

PRINCIPLES OF PERSONALIST ECONOMICS



A Critical Examination of Human Persons as Economic Agents

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FOUNDATIONS

Addressing Economic Affairs from the Perspective of the Human Person

TOPIC 1 THREE DEFINITIONS OF ECONOMICS

**To demonstrate that economics involves the study of certain material objects such as goods and services, natural resources, and wealth, but most fundamentally it involves the study of human beings as workers and consumers and their behavior in those roles.
For that reason economics is a moral science.**

There are three definitions of economics: (1) the study of the transformation of economic resources into goods and services; (2) the study of the nature and causes of the wealth of nations; and (3) the study of human beings as economic agents.

As to the first definition, there are two economic resources involved in the transformation process: natural and human. There are three types of goods (something tangible such as a desk or a book) and services (something intangible such as legal advice or medical consultation): consumer, capital, and public. A consumer good or service is used by consumers to satisfy a want or meet a need. A capital good or service is used in the workplace to help produce other goods and services more efficiently. A public good or service that is purchased and administered by a government agency is intended for use by the general public.

*Need, or its equivalent necessities, is mentioned several times in the 1948 edition of Samuelson's **Economics**¹ in ways that indicate that the concept has a legitimate place in analyzing and understanding everyday economic affairs. Nevertheless, mainstream economics today has removed need entirely from the conceptual tools used by economists to address economic affairs.² Excluding the concept of need is required in order to preserve the appearance of economics as a positive, value-free science because need is a normative concept that is defined and used differently by different analysts according to each one's own value system. This exclusion, however, proves to be especially awkward when it comes to addressing the problem of poverty that obviously must be defined and measured in terms of human need.*

A capital good or service is used in the workplace to help produce other goods and services more efficiently. A public good or service that is purchased and administered by a government agency is intended for use by the general public.

¹ See for example pages 16, 31, 67, 72, 83, 118, 256, and 581. The first edition of **Economics** that was published in 1948 quickly became the number one best-selling college textbook of its time, and remains even today in its 19th edition a very popular principles text. **Economics** is cited here and elsewhere in this e-text because for many years Samuelson set the standard for anyone who authors his/her own principles textbook and for those who teach or take the principles course. Later in his career, Samuelson was awarded the Nobel Prize in economics.

² Throughout this text, "mainstream economics" and "conventional economics" are used interchangeably.

Consumer goods and services and capital goods and services are owned and controlled by persons or private organizations and are classifiable as private property. Public goods and services are classifiable as public property because they do belong not to a specific person or private organization but to everyone. By transformation we mean the systematic transforming of economic resources into goods and services in a process that is called the production process and in a special space that we call the workplace.

There are eight types of natural resources or endowments of nature: minerals, animals, plants, air, water, weather, climate, and land or soil. Minerals such as oil and natural gas for example are crucial to the Louisiana economy. Animals are a source of food and clothing, as well as serving us as companions or pets. Animals entertain us, as for example thoroughbred horses at a racetrack, and at times are used as beasts of burden. Plants such as soybeans are transformed into food, other plants such as cotton are made into clothing, and others such as trees are changed into paper and lumber. The air we breathe may be clean and sweet as in the Dolomite Mountains of northern Italy or foul and acrid as in Los Angeles, and thus may affect the health of the persons who live and work there, the tourism that is sited there, and the willingness of families to remain or relocate there.

Water as we all learned from our grade school science teacher is essential for human life. Water is used as a means of transportation; the Mississippi River is an important waterway in the Louisiana economy. Water is used in the process of producing steel, and is one of the ingredients in certain products such as beer. Thus a lack of water obstructs economic affairs, such as the effect that a drought has during the growing season. An extreme lack of water is the essential characteristic of a desert -- land with no value and therefore land that is not fenced and claimed as private property. Weather refers to variations in temperature, precipitation, humidity, and wind that influence economic activity. In the northern United States such as Minnesota and North Dakota outdoor construction activity comes to a halt during the severe weather of the winter months. In Louisiana hurricanes and tornadoes can wreak havoc on human life and property including workplace facilities. Climate refers to the four main zones: arctic, moderate, subtropical, and tropical. Certain crops such as sugar cane and rice are grown in a subtropical climate. Others such as strawberries may be raised in a subtropical or moderate climate. Land or soil may be fertile as is true of much of the land in the United States and therefore suitable for raising crops or it may be very rocky as in the west of Ireland and best suited for raising sheep.

The second economic resource that is transformed into goods and services is the human worker. Of the two economic resources, the human resource is by far the more important because only the human worker can report to work and do nothing, do something, do all the work that he/she is assigned, or do more than what is assigned and expected. The challenge for the worker/manager is to evoke from his/her subordinates all that each one is capable of producing. Ideally, the supervisor is expected to assign work that provides opportunities for each worker to utilize his/her special creative talents and energies, makes each worker feel that he/she is a vitally important part of the organization, produces a good or service that is needed or wanted, and allows the company to earn a profit so that it can remain in business. Personalist economics underscores that work has two central effects: on the goods and services produced and on the person who performs the work. Conventional economics focuses essentially if not entirely on the first effect, ignoring the second.

The production of goods and services in the workplace has two bad consequences both related to the two types of resources that are used in the transformation process. The “bads” relating to the utilization of natural resources are the depletion of renewable and nonrenewable resources and contamination of the air, soil, and water. The “bads” relating to the use of workers in the production process are unemployment, excessive hours, wages that are below the legal minimum wage, and unsafe working conditions. To reduce or eliminate these “bads” certain limits are imposed on employers such as a limit on the amount of pollution that they are allowed to release into the environment, and a limit on the number of hours that employees are required to work without some extended rest period.

*The second definition of economics is the study of the nature and causes of the wealth of nations. This definition originates in Adam Smith’s seminal work **The Wealth of Nations** that was published in 1776 and is regarded as the beginning of economics as a formal discipline. This definition calls attention to the question Why are some nations rich and others poor? The answer to that question is embraced by virtually all professional economists. Production is the key to creating wealth because goods and services that are needed and wanted and, when sold, generate revenues for companies that are then able to employ labor and natural resources and earn profits. “Taking from the rich and giving to the poor” that is romanticized in the Robin Hood legend is a fascinating story but it is bad economics. Unfortunately for Louisianians Huey Long built his political career on appealing to the poor by arguing that he would tax the rich oil companies to provide the poor with roads, bridges, schools, textbooks, hospitals, and universities. “Taking from the rich and giving to the poor” is bad economics because it attacks the motive for producing the wealth. If the wealth one earns is taken forcibly by the government in the form of confiscatory taxes, who would continue to work and produce wealth only to have it seized by the government?*

The first and second definitions are intertwined in the sense that the first calls attention to what takes place in the production process -- the transformation of resources into goods and services -- and the second points to production as the wellspring of wealth.

Most of the rich nations of the world are located in the northern hemisphere. Most of the poor nations are located in the southern hemisphere. We in the United States have a selfish reason for wanting to know more about the creation of wealth because many of the poor people of the world want to enter the United States legally if possible. Some are even willing to enter illegally and suffer the consequences in order to escape the poverty of their homeland.

Barbara Ward in the early 1960s identified four revolutions that differentiate rich nations from poor nations in which these revolutions have taken hold in nations that are rich but not in nations that are poor. The four revolutions are: (1) the biological revolution that brings with it the benefits of modern medicine and public health; (2) the intellectual revolution that substitutes hard work and reason for the mystery and magic that is characteristic of tribal societies; (3) the political revolution of equality that replaces the hierarchical order of king, warrior, and landlord of tribal and class society all of which subordinate the merchant with one in which the young do not have to wait their turn to express their ideas to the elders; (4) the scientific-technological revolution in which the

physical matter of the universe is manipulated by the human intellect to better provision human needs and wants, and in which savings are accumulated to build the infrastructure necessary for economic development.¹ Nobel laureate Amartya Sen has asserted that “no major famine has ever taken place in any country with a multiparty democracy with regular elections and with a reasonably free press.”²

However, all four revolutions are vulnerable to counter-revolutionary forces. The biological revolution could be undone by environmental factors that threaten all living things including human beings and by infectious diseases that are drug-resistant and easily transmitted via modern intercontinental transportation systems.³ The intellectual revolution could be reversed by a gambling mentality that proclaims that it is not reason and hard work that determine a person’s material well-being but luck – a roll of the dice, a turn of a card, a series of numbers on a lottery ticket.

Ward’s third revolution, the political revolution, can and to some extent is being thrown back by youth gangs that vie for territorial control not through public discourse and the ballot box but by tribal codes and automatic weapons. The scientific-technological revolution can be upended by educational systems that fail to teach students even the rudiments of the math and science necessary to sustain that revolution.

Further, gambling attacks the scientific-technological revolution in that it siphons off the personal savings of gamblers that otherwise could be used to energize genuine economic development, especially high-tech economic growth that is driven by bright and persistent entrepreneurs. In effect instead of meeting human needs and satisfying human wants through economic enterprises that sell something of real value for the money that the consumer gives in exchange, casinos exploit a basic human weakness by promising a huge payoff and then confiscating the savings of gamblers, providing nothing of substantial value in return.

The third definition of economics states that economics is the study of human beings as economic agents such as buyers and sellers, employers and workers, creditors and borrowers, and entrepreneurs. This definition, in contrast to the first two, focuses squarely on human beings and human behavior in economic affairs as the subject of economics. Because it deliberately construes economic affairs in terms of things, conventional economics is more comfortable with the first two definitions. Personalist economics, which sees economic affairs chiefly in terms of human beings, incorporates the third.

Premises of Conventional Economics vs. Premises of Personalist Economics.

Conventional economics and personalist economics begin with different premises. As a result, even when they use the same theories and the same information and data, personalist economists and

¹ See Ward’s *The Rich Nations and the Poor Nations*, New York: W.W. Norton, 1962, pp. 40-41.

² See Sen’s “Rationality and Social Choice,” *American Economic Review*, March 1995, p. 16.

³ See, for example, Michael Osterholm, “Preparing for the Next Pandemic,” *New England Journal of Medicine*, May 5, 2005, pp. 1839-1842.

conventional economists are likely to understand economic affairs differently. The difference, in other words, lies in their different premises. Premises are like the foundations of a building: out of sight, but essential to the structure.

The four premises of conventional economics, stated very briefly, are: the individual, the law of nature, certainty, and instrumental value. The four premises of personalist economics, also stated briefly, are: the person, institutions, uncertainty, and sacred dignity.

*The most important premise of conventional economics is that the central unit of economic analysis is the **INDIVIDUAL**. For personalist economics the central unit of analysis is the **PERSON**. What conventional economics means by the individual is set forth in the philosophy of individualism. What personalist economics means by the person is expounded in the more modern philosophy of personalism.*

*By **INDIVIDUAL** conventional economics means a human being in whom human individuality is emphasized and human sociality is disregarded. Additionally the individual is represented as self-interested, intelligent and rational in all economic decision-making. Human materiality -- the body -- finds representation in the individual of conventional economics, to the exclusion of the human spirit. All economic agents are represented as “homo economicus” as a kind of shorthand expression affirming that economic agents have the characteristics of the individual as set forth in individualism. By each one single-mindedly serving his/her own self-interest, the typical economic agent serves the common good through the “invisible hand of the market.”¹*

*By **PERSON** personalist economics means a human being in whom both individuality and sociality are recognized and emphasized. Notice, for example, that every human being is identified by a first name, reflecting that person’s individuality, and a family name, reflecting his/her sociality.*

The person is represented as self-interested, intelligent and rational in economic decision-making as indicated in conventional economics, but the person also characteristically is interested in the well-being of others, is emotional at times in economic decision-making, and most importantly is not just a body but a human spirit as well. The human spirit, following personalist economics, plays a major role in two main economic activities: work and consumption.

As to work as such, the spirit in every human being longs for a job that affords opportunities to put to work one’s creative talents and energies, and scorns the “dead-end” job. Further, the human spirit needs acceptance by others on the job. It is normal for a person to be distressed whenever he/she is not fully accepted as a member of the work group.

As to consumption, humans need more than the goods and services required for physical well-being. The human spirit seeks goodness, truth, and beauty in various forms such as music, art, drama,

¹ In his first-edition *Economics* Samuelson asserts (p. 36) that the invisible hand argument that has been used to restrain government intervention “has done almost as much harm as good in the past century and a half.”

nature, literature, dance, and sports. Economists are fond of the expression “there is no such thing as a free lunch.” It means that everything has a price. In searching for goodness, truth, and beauty in whatever form it might take it is necessary to purchase goods and services. To attend a concert, it is necessary to pay an admission fee. To enjoy the beauty of seashore or the mountains, certain travel expenses are necessary. In other words, one cannot experience goodness, truth, and beauty without paying for certain goods and services, and thus an important dimension of consumption is to meet the needs of the human spirit.

Human beings are marvelously and mysteriously different in countless ways. What may satisfy the spirit of one person may be of no interest or value to another. Some are drawn to opera, others to rap. One family member may find the beach the perfect place to vacation, another may strongly prefer the mountains. Baseball may excite the spirit of some persons who at the same time are bored by low-scoring soccer games. Personalist economics thinks of the purchase and use of goods and services in this manner as leisure, a third kind economic activity distinct from work and consumption. Conventional economics, on the other hand, defines leisure in a negative sense: time spent not working.

For thousands of years students of philosophy have struggled to understand human nature more fully by addressing these three questions: ‘Who are we?,’ ‘What are we?,’ and ‘Whose are we?.’ Mainstream economics says in effect that we are individual beings, made of matter and reason, belonging to no one other than our own selves. Personalist economics says that we are at once individual beings and social beings, made of matter and reason, emotion and spirit, belonging to no one other than the Heavenly Father who created us in His image and likeness. These differences between mainstream economics and personalist economics are summarized on the following page.

By embracing the individual as the basic unit of economic analysis, mainstream economics also embraces its philosophical foundations in individualism which originated in the 17th-18th century Enlightenment when human communication was in the script stage.

By espousing the person as the basic unit of economic analysis, personalist economics accepts its philosophical foundations in personalism which emerged with the electronic stage of human communication that began with the invention of the telegraph in the mid 19th century.

*By the **LAW OF NATURE** conventional economics means that markets such as product markets, labor markets, and financial markets provide a forum for the interaction of economic agents and those markets by their very nature function efficiently and effectively. There is no need for any intervention on the part of private groups or public bodies to correct any market dysfunction or failure. Personalist economics argues instead that markets at times dysfunction and **INSTITUTIONS** are needed to intervene in order to address that dysfunction. For example, some employers left to their own devices would contaminate the air, soil, or water with their waste discharge. Therefore it is necessary to limit the amount of waste that they are allowed to discharge legally and to fine them and shut them down whenever they exceed that limit. The limit is determined by science, by an investigation that addresses the question How much of a specific waste such mercury can be*

INDIVIDUAL VERSUS PERSON

Who are we?

Mainstream economics:	individual beings
Personalist economics:	individual beings and social beings, a union of individuality and sociality

What are we?

Mainstream economics:	material creatures endowed with reason
Personalist economics:	material creatures endowed with reason, spirit, and emotion

Whose are we?

Mainstream economics:	belonging to no one other than our own selves
Personalist economics:	belonging to no one other than our Heavenly Father who created us in His own image and likeness.

discharged into the environment without inflicting harm especially on human beings? Another limit is the legal minimum wage that forces employers to pay the legal minimum when otherwise they might take advantage of their workers and pay them less.

*By **CERTAINTY** conventional economics means that with the right theory and the right information, economists are able to address and answer economic questions, issues, and problems and provide answers with certainty. Personalist economics is less confident about economists' abilities to understand economic affairs. Since economic affairs involves humans acting as economic agents, and humans are not fully understood and fully predictable, we cannot always know what is necessary to do economic analysis with certainty. The typical human being is at least in part still a mystery, not fully understood by others and even at time by himself/herself. Thus, all questions, issues, and problems are answered with some **UNCERTAINTY**.*

*By **INSTRUMENTAL VALUE** conventional economics means that the worth of every economic agent is determined by the contract (explicit or implicit) that sets forth what payment that agent has accepted for the work he/she performs. Personalist economics insists that most fundamentally a person's worth is not determined by any contract. Rather every person has the same worth because*

everyone has a **SACRED DIGNITY** that must be respected.

Role of Culture in Economic Affairs.

Personalist economics sees culture as playing an important role in economic affairs. Conventional economics asserts that there is no such role for culture in economic affairs. A helpful definition of culture is provided by Dulles.

Culture ... is a pervasive atmosphere ... a social force that encompasses individuals and welds them into communities. It shapes their prejudices, ideas, values, habits, attitudes, taste and priorities ... it inquires into what we are as human being, and what reality is in its most comprehensive dimensions.¹

Culture relates to the specific ways in which the needs and wants of the human body and human spirit are addressed. To illustrate, at a traditional Cajun wedding reception it is customary for a guest who would like to dance with the bride to pin paper currency to her dress. Across Europe the month of August is set aside for vacations, and it is not uncommon for businesses to close for the entire month. In the United States work itself is so highly valued that many Americans are workaholics. Related to that addiction many Americans experience a sleep deficit, and at times fall asleep on the job.

The economy may be compared to a twin-engine aircraft that is fueled by the credit created by private commercial banks, and is piloted by the entrepreneur who controls the aircraft in flight. The-economy-is-like-an-aircraft is a particularly apt analogy because it has several instructional applications. One, for instance, allows us to portray a stage in the economic development process as “take-off” a term which today is widely used that way by mainstream economists. Other applications are presented in later topics in this text.

Culture relates to the economy the same way weather influences the aircraft. A culture of life and hope, which is affirmed most fundamentally when human beings are not totally self-absorbed and at least from time to time care about one another in economic affairs, speeds up the performance of the economy just as the aircraft performs better in good weather. In contrast, a culture of death and despair, which in the extreme is reinforced by a pervasive attitude that death is the answer to social problems, slows down the performance of the economy just as the aircraft performs less effectively in bad weather.

Two examples come to mind. The performance of the U.S. economy during the last three months of 2001 was more favorable than expected, especially in the wake of the atrocities committed on September 11. Was this due perhaps to the huge outpouring of help extended to the victims, their families, and the rescue workers that had an energizing effect on the economy by unifying Americans?

¹ Avery Dulles, “Centesimus Annus and the Renewal of Culture,” *The Journal of Markets and Morality*, Spring 1999.

Economic Principles and Theories.

This course is known as the principles course and whatever book might be used in this course always is called the principles textbook. Even so, virtually all principles textbooks refer to “laws” such as the law of supply (the higher the price, the greater the quantity supplied by producers) and the law of demand (the lower the price, the greater the quantity demanded by consumers). I prefer to use “principle” in place of “law” because it is consistent with how we refer to the course and the textbook, and because “law” in our society signifies a bill passed by a legislature and signed by governor or president.

A principle is the statement of the truth as the truth is humanly perceived. Principles can be classified according to their nature and their scope. By nature, principles are either descriptive or analytical. By scope, principles are either general or universal. A descriptive principle simply describes some human behavior or event; an analytical principle attempts to explain that behavior or event. A general principle is one that applies in most instances; a universal principle applies in all cases. The principle of supply and the principle of demand are descriptive principles and general principles. Throughout this course whenever we introduce a new principle we will identify it accordingly.

Economic principles are helpful in better understanding economic affairs. The principles of supply and demand tell us something important and predictable about the behavior of producers and consumers. However, a single principle by itself often is not sufficient to help us understand more complex economic affairs such as how prices are determined in a market system. Theories are developed to handle the more complex questions, issues, and problems in economic affairs. An economic theory is a set of two or more principles that have been built into a unified system of ideas to address a specific question, issue, or problem. Price theory that originates in the late 19th century with the insights of English economist Alfred Marshall brings together the principle of supply and the principle of demand to answer the question What determines price? Principles have the same kind of relationship to theory as a pile of bricks has to a load-bearing brick wall. The wall is constructed from the bricks but is something entirely different than a pile of bricks. The test of such a wall is whether it holds the load that is placed on it. If not, the wall will have to be re-built. Similarly, the test of any economic theory is whether it stands or falls in the real world of economic affairs. If not, it too will have to be re-constructed.

Economic theory is divided into two main parts: microeconomics and macroeconomics. Microeconomics represents economic affairs from the perspective of human individuality. Macroeconomics, on the other hand, investigates economic affairs from the perspective of human sociality. A major shortcoming in economic theory is that microeconomics and macroeconomics have not been integrated into a unified general theory. Such integration is necessary because human beings are not one part individual being and one part social being. Rather, humans are fully integrated such that it is impossible to separate the individual being from the social being.

REVIEW SECTION: TOPIC 1

Central Concepts:

premises:

- mainstream economics -- individual, law of nature, certainty, instrumental value
- personalist economics -- person, institutions, uncertainty, sacred dignity

invisible hand of the market

principle:

- general or universal
- descriptive or analytical

theory

economic resources:

- labor resources
- natural resources

goods and services:

- consumer
- capital
- public

economic “bads” relating to:

- labor resources
- natural resources

creation of wealth

human person:

- body and spirit
- individual and social

microeconomics and individuality

macroeconomics and sociality

limit

Important Questions:

Define the study of economics in the context of things or objects.

in terms of human beings

Why is the definition of economics so important?

Why is economics a moral science?

What is meant by a principle?

What is the difference between a descriptive principle and an analytical principle?

... between a general principle and a universal principle?

How are theories constructed from principles?

How are theories tested/validated?

(continued on following page)

True/False:

- a. Microeconomics is economic theory that originates in human sociality.
- b. Macroeconomics is economic theory that originates in human sociality.
- c. An economic principle is best defined as a statement of the truth about economic affairs as the truth is humanly perceived.
- d. An economic theory, such as price theory, is a set of economic principles that addresses questions, issues, or problems too complex to be addressed by means of a simple economic principle alone.

Mark your answer below.



- Item a is true, items b, c, and d are false.
- Items a and b are true, items c and d are false.
- Item a is false, items b, c, and d are true.

TOPIC 2 THREE PRINCIPLES OF ECONOMIC JUSTICE

To present three principles of economic justice that define the duties of buyer and seller, worker and employer, superior and subordinate, member and group.

As stated in Topic 1, the third definition of economics is the study of human beings as economic agents. Acting as economic agents, and given their free will and intelligence, human persons are capable of making choices. In the decision-making process, mainstream economics draws the student's attention to the cost – known as opportunity cost – of what the economic agent cannot do or cannot have when he/she makes a decision even in those cases where the agent is not explicitly aware of this cost. To illustrate, the opportunity cost when the producer decides to use barley to produce coffee is that the barley cannot be used to produce whiskey. The opportunity cost when the restaurant patron has red wine with filet mignon for her evening meal is that she cannot at the same time have white wine with chicken cordon bleu.

One obvious way to reduce the opportunity cost of not selecting the chicken cordon bleu is to dine with a friend or family member who does and who offers to share it for a portion of the filet mignon. However, mainstream economics does not recognize sharing with another person as a way of reducing opportunity cost because it represents the economic agent as a totally self-centered, utility-maximizing individual. We have more to say about opportunity cost when we take up gain-seeking behavior later in this topic.

Without dismissing the importance of opportunity cost, personalist economics is more inclined to look at the decision-making process in terms of its ethical dimensions. There are many instances, for sure, when the choices made are ethically neutral, when they involve no ethical issues. For example, the decision to paint the outside of one's house with white paint versus some other color has no ethical content. One color is not morally right and another morally wrong. However, the decision as to what you should pay a person to work for you very likely has an ethical dimension. To illustrate, deliberately withholding the pay until the work has been completed and paying the worker less than what was agreed to even though the work was done to your exact specifications is unethical.

Are decisions regarding ethical issues in economic affairs entirely arbitrary, depending completely on the whims, fancies, feelings, opinions, attitudes, and values of the persons making those decisions? Or, are there objective standards that apply in economic affairs rendering ethical decision-making reasoned, defensible, and alike from one person to the next except in instances of specific extenuating circumstances? Overwhelmingly mainstream economics argues that ethical standards are essentially relative, that they differ from one person to the next, and therefore are

entirely outside the limits of legitimate inquiry for economic science.¹ Moreover, the law of nature sorts out all conflicts between economic agents including ethical disputes and for that reason there is no need to concern ourselves with ethics and ethical issues.

Our view is that there are certain objective ethical standards to be applied in economic affairs, and that those standards come from that specialized branch of learning known as ethics. However, ultimately those ethical standards originate in the human experience. Thus, shoplifting is destructive of retail trade because clearly it is unreasonable to expect a shopkeeper to operate his/her store when customers are entirely free to take whatever they want from the shelves and exit the store without paying. Indeed, not punishing shoplifting assures that few if anyone would be so foolish as to become a merchant and expect to earn a living. To teach and reinforce the ban on shoplifting, it is necessary to have laws and enforcement officers to assure that shoplifting is punished.

We begin with a general definition of justice. **Justice is the virtue or good habit of rendering to another that which is owed.** In economic affairs there are three principles of justice that apply: the principle of equivalence, the principle of distributive justice, and the principle of contributive justice. We call the three principles of economic justice because they apply strictly in the economic order. Other principles of justice as for example in criminal affairs with no direct ties to economic affairs as in the case of child or spouse abuse or treason are not our concern here.

There are three principles of economic justice because there are only three modes of human interaction in economic affairs: person to person, superior to subordinate, and member to group. The principle of equivalence sets forth the duty of buyer to seller in the marketplace and worker and employer in the workplace. The principle of distributive justice defines the duties of the superior to his/her subordinates whether that interaction takes place in the marketplace or the workplace. Finally, the principle of contributive justice sets down the duties of the member to the group in interactions occurring in the workplace or the marketplace.

Economic Gain: Profits, Consumer Surplus, and Economic Rent.

Before moving on to the principle of equivalence, it is instructive to address first what happens in a market exchange. Every exchange involving economic agents who are well-informed and free to act entails gain for the parties involved: what is gotten in the exchange is more highly valued than what is given up. To illustrate, a person shopping for shoes comes across a pair priced at \$118. In deciding whether to purchase those shoes that person routinely asks the question 'Are these shoes really worth \$118 to me?' If the answer is affirmative, that person actually purchases the shoes. If the answer is negative, he/she turns away. If that person is not sure, he/she turns away but may return later to buy the shoes provided they really are worth \$118.

As with conventional economics, personalist economics differentiates between exchange value and use value. Exchange value is what is given up for the good or service acquired through exchange.

¹ Samuelson's first edition *Economics* (p. 14) employs the relativist argument that ultimately there is no disputing ethics.

Use value is what is gotten, the usefulness of the good or service to the person who acquires it.

Under competitive market conditions, exchange value should not vary from one person to the next. The price paid for the same dog food in a supermarket is the same for everyone buying that brand of dog food there. However, use value is not the same for everyone who buys that dog food because some persons are more deeply attached to their dogs and derive greater pleasure from feeding and caring for them than do others. While exchange value is determined by market conditions at the time and place of the exchange, use value is determined by the value systems of the uniquely different persons involved in the exchange. Exchange value is an objective piece of information. Use value, on the other hand, is a subjective human experience. For every one of the persons involved, use value (what is gotten) must be greater than exchange value (what is given up). Without that gain, the exchange cannot be carried out.

The opportunity cost of purchasing the \$118 shoes is the gain available from whatever else might have been purchased with that money but forsaken once the shoes were bought. If the shoes meet a need, as with safety shoes required on the job -- the opportunity cost is zero because nothing else will do. If, however, the shoes satisfy a want, are desired but not required, there is an opportunity cost in purchasing them. Nevertheless it is reasonable to presume that the shopper would buy the shoes desired only if they represent the greatest gain possible. Mainstream economics admits of no circumstance in which the opportunity cost is zero because all consumer behavior is construed in terms of want satisfaction: satisfying this want means not satisfying that want. Need has no place in the mainstream microeconomics. Nevertheless, need more or less silently finds its way into mainstream macroeconomics via an examination of the issue of poverty. Personalist economics makes allowance for the case of zero-opportunity cost because it recognizes the difference between need and want, addresses need in both microeconomics and macroeconomics, and thereby represents all makes economics as value-laden.

However, without a limit to the extent of that gain and its origins, some persons in the exchange process are able to take more than their due while others are left with less. Conventional economics brushes aside the problem of exploitation and victimization with the invisible hand argument. Every economic agent in the pursuit of his/her self-interest serves the good of all through the invisible hand of the market. Introducing justice into economic affairs is unnecessary and threatens the value-free nature of conventional economic science. Personalist economics rejects the invisible hand on grounds that its appeal to magic and rhetoric is no substitute for the call of justice to reason and substance. Personalist economics accepts a value-laden economics as the price for aligning the study of economics more closely with economic reality.

In the workplace, for example, when the baker hires a sales clerk to tend to his/her customers, there is gain for both parties. The baker gets the clerk's labor services that are more useful to him/her than the wages that must be paid, thereby adding to the baker's profits. Without that gain, the baker could not afford to hire the sales clerk. At the same time, the clerk contributes his/her labor services because the wages paid are more useful than the time and effort involved in working. Without that

gain (known among economists as economic rent) the clerk would not accept the job. As we just observed with the shopper, both the baker and the clerk presumably are guided in their decision-making by the greatest gain available.

The gain to the worker or the owner of natural resources that are used in the production process may be enhanced further by the generous employer/producer who pays more (adds more to economic rent) than is absolutely required perhaps in the expectation that his/her generosity will be repaid by more diligent workers and more careful suppliers, thereby adding to the employer's profits. The model employee or supplier is one who contributes more to profits than is normally expected.

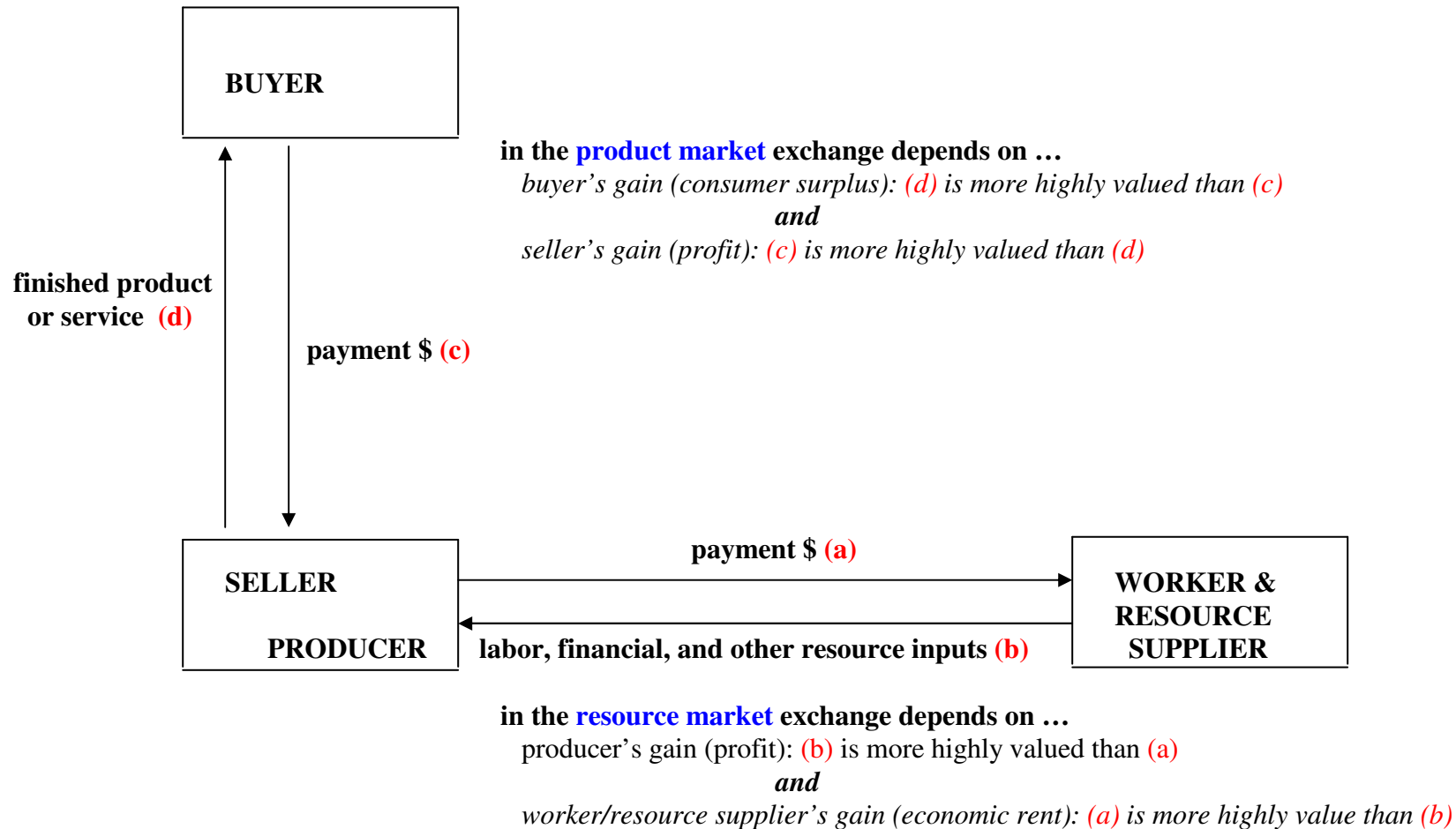
In the marketplace, the baker produces more loaves of bread than can be used for his/her own personal consumption, and sells them provided what is gotten (the price paid by the customer) is more useful than what is given up (the cost to produce the bread), thereby adding to the baker's profits. Without that gain, there is no incentive for the baker to produce and sell bread. At the same time, the baker's customer who does not bake bread, or does not make it as well or as inexpensively, buys from the baker because the bread that is gotten is more useful than the money given up. The gain achieved by the consumer (consumer surplus) can be saved or applied to buying other things that the customer wants or needs. A bargain is an exchange in which the consumer's gain is greater than initially expected.

To return to one of our two examples regarding opportunity cost -- using barley to produce coffee instead of whiskey -- if the producer is a coffee specialist, the real opportunity cost of not producing whiskey is zero. Similarly, if the baker is a specialist in baking bread, there is no real opportunity cost in not producing something else.

When a buyer and a seller have exchanged the same item at the same price time after time, both parties know in advance the gains associated with that exchange and the gains forsaken and therefore act with considerable certainty. However, when a new item is exchanged or at least one of the parties enters the exchange for the first time, the gains properly considered are expected gains and there is some uncertainty in that exchange. Considerable certainty applies as well to the exchange between an employer and a long-time employee. On the other hand, when an established employer hires a new worker, or a new business is recruiting its startup work force, uncertainty attends the decision-making.

To sum up, there is an important difference in emphasis in the way personalist economics and mainstream economics define opportunity cost. Mainstream economics defines it in terms of whatever else the decision-maker cannot do or have once his/her decision has been made. Personalist economics defines it as the gain available from whatever else might have been acquired with the money at hand but in the end was forsaken. Personalist economics departs from mainstream economics in two ways. First, personalist economics links opportunity cost to the straightforward language and logic of economic decision-making: what is gotten in exchange is more highly valued

**ECONOMIC GAIN:
WHAT IS GOTTEN THROUGH EXCHANGE IS MORE HIGHLY VALUED THAN WHAT IS GIVEN UP**



producer profit is determined by two economic factors: the cost of producing the good or service and the price at which it sells.

than what is given up. Second, personalist economics introduces need into the behavior of economic agents and the possibility of zero opportunity cost. Mainstream economics does not.

Profits flow from two sources because the producer engages in exchange in two markets each yielding its own gain. There is (1) the gain that comes from the producer's buying inputs in the resource market for use in the production process, and (2) the gain that derives from selling the finished goods in the product market. Thus the producer's profits are enhanced in two fundamental ways: by reducing the cost of production and by selling finished products at a higher price.

However, with economic rent and consumer surplus, the gain originates in exchange that takes place in a single market. For the worker and the owner of natural resources, economic rent originates in exchange only in the resource market. For the consumer, it is exchange only in the product market that gives rise to consumer surplus. Though the language used in mainstream economics to designate these gains -- profits, economic rent, and consumer surplus -- suggests that they are incidental to the exchange process, the hard reality is that all three gains are absolutely necessary to that process. In their absence, exchange tends to break down. See the exhibit on the preceding page for a visual representation of the three components of economic gain.

Simply put, whether we are talking about a buyer or seller, an employer or employee, or for that matter any other type of economic agent, exchange takes place when there is economic gain (when it is worth it) for both parties involved. On the other hand, exchange does not place when there is no economic gain (when it is not worth it) for one or both parties involved.

There must be limits to profits, consumer surplus, and economic rent in order to prevent one party from taking advantage of another and to assure that market exchange serves all economic agents fairly and effectively and not just those with the power and will to turn gain into excess. Later in this chapter we will see more specifically that those limits are grounded in the duties that economic agents owe one another under the principle of equivalence, the principle of distributive justice, and the principle of contributive justice.

Justice in Product and Resource Markets.

The principle of equivalence states that buyer and seller in the marketplace and worker and employer in the workplace have two duties that are binding on both parties. First, they are to exchange things of equal value. Second, they are to impose equal burdens on one another. In many such transactions, personal experience informs us as to what equal value means. By equal burden we mean that the burden of the seller is to give up possession of the good or service in question. For the buyer, the burden is to give up possession of the money necessary to buy and take possession of that good or service. For the worker, the burden is performing the work required by the employer. For the employer, the burden is paying the worker the wage that they agreed to.

At first glance, exchanging things of equal value implies that there is no gain involved. On closer examination we see that this is not the case. Exchanging things of equal value means that what is exchanged is of equal **exchange** value, not equal use value. As we indicated previously, exchange

value refers to (a) the price paid to purchase a good or service and (b) the wage or price paid to hire a worker or natural resource to produce that good or service. Use value is what is gotten, the usefulness of the good or service or resource to the person who acquires it. The two taken together result in economic gain under the following condition:

gain is **realized** when use value > exchange value.

Whereas use value cannot be influenced by the other party to an exchange, exchange value at times can be determined directly by the other party. In those cases, restraint may be necessary. However, when a market is reasonably competitive, exchange value normally does not fluctuate markedly from day to day and is the same or nearly the same for all buyers on the same day. Competition in other words reduces the control that any single buyer or seller has over price, keeps the market price close to the cost of production, and allows a reasonable but not undue profit margin. Thus there may be little need for personal restraint. Gain under these circumstances can be represented as follows:

gain is **justified** when use value > exchange value **restrained** by competition.

A problem arises, however, when the market does not impose this restraint, and agents are free to act, more or less, without restraint. Action of this type can occur when the producer fixes the price through a cartel or when the buyer is simply ill-informed about the market price and overvalues the product or service offered for sale. In such cases, the gain of the seller is ill-gotten because it is based on taking advantage of the buyer. Unrestrained action may involve a buyer who has an opportunity to enhance his/her gain when the seller is unaware of the true value of the product or service offered for sale. This could happen, for example, in a flea market where the seller offers a book for sale at a low price unaware that the book is a very valuable first edition, or when a widow offers property for sale which she has grossly and innocently undervalued. The principle of equivalence in all such cases informs both parties that the only justifiable gain is one that does not deprive the other party of the gain that is rightfully his/hers. The following simplification expresses the nature of the gain that is justified under these conditions:

gain is **justified** when use value > exchange value **restrained** by faithful adherence to the principle of equivalence in a situation where competition alone does not provide the necessary restraint.

Two other examples -- one involving the marketplace, the other concerning the workplace -- may be instructive in driving home this argument. A market price that is determined entirely by the producer -- in the extreme by a monopolist -- violates the principle of equivalence because the margin of profit inflates the price and effectively manipulates exchange value, yielding ill-gotten gain for the monopolist. In this case, the buyer who needs the monopolist's product or service has no option other than to buy from the producer who controls the price. The same problem arises in a labor market when a labor union imposes wages much higher than the going rate on an employer who in a closed-shop state is compelled to hire his/her workers only from the union. It follows that the principle of equivalence is supported by and indeed justifies government interventionist policies

which encourage competition by, for instance, breaking up firms that dominate a market and which punish noncompetitive practices such as collusive price fixing.

From time to time we may not know precisely the exchange value of a specific item such as a Rolex watch but we very likely know that it does not sell for the same price as a Timex watch. Anyone attempting to sell a watch that is represented as an authentic Rolex for, say, \$49 should be suspected of (1) selling a Rolex watch that is stolen, (2) selling a watch that actually is a counterfeit or a “knockoff,” or (3) selling a genuine Rolex but having no real appreciation for its true worth. The principle of equivalence means that selling stolen goods is unjust because the seller has no right to sell what does not belong to him/her and the buyer has no right to buy and take possession of a watch that belongs to some else. Indeed, such practices are illegal precisely because they are unjust.

Misrepresenting a “knockoff” as the genuine article is unfair because the seller is deliberately deceiving the buyer. Finally, and with one exception, buying a good at a price well below its current market price is unjust because the buyer has no right to exploit the seller who is unaware of the watch’s real value. There is, however, no such exploitation when the seller is fully informed as to the good’s real value and freely sells it for less. In that case, the good exchanged is in part a gift.

*There are other sources of information about what equal means in a marketplace or workplace exchange. They include information available through family members, friends, co-workers, neighbors, and consultants. There are published sources of information as well such as **Consumer Reports**, newspaper advertising, and electronic exchanges such as **E-Bay**.*

At times, the things exchanged at the very moment the exchange is executed are not of equal value, such as when a house is sold and the buyer makes only partial payment in cash but takes possession of the entire house at the time of closing. To simplify this example, we assume that the buyer does not obtain a mortgage from a third-party lender such as a bank. Rather the seller offers to lend the buyer the unpaid balance by allowing the buyer to make regular payments over time until the balance is paid in full. Notice at closing, the buyer’s immediate burden is to make partial payment in cash to the seller. The seller’s burden is to surrender the whole house, and accept the buyer’s written promise to pay the balance in the future. Under those circumstances, the seller faces the risk that the buyer may not be faithful to his/her promise to make payments in the future until the balance is paid in full. And the seller must wait until payments are made and at closing forgoes the use of that money had he/she insisted instead on payment in full at closing. Consequently, the seller/lender is justified in requiring the buyer/borrower to repay more than the amount of money that was borrowed. Indeed, the seller/lender is justified in charging interest in order to equalize the burdens involved.

The precise amount of interest that equalizes the burden is problematical. However, we know by experience that a rate of interest of 100 percent is excessive because it imposes an undue burden on the buyer/borrower. Similarly, a 50 percent rate of interest is excessively burdensome. However, in 1981 banks across the United States were charging their most credit worthy customers an average of 21 percent on loans and as much as 35 percent for other higher-risk borrowers. Today, credit card

companies commonly charge 18 percent annual interest and, even though some cardholders are not able to pay their credit charges, most cardholders do pay what they owe. We conclude that a rate of interest around 20 percent is reasonable and in general satisfies the requirements of the principle of equivalence.

Some common expressions for the principle of equivalence in the marketplace, involving buyer and seller, are the money-back guarantee, the merchant's refusal to accept a third-party check, and the buyer's experience of getting his/her money's worth. The money-back guarantee is the seller's recognition that at times an honest mistake has been made in routine transactions, whether the fault lies with the buyer or the seller, and that the things exchanged are not of equal value. Merchants who depend on repeat business understand that the money-back guarantee is good for their business even though they might not understand consciously that they are being faithful to the demands of the principle of equivalence. Shopkeepers often refuse the third-party check because they are fearful that the check has been stolen by the third party to whom it has been made payable and that the person who issued the check has put a stop-payment order on that check with his/her bank, rendering it worthless. "Got my money's worth" is a common expression for a buyer who has entered an exchange with a seller and actually received more than he/she bargained for. In the workplace, the common expression "full day's work for a full day's pay" is a reminder of the worker's obligation under the principle of equivalence. Reversing the language to "full day's pay for a full day's work" underscores the employer's duty to the worker.

There are several specific ways in which the principle of equivalence may be violated in the marketplace. Shoplifting is one, and issuing a bad check is another. Loan sharking -- charging excessive interest -- and price gouging that may take place in an emergency such as a hurricane are two more examples. Counterfeiting, whether it involves paper currency or "knockoffs" violates the principle of equivalence as does the bait and switch scheme. Bait and switch is the practice of a merchant attracting customers into his/her store by offering an item at a very attractive price, telling customers as they enter the store that the item is sold out, switching them to a more expensive substitute item, and high-pressuring them into buying that item.

