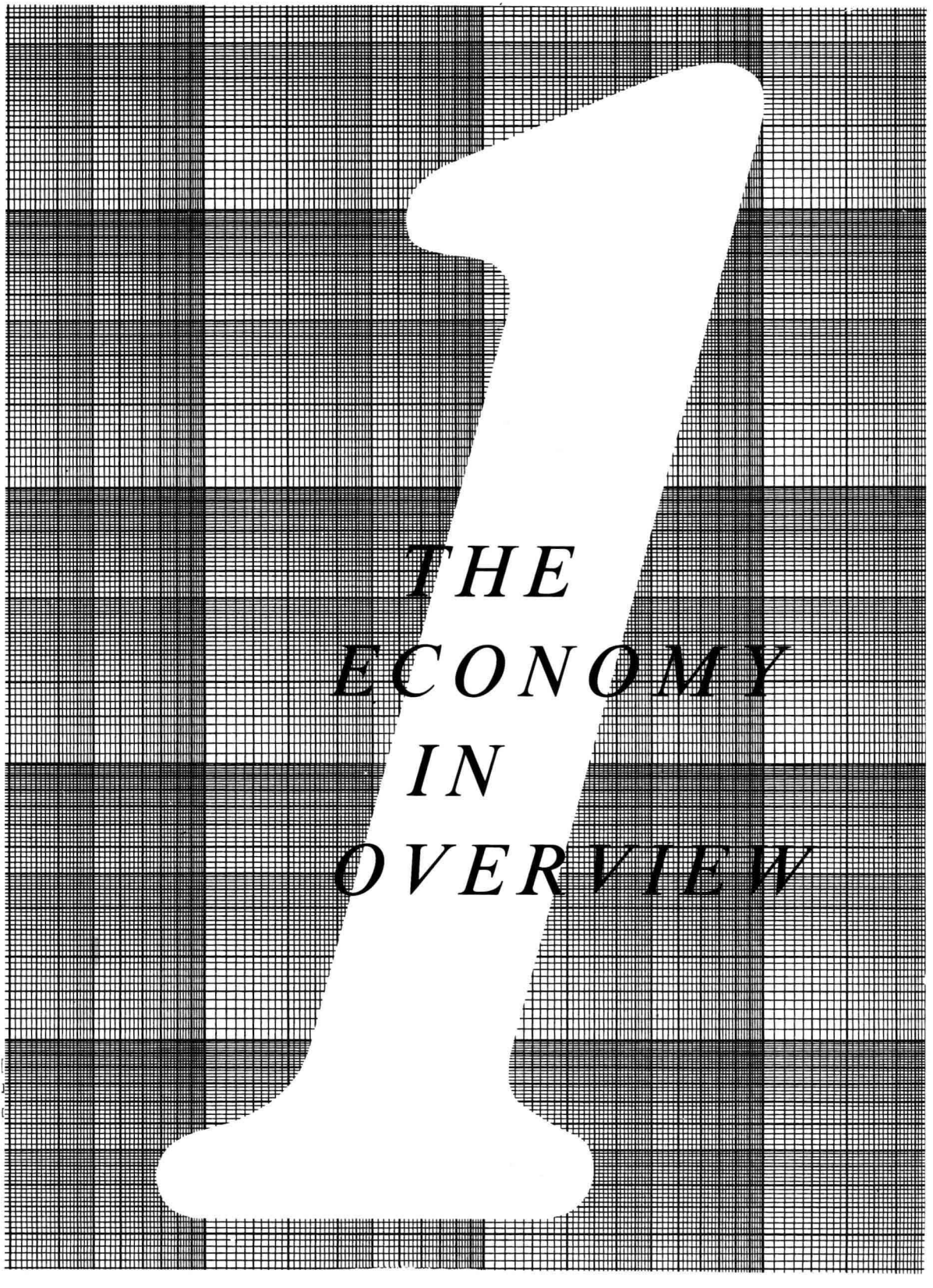
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