In the workplace there are several ways in which the principle of equivalence may be violated. We have enumerated five specific instances: expense padding, sweatshop, embezzling, pilfering, and featherbedding. All violate the principle of equivalence either regarding the duty to exchange things of equal value or to impose equal burdens on one another.

Expense padding means seeking reimbursement from your employer for personal expenses incurred when you have been traveling on official business. Or it may be seeking reimbursement for legitimate business expenses but those expenses have been inflated or padded.¹ A sweatshop is an employer who cheats his/her workers in terms of wages, hours, or working conditions. Paying less than the minimum wage or the wage agreed to, forcing employees to work very long hours without

¹ Business establishments can purchase high-tech expense reporting services that automate and analyze employee expense reporting and reimbursement for the purpose of reducing the risk of expense padding. See www.concur.com.

rest or compensation, operating a workplace that violates the local building code or that is generally unsafe are ways in which an employer “sweats” his employees in order to reduce labor costs and add to profits.

Pilfering and embezzling are ethical twins. Pilfering happens when an employee steals supplies or merchandise from his/her employer. Embezzling takes place when an employee takes cash from his/her employer. Featherbedding occurs when an employee reports to work but does not perform his/her assigned duties. Instead the employee occupies him/herself with personal business such as surfing the internet, playing solitaire on the computer, balancing the personal checkbook, reading the newspaper, generally “schmoozing” with other employees, and the like. Featherbedding is an employee failing in the obligation to perform a full day’s work for a full day’s pay.

The second principle of justice -- distributive justice -- defines the duties of the superior to his/her subordinates. Specifically, distributive justice requires the superior to distribute the benefits and burdens of the group under his/her supervision among its members in some generally equal fashion. This does not mean strictly equal because there likely are significant differences among subordinates and it is entirely appropriate to take those differences into account. For example, handicapped employees appropriately may require different parking and restroom accommodations than able-bodied employees. Single parents in general shoulder heavier child care responsibilities than married parents. Persons of different faiths may observe different holy days. Distributive justice demands that the superior differentiate among subordinates only when the differences among them are real and substantial and require different arrangements. A superior may allow a single parent to rush home to tend to a sick child when the same permission might not be given to a married worker with a spouse who routinely stays at home to look after the children. A strict orthodox Jew may not be required to work on Saturday, the Sabbath in his/her religion, whereas persons of other faiths might have to work on that day.

Discrimination occurs when the superior differentiates among subordinates for reasons that are insubstantial. In this regard, false stereotyping may be the device used to rationalize the difference in treatment among subordinates. For example, older workers may be treated differently because they simply have “less upside potential” than younger workers. Women may be treated differently because for them work is of secondary importance in their lives. Immigrant workers may be treated differently because they dress differently or speak with heavy accents. Favoritism is simply the other side of the coin of discrimination: treating some better than others for reasons that are superficial or based on the false stereotyping of others.

The Civil Rights Act of 1964 accorded special legal protection against discriminatory practices to women, African Americans, Native Americans, Jews and persons of other faiths, and persons born in other countries. In 1968 persons 40 years of age or older were included in the “protected class”; 22 years later persons with disabilities were included. Even so, false stereotyping is the means by which discrimination persists and flourishes today in the United States. By assigning negative

THREE PRINCIPLES OF ECONOMIC JUSTICE: WORKPLACE AND MARKETPLACE APPLICATIONS

Principle	Obligated Person	Definition	Common Expressions in		Unjust Practices in	
			Marketplace	Workplace	Marketplace	Workplace
Equivalence =====> also called commutative or exchange justice	buyer and seller mutually obligated worker and employer mutually obligated	both persons obliged to exchange things of equal value and impose equal burdens on the other	money-back guarantee got my money's worth no third party checks accepted	full day's work for full day's pay	shoplifting bad check bait and switch loan sharking price gouging counterfeiting	expense padding sweatshop embezzling pilfering featherbedding
Distributive Justice =====>	superior obligated to subordinate	superior obliged to distribute benefits and burdens of belonging to a group among its members in some equal or proportional fashion	rain check available limit 3 per customer everyday low prices sale price effective as long as supplies last	equal pay for equal work equal opportunity affirmative action	discrimination: sex/race/age family/friend religion national origin ethnicity kickback	harassment
Contributive Justice =====> also called social or legal justice	member obligated to group	to the extent that a member benefits from belonging to a group that person has an obligation to contribute to the support of the group	you were here before me where does the line begin?	doing my fair share pulling my load paying my dues	insider trading insurance fraud dumping product tampering	industrial spying and sabotage computer tampering provoking trouble

characteristics to a person based on what is taken to be common characteristics of the minority group to which that person belongs, false stereotyping essentially blames the victim for certain character defects and thereby rationalizes treating that person differently. Thus a specific minority person is branded as shiftless, boisterous, drunken, or is labeled as practicing odd religious rituals, having too many babies, speaking a foreign language, enjoying strange foods, emitting a body odor or foul breath, wearing bizarre clothing, and the like. For those reasons and others, it becomes much easier to treat that minority person differently than others. Our language itself conveys and reinforces such false stereotypes: the “n” word, the “b” word, “coon ---,” “dago,” “gook,” “kraut,” “kike, “redneck,” hick.” False stereotyping is especially insidious because until it is exposed false stereotyping attributes the discrimination to the victim rather than the perpetrator, justifying the discrimination on the basis of an alleged defect in the character of the victim.

Discrimination and the government intervention required to address it are evidence that the law of nature, which asserts each individual economic agent in the pursuit of his/her self interest also serves the common good through the invisible hand, is not always sufficient to resolve important conflicts in economic affairs.

*Two especially noteworthy violations of distributive justice are kickbacks and harassment. A kickback is the ethical equivalent of a bribe. A bribe is a payment to a superior in the expectation of special treatment. The payment **precedes** the special treatment. A kickback is a payment for special treatment wherein the payment **follows** the special treatment. A contractor bribing a state highway official in order to influence that official’s decision as to which contractor is to be awarded a construction contract makes payment beforehand. A contractor kicking back to a highway official promises beforehand to make payment after the deal has been closed. Harassment is the practice of a superior exacting special sexual favors from a subordinate, or touching or addressing him/her in ways that are disrespectful in exchange for a favorable performance evaluation, a raise, a promotion, job assignment, or the like.*

*“Equal pay for equal work” is a requirement under distributive justice. It means that persons doing the same work, with the same on-the-job-performance of their assigned duties, are to be paid the same wages. **Please note that “equal pay for equal work” is not the same as “a full day’s pay for a full day’s work” which is the employer’s duty under the principle of equivalence.***

“Equal opportunity” too is a requirement under distributive justice. It means that persons of equal experience and qualifications are to be afforded the same chance to be hired and promoted. “Affirmative action” is controversial because some argue that it is necessary and others assert that it is reverse discrimination. The principle of the double effect, which we borrow from ethics, is instructive regarding affirmative action because affirmative action -- the hiring and promoting of persons in the protected classes over others -- has two effects, one positive and one negative. The positive effect is the good that is done for the person(s) hired or promoted. The negative effect is the bad that is experienced by those who are passed over in the hiring or promotion process. The principle of the double effect says that: (1) the good effect must be greater than the bad effect, otherwise the superior/decision-maker is doing more harm than good; (2) the bad effect must not be

intended. The superior/decision-maker must not intend to bring harm to the person(s) being passed over, but recognizes that there is no way to hire or promote one or two from an applicant pool without passing over everyone else.

The principle of distributive justice has application in the marketplace too, but here the issues are not nearly as serious as in the workplace. In the marketplace, it is the merchant or shopkeeper who is the superior because he/she is the one who must treat his/her customers with fairness. There are several ways in which this is done. A merchant who makes rain checks available to his/her customers is saying in effect that when an item is put on sale at a very favorable price, he/she will treat all customers alike even those who come to the store after the supply of that item has been exhausted. Under those circumstances, the merchant re-orders the item in such quantities to satisfy all customers who have been issued a rain check. "Limit 3 to a customer" tells all customers that everyone is entitled to purchase no more than three of a specific item on sale so that one customer will not buy the entire available supply. "Everyday low prices" indicates that the store does not raise and lower prices from one day to the next so that every shopper has access to the item at the same price whenever that shopper enters the store. "Sale price effective as long as supplies last" tells customers when the item is put on sale that customers who delay in coming to the store may find that the item has been sold out.

The key to understanding all such practices as meeting the merchant's obligations under the principle of distributive justice is that while the specific terms of sale differ across these practices once a specific practice is put in place there is no difference in the way those terms are applied to any customer. Further, though some customers may not be able to take advantage of the favorable opportunities afforded by the merchant, due perhaps to their lack of transportation, their infirmities or disabilities, their being away from home on business, the merchant's duties under distributive justice extend only to those who actually enter the store, provided the merchant has made an effort to properly inform his/her customers of the opportunities and to maintain the usual store operating hours.

The third and last principle of economic justice is contributive justice that lays down the obligation of the member to the group to which that person belongs. Insofar as a person receives benefits from the group, that person has a duty to maintain and support the group. Paying dues -- a duty -- is the usual requirement for the persons joining and remaining active in a membership organization. Failure to pay membership dues typically reduces a person to inactive membership status enjoying fewer or even little benefits of membership as compared to those in good standing.

Of the three principles of economic justice, contributive justice is least familiar because we Americans think of ourselves as individuals first and indeed have a high regard for "rugged individualism." For that reason, we have only weak examples of common expressions for contributive justice in the workplace and the marketplace.

In the workplace, where employees commonly work in groups or teams, expressions such as "doing my fair share," "pulling my load," and "paying my dues" are sometimes heard. There are even

greater problems in seeing contributive justice faithfully practiced in the marketplace. Even so, there are certain expectations when persons come together whether for a concert, ball game, or to enter a flow of traffic. The newest arrival in a ticket line or traffic line is expected to wait his/her turn and not cut into the line. To do otherwise is disrespectful of those who have been waiting and sets an example for others to do the same in which case pushing, shoving, and cutting off other cars may become the rule rather than the exception. A general loss of civility may follow that is destructive of a sense of community.

However, when it comes to violations of the principle of contributive justice, there are several powerful examples in the marketplace and the workplace. In the workplace, industrial spying and sabotage violate contributive justice because the person who appears to be a loyal and productive member of one business establishment actually is faithful to a rival organization and seeks to undermine the effectiveness of the first establishment by stealing secrets and disrupting its work. Is it a violation to hire a person from a rival establishment and then pick his/her brain for whatever information he/she might be able to share with the new employer? It does, if that person surrenders proprietary information to which the former employer can claim a clear property right such as a secret formula for making a product.

Computer tampering violates contributive justice because the persons who use a common resource such as the internet are expected to respect the work and files of others using that resource. Otherwise, confusion and destruction reign, and the internet becomes a less effective tool for all who use. Persons who provoke trouble on the job by spreading rumors, by exaggerating the faults of others, by complaining constantly about supervisors and working conditions violate contributive justice because they tear down the organization making it less effective and less successful in day-to-day operations.

Product tampering in the marketplace is the moral equivalent of computer tampering in the workplace. Tampering with a product is harmful to everyone who uses that product, because it makes consumers fearful that the product is unsafe to use. That in turn can have a powerful negative effect on the company that makes that product. Insurance fraud violates contributive justice because if a fraudulent claim is not detected by the insurance company, payment is made to the insured party that drives up the costs of the insurer who then may pass those additional costs on to all policy holders in the form of higher premiums. The Coalition Against Insurance Fraud estimates that insurance fraud costs Americans about \$80 billion every year. According to the Coalition, the extent of insurance fraud is greater than this estimate because much fraud is undetected and unreported (see www.insurancefraud.org).

Insider trading is the practice of persons within a corporate organization whose shares of stock are publicly traded on a stock exchange using information that is confidential and not available to the trading public in order to buy or sell shares in that corporation for personal gain. Insider trading is morally the same as playing cards with a marked deck. The gains achieved by the insiders come at the expense of other traders who do not have access to that confidential information and therefore are buying shares that soon afterward will fall in value or are selling shares that later will rise in

value. The federal Securities and Exchange Commission is charged with the responsibility of monitoring trades made by senior corporate executives involving shares of stock in their own corporation in order to detect and punish insider trading.¹ Unrestrained insider trading undermines the effectiveness of a stock exchange because in effect the big fish are eating the little fish.

Dumping involves the sale of a product made in one country in another country under circumstances where it is clear that the intent is not to compete but to destroy. An example will help illustrate the practice of dumping. The table below provides information on two companies manufacturing and selling DVD players, the one is American and the other is, say, Taiwanese. The American company sells its product in the U.S. market at \$205 retail, and earns a profit of \$60 per unit sold because its unit cost of production is \$145. The Taiwanese company in Taiwan sells an equivalent DVD player at \$180 and achieves a profit of \$80 per unit sold because its unit cost of production is \$100.

If the Taiwanese company begins selling in the U.S. market at the same price that it charges for its product in Taiwan, the U.S. company is put at a competitive disadvantage because its price is \$25 higher. The U.S. company could become competitive again by matching the \$180 price of the made-in-Taiwan DVD by taking a smaller profit on every unit sold or by reducing the cost of production in order to protect its \$60 profit margin. To this point, there is nothing ethically untoward. This is the normal, everyday price competition between two rival firms. Indeed, there is nothing untoward even if the Taiwanese were to drop its unit price to \$100 completely wiping out its profit margin. The U.S. company may find it very difficult to match that lower price, and may even be driven out of the DVD manufacturing business. This is “hardball” competition. Dumping occurs when the Taiwanese firm sets its price in the United States below its own cost of production, thereby losing money on every unit sold. It is able to do this if it has earned profits in the past and has retained some of those

THE PROBLEM OF DUMPING

	U.S. Company	Taiwanese Company
Price in home country	\$ 205	\$ 180
Unit cost of production	145	100
Profit per unit sold	60	80

profits in the form of cash on hand. The losses that the company in Taiwan takes on every unit sold reduces its cash on hand but does not drive it out of business. It is able to continue operating and paying for the resources that it uses in the production process in part from sales revenues and the

¹ Bill Gates, for example, owned 338 million shares of Microsoft in February 2014. A one-cent fluctuation in the share price of Microsoft means a loss or gain for Gates of approximately \$3,380,000.

rest from cash on hand. This practice, selling a product in another country below the cost of production, is dumping. Its purpose is not to compete with rivals but to destroy them in order to dominate the market and then be able to run up the price to the disadvantage of U.S. buyers of DVD players. The U.S. company that has been attacked this way can sue the Taiwanese company to stop dumping and to require payment for any financial damages that it might have suffered.

Under the Tariff Act of 1930, U.S. industries may petition the federal government for relief from imports that are sold in the United States at less than fair value (“dumped”) or that benefit from subsidies provided by foreign governments. The U.S. Department of Commerce determines whether dumping or subsidizing exists and the margin of dumping or amount of subsidy. The U.S. International Trade Commission (www.usitc.gov) determines whether there is material injury or threat of injury to the domestic industry due to dumped or subsidized imports. In 2013, for example, the Commission found that Samsung was dumping clothes washing machines produced in South Korea and Mexico injuring U.S. manufacturer Whirlpool. This decision led to the imposition of duties on Samsung imports.¹

Tax evasion² – the deliberate effort to not pay the taxes owed under tax code – violates the principle of contributive justice because when evasion is successful other citizens are forced to make up the difference either in the form of reduced spending, higher taxes, or increased public indebtedness. Litter, trash, and environmental pollution³ are problems in contributive justice in that they are destructive of the air we breathe, the water we drink, and the tranquility and wonders of nature we enjoy. It follows that every member of the community has an obligation in contributive justice to limit such destructive practices in order to help preserve those endowments of nature that are vital to the health and well-being of all living creatures.

As stated previously, limits on the amount of gain in the form of profits, consumer surplus, and economic rent are necessary to prevent one party from taking advantage of another and to assure that market exchange serves everyone fairly and effectively. Those limits derive from the duties that economic agents owe one another under the principles of equivalence, distributive justice, and contributive justice. Specifically, the principle of equivalence limits ill-gotten or excessive gain because what is gotten and what is given up in the exchange are what were freely and openly agreed to before the exchange takes place. For example, the ill-gotten gain for the employer who operates a sweatshop is the added profits from denying his/her workers what is due them. The ill-gotten gain for the employee who embezzles is money that rightfully belongs to the employer. The principle of distributive justice limits ill-gotten gain because the superior assures that what is gotten and what is given up are the same for everyone in the same or similar circumstances. To illustrate, the ill-gotten

¹ See *Bloomberg Businessweek News*, January 23, 2013, available at www.businessweek.com

² Tax avoidance is an entirely different matter. Avoidance means arranging one’s income in a way which conforms to the tax code but reduces the amount owed in taxes.

³ In addition to contamination of the air, water, and soil, we include noise pollution originating from heavy train traffic or commercial air traffic.

gain for the employer who pays some workers less than others for the same work is the added profits gotten through discrimination. The ill-gotten gain for the public official who has been bribed to award a contract for a clearly substandard proposal is the money which that official has gotten dishonestly. The principle of contributive justice limits excessive gain because each member gives up (contributes) what is necessary to maintain the group provided what is gotten by that member is the same or similar to what is gotten by the other members of the group. The ill-gotten gain for the inside trader comes at the expense of persons who sell shares that the inside trader knows are undervalued or who buy shares that the insider knows are overvalued. The ill-gotten gain in industrial spying is the property that rightfully belongs to someone else.

Justice and the Problem of Wage and Salary Administration.

One of the most important tasks of the supervisor is wage and salary administration. It involves two main tasks: evaluating performance and linking pay to performance. In this regard, there are three central questions that must be addressed. First, how much does he/she contribute as an individual to the assigned tasks, and how much is that work worth? Second, how much are others being paid for the same work? Third, how much does he/she contribute as a member to the success of the group or team to which he/she is assigned, and how much is that contribution worth?

Performance evaluation involves the careful, honest, and comprehensive evaluation of the amount and quality of the assigned work that the subordinate has carried out over a given period of time, the last week, month, quarter, year. Supervisors are expected to conduct performance evaluations of those persons who are known as “direct reports,” they report directly to that supervisor.

To the extent possible, evaluation should be quantifiable but for many professional workers the nature of their work does not always lend itself well to strict quantification. Inevitably, therefore, performance evaluation involves judgment on the part of the supervisor. There are two procedures that help reduce the arbitrariness in making judgments. First, the subordinate prepares his/her own performance evaluation and submits it to the superior for review and approval. Second, the performance evaluations conducted by the supervisor are subject to review by the person to whom the supervisor reports.

The best way to assure that performance evaluation is done properly is to select the right persons to serve in supervisory positions and train them well for the difficult task at hand. The mere fact that a supervisor may have done the very same assigned tasks as the person whom he/she is evaluating is no assurance that performance evaluation will be conducted carefully, honestly, and comprehensively. Ultimately, the supervisor must be a person of integrity.

As to the problem of linking pay to performance, it is necessary to address the problem first from the perspective of the employer/supervisor and then from the perspective of the employee. The employer/supervisor has two obligations drawn from the principle of equivalence and the principle of distributive justice. In common-expression language, under the principle of equivalence the employer/supervisor has a duty to the employee for “a full day’s pay for a full day’s work.” Under the principle of distributive justice, the employer/supervisor has an obligation for “equal pay for equal work.” Failing with regard to the first duty is in effect to break the employment contract and

the wages and work agreed to in that contract. Failing with the regard to the second duty is discriminatory. By meeting his/her obligations under the principle of equivalence, the employer in effect affirms his/her own individuality and the individuality of the worker. Similarly, by carrying out his/her duties as set forth in the principle of distributive justice, the employer affirms her/her own sociality and the sociality of the worker.

THE PROBLEM OF WAGE AND SALARY ADMINISTRATION

Wage and Salary Administration Involves All Three Principles of Economic Justice Simultaneously To Address Three Central Questions:

1. **How much work does this person (do I) do as an individual, and how much is that work worth?**
 2. **How much are others being paid for the same work?**
 3. **How much does this person (do I) contribute to the work done as a member of the team, and how much is that work worth?**
- **For the employer/supervisor the obligation is two-fold:**
 - (1) from the principle of **equivalence** to exchange things of equal value and impose equal burdens on the employee/worker:

a full day's pay for a full day's work -- affirms human individuality
 - (2) from the principle of **distributive justice** to distribute the benefits and the burdens of the work in some equal fashion among all employees/workers:

equal pay for equal work -- affirms human sociality
 - **For the employee/worker the obligation is two-fold:**
 - (1) from the principle of **equivalence** to exchange things of equal value and impose equal burdens on the employer/supervisor:

a full day's work for a full day's pay -- affirms human individuality
 - (2) from the principle of **contributive justice** to contribute to the maintenance and support of the work group:

doing my fair share; paying my dues -- affirms human sociality
-

The employee also has two obligations, one drawn from the principle of equivalence and the other from contributive justice. "Full day's work for a full day's pay" is what the employee owes the employer/supervisor under the principle of equivalence, and as with the employer/supervisor, any failure effectively breaks the employment contract. The employee's second duty is to "do his/her fair share," "pay his/her dues," to contribute positively to the success of the group or team to which

he/she has been assigned. This duty is less sharply defined than the first. Much depends on the circumstances at the moment in the workplace and the marketplace. More may be required of a person as a member of the team when the company is facing a difficult deadline in making delivery to a customer, or when the necessary supplies for production are not readily available, or when someone on the team is sick or otherwise absent from work. Further, more may be required when the company is on the brink of financial failure. In that sense, the principle of contributive justice requires a member of the group or team to do all that is required for group success provided what is required is reasonable. Thus, judgment inevitably is a part of any decision as to one's duty under the principle of contributive justice. As we have just seen with the employer, by meeting his/her obligations under the principle of equivalence, the worker validates his/her own individuality and the individuality of the employer, and by fulfilling his/her duties under the principle of contributive justice, the worker authenticates his/own sociality and the sociality of everyone else in the group.

Justice in the Financial Sector.

There is a profoundly important difference in the way economic agents function in product and resource markets – the so-called real economy -- and in financial markets. In the real economy, as we have just observed, buying and selling is based on the positive-sum premise that every person engaged in a given exchange achieves a gain. Without that gain, exchange collapses. Buying and selling typically take place under conditions of certainty and transparency to help assure that justice is served.

In the financial sector investing, hedging, and speculating are based on the zero-sum premise that one agent's gain is another's loss. Investors, hedgers and speculators are driven by the uncertainty and risk associated with future price movements. Hedgers are risk-averting; they avoid risk at the expense of the greater gains possible. Speculators are risk-seeking; they take on risk for the greater gains possible. Investors can be risk-averting, risk-seeking, or both. Often all three types – hedgers, speculators, investors -- are referred to as traders. We do not employ that language herein, preferring instead investor, hedger, and speculator in order to convey our meaning more clearly.

In the following we address buying and selling in the real economy and investing, hedging, and speculating in the financial sector in order to better understand how they are alike and how they differ. Our purpose is not to exam these activities to the finest detail but to underscore the difference between positive-sum and zero-sum activities and the role of justice in the real economy and the financial sector.

A futures contract is a legally-binding commitment to buy or sell a specific commodity such as wheat or oil or financial product based on the S&P index or Dow Jones index or the like for a fixed price on a specific date in the future. Hedgers are producers and users of commodities who are risk-averse regarding future prices.¹ Both try to reduce that risk by signing futures contracts that call for the producer to sell the commodity at a fixed price and deliver it on a given date in the future to the

¹ Daniels Trading, "Hedges & Speculators." available at www.danielstrading.com.

*user who must buy that commodity at that price and take delivery on that date. Producers win and users lose when the price of the commodity on the delivery date is **below** the agreed price as specified in the contract. Users win and producers lose when the price on the date of delivery is above the price specified in the contract.*

*Even though the futures contract on the date of delivery is a zero-sum agreement in which one party eventually wins and the other loses, justice is served as long as they understand in full and accept without reservation the terms of the contract when they commit themselves contractually. In other words, a futures contract meets the demands of justice when the terms are transparent and the parties are free to act. Under the principle of equivalence they are exchanging things of equal value – a clearly stated price for a clearly specified commodity or financial product -- and imposing equal burdens on one another – the uncertainty and risk involved in future price movements **over which neither one has any control**. If, however, one of the parties has control over prices in the future, justice is not served because uncertainty and risk are much lower for the one who controls those prices and therefore that party is not imposing equal burdens on the other. In strictly ethical terms, that contract is unjust and not binding.*

*A futures contract can be bought and sold multiple times just as a stock can be bought and sold time after time on the New York Stock Exchange and the NASDAQ. Thus the holder of a futures contract can transfer the risk to someone else in exchange for cash. Speculators buy and sell futures contracts through commodity exchanges but are neither producers nor users of the underlying commodities. Unlike hedgers, speculators are risk seeking with regard to future changes in commodity prices.¹ They buy commodity contracts which they regard as **undervalued** today because they expect the future price of the underlying commodity will be higher than the commodity price set forth in that contract and therefore they can expect to sell that contract in the future at a higher price than what they paid for it. They sell commodity contracts they regard as **overvalued** today because they expect the future price of the underlying commodity will be lower than the commodity price set forth in that contract and for that reason the contract itself will sell at a lower price in the future. Speculators win whenever they have predicted future price movements correctly. Otherwise they lose. Unlike hedgers, speculators cannot afford to be obligated under the terms of a contract on its date of delivery because they are in no position to deliver the underlying commodity nor can they take delivery because they have no use for it.*

For a futures contract based on a financial product such as the S&P index, the buyer of that contract experiences a gain when the index rises and a loss when it falls. Specifically, a change of one index point in the S&P index represents a gain or loss of \$250.² If at the end of the trading day, for example, the index rises by 20 points the person who has purchased that contract captures a \$5,000

¹ See preceding footnote.

² The dollar gain/loss for every point change in the Dow is \$10. For the NASDAQ it is \$100; for the S&P it is \$250. See “What do the S&P, Dow and Nasdaq futures contracts represent?” available at www.investopedia.com/ask.

gain and the person who sold that contract must transfer \$5,000 to the account of the person who purchased it. If the index falls, the purchaser must transfer to the seller's account \$250 for each point the index has fallen. This kind of futures contract is bought and sold on either the Chicago Board of Trade or the Chicago Mercantile Exchange **and provides agents in that market with valuable information that helps inform their decision-making for the day.**

The CBOT and the CME are not the only futures contract exchanges in the United States. The New York Mercantile Exchange specializes in oil futures contracts. The New York Board of Trade provides a market for cocoa, coffee, cotton, orange juice, and sugar. Other futures exchanges operate in London, Tokyo, Sydney, Singapore, and elsewhere.

The pejorative inference in the name notwithstanding, speculators provide an important service to daily commodity and financial product markets. Speculators, especially those who are specialists in a specific commodity or financial product such as corn or the euro focus attention on future price movements. They are in fact specialists in future price expectations who put at risk their own money on the basis of their analysis of those expectations. Future price expectations in turn influence the daily market price from both the demand side and the supply side.

On the demand side, consumers who expect prices to rise in the future are likely to buy today in order to avoid those future price increases. Conversely, consumers who expect prices in the future to fall are likely to postpone current spending in order to take advantage of the lower expected prices in the future. On the supply side, producers who expect higher prices in the future are likely to hold back current production in order to sell more when prices are higher. Producers who expect prices to fall in the future are likely to sell more in order to take advantage of those higher prices.

By following exchange activities relating to the buying and selling of futures contracts, consumers and producers are better informed regarding future price expectations. Whenever the price of a futures contract itself (not the agreed price as set forth in that contract) for a specific commodity or financial product is **falling** consumers and producers can expect the price of that commodity or financial product to fall in the future and can adjust their current buying and selling accordingly. When the price of such a contract is **rising** consumers and producers can expect the price of the underlying commodity to rise in the future and can apply that information to their own current market decision-making.

By informing consumers and producers in their day-to-day market decision-making, speculators help determine current market prices.

An options contract is similar to a futures contract except that the person holding such a contract has the option of meeting his/her obligations as set forth in the contract or backing out. As with futures contracts, option contracts are exchange-traded. An option to sell a futures contract is called a **put**. An option to buy a futures contract is known as a **call**.

A forward contract is like a futures contract but is more complex. To reduce the risk of a very large gain/loss on the date of delivery, a futures contract is re-balanced every day to the daily spot price of a futures contract with the same agreed price on delivery and the same underlying asset. This practice, known as “marked to market,” reduces the risk that there will be a very large gain/loss on delivery date because the loser on a daily basis must transfer monies to the margin account of the winner. A forward contract is not re-balanced and therefore exposes the contracted parties to a large gain for the one and a large loss for the other on the date of delivery. Thus there is a credit risk associated with a forward contract in that the seller/producer may not be able to deliver the underlying commodity and the buyer/user may not be able to make payment in full at delivery. Futures contracts are exchanged traded whereas forward contracts are bought and sold over the counter. This difference means that futures contracts are much more standardized than forward contracts.

The risk of failure on the part of the producer or the user of a futures contract on delivery date is borne by the exchange thereby limiting credit risk in futures contracts. To illustrate, participants in the New York Mercantile Exchange are required to maintain accounts with deposits sufficient to cover any losses they may experience.

*The currency market is a financial market where currencies are bought and sold in anticipation of the gain from holding one currency versus another. Trades are executed through brokers or market makers who provide access to the currency market which is a network of world banks that buy and sell currencies electronically and through that activity, **which can be rough and tumble, provide the essential service of setting currency exchange rates.** For more on the currency market see Topic 22.*

If, for example, the U.S. dollar exchanges today for 105 yen and a currency speculator expects that the dollar will exchange for 120 yen next week, that speculator would sell yen and buy dollars today in anticipation of the gain of 15 yen for each dollar sold and exchanged for 120 yen next week. The speculator who anticipates the change in the rate of exchange correctly and buys or sells accordingly captures the gain. Any speculator on the other side of that buying or selling activity who in effect anticipated the rate of exchange incorrectly suffers the loss. Key to this zero-sum outcome is that the currencies are being bought and sold not for the purpose of exchanging that money for some good or service but for the expected gain in the exchange process itself. The use value/exchange value calculus of buying and selling does not apply to speculating. For currency speculators gain and loss originate in the difference in the exchange rate (the currency’s price or exchange value) from one point in time to another.

Just as we observed with future prices for commodities, a person actively engaged in buying and selling currencies can hedge against changing currency prices in the future by turning to a futures contract, an options contract, or a forward contract. With the exception of options and forwards which are addressed later in this section, and in keeping with our opening statement, we have nothing further to say about the currency market.

Daily economic affairs are not as cut and dried as conventional economic theory suggests. Buying and selling, investing hedging, and speculating can be separated in the abstract but not always in day-to-day economic activity. Actually purchasing shares of stock in a given corporation today is buying and selling in the sense that gain is involved for both the buyer and seller. Certainty, transparency, and reduced risk attend the trade when the sale is executed because there is a clear, accessible record of the performance of that corporation.

However, neither the buyer nor the seller of those shares knows for certain what they will yield in terms of dividend stream and share price in the future. Uncertainty, obscurity, and elevated risk attend the holding of those shares in the future. The person holding them to support retirement well into the future is an investor when he/she expects a long-term gain based on dividends and the share price. The person who deliberately buys only shares in corporations with a rock-solid record of paying dividends and slow but steady growth in share price is a hedger. On the other hand, the person who buys shares in corporations with an erratic performance record or no record whatsoever is a speculator.

Whatever the buyer's underlying purpose in these stock purchases, the practice is known as "buying long" and is based on the simple premise that the stock is undervalued and will increase in price in the future. "Selling short," on the other hand, is based on the premise that the stock is overvalued and will decrease in price in the future. Selling short is the practice of paying another person a fee to borrow his/her shares with the promise to replace them at a given date in the future, selling those shares immediately, and replacing them as required at the share price on that given date. The person selling short pockets a gain if the future price is lower and takes a loss if the price is higher. Day traders are speculators. So too are those who financially back a theatrical production in the hope that it will have a long and successful run on Broadway.

Even so, as we noted already with futures contracts, selling short is not unjust as long as the terms of the contract are transparent and the parties are free to act. If, however, one of the parties has control over the share price in the future, justice is not served because uncertainty and risk are much lower for the one who controls that price and therefore that party is imposing an unequal burden on the other. In strictly ethical terms, that contract is unjust and not binding.

Although it is not defined in the federal securities laws or SRO¹ rules, "naked" short selling is the practice of selling short without first having borrowed the shares. Not being able to borrow the necessary shares could happen in the case of a small company with only a few outstanding shares. Under Securities and Exchange Commission rules the seller is allowed three days to deliver the shares to the buyer before that seller is reported for failure to deliver. A sudden increase in failure-to-deliver reports involving the shares of a specific firm suggests some irregularity in the trading of those shares.

¹ An SRO is a self-regulatory organization such as the New York Stock Exchange that exercises some degree of regulatory authority over an industry or profession.

Though not illegal per se, naked short selling could be a sham or abusive practice in certain instances as when a broker-dealer lends the same shares to different short sellers. This abuse can happen because shares typically are transferred electronically and no registered stock certificates ever change hands. Thus, under its emergency rule making authority, the SEC can declare naked short selling legal for some and illegal for others depending on how the Commission responds to changing market conditions and the behavior of lenders and sellers especially when major financial stocks are severely threatened. In July 2008, for example, the SEC exempted market makers from a new rule which otherwise prohibits naked short selling of the shares of 17 Wall Street banks along with the two government mortgage guarantors Fannie Mae and Freddie Mac.¹ Market-makers buy and sell shares in order to match buy/sell orders and thereby help stabilize the market.

Naked short selling with the deliberate intent to drive the share price down is illegal. It is unjust because the seller, hoping to capture an ill-gotten gain, necessarily conceals his intent from the lender and thereby violates both the transparency rule and the price control rule. Naked short selling in which the seller has no intention of ever delivering the shares is unethical because it violates the transparency rule. Proving such ill intent, that the transparency rule or price control rule has been violated intentionally, makes enforcement difficult and leads at times to the SEC being accused of not doing its job.

Apart from those who buy a house to make it their home and expect to stay there for a long time, a house or similar property can be purchased for the purpose of investing, hedging, or speculating. An investor expects the property to increase in value in the long term and plans to hold it in anticipation of that long-term gain. A hedger purchases the property because other types of investments such as equities and commodities are too risky at the moment. A speculator acquires the property in the expectation of the gain to be made over the short term in a market where property prices are rising rapidly. “Flipping” a house is speculative behavior in that the house is held only long enough to make some improvements which at times can be more superficial than substantial and are expected to increase its resale value by more than the cost of those improvements.

The key to setting apart buying and selling in the real economy from investing, hedging, and speculating in the financial sector is found in what is being purchased and why it is being acquired. With the exception of hoarding, a bunch of bananas, a box of cereal, a gallon of gas for one’s car are consumables in which the buyer and the seller have carried out the use value/exchange value calculus and have decided there is gain for both in the exchange process. Similarly, labor and physical resources are consumables in the sense that they are consumed, used up, in the production process and are subject to the same calculus. Thus, buying and selling in the real economy are positive-sum activities.

¹ See Forbes, no date. “SEC Retrenches on New Short-Selling Rules,” available at: www.forbes.com/2008/07/18/sec-short-trading-biz-ck_em_0718nakedshort.html,

A real estate holding, a share of stock, an oil futures contract are assets, things of value, which are acquired not for their use value but with the expectation that they will increase in exchange value in the future and can be cast off when that expectation does not materialize. The person who pays for an asset which appreciates in value enjoys a gain. The person who exchanges that asset for cash takes a loss. Investing, hedging, and speculating in the financial sector are zero-sum activities.

A home is a special case. It is both a consumable and an asset. As a consumable, it is subject to the use value/exchange value calculus and buying/selling is based on the positive-sum premise. As an asset, it is acquired with the expectation that it will increase in value over time and therefore is based on the zero-sum premise. The new owner seizes the gain, and the former owner relinquishes that gain, if the house appreciates in value. If the house depreciates in value, the new owner is the loser and the former owner is the winner.

Though not contractual in nature, hoarding is a form of hedging in that the buyer is betting that an expected shortage of a commodity will drive the price higher and therefore decides to purchase more of that commodity today than usual in order to avoid both the shortage and the anticipated higher price. The buyer who hoards suffers a loss if the future price is lower than today's price and the seller captures a gain. If, on the other hand, the anticipated higher price materializes the seller suffers a loss by selling today and the buyer captures a gain by getting the commodity at today's lower price.

Casino gambling is a form of speculation in which the gambler initiates an exchange involving a relatively small amount of money that is wagered in the expectation that there will be a very substantial payoff. Risk, uncertainty, and obscurity attend every gambling play in which the experienced gambler is likely to know how to reduce the risk – by playing blackjack for instance instead of the slot machines, by counting cards at the poker table – but is not able to eliminate uncertainty, obscurity, or risk entirely. Unlike buying and selling in the real economy, what is given up in casino gambling is clear and assured, what is gotten in return is not. The betting outcome is nearly instantaneous in a casino where gamblers are enticed to recoup their losses by continuing to bet even though it is well-known that the odds overwhelmingly favor the house.

REVIEW SECTION: TOPIC 2

Central Concepts:

- opportunity cost
- exchange value
- use value
- gain
 - profits
 - consumer surplus
 - economic rent
- principle of equivalence
- principle of distributive justice
- principle of contributive justice
- principle of the double effect
- duty/obligation
- rip off
- favoritism
- discrimination
- dysfunctional community
- justice in wage and salary administration
- false stereotyping
- hedging, speculating, investing
- hoarding
- gambling
- futures contract
- options contract
 - put
 - call
- forward contract
- positive-sum activity
- zero-sum activity
- currency market
- buying long
- selling short
- naked short selling

Important Questions:

- In terms of your own personal experience as a decision-maker, how would you define opportunity cost?
- What is the difference between exchange value and use value?
- Define profit, consumer surplus, and economic rent.

(continued on following page)

Define the virtue or good habit of justice.

What are the three main principles of economic justice? In all three cases, name the specific parties involved.

In the context of the three principles of economic justice, what is discrimination, rip off, dysfunctional community?

For each of the three principles of economic justice, name at least four specific examples of violations and at least two common workplace or marketplace expressions.

What is the essential difference between hedging, speculating, and investing?

Explain the difference between a zero-sum activity and a positive sum activity.

Why are futures contracts, options, and forward contracts zero-sum activities?

Define buying long, selling short, and naked short selling.

How do assets and consumables differ?

True/False:

Favoritism is indicative of a violation of the principle of ...

- a. distributive justice.
- b. contributive justice.
- c. equivalence.
- d. all of the above.

Mark your answer below.



_____ Item a is true, items b, c, and d are false.

_____ Items a and b are true, items c and d are false.

_____ Item a is false, items b, c, and d are true.

TOPIC 3

PROCESSES, ORGANIZING PRINCIPLES, SOCIAL VALUES, AND ECONOMIC JUSTICE

To demonstrate how an economy system is organized, what social values lay beneath the forces that energize and limit economic affairs, how those social values are linked to economic justice, and how the system is driven by the entrepreneur.

Our extended discussion of the three principles of economic justice has not addressed directly questions as to whether and how those principles are embedded in the market system. What we are about to see is that justice is foundational to the three principles by which economic affairs are organized: competition, cooperation, and intervention. But we are getting ahead of ourselves. It is necessary to back up somewhat and focus first on the five economic processes and their associated economic functions.

Five distinct economic processes characterize the market system and economic affairs: production, distribution, exchange, consumption, and investment. Economic resources – natural and human – along with financial resources and the entrepreneur are used across all five processes either directly or indirectly. Production, as stated earlier, involves the transformation of resources into consumer, capital, and public goods and services. Distribution moves those goods and services through space and time from the workplace to the marketplace. Exchange involves the transfer of the ownership of the goods and services from the producer to the user.

Consumption is the fourth process in which private goods and services are used to satisfy a want or meet a need. A need is something required. Insulin is required by diabetics. Personally, I need eyeglasses whereas many of you do not. A want is something desired. For me, a ticket to the NCAA final four is a want but not a need. Needs and wants differ from person to person because human beings either in terms of the body and the spirit are magnificently different. And needs and wants inhere not in the good or service itself, although we may use language that suggests as much, but in the human person. The critical word in “I need eyeglasses” is “I.” Consumption also involves the utilization of public goods and services to meet needs that cannot be met at all or cannot be met as effectively by private goods and services.

Investment is two dimensional, involving both capital goods and services and public goods and services. The entrepreneur initiates and directs investment in capital goods and services that are deployed to enhance efficiency in production, distribution, and exchange (more about the entrepreneur later in this topic). The public official with the consent of the public directs investment in public goods and services to improve the infrastructure (fundamental structure) of the economy in order to better provision those common needs that derive from persons and families living together in communities. Examples of such public investment include expenditures on highway systems, seaports, airports, sewer and water systems, public elementary and secondary schools, state

universities, public hospitals and clinics.

The five economic processes -- production, distribution, exchange, consumption, and investment -- are like the five principal parts of a twin-engine commercial jetliner: cockpit, cabin, wings, tail, and landing gear. Just as each part has been designed to serve a unique purpose, each one of the economic processes has its own unique function.

Humans work for the income that they earn and importantly in order to meet their need to belong that originates in their human sociality and their need for opportunities to make use of their creative talents that originate in their human individuality. Conventional economics addresses work as a source of income but ignores work in terms of belonging and human creativity. Consumption is critically important because it provides the goods and services, such as food, shelter, clothing, medical care, necessary to sustain human life and restore human vitality through rest. Consumption of goods and services serve an additional purpose overlooked by conventional economics. They are necessary to the experience of encountering truth, goodness, and beauty, the needs of the human spirit. For example, to experience the beauty of the Golden Gate Bridge it is necessary to travel to San Francisco and to purchase certain goods and services along the way in order to make that trip possible. A university education requires years of considerable expenditures on goods and services in order to take hold of the truth either narrowly defined in terms of specific professional skills such as accounting or chemical engineering or much more broadly construed in terms of understanding the human condition.

Production, distribution, exchange, consumption, and investment are organized by three principles: competition, cooperation, and intervention. The first two are activating principles supplying energy to economic affairs in the same way that the engines of a twin-engine aircraft provide the power for lift. The third organizing principle – intervention – operates in the limiting mode acting as a force to limit certain abuses that may attend vigorous competition and cooperation.

In terms of our analogy of the economy as a twin-engine aircraft, intervention that limits competition and cooperation may be represented as the control surfaces of the aircraft, the rudder and the flaps for example. The entrepreneur/pilot is not able to handle the aircraft safely, to set it on a course and reach its destination predictably, without those control surfaces.

Competition is the human disposition to undertake certain tasks individually for the individual reward. Cooperation is the human disposition to undertake certain tasks collectively because they cannot be done at all or as well by an individual working alone. Some humans are more generously endowed with the competitive disposition. Michael Jordan for sure was one. Others are more disposed to cooperation. Consider how often John Stockton and Karl Malone of the Utah Jazz executed the “pick and roll” in defeating their opponents.

In American culture men tend to be more aggressive and competitive because they learn as little boys that those characteristics are important to establishing their manhood. Women are inclined to be more cooperative in part because their bodies are made for nurturing human life and in part

because little girls are not encouraged to engage in the rough and tumble play of little boys. Our language conveys and reinforces those stereotypes. A man with too little competitive drive is called a “wimp.” A woman with too much competitive energy is known as a “b----.” Boys and girls like this often are called “sissies” and “tomboys.”

That is not to say or imply that women cannot learn to be competitive and that men cannot take on the nurturing role. Indeed, American culture at least since the sexual revolution began has been changing the stereotypes of what a little boy should be and what a little girl should be. And as a consequence, men and women alike are aggressive and competitive at times and nurturing and cooperative at other times. The balance between those dispositions differs from one woman to the next and one man to the next.

Competition requires aggressive behavior and to the extent that men typically are aggressive competition is more masculine. Cooperation requires nurturing and insofar as women are nurturing cooperation is more feminine. We have indicated this association between the two activating principles of competition and cooperation and masculinity and femininity with the male (♂) and the female (♀) symbol.

The limiting principle of intervention can be operationalized by a public agency or a private group. For example, the U.S. Department of Labor enforces the federal minimum wage limiting employers to paying their workers no less than the minimum. The U.S. Department of Commerce intervenes when necessary to stop foreign producers from dumping products in the United States. Private industry groups have intervened many times over the years to forge agreements on standards for specific items such as standard sizes for shoes, clothing, and tires, standard grades to identify different quality lumber and cuts of beef, standard factors to identify differences in insulation material and sun screen. And professional societies such as for lawyers, accountants, and engineers establish standards of professional practice and ethical conduct for their members. The effect of these standards is to limit producer/professional freedom to create his/her personal standards that if carried through by all producers/professionals would lead to confusion and possibly chaos.

The effective utilization of the three organizing principles of competition, cooperation, and intervention requires the affirmation of a particular value across society, or what we call a social value. Competition clearly depends on society valuing freedom because how does competition come into play if human beings do not enjoy the freedom necessary to compete? Cooperation depends on the social value of community in the sense that tasks will not be undertaken collectively if the persons who are assigned those tasks are not willing to come together as a community or work as one. Indeed many U.S. companies refer to themselves as families as a way of reinforcing that social value and breathing more life into cooperation. The very successful 1979 Pittsburgh Pirates deliberately chose “We Are Family” as the theme song for their season as a way of reminding every player of the importance of playing as a team.

Intervention depends on the social value of equality if that intervention is to be successful and long-lasting. Notice the recent disclosures that the IRS was scrutinizing applications for 501c3 tax-exempt

status from conservative organizations more intensely than applications from progressive groups. Notice as well the controversy surrounding the practice at many colleges and universities of admitting minority students preferentially over equally or better qualified applicants with no minority standing.

But there is a price to pay for each of the three social values of freedom, community, and equality. Each one depends on a human beings faithfully practicing one of the three principles of economic justice. Freedom is undermined when the principle of equivalence is violated because persons who have been “ripped off” lose some of their freedom to act and compete in economic affairs. Community cannot exist without the contributions of their members, without faithful adherence to the principle of contributive justice. Equality is denied when the principle of distributive justice is flaunted by, say, public officials who discriminate against some and play favorites with others.

And thus do we see better than before how the three principles of economic justice are embedded in the market economy.

*Two other principles require our attention. One is the principle of efficiency; the other is the principle of subsidiarity. The principle of efficiency is instructive because it allows us to measure the performance of a business enterprise on the basis of how well it uses economic resources. The principle is stated as follows: maximum efficiency is achieved by a business enterprise when it achieves maximum output of a good or service from a fixed or given amount of resources. Or the principle may be stated in this manner: maximum efficiency is achieved by a business enterprise when it produces a given or fixed amount of output from a minimum amount of resources. To help illustrate, fuel efficiency is measured in terms of miles per gallon. The most fuel efficient car is one that gets the most miles from a gallon of gas. **Notice that the principle of efficiency is misstated in the following: maximum efficiency is reached when maximum output is obtained from the minimum amount of resources.***

The principle of subsidiarity addresses the question When should a business enterprise be privately owned and managed and when should it be publicly owned and managed? And When should intervention to limit competition and cooperation that is running out of control be undertaken by a private organization and when more appropriately should a public agency intervene? Societies are constructed around elements or units of different size and strength. The largest and strongest element of American society is the federal government. The smallest and weakest is the human person. Falling between those two elements are four other basic social elements: state governments, local governments, private organizations such as businesses, unions, trade associations, and families. Within this set, state governments in general are the larger and stronger elements, while families are the smaller and weaker.

The principle of subsidiarity states that (1) larger, stronger elements of society should not take about the functions of smaller, weaker elements, but instead (2) should help the smaller, weaker elements function more effectively. That means, for example, if a private company is fully capable of generating electric power, there is no need for power generation to be directly in the hands of the

NEEDS & WANTS OF THE HUMAN BODY & SPIRIT MET/SATISFIED THROUGH WORK & CONSUMPTION

* PRODUCER/WORKER/ENTREPRENEUR * use NATURAL, LABOR, FINANCIAL, and OTHER RESOURCES in ...



the NEEDS and WANTS of the HUMAN BODY and SPIRIT for ...

**INCOME, BELONGING, and
CREATIVE WORK OPPORTUNITIES**
met and satisfied through work

**SUSTENANCE, REST,
TRUTH, GOODNESS, and BEAUTY**
met and satisfied through consumption

respecting human differences, the economic processes of production, distribution, exchange, consumption, and investment are activated by ...

COMPETITION ♂
↓ and
↓ COOPERATION ♀
↓ are limited by ...
↓ GROUP *
↓ INTERVENTION
↓
embracing:
FREEDOM
↓
practicing:
EQUIVALENCE

COMPETITION ♂
and
COOPERATION ♀
↓ are limited by ...
↓ GROUP *
↓ INTERVENTION
↓
embracing:
COMMUNITY
↓
practicing:
CONTRIBUTIVE JUSTICE

COMPETITION ♂
and
COOPERATION ♀
are limited by ...
GROUP *
INTERVENTION
↓
embracing:
EQUALITY
↓
practicing:
DISTRIBUTIVE JUSTICE

*: private or public as determined by *principle of subsidiarity*: government should do for the people what the people are unable to do for themselves.
 **: evaluated by *principle of efficiency*: maximum efficiency is achieved when maximum output is obtained from a fixed or given amount of resources.

Public G/S are produced by private or state enterprise and are public property because they are purchased with taxes or borrowed funds for use by the general public.

government. Instead, the government might offer the private company tax credits on its investments in new power generation facilities, in order to help that company bring that power on line. It also means that if airport security, for instance, cannot be handled effectively by private companies, the federal government should intervene and take control of security.

By affirming a strong preference for private enterprise compared to public enterprise, the principle of subsidiarity effectively decentralizes ownership and control of economic activities that in turn (1) lead to a greater diversity of goods and services produced because entrepreneurs have a freer hand; (2) a smaller risk that large-scale mistakes will be made because in general private enterprises are smaller than public enterprises; and (3) private enterprises will be more responsive to their customers because they are driven by the profit motive. For more on the principle of subsidiarity see Topic 30.

The entrepreneur is the key agent in economic affairs because the entrepreneur precipitates change in the workplace and in the marketplace. We prefer to identify the entrepreneur as the two-dimensional **acting person**, as opposed to simply the one-dimensional **homo-economicus**, because the entrepreneur is a real, living, breathing person engaged in human action in economic affairs and not some totally self-interested, self-absorbed, completely rational calculating machine with neither the time nor the interest in the romantic. In terms of our analogy to the twin-engine aircraft, we note that there is a profound difference between the human pilot with a mind and a heart, possessing both intelligence and emotions, and the auto-pilot that has neither mind nor heart and for which intelligence is entirely programmed.

The entrepreneur triggers change in the following five ways. In the marketplace, the entrepreneur initiates two types of change: the introduction of a new good or service and the penetration of a new market. In the workplace, the entrepreneur brings about three kinds of change: the utilization of different materials in the production process, the introduction of a new process of production, the development of a new business model – a new way of organizing, managing, administering the business enterprise. At times, more than one type of change is necessary for success. For example, introducing a new product may require a change in the process of production.

The masculine-feminine dimensions of human nature play a role here too. The masculine gender trait that rests on human individuality is vital to success in marketplace innovations because the marketplace is a competitive forum wherein individuals clash and compete for the rewards that follow from beating the competition. The feminine gender trait that is grounded in human sociality is vital to success in the workplace because the workplace is a cooperative environment wherein individuals must work together to accomplish their common objectives. Because entrepreneurial change often involves more than one type at once, both gender traits may be vital to the successful implementation of the entrepreneur's ideas.

Entrepreneurs are persistent. Indeed, Joseph Schumpeter identifies persistence as the key personal trait of the entrepreneur, setting him/her apart from others. The entrepreneur is dogged in the

pursuit of his/her innovational ideas, and simply does not give up in the face of opposition. Entrepreneurs are visionary in the sense that they see opportunities and possibilities where others see nothing beyond the present. Large established companies resist entrepreneurial change in a way that is reminiscent of Newton's third principle of motion: for every action there is an equal and opposite reaction. Thus entrepreneurs often are associated with small companies including firms that they themselves established specifically to implement their innovational ideas. They are driven at times by the survival needs of the company, but are not always successful. However, they are more likely to accept the risk of failing and to try again in a culture where failure in business does not spell personal failure. Bankruptcy relief and "the golden parachute" are two ways in which the American culture encourages the entrepreneur to try again.

Unlike accountants, musicians, veterinarians, and other professional persons, the entrepreneur is not required to master a body of knowledge and demonstrate a certain set of skills. There is no designated educational pathway to becoming an entrepreneur, although entrepreneurial skills can be enhanced through formal education and training, and by entrepreneurial role models such as an older member of the family. There is no profession known as "entrepreneur" and no professional membership organization for entrepreneurs to join.

As we have stated previously more than once, the entrepreneur is the pilot of the economy who decides where the economy is headed, following in general one of five flight plans, but capable of departing from that flight plan as circumstances require or allow, at times flying directly into heavy weather to deliver the payload. By making credit available to the entrepreneur through the loan process, the private commercial banker provides the fuel necessary to power the economy's twin engines of cooperation and competition.

To change the analogy, the typical business enterprise is like the human cell that must divide and separate in order to survive. In order for a company to prosper and endure, someone must be entrepreneurial. Failing to innovate assures its ultimate demise.

Successful entrepreneurs engage in a dynamic process that has two major effects. First, they create new business enterprises, new jobs, new resource requirements that translate into new opportunities for workers, resource holders, suppliers, investors, and communities. At the same time, they destroy old business enterprises, old jobs, established supplier networks that translate into financial hardship or ruin for other workers, resource holders, investors, and communities. This process Schumpeter called "creative destruction."

*As a matter of conscience, the successful entrepreneur must weigh the negative aspects of innovation against its positive aspects. In this regard, the principle of the double effect comes into play and sets limits on what the entrepreneur **should** do. The destructive, negative effects must not be greater than the creative, positive effects, and the entrepreneur must not intend the destructive effects as a way of singling out certain persons or organizations for punishment.*

In American culture, however, the entrepreneur it seems is not held to account if his/her initiatives do not measure up to these ethical standards. Did Sam Walton regret what Wal-Mart did to Sears and to many small town families businesses? Did the two men behind the original Apple computer -- Steve Jobs and Steve Wozniak -- shed a tear for the havoc they visited on IBM? Does Ted Turner lose sleep at night for the damage that CNN did to the 6PM network news?

REVIEW SECTION: TOPIC 3

Central Concepts:

- principle of competition
- principle of cooperation
- principle of intervention
- principle of subsidiarity
- principle of efficiency
- economic processes
- economic functions
- economic change
- organizing principles
 - activating
 - limiting*
- social values
 - freedom
 - community
 - equality
- entrepreneurship
- homo economicus
- acting person

Important Questions:

- What are the five economic processes? the five economic functions?
- What are the three organizing principles? the three underlying social values?
- How are the five economic processes related to the workplace, the marketplace, and the household?
- How are the economic processes, functions, organizing principles, and underlying social values linked to the three principles of economic justice?
- Who triggers economic change in a market economy?
- What does “creative destruction” mean?
- Who was Joseph Schumpeter?

(continued on following page)

True/False:

- a. The two activating principles and the one limiting principle are expressions of specific social values.
- b. Competition expresses the social value of individual freedom.
- c. Cooperation expresses the social value of equality.
- d. Intervention expresses the social value of community or teamwork.

Mark your answer below.

- Item a is true, items b, c, and d are false.
- Items a and b are true, items c and d are false.
- Item a is false, items b, c, and d are true.

TOPIC 4 ESSENTIAL CHARACTERISTICS OF CAPITALISM

To explore the essence of the capitalist system, especially its key institutions.

*There are twelve characteristics that are essential to the capitalist economic system. We begin with the **PRIVATE CREATION OF CREDIT**. This is not the most important characteristic of capitalism, but it is the **distinguishing** characteristic of the capitalist system. No other system operates with private commercial banks making loans to commercial customers on the basis of created credit. When you borrow money from a friend or family member, that person must have saved the money beforehand if you are to have any chance of getting a loan from that person. Thus, if that person is “tapped out” or “broke,” there is no way he/she can assist you with a loan. In our banking system -- more later in Topic 6 -- there is no requirement that the money be saved before the loan is made. The loan derives from **created credit**. Joseph Schumpeter, an Austrian-born economist who joined the Harvard University faculty in the 1930s, identified the private creation of credit as the **distinguishing** characteristic of capitalism. He also was the one who pointed to the role of the entrepreneur in economic affairs. Indeed, he showed that the entrepreneur is linked to the banker in which the entrepreneur depends on the credit made available by the banker to carry out his/her entrepreneurial schemes just as the pilot of the twin-engine aircraft depends on the company that supplies the fuel to the craft’s engines.*

*By **PRIVATE PROPERTY** we mean the private ownership and control of economic resources. Here we intend to emphasize both ownership and control. In a communist system such as the former Soviet Union, property is publicly owned and controlled through a highly centralized planning board. In a fascist system such as Nazi Germany, property is privately owned but publicly controlled through a central planning board.*

*Decision-making in capitalism is decentralized through a **MARKET** system -- product markets, financial markets, resource markets -- in which buyers and sellers, creditors and borrowers, resource holders and producers, along with employers and workers, interact and through that interaction determine what goods and services are produced, how much of the goods and services will be produced, the prices of those goods and services, the value of financial and physical assets, wages and salaries, rent, interest rates, and profits.*

*A **primary market** is a market in which the original producer of the product or service is the seller. A new car manufacturer selling brand-new automobiles to a dealer is an example of a primary market. Notice that the dealer makes payment directly to the original producer. A business enterprise selling shares of stock to the public for the first time – an initial public offering (IPO) – is another example of a primary market because the buyers of those shares make payments directly to the stock-issuing enterprise.*

*A **secondary market** is a market in which the original producer is not involved in the exchange. A person buying a second-hand car makes payment directly to the dealer who is offering that car for sale. Notice the manufacturer of that car receives nothing from that exchange. A person buying shares of stock issued in the past by a public corporation makes payment to the person whose shares he/she is buying. The corporation receives nothing from that trade.*

***COMPETITION** is the central energizing force in a capitalist system, though increasingly in the U.S. cooperation is being employed deliberately to activate economic affairs. The principal social value is **FREEDOM** that as we observed in the last topic is foundational to competition. A strict libertarian such as syndicated columnist Walter Williams defines this social value as freedom **from** government intervention and regulation, and single-mindedly advocates what for many years has been called a *laissez-faire* economy. To the extent that cooperation is used as an energizing force, the social value of community or teamwork becomes important.*

*In a capitalist system, this question naturally arises: Who finally makes the decisions regarding the goods and services produced, the producer or the consumer? In conventional economics, the answer is that consumers make the final decisions by buying or not buying certain goods and services. The way in which consumers forced Coca Cola to return to the classic formula for Coke when the company tried to abandon it is indicative of **CONSUMER SOVEREIGNTY**. But the way in which Microsoft dominates operating systems for personal computers with Windows and the deliberate bundling of application programs with that operating system means that consumers quite often have little real freedom of choice when buying a personal computer. That practice is called **PRODUCER SOVEREIGNTY**. In a world that is as complex and varied as ours, consumers are sovereign in some cases and at certain times, and producers are sovereign in other cases at other times. Producer sovereignty and consumer sovereignty are regarded as the two dimensions of a single characteristic.*

The following incident helps illustrate the significance of producer sovereignty and gives practical meaning to the concept of consumer surplus which we addressed in Topic 2. A person is observed inserting a dollar bill into the soft-drink machine. She presses the “button” for the soft drink of her choice but the machine does not dispense her selection. She says to an observer standing nearby “I guess I’ll have to take a Classic Coke.” The observer remarks “producer sovereignty.” The student then presses the Classic Coke “button.” This time, she gets two bottles instead of the one she had bargained for and expected. Her observer says “consumer surplus.”

***MERITOCRACY** refers to the characteristic of capitalism whereby those persons who make greater contributions to economic affairs through their labor services or the natural resources that they are able to offer enjoy the greater incomes. Critics of capitalism point out that often persons receive income that they have not earned by merit. The AFL-CIO union organization reported that in 2013 the chief executive officers at companies listed in the Standard&Poor’s 500-stock index earned 331 times more than the average worker who earned \$35,239.¹*

¹ “Executive Pay Watch,” available at www.aflcio.org.

A stock option allows a company employee who is granted the option an opportunity to buy a stated number of shares of the company's stock at a specific pre-determined price (usually the market price on the date the option is granted) over a given future time period. The stock option is designed to link the fortunes of the employee, especially a high-ranking employee, to the performance of the company and thereby elicit from that employee even greater attention to his/her assigned duties. The underlying premise is that the recipient will work more diligently to improve the performance of the company and enhance its share price and thereby participates in that gain by purchasing shares at the stated option price and later selling them at the higher market price. In that sense, a stock option is a type of merit-based pay. By specifying that the option expires when the recipient no longer is employed, the company hopes to retain that employee by making it more costly to leave.

A relatively new method in use today to give the appearance of conforming to the demands of merit-based pay is the back dating of stock options. Back-dating moves the option back to a time when the share price was lower than the current market price, thereby enhancing the gain that is available to the recipient even though some of that gain strictly speaking may not be merit-based and for that reason may be fraudulent.

Meritocracy is under attack today in the United States by the cronyism that too often describes the relationship between the senior management of major public corporations and the board of directors of those corporations that set the salaries of senior managers, and the gambling counter-revolution that includes notably state-run lotteries and private casinos where patrons are reinforced in the fantasy that their fortunes are to be made not through hard work and reason but luck and magic.

*There are two forces that allocate resources among the various producers who transform them into goods and services in a capitalist system. According to conventional economics, **PRICES ALLOCATE RESOURCES** in the sense that the producer who is willing to offer the highest price for a labor resource or natural resource is the producer who gets that resource. The New York Yankees took Alex Rodriguez from the Texas Rangers by offering him more than the Rangers were able or willing to pay him. Personalist economics refers to this method of resource allocation as the "pulling force of prices." But there is more at work here than conventional economics admits. **UNMET HUMAN NEED** often drives laborers and persons who hold natural resources to accept a lower price for their resources, or to transfer to another city to take a job, because otherwise they cannot pay their bills or meet their needs and the needs of their dependents. We refer to this method of resource allocation as the "pushing force of unmet need."*

*Everyone in a capitalist system is subject to **THE RISK OF UNMET NEED** relating to an interruption in their income due to job loss or business closing. There is no lifetime security in the capitalist system. On one occasion the owner of a very successful janitorial service told me that he always faced the risk of losing business to "any guy with a mop and a bucket." Thus, the capitalist system deliberately instills anxiety in all of us that has at least this beneficial result: it gets us to work on time and it tends to make us more conscientious about our work.*

The **DILEMMA** of capitalism is that it uses unmet human need to allocate resources but too much unmet need is destabilizing. The Great Depression of the 1930s when an estimated 25 percent of the U.S. labor force was unemployed was a time in which there were many advocates for abandoning capitalism for socialism, communism, or fascism.

CREATIVE DESTRUCTION is possibly the most popular phrase from economics (the “invisible hand” too is widely used). Schumpeter coined this phrase to represent what the entrepreneur does. The entrepreneur by creating something new and attractive destroys something old that might have been well-established and widely accepted for a long time. Sam Walton created the giant discount retailing enterprise Wal-Mart starting in towns in the South thought to be too small for such large outlets. Over the years Wal-Mart has grown to become the largest retailer in the world replacing Sears that at one time was the dominant retailer in the United States.

REVIEW SECTION: TOPIC 4

Central Concepts:

- private property
- principle of private property
- market:
 - primary
 - secondary
- laissez-faire economy
- innovation and creative destruction
- consumer sovereignty
- producer sovereignty
- stock option
- dysfunction of capitalism
- dilemma of capitalism

Important Questions:

- What is the distinguishing characteristic of the capitalist system?
- What are the five general types of entrepreneurial activity?
- In principle, is capitalism the only type of market economy?
- Who controls decision-making in a capitalist system?
- In economics, what is meant by private property?
- What is a market?
- In a capitalist economy, what do consumers and producers alike seek?
- What do we mean when we characterize capitalism as a meritocracy?
- What is the central dysfunction of a capitalist economy?
- What is the dilemma of a capitalist economy?
- Why is entrepreneurship reminiscent of Newton's third principle of motion?

(continued on following page)

True/False:

- a. Schumpeter argued that private property and meritocracy are the *distinguishing* characteristics of capitalism.
- b. The central dysfunction of the capitalism is that everyone is subject to the risk of unmet human material need.
- c. The dilemma of capitalism is that it uses unmet need to help allocate resources but too much unmet need has a destabilizing effect on the economy.
- d. In a capitalist system, meritocracy means that economic agents are compensated according to the value of the contributions they make to economic affairs.

Mark your answer below.



_____ Item a is true, items b, c, and d are false.

_____ Items a and b are true, items c and d are false.

_____ Item a is false, items b, c, and d are true.

MICROECONOMICS

Addressing Economic Affairs from the Perspective of Human Individuality

TOPIC 5 MONEY AND BANKING

To explain what money is, what a private commercial bank looks like, and the role of the Federal Reserve System.

Money is best defined as whatever the public accepts as money. When the convenience store on the interstate highway refuses your check or credit card in payment for the items that you bought there, neither one is money. When the taxi driver refuses your \$50 after 6 PM because he is able to make change only for a \$20 bill or less, your \$50 is not money even though it has been issued by the U.S. government. The Susan B. Anthony dollar coin and the new gold-color dollar coin in general were not been accepted by the American public, and in that sense neither one functions effectively as money. .

Money serves three functions: (1) medium of exchange, (2) store of value, and (3) standard of value. As a medium of exchange, money facilitates buying and selling. Consider what it was like under a barter-exchange economy. If you were a shoemaker and wanted bread for your family, you would have to find a baker who would be willing to exchange his bread for your shoes. As a store of value, money is one of several ways in which wealth is held. Wealth can be held in various forms such as gold bars, antique cars, stamp or plate collections, stocks and bonds. It can be held in the form of cash with one major disadvantage: holding your wealth in this form assures that it will not increase in value as it would if you held it in the form of a bank deposit or government bond that due to the interest earned actually increase in value. The third function of money – standard of value – means that the seller signals the value that attaches to whatever is offered for sale in terms of money. This textbook for \$109.95, that pair of sneakers for \$74.55. We are so accustomed to this function of money, that we scarcely notice it. But money functioning as a standard of value becomes an issue whenever we travel, because in a foreign country the seller signals the values that he/she attaches to the items for sale not in terms of the U.S. dollar but instead in terms of the national currency of that country. To try to sort out the issue as to whether an item that is denominated in terms of the national currency of some country other than the United States is expensive or cheap, it becomes necessary to convert the price from the local currency to the U.S. dollar using the current exchange rate. A set of bath towels that is priced in England at 45 pounds, has a price of \$67.50 in the United States if the exchange rate is one pound = \$1.50.

There are five types of money in use today: (1) paper currency, (2) coins, (3) checks, (4) plastic, and (5) electronic transfer. In 1862 the United States adopted a national currency to address the huge counterfeiting problem linked to the 7,000 varieties of authentic paper currency designed, printed, and put in circulation by approximately 1,600 state banks.¹ Today only the U.S. government can

¹ See U.S. Secret Service, www.secretservice.gov/criminal.shtml.

issue paper currency and coins. Even so, as indicated earlier, government-issued does not automatically make them money. It is instead public acceptance that makes them money. In terms of the total amount of money used in transactions, one of the most important types of money is the private check. Notice that checks are printed by private printing companies and ordered through private commercial banks, according to your personal specifications as to color, design logo, address, phone number, driver's license number, and other information including employer. Thus checks are privately issued and custom designed. They become money when they are accepted by the public. They no longer function as money when the public refuses to accept them.

There are two general types of plastic-card money: a debit card and a credit card. With a credit card, the cardholder gets to take away the good or service at the point of sale but is not required to make payment until sometime later when he/she receives his/her monthly statement enumerating the various charges made and the total amount owed. With a debit card, the money is encoded on the magnetic strip embedded in the card, and at the point of sale the amount owed is debited directly. Thus, with a debit card there is no payment to be made at some later time.

Electronic transfer means that you the buyer have authorized the seller to access your checking account directly and transfer from your account to his/hers the amount that you owe the seller. Electronic transfer is commonplace for depositing income earned from employers and benefits received from the federal government. Today many companies including electric utilities permit customers to pay their bills by authorizing those companies to access their checking accounts electronically and transfer the amount owed directly to their accounts.

Banks are moving away from checks and more toward plastic for two central reasons. Checks are costly to process because each one must be microfilmed back and front as a permanent record in case the check is lost. They are costly as well because they require human labor to encode the amount for which the check was issued directly on the check (lower right hand corner), and because they have to be sorted and batched to make them ready for mailing to the accountholder with the usual enclosed bank statement detailing the status of the account. Cutting those expenses would enhance the bank's bottom line, making it more profitable. Accordingly, banks are encouraging much wider utilization of credit cards and debit cards. A credit card not only reduces the bank's labor costs it adds interest earned to the bank's revenues whenever the accountholder does not pay the outstanding balance in full.

"Hard currency" refers to paper currency that is issued by one government and is accepted in routine transactions in another country. The U.S. dollar is hard currency in many foreign countries because it is regarded as more stable in value than the national currencies of those countries. With hard currency, therefore, two currencies function side by side: the national currency and the hard currency. The U.S. dollar has been hard currency for more than 50 years and is likely to continue to function in that capacity in the years immediately ahead.

"Dollarization" refers to the national currency of one country officially replacing the national currency of another country. Ecuador, for example, adopted the U.S. dollar as its national currency

in 2000. Shortly thereafter dollarization was accepted in El Salvador, Panama, and Liberia.¹ Notwithstanding an agreement in 1994 to reduce trade barriers between Mexico, Canada, and the United States known as NAFTA (North American Free Trade Agreement), efforts to establish a free trade area among the 34 democracies of the Western Hemisphere, which likely would have established a common currency as evidenced in Europe's euro zone, came to an unsuccessful end in 2004.

Financial Reports.

Two financial reports – the balance sheet and the profit and loss (P/L) statement – are helpful sources of information regarding the performance of any business enterprise, including a private commercial bank. The balance sheet lists assets and liabilities. An asset is a thing of value that is held by the enterprise; a liability represents what the enterprise owes someone else. A company has positive net worth when its assets > its liabilities. It has negative net worth when its assets < its liabilities.

SUPER-SIMPLIFIED BANK BALANCE SHEET

Assets	Liabilities
loans (promissory notes) cash	funds in checking accounts

SUPER-SIMPLIFIED BANK PROFIT AND LOSS STATEMENT

Income	Expenses
interest earned other sources such as bank-issued credit cards	labor resources other resources

¹ James Keeley and Adam Kess, "Ecuadorian Economics, 2000-2013," *Global Advanced Research Journal of Management and Business Studies*, January 2013, p. 022.

The profit and loss statement, also known as the income and expense statement, lists all of the sources of income that the enterprise is receiving, and all of its expenditures. The company is earning a profit when its income > its expenditures. It is losing money when its income < its expenditures.

A business enterprise fails whenever it no longer is able to meet its obligations to its creditors, is not earning sufficient income from the sale of its product or service, and therefore cannot pay in full for the resources that it has used to produce that product or service. It is no different with a bank. It is possible for a bank or any other business enterprise to sustain losses for a short period of time by borrowing funds to help it pay fully for the resources that it has been using in the production process. Or it may require that the owners advance their own personal funds to make up for its operating losses. Over a longer period of time, those two options are closed off for the simple reason that no bank and no owner will long endure a business that is not able to turn a profit. When that happens, the business fails and must close permanently. It is no different with a bank that sustains long-term losses.

The main reason why a bank fails is that the loans it has made are non-performing or “bad” loans--borrowers are not making the interest and principal payments that are required in their original loan agreements.

A super-simplified P/L statement shows that the effect of non-performing loans is reflected in interest earned, a major source of income for any private commercial bank. A super-simplified balance sheet shows the effect of non-performing loans on bank assets.

Common sense alone tells us that the bank protects itself against failing by not making loans to persons and businesses that will not meet their obligations fully under the terms of their loan agreements. Thus, for a bank much depends on the competency and integrity of its loan officers.

Historically, bank failures have triggered crises that at times have spread from the banking sector to the entire economy. In terms of our analogy to the twin-engine aircraft, where the loans made by private commercial banks are the fuel supply for its engines, a banking crisis may effect the entire economy the same way contaminated fuel may affect the performance of those engines and thereby represents a real danger to the aircraft, its passengers, crew, and cargo. A central banking authority known as the Federal Reserve System (FRS) was established in the United States in 1913 to help prevent banking crises and thereby bring greater stability to the entire economy.

A banking crisis can occur even today if depositors become panicked by news reports or rumors and attempt to withdraw the funds in their checking accounts. A partial-reserve banking system with a central banking authority can prevent this from happening by lending funds to any bank that is experiencing large numbers of depositors making substantial withdrawals from their accounts. However, if this panicky behavior spreads to other banks, the central banking authority may not be able to supply the necessary funds to accommodate the demands of those depositors. This kind of behavior once it begins spreading across the banking system may force the central banking authority

to close the affected banks in order to halt an even wider crisis or “meltdown” from developing in a process that is like the spread of a contagious disease. Topic 31 speaks to the meltdown of the financial sector in 2008 from a macro-economic perspective.

Federal Reserve System.

The FRS operates 12 Federal Reserve Banks throughout the United States, each one serving a specific geographic area. These banks, however, serve a special clientele: the private commercial banks in their region. They do not serve the general public nor do they provide services to private business enterprises. The FRS is under the direct management of a seven-member Board of Governors. Each governor is nominated for a 14-year term by the U.S. president subject to confirmation by the U.S. Senate. The president names the chairman and vice-chairman of the Board for four-year terms subject to Senate confirmation. Janet Yellen is the current Board chairman.

One of the most important services the FRS provides is making cash available to a private commercial bank that has run short of cash typically because of an unusually large amount of funds having been withdrawn from the checking accounts of its depositors. Private commercial banks hold cash in order to service their customers who are cashing checks, closing their accounts, or making withdrawals through an ATM. A shortage of cash does not mean that the bank is losing money and is headed toward failure. Indeed, such a shortage can occur on any given day in a bank that is and for many years has been earning profits. Under those circumstances, the cash-strapped private commercial bank may turn to the Federal Reserve Bank for a loan. The rate of interest on such loans is called the discount rate. Responding to the financial crisis of 2008, the Federal Reserve System now publishes detailed information on discount window transactions.¹

Any bank that is short of cash may turn to another bank for a loan, in which case it pays a rate of interest that is called the overnight funds rate or the federal funds rate. Both rates, the discount rate and the overnight funds rate, are set by the Board of Governors. Since the start of the Great Recession the FRS cut these rates to a bare minimum to make borrowing cheaper and thereby help stimulate the economy. In other words, the rate of interest (the price of borrowed funds) is so important to the entire economy that these two interest rates are set not by the market but by the central banking authority. The practice of turning to other private commercial banks for loans during a cash shortfall is another example as to how economic affairs are energized and activated by the organizing principle of cooperation.

The FRS performs other functions as well. Worn out paper currency and coins are removed from circulation through the FRS and replaced with newly printed paper currency and newly minted coins. The FRS serves as a clearinghouse for checks that must be physically transferred from the banks into which they were deposited to the banks where they were drawn and finally into the hands of the persons or organizations with the checking accounts against which those checks were written. Due to the decline in the volume of checks written, the FRS has been reducing the number of check

¹ See www.federalreserve.gov.

processing centers it operates. By keeping interest rates low, the FRS can assist the U.S. Treasury in selling federal government bonds at a lower interest cost. The Treasury sells bonds whenever the federal government must borrow money because it has not raised sufficient revenues from taxes to pay for all the programs and services that it supports. In other words, whenever there is a deficit in the federal government budget.

Most recently the FRS has been assisting private commercial banks with under-or-nonperforming assets on their books by buying their holdings of mortgage-backed securities that played a big role during the real-estate bubble in the years leading up to the Great Recession. There is more on mortgage-backed securities in Topic 31.

REVIEW SECTION: TOPIC 5

Central Concepts:

money:

types

functions

euro

hard currency

dollarization

reserves:

required

excess

balance sheet

profit and loss statement

discount rate

bank failure

bank fraud

central banking

Important Questions:

What are the three central functions or roles of money?

What are the various forms or types of money?

What is the critical factor in determining whether something is regarded as money?

What is a partial-reserve or fractional-reserve banking system?

What are required reserves? excess reserves?

For the typical private commercial bank, what are its chief liabilities? chief assets?

What are the duties of the Federal Reserve System?

What is the discount rate?

What does “cooking the books” mean?

(continued on following page)

True/False:

- a. The reserve requirement is the amount of gold that each bank is required to hold in reserve to protect its depositors' money.
- b. Hard currency is money issued in one country and accepted in transactions taking place in other countries.
- c. In general a bank fails for the same reason that any other private business establishment fails: it no longer can meet its obligations to its creditors.
- d. The prime rate is the interest rate that the bank charges its best (lowest-risk) customers.

Mark your answer below.



_____ Item a is true, items b, c, and d are false.

_____ Items a and b are true, items c and d are false.

_____ Item a is false, items b, c, and d are true.

TOPIC 6 PRIVATE CREATION OF CREDIT

To explain how a private commercial bank in a partial-reserve banking system makes loans not from accumulated savings but from excess reserves and how that capability makes such a bank vulnerable to failure.

Partial-Reserve Banking.

*A private commercial bank does not make a loan by transferring cash that it has in its vault to the borrower. Neither does it make a loan in the manner to which we are accustomed when we borrow from family or friends who must have saved some money in order to be able to lend us that money. With a private commercial bank, no prior savings are required. Rather, **a private commercial bank makes a commercial loan simply by making a bookkeeping entry in the borrower's checking account that indicates that a deposit has been made in the amount of the loan.** If a company borrows, say, \$100 million from a bank in order to purchase and install new equipment, the bank simply records a deposit of that amount in the company's checking account without transferring cash from its vault and without removing funds from its depositors' accounts.*

*Is this loan really money? If a check written on that company's account, for example to an employee, is taken by that employee, endorsed and deposited into his/her own checking account, is transferred through the FRS clearinghouse to the bank where that company has its own checking account, is debited against that account, and batched with the other checks cleared against that account and sent to the company in its monthly bank statement, the check meets the most fundamental standard for defining a thing as money – public acceptance. It is indeed money, and given the unusual way in which that money came into being, we refer to that loan process as the private **creation** of credit. It is private in the sense that the money originated in actions taken by a private commercial bank.*

The private commercial bank cannot willy-nilly make whatever loans it pleases in whatever amounts it pleases to whatever customers it pleases. The FRS has established a limit that every bank must respect. The total amount of outstanding loans in a bank's loan portfolio cannot exceed the amount of its excess reserves that are defined as the difference between the total funds in its depositors' accounts minus the amount of required reserves. A bank's required reserves are defined as the amount of funds that the bank must deposit with its Federal Reserve Bank and are determined as a percentage of the bank's funds on deposit. If, for example, a private commercial bank has a total of \$800 million in the accounts of its depositors and the FRS has set the reserve requirement at 10 percent, the bank's required reserves that it must hold on deposit with the Federal Reserve Bank are \$80 million. Its excess reserves are then simply \$720 million or \$800 million minus \$80 million.

Under these circumstances, this private commercial bank cannot hold in its portfolio a total amount in loans already approved greater than \$720 million. If its portfolio is smaller than \$720 million, it

may authorize additional new loans. If its portfolio is larger than \$720 million, it may have to sell some of its loans to other financial institutions to get under the limit. It is important to note that while the loans themselves represent money, and the funds deposited with the Federal Reserve Bank as required reserves are money too, excess reserves do not represent money. They represent instead the limit that the FRS imposes on the loan portfolios of every private commercial bank. Put differently, the FRS directly controls not only the price of borrowed funds through the discount rate and the overnight funds rate but also the total amount of loans that private commercial banks can hold in their portfolio through the reserve requirement.

In making loans through the credit creation process, the private commercial bank assumes the risk that the borrower may not honor his/her obligations under the terms of the loan agreement, may default. To repeat, when a new loan applicant has been approved the bank opens a checking account in the name of that applicant and then the bank posts an opening balance equal to the amount of funds that it has agreed to make available to the borrower. The same general process is employed when the loan applicant is an established customer of the bank with a checking account that was opened at some earlier time. Because loans are made through the credit-creation process, no prior savings are required. Additionally, no money is transferred from other accounts in the bank, nor is the money taken from the bank's cash on hand. For those reasons, the process is properly referred to as the private creation of credit. Only a capitalist economy operates in this fashion. Private creation of credit is entrepreneur-friendly because it makes more funds available to finance innovational activity.

The bank typically will ask the borrower to pledge in writing some asset as security or collateral that in the event of default the bank can seize from the borrower. At times, the borrower may have to find another person to co-sign the note because he/she is not regarded as sufficiently credit worthy alone to be approved for a loan. Some borrowers are so credit worthy that they are exempted from pledging an asset as collateral. Their signature alone on the promissory note is sufficient in and of itself. The bank's loan department is charged with the responsibility for deciding the credit worthiness of its loan applicants. Those who are regarded most favorably or least likely to default are normally approved for an interest rate that is called the prime rate of interest. This rate, that is determined by each bank in a competitive environment with other private commercial banks, responds to the discount rate and the overnight funds rate in the sense that the prime rate increases and decreases as the FRS increases or decreases those two rates.

During the late 1970s banking was deregulated in the sense that savings and loan associations that historically had specialized in home loans (mortgages) and were not allowed to offer checking accounts were authorized for the first time to offer checking services to their customers and to make loans for a variety of purposes such as to build shopping centers, to purchase automobiles, and to pay tuition. The premise behind this deregulation – a return to the law of nature and the invisible hand of the market – was that deregulation would stimulate more competition and that in turn would benefit ordinary consumers and commercial enterprises by making loans available at a lower price (lower rate of interest). Unfortunately, many savings and loans made poor decisions regarding the credit worthiness of their new clients and were deluged with nonperforming loans. These bad loans,

of course, eroded the interest income earned by these financial institutions and in many instances drove those institutions into circumstances where they were losing money. As a consequence, many savings and loan associations failed during the mid to late 1980s and early 1990s. This mess in the savings and loan industry led to the use of “zombie” to characterize failing savings and loan associations that had the outward appearance of being alive but were financially dead on the inside.

So many savings and loans failed during this period that the Federal Savings and Loan Insurance Corporation (FSLIC) that protected their account holders had its funds depleted and they had to be bailed out. The U.S. taxpayer eventually paid approximately \$150 billion to cover the cost of paying account holders the money in their accounts that no longer could be paid from FSLIC. Today, just as with private commercial banks, savings and loans insure deposits through the Federal Deposit Insurance Corporation (FDIC) that provides \$250,000 insurance per depositor, per insured bank. This insurance applies to deposit accounts such as checking, NOW and savings accounts, money market deposit accounts, and certificates of deposit.¹ See Topic 31 for more on the most recent banking crisis.

As mentioned previously, banks fail mainly due to non-performing or bad loans. A second major reason for bank failure is bank fraud on the part of senior banking officials. One typical way in which a bank is defrauded by its own senior management is approving a loan to a friend or family member and over time posting entries that indicate that the loan is being repaid when in fact it is not being repaid. This kind of fraud denies the bank the interest income that it is due and therefore some of the profits that are due the bank’s owners.

Partial reserve banking is based on the social value of individual freedom in the sense that facilitating the rugged individualism of the entrepreneur is so highly valued that the system risks bank failure to sustain that value.

100-Percent Reserve Banking.

In a 100-percent reserve banking system, the private commercial bank makes no loans and therefore assumes no risk of default. Instead, the bank serves as an intermediary between persons with savings available for lending and others who are interested in borrowing money. The risk of default therefore is assumed by the person who makes the loan. The bank draws a commission by bringing the two parties together in the same way a real-estate broker receives a fee for helping buyer and seller close a deal on a home. In a 100-percent reserve system, prior savings are required. When the loan is made the money is transferred from the lender to the borrower and for that reason no credit is created. This type of loan resembles the loan that your parents make to you: whatever money they lend you no longer is available for their use. 100-percent reserve banking is not entrepreneur-

¹ A NOW (Negotiable Order of Withdrawal) account that is offered to the public by private commercial banks and other financial institutions is one in which the customer is allowed to write drafts against funds held on deposit. At one time a NOW account and an ordinary demand deposit (checking account) were different because a bank could pay interest on a NOW account but not on a demand deposit. Since that ban was lifted in 2011, there is no difference between these two accounts.

friendly because there is relatively less funding available for innovational activity.

In a 100-percent reserve banking system, a bank can fail whenever it is unable to meet its obligations to its creditors. This can happen when the bank is poorly managed. However, since banks do not actually make loans in a 100-percent reserve system, there is no risk that nonperforming loans will cause banks to fail. 100-percent reserve banking is based on the social value of community in the sense that entrepreneurs depend on others who are able to save some of their income and are willing to make those savings available to support their innovational ideas.

REVIEW SECTION: TOPIC 6

Central Concepts:

- partial-reserve banking
- prime rate
- promissory note
- collateral
- private creation of credit
- limit
- nonperforming loans
- deposit insurance
- bank failure
- bank fraud
- “zombie” financial institutions
- 100-percent reserve banking

Important Questions:

- How do private commercial banks create credit?
- Is there a *limit* to the amount of credit a private commercial bank can create?
- How do private commercial banks secure their loans?
- What is the promissory note?
- In a 100-percent reserve banking system, who is the risk-taker when a loan is made?
- Why do banks fail in a partial-reserve banking system?
- Why did so many U.S. banks failed during the 1980s?
- What is the role of the Federal Deposit Insurance Corporation?
- How can bank failures be prevented?
- What provides the security for a bank's depositors?
- Why doesn't deposit insurance prevent bank failure?
- In terms of the banking system, what is a “meltdown”?

(continued on following page)

True/False:

- a. Subject to the limit of \$250,000 per depositor, the FDIC protects the bank's depositors (account holders) from losses they might sustain if the bank fails.
- b. In a partial-reserve banking system, the bank serves as an intermediary between depositors with surplus funds which are available to be loaned out and other persons who are interested in borrowing money.
- c. In a 100-percent reserve banking system, the private commercial bank actually creates credit.
- d. In a partial-reserve banking system, a loan is made by physically transferring the excess cash in depositors' accounts into the newly opened borrowers' accounts.

Mark your answer below.



_____ Item a is true, items b, c, and d are false.

_____ Items a and b are true, items c and d are false.

_____ Item a is false, items b, c, and d are true.

TOPIC 7 WHO/WHAT DETERMINES PRICE?

To explain how a market system automatically and routinely eliminates shortages and surpluses and thereby arrives at a market price.

This topic begins with the following question: How do markets work? This question, in turn, raises two others: Who/what determines prices; and How do markets allocate resources? We begin with Who/what determines prices? Stating the question in terms of “what” leads the student to think of markets in terms of things that are exchanged such as goods and services and natural resources, or more simply supply and demand. Formulating the question in terms of “who” directs the student’s attention to the human beings who are interacting in the marketplace and the workplace -- buyers and sellers, employers and employees, producers and resource holders. As we have stated previously, our approach presents the market system in terms of the human beings who are engaged in their everyday economic activities.

To begin, consumer behavior is described by the principle of demand: the lower the price, the greater the quantity demanded by consumers. Producer behavior is described by the principle of supply: the higher the price, the greater the quantity supplied by producers. Both are general principles and both are descriptive. Neither one actually explains consumer or producer behavior, and for both there are exceptions. Vegetarians for example do not buy more beef when beef is on sale, and animal-rights activists are not induced to buy sealskin coats when those coats are offered at a lower price. Producers in general prefer a higher price for their product or service because the higher price makes for a larger profit margin. But some producers are reluctant to raise their prices for fear of losing their customers to a producer with a lower price. Further, larger profit margins can be achieved as well by bringing down the cost of production through improvements in productivity that have the effect of using resources more efficiently. It bears repeating: the principle of supply and the principle of demand are general principles and descriptive principles.

For more than 100 years, economists were divided as to whether it was the buyer (demand) or the seller (supply) who determined price. Finally, the English economist Alfred Marshall in the 1890s resolved the issue. Marshall stated that asking the question Who determines price? is like asking the question Which edge of the scissors does the cutting? Since any school child knows that the answer to the scissors questions is that both the lower blade and the upper blade do the cutting, Marshall was able to convince economists to think of the question Who determines price? in terms of both buyers and sellers, demand and supply.