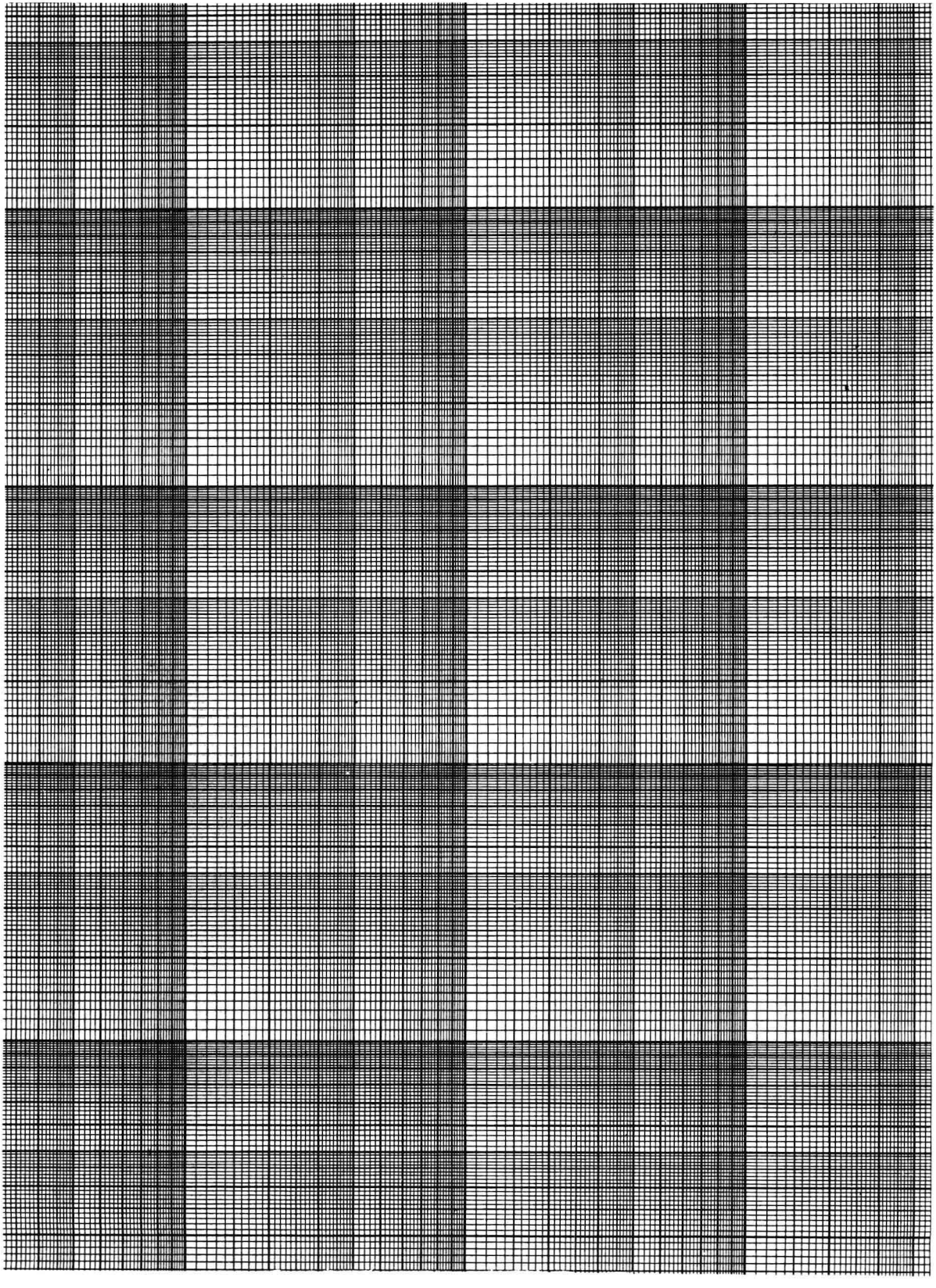