*The principle of demand can be represented diagrammatically by plotting the price of the product (the independent variable) along the vertical axis and the quantity demanded (the dependent variable) along the horizontal axis. The result is a demand curve that is downward sloping to the right, reflecting the principle of demand: the lower the price, the greater the quantity demanded by consumers. **The placement of the independent variable along the vertical axis is a departure from the common practice in other disciplines such as engineering of plotting the independent variable along the horizontal axis.***

The principle of supply can be represented in like manner by plotting the price along the vertical axis and the quantity supplied along the horizontal axis. The result is a supply curve that is upward sloping to the right, reflecting the principle of supply: the higher the price, the greater the quantity supplied by producers. Here too price as the independent variable is plotted along the vertical axis not the horizontal axis.

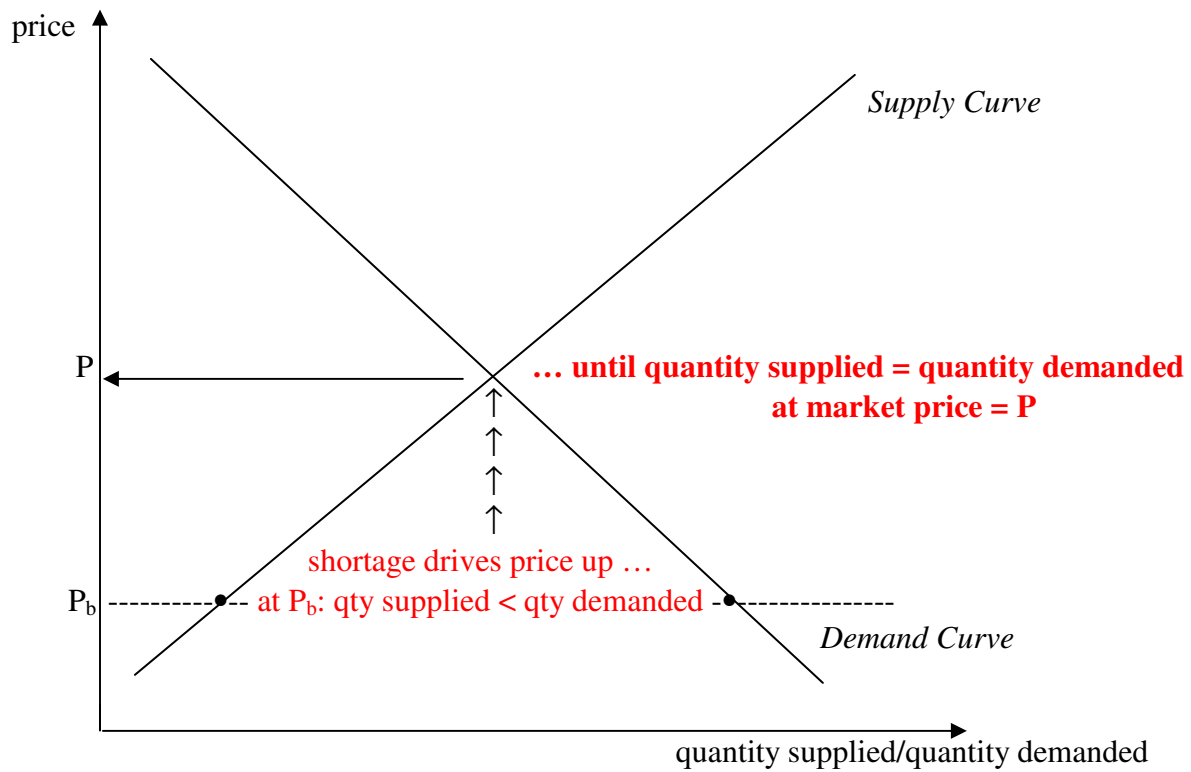
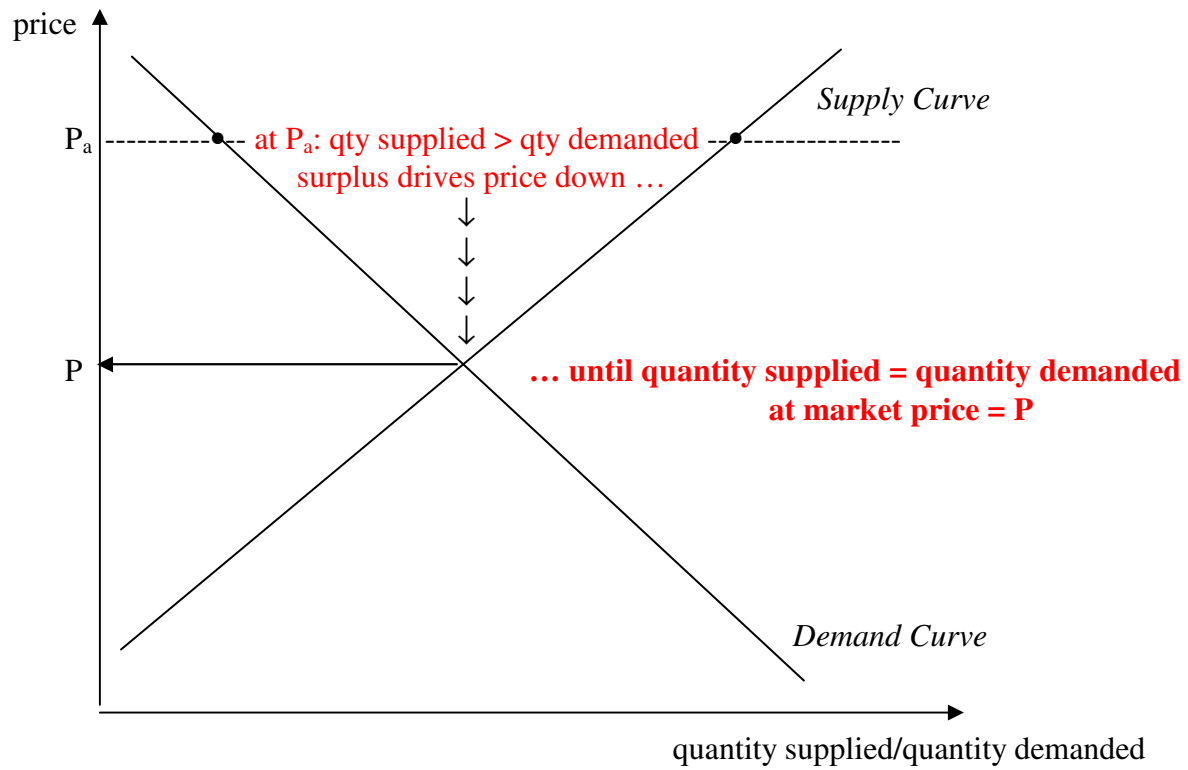
A supply curve that is upward sloping to the right never originates below the origin because below the origin prices are negative which means that when a person buys an item from a merchant the buyer gets the item and the merchant pays the buyer to take the item from the store. There is no such thing as a negative price.

Taking advantage of the analogy to the scissors, Marshall united the supply curve and the demand curve in a single diagram that when handles are added to the bottom of both curves has the appearance of a scissors. Thus, the diagram ever since has been known as Marshall's scissors diagram. The market price and the quantity exchanged in a market for a specific good or service are determined by the intersection of the supply curve and the demand curve because only at that intersection are the quantity supplied and the quantity demanded equal, only there are buyers and sellers in agreement. At P, the buyers want to buy exactly the same amount of that product or service as the sellers are willing to offer. The quantity supplied = the quantity demanded. See the diagrams on the following page.

Mainstream economists like to refer to the intersection of the supply curve and the demand curve as the point of equilibrium, and the market price as the equilibrium price. Personalist economists prefer to call that intersection the point of agreement and the market price the agreed price because agreement underscores that markets are places for sorting out differences between humans whereas equilibrium suggests that markets are places for striking a balance between things.

Even so, there is more to understanding how markets determine prices than is represented by the intersection of the supply curve and the demand curve. Markets operate systematically and automatically to produce the conditions whereby buyers and sellers are brought to agreement. Whenever the price is greater than the market price, the quantity supplied > the quantity demand. The resulting surplus sends a clear signal to sellers to lower the price since sellers are interested in selling their products and services not holding on to them. Sellers lower price until the surplus is eliminated. Similarly, whenever the price is less than the market price, the quantity demanded > the quantity supplied. The resulting shortage signals sellers to raise the price until the shortage is

WHAT DOES THE AUTOMATICITY PRINCIPLE TELL US ABOUT A MARKET?
a market **automatically** eliminates surplus/shortage by lower/higher price



eliminated that occurs at the point of intersection of the supply curve and the demand curve. In other words, when buyers and sellers are in agreement.

This system of unambiguous signals means that the market automatically eliminates or clears out a surplus or a shortage and thereby drives buyers and sellers toward agreement. We refer to this systematic and predictable market reaction to a surplus and a shortage as the automaticity principle. Some markets, however, remove a shortage or surplus much more quickly than others. A stock market functions quickly whereas a labor market or real-estate market operate much more slowly. Thus when we say that markets operate automatically, we do not mean to imply that they always operate quickly.

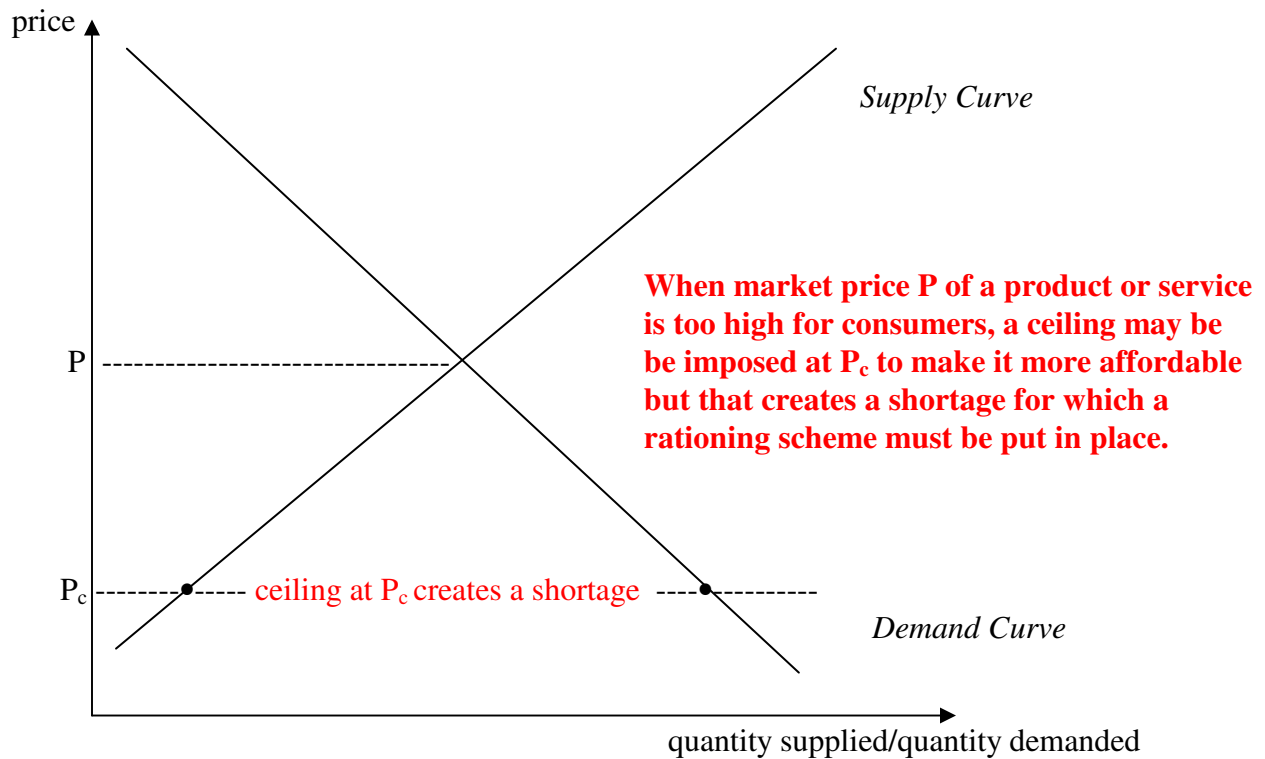
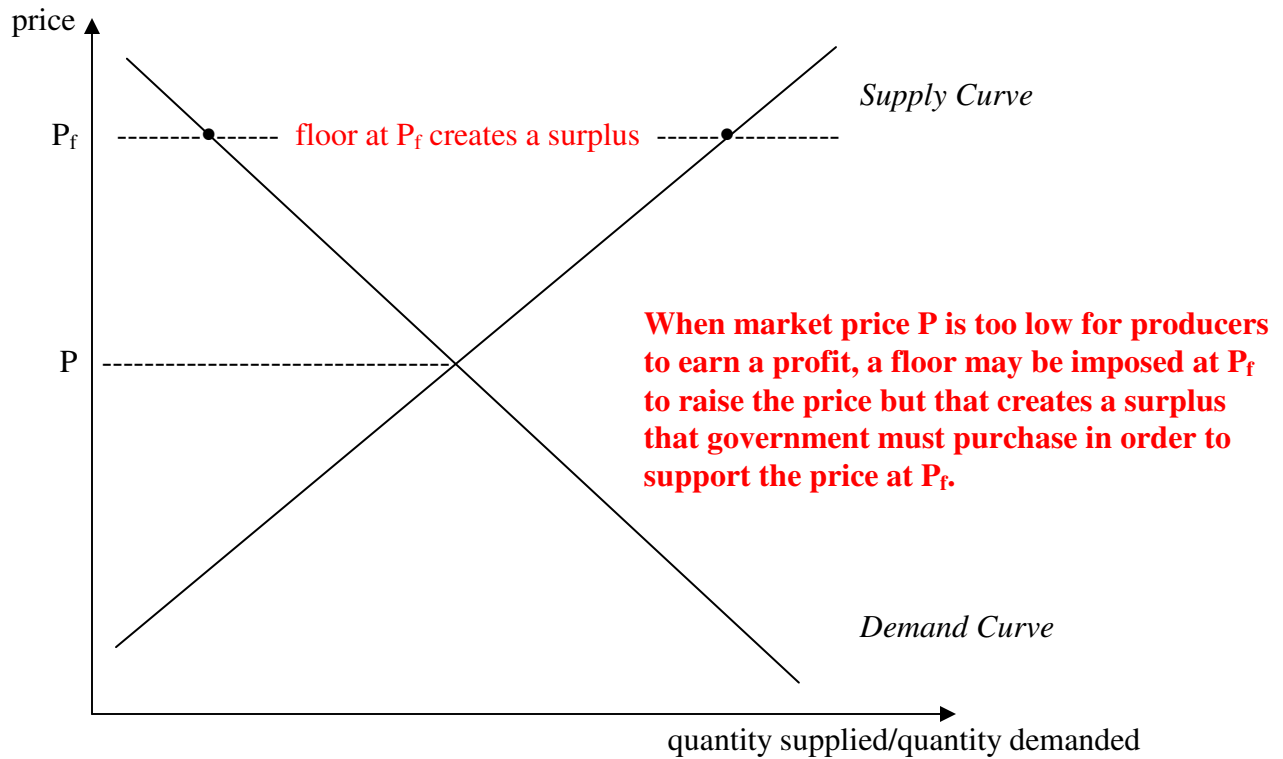
Two problems centering around the price beset the market system. First, what to do when the market price is so high that it is beyond the reach of consumers? Second, what to do when the market price is so low that producers are unable to turn a profit? Intervention, the organizing principle that operates in the limiting mode, may be brought into play. If the product or service that is unaffordable for consumers is truly needed rather than merely wanted, government might intervene and impose a price ceiling below the market price. By driving the price below the market price, a ceiling (that is easily enforced by urging consumers to call an 800 number to report violators) creates a shortage. To deal with that shortage, some type of rationing scheme may have to be implemented in order to allocate the short supply among consumers. At many locations that have a large volume of vehicle traffic, a shortage of parking is routinely addressed through the rationing scheme of first-come, first-served. If there is a shortage of gasoline because the government imposed a ceiling on the price of gasoline, it may be necessary to allocate the short supply by issuing gasoline rationing coupons based on need. The ambulance driver would be allocated more gasoline than the stock car driver. Need would be determined by a government agency as happened during World War II and coupons issued accordingly. Under those circumstances, consumers simply have to manage their daily lives without some of the rationed good that they normally would be able to buy. At the store, the merchant would require both the cash and the coupon to sell the rationed item to the consumer. A rationing coupon is not the same as a food stamp. Though both are allotted on the basis of need, the food stamp is a substitute for money, whereas the rationing coupon is a necessary complement. Without the coupon, it is strictly illegal to buy an item that is rationed.

Early in his first term of office, President Clinton appointed a commission to investigate the U.S. health care system. One of the commission's recommendations was to put a "cap" on health insurance premiums to make health insurance more affordable. A cap is the same as a price ceiling and if imposed would have created a shortage. A short supply of health insurance due to the withdrawal of private insurers from the health insurance market where profit margins were thinner due to the lower price (premium) effectively means that the government would have to provide the insurance directly as it does already with health insurance for the elderly known as Medicare. Clinton's health care reforms never passed Congress.

What to do when the price is so low that producers are not able to turn a profit? Again, government intervention could be called upon to provide a price floor, a lower limit to the price that would have

WHAT HAPPENS WHEN PRICE CONTROLS ARE INSTITUTED?

a floor raises the price and **creates a surplus** and a ceiling lowers the price and **creates a shortage**



the effect of driving the price above the market price. Under those circumstances, a surplus emerges that forces the government to purchase the excess supply in order to prop up the price. We have had price floors for many years in agriculture in order to keep prices high enough to make farming profitable. See the diagrams on the preceding page.

The minimum wage, which originated in the 1930s at \$.25 per hour, has the same effect. The resulting surplus is called unemployment and that surplus has been the principal argument of the critics of the minimum wage from the very beginning. The principal argument of its advocates is that the United States is a wealthy country and no one should have to work at a wage that is insufficient to provide a decent standard of living.

*The lesson to be learned from experience with price floors and ceilings is that they do not solve the problem. They change the problem from an unaffordable price to a shortage and from an unprofitable price to a surplus. A word of caution. To be effective a price floor must be imposed **above** the market price, though we are used to thinking of the floor as being below. For a price ceiling to be effective it must be imposed **below** the market price, though we think of a ceiling as being above.*

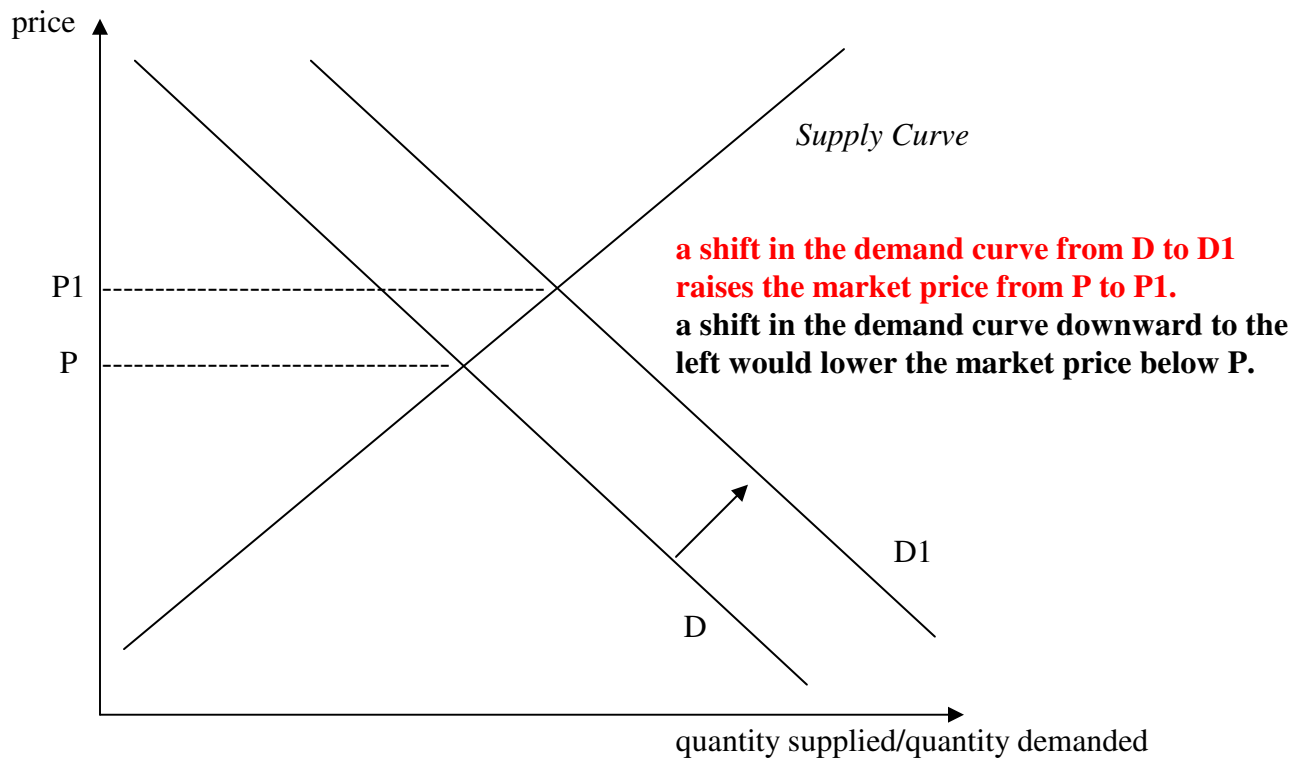
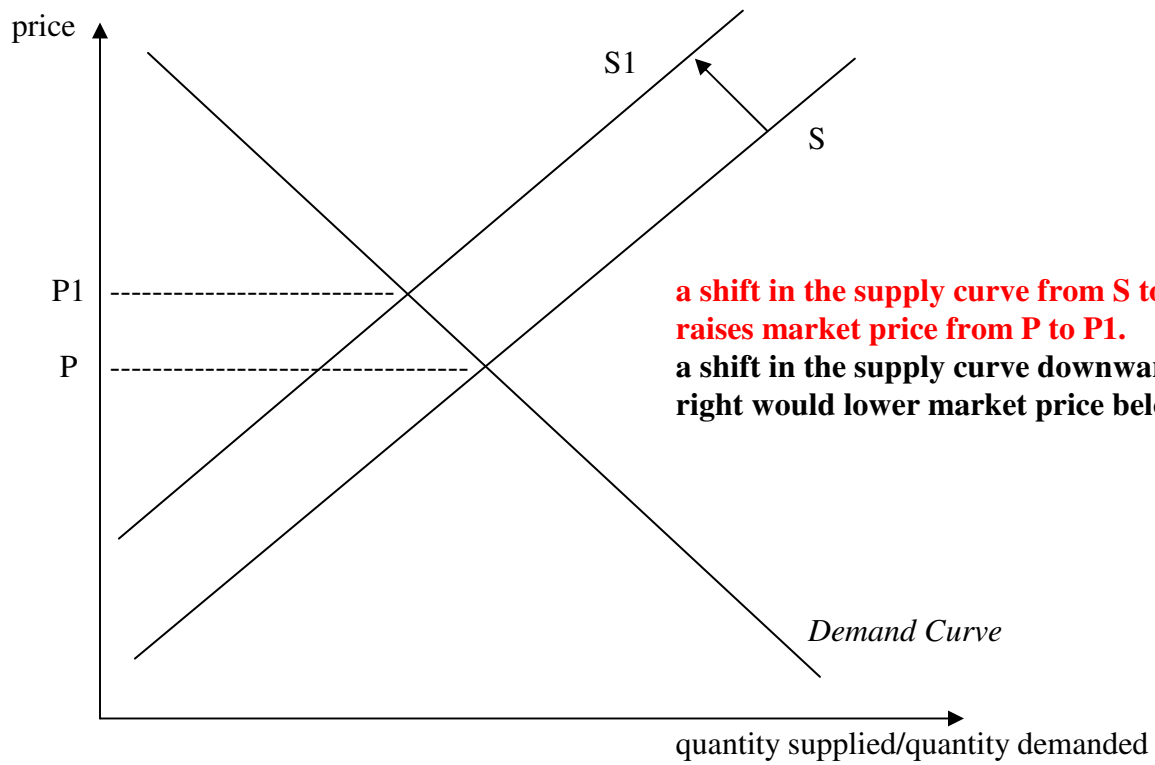
Having addressed the question as to how markets determine prices, we next address the question as to how prices change in a market system. Prices change because of some fundamental change in the conditions of supply or demand such that the supply curve, the demand curve, or both actually shift. For a supply curve, the shift may be either downward to the right or upward to the left. For a demand curve, the shift may be either downward to the left or upward to the right. A shift in one of the two curves changes the point of intersection between the curve that has remained stable and the one that has shifted. A shift in both at the same time has the same effect: it changes the point of intersection or the point of agreement. See the diagram on the following page.

Demand curves shift for one of five general reasons: (1) a change in consumer income; (2) a change in consumers' tastes and preferences; (3) a change in the price of a substitute product or service or the price of a complementary product or service; (4) a change in the size or composition of the consumer population; and (5) a change in future price expectations. Supply curves shift for one of three reasons: (1) a change in the cost of resources; (2) a change in technology that improves the efficiency of the production process; (3) a change in future price expectations.

Recall that Topic 7 began with two questions Who/what determines prices; and How do markets allocate resources? We are ready to turn our attention to the second question. As indicated in Topic 4 markets allocate resources through the "pulling force" of prices and the "pushing force" of unmet need. Let us flesh out the meaning of that assertion with the example of two producers, one that faces a shortage market for the product that he/she is producing, while the other confronts a surplus market. See the exhibit titled "ALLOCATING RESOURCES: THE PULLING FORCE OF PRICES, THE PUSHING FORCE OF UNMET NEED" displayed below.

WHAT CAUSES A CHANGE IN THE MARKET PRICE?

a **shift** in the supply curve or a **shift** in the demand curve



**ALLOCATING RESOURCES:
THE PULLING FORCE OF PRICES, THE PUSHING FORCE OF UNMET NEED**

Producer A faces **shortage**
of his/her product



Producer A raises price
and increases output



Producer A hires more
resources and is able to
pay more because the
price of the product
is rising



Producer B faces **surplus**
of his/her product



Producer B lowers price
and decreases output



Producer B discharges
resources and is not able
to pay more because the
price of the product
is falling



The resources discharged by Producer B are attracted to Producer A who is hiring and is paying more for the resources he/she requires. This is the way in which mainstream economics explain the allocation of resources in a market economy: **the pulling force of prices** draws resources away from producers where they are in excess supply and toward producers where they are in short supply, thereby simultaneously remedying Producer B's surplus market condition, and Producer A's shortage market condition.

Personalist economics adds **the pushing force of unmet need**. **Redundant workers and other idle resources** are pushed away from producers where they are in excess supply and toward producers where they are in short supply by the hardship and unmet need brought on by their idleness.

APPENDIX

Supply and Demand as Linear Functions of Price

Both supply and demand are linear functions of price. In other words, price is the independent variable and quantity supplied and quantity demanded are the dependent variables. More precisely, both seller behavior (as *represented* by the quantity supplied) and buyer behavior (as *represented* by quantity demanded) are determined by the price.

The general forms of the equations representing the supply curve and the demand curve are:

$$\text{Quantity supplied} = a + b(\text{price})$$

where “+b(price)” indicates that the supply curve is upward sloping to the right

$$\text{Quantity demanded} = c - d(\text{price})$$

where “-d(price)” indicates that the demand curve is downward sloping to the right.

“c” by definition is greater than “a”

(the y-intercept of the demand curve is greater than the y-intercept of the supply curve)

Plugging in some representative numbers for both functions gives:

$$\text{Quantity supplied} = 10 + 2(\text{price})$$

$$\text{Quantity demanded} = 45 - 3(\text{price})$$

Since the quantity demanded = quantity supplied at the market price, setting the two functions equal allows us to solve for the market price.

$$10 + 2(\text{price}) = 45 - 3(\text{price})$$

$$5(\text{price}) = 35$$

$$\text{market price} = 7$$

Plugging in other representative numbers in the same functions gives:

$$\text{Quantity supplied} = 4 + 4(\text{price})$$

$$\text{Quantity demanded} = 60 - 2(\text{price})$$

To solve for the market price, set the two functions equal.

$$4 + 4(\text{price}) = 60 - 2(\text{price})$$

$$6(\text{price}) = 56$$

$$\text{market price} = 9.33$$

Whenever the quantity demanded > the quantity supplied, price rises automatically to remove the shortage. Whenever the quantity demanded < the quantity supplied, price falls automatically to remove the surplus. Thus agreement between buyers and sellers is reached via changes in the price such that finally the quantity supplied = the quantity demanded. Price is the independent variable.

REVIEW SECTION: TOPIC 7

Central Concepts:

- principle of demand
- principle of supply
- automaticity principle
- Alfred Marshall's scissors diagram
- market (agreed) price
- market clearing
 - shortage
 - surplus
- price controls
 - ceiling (cap)
 - floor (support)
- agreement
- rationing
- resource (re-)allocation
 - pushing force
 - pulling force

Important Questions:

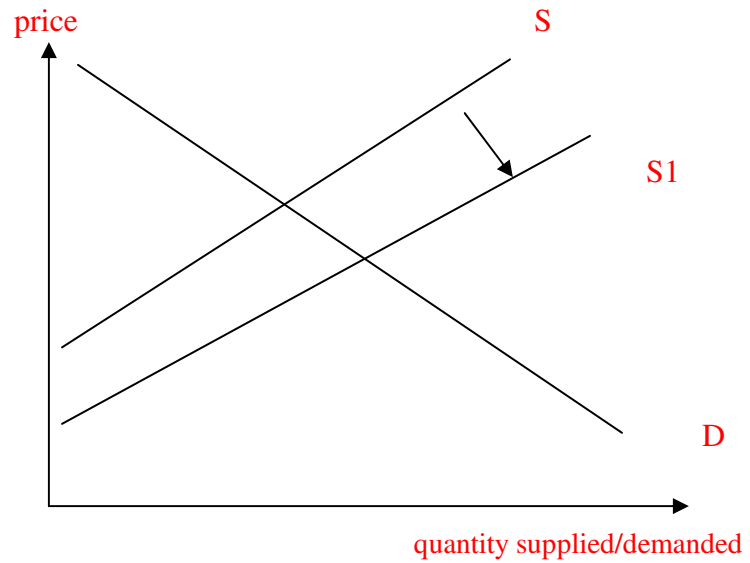
- State the principle of supply and the principle of demand.
- Why are the principle of supply and the principle of demand general principles?
 - descriptive principles?
- How does the market system eliminate shortages and surpluses?
- Who was Alfred Marshall?
- How did the scissors diagram come about and how did it help resolve the issue of price determination?
- What happens when the government imposes a price ceiling? a floor?
- What are the various ways in which goods and services in short supply can be rationed?
- According to mainstream economics, how are economic resources (re-)allocated?
- What is the role of unmet human material need in (re-)allocating economic resources?
- Why does personalist economics insist on the language “agreement/disagreement” to characterize the way in which economic agents interact in a market system?

(continued on following page)

True/False:

This graph shows a shift ...

- a. in the supply curve that changes the market price.
- b. in the supply curve that increases the market price.
- c. in the demand curve that decreases the market price.
- d. in the demand curve that increases the market price.



Mark your answer below.



- Item a is true, items b, c, and d are false.
- Items a and b are true, items c and d are false.
- Item a is false, items b, c, and d are true.

TOPIC 8 CONSUMER BEHAVIOR

To demonstrate that consumer behavior is characterized by both want satisfaction and need fulfillment and that poverty is a central factor in consumer behavior raising the question as to what to do for the poor.

The principle of diminishing marginal utility helps us understand consumer behavior because it goes beyond the descriptive nature of the principle of demand. All consumer behavior involves two limits that originate in the human body, requiring us to deal with those limits when we are acting as consumers wherein the consumption of any product or service is perceived as being driven by satisfaction or the utility that derives from that consumption.

*Limit I refers to the one unit consumed that produces the largest increase in utility or satisfaction. We reference Limit I as maximum **marginal** utility. Limit II refers to the last unit consumed that offers some increase in utility but beyond which disutility sets in. We refer to Limit II as the point of maximum **total** utility. The table on the following page shows Limit I and Limit II in the context of a person who consumes whiskey by the shot in a bar. Notice that this consumer conforms to the principle of demand: he/she buys more when the price per shot is lower. The bartender also understands the principle of demand, and demonstrates that knowledge whenever he/she schedules happy hour.*

Limit I is associated with the second one-ounce shot of whiskey consumed. We can even think of the satisfaction or utility of that shot in terms of “buzzes.” Limit II is associated with the fourth one-ounce shot of whiskey consumed. “Pigging out” is a common reference to having exceeded Limit II in consuming some especially enticing product and afterward having some regrets for having over indulged. In our whiskey example, the common expression “knowing my limit” refers to Limit II.

Why do consumers at times freely exceed Limit II? Peer pressure is one reason. The availability of the product free of charge is another. To illustrate, a friend says “drinks are on me” or “let’s have one more for the road.” Another reason is that the consumer is willing to challenge his/her own limit, thinking that perhaps it is higher than it actually turns out to be. The disutility of exceeding Limit II presents itself in terms of a fight with a close friend, an accident while driving under the influence, a hangover the next day. “Pigging out” on food or sweets can lead to unwanted weight gain or some physical problem such as a blemished complexion.

Now we are able to supply a formal statement of the principle of diminishing marginal utility in terms of its two limits. When a person begins consuming a good or service, he/she experiences a large increase in total utility with every additional unit consumed. After a certain point (Limit I), he/she notices that the increase in total utility begins to diminish with every additional unit consumed. Consumption continues until the additional utility from one more unit consumed

approaches zero. At that point (Limit II), he/she experiences maximum utility.

**THE TWO LIMITS EMBEDDED IN THE PRINCIPLE OF
DIMINISHING MARGINAL UTILITY**

<u>Price</u>	<u>Quantity Consumed</u>	<u>Marginal Utility</u>	<u>Total Utility</u>
\$2.25	0		0
		10	
2.00	1		10
		11 <===== Limit I	
1.75	2		21
		3	
1.50	3		24
		2	
1.25	4		26 <===== Limit II
		-4	
1.00	5		22

Every human being as a consumer faces these two limits because every human being is embodied. Dispose of the body, and the limits disappear. Even so, the limits are not the same for every consumer because each one of us has his/her own body with its own metabolism and tolerances. And as we age, our limits tend to change as well. The hyperactive body of the teenager or athlete requires more calories than the sedentary body of the same person much later in life.

Finally, we are called on to tighten the linkage between the principle of demand, the principle of diminishing marginal utility, and economic gain. We use the demand for gasoline in our example because it allows us to differentiate need from want that mainstream economics refuses to do in addressing consumer behavior.

The reason consumers buy more when the price of gasoline is lower is that at the lower price they are better able and more willing to use their vehicles for less pressing needs (driving rather than walking to a nearby store) and may even use them for satisfying wants (cruising with friends) in addition to meeting needs. They are likely to forego those wants and less-pressing needs when prices are higher.

To generalize across consumer behavior, consider the following. Early on with every additional unit of a good or service consumed, the consumer experiences ever larger increases in total utility until Limit I is reached: what is gotten in exchange (marginal utility) is rising. Once Limit I is passed, with each additional unit consumed the consumer experiences ever smaller increases in total utility

until Limit II is reached: what is gotten (marginal utility) is falling.

*The rational consumer, **homo economicus**, is willing to buy more of a good or service even when what is gotten is becoming ever smaller provided what is given up – the price – is lower. There is, in other words, some economic gain to the consumer and for that reason exchange takes place. This process continues until what is gotten from the very last unit consumed is only slightly more highly valued than what is given up. Under these extreme conditions the gain is just sufficient for the consumer to execute the exchange. After that point (Limit II), for any additional unit consumed what is gotten has negative marginal utility and therefore reduces the total utility gotten from all units consumed. Exchange after Limit II breaks down for lack of any economic gain.*

***Homo economicus** is more than what is represented by the principle of diminishing marginal utility. Following mainstream economics, the consumer is unique, solitary, autonomous, self-centered, and self-made, traits that accent the consumer's individuality. For example, the practice of power dressing and the popularity of health foods, along with cosmetic surgery and liposuction, give evidence of the consumer who is self-made. Self-centered and self-interested consumers properly purchase goods and services for their own use without necessarily becoming selfish when those items are necessary for their well-being.*

*The consumer behaves predictably in ways that are described as utility-maximizing, privacy-protecting, and commodity-acquiring. In American culture, for sure, acquiring and accumulating goods are perceived as a sign of success. As **homo economicus** the consumer is free to choose whatever he/she is able to afford, makes those choices informed strictly by reason for the purpose of satisfying some want, and takes into account not only experiences in the past (is hind sighted) but also hopes and plans for the future (is foresighted). Adults typically plan years ahead for their retirement, carefully budgeting -- rationally planning income and expenses -- to achieve that goal.*

Comparisons are made but they are rigorously intra-personal or inward-looking, wherein consumers evaluate their own needs and wants over time without any regard for others. Our language points to specific instances of the consumer acting mainly according to human individuality. The trendsetter and the traditionalist are consumers with much individuality. The conformist is one with little individuality.

Even so, there is more to the consumer than even this expanded perspective from mainstream economics. The consumer is a social being as well as an individual being, and as such is both unique and alike, solitary and communal, autonomous and dependent, self-centered and other-centered, self-made and culture bound. Soul food and Cajun cuisine originate in specific cultures and appeal especially to persons born and raised in those cultural environments. Pre-teens are persons who are dependent on their parents for the things they need and want. Similarly, the elderly may become dependent on their adult children because of some debilitating condition.

Additionally, the consumer behaves in ways that are described as at once utility-maximizing and utility-satisficing, privacy-protecting and company-seeking, and commodity-acquiring and gift-

THE PERSONHOOD OF THE CONSUMER

AS A PERSON THE CONSUMER IS BOTH ...

Individual Being and Social Being

unique and alike
solitary and communal
autonomous and dependent
self-centered and other-centered
self-made and culture-bound

whose decisions are grounded in his/her two-dimensional nature ...

wherein those decisions must be made in a way that reconciles the consumer's ...
individualityand sociality

that involve making both ...
intra-personal comparisons and inter-personal comparisons

and that is both ...
privacy-protecting and company-seeking
commodity-acquiring and gift-giving

because the consumer is both an individual being and a social being, he/she may be a ...
trendsetter + caring neighbor * conformist ++
free-rider ** traditionalist + philanthropist *

homo economicus is utility-maximizing, free to choose and act, rational in all decision-making, strictly want-satisfying, both foresighted and hind sighted

the acting person is utility-maximizing at times and utility-satisficing at other times, free to choose and act but accountable for his/her choices, rational at times and emotional at other times, usually need-fulfilling before want-satisfying, both foresighted and hind sighted

THE SOCIAL QUESTION: WHAT TO DO FOR THE POOR?

< If individual need is met even when choices are made unwisely, there is no reason to differentiate needs from wants: there is no social question.

< If individual need is not met even when choices are made wisely, wants are to be differentiated from needs: there is a social question.

< The principle of subsidiarity asserts that to some extent the state should provision goods and services not for unsatisfied wants but for unmet need and only insofar as the private sector is unable to provision that need.

< The firm has a duty in justice to refrain from selling activities that have a direct, significant, negative impact on human physical need. In equivalence, the firm is admonished about imposing an unequal burden on buyers. In contributive justice, the firm is admonished not to shift the true cost of its selling operations to taxpayers who are not involved in operational decision-making. In distributive justice, the firm is admonished to treat all of its customers as equals.

< The firm has a duty in subsidiarity not to force its poor customers to turn to others in the social order for help in meeting need worsened by the firm's inducing poor customers to satisfy wants before meeting needs.

+ : much individuality * : much sociality ++ : little individuality ** : little sociality

giving. At times, a person will take less in terms of the maximum utility available at the moment so that a friend might have more. Or both may decide to share what they have, each one taking less than the maximum available if he/she were to exclude the other, in order that the other might have more, thereby affirming and strengthening their friendship.

*As the **acting person**¹ the consumer is free to choose whatever he/she is able to afford, but is morally accountable for the choices made, makes those choices informed by reason and emotion, both by mind and heart, for the purpose of satisfying some want or meeting some need. Fear drives some consumer choices, as at times with handguns and security systems. Some persons known as compulsive consumers or shopaholics are addicted to shopping. Their choices are not rationally determined, nor are they freely made. O. Henry's "The Gift of the Magi" is a short story of a young married couple too poor to buy one another presents for Christmas. The husband buys a comb for his wife's beautiful long hair by selling his gold watch and she buys a chain for his watch by cutting and selling her hair. This story is enchanting because it exemplifies the gift-giving behavior of a husband and wife in love. As with **homo economicus**, the **acting person** is not only hind sighted but also foresighted as when parents have to reduce their current consumption for years in order to set aside sufficient funds for their children's future education.*

Human individuality prompts the consumer to make comparisons that are intra-personal, but his/her human sociality encourages regard for others. Here as well our language informs us about the consumer whose behavior reflects human sociality. The free-rider or deadbeat is a person with little sociality. The caring neighbor and the philanthropist are consumers with much sociality. So too the man who at the site of the collapsed World Trade Center towers gave away shoe insoles to help protect and comfort the feet of the rescue workers climbing over the jagged rubble.²

Now we are ready to address the social question: What to do about the poor? In the United States, using a poverty definition that is based on the cost of the goods and services necessary to maintain a minimal standard of living (more about that in Topic 23), an estimated 15.0 percent of the population or approximately 46.5 million persons were classified as poor in 2012. From the very start, it is necessary to differentiate (1) those poor persons who use their resources responsibly and still do not have enough to meet their needs from (2) others who use their resources irresponsibly. Because assisting the irresponsible simply enables them to continue acting irresponsibly it is important to do whatever is possible to restrict them from getting assistance.

¹ In the past we referred our replacement for **homo economicus** as **homo socio-economicus**. Today we use instead the **acting person** for two reasons. First, **acting person** underscores much more effectively than **homo socio-economicus** the economic agent as a human person acting in economic affairs both as an individual being and a social being. Second, whereas **homo economicus** is tied to the philosophy of individualism, **acting person** links our conception of economic agency to the philosophy of personalism.

² See Stephen Jay Gould, "Ground Zero," *The Antioch Review*, Winter 2002.

As we had seen earlier, the principle of subsidiarity is helpful in sorting out the issue of private versus public ownership of any given business enterprise and in reaching a decision as to where in the social order the source of assistance for the needy should be located. Thus, larger, more powerful units of society such as the federal government (1) should not usurp the functions of smaller, weaker units but (2) should help those smaller, weaker units function effectively. The principle of subsidiarity states that the source of the assistance should be located as close as possible to the persons and families in need. This decentralization of the programs and organizations offering assistance helps limit two abuses. First, it helps reduce the abuse of persons applying for assistance who are not needy or who are irresponsible because by being closer the agency likely is better informed and more likely to identify would-be abusers. Second, it helps remedy the problem of the program staffer who is abusive to applicants, demeaning and belittling them, because by being closer the applicant finds it easier to complain to the supervisor about the abusive staffer, and to bring the problem to a successful resolution.

In his State of the Union address in January 2003 President Bush affirmed the principle of subsidiarity using this language.

Americans are doing the work of compassion every day – visiting prisoners, providing shelter for battered women, bringing companionship to lonely seniors. These good works deserve our praise ... they deserve our personal support ... and, when appropriate, they deserve the assistance of our government. I urge you to pass both my faith-based initiative and the Citizen Service Act – to encourage acts of compassion that can transform America, one heart and one soul at a time.

There are two benefits that flow from organizing assistance in a decentralized manner. First, the applicants are more likely to participate in re-shaping the assistance program because they are closer to the administrative control of the program, thereby reinforcing the democratic principle that everyone should participate in the decisions that affect their lives. Second, a decentralized system allows for the development of many different programs, and with the passage of time the emergence of a consensus as to which ones work best and which “best practices” should be adopted elsewhere.

*The social question raises a corollary question: What is the company or firm to do in dealing with poor customers? One school of thought that follows the libertarian philosophy argues that even the poor should be free to make their own decisions with regard to their own consumption spending, and no one should intervene in such matters because the poor better than anyone else know what is best for them. And, if a specific consumer is wronged, it is a small price to pay for liberty. In any case, let the buyer beware (*caveat emptor*).*

Another school of thought that follows the personalist philosophy asserts that the firm has a set of duties originating in the three principles of justice. First, the firm has an obligation to refrain from marketing and selling activities that make any unmet need of their customers worse than before. Second, under the principle of equivalence, the firm is admonished not to impose an unequal burden on its customers that derives from the customers’ poverty-stricken status such as powerlessness in the face of a large, intimidating or indifferent firm. Third, contributive justice informs the firm that it may not force additional assistance costs on taxpayers who are required by law to come to the aid of

a needy person even when that person's unmet need has been made even worse by a merchant whose only interest is profits. Fourth, and last, in distributive justice the firm is instructed to treat all of its customers as equals. A merchant with multiple locations including some in the suburbs and others in the inner city, may not charge inner-city customers a higher price than suburban customers unless there are higher costs in operating in the inner city.

The libertarian perspective values liberty above all else. A person's free choices, especially when that person is an adult, should not be preempted by another person. The personalist view, while respecting liberty, argues that no one has a right to make another person's unmet need even worse, whether through trickery, bare-knuckled exploitation, or simply by taking advantage of their innocence or ignorance.

REVIEW SECTION: TOPIC 8

Central Concepts:

principle of diminishing marginal utility

principle of subsidiarity

need

want

limit:

maximum additional utility (*Limit I*)

maximum total utility (*Limit II*)

“pigging out”

homo economicus

the *acting person*

compulsive consumer

social question

abuse of programs of aid to the needy:

recipient

administrator

benefits from principle of subsidiarity:

recipient input to program

program experimentation

Important Questions:

What are the two *limits* embedded in the principle of diminishing marginal utility?

What is the difference between a need and a want?

What is the perspective of conventional economics as to the nature of the consumer?

What is the perspective of personalist economics as to the nature of the consumer?

State the principle of subsidiarity and in the context of addressing unmet physical need, explain the role of this principle.

Explain the relationship between the principle of subsidiarity on the one hand and democracy and the problem of abuse of entitlement programs on the other hand.

What is the relationship between the principle of demand and the principle of diminishing marginal utility?

(continued on following page)

True/False:

- a. “Homo economicus” is the term used by mainstream economists for the typical consumer who is represented as an individual being.
- b. The “acting person” is the term used by personalist economists for the typical consumer who is represented as both an individual being and a social being.
- c. The individuality of the consumer means that he/she is communal and other-centered.
- d. The sociality of the consumer means that he/she is autonomous and unique.

Mark your answer below.



_____ Item a is true, items b, c, and d are false.

_____ Items a and b are true, items c and d are false.

_____ Item a is false, items b, c, and d are true.

TOPIC 9

STARTING AND CONTROLLING PRIVATE BUSINESS ORGANIZATIONS

To explain how a private business organization is established and operates either on the basis of *owning* or *working*, and to contrast and compare control of decision-making in various types of business organizations.

As stated previously, economic affairs are activated by humans acting as economic agents not only as individual beings for example as consumers and entrepreneurs but also as social beings through economic organizations created to produce in some cases only a single product or service and in other cases a range of products and services. Thus in a market economy the private business enterprise is crucial to the production of goods and services and therefore to the ability of the market system to provision human material need.

*There are two foundations upon which a firm in a market system can be established and operated. The one is on the basis of **owning** the assets of the business which gives rise to a property right. This right is confirmed by papers of incorporation and in the case of the corporation by certificates of share ownership. The second is on the basis of **working** at the enterprise which gives rise to a personal right. This right is confirmed by the employment contract. Control of the business depends on which of the two rights is dominant and which is subordinate.*

Though clearly distinct, owning and working are directly related to human material need, specifically physical need and the need for work as such. Owning a business is one means by which physical need is met. Working for a company is one means for meeting the need to belong which, along with self-expression or creativity, is an aspect of the need for work as such.

Physical need draws together the following four parties: owners, employees, suppliers, and customers. The need for work as such draws together these two parties: owners and employees. A successful private firm operating in a market economy is one that is able to meet these two aspects of the human material need for the parties involved including the need of the owners to the economic gain necessary to continue operating the business.

A private business is established in the eyes of the law in one of four ways: sole proprietorship, partnership, corporation, or cooperative. The first three emphasize owning the assets, the fourth emphasizes working at the firm. Under the first two types, the owners are fully liable for the indebtedness of the business. If the business fails, the owners have a legal duty to make payment in full to its creditors even if that means that the owners must surrender assets which are personal holdings entirely separate and distinct from the assets of the failed business. Under the third, the

stockholders have only limited liability for the corporation's indebtedness.¹ The stockholders' liability to its creditors is restricted to the corporation's own assets. They have no legal obligation to the creditors to surrender their privately-held assets in the event that the corporation's assets are insufficient to make payment in full to the creditors. If the producer cooperative is legally organized as a corporation, its owners also have limited liability. Creditors must be wary as to how the business is organized since under limited liability they may not be paid in full if the business fails. A bankruptcy procedure sorts out how the assets of the failed business will be distributed among its creditors.

In the case of the sole proprietorship and partnership, ownership and control are merged in the same person(s). In the corporation, on the other hand, ownership and control are separated by means of a board of directors elected by the stockholders to determine general policy for the corporation and to appoint the senior management to handle day-to-day operations. One of the significant advantages of the corporate organizational structure is that one can share in the profits of the business without having to take day-to-day management responsibility.

There are two main types of corporations, public and private. A public corporation is one that issues shares of stock to the public through a stock exchange where those shares can be traded over and over again. Profits are paid in the form of dividends to the parties who own the shares at that moment. A private corporation is one that issues shares to a generally small circle of persons who cannot sell those shares outside that circle. For that reason, the shares of a private corporation are not listed on a stock exchange though the corporation may decide at some point in time to transform itself into a public corporation. That process is known as "going public." The process of converting from a public corporation into a privately-held corporation is called "going private."

In three of the four types of ownership – sole proprietorship, partnership, and corporation -- control is proportional to the percentage of the assets that one owns. Thus, in general, owning most of the assets of the business gives one control over that business. Owners such as these are known as majority owners. Others are called minority owners. Minority ownership often means that one has little if any effective control over the day-to-day operations of the business.

There are four types of cooperatives: consumer, producer, purchasing/shared services, and worker.² A consumer cooperative is owned by the persons who purchase goods and services through the cooperative. Recreational Equipment Inc (REI) is the largest consumer cooperative in the United States with more than 5.0 million active members and annual sales of \$2.0 billion in 2013. A producer cooperative is owned by the persons who produce similar products. Land O'Lakes (2013 net sales of \$14.2 billion) and Ace Hardware (2013 revenue of \$4.2 billion) are two well-known

¹ Sometimes a corporation is publicly identified by the letters "Ltd." following its name to indicate that the owners (stockholders) have limited liability in the event of failure.

² The National Cooperative Business Association provides more information on cooperatives in the United States at www.ncba.org.

producer cooperatives. The purchasing/shared service cooperative is owned by business owners who come together in order to enhance their purchasing power, lower the cost of production, improve their competitiveness and their ability to provide quality services. One example of this type of cooperative is Restaurant Supply Chain Solutions which manages the supply chain for companies such as A&W, KFC, Pizza Hut, and Taco Bell.

The worker cooperative is owned and controlled by the employees of the firm in which each employee has one vote in the decision-making process. For that reason, the worker cooperative is known as “industrial democracy.” Port Townsend Shipwrights Co-op located in the State of Washington is a 13-member worker cooperative specializing in servicing the Alaska fishing fleet, motor vessels, and sailing vessels of the Pacific Northwest. Worker cooperatives at times evolve from companies in failure that are bought out by the employees in order to secure their jobs but often fail later for a variety of reasons.

Employees may legally participate in business decisions through an employee stock ownership program (ESOP) which makes them stockholders in the corporation and thereby gives them “one vote for each share” in the election of the board of directors unless the shares are held in trust and are voted by the trust administrator for the employee stockholders. In 2014 there were approximately 12,000 ESOPs in the United States covering about 11 million employees. Additionally an estimated 10 million employees participate in plans that provide stock options or other individual equity.¹

Control of the business means control of decisions such as the following.

Which goods/services are to be produced?

How much of those goods and services are to be produced?

What processes are to be used in the production of those goods and services?

What wages are to be paid to the employees of the business?

What prices are to be charged for the goods and services produced?

Whether to retain some of the profits for future operations (internal financing), sell additional shares of ownership to raise additional funds as may be needed (equity financing), or borrow those funds (debt financing)?

Legal control is not the same as actual control. Actual control may be exercised by persons and parties other than the owners, such as employees who are not shareholders, fund managers, take-over specialists, other business enterprises. Employees may gain control through co-determination, gain-sharing, and such participatory-management practices as quality circles, town-hall meetings, and cost-containment. Co-determination involves granting employees direct representation on the board of directors. It is a method used much more commonly in Europe than in the United States. Gain-sharing brings workers into the decision-making process by offering to share in some pre-determined fashion the gains (added profits) derived from improvements they make to the process of

¹ For more about employee stock ownership plans see the National Center for Employee Ownership at www.esop.org.

production that lead to greater efficiencies and lower production costs. All of the methods enumerated above provide access to actual control through an expansion of personal rights and a contraction of property rights. An ESOP provides access to control through property rights.

Managers of investment funds such as mutual funds exert control by virtue of the amount of the funds which they invest and the impact that their investment decisions have on the price of a share of stock in a public corporation. Thus, they are able to drive up/drive down the price of a share of stock by buying/selling large blocs of shares. Since fund managers are hired to increase the value of the holdings of the fund through shrewd investments and since corporations paying larger dividends will accomplish that purpose better than corporations paying smaller dividends, the senior management of the corporation is sensitive to the amount of its profits distributed as dividends to the stockholders and the amount that is retained for re-investment in the corporation.

Take-over specialists have actual control by virtue of the number of shares they own or their ability to acquire large share holdings and thereby are in a position to threaten the stockholders, board of directors, and especially senior management. Other business enterprises have actual control whenever they are a major customer of another business and by virtue of that relationship are able to force that supplier to change in order to maintain the relationship. Wal-Mart is well known for exerting control over its suppliers by threatening to switch to other sources of supply whenever its demands are not met.

Exclusive Control of the Firm vs. Inclusive Control.

Nobel Laureate Milton Friedman for years has insisted that the business firm's one and only purpose is to produce a profit for its owners/shareholders. His concept of community excludes everyone except the owners/shareholders on grounds that they alone actually own the firm. Many in mainstream economics enthusiastically concur with him, as do many others especially libertarians. Their view of human nature is individualistic.

Personalist economics, on the other hand, insists that community is inclusive of everyone with a stake in the company including shareholders, management, labor, suppliers, and customers. Their well-being is tied to the company. Also tied to the company are the towns and cities where the company operates (minimally in terms of its demands on the infrastructure and its impact on the quality of the air, soil, and water). This view is personalistic.

How do we argue effectively that inclusive (personalist) is better than exclusive (individualist)? A part of the answer to that question is that the owners/shareholders have a legal right to the profits of the company and to use the company for that purpose. Indeed, because the owners/shareholders fully expect a profit when they commit to becoming owners/shareholders and depend on that profit to justify maintaining that commitment, the company cannot survive without profits.

Even so, the owners/shareholders do not have an absolute right to achieve their ends at the expense of others. That right, in other words, is limited by others who rely on the company at least in part to meet their needs. For its workers, the company is a reliable source of employment. For its suppliers, it is a reliable demand for their products/services. For its customers, the company is a reliable

supply of the goods and services it produces. For the cities and towns where it has located its operations, it is a reliable taxpayer and one which respects and values the environment. Subject to the company's ability to support its stakeholders and still survive as a profitable enterprise, helping meet the needs of others whose fortunes are tied to the company is the meaning of the good company.

Having said that, personalist economics recognizes that capital has become even more mobile (potentially more exclusive) due to the globalization of financial affairs. For that reason, now more than ever, the inclusiveness of the company must be underscored.

How does personalist economics seek to achieve that end? How does it assure that the company is a good company? (1) By teaching over and over that including everyone with personal rights deriving from their common contractual ties to the company as owners/shareholders, employees, suppliers, customers, and host cities and towns rather than excluding everyone except those with property rights as represented by their ownership shares makes for a stronger company because inclusion brings together and makes available to the company a wider array of human skill, talent, and energy. (2) By reaffirming the need for codes of ethical conduct that incorporate widely shared ethical concepts such as the prohibition on insider trading and insurance fraud that can be embraced across the entire spectrum of persons who are tied to the company and that are revised as new problems arise in financial affairs such as backdating stock options. (3) By offering technical assistance to companies as they establish and update their codes of ethics so that they are more inclusive in scope rather than exclusive. (4) By instituting forums, permanent or ad-hoc as required, that encourage dialogue among the various parties involved so that the voices of all the stakeholders have an opportunity to be heard. In this regard, the "best practices" model can be most useful. (5) By defining with clarity and specificity what it means to be a good company and doing the type of hands-on, on-site evaluations of companies required to identify the ones that are good companies, construct a listing of such companies with brief sketches that demonstrate why they were selected, and release that listing to the general public so that other companies may learn how to become good companies.

Much of this work can and should be done by or with the active support of universities provided those universities have the technical competencies, objectivity, and impartiality to conduct themselves not as champions of one of the parties involved but as advocates for sorting through the tough issues and conflicts in order to help work out a reasonable agreement. There was, for example, at one time such an institutional force in the United States in the Institute of Social Order at Saint Louis University where committed specialists in issues such as labor negotiations, unemployment insurance, and codes of ethical conduct worked in a hands-on way with the parties involved in disputes with considerable success. We need to see that kind of institution re-emerge with the support and energy of good men and women of faith and conviction. Our words have to be put into action and that happens only when men and women are well prepared and willing to act intelligently and reasonably, lest they do more harm than good.

Personalist economics is firmly convinced, no less than the Friedman was about his views in this matter, that what we would find with such hands-on, on-site evaluations is that a good company is a profitable company, in the short run possibly even a more profitable company simply for being a good company, and conceivably in the long run what is so highly prized by mainstream economics -- the profit-maximizing company.

REVIEW SECTION: TOPIC 9

Central Concepts:

- property rights
- personal rights
- separation of ownership and control
- owning
- belonging
- sole proprietorship
- partnership
- corporation:
 - public
 - private
- cooperative
- stockholder
- liability:
 - limited
 - not limited
- takeover
- board of directors
- co-determination
- fund managers
- industry council
- ESOP

Important Questions:

- With regard to the legal foundations of business, what is the difference between property rights and personal rights?
- What is meant by the “separation of ownership and control?”
- What are the four main forms or structures for legally establishing a business?
- What is meant by limited liability?
- Name four ways in which personal rights are being expanded in the U.S. workplace.

(continued on following page)

True/False:

- a. In general, owning most of the assets of a business gives a person control over that business. This kind of owner is known as a majority owner. Anyone owning only a small share of a business is called a minority owner. A minority owner typically has little if any effective control over the day-to-day operations of the business.
- b. In the United States a private company is controlled by a single individual or several individuals principally through ownership of the company's assets. Another method of control is by working for the company. The first method of control is called owning and the second is known as belonging.
- c. According to personalist economics, all private companies are established for one purpose only: to make a profit for their owners. No other consideration, such as the well-being of the workers or the need of the consumers, is important.
- d. The owners or stockholders of the corporation enjoy full liability, meaning that in the event that the corporation fails the creditors of the corporation may seize the personal assets of the stockholders to satisfy their claims. In the case of the partnership and sole proprietorship, however, the owners have limited liability.

Mark your answer below.



- Item a is true, items b, c, and d are false.
- Items a and b are true, items c and d are false.
- Item a is false, items b, c, and d are true.

TOPIC 10 WORKER AND PRODUCER BEHAVIOR

To demonstrate that worker and producer behavior, or the simple concept “supply,” is linked most fundamentally to the production function that herein is represented as $x = f(y)$.

*As stated previously in Topic 1, work has two principal effects: on the goods and services that are produced and on the person who does the work. We present the person who works as the **acting person** for the same reason we characterized the entrepreneur as the **acting person**. The worker is two-dimensional, at once an individual being and a social being, capable of competing with co-workers and cooperating with them. As with the entrepreneur, the worker is a real, living, breathing person engaged in economic affairs and not merely a resource to be used in the production process. The worker, in other words, has dignity well beyond and apart from the instrumental value that attaches to his/her contribution to economic affairs.*

Human beings work in order to earn the income to purchase the goods and services that meet human physical need and satisfy human physical wants both of which originate in the human body. The amount of income earned through work depends in principle on the significance of the worker's total contribution to the production of goods and services. Thus, earnings are linked to the first main effect of work, and therefore are an implicit affirmation of the principle of private property that asserts the simple truth that whatever is produced belongs to the person(s) who produced it.

Critics argue that this notion of linking pay to contribution, or simply meritocracy, is not always faithfully followed in a market system wherein some persons have more power and influence in economic and political affairs than others. Over the years, for example, there has been some condemnation of the chief executive officers of public corporations for using their influence to get their friends elected to the boards that govern those corporations on grounds that it is the board that ultimately hires and sets the compensation of the chief executive officer.

*Humans also work to meet the **need for work as such** that originates in the human spirit. The need for work as such is linked to the second main effect of work and is two-dimensional conforming to the duality of human nature.*

Because he/she is an individual being, the worker has a need for job that provides on-the-job opportunities for the utilization of his/her own special gifts and talents. This is done by incorporating into the worker's job description specific tasks that require the use of those gifts and talents. The uniqueness of the worker is underscored here.

Because he/she is a social being as well, the worker has a need for a job that makes him/her a respected partner in the work being done by the company that employs him/her. A real sense of belonging follows when the company has made an effective effort to integrate the worker into the organization such that whenever the worker is absent he/she is genuinely missed by others who work for the company. The worker's need for acceptance and inclusion is underscored here.

It follows that work is an opportunity for human beings to develop more fully as persons by (1) meeting their need for self-expression through their own individual contributions; and (2) meeting their need to belong through the formation of integrated and inclusive teams in the workplace. Self-expression proceeds from and enhances the individual contribution of the worker that flows from authentic self-interest that is necessary for human survival. Belonging proceeds from and enhances teamwork that flows from caring for others that is rooted in a person's moral perceptivity, the ability to sense or to be aware of the needs of others.

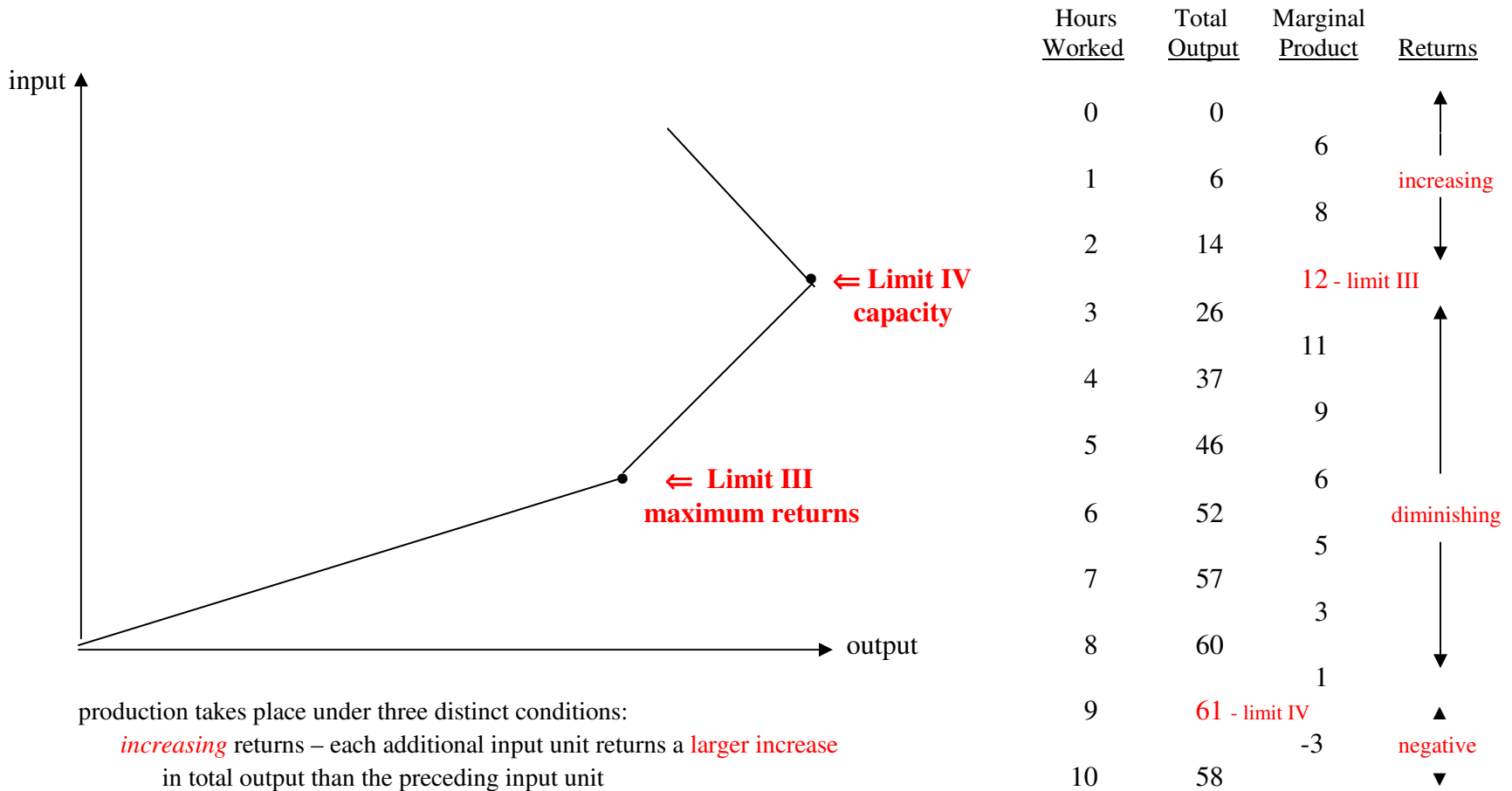
Producer Behavior, the Principle of Supply, and the Principle of Diminishing Returns.

Understanding producer behavior begins with the principle of supply: the higher the price, the greater the quantity supplied. However, this principle as in the case of the principle of demand relating to consumer behavior is strictly descriptive. It does not probe deeply into the behavior of the producer. It merely describes it in terms of price. And as with the principle of demand another principle is required to help explain producer behavior. That principle is the principle of diminishing returns. And as with the role of principle of diminishing marginal utility in explaining consumer behavior, the principle of diminishing returns explains producer behavior in terms of two limits: Limit III or maximum returns and Limit IV or capacity. The limits applying to producer behavior originate in the human body just as we observed regarding the limits applying to consumer behavior.

To explain how those limits help improve our understanding of producer behavior we begin with a very simple case – the man who makes hand rolled cigars (see the exhibit on the following page). The table that is part of that exhibit shows the number of cigars he is able to produce in a typical day. If he works 1 hour, he is able to make 6 cigars. If he works 6 hours, he is capable of rolling 52 cigars. With 9 hours of work, his production is 61 cigars, but beyond 9 hours his total output drops to 58 cigars. His capacity, Limit IV, is reached in the ninth hour, and if he works beyond that limit, his output drops due to physical exhaustion, perhaps spilling some coffee on three cigars and ruining them. We see this kind of behavior very dramatically on the highway where from time to time exhausted truck drivers fall asleep, wreck their trucks, destroy some of the goods they are carrying, or worse yet injure or kill someone. Limit IV or capacity applies to everyone who works because everyone who works is embodied and the human body requires rest on a daily basis.

But there is a second limit operating on everyone who works, and that limit too originates in the human body. The cigar maker's hourly production varies in ways that are predictable. In the first three hours of work, his hourly production rises from 6 to 8 to 12 cigars where it reaches a peak. After the third hour of work his output per hour begins to fall until in the ninth hour he produces only 1 more cigar. Limit III refers to the single hour of work in which he produces more cigars than

THE PRINCIPLE OF DIMINISHING RETURNS AND THE PRINCIPLE OF PRODUCTIVITY



production takes place under three distinct conditions:

- increasing* returns – each additional input unit returns a **larger increase** in total output than the preceding input unit
- diminishing* returns – each additional input unit returns a **smaller increase** in total output than the preceding input unit
- negative* returns – each additional input unit returns a **decrease** in total output

Principle of productivity: workers achieve maximum productivity when they produce the maximum output from a given amount of resources.

any other and is called maximum returns. “Returns” is the language of economics and refers to the output returned from the use of economic resources. In our example, the cigars produced are the returns. Notice that after Limit III is reached, returns are falling or diminishing. Notice that before Limit III is reached, returns are rising or increasing. After Limit IV is reached, returns are negative. Limit III or the point of maximum returns pinpoints the single hour of work in which our worker is most productive. Diminishing returns reflects our own experience with work. Exhaustion does not suddenly overtake us. Rather, we tire little by little as the workday unfolds, with hourly output declining as the work itself saps our strength, until full exhaustion sets in and mistakes take over.

When we plot the cigar maker’s hours worked against his total output, we arrive at what economists call the production function that simply displays visually the relationship between input and output. You will notice that we have departed from the conventional practice of always plotting the dependent variable (output in our example) along the vertical axis and the independent variable (input) along the horizontal axis. We will explain later why we have done this.

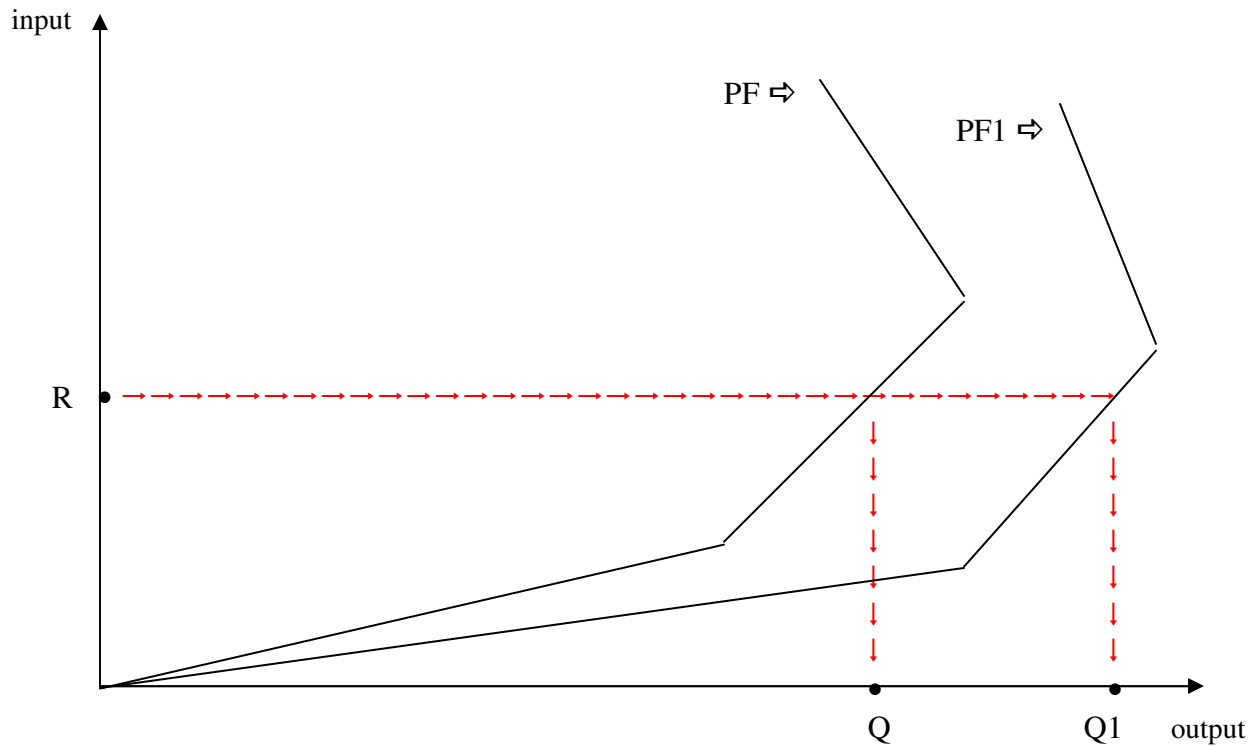
The production function always starts at the origin for the common sense reason that there can be no output without some input. The function, that we have drawn is linear in form, rises to the right, encounters a kink that we identify as Limit III or the point of maximum returns, then continues to rise but on a steeper slope until it reaches a second kink, Limit IV, and bends backwards. The backward bend indicates that increasing input beyond that point (9 hours with our cigar maker) is counterproductive. Output actually falls due to physical exhaustion and the mistakes that attend exhaustion.

The principle of productivity states that workers achieve maximum productivity when they are able to evoke from a fixed or given amount of resources the greatest possible output of a given product or service. Improvements in productivity derive from reducing wasted natural and labor resources. Improved productivity, the result perhaps of new and better management, a long-term worker training program, a production incentive program, is represented by a production function that still originates at the origin, and maintains its unique kinked shape, but shifts to the right. Notice that when the production function shifts to the right from PF to PF1 as shown in the exhibit on the following page, the same input yields or returns more output. **The secret to improved productivity is in finding ways to reduce waste.**

The machines used in the production process are like human workers in the sense that both are material in nature, the one animate the other inanimate. Due to their materiality, both wear out under use and both require maintenance. Human maintenance means time away from work, in the form of a coffee break, lunch hour, over night rest, weekends and holidays off, and vacations to provide for even longer periods of rest and relaxation. Machines cannot run indefinitely. They too require downtime that the careful producer does not want to occur when the machines are most needed in the production process. For that reason, producers often schedule maintenance ahead of time so as to assure that the equipment is ready when it is called into use. The scheduling of maintenance is called preventive maintenance and though it can be costly is undertaken for fear that in the absence of such procedures the cost would be even greater.

The production function is represented in terms of two limits for two related reasons: machines and humans wear down with use and that wearing down effectively limits production.

IMPROVED PRODUCTIVITY



Productivity improvement that is represented by the shift in the production function from PF to PF1 induced perhaps by a gain sharing or training program reduced waste in the utilization of labor and other resources such that with the same amount of resources, R, total output increased from Q to Q1.

Production Function and Cost of Production.

Next we turned to a demonstration as to the connectedness between the production function on the one hand and the cost of production on the other (see the table on the following page). There are three salient points to be made about this connectedness. First, maximum returns (Limit III on the production function) drives the point where marginal cost is lowest (Limit VI).¹ Second, capacity (Limit IV on the production function) drives the point where average fixed cost is lowest. Third, Limit V is the point where the average total cost is lowest. Each of these points requires elaboration.

¹ Marginal cost is defined as the change in total cost as output changes by one unit.

PRODUCTION FUNCTION AND COST OF PRODUCTION: TWO CONSTITUENTS OF SUPPLY

-----Production Function -----			----- Cost of Production -----						
total hours	output	marginal product	total fixed cost	total variable cost	total cost	average fixed cost	average variable cost	average total cost	marginal cost
0	0		\$ 50	\$ 0	\$ 50				
		6							\$ 1.67
1	6		50	10	60	\$ 8.33	\$ 1.67	\$ 10.00	
		8							1.25
2	14		50	20	70	3.57	1.43	5.00	
		12 - Limit III							Limit VI - .83
3	26		50	30	80	1.92	1.15	3.07	
		11							.91
4	37		50	40	90	1.35	1.08	2.43	
		9							1.11
5	46		50	50	100	1.08	1.08	2.17	
		6							1.67
6	52		50	60	110	.96	1.15	2.115	
		5							2.00
7	57		50	70	120	.88	1.23	Limit V - 2.105	
		3							3.33
8	60		50	80	130	.83	1.33	2.16	
		1							10.00
9	61 - Limit IV		50	90	140	.82	1.48	2.30	
		-3							- 3.33
10	58		50	100	150	.86	1.72	2.58	

marginal cost how much does total cost change when total output is increased/decreased by one unit?
average total cost how much does each unit of production cost on average at a given level of output?

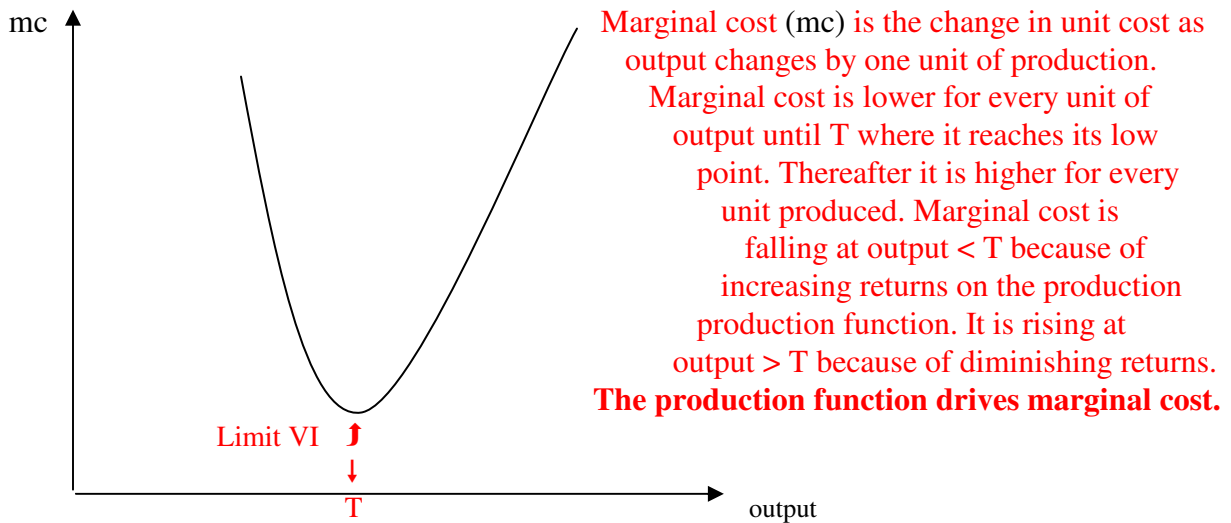
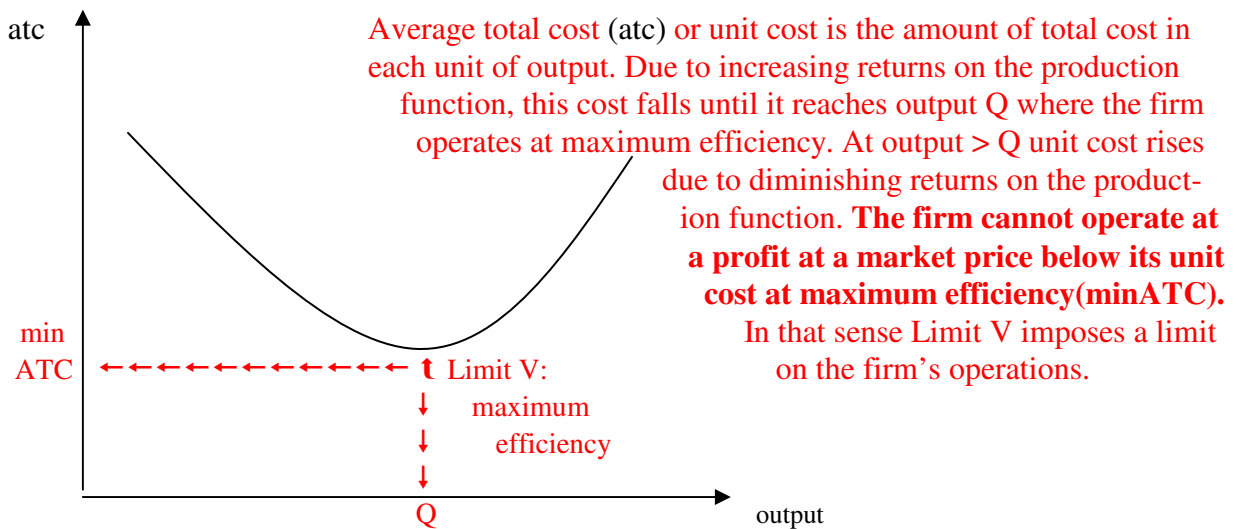
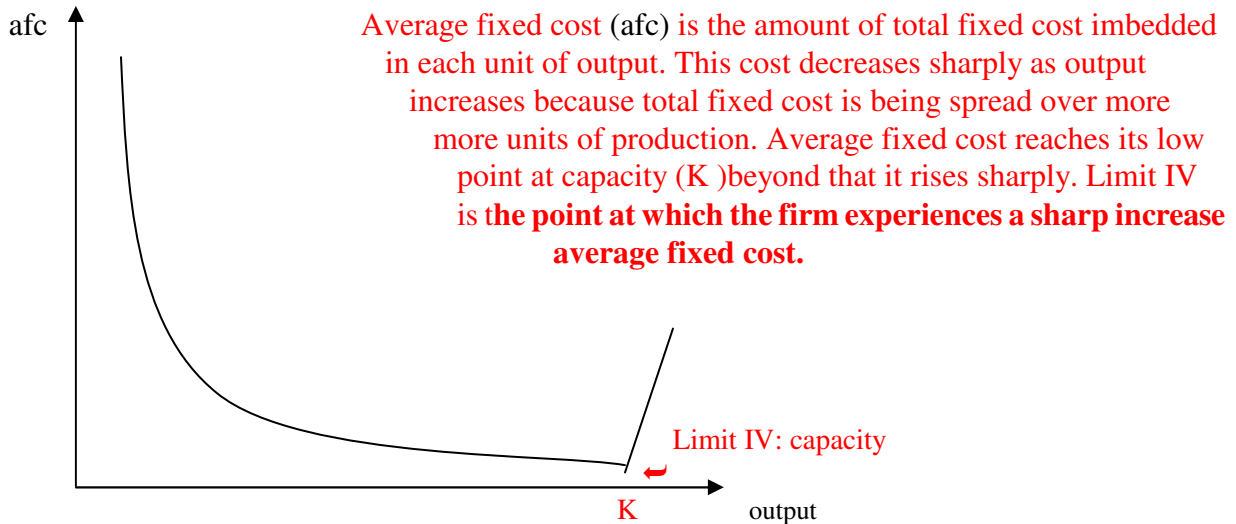
There are two types of cost. Fixed cost does not change as output changes. Examples include the monthly cost of paying for a security system that operates on sound and motion detectors, and the monthly payments owed the bank for funds borrowed in the past. Variable cost does change as output changes. Examples include the cost of labor services and the cost of materials used in the production process, because more of both are required as output increases. In the table on the preceding page we assume that total fixed costs = \$50. We attribute these costs to the cost of the occupational license that the cigar maker must purchase every year from the state where he works and resides. His variable costs are the cost of his own labor services that we assume to be \$10 per hour on grounds that if he were not self-employed and instead were working for someone else as a cigar maker, he would earn the market wage of \$10 per hour. Our cigar maker, as with others who are self-employed, has expectations that his business will be profitable. But profits are distributed typically four times a year or just once a year, and he has bills to pay on a regular basis. In other words, he pays himself an hourly wage so that he will have a regular paycheck often enough, perhaps once a month, to pay his regular expenses. His total cost of production (TC) is simply the sum of total fixed cost (TFC) and total variable cost (TVC).

Three average cost figures can be derived from the information on TC, TFC, and TVC and output. Thus, average fixed cost indicates the amount of fixed cost embedded in each cigar produced that we note declines sharply as output increases because the cigar maker is spreading the same amount of total fixed cost over ever larger numbers of cigars produced. At capacity (Limit IV), AFC rises sharply because total fixed cost is spread over a smaller output than before. The observant manager is able to tell when capacity has been reached when he/she notices that AFC is rising. Once production has been pushed beyond Limit IV, mistakes take hold and workers are exposed to greater risk of injury or worse, and defective units are produced that require costly re-work. Both average variable cost (AVC) and average total cost (ATC) are U-shaped, falling with every increase in production but eventually rising again at higher levels of output. It is the production function that accounts for the U-shaped nature of AVC and ATC. Both AVC and ATC fall because of increasing returns on the production function. With each additional hour of work the cigar maker is producing more cigars than in the preceding hour until Limit III is reached. After that point, with each additional hour of work the cigar maker is producing fewer cigars than in the preceding hour. AVC and ATC rise as output increases due to diminishing returns on the production function. Our interest in what follows is not with AFC or AVC, but with ATC or what often is called unit cost.

We refer to the low point on the ATC as Limit V. It represents the lowest unit cost that the producer is capable of achieving for whatever product or service he/she is producing. Economists refer to Limit V as maximum efficiency that is a financial concept related to but distinct from Limit III the point of maximum returns that is a physical concept.

Marginal cost (MC), as we noted earlier, is the change in total cost as output changes by one unit. Compared to the conventional U-shaped ATC, the associated MC is much steeper in the descent and much steeper in the ascent, and always intersects ATC from below and through the point of maximum efficiency or Limit V. See the exhibits on the following page.

AVERAGE FIXED COST, AVERAGE TOTAL COST, MARGINAL COST



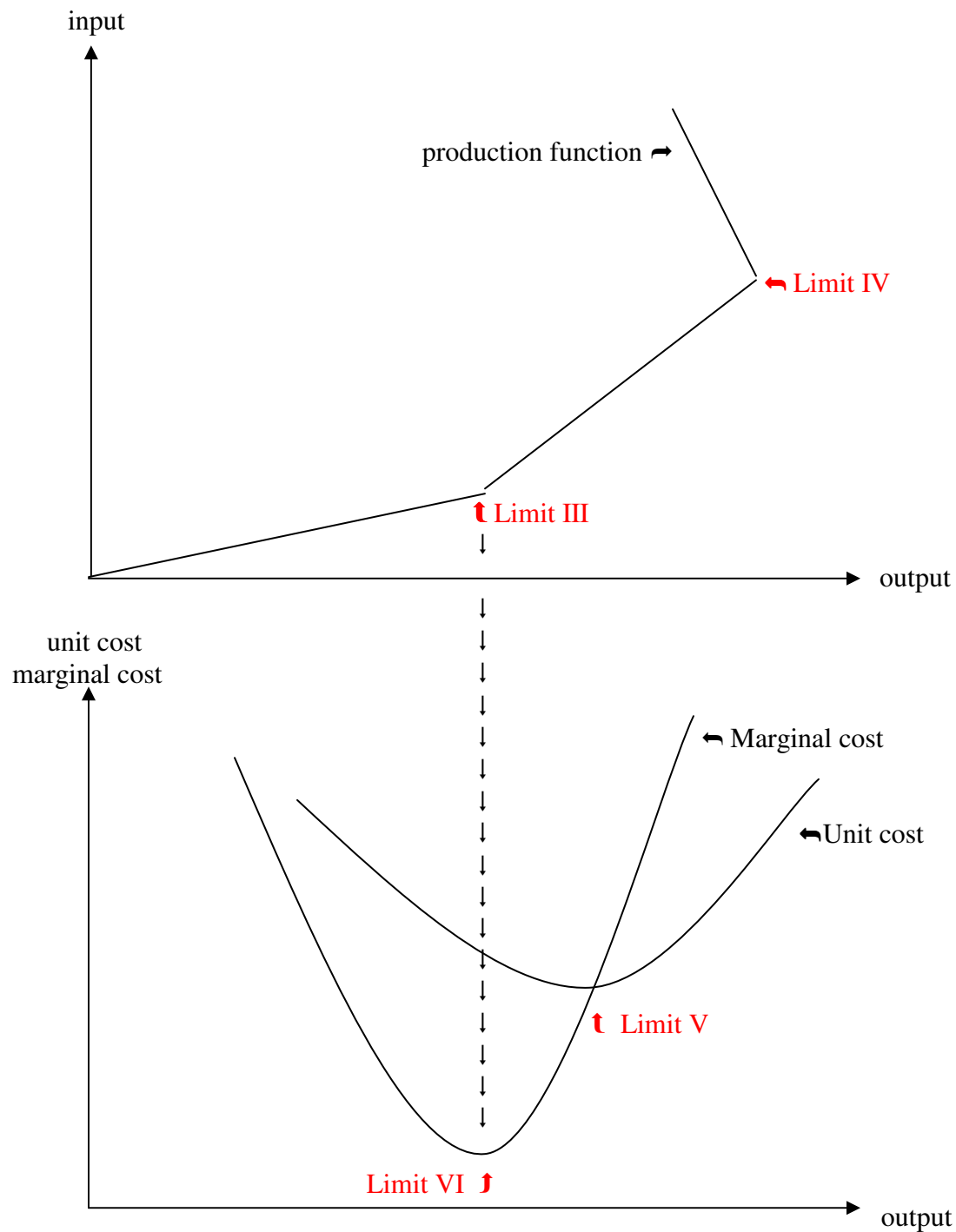
MC is a crucial concept in business decision-making although it is not readily apparent without some explanation. An example will suffice to make our point. You operate a very successful janitorial service company and you are approached by the operator of a large shopping mall who would like to engage your firm to provide certain services in the mall such as keeping the parking lot and the common areas in the mall clear of trash, cutting the grass, trimming the trees and shrubs, painting the stripes to mark the parking spaces, and reporting anything in need of repair that otherwise might pass unnoticed. The mall operator offers to pay your company, say, \$309,000 per year to provide these services. To make an informed decision as to whether it makes sense to accept this offer, you have to estimate as accurately as possible the cost of purchasing the labor resources and other materials and supplies necessary to render the services required by the mall owner. If you estimate that cost at, say, \$262,000 per year, you would earn a profit of \$47,000 ($\$309,000 - \$262,000$) by accepting the offer. By making this common-sense calculation, you have been comparing the marginal cost of providing one more unit or package of services versus the marginal revenue¹ to be earned by accepting the mall owner's offer. In that sense, MC is one-half of the information needed to determine the profitability of taking on additional work.