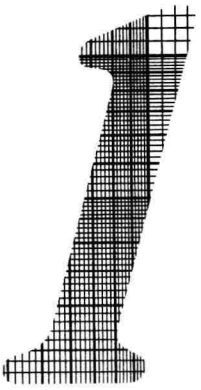

The Economic Problem

ONE NEED HARDLY TELL A STUDENT who is about to plunge into a two-hundred-page text that the subject is complicated. A riffle through the pages of this book, with its incomprehensible graphs and unfamiliar vocabulary, makes it very clear that economics *is* complicated. Indeed, the reader may feel that he is embarking on a long and hazardous expedition in which he will end up hopelessly lost, and from which he will be lucky to emerge at all.

Fortunately, the trail through this forbidding territory is a good deal less difficult than a first impression may convey. This is particularly the case if the student has a general idea of what the country is like, where the great mountain ranges lie, and where the journey is headed.

Hence this first part, to give the reader his bearings before we begin to cover the ground in a more systematic and thorough way. Unlike later chapters, which move along slowly and carefully on the ground, these initial chapters will take us on an aerial reconnaissance, a quick overflight to give us a first impression of that *terra incognita* we call economics. Moreover, unlike later chapters, many of which will no doubt require underlinings and notes in the margins, this first short section is just to be read, possibly even enjoyed. The hard work will come later.

THE PROVISIONING PROBLEM

Everyone is generally aware of some of the things that economics is "about": inflation and poverty, unemployment and monopoly, the mysteries of money, to name but a few. What is needed to begin with, however, is a feeling for the subject as a whole, for what we might call The Economic Problem. What underlying theme runs through these chapters that touch on so many problems?

The answer is surprisingly simple. *Economics is the study of how mankind copes with the problem of provisioning itself.* However complex or sophisticated the individual aspects of the subject may be, at bottom the unifying question is how man earns his daily

bread or how he divides it among his brethren.

This hardly seems like a particularly demanding subject: most of us take for granted the matter of sustenance. But if we look back over history or across the oceans to the realities of life in Africa, Asia, or Latin America, the problem takes on an unexpected urgency. For man has by no means solved the economic problem satisfactorily. Over most of his tenure of occupancy on earth, life has been as Thomas Hobbes described it: "poor, nasty, brutish, and short." Even today, for the peoples of the underdeveloped world, Hobbes's description is all too true. According to the 1967 report of the President's Science Advisory Panel on World Food Supply, malnutrition affects some 600 million inhabitants of the backward world, 200 million of whom suffer from undernutrition or actual slow starvation. Not many years ago an Indian demographer made a chilling calculation that of one hundred Asian and one hundred American newborn infants, more of the Americans would be alive at age sixty-five than the Indians at age *five*.

In our own world, of course, such considerations seem very remote. Yet even in America, the problem of provisioning asserts its importunate demands. In most American cities a few blocks separate a world of air-conditioned affluence from one of mean squalor, and within that squalor one can still find populations afflicted by malnutrition and touched by undernutrition. Moreover, even in affluent America there remains, however unnoticed, a reminder of the underlying problem of brute survival. *This is our helplessness as economic individuals.*

THE INDIVIDUAL AND SOCIETY

For it is a curious fact that as we leave the most impoverished peoples of the world, where the human being scratches out for himself a meager existence, we find the economic insecurity of the individual many times multiplied. The solitary Eskimo, Bushman, Indonesian, African, left to his own devices, will survive a considerable time. Living close to the soil or to his animal prey, such an individual can sustain his own life, at least for a while, singlehanded. With a community numbering only a few hundred, he can live indefinitely. Indeed, a very large percentage of the human race today lives in precisely such fashion—in small, virtually self-contained peasant communities that provide for their own survival with a minimum of contact with the outside world. This large portion of mankind suffers great poverty, but it also knows a certain economic independence. If it did not, it would have been wiped out centuries ago.

When we turn to the New Yorker or the Chicagoan, on the other hand, we are struck by exactly the opposite condition, by a prevailing ease of material life coupled with an extreme *dependence* on others. We can no longer envisage the solitary individual or the small community surviving unaided in the great metropolitan areas where most Americans live, unless they loot warehouses or stores for food and necessities. The overwhelming majority of Americans have never grown food, caught game, raised meat, ground grain into flour, or even fashioned flour into bread. Faced with the challenge of clothing themselves or building their own homes, they would be hopelessly untrained and unprepared. Even to make minor repairs in the machines that surround them, they must call on other members of the community whose business it is to fix cars or repair plumbing or whatever. Paradoxically, perhaps, the richer the nation, the more apparent is this inability of its average inhabitant to survive unaided and alone.

DIVISION OF LABOR

There is, of course, an answer to the paradox. We survive in rich nations because the tasks we cannot do ourselves are done for us by an army of others on whom we can call for help. If we cannot grow food, we can buy it; if we cannot provide for our needs ourselves, we can hire the services of someone who can. This enormous *division of labor* enhances our capacity a thousandfold, for it enables us to benefit from other men's skills as well as our own. In our next chapter it will play a central role.