The exhibits on the following page show that Limit VI, the low point on the marginal cost curve, is derived directly from Limit III on the production function. It follows that as Limit III changes due to some improvement in productivity, MC and Limit VI change. And since MC is critical to making a decision as to profitability, it follows that the production function drives profits.

Topic 10 has focused our attention on the workplace, on the production function, and the cost of production. The workplace is important because it is there that profits and losses are made in the sense that the cost of production is one-half of the information required to determine if the business is earning a profit or suffering a loss. Topics 11, 12, 13, and 14 expand our focus to include the marketplace where sales are made and revenues are generated that make up the other half of the information necessary to determine how well the business is performing.

¹ Marginal revenue is defined as the change in total revenue with the sale of one more unit of output.

THE PRODUCTION FUNCTION, MARGINAL COST, AND UNIT COST



The production function drives marginal cost. Limit VI on the marginal cost curve derives from Limit III on the production function. The marginal cost curve intersects the unit cost curve from below at Limit V.

REVIEW SECTION: TOPIC 10

Central Concepts:

principle of diminishing returns

principle of productivity

input

output

limit:

maximum returns = maximum productivity (*Limit III*)

capacity (*Limit IV*)

standard production function

returns:

increasing, diminishing, negative

wasted resources

fatigue and materiality:

death and injuries (impact on humans)

defects and re-work (impact on things)

breaks and preventive maintenance

boredom and monotony

cost of production:

fixed, variable

cost of production:

unit, marginal

minimum average total cost = maximum efficiency (*Limit V*)

marginal cost

minimum (*Limit VI*)

marginal revenue

homo economicus

the *acting person*

Important Questions:

What are the two *limits* embedded in the principle of diminishing returns?

What do we mean by diminishing returns?

How is an overall improvement in productivity visually represented?

Where along the average cost curve is maximum efficiency achieved?

What causes average total cost to rise after reaching the point of maximum efficiency?

How are the production function and the marginal cost curve related?

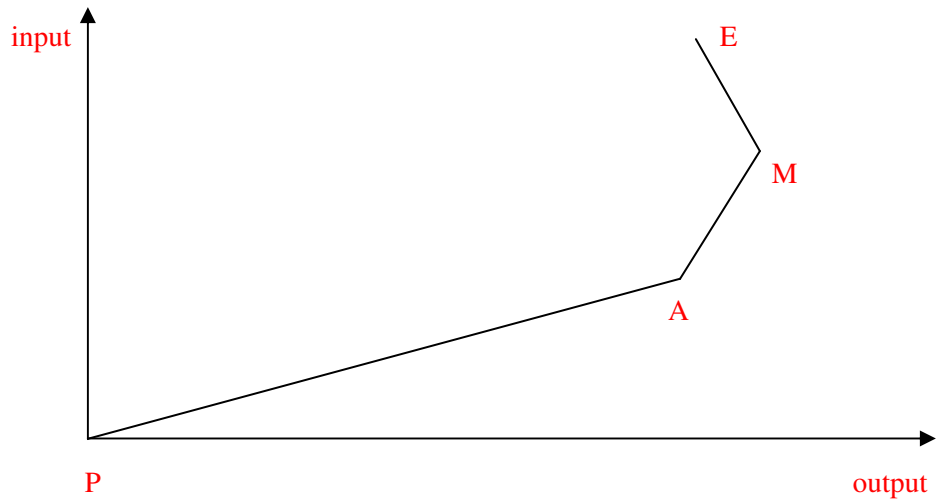
When productivity improves, how do the average total cost curve and marginal cost curve shift?

What two variables determine profits?

True/False:

Capacity or Limit IV is represented on the graph below at ...

- a. point M. b. point A. c. point E. d. point P.



Mark your answer below.

- ▼
____ Item a is true, items b, c, and d are false.
____ Items a and b are true, items c and d are false.
____ Item a is false, items b, c, and d are true.

TOPIC 11 PERFECT COMPETITION

To demonstrate that perfect competition is regarded as a standard of excellence because it maximizes efficiency, thereby allowing producers to lower prices.

There are two major types of marketplace conditions that the typical firm is likely to encounter. One is called perfect competition, the other imperfect competition. Imperfect competition is taken up in Topic 13 (monopoly) and 14 (monopolistic competition and oligopoly).

Perfect competition is a marketplace characterized by three central conditions. First, there are many buyers and sellers, so many that no one buyer and no one seller can influence the price. The price is determined strictly by market interaction. Second, the product or service is homogenous, is virtually the same from one producer to another. Farm crops such as one farmer's bushel of corn compared to another's, or one farmer's bale of cotton compared to another's, come to mind as homogenous products or nearly homogenous products. Third, there are few if any barriers to the entry of new firms into the marketplace where the product or service is being offered for sale. Economists refer to this condition as low barriers to competition. Examples of barriers to competition include the established firms' copyrights, patents, hold on specialized labor resources, access to natural resources, along with the amount of financial resources to launch a new firm, all of which have the effect of making it more difficult for a new firm to enter the marketplace and to begin competing.

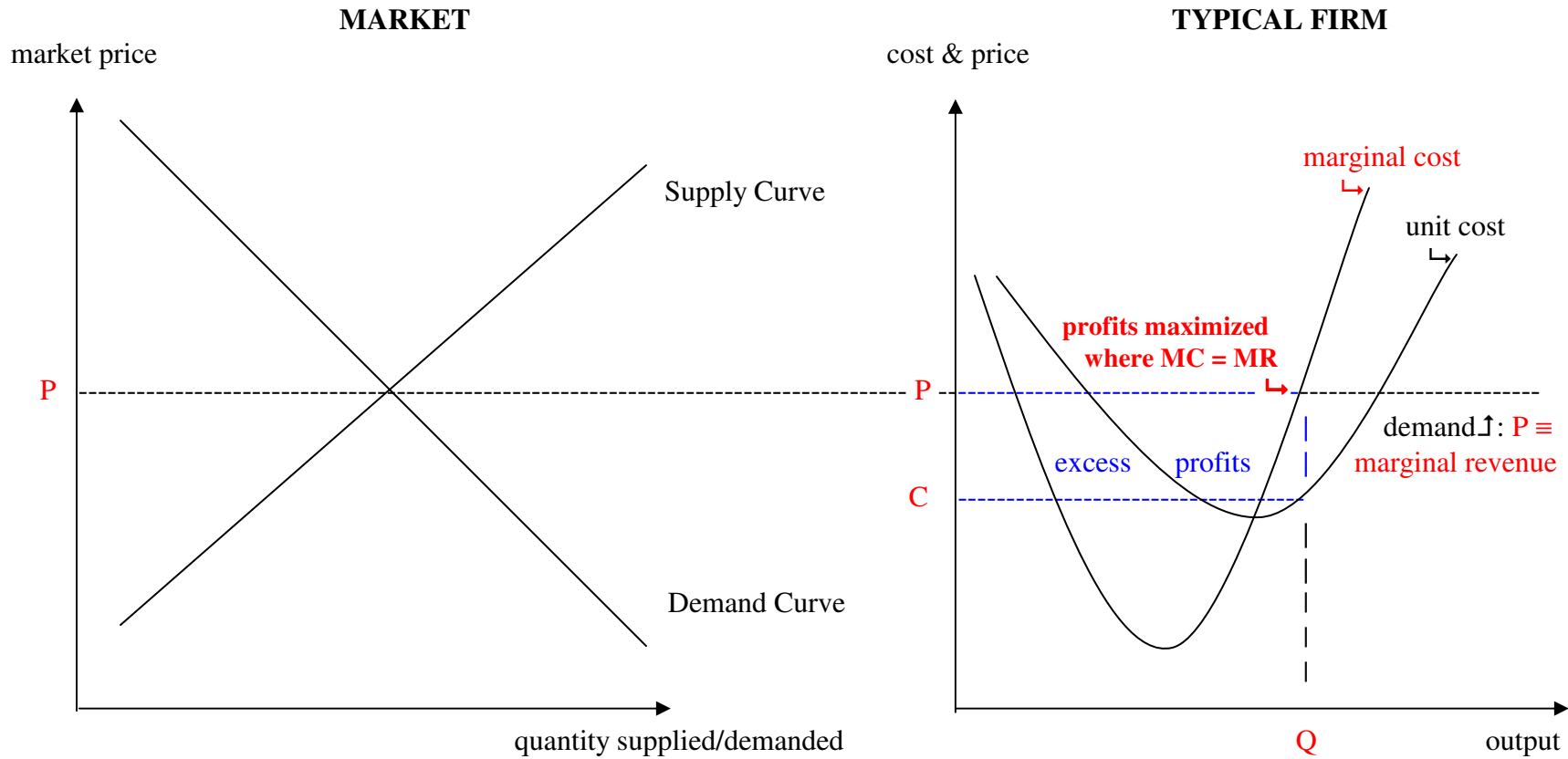
Short Run.

The exhibits on the following page display the essential elements of a typical firm operating in the short run in a perfectly competitive market. The short run is that period of time from the present into the future when the established firms in a market can be assured that they will face no new competition. The long run is that time in the future and beyond when established firms can anticipate new firms entering their market and competing against them.

The short run and the long run vary from one industry to another.¹ For a fast-food restaurant the short run may extend from the present to six months in the future because six months is the time it takes for a new restaurant to purchase or lease the land, complete the construction work, hire and train the staff, order and stock the necessary supplies, open for business, and begin competing against the established fast-food restaurants in a specific location. In contrast, the short run for a petroleum refinery may be much longer, probably several years, because it takes much longer to

¹ An industry is a set of firms that produce the same type of product or service, such as the furniture manufacturing industry, the steel industry, and the airline industry.

SHORT RUN PERFECT COMPETITION

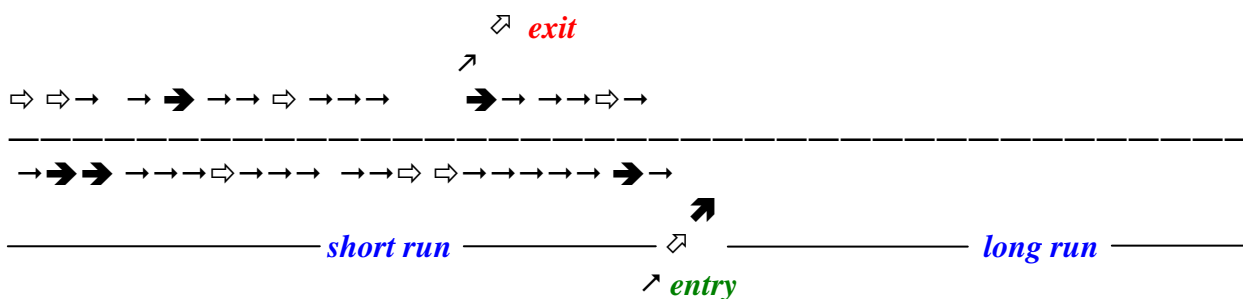


A perfectly competitive market is one in which (a) the product is homogenous, (b) there are so many buyers and sellers that no single buyer or seller has control over the price or, simply, price P is determined in the market, and (c) there are low barriers to competition and therefore it is easy for a new firm to penetrate this market. The typical firm in such a market is able to sell as much or as little at the market price without influencing that price. $P \equiv MR$ because each additional unit sold adds to the firm's total revenue an amount equal to the product's market price. The short run is that time period from the present into the future during that the firm faces no new competition. This time period is longer for firms producing complex products or services and utilizing capital-intensive and roundabout production processes. **With price P , the firm maximizes short-run profits by producing Q . Excess profits = $[(P - C) \times Q]$.**

put in place all the pieces necessary to begin operating a new refinery where the process of production is much more complex than it is in the fast-food restaurant business.

Just as a driver enters a highway when it facilitates going from one place to another and exits when that purpose has been served, a business manager enters a market when that market opens up opportunities to earn a profit and exits when those opportunities close down. Carrying that analogy a step further (see exhibit below) illustrates the difference between the short run and long run.¹

ILLUSTRATING THE ECONOMIC CONCEPTS OF THE SHORT RUN AND THE LONG RUN IN TERMS OF THE FLOW OF TRAFFIC ALONG A HIGHWAY



The **short run** is that time period when some firms may exit the market but no new firms enter the market; competition takes place among the firms already in “the flow of traffic.”

The **long run** is that time period “down the road” when new firms enter “the flow of traffic”; with their entry the competition becomes more intense.

Low barriers to new firms entering “the flow of traffic” may be thought of as a large number of highway entry ramps that are tightly clustered as in a densely populated urban area. High barriers may be construed as a small number of entry ramps that are widely dispersed as in a sparsely populated rural area. A monopoly (single seller) and a monopsony (single buyer) may be represented in terms of a single vehicle traveling along a highway where there are no entry ramps.

In the exhibit on the preceding page, the scissors diagram on the left indicates that the market determines both the price of the product or service in question and the amount that will be sold across the entire market. The diagram to the right displays the conditions facing the typical established firm operating in this market with the specific goal in mind of achieving maximum profits. This firm is required by conditions in this perfectly competitive market to accept the price as determined in the market, and to adjust its output accordingly. Its cost of production, specifically MC and unit cost (average total cost), are represented the same way they were presented in Topic10.

Since the price is determined strictly in the market, it is represented to the typical firm as a horizontal line extended from the left-hand diagram at the market price. We refer to this horizontal line as the typical firm’s demand curve because it says in effect that at the market price, the typical firm in a

¹ A student suggested this way of representing the difference between the short run and the long run.

perfectly competitive market is able to produce and sell as much or as little of its output as it chooses without having to worry that its production/sales decisions will change its price. Put differently, its price remains the same as determined by the market whatever number of units the firm may decide to produce and offer for sale. **Please note that the demand curve facing the typical firm in a perfectly competitive market does not conform to the principle of demand precisely because the typical firm is so small in a marketplace with many sellers that it represents an infinitesimal part of the total market supply.**

Since each additional unit sold adds exactly the price of that sold unit to the firm's total revenue, and in a perfectly competitive marketplace that price is the market price, it follows that the market price (P) is not just equal to its marginal revenue (MR) but actually is identical to it. At this point we have two pieces of information, MC and MR , necessary to make an informed decision about profits. The principle of profit maximization that we will prove later in this topic states that profits are maximized at that unique output level associated with the intersection of MR and MC provided MC is rising. We identify and designate that unique output level with the letter Q . The typical firm is generating excess profits because its price is greater than its unit cost of production ($P > C$), those profits will serve to attract new firms into this marketplace in the long run. The diagram shows the total amount of the firm's excess profits under profit maximization, and how those profits are calculated.

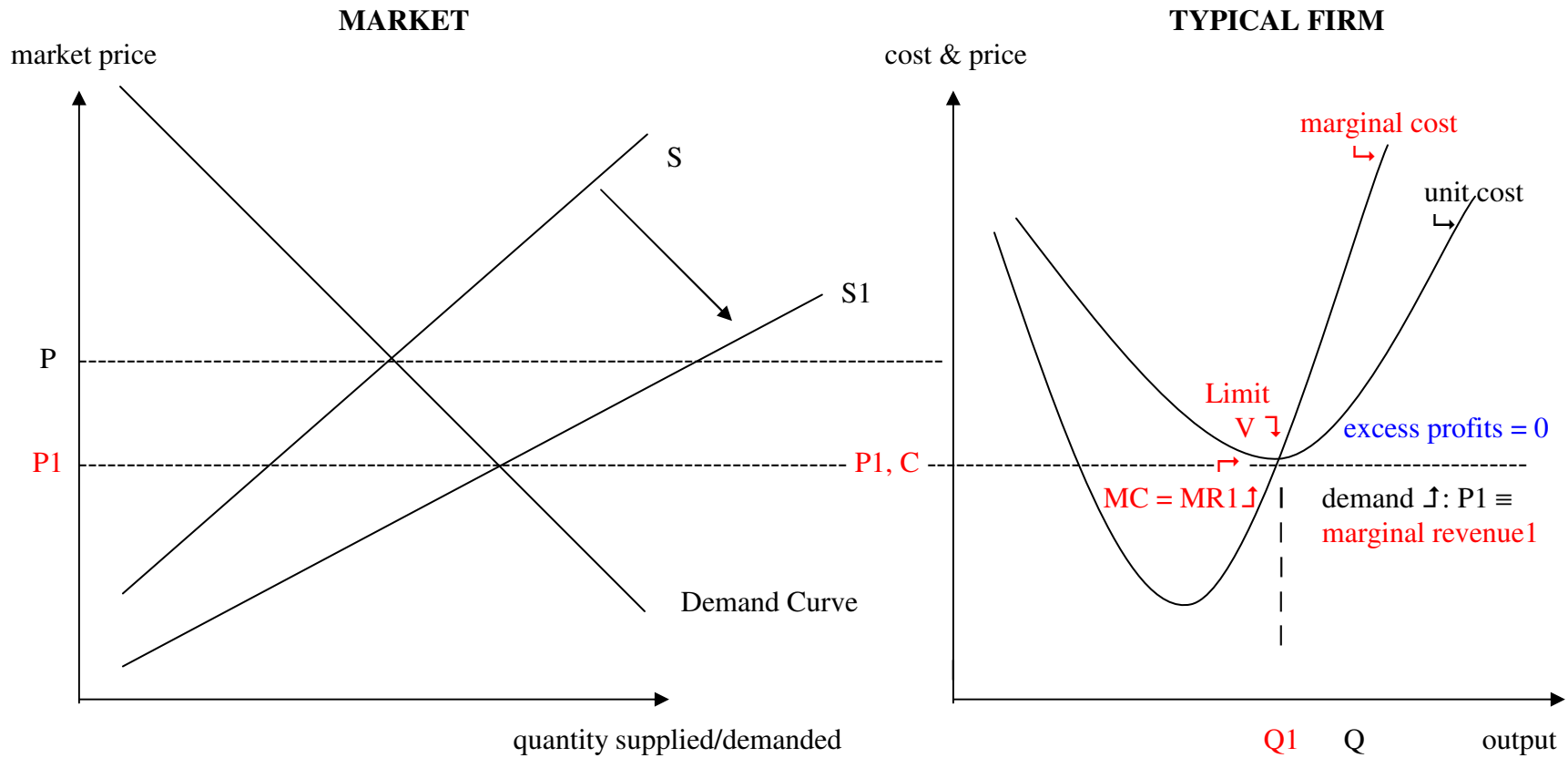
Long Run.

When new firms enter this marketplace and begin competing against the established firms, the supply curve in the market shifts from S to $S1$ as indicated in the exhibit on the following page. This shift has the effect of reducing the market price which is what our own experience suggests should happen. More competition makes for a lower price ($P1$). And the principle of demand indicates that at the lower price consumers will demand more of the product or service in question. The typical firm encounters a squeeze on its profits brought on by the more intense competition and this squeeze will continue until all excess profits are eliminated.

In the long run, the typical firm operating in a perfectly competitive market is forced to operate at maximum efficiency (Limit V) which is why conventional economics refers to such a market as **perfect** competition, a standard of excellence. If the firm stubbornly decides to operate at an output level higher or lower than the one uniquely associated with its maximum efficiency, it will sustain financial losses because at every output level other than the one associated with its maximum efficiency unit cost is greater than $P1$.

Following conventional economics, a perfectly competitive market is a standard of excellence not only because the typical firm is forced to operate at its maximum efficiency, that is to produce the product or service with the minimum wasted resources, but also because the market price is driven down through the systematic elimination of excess profits and the reduction of waste. Put differently, the perfectly competitive firm in the long run operates under these conditions: $P1 = \text{unit cost @ Limit } V$. This of course raises the question Why would the owners/shareholders continue to operate a business in a perfectly competitive marketplace where in the long run excess profits are systematically eliminated? Conventional economics finesses the answer to that question by including **in the cost of production** the cost of retaining the owners/shareholders in this company so that it continues to operate. This cost is

LONG RUN PERFECT COMPETITION



In the long run new firms will enter a perfectly competitive market expecting to earn the same excess profits that the typical firm has been achieving in the short run. Their entry shifts the supply curve from S to $S1$ that drops the market price from P to $P1$. New firms continue to enter the market until $P1 =$ unit cost at Limit V . Following the profit maximization principle, the firm reduces output from Q to $Q1$ thereby conforming to the principle of supply: the lower the price ($P \rightarrow P1$), the smaller the quantity supplied ($Q \rightarrow Q1$). At $Q1$ that is the output uniquely associated with $MC = MR1$, the firm operates at maximum efficiency (Limit V). If it operates at any output $>> Q1$, it loses money because at every output $>> Q1$ unit cost $> P1$. **The activating principle of competition forces the firm to minimize waste or be driven out of business. Though excess profits = 0, the normal profits of the efficient firms enable their owners to continue operations.**

called **normal profits**. Thus, even though excess profits are systematically wiped out in the long run, normal profits remain and they are sufficient to sustain the firm in the long run under conditions that some have described as “social Darwinism,” that is the survival of the fittest, the most efficient.

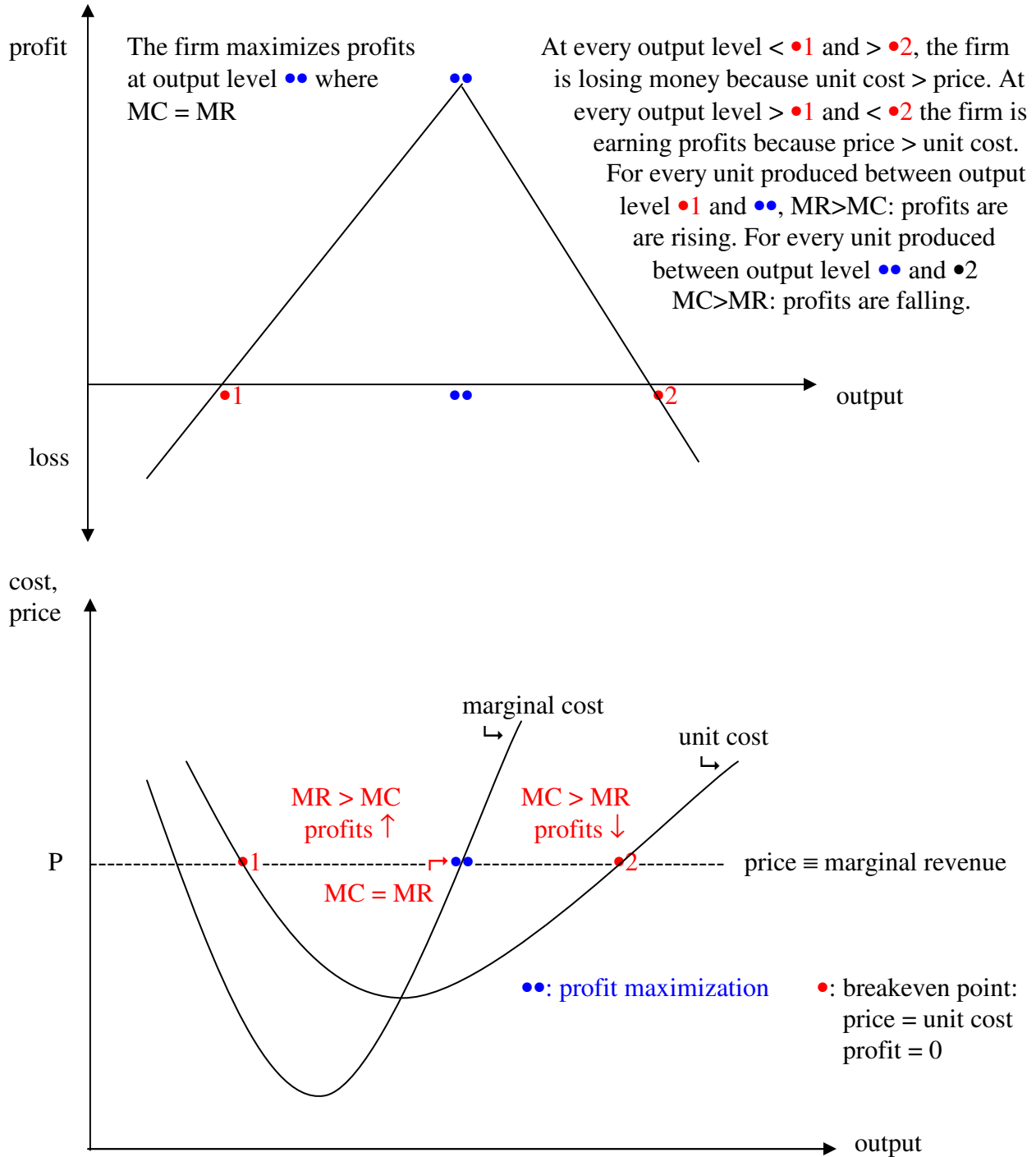
Why Profits Are Maximized at $MR = MC$.

Before proceeding to the case of imperfect competition, it is necessary to prove the principle of profit maximization: the profits of the firm are maximized at the output level uniquely associated with the intersection of marginal revenue and marginal cost ($MR = MC$). There are two diagrams on the following page that are helpful in presenting the proof. The lower diagram represents the typical firm operating in a short run, perfectly competitive market. The upper diagram displays the total profits (plotted along the vertical axis) earned by that firm at different levels of output (plotted along with horizontal axis).

Beginning with the lower diagram, we take note of the usual unit cost curve, marginal cost curve, and the market-determined demand curve ($P \equiv MR$). The two points where the demand curve intersects with the unit cost curve are called breakeven points (•1 and •2) because by definition at those two points the firm is operating at zero profits. Extend two imaginary lines from the breakeven points to the upper diagram and mark two points on the horizontal axis to indicate that at those two points the firm is generating zero profits. Notice that at every output level below or to the left of the first breakeven point (•1), the firm is losing money because systematically unit cost > market price. Similarly, at every output level above or to the right of the second breakeven point (•2), the firm is losing money for the same reason (unit cost > market price). We represent these conditions of systematic losses in the upper diagram by a line segment drawn downward to the left from the zero-profit first breakeven point and another line segment drawn downward to the right from the zero-profit second breakeven point.

Returning to the lower diagram, we observe that between the two breakeven points (•1 and •2) market price > unit cost, and thus the firm is making profits at every level of output between those two points. The question is: Precisely at what output level are profits maximized? To answer that question convincingly, note that between the first breakeven point and the intersection of marginal cost and marginal revenue, $MR > MC$ which means that as the firm increases production above that breakeven point, every additional unit of output sold adds more to total revenue than to total cost. Total profits must be rising. In the upper diagram this is represented by a line segment drawn upward to the right from the first breakeven point. Returning to the lower diagram, we observe that between the intersection of marginal cost and marginal revenue and the second breakeven point, $MC > MR$ that indicates that as the firm continues to increase production every additional unit of output sold adds more to total cost than to total revenue. Total profits must be falling. In the upper diagram this is represented by a line segment drawn downward to the right from the point at which the last line segment drawn ended that is where $MC = MR$. Thus, total profits peak or reach a maximum at the output level uniquely associated with the intersection of marginal cost and marginal revenue.

THE PROFIT MAXIMIZATION PRINCIPLE



It may be helpful to think of the upper diagram as a profit mountain rather than a profit curve. When you are standing on the peak of a mountain, whether you take a step to the north or the south, to the east or the west, you are stepping down to a lower elevation. In like manner, whether the firm operates below the output level uniquely associated with the intersection of its marginal cost and marginal revenue curves, or above that level, its total profits are reduced. The insight that profits are reduced as production and sales increase past the output level uniquely associated with the intersection of marginal cost and marginal revenue is counterintuitive. Nevertheless, it bears repeating that profits are maximized not by increasing production but by operating at the one and only output level uniquely associated with $MC = MR$.

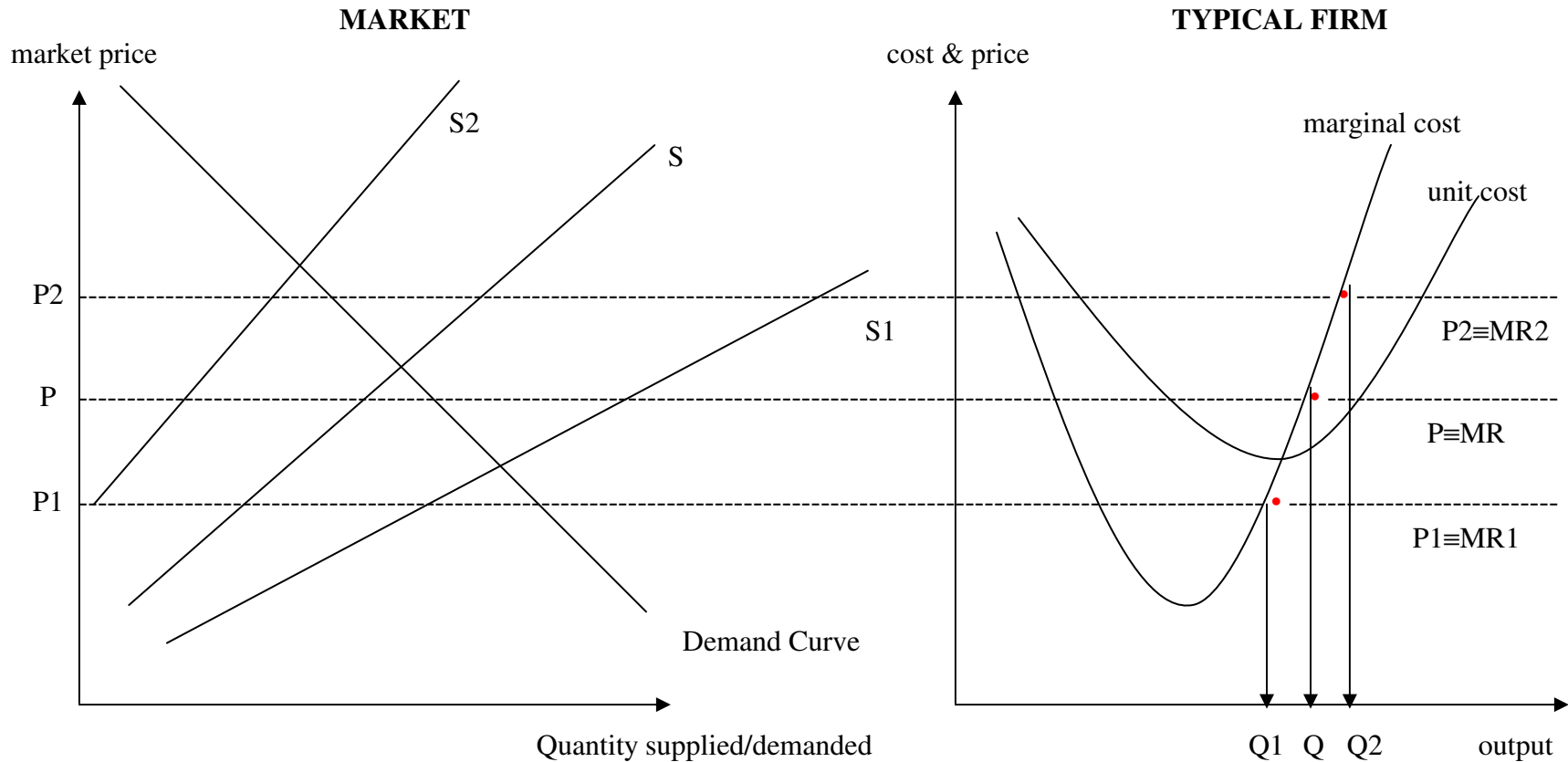
We have chosen to demonstrate the proof for the profit maximization principle in terms of a firm operating in a perfectly competitive marketplace. Even so, the same principle applies to a firm operating in an imperfectly competitive marketplace. It is in other words a universal principle. We have chosen to use the case of perfect competition to prove this principle simply because the proof is simpler and there is nothing more to be learned from making the proof more difficult.

Firm's Marginal Cost Curve Is Its Supply Curve.

The diagrams on the following page demonstrate why the firm's marginal cost curve is its supply curve. Recall the principle of supply: the higher (lower) the price, the greater (smaller) the quantity supplied by producers. When producer behavior is represented by supply curve S and consumer behavior by demand curve D , the market price is P and marginal revenue therefore is MR . Profit maximization, as we have just seen, occurs where marginal revenue intersects with marginal cost (indicated by \bullet). At market price P the typical firm produces Q which is the output level uniquely associated with profit maximization.

When producer behavior changes as represented by the shift in the supply curve downward to S_1 , market price falls from P to P_1 and marginal revenue is MR_1 . Under these conditions, the output level uniquely associated with profit maximization is Q_1 . When producer behavior changes again as represented by the shift in the supply curve upward to S_2 , market price rises from P_1 to P_2 and profit maximization occurs at output level Q_2 . Notice that whenever price and marginal revenue change the firm "travels" along its marginal cost curve "searching" for the intersection with the new marginal revenue curve. Notice further the typical firm produces more when the price is higher: because P_2 is higher than P , Q_2 is greater than Q , and because P is higher than P_1 , Q is greater than Q_1 . It follows that the marginal cost curve (rising) is the firm's supply curve. This identity between the firm's marginal cost curve and its supply curve applies both in perfectly competitive markets and in imperfectly competitive markets.

THE MARGINAL COST CURVE IS THE FIRM'S SUPPLY CURVE



At market price P the typical firm produces Q -- the output level uniquely associated with profit maximization. When producer behavior changes and the supply curve shifts to S1, market price falls to P1 and marginal revenue is MR1; profit maximization takes place at Q1. When producer behavior changes and the supply curves shifts to S2, market price rises to P2 and profit maximization occurs at Q2. Thus, whenever price and marginal revenue change the firm "travels" along its marginal cost curve "searching" for the intersection with the new marginal revenue curve, conforming to the principle of supply. Thus, the higher the price ($P2 > P > P1$); the greater the quantity supplied ($Q2 > Q > Q1$). It follows that the marginal cost curve (rising) is the firm's supply curve.

REVIEW SECTION: TOPIC 11

Central Concepts:

principle of profit maximization

profits:

normal

excess

profit maximization (*limit*)

long run

short run

Important Questions:

What do we mean when we say that in long-run perfect competition the price is equal to minimum average total cost?

Why are profits maximized at the one output level where $MR = MC$ (rising)?

Why is the typical profit-maximizing firm operating in long-run perfect competition forced to operate at maximum efficiency or suffer economic losses and be driven out of business?

What is the difference between the short run and the long run?

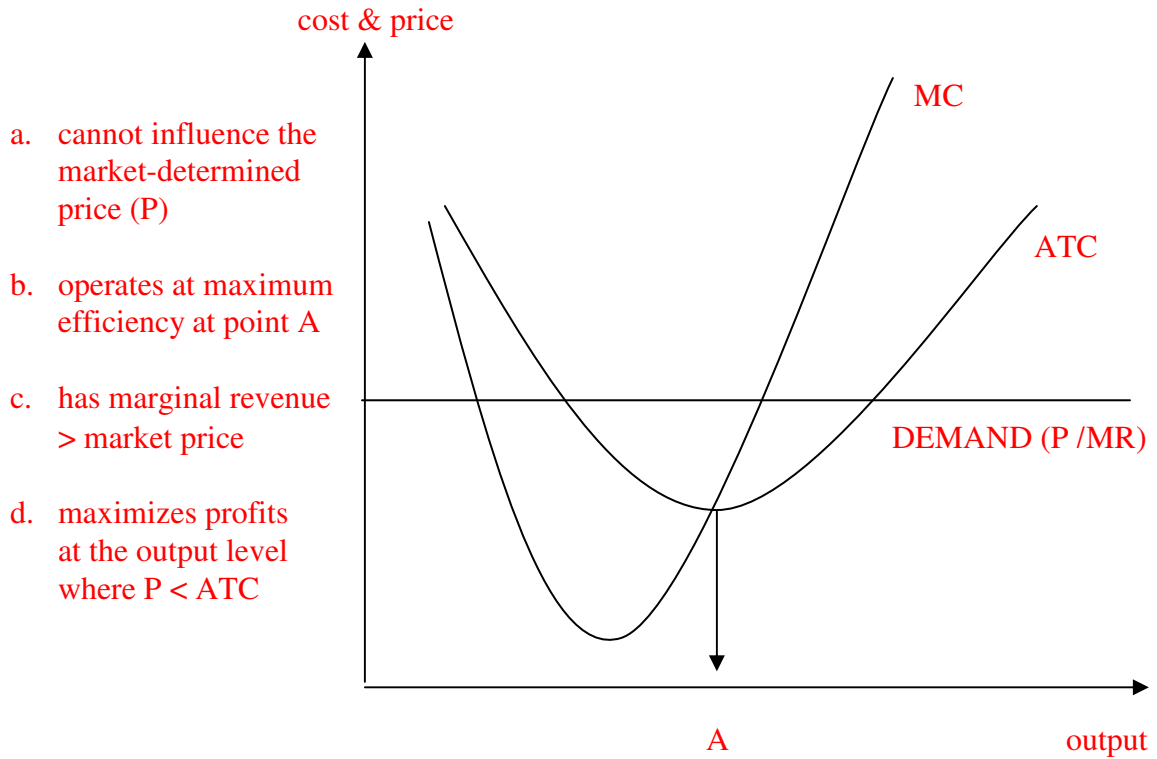
What are the conditions that make a market perfectly competitive?

How can a firm continue operating in the long run if its excess profits are entirely eliminated?

(continued on following page)

True/False:

The typical firm operating in a short-run, perfectly competitive market structure (see graph below) ...



Mark your answer below.



_____ Item a is true, items b, c, and d are false.

_____ Items a and b are true, items c and d are false.

_____ Item a is false, items b, c, and d are true.

TOPIC 12 DEMAND, MARGINAL REVENUE, AND MARKET STRUCTURE

To contrast the relationship between marginal revenue and demand in a market structure of imperfect competition versus perfect competition.

Topic 12 presents two visual demonstrations to help students come to terms with marginal revenue because marginal revenue is one-half of the information needed for a firm to reach a decision regarding the output/price combination that results in profit maximization. The other half, as we have just seen in Topic 11, is marginal cost. The first demonstration shows the connection between the demand curve and the marginal revenue curve, between price and marginal revenue, under conditions of perfect competition and imperfect competition. The other demonstration links those three variables to the elasticity of demand.

***First**, the typical firm operating in a perfectly competitive market can sell as much or as little of its output as it chooses without influencing the market price. Therefore every additional unit of output produced and sold adds an amount to its total revenue that exactly equals the market price.*

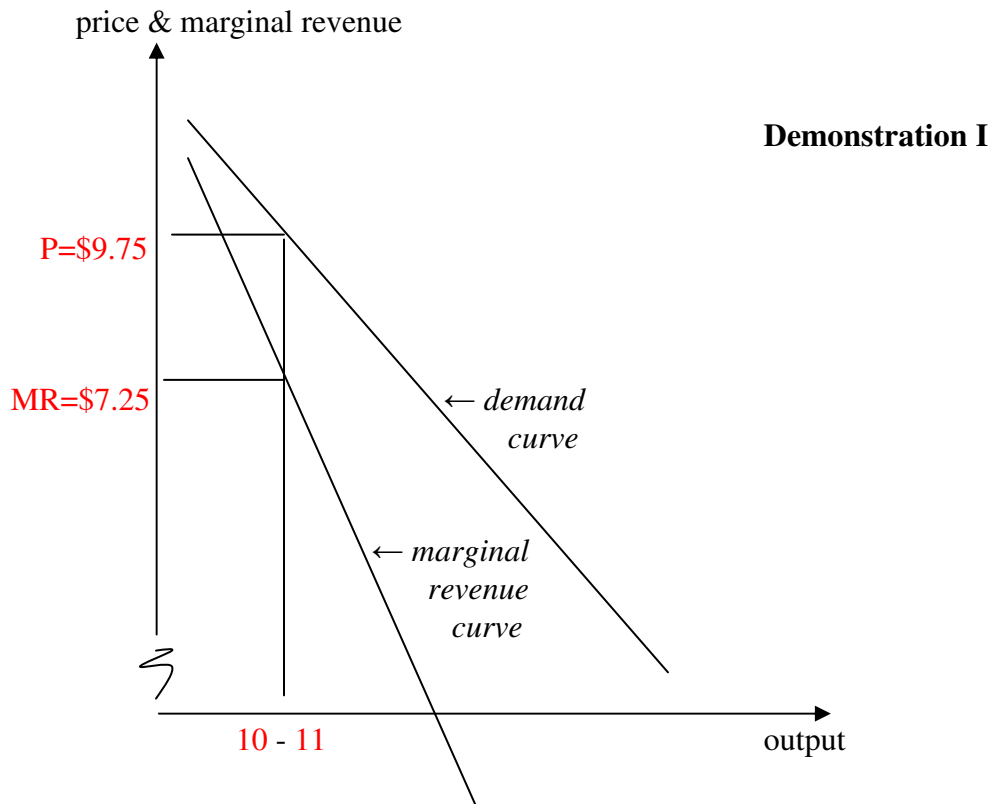
Assume the typical firm is producing and selling 1,000 units at the market price (P) = \$10; total revenue = \$10,000. If that firm produces and sells one more unit, total revenue = \$10,010. The change in total revenue (marginal revenue) = ($\$10,010 - \$10,000$) = \$10. If the firm then produces and sells one more unit, total revenue = \$10,020. Marginal revenue = ($\$10,020 - \$10,010$) = \$10.

Without fail, the same \$10 increase in total revenue arises with very additional unit produced and sold by the typical firm as long as the $P = \$10$. It follows that for the typical firm operating in a perfectly competitive market $P \equiv MR$.

The typical firm operating in an imperfectly competitive market, on the other hand, can sell one more unit of its output only by lowering its price. In other words, it must accept the discipline imposed by the principle of demand: the lower the price, the greater the quantity demanded. Further, it must lower the price for every unit it sells not just the additional unit sold.

A manufacturer is able to sell 10 units when the price (P) = \$10 per unit yielding total revenue = \$100. In order to sell one more unit, the firm has to drop its price to \$9.75 giving it additional income from the sale of that unit = \$9.75. However, there is no way for the firm to cut its price on the last unit sold without reducing its price for all units sold. Thus the loss of revenue on the first 10 units sold at the lower price = $10 \times \$.25 = \2.50 . See Demonstration I on the following page which shows that under market conditions of imperfect competition $P > MR$.

IN AN IMPERFECTLY COMPETITIVE MARKET, PRICE > MARGINAL REVENUE

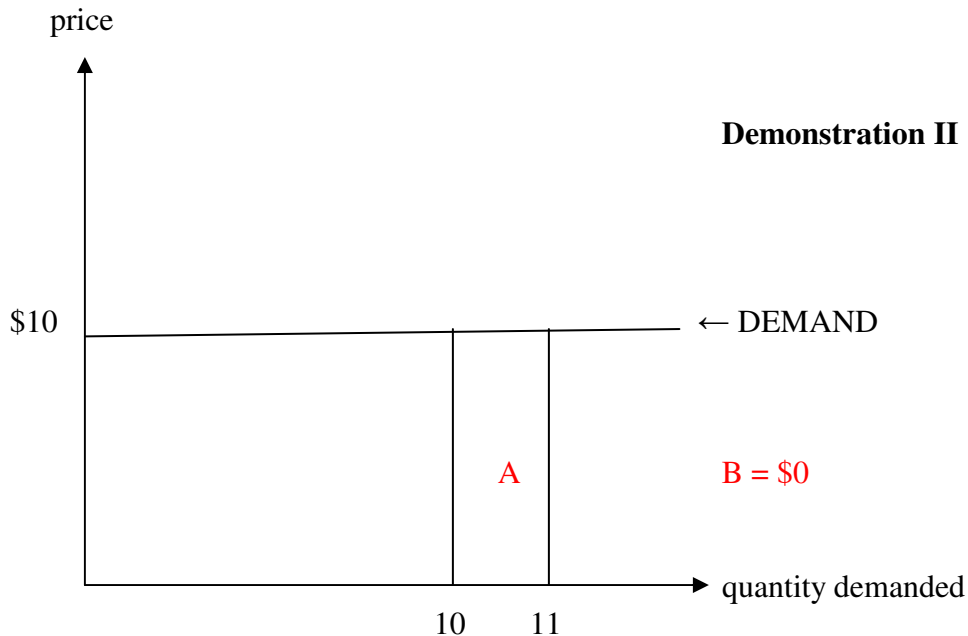


Marginal revenue = (revenue gained from selling one more unit at \$9.75) – (revenue lost from selling the first ten units at \$9.75) = $\$9.75 - \$2.50 = \$7.25$. **When the firm increases production and sales from 10 units to 11 units and drops the price to \$9.75, $MR = \$7.25$.** The same general results occur whenever the firm produces and sells one more unit. It follows that for the typical firm in an imperfectly competitive market $P > MR$.

Second, assume that the typical firm operating in a perfectly competitive market is producing and selling 10 units at the market price (P) = \$10; total revenue = \$100. If that firm produces and sells one more unit, total revenue = \$110. The gain in total revenue (see **A** in Demonstration II on the following page) = $(\$110 - \$100) = \$10$. The loss of total revenue = \$0 (see **B** in Demonstration II). Marginal revenue = $\$10 - \$0 = \$10$.

Without fail, the same \$10 increase in total revenue arises with every additional unit produced and sold by the typical firm as long as the $P = \$10$. It follows that for the typical firm operating in a perfectly competitive market $P = MR$.

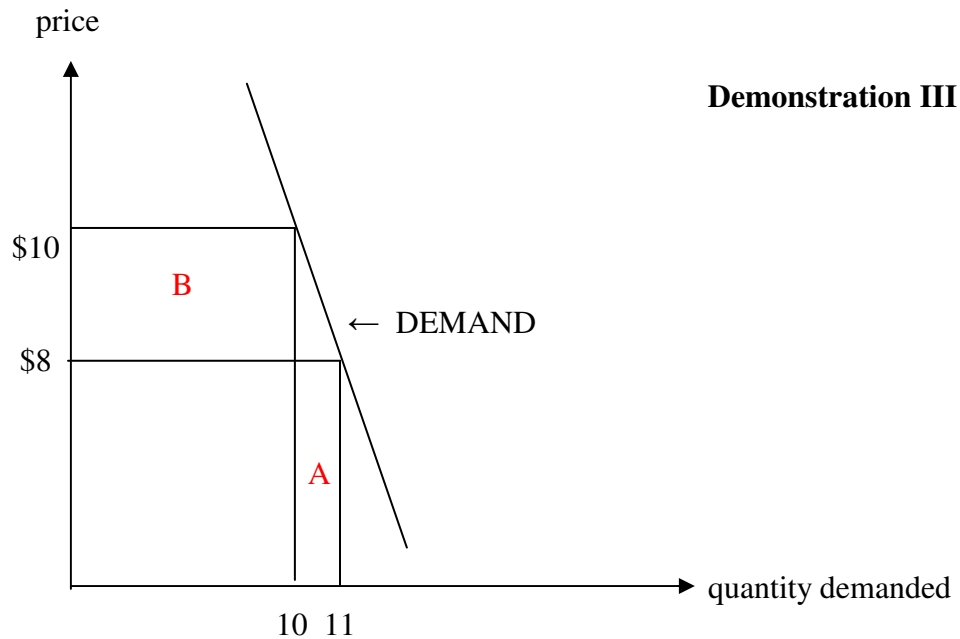
IN A PERFECTLY COMPETITIVE MARKET, PRICE \equiv MARGINAL REVENUE



A = gain in total revenue from the sale of one more unit = \$10
B = loss of total revenue from the sale of one more unit = \$0
MARGINAL REVENUE = A - B = \$10 - \$0 = \$10 = PRICE

*There is another way to demonstrate why for a firm operating in an imperfectly competitive market $P > MR$. Assume that a manufacturer is able to sell 10 units when the price (P) = \$10 per unit yielding total revenue = \$100. In order to sell one more unit, the firm has to drop its price to \$8 giving it additional income from the sale of that unit = \$8. However, there is no way for the firm to cut its price on the last unit sold without reducing its price for all units sold. Thus the loss of revenue on the first 10 units sold at the lower price = $10 \times \$2 = \20 . Marginal revenue = revenue gained from selling one more unit at \$8 (see **A** in Demonstration III on the following page) – revenue lost from selling the first ten units at \$8 (see **B** in Demonstration III) = $\$8 - \$20 = -\$12$. When the firm increases production and sales from 10 to 11 units and has to drop its price to \$8, marginal revenue = $-\$12$. The same general result occurs whenever the firm produces and sells one more unit. It follows that for the typical firm functioning in a market structure of imperfect competition $P > MR$.*

IN AN IMPERFECTLY COMPETITIVE MARKET, PRICE > MARGINAL REVENUE

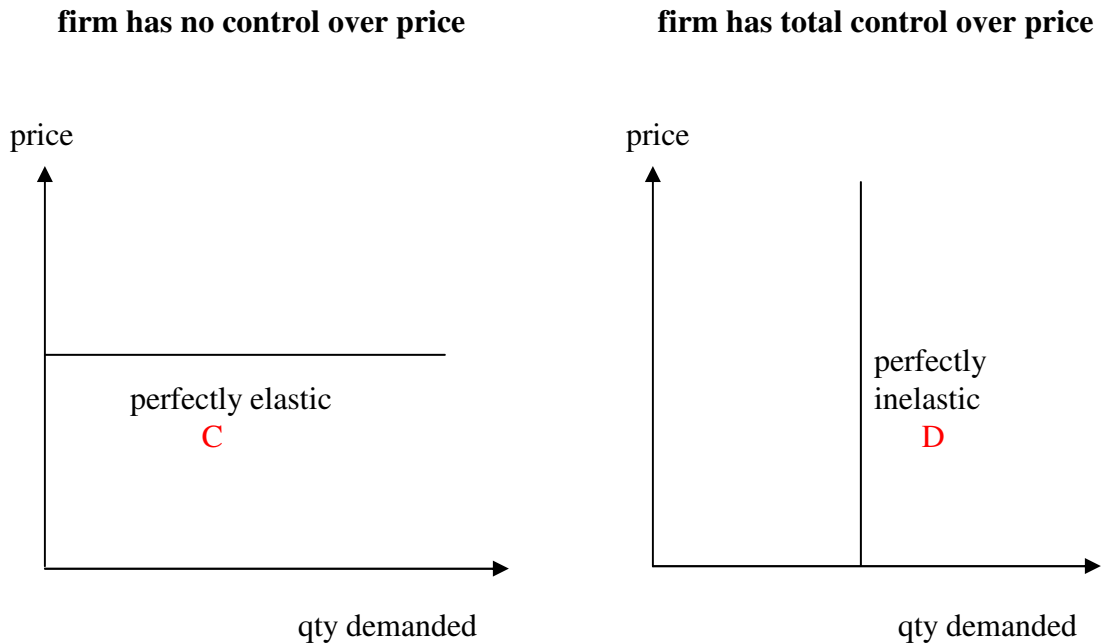


A = gain in total revenue from the sale of one more unit = \$8
B = loss of total revenue from the sale of one more unit = \$20
MARGINAL REVENUE = A - B = \$8 - \$20 = -\$12 < PRICE

*These three demonstrations point to a further relationship between marginal revenue and elasticity of demand. In a market structure of perfect competition, the firm faces a perfectly elastic demand curve (see **C** on the following page) and has **NO CONTROL** over price in the short run or the long run because price is entirely market determined. $P \equiv MR$.*

*In a market structure of imperfect competition, the firm has a perfectly inelastic demand curve (see **D** on the following page) when it has **TOTAL CONTROL** over price. Between the two extremes of **TOTAL CONTROL** and **NO CONTROL** -- they rarely if ever occur in the real world of economic affairs especially in the long run -- there are varying degrees of elasticity and control over price. $P > MR$.*

ELASTICITY OF DEMAND AND CONTROL OVER PRICE



Three simple rules of thumb help determine whether a demand curve between these extremes is more generally elastic or more generally inelastic.

*Rule 1. If a decrease in the price of a given good or service results in a decrease in total revenue from the sale of the good or service ($MR < 0$), demand is **inelastic**.*

*Rule 2. If a decrease in price of a given good or service results in an increase in total revenue ($MR > 0$), demand is **elastic**.*

*Rule 3. If a decrease in price results in no change in total revenue ($MR = 0$), demand is **unit elastic**.*

In the following pages we explain the following types of imperfect competition in detail: monopoly (Topic 13) plus monopolistic competition and oligopoly (Topic 14).

REVIEW SECTION: TOPIC 12

Central Concepts:

- market structure
 - perfect competition
 - imperfect competition
- marginal revenue
- loss
- gain
- elasticity of demand
 - perfect elasticity
 - perfect inelasticity
 - unit elasticity
- control over price

Important Questions:

- What are the three rules that define the relationship between marginal revenue and price elasticity of demand?
- Why is the demand curve in a market structure of perfect competition perfectly elastic? perfectly horizontal?
- Why is the demand curve in a market structure of imperfect competition not perfectly elastic? downward sloping to the right?
- Why in a market structure of perfect competition is marginal revenue \equiv price?
- Why in a market structure of imperfect competition is marginal revenue $<$ price?

(continued on following page)

True/False:

- a. In a perfectly competitive market structure, marginal revenue $>$ price.
- b. In an imperfectly competitive market structure, marginal revenue $<$ price.
- c. A perfectly elastic demand curve is indicative of a perfectly competitive market structure.
- d. A demand curve that is downward sloping to the right indicates that the producer has some control over price.

Mark your answer below.



- Item a is true, items b, c, and d are false.
- Items a and b are true, items c and d are false.
- Item a is false, items b, c, and d are true.

TOPIC 13 MONOPOLY

To explain why in general a monopoly firm is less efficient in transforming resources into goods and services and more likely to generate excess profits than a firm operating in a perfectly competitive environment, and to call attention to the special case of the natural monopoly.

The single most important characteristic of any firm operating in a market structure other than perfect competition is its control over price which is attributable to the fact that its product or service is heterogeneous rather than homogenous. The producer, in other words, has been successful in differentiating the product or service in the mind of the consumer such that when the producer raises the price the consumer does not switch to a cheaper substitute or is unable to switch. Put differently, the demand curve of the firm operating in a market structure other than perfect competition is downward sloping to the right.

One such market structure is the monopoly, the single seller, which is examined in this topic. The other two types are monopolistic competition and oligopoly. In all three structural types the firm has two decisions to make. How much should it produce, and how much should it charge its customers? We assume all along the firm relentlessly pursues the goal of maximizing profits. Monopolistic competition and oligopoly are scrutinized in Topic 14.

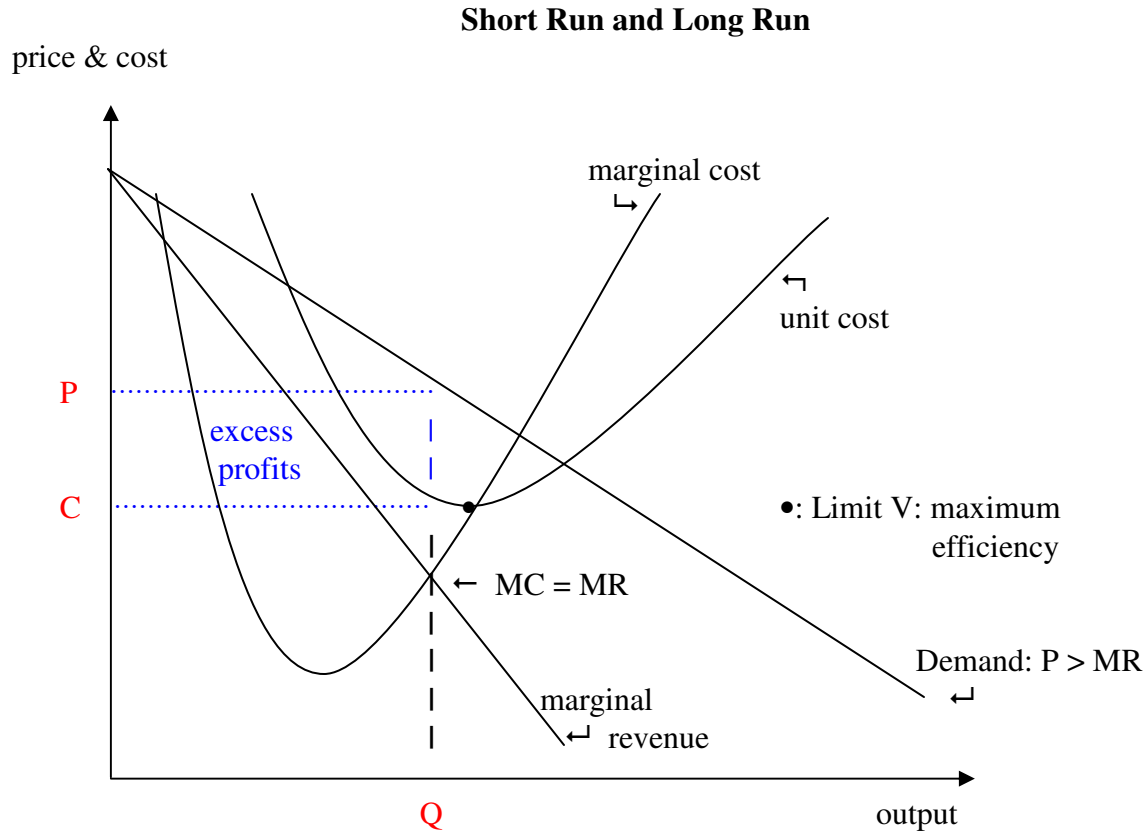
A monopoly is a market structure that is controlled by a single seller with a product or service for which there is no close substitute. The monopoly operates behind high entry barriers that derive from (1) owning a key natural resource, (2) being designated by a government agency as the sole source of supply of a given product or service, (3) enjoying special economies of scale that are unavailable in a market with many producers such as in the distribution of electric power to homes and commercial enterprises and long lines phone and cable services.

As in the case of perfect competition, the monopolist maximizes profits at the output level uniquely associated with marginal cost = marginal revenue. Unlike perfect competition, there is no need to differentiate the performance of the monopolist in short run from the long run. By operating behind high entry barriers, the monopolist is protected from any new competition in the long run. These conditions allow it to protect its excess profits at the same time the compelling logic of profit maximization forces it to operate inefficiently without fear of attracting the new competition that would eliminate those profits and force it to operate efficiently or be driven out of business. See the diagram on the following page.

Monopoly versus Perfect Competition.

In the long run the profit-maximizing price of the monopoly firm is higher than the profit-maximizing price of the firm operating in a perfectly competitive market structure for two reasons relating to the

MONOPOLY



The monopoly is the only producer and seller of product or service, functioning behind high entry barriers such as patents, trademarks, copyrights that effectively prohibit other firms from entering its market. A monopoly generates excess profits in the short run provided its unit cost $C <$ its price P . If the firm is guided by profit maximization it will produce and sell Q . The monopolist does not operate at maximum efficiency because maximum profits invariably occur at an output level below the output uniquely associated with maximum efficiency (identified as Limit V or simply •). Since it functions with the protection of high entry barriers, the monopolist can expect to achieve excess profits in the long run. Thus, **the monopoly is indicted for two reasons. First, it operates inefficiently. Second, by keeping new firms from entering the market and competing against it, the high barriers allow the monopoly to inflate its price and maintain that price indefinitely.**

competitive environment. First, the monopoly uses the high entry barriers to fend off the competition and thereby maintain a price that is higher than its average total cost and protect its excess profits. Second, operating in a market devoid of competition means that the profit-maximizing monopoly does not, indeed cannot, operate at its maximum efficiency. In contrast, the firm that operates in a perfectly competitive market must accept the price that is determined by the marketplace interaction of many buyers and sellers and is forced to operate at its maximum efficiency or face the prospect of being forced out of business. See the comparative diagrams on the following page.

Natural Monopoly versus Perfect Competition.

In the long run the unregulated natural monopoly sets a price that is higher than the price of the profit-maximizing firm operating in a perfectly competitive market structure and earns excess profits that it is able to protect. Further, the natural monopoly has a huge advantage in terms of its average cost of production compared to the unit cost of the firm in a perfectly competitive market. This unit cost advantage is so substantial that it provides long-run excess profits for the natural monopoly even though it is not operating at its maximum efficiency -- to do so would force it away from its profit-maximizing output position -- and even though the perfectly competitive firm is operating at its maximum efficiency with no excess profits that it can protect. See the comparative diagrams on the second page following,

*By **regulating** the price of the natural monopoly through a state or federal government agency, it becomes possible to reduce that price below the perfectly competitive price, thereby taking advantage of its much lower unit cost and passing it along to consumers in the form of a lower price. However, under **regulation** the natural monopoly still operates inefficiency and still earns excess profits, though far less than in an unregulated market.*

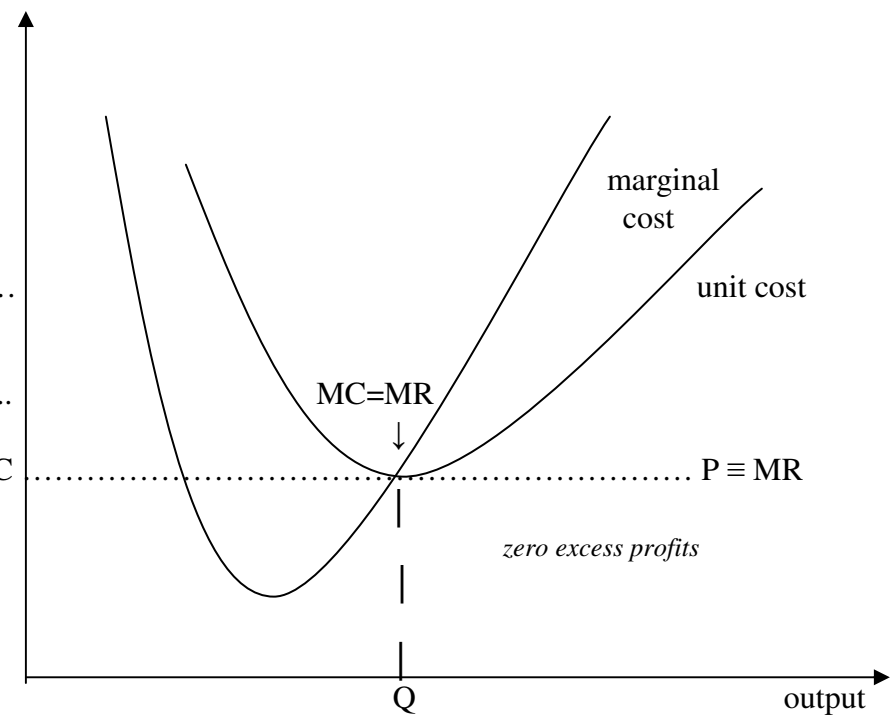
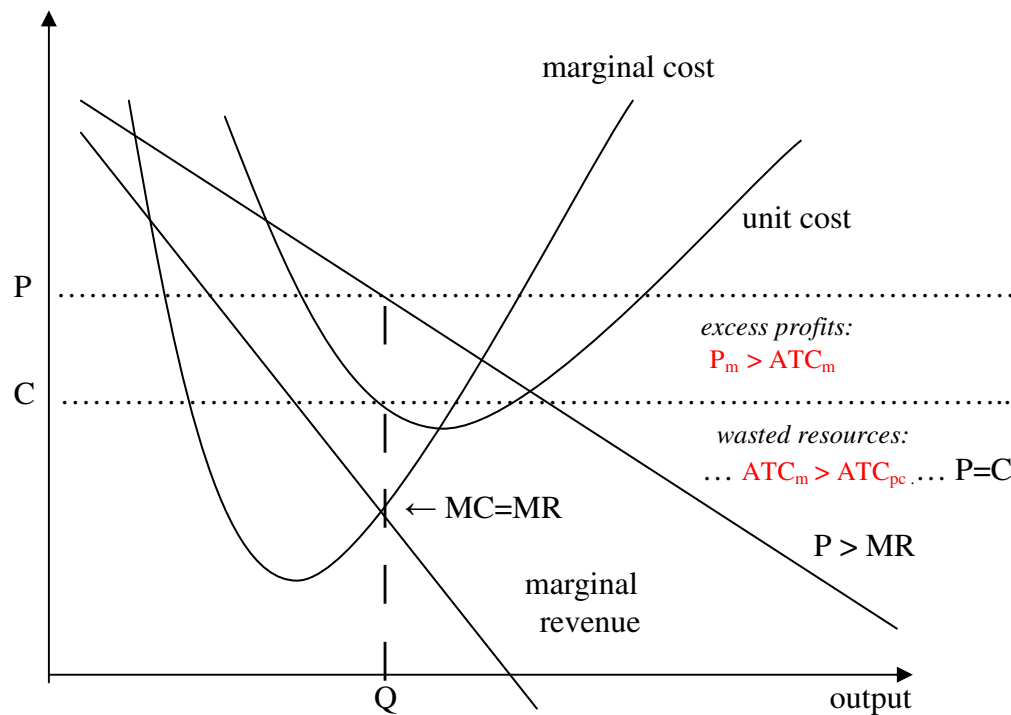
MONOPOLY VERSUS PERFECT COMPETITION

price & cost

MONOPOLY

price & cost

PERFECT COMPETITION

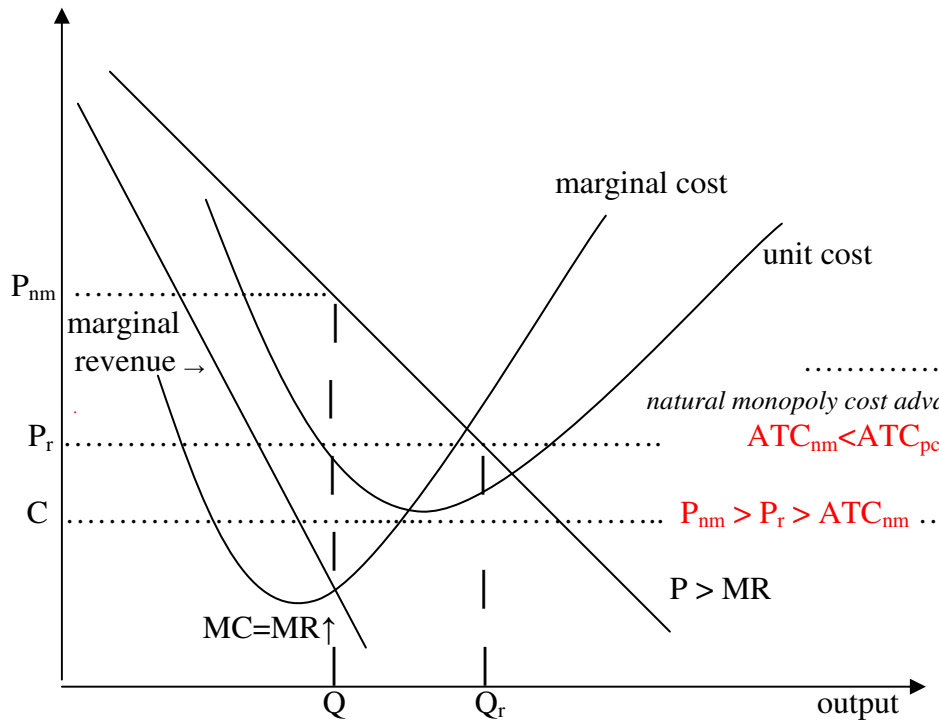


In the long run the profit-maximizing price of the monopoly firm is higher than the profit-maximizing price of the firm operating in a perfectly competitive market structure for two reasons relating to the competitive environment. First, the monopoly uses the high entry barriers to fend off the competition and thereby maintain a price that is higher than its unit cost (@ profit max, $P_m > ATC_m$) and protect its excess profits. Second, operating in a market devoid of competition means that the monopoly does not (cannot) operate at its maximum efficiency (@ profit max, $ATC_m \neq \text{maximum efficiency}$). In contrast, the firm that operates in a perfectly competitive market must accept the price that is determined by the marketplace interaction of many buyers and sellers and is forced to operate at its maximum efficiency or face the prospect of being forced out of business (@ profit max, $P_{pc} = ATC_{pc} = \text{maximum efficiency}$).

NATURAL MONOPOLY VERSUS PERFECT COMPETITION

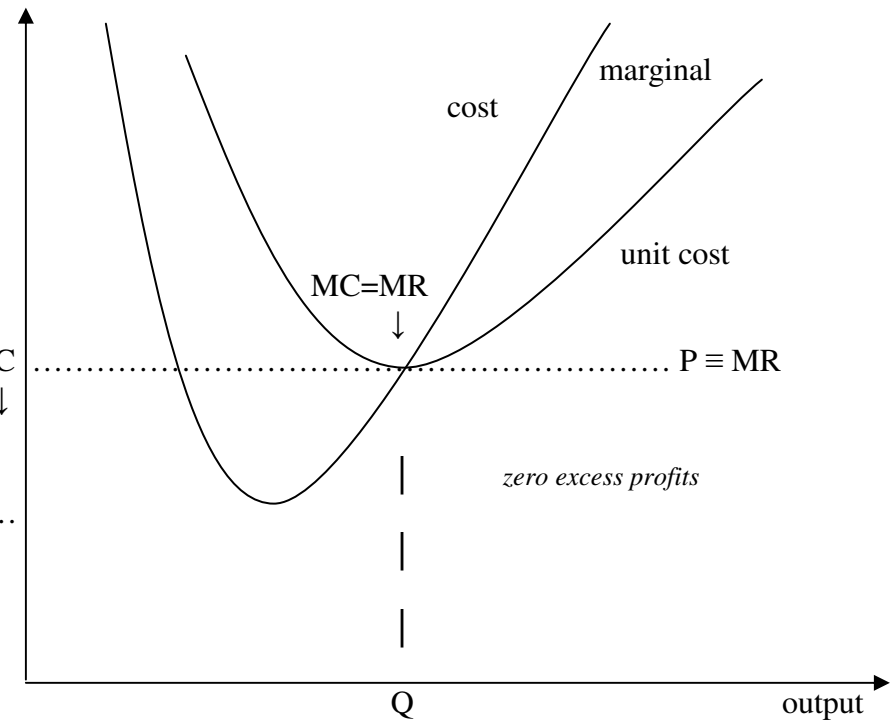
price & cost

NATURAL MONOPOLY



price & cost

PERFECT COMPETITION



In the long run the *unregulated* natural monopoly sets price at P_{nm} which is higher than the price P_{pc} of the profit-maximizing firm operating in a perfectly competitive market structure and earns excess profits $= ([P_{nm} - ATC_{nm}] \times Q)$. However, the natural monopoly has a substantial unit cost advantage compared to the firm in a perfectly competitive market ($ATC_{nm} < ATC_{pc}$). This unit cost advantage is so substantial that it provides long-run excess profits for the natural monopoly even though it is not operating at its maximum efficiency ($@$ profit max, $P_{nm} > ATC_{nm} \neq$ maximum efficiency) and even though the perfectly competitive firm is operating at its maximum efficiency with no excess profits ($@$ profit max, $P_{nm} < P_{pc} = ATC_{pc} =$ maximum efficiency). By *regulating* the price of the natural monopoly, it becomes possible to reduce that price below the perfectly competitive price ($P_r < P_{pc}$), though the *regulated* natural monopoly still operates inefficiency ($@$ output Q_r , $P_r > ATC_{nm} \neq$ maximum efficiency) and still earns excess profits $([P_r - ATC_{nm}] \times Q_r)$.

REVIEW SECTION: TOPIC 13

Central Concepts:

- market structure
 - perfect competition
 - monopoly
 - natural
 - unregulated
 - regulated
- homogenous product
- heterogeneous product
- product differentiation
- entry barriers
- profit maximization principle
- maximum efficiency (Limit V)
- excess profits
- wasted resources
- control over price

Important Questions:

- What are the main differences between long-run perfect competition and monopoly?
- Are those differences on the demand side, the supply side, or are they related to outcomes?
- Does producer control of price influence demand in a monopoly market structure?
- Why is perfect competition regarded as superior to monopoly?
- What is the main flaw of monopoly?
- What is the central difference between an unregulated natural monopoly and a regulated natural monopoly?
- Why is it impossible for a monopoly to maximize profits and efficiency at the same time?

(continued on following page)

True/False:

- a. Monopolies are routinely criticized and attacked because lack of competition means that monopolies waste resources, drive up prices, and are able to generate excess profits in both the short run and the long run.
- b. Due to the nature of the production process and to special circumstances in production and distribution, the natural monopoly has a very large cost advantage over perfect competition. Thus, even taking into account certain excess profits, the natural monopoly is able to price its product or service well below the competitive price.
- c. The perfectly competitive firm is more wasteful of resources in general than is the monopoly firm.
- d. Most producers who operate in monopoly market structures produce at the one level of output uniquely associated with maximum efficiency (minATC). For that reason, a monopolist always charges a price that is below its unit cost (ATC).

Mark your answer below.



- Item a is true, items b, c, and d are false.
- Items a and b are true, items c and d are false.
- Item a is false, items b, c, and d are true.

TOPIC 14 MONOPOLISTIC COMPETITION AND OLIGOPOLY

To examine the performance of the typical firm operating in a market characterized by monopolistic competition and another firm operating under oligopolistic market conditions.

Topic 14 addresses two other market structures -- monopolistic competition and oligopoly – which are characterized by the producer having some control over price. Our exposition of monopolistic competition reduces to two cases: low-entry barriers and high-entry barriers. Even though there are many small firms in a market characterized by monopolistic competition, the market itself is not directly represented in either case because due to product differentiation it is not the market that directly determines price but the individual firm.

Monopolistic Competition.

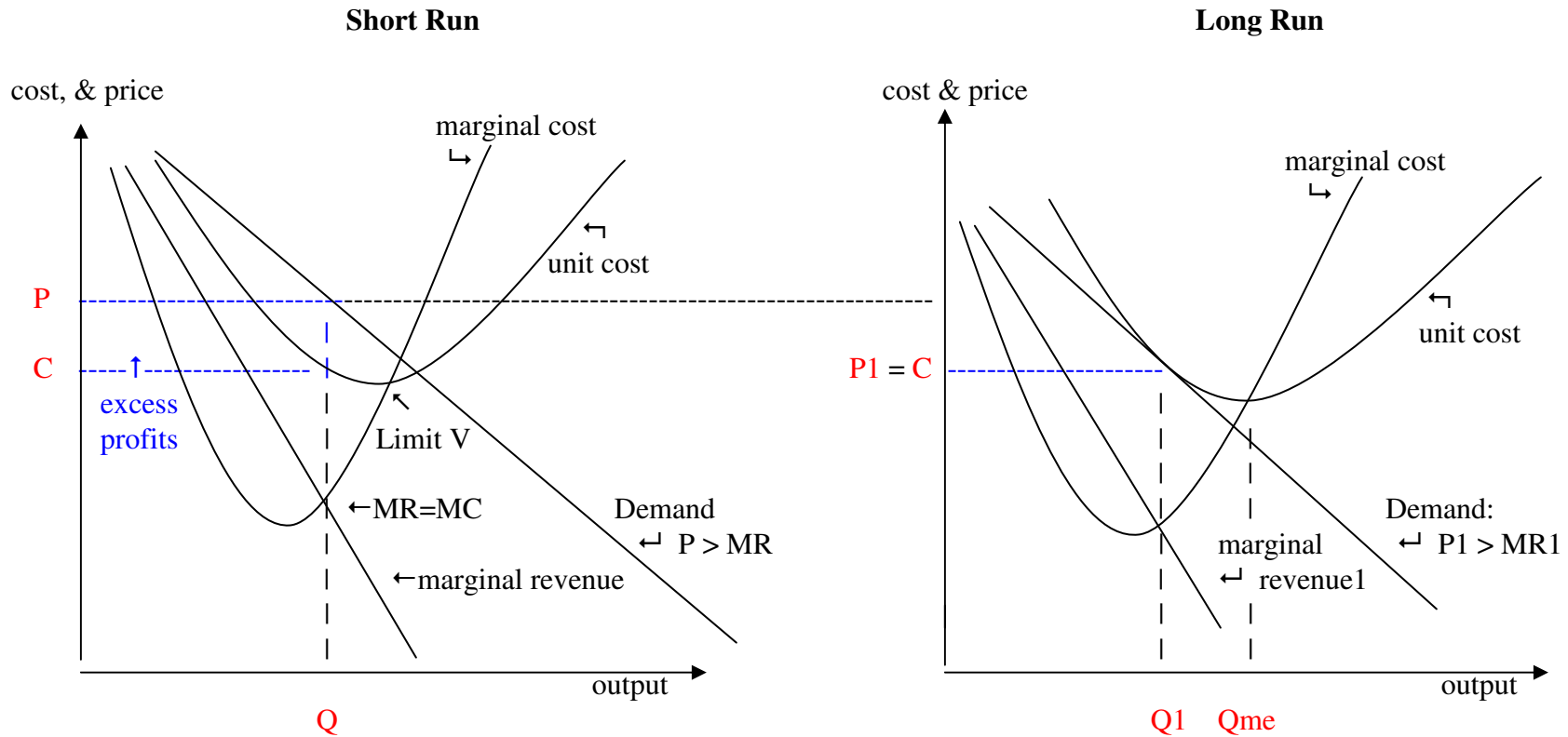
The firm operating under conditions of monopolistic competition has the same type of cost of production conditions as the firm operating in a perfectly competitive marketplace. In other words, average total cost and marginal cost are no different in appearance than we observed for perfect competition. The main difference lies in the demand curve which for monopolistic competition conforms to the principle of demand: the lower the price, the greater the quantity demanded by consumers. Product differentiation gives the firm some control over its price.

The marginal revenue curve is downward sloping to the right but lies to the left of the demand curve for reasons indicated previously in Topic 12. In constructing a marginal revenue curve accurately the student is advised to extend a horizontal line from any point on the vertical axis to the demand curve, split that line into two equal segments, and draw a straight line from the place where the demand curve touches the vertical axis through the midpoint of the line segment, until the drawn marginal revenue curve passes through and below the horizontal axis. Care in constructing the marginal revenue curve is important because marginal revenue is one of the two pieces of information necessary to determine the output level that achieves maximum profits. The other piece, of course, is marginal cost.

To maximize profits, the firm operating in a market behind low-entry barriers selects the output level Q uniquely associated with marginal cost = marginal revenue. Then it must find the one price P that will sell exactly the profit-maximizing output. Getting the wrong price means that its customers will want to buy more than the profit-maximizing output or less and therefore the firm will be forced to settle for less than its maximum profits.

When the firm generates profits in the short run and functions behind low-entry barriers, it can expect to face new competition. The new competition has the effect of drawing away some of the customers of the established firm that we represent diagrammatically by a shift in the demand curve and its associated marginal revenue curve downward to the left. They are drawn away by what they

MONOPOLISTIC COMPETITION: LOW-AND HIGH-ENTRY BARRIERS



Monopolistic competition is a market condition in which there is a large number of competing firms with each one having some control over price due to a differentiated product or service. Even so, the typical firm is unable to keep new firms from entering the market and competing. In the short run, the firm has to decide the price and quantity that produce maximum profits. P and Q are the only combination of price and quantity that produce maximum excess profits $[(Price - Cost) \times Q]$ in the short run. The profit-maximizing firm is **not operating at maximum efficiency** (Limit V). In the long run, new firms enter the market attracted by the excess profits of the established firms. The new competition draws off some of the customers from the typical established firm until eventually that new competition drives the price down from P to P_1 , reduces output from Q to Q_1 , and eliminates excess profits. That result is represented diagrammatically by a shift in its demand curve downward to the left until it becomes tangent with the unit cost curve. In the long run **the firm cannot survive when it operates at maximum efficiency – Q_{me} – because at that output its price $<$ unit cost, and the losses sustained there would drive it out of business.**

perceive to be a better product or service, by a better price, or by better service after the sale. See the diagrams on the preceding page.

We represent this long-run condition by drawing the shifted demand curve such that it is tangent to average total cost curve. Profit-maximizing output Q_1 is identified by applying the profit maximization principle. The price P_1 is derived from the demand curve which shows the price that will attract consumers to buy exactly that output, no more, no less. In the long run, low-entry barriers mean that the additional competition drives the price down to the point where excess profits are entirely eliminated ($P_1 = C$). However, the firm cannot operate at the higher output level associated with its maximum efficiency (Limit V) because it would have to cut its price below the cost of production in order to sell that additional output. This result is counterintuitive. The typical firm operating in under conditions of monopolistic competition in the long run cannot operate at its maximum efficiency because at that output level it would generate financial losses that in turn would force it out of business. In other words, to achieve maximum profits it is necessary for the typical firm to operate inefficiently. Even so, monopolistic competition with low entry barriers has one advantage. It squeezes excess profits and thereby makes goods and services available to consumers at lower prices ($P_1 < P$).

The high-entry barriers case is virtually the same as the low-entry barriers case in the short run. Excess profits are achieved in the short run whenever price at the profit-maximizing output is greater than unit cost. To the extent that the firm is protected by high-entry barriers it can protect its excess profits in the long run. It is not invulnerable, however. It still faces the possibility of a creative new product or service developed by an established rival or upstart sweeping away its customer base, cutting into its profits, and even destroying the company. Its long run survival depends on its success in bringing new ideas to the marketplace.

Monopolistic competition is like perfect competition in the sense that there are many sellers and in general there are low entry barriers. Excess profits are possible in the short run but not the long run. It is unlike perfect competition in that the product or service is not homogenous, giving the firm some control of its price. Additionally, when it maximizes profits it cannot operate at its maximum efficiency.

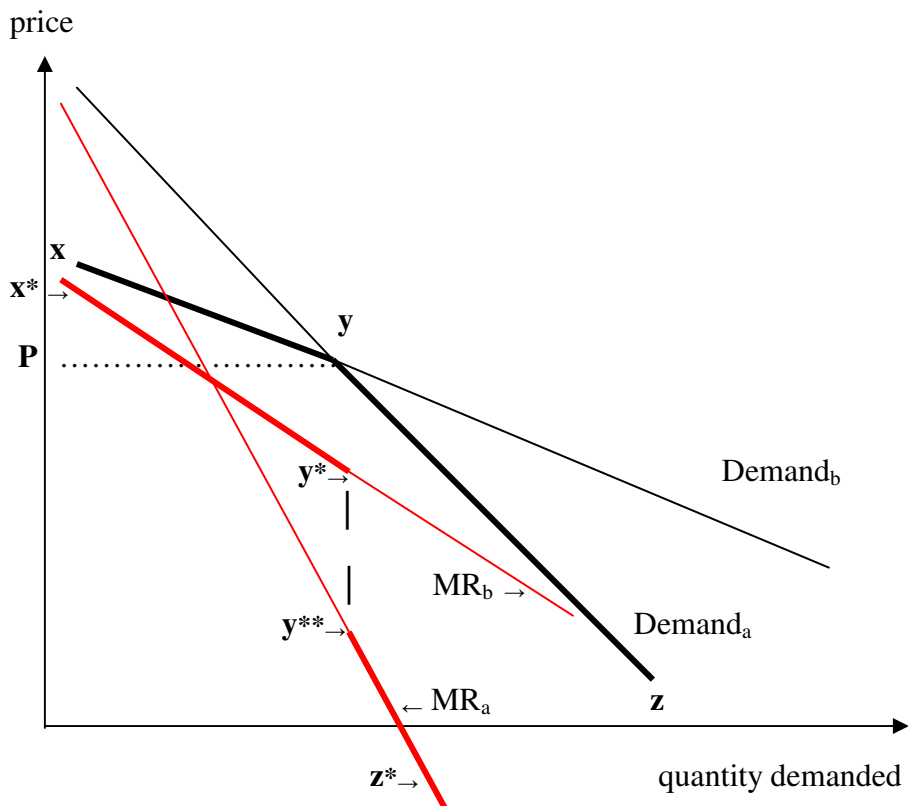
Oligopoly.

An oligopolistic market structure is one in which there is a small number of sellers -- two or more but in general no more than 15 -- all of whom have some control over the market price but one firm claims a large share of the market. An oligopoly may be characterized by products and services that are homogenous or heterogeneous. This special market structure is distinguished by mutual interdependence and at times by collusion.

The kinked demand curve helps explain mutual interdependence. Assume that the typical oligopolistic firm prefers to undersell its rivals but does not want to be undersold. That type of firm can expect its rivals to hold their prices constant if it raises its price which means that above some given price its demand curve is elastic (a small change in price brings a large change in sales). At

the same time, if the typical oligopolistic firm reduces its price it can expect the competition to follow suit and it can expect only a small increase in sales. Its demand curve becomes inelastic (a **small change in price brings only a small change in sales**). The result is a demand curve that above some given price (P) is represented by line segment xy along $Demand_b$ (see the diagram below) and by line segment yz along $Demand_a$. The result is a kinked demand curve xyz . Marginal revenue is represented by the line segment x^*y^* and line segment $y^{**}z^*$, with a break between y^* and y^{**} .

CONSTRUCTING THE KINKED DEMAND CURVE



The kinked demand curve which is used to help explain the oligopolistic market structure is derived in the following manner. Assuming that the typical firm operating in such a market structure prefers to undersell its rivals but does not want to be undersold, the firm can expect its rivals to hold their prices constant if it raises its price **above P** . Its demand curve **above P** is elastic (a small change in price brings a large change in sales) and is represented by line segment xy along $Demand_b$. If, on the other hand, it reduces its price **below P** it can expect the competition to follow suit and it can expect only a small increase in sales. Its demand curve below P is inelastic (a small change in price brings only a small change in sales) and is shown as line segment yz along $Demand_a$. The result is a *kinked* demand curve xyz . Marginal revenue is represented by the line segment x^*y^* and line segment $y^{**}z^*$, with a break between y^* and y^{**} .

*Oligopoly is a very special market structure in the sense that the typical firm is unable to use its demand curve to determine what its sales would be at a given price because its rivals will react to any change in price and that reaction in turn will prompt the typical firm to react and so on in a type of chain reaction. However, if one knows that the firm is reluctant to raise its price for fear of losing its customer base and is hesitant to lower its price for fear of triggering a price war it is possible, as we demonstrated above, to approximate its demand curve. Further if through experience the firm is able to discover the critical pricing point where the demand curve changes from elastic to inelastic and if that price affords a margin of profit, the firm will generate excess profits. However, unlike firms operating in other market structures, the oligopolistic firm can experience a change in its average total cost and its marginal cost (along the vertical line segment **kc** in the diagram on the following page) that **does not** lead to a change in its price or output. Under these conditions and given the mutual interdependence of the oligopolistic market structure, price tends toward rigidity rather than flexibility.*

This price rigidity can be reinforced by a cartel in which the member companies collude by fixing the price and dividing market share among the members by a system of production quotas. The Achilles heel of the cartel is the break-away member, usually one of the smaller companies which can increase production without substantially boosting total market supply or cut its price without influencing the agreed price and initiates one or the other to reap the benefits of the greater revenue stream that follows. OPEC (oil-producing and exporting countries) is a classic cartel which over its history has seen some of its smaller members cheat regarding production quotas or agreed pricing, Saudi Arabia has playing a special stabilizing role by cutting its production whenever a small member increases its.

Economic theory regarding the way in which oligopolies operate is incomplete. One view shared by many economists is that prices are established formulaically. The most common formula is the markup. Under this practice the firm establishes a base price by adding a certain percent markup to the cost of production at its breakeven level of production. Sales beyond that point generate excess profits.

Price leadership is one method for achieving orderly changes in prices in an oligopoly formulaically. Prices are set by one company and all the rest respond predictably, raising or lowering their prices whenever the leader boosts or cuts his/her price. The price leader emerges not through formal agreement but by practice over a long period of time in which the leading company establishes its credibility by taking into account the interests of its rivals.