Along with this invaluable gain, however, comes a certain risk. It is a sobering thought, for example, that we depend on the services of less than 138,000 men, out of a national labor force of 90 million, to provide us with that basic commodity, coal. An even smaller number of workers are responsible for running the locomotives that haul all the nation's rail freight. A much smaller number—roughly 40,000—comprises our total airline pilot crew. Failure of any one of these very small groups to perform its functions would cripple us: in the case of airplane pilots, slightly; in the case of locomotive engineers, badly; in the case of coal miners, perhaps disastrously. As we know, when from time to time we face a bad strike, our entire economic machine may falter because a strategic group ceases to perform its accustomed tasks.

Thus along with the abundance of material existence as we know it goes a hidden vulnerability: our abundance is assured only insofar as the organized cooperation of huge armies of people is to be counted upon. Indeed, our continuing existence as a rich nation hinges on the tacit precondition that the mechanism of social organization will continue to function effectively. *We are rich, not as individuals, but as members of a rich society, and our easy assumption of material sufficiency is actually only as reliable as the bonds that forge us into a social whole.*

ECONOMICS AND SCARCITY

Strangely enough, then, we find that man, not nature, is the source of most of our economic problems, at least above the level of subsistance. To be sure, the economic problem itself—that is, the need to struggle for existence—derives ultimately from the *scarcity* of nature. If there were no scarcity, goods would be as free as air, and economics—at least in one sense of the word—would cease to exist as a social preoccupation.

And yet if the scarcity of nature sets the stage for the economic problem, it does not impose the only strictures against which men must struggle. For scarcity, as a felt condition, is not solely the fault of nature. If Americans today, for instance, were content to live at the level of Mexican peasants, all our material wants could be fully satisfied with but an hour or two of daily labor. We would experience little or no scarcity, and our economic problems would virtually disappear. Instead, we find in America—and indeed in all industrial societies—that as the ability to increase nature's yield has risen, so has the reach of human wants. In fact, in societies such as ours, where relative social status is importantly connected with the possession of material goods, we often find that "scarcity" as a psychological experience and goad becomes more pronounced as we grow wealthier: our desires to possess the fruits of nature race out ahead of our mounting ability to produce goods.

Thus the "wants" that nature must satisfy are by no means fixed. But, for that matter, nature's yield itself is not a constant. It varies over a wide range, depending on the social application of human energy and skill.

Scarcity is therefore not attributable to nature alone but to "human nature" as well; and economics is ultimately concerned not merely with the stinginess of the physical environment, but equally with the appetite of the human being and the productive capability of the community.

THE TASKS OF ECONOMIC SOCIETY

Hence we must begin a systematic analysis of economics by singling out the functions that social organization must perform to bring human nature into social harness. And when we turn our attention to this fundamental problem, we can quickly see that it involves the solution of two related and yet separate elemental tasks a society must:

1. *organize a system to assure the production of enough goods and services for its own survival, and*
2. *arrange the distribution of the fruits of its production so that more production can take place.*

These two tasks of economic continuity are, at first look, very simple.* But it is a deceptive simplicity. Much of economic history is concerned with the manner in which various societies have sought to cope with these elementary problems; and what strikes us in surveying their attempts is that most of them were partial failures. (They could not have been *total* failures, or society would not have survived.) So we had better look more carefully into the two main economic tasks, to see what hidden difficulties they may conceal.

*In later chapters we will return to the Economic Problem in a somewhat more technical perspective. There we will note that the production problem is itself a twofold task, involving both a choice of different *ends* to which effort may be put and also of different *methods* by which those ends may be sought. Here, where the challenge of social organization is emphasized, we combine these two tasks into a single concern.

Production and Distribution Problems

MOBILIZING EFFORT

What obstacles does a society encounter in organizing a system to produce the goods and services it needs?

Since nature is usually stingy, it seems that the production problem must be essentially one of applying engineering or technical skills to the resources at hand, of avoiding waste and utilizing social effort as efficaciously as possible.

This is indeed an important task for any society, and a great deal of formal economic thought, as the word itself suggests, is devoted to economizing. Yet this is not the core of the production problem. Long before a society can even concern itself about using its energies "economically," it must first marshal the energies to carry out the productive process itself. That is, *the basic problem of production is to devise social institutions that will mobilize human energy for productive purposes.*

This basic requirement is not always so easily accomplished. For example, in the United States in 1933, the energies of nearly one-quarter of our work force were not directed into the production process at all. Although millions of unemployed men and women were eager to work, although empty factories were available for them to work in, despite the existence of pressing wants, somehow a terrible and mystifying breakdown short-circuited the production process, with the result that an entire third of our previous annual output of goods and services simply disappeared.

We are by no means the only nation that has, on occasion, failed to find work for willing workers. In the very poorest nations, where production is most desperately needed, we frequently find that unemployment is a

chronic condition. The streets of Asian cities are thronged with people who cannot find work. But this, too, is not a condition imposed by the scarcity of nature. There is, after all, an endless amount of work to be done, if only in cleaning the filthy streets or patching up the homes of the poor, building roads, or digging ditches. What is lacking is a social mechanism to put the unemployed to work.

Both these examples point out to us that the production problem is not solely a physical and technical struggle with nature. On these "scarcity" aspects of the problem will depend the ease with which a nation may forge ahead and the level of well-being it can reach with a given effort. But the original mobilization of productive effort itself is a challenge to its *social organization,* and on the success or failure of that social organization will depend the volume of the human effort that can be directed to nature.

ALLOCATING EFFORT

But putting men to work is only the first step in the solution of the production problem. Men must not only be put to work; they must be put to work *in the right places.* They must produce the goods and services that society needs. Thus, *in addition to assuring a large enough quantity of social effort, the economic institutions of society must also assure a viable allocation of that social effort.*

In a nation such as India or Bolivia, where the great majority of the population is born in peasant villages and grows up to be peasant cultivators, the solution to this problem offers little to vex our understanding. The basic needs of society—food and fiber—are precisely the goods that its peasant population "naturally" produces. But in an industrial society, the proper allocation of effort becomes an enormously complicated task. People in the United States demand much more than bread and cotton. They need, for instance, such things as automobiles. Yet no one "naturally" produces an automobile. On the contrary, in order to produce one, an extraordinary spectrum of special tasks must be performed. Some people must make steel; others must make rubber. Still others must coordinate the assembly process itself. And this is but a tiny sampling of the far from "natural" tasks that must be performed if an automobile is to be produced.

As with the mobilization of its total production effort, society does not always succeed in the proper allocation of its effort. It may, for instance, turn out too many cars or too few. Of greater importance, it may devote its energies to the production of luxuries while large numbers of its people are starving. Or it may even court disaster by an inability to channel its productive effort into areas of critical importance.

Such allocative failures may affect the production problem quite as seriously as a failure to mobilize an adequate quantity of effort, for a viable society must produce not only goods, but the *right* goods. And the allocative question alerts us to a still broader conclusion. It shows us that the act of production, in and of itself, does not fully answer the requirements for survival. Having produced enough of the right goods, society must now *distribute* those goods so that the production process can go on.

DISTRIBUTING OUTPUT

Once again, in the case of the peasant who feeds himself and his family from his own crop, this requirement of adequate distribution may seem simple enough. But when we go beyond the most primitive society, the problem is not always so readily solved. In many of the poorest nations of the East and South, urban workers have often been unable to deliver their daily horsepower-hour of

TRADITION IN ACTION

Tradition not only provides a solution to the production problem of society, but also regulates the distribution problem. Take the Bushmen of the Kalahari Desert in South Africa, who depend for their livelihood on their hunting prowess. Elizabeth Marshall Thomas, a sensitive observer of these peoples, reports on the manner in which tradition solves the problem of distributing their kill.

The gemsbok has vanished ... Gai owned two hind legs and a front leg. Tsetchwe had meat from the back, Ukwane had the other front leg, his wife had one of the feet and the stomach, the young boys had lengths of intestine. Twikwe had received the head and Dasina the udder.

It seems very unequal when you watch Bushmen divide the kill, yet it is their system, and in the end no person eats more than any other. That day Ukwane gave Gai still another piece because Gai was his relation, Gai gave meat to Dasina because she was his wife's mother ... No one, of course, contested Gai's large share, because he had been the hunter and by their law that much belonged to him. No one doubted that he would

work because they have not been given enough of society's output to run their human engines to capacity. Worse yet, they have often languished on the job while granaries bulged with grain and the well-to-do complained of the ineradicable laziness of the masses. At the other side of the picture, the distribution mechanism may fail because the rewards it hands out do not succeed in persuading people to perform their necessary tasks. Shortly after the Russian Revolution, some factories were organized into communes in which managers and janitors pooled their pay, and from which all drew equal allotments. The result was a rash of absenteeism among the previously better-paid workers and a threatened breakdown in industrial production. Not until the old unequal wage payments were reinstituted did production resume its former course.

As was the case with failures in the production process, distributive failures need not entail a total economic collapse. Societies can exist—and most do exist—with badly distorted productive and distributive efforts. Only rarely, as in the instances above, does maldistribution actively interfere with the actual ability of a society to staff its production posts. More frequently, an inadequate solution to the distribution problem reveals itself in social and political unrest or even in revolution.

Yet this, too, is an aspect of the total economic problem. For if society is to insure its steady material replenishment, it must parcel out its production in a fashion that will maintain not only the capacity but the willingness to go on working. And thus again we find the focus of economic inquiry directed to the study of human institutions. For a viable economic society, we can now see, must not only overcome the stringencies of nature, but also contain and control the intransigence of human nature.

The Three Solutions to the Economic Problem

Thus to the economist, society presents itself in an unaccustomed aspect. Underneath the problems of inflation or monopoly or money, he sees a process at work that he must understand before he can turn his attention to the issues of the day, no matter how pressing. That process is society's basic *mechanism for survival,* a mechanism for accomplishing the complicated tasks of its production and distribution necessary for its own continuity.

But the economist sees something else as

*share his large amount with others, and they were not wrong, of course; he did.**

The manner in which tradition can divide a social product may be, as the illustration shows, very subtle and ingenious. It may also be very crude and, by our standards, harsh. Tradition has usually allocated to women, in nonindustrial societies, the most meager portion of the social product. But however much the end-product of tradition may accord with, or depart from, our accustomed moral views, we must see that it is a workable *method* of dividing society's production.

. . . . .

This is the first of a series of boxes whose purpose is to add illustration, insight, even occasionally amusement, to the basic text. Read the boxes for enjoyment and for added understanding; note that the material in the boxes is *not* summarized at the end of each chapter.

*Elizabeth Marshall Thomas, *The Harmless People* (New York: Knopf, 1959), pp. 49–50.

well, something that at first seems quite astonishing. Looking not only over the diversity of contemporary societies, but back over the sweep of all history, he sees that man has succeeded in solving the production and distribution problems in but three ways. That is, within the enormous diversity of the actual social institutions that guide and shape the economic process, the economist divines but three overarching *types* of systems that separately or in combination enable humankind to solve its economic challenge. These great systemic types can be called economies run by *Tradition*, economies run by *Command*, and economies run by the *Market*. Let us briefly see what is characteristic of each.

TRADITION

Perhaps the oldest and, until a very few years ago, by far the most generally prevalent way of solving the economic challenge has been that of tradition. It has been a mode of social organization in which both production and distribution were based on procedures devised in the distant past, rigidified by a long process of historic trial and error, and maintained by heavy sanctions of law, custom, and belief.

Societies based on tradition solve the economic problems very manageably. First, they deal with the production problem—the problem of assuring that the needful tasks will be done—by assigning the jobs of fathers to their sons. Thus a hereditary chain assures that skills will be passed along and jobs will be staffed from generation to generation. In ancient Egypt, wrote Adam Smith, the first great economist, "every man was bound by a principle of religion to follow the occupation of his father and was supposed to commit the most horrible sacrilege if he changed it for another." And it was not merely in antiquity that tradition preserved a productive orderliness within society. In our own Western culture, until the fifteenth or sixteenth century, the hereditary allocation of tasks was also the main stabilizing force within society. Although there was some movement from country to town and from occupation to occupation, birth usually determined one's role in life. Born to the soil or to a trade and on the soil or within the trade, one followed in the footsteps of one's forebears.

Thus tradition has been the stabilizing and impelling force behind a great repetitive cycle of society, assuring that society's work would be done each day very much as it had been done in the past. Even today, among