REVIEW SECTION: TOPIC 14

Central Concepts:

- principle of profit maximization.
- wasted resources
- barriers to competition
- product differentiation
- innovation
- cartel
- collusion
- markup
- price leader
- quotas
- market share

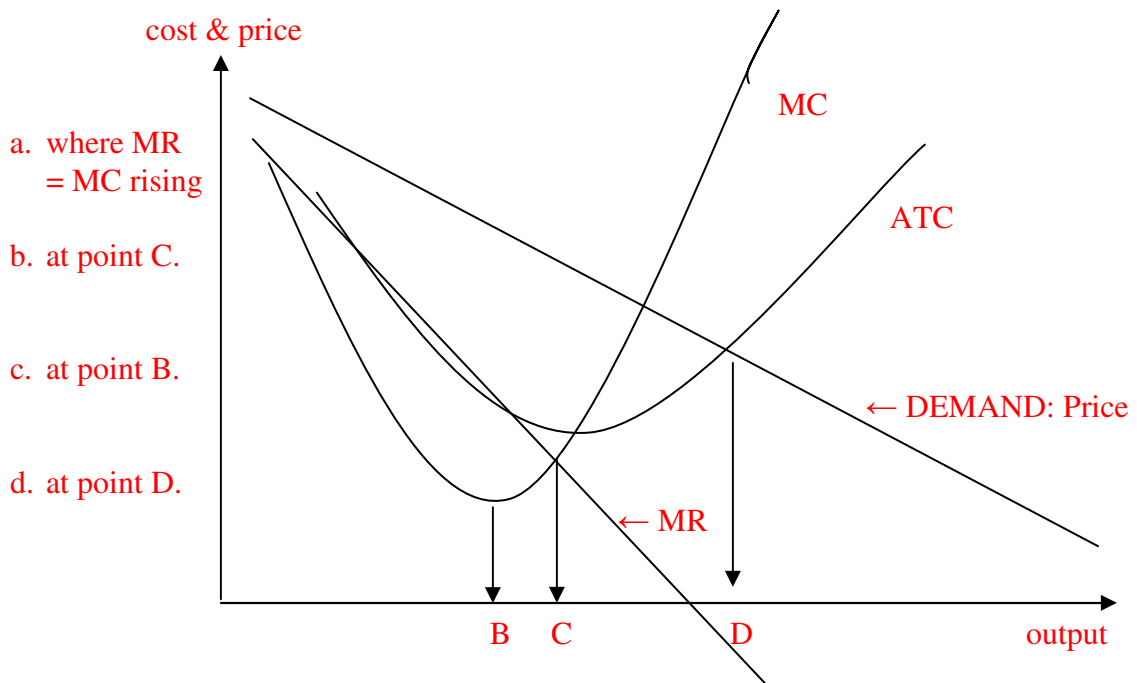
Important Questions:

- In what way is monopolistic competition similar to monopoly? ... similar to perfect competition?
- What is the central flaw of monopolistic competition?
- Why is monopolistic competition considered by mainstream economics as inferior to perfect competition?
- In terms of an oligopoly market structure, what is meant by price leadership?
- As regards oligopoly, what is the role of pricing formulas such as markup pricing?

(continued on following page)

True/False:

The typical firm operating in a market structure of monopolistic competition (see graph below) achieves maximum profits ...



Mark your answer below.

- ▼
- _____ Item a is true, items b, c, and d are false.
- _____ Items a and b are true, items c and d are false.
- _____ Item a is false, items b, c, and d are true.

RE-CONSTRUCTING MICROECONOMICS

Replacing Homo Economicus with the Acting Person

TOPIC 15

PROFIT MAXIMIZATION AND THE SUBJECTIVE DIMENSION OF WORK

To demonstrate why maximizing profits is not an authentic operating principle for the typical firm and to replace it with maximizing personalist capital.¹

*In **Laborem Exercens** John Paul II recognized that work has two dimensions, the objective and the subjective. The objective dimension refers to the goods and services produced by the person who by working “subdues the earth.” The subjective dimension refers to the effect that work has on the worker who “performs various actions ... that] independently of their objective content ... serve to realize his humanity, to fulfill the calling to be a person that is his by reason of his very humanity.” John Paul insisted that the subjective dimension is more important than the objective dimension: “... the primary basis of the value of work is man himself, who is its subject [emphasis in the original].² This assertion is entirely consistent with his repeated affirmation regarding the primacy of “being” over “having.”³*

At the same time, John Paul called attention to the conflict between labor and capital in which “entrepreneurs, owners or holders of the means of production” who in “following the principle of maximum profit tried to establish the lowest possible wages” and the vastly larger number of workers who depend entirely on those wages for their livelihood.⁴

Reconciling the Objective and Subjective Dimensions of Work.

How, then, to reconcile (a) the profit that is the fruit of success in a market economy and the principle of profit maximization that constitutes a central concept in the theory of the firm according to conventional economics with (b) the primacy of the subjective dimension of work? Which one is the more important: the effect that the production of goods and services has on the profits of the firm or the effect that work has on the persons who carry out that work?

The conventional wisdom in microeconomics is that firms maximize profits. The analytics have been developed to establish certainty as to the specific output level that accomplishes this objective and the unique market price that assures that the profit-maximizing output is sold. As indicated in Topics 11, 12, 13, and 14, the analytics are reinforced by diagrams that are simple, straightforward, and

¹ See Topic 32 that demonstrates that the ultimate purpose of human society is human perfection, in which economic affairs is achieved by maximizing integral human development.

² John Paul II, *Laborem Exercens*, September 14, 1981, §§4-6, available at www.vatican.va.

³ See, for instance, *Address of His Holiness John Paul*, Third General Conference of the Latin American Episcopate, Puebla, Mexico, January 28, 1979, §III.4; *Centesimus Annus*, May 1, 1991, §36; and *Sollicitudo Rei Socialis*, December 30, 1987, §28. All three are available at www.vatican.va.

⁴ John Paul II, *Laborem Exercens*, §11.

convincing, and are found in virtually textbook used to teach principles of microeconomics.

We turn first to the question of profits, specifically the maximization principle and the confusion embedded in that principle, the need to reconstruct economic science, and evidence confirming the flaws in the profit maximization principle and in the principle of maximum personal net advantage. To reconcile the difference between profits and the subjective dimension of work, we bring to bear the relatively new concept of personalist capital. In the end, our reconciliation involves subordinating profits to the subjective dimension and argues that instead of being the primary objective of the firm, profits are a necessary condition for its survival.

The Profit Maximization Principle.

*The mainstream demonstration of the profit maximization principle is essentially mechanical in which the economic agent is represented as fundamentally **passive** in nature, taking price as given and then locating the point of profit maximization. Any departure from the profit-maximizing solution is self-correcting because the loss of profits associated with that departure prompts the firm to return to the level of output uniquely identified with maximum profits. Any other behavior is unthinkable.*

*Add to these analytics the assertion made most powerfully by Nobel laureate Milton Friedman¹ and widely embraced today by mainstream economists that the only purpose for which the firm exists is to earn profits for its owners, and the analytical concept of profit maximization that at best is a premise becomes the one and only purpose of the firm. No proof is necessary because its validity is self-evident. In other words, the property rights of the owners deriving from the monies they invest and put at risk are foundational to the operations of the firm and those rights rule. The personal rights of the workers as confirmed by the employment contract count for nothing.² There is no room in this theory of the firm for the entrepreneurial person **who wants to do more than make a profit, who wants to make a difference.***

This mainstream account of the operations of the typical firm is not without its critics, some of whom argue that firms can and do pursue other objectives such as maximizing sales, revenues, market share, employment. In one instance a firm may lower its price below the cost of production -- may deliberately take losses -- in order to destroy the competition. In another it may operate at an output level greater than the one that yields maximum profits in order to placate an aggressive union that threatens to strike if management cuts the workforce to what is necessary for profit maximization. Most recently this account has been directly challenged by Anderson and Escher who assert that the purpose of the firm is to maximize shareholder value. They see the firm as an instrument not for

¹ Milton Friedman, *Capitalism and Freedom*, Chicago: The University of Chicago Press, 1962, p. 133.

² For more on property rights and personal rights, see David P. Ellerman, "The Employment Contract and Liberal Thought," *Review of Social Economy*, Volume XLIV, Number 1, April 1986, pp. 13-39. Notice that employee stock ownership plans award profits to workers by providing access to property rights. Profit-sharing plans on the other hand award profits to workers by affirming their personal rights.

*extracting value but for creating it.*¹

Thus, the firm may have its own good reasons for eschewing profit-maximization. Further, there is no way for the average shareholder to know when the firm is not maximizing profits. What he/she does know with any certainty is whether or not the firm is earning profits, whether or not it is paying dividends.

Confusion Embedded in the Profit Maximization Principle.

The confusion originates in construing a premise as an objective. The syllogism underlying profit maximization premise taken as an objective fails.

- *The firm exists for one purpose only: to produce profits for its owners.*
- *The owners are best served by maximum profits.*
- *It follows that the firm **necessarily** operates in a way that maximizes profits.*

The third statement in that syllogism, however, does not follow from the first two. Taking the first two statements as givens, the third statement ought to read:

- *It follows that the firm **should** operate in a way that maximizes profits.*

Thus, properly constructed, this syllogism ends not with a positive statement of fact but with a normative assertion of opinion.

Even the would-be profit maximizing firm may fall short because of numerous operational unknowns: the reliability of its suppliers to deliver on time, the dependability of its workers to report to work and meet production schedules, the loyalty of its consumers to continue to buy its products/services, the ability of its competitors to innovate and bring superior products/services to market, the willingness of its bankers to extend credit as needed, the propensity of government to regulate it in the public interest.

Profit maximization for producers is the second half of the principle of the maximization of personal net advantage that in mainstream economics is known as utility maximization for consumers. This general principle, as Waters points out so insightfully, removes all active and spontaneous human action in economic affairs for the purpose of transforming economics into a more nearly exact science. This maximization principle, along with the utility calculus, Waters traces to utilitarianism that in turn derives from rationalism²

¹ Max Anderson and Peter Escher, *The MBA Oath: Setting a Higher Standard for Business Leaders*, Penguin Books, 2010, pp. 5, 38, 86-87, 92-98, 236.

² See William R. Waters, *Entrepreneurship, Dualism, and Causality: An Appreciation of the Work of Joseph A. Schumpeter*, Ph.D. dissertation, Department of Economics, Georgetown University, Washington, D.C. 1952. pp. 82, 87-

Guided by feelings of pleasure and pain, economic agents make decisions passively and automatically. Walras and Jevons were the ones who supplied the necessary techniques of quantification to operationalize this principle and advance economics as a modern science.¹ Waters does not mince words condemning this development.

*... to mistake what could only be an assumption [the maximization principle], to be used as a tool of analysis, for an actual phenomenon is **unpardonably bad scholarship** (emphasis added).²*

John Paul II is critical of the utility-maximization half of the principle of maximum personal net advantage for more profound reasons.

*All of us experience firsthand the sad effects of this blind submission to pure consumerism: in the first place a crass materialism, and at the same time a radical dissatisfaction, because one quickly learns -- unless one is shielded from the flood of publicity and the ceaseless and tempting offers of products -- that **the more one possesses the more one wants**, while the deeper aspirations remain unsatisfied and perhaps even stifled (emphasis added).³*

Reconstructing Economics to Address the Confusion Surrounding Profit Maximization.

*To reconstruct economic science, according to Waters,⁴ it is necessary to uproot the mainstream's representation of the economic agent as a passive, automatic, and thoroughly predictable utility-maximizing machine. In its place he offers an economic agent who in everyday economic affairs is an active, often creative, complex and therefore not always predictable human being. We call this economic agent the **acting person**. It is more than a little ironic that mainstream economists deny the economic agent the very individuality that they find so appealing in the individualism that serves as the philosophical foundation for their way of thinking about economic affairs.*

*Like the products/services of the typical firm operating in a perfectly competitive market environment, the **homo economicus** of mainstream thinking is always and everywhere the same, always and everywhere a rational, self-interested, predictable, profit-maximizing machine.⁵ In sharp contrast, the **acting person** of personalist thinking is always and everywhere one of a kind, always and everywhere a complex, unpredictable human being, a living, breathing, existential actuality.*

*Our guiding premise therefore is this: profits are a **necessary condition** for the survival of the firm over the long run. This premise truly is self-evident and requires no drawn-out proof because the*

88. Accessible, with different pagination than in the original at www.mayoresearch.org under "PUBLICATIONS."

¹ Waters, p. 88.

² Waters, p. 89.

³ John Paul II, *Sollicitudo Rei Socialis*, December 30, 1987, §28, available at www.vatican.va.

⁴ Waters, pp. 90-91ff.

⁵ In the case of the consumer, a want-satisfying, utility-maximizing machine.

real-world evidence is overwhelming. Though it may survive for a while by drawing down cash reserves, selling some of its assets, and bringing in new senior managers, in the end the firm must earn a profit or see its share price and market capitalization plunge to zero as unhappy shareholders divest their holdings.

*In a strict accounting sense there is only one way to make profits: by selling a product/service at a price greater than its cost of production. However, this is a truism, not an operating principle. Our operating principle is that the firm is **most likely** to earn profits and survive by conducting its affairs in an upright manner. This principle is expressed in the following syllogism.*

- The firm's survival depends on motivating managers, suppliers, and employees to do their best and retaining the best among them.*
- The best way to motivate and retain these persons along with the firm's customers is to treat all of them in an upright manner.*
- Thus, treating everyone in an upright manner is the best strategy for the firm to operate profitably and survive.*

*The best strategy, however, does not provide an **ironclad guarantee** that the firm will operate profitably and survive. Firms fail even when they are operated in a totally upright manner if they are not smart enough or nimble enough to stay ahead of their competition. Vision -- seeing opportunities and possibilities where others see nothing beyond the way things are at the moment -- along with a willingness to gamble with the new and different are key ingredients to success in business. Virtue alone, in other words, is insufficient to secure the future of the firm.*

Evidence Confirming Flaws in the Mainstream's Profit Maximization Principle.

Two sets of evidence are offered to confirm our argument that the maximization principle of mainstream economics is flawed. Maximizing profits is not a satisfactory operating principle because many companies set aside greater profits for an even greater good. Maximizing personal net advantage is not a satisfactory behavioral principle because many human beings have been destroyed in the pursuit of that end.

The evidence we offer in both instances is strictly anecdotal but compelling, we submit, because it (a) reflects real-world experiences that contradict the conventional wisdom of mainstream economics and (b) clearly represents a much larger set of similar experiences that could be cited but would not contribute additional weight to our argument.

Maximizing personal net advantage is not a satisfactory behavioral principle. *There are for sure many cases of persons engaged at the highest levels of business affairs who of late have destroyed themselves in the pursuit of maximum personal net advantage. They include Andrew Fastow (Enron), Bernie Madoff (Bernard L. Madoff Investment Securities), Michael Milkin (Drexel, Burnham, Lambert), Dennis Kozlowski (Tyco), Bernie Ebbers (Worldcom), Jeffrey Nacchio (Qwest), James McDermott, Jr. (KBW), Sam Waksal (ImClone), Sam Israel (Bayou Group), Lou Pearlman (Trans Continental Airlines), not to mention many others already convicted or under indictment.*

In each case, a person or group of persons failed to conduct business in an upright manner. Instead of settling for the expected and perfectly justifiable economic gains that come from routine business transactions, they deliberately took for their own or recklessly destroyed the expected gains of their counterparties. By failing to conduct their business in an upright manner we mean that minimally they did not render to their counterparties that which was owed. They failed the most basic test of justice in economic affairs. They took what belonged to others.

Once their unjust and illegal practices were exposed, the zero-sum activities that they had misrepresented to their counterparties as positive-sum in nature degenerated into negative-sum activities, and torn their business organizations apart. In some instances, those negative-sum activities actually destroyed their organizations.

*Fastow, Madoff, Kozlowski, and the others do not fit the mold of **homo economicus** -- a passive, automatic, and thoroughly predictable utility-maximizing machine. Each one is different. Each one is an **acting person** -- an active, often creative, complex and not always predictable human being -- whose behavior in business affairs is driven not by the prospect of economic gain but by the opportunities for any and all gain including ill-gotten gain. Though they likely would have regarded any gain available to them as rightfully theirs, they crossed the line from upright behavior to criminal conduct.*

They can be represented as pursuing the maximization principle of personal net advantage only if one sees no limits to that principle, only if one is unwilling to acknowledge the difference in business behavior that at minimum is based on the virtue of justice from conduct that is grounded in the vice of greed. However, for many who are engaged in business affairs, there is a greater good than maximizing personal net advantage. Perhaps a sense of justice or a fear of public exposure keep them from crossing the line or a realization that at times it is necessary to limit personal net advantage in order to serve the greater good.

***Maximizing profits is not a satisfactory operating principle.** Notwithstanding the evidence of egregious wrongdoing on the part of the aforementioned persons, our own experience persuades us that many companies can and do operate in an upright manner. Over an 11 year period we visited more than 50 firms in Louisiana in order to evaluate their efforts to improve quality and productivity and their success in bringing new ideas to the workplace and marketplace. These firms covered a wide spectrum of successful activity in health care, shipbuilding, crude oil, light manufacturing, construction, lumber, and heavy manufacturing.¹*

During those visits we observed several successful strategies that firms employ to operate in an upright manner, to meet their obligations under the principle of justice. Those strategies include gain-sharing, employee stock ownership, quality circles, vendor partnership, and company code of

¹ For more on these visits, see Edward J. O'Boyle, "Louisiana Works!: Workplace and Marketplace Innovation from Louisiana's Award-Winning Entrepreneurs," 2002, available at www.mayoresearch.org/files/LAWORKS.pdf.

ethics.¹ The first three -- gain-sharing, employee stock ownership, and quality circles -- encourage employees to do their best. Vendor partnership encourages suppliers to do their best through a formal commitment between the firm and a vendor that is grounded in mutual trust, cooperation, and coordination. The company code of ethics challenges the firm to do its best to meet its obligations to its owners, suppliers, managers, employees, and customers.² In the end, all of these strategies have one thing in common: they attempt to improve the firm's profitability and survivability by setting higher standards for human behavior.

A company is not a machine. It is a human organization that sets its objectives according to its own values. The following evidence demonstrates that companies often pursue objectives more highly valued than maximum profits, that the upright company is not a hopeless and unattainable ideal of personalist economics. Companies can and do succeed and survive without rigidly following the profit maximization principle.

*Consider **TOMS Shoes** that is based on the premise that "with every pair you purchase, TOMS will give a pair of new shoes to a child in need." Or **Hershey Company** that over the last six years has donated more than \$1.75 million to the Young Survival Coalition that is dedicated to "the critical issues unique to young women and breast cancer." Or **Vanguard** that offers its FTSE Social Index Fund that invests in "companies that work to protect the environment, maintain fair hiring and promotion practices for women and minorities, and institute safe and healthy workplace habits."*

*Or **Life Is Good**, the company that uses the "life is good" theme on its products and since 2003 has organized festivals to raise funds for various causes including a summer retreat for children with life-threatening conditions. Or **Hyundai's Hope on Wheels** program that every time a new vehicle is sold in America donates \$5 to children's hospitals to help children afflicted with cancer. To date, Hope on Wheels has raised more than \$23 million. Or **Merck** and **Astrazeneca** that offer medicines at no cost to qualified patients.*

*Or **Newman's Own** that produces a variety of food products and over the last 23 years has donated all of its more than \$280 million in profits to good causes such as food banks, basketball tournaments, initiatives for improving the quality of life for military personnel, and summer camps for children with deadly diseases.*

*Or **Goodshop**, an online service that allows shoppers to make purchases from popular stores such as Home Depot, Amazon.com, and Banana Republic, with up to 30 percent of their purchases going to any one of more than 93,000 nonprofit organizations.*

¹ The producer cooperative and co-determination are two other strategies that can encourage upright behavior, but we observed neither one during our visits.

² For more on the duty of the firm in selling to the poor, see Edward J. O'Boyle, "The Duty of the Firm in Selling to the Poor: A Question of Person, Justice, and Subsidiarity," *Forum for Social Economics*, Fall 1998, pp.7-21.

Perhaps most significant of all is the **Committee Encouraging Corporate Philanthropy** that was established in 1998 largely at the behest of Paul Newman to encourage a greater corporate response to needs in their communities. Today the Committee has 175 CEO members involving 150 major corporations that annually give \$10 billion to charitable causes.

Profit maximization does not take into account that companies as we have seen often use some of their profits to serve a greater good. For that reason, Friedman's assertion that the firm's only purpose is to earn profits for its owners strictly speaking is an **opinion**. It is not an operating principle.

Additionally, profit maximization is a flawed operating principle largely due to the unknowns that the typical company faces: suppliers who may not deliver on time, workers who do not report to work or meet production schedules, consumers who switch to other companies producing a cheaper or superior item, bankers who may withhold credit when it is needed, government that may intervene in its affair to protect the public interest, severe weather that disrupts normal commuting, work, and shipping routines. Given these unknowns, the typical firm is capable of only an informed guess as to what and how much to produce and what price to charge. It can make adjustments in the expectation of improving profits but those adjustments always are made subject to the unknown. In the midst of all these uncertainties, one operating principle is clear and necessary. It must earn a profit to survive.

Flaws in the Principle of Maximum Personal Net Advantage.

Maximizing personal net advantage is flawed most fundamentally because conventional economics eschews any personal sense of justice on the part of economic agents on grounds that injecting justice in economic affairs transforms economics into a normative, value-laden discipline analytically beset with uncertainty. Instead, the invisible hand of the market is employed that sets no such limits and is entirely consistent with its representation of **homo economicus** as a passive, automatic, and predictable profit and utility-maximizing machine. Accordingly, economics is a positive, value-free discipline analytically freed of uncertainty.

The examples we have supplied regarding business executives who stole the economic gains that rightfully belonged to their counterparties demonstrate forcefully that the invisible hand does not prevent an active, often creative, complex and unpredictable economic agent – the **acting person** – from behaving in a criminal manner. The other examples we cited provide evidence to the effect that some business executives are **acting persons** who behave in an upright manner. The **acting person** in other words is not an automaton. Some ruthlessly pursue maximum personal net advantage. Others march to a different drummer.

A human being is a living, breathing, existential actuality who is more or less free to choose between uprightness and wickedness. He/she accumulates what we prefer to call personalist capital and develops as a person by uprightness in everyday affairs. On the other hand, a human being suffers a loss of personalist capital and regresses as a person by wickedness in everyday affairs. Like it or not, just as unemployment (both involuntary and voluntary) is the price we pay for freedom in the labor market, ill-gotten gain is the price we pay for freedom more generally in market transactions.

We should not be surprised that a person who for years has lived in a truly upright manner may be seduced by the opportunity for ill-gotten gain. Or that a person who gives every appearance of uprightness at heart may be driven by wickedness. Scruton points out that Enron, for example, was adept at publicly supporting “diversity, equal opportunities, care for the environment” that he characterizes with hindsight as Enron wrapping itself in a “veil of political correctness.”¹

Given that economic agents are living, breathing, existential actualities, complex and unpredictable, wickedness and goodness are to be found in everyday economic affairs. Which one prevails depends very much on how economic power is applied, on how economic agents decide to act in any given situation, to exploit or render what is owed.

Because companies are human organizations we can say with confidence that they are neither all upright nor all wicked. Rather they function somewhere along a spectrum between those two extremes, moving from time to time in one direction or the other depending most fundamentally on how the company’s principals define its primary objectives and what means they are willing to employ in pursuing those ends.

Maximizing Personalist Capital: Replacement for Maximizing Personal Net Advantage.

In this topic, we explored the role of uprightness and wickedness in business affairs along with profit maximization as the governing principle in the typical business enterprise. Our intent has been to demonstrate that a firm can operate in an upright manner and earn profits at the same time. Indeed, in the long run, it cannot operate in an upright manner in the absence of profits. Such a firm understands that operating in that manner means that it must restrict itself to the gains (profits) that are justifiably its own. Included in its net worth is the asset goodwill that originates by operating in an upright manner, in respecting and accepting the gains that rightfully belong to others that it engages in everyday affairs.

A firm, for sure, can choose to operate in a wicked manner and also earn profits. In the long run, however, by not respecting the gains that rightfully belong to others, by instead seizing those gains for its own, the firm engages in practices that in the end are self-destructive because in the end when they are publicly exposed it is ill will not goodwill that attends those practices. Sufficient ill will can destroy the firm by reducing its net worth to zero wiping out the holdings of its owners and leading to its total collapse. Consider the immediate demise of the prestigious accounting firm Arthur Anderson when the public learned that it had been “cooking the books” for Enron.

To replace the maximization of profits as the fundamental operating principle of the firm, personalist economics offers the maximization of personalist capital. To explain, a person who acts in an upright manner in business affairs -- is diligent, trustworthy, fair-minded, honest, hardworking -- develops personalist capital, which like human capital, adds to that person’s value as an economic

¹ Roger Scruton, “Virtue and Profit: A Critique of Managerial Reasoning,” in ***Profit, Prudence, and Virtue: Essays in Ethics, Business and Management***, edited by Samuel Gregg and James Stoner, Charlottesville, VA: Imprint Academia, 2009, p. 37.

agent.

*Further, the company becomes an upright firm when the persons working there act accordingly. And because persons who act in an upright manner are more effective as economic agents, the firm is more effective, including more profitable though profitability cannot be guaranteed for all times and places. Thus, **the firm ought to maximize personalist capital and thereby will become more effective as a profit-making enterprise.** The key to operationalizing itself as an upright firm is in selecting, training, nurturing, motivating, and retaining employees who routinely conduct themselves in an upright manner, who are better persons and more effective employees because for the most part they put virtue into action.¹ Topic 18 has more on the **acting person.***

There is no direct, absolute correspondence between personalist capital and compensation. Persons who genuinely love the work they do as ministers, social workers, firefighters, and the like are not necessarily well-paid, though they may have accumulated substantial personalist capital. In contrast, others who act viciously and have no personalist capital -- drug dealers, money launderers, and assassins for hire come to mind -- may be very well paid. Even so, society at times applauds the former though too often just takes their goodness for granted, while it emphatically condemns the latter precisely for their wickedness.

The upright company that maximizes personalist capital does not have to outperform the profit-maximizing firm. It simply needs to earn enough profits to satisfy its owners. However, there is nothing intrinsic in maximizing personalist capital that keeps the upright company from outperforming the profit-maximizing firm by producing a better product at a better price with better service after the sale. It is possible, in other words, to do good, to do well, and to outperform the competition all at the same time.

Beyond assuring a level playing field by aggressively punishing unfair business practices, government need not afford the upright company special protection to assure its survival in a tough competitive environment. The discipline of the market in general will determine which firms succeed and which ones fail. The firm that maximizes profits has no lock on street smarts. Neither does the firm that maximizes personalist capital.

*There is support for the personalist-capital argument to be found in the very origins of economics in that Smith's **Moral Sentiments**, though overshadowed by his **Wealth of Nations**, speaks often of the importance of the virtues of generosity, benevolence, and sympathy. Further, there is recognition in mainstream economics of the significance of three other virtues in economic affairs: thrift, industriousness, and diligence. In this topic we have not addressed the thorny question as to how the innocent baby becomes an upright or wicked person. Instead, we have demonstrated that (a) it is not only possible and feasible but also rational and profitable for the firm to maximize personalist capital and (b) there is a corresponding need to re-construct the theory of the firm to incorporate uprightness and wickedness. For more on personalist capital, go to Topic 19.*

¹ In this regard, a company code of ethics can be helpful provided it is more than just a wall hanging. Rather, it is a living document that guides the entire workforce, most especially senior management, toward uprightness in everyday affairs.

Personalist capital does not replace the role of self-interest in economic affairs, that economic agents as Danner¹ puts it routinely pursue gain in every economic activity. Self-interest, however, is neither a virtue nor a vice and therefore does not contribute to or take from personalist capital. Generosity on the other hand contributes to personalist capital and greed takes away.

For Danner the difference between self-interest and greed, which he prefers to call selfishness, lies in the “the nature of the object sought and the reason why sought.” Notice, he says, the difference in intent in the purchase of a revolver by a police officer and a teen gang leader.²

*Virtue and vice, as in the case of generosity and greed, are not polar opposites. Rather, virtue is grounded in the truth about the good discovered through the human intellect whereas with vice the truth has been lost or is missing due to a poorly informed or twisted intellect that misrepresents the good. In other words, with virtue the good is present. With vice, it is absent. Fastow, Madoff, Kozlowski, and the others actually considered their ill-gotten gains not as taking what rightfully belonged to others but as reaping the rewards for their own best efforts, as the good. Tragically many innocent persons paid for the wicked ways these **acting persons** sought to have more, the ways they misrepresented the good.*

To be consistent with John Paul II’s assertion of the primacy of the subjective dimension of work, of “being” versus “having,” we must reject profit maximization as the primary purpose of the firm. In its place we propose instead that the firm’s foremost objective is the maximization of personalist capital. Properly understood, profits are a necessary condition for the firm’s survival and when the firm complies with the demands of economic justice profits are a good. Personalist capital in effect incorporates the subjective dimension of work into microeconomic theory without dismissing the importance of profits or self-interest.

Maximizing profits underscores the importance of having more and as John Paul warns us leads to wanting more and to a crass materialism in which “deeper aspirations remain unsatisfied and perhaps even stifled.”³ Maximizing personalist capital, on the other hand, opens the door to being more.

¹ Peter Danner, *The Economic Person*, Lanham: Rowman and Littlefield, 2002, p.154.

² Danner, pp.158-159.

³ John Paul II, *Sollicitudo Rei Socialis*, §28.

REVIEW SECTION: TOPIC 15

Central Concepts:

objective, subjective dimensions of work
maximizing
 personal net advantage
 profits
 utility
 personalist capital
personal rights
property rights
uprightness
wickedness
behavioral principle
operating principle
syllogism
positive-sum, zero-sum, negative-sum activities
ill-gotten gain
ill will
goodwill
making a ...
 profit
 difference
doing well, doing good
homo economicus
acting person

Important Questions:

How does one reconcile the subjective dimension of work and profit maximization?
Is the company that maximizes personalist capital simply a hopeless and unattainable ideal or are there real-world examples of companies moving in that direction?
Can the company that maximizes personalist capital compete successfully with the profit-maximizing firm?
Does the company that maximizes personalist capital have to outperform the profit-maximizing firm?
How does the company that decides to maximize personalist capital actually operationalize that objective?
Why is maximizing profit an unsatisfactory operating principle?
Why is maximizing personalist capital a satisfactory operating principle?

(continued on following page)

True/False:

- a. Maximizing profits is a satisfactory operating principle.
- b. Maximizing personalist capital is a satisfactory operating principle.
- c. The company that maximizes personalist capital does not have to outperform the firm that maximizes profits.
- d. It is possible for a company to do well and to do good, to make a profit and make a difference.

Mark your answer below.



_____ Item a is true, items b, c, and d are false.

_____ Items a and b are true, items c and d are false.

_____ Item a is false, items b, c, and d are true.

TOPIC 16 MAINSTREAM ECONOMICS, SCHUMPETER, AND MARKET STRUCTURE

To explain why instilling more competition, especially in product markets, has for more than 100 years been the official policy in the United States, and why this policy has been re-invigorated over the past 30 years. Additionally, to explain why a Schumpeterian economist does not fully embrace perfect competition as the standard of excellence.

The following provides a summary comparison of perfect competition and four other market structures: monopoly, natural monopoly, monopolistic competition, and oligopoly. According to mainstream economics, in the long run the profit-maximizing firm in ...

*.. a perfectly competitive market **operates at maximum efficiency (Limit V) and generates no excess profits:***

price = minimum unit cost @ profit-maximization

*... a monopoly market **operates below its maximum efficiency and generates and is able to protect its excess profits** in the long run because it has no competitor with a product or service that is a close substitute to hold its prices in check:*

price > unit cost > minimum average total cost @ profit maximization

*... a natural monopoly market **operates below its maximum efficiency.** Even so it has a **huge advantage in terms of its unit cost and generates and protects its excess profits** in the long run:*

*price > unit cost > minimum unit cost @ profit maximization
unit cost is substantially lower than in perfect competition
price and profits can be reduced by regulation*

*... a market structure of monopolistic competition with low entry barriers generates **no excess profits** but **operates inefficiently** because it sustains losses when it operates at maximum efficiency:*

price = unit cost > minimum unit cost @ profit-maximization

*... a market structure of monopolistic competition with high entry barriers **protects its excess profits** but **does not operate at maximum efficiency:***

price > unit cost > minimum unit cost @ profit maximization

... in an oligopolistic market structure operates **below its maximum efficiency** and its **excess profits are protected** in the long run especially through collusion.

price > unit cost > minimum unit cost @ profit maximization

*In a perfectly competitive market, the typical firm's demand curve is **identical** to its marginal revenue curve. In every other market structure addressed in these pages, the two are **not identical**. As to the difference in price in the long run, **price in a perfectly competitive market < price in the other types of markets with possible exception of the regulated natural monopoly.***

*As to the very nature of competition, mainstream economists assert that **competition is driven by prices** and firms that survive in the long run are the ones that are able to operate most efficiently. The more competition that can be injected into the marketplace through strict enforcement for example of the Sherman Anti-Trust Act (1890) that prohibits restraint of trade and monopolization and the Clayton Act (1914) that outlaws price discrimination,¹ the more efficiently the firms are forced to operate, and the lower the prices that consumers are required to pay. In social Darwinian fashion, only the efficient survive.*

Schumpeter would argue differently. Entrepreneurs are the key agents of change in a market economy and by introducing new products and services and by penetrating new markets undermine one of the conditions necessary for perfect competition to become a reality and to continue for an indefinite period of time, that is a homogenous product or service. Indeed, perfect competition is impossible because it is absolutely incompatible with entrepreneurship. Further, for many years society and the government have acknowledged the importance of innovation and have protected the entrepreneur by awarding copyrights and patents, and by holding legally liable those who do not respect the entrepreneur's right to any profits that are associated with the commercial use of those copyrights and patents.²

*Schumpeterian economists assert that **competition is driven by innovation as well as prices**. The firms that survive in the long run are the ones that innovate; excess profits are the reward for their risk-taking entrepreneurship. In other words, the dominant social values in America assure that virtually every firm operates in an imperfectly competitive market. Even mainstream economists affirm that innovation plays a competitive role when they enter the product market with their own economics textbooks which invariably are touted by their publishers as different and better than the competition. Their textbooks never are marketed to instructors of economics on the basis of price.*

¹ The marketplace practice of charging different customers different prices for the same product or service when those differences are not justified by differences in the cost of production.

² For more detailed information on patents, including international patents and design patents, see uspto.gov.

REVIEW SECTION: TOPIC 16

Central Concepts:

- principle of profit maximization
- efficiency
- competition driven by price
- homogenous product
- entrepreneurship
- competition driven by innovation
- heterogeneous product
- price discrimination

Important Questions:

- What is the Schumpeterian perspective as to the relative merits of perfect competition vs. monopoly, oligopoly, and monopolistic competition?
- In what sense would a student of Schumpeter argue that perfect competition is inferior to monopoly, oligopoly, and monopolistic competition?
- Do private firms typically follow the mainstream model and compete on the basis of price or do they follow the Schumpeterian model and compete on the basis of price and innovation?

(continued on following page)

True/False:

- a. In the main, there is no difference between mainstream economics and Schumpeterian economics regarding perfect competition as the standard of excellence.
- b. As in so many other areas of human endeavor, competition is not strictly a matter of either price alone or innovation alone. Rather is it a matter of both price and innovation.
- c. Price in general under perfect competition is lower than any of the other types of market structure.
- d. Firms under conditions of perfect competition generally operate more efficiently than any other type of market structure.

Mark your answer below.



- Item a is true, items b, c, and d are false.
- Items a and b are true, items c and d are false.
- Item a is false, items b, c, and d are true.

TOPIC 17

THE INDUSTRIAL COMMONS AND OTHER WORKPLACE REGIMES

To describe the seven workplace regimes in which human material need is more salient than property rights, personal rights, or organizational types such as sole proprietorship, and address the characteristics of the industrial commons.

Mainstream economics views the workplace from the perspective of property rights, maximum efficiency, and profit maximization. Economic resources are depicted as human and nonhuman and both are represented as instrumentalities. To the extent that “person” has any relevancy, it is in terms of the long-standing fiction that the corporation is a “legal person.”

Management and control of the workplace turn on the question Who owns the firm? In the extreme, owner control of the workplace is absolute, even when the day-to-day management is handed over to professionals. Conventional economics envisions the workplace implicitly as enclosed space. Since there are no living, breathing, existential actualities in that space, only economic agents, there is no human material need and therefore no requirement to take that need into account.

If human material need actually is admitted as, for example, in a discussion of human poverty, conventional economics addresses it through the “invisible-hand” argument. Thus, there is no requirement to become personally responsible either as an individual or through a private or public group for another person's unmet material need.

Personalist economics, while affirming the problem of unmet human material need and the inadequacy of the “invisible-hand” solution, does not provide a single paradigm as to how the workplace is to be reconstructed in order to meet that need. Walter Adams,¹ for example, defines the problem in terms of “a new paradigm which recognizes the dominant role of the giant corporation, the giant trade union, the giant state in the social decision making process” -- and the ways in which the first two protect themselves from the forces of Schumpeterian creative destruction by building private shelters and use the third to build public shelters for the same purpose. William Dugger defines the problem similarly, but Dugger's giantism encompasses the corporation only.

Government has many shortcomings, to be sure, but it is not the primary source of our economic ills. The source lies elsewhere: in the world of the giant, conglomerate corporation.²

The values corrupting us are products of corporate hegemony, not of welfare statism.³

¹ Walter Adams, “Economic Theory and Economic Policy,” *Review of Social Economy*, April 1982, pp. 1-12.

² William Dugger, “The Continued Evolution of Corporate Power,” *Review of Social Economy*, April 1985, pp. 1-13.

³ William Dugger, “Emulation: An Institutional Theory of Value Formation,” *Review of Social Economy*, Summer 1989, pp. 134-154.

*Social economists Severyn Bruyn and David Ellerman are more focused on the workplace. Bruyn has fixed his research on worker self-management but several years ago was not convinced that managing the workplace in that fashion is key to solving the problems of the economic order. Bruyn's research ranges well beyond the United States and therefore his conclusions do not necessarily apply across the board to the United States. en so, Bruyn appears to support industrial democracy: "Based on self-managing principles, studies may show how to structure companies in **the private sector** to operate in **the public interest**"¹ (emphasis in the original).*

Bruyn seems to be more optimistic about the positive effects from self-management.

Firms moving toward higher levels of self-management have the potential to be more productive and efficient, to reduce absenteeism and labor turnover, to curb the extent of tardiness and sickness among employees, and to reduce pilferage. Further, they provide the best structure for employees to develop a sense of purpose and meaningfulness in their work, and have the potential to save money and increase efficiency by reducing the corporate costs of middle management, and the multiple costs of bureaucracy. Finally, the evidence suggests that self-managed firms may lead to fewer social problems locally and a consequent lessening of the financial burden on government and ultimately the taxpayer²

For Ellerman, the question is not Who owns the firm? It is, instead, Who can claim the whole product of the workplace? Ownership of the means of production or ownership of the firm does not determine who is entitled to appropriate the whole product because capital goods can be hired by labor³ just as labor is hired by capital owners. Ellerman denies that there is a property right such as owning the firm which decides the matter. Appropriation of the whole product is determined instead by the direction of the hiring contract. If the capital-owning corporation hires labor, the corporation is the firm and the whole product belongs to the corporation. If labor hires capital goods, labor is the firm and it is labor who can claim the whole product, even when the capitalists retain ownership of the capital goods. Who it is that constitutes the firm is determined by the contract of hire and not by the ownership of property.

There are many ways to misinterpret this deceptively simple argument that there is no legal right of "ownership of the firm." ... The corporation is indeed owned by its shareholders, but there is no legal necessity for the corporation to be the "firm," to be the legal party undertaking production using the corporation's assets. If the corporation's assets are hired out instead of labor being hired in, then the identity of the "firm" changes hands -- but with no corporate shares being bought or sold. Hence the "Rulership" or direct control rights over the human activity of production using the corporate assets was not a part of the property rights attached to corporate shares. In that sense, the ownership of the

¹ Severyn Bruyn, "The Community Self-Study: Worker Self-Management Versus the New Class," *Review of Social Economy*, December 1984, pp. 388-412.

² Severyn Bruyn, *A Future for the American Economy: The Social Market*, Stanford: Stanford University Press, 1991.

³ David Ellerman's "Property Appropriation and Economic Theory," in *The Reconstruction of Economic Theory*, Philip Mirowski (editor), Kluwer-Nijhoff Publishing, Boston, 1987 defines labor as "the humans involved in production" and "the people working in an enterprise." Thus, he includes all employees, whether white collar or blue-collar.

corporation does not include a so-called "ownership of the firm".¹

Capital goods and natural resources cannot be legally responsible for the used-up inputs and for the produced outputs because neither factor is capable of acting. Labor alone is responsible in this sense because only human beings are capable of transforming resources into goods and services. Thus, labor alone "should have the legal liability for the used-up inputs and the legal ownership of the produced outputs" (see footnote 2 below).

Further, according to Ellerman, the employment contract is a form of slavery because by removing labor's responsibility for the fruits of the workplace the contract legally transforms labor from person to non-person or thing. Such a contract per se is fraudulent and invalid because persons cannot be transformed into instrumentalities and employees therefore cannot legally transfer responsibility to employers.

The employee is in fact not a conduit of responsibility; the employee inexorably remains a de facto responsible person. The employees, together with any working managers/employers, are de facto co-responsible for the results of their action.²

In what follows a somewhat different question is raised, that is How does human material need intersect with the ownership, control, and management of the workplace? In addressing this question, it is instructive to view the workplace as if it were simply a valuable natural resource which, following Bromley,³ initially can be classified as private property, state property, common property, and open-access or no one's property.

*As to the industrial order, however, there appear to be seven rather than four types which, also following Bromley, are called herein "regimes" to underscore that all seven are human developments reflecting different social values, organizing principles, and ideologies. "Regime" has more appeal than "paradigm" because "paradigm" suggests a **single** model that represents a permanent, clear-cut, and irreversible break from the past whereas "regime" implies **several** human structures which may co-exist in the same socio-economic order.*

There are two components to human material need: physical need and the need for work as such. The latter embraces both the need to belong and the need for self-expression. The former includes any good or service that is a requirement for human existence and for daily functioning, while a

¹ David Ellerman, "The Employment Contract and Liberal Thought," *Review of Social Economy*, April 1986, pp. 13-39.

² David Ellerman, "Property Appropriation and Economic Theory," in *The Reconstruction of Economic Theory*, Philip Mirowski (editor), Boston: Kluwer-Nijhoff Publishing, 1987.

³ Daniel Bromley, "The Commons, Property, and Common-Property Regimes," in *Making the Commons Work: Theory, Practice, and Policy*, Daniel W. Bromley (general editor), San Francisco: ICS Press, 1992.

want is a good or service that is desired for some other reason. Need and want are dealt with differently in the seven workplace regimes briefly described below.

The balance of this topic is organized into two main parts. The first describes each one of the seven workplace regimes in which human material need is more salient than property rights, personal rights or organizational types such as the sole proprietorship, the partnership, or the corporation. The second describes the attributes or characteristics of the industrial commons, drawing upon Oakerson's framework for analyzing the natural-resource commons. Some concluding remarks follow.

Private-individual regime. Under this regime, economic resources are owned, controlled, and managed by private individuals primarily for the purpose of satisfying the self-determined wants of the owners and meeting their self-determined need. The benefits that are produced by these resources are claimed by the owners as a property right. The wants and need of others such as workers, suppliers, customers are admitted not as ends in themselves but as means toward furthering the want satisfaction and need fulfillment of the owners.

In the extreme, this regime is similar to the slave-state regime (see below) in that humans are reduced to mere instrumentalities. However, the human carnage is much greater in the slave-state regime because of the state's far greater powers of oppression. The private-individual regime is a reflection of the strict individuality of human nature and is based primarily on the foundation of individualism, with its accentuation of self-interest. Further, the pursuit of self-interest also serves the common good through the "invisible hand" of the market.

Economic affairs are organized almost entirely on the actuating principle of competition. Other regimes, with their different views on ideology and social values, may be tolerated.

Democratic-state regime. Economic resources are owned, controlled, and managed by the state to meet the need of private individuals that they are unable to meet at all by themselves or meet sufficiently without some help. The amount of need to be met by the state is determined by democratic processes, guided by the principle of subsidiarity and the primacy of the individual whom the state was established to protect and assist.

This regime perceives human nature in terms of a duality -- individual being and social being. It rests chiefly on the foundation of a communitarian ideology such as humanism.

Economic activity is energized by all three organizing principles -- competition, cooperation, and intervention -- but the way they are blended differs from one time to the next and from one state to another. Other regimes likely are accepted.

Dominant-state regime. In this regime, economic resources are owned, controlled, and managed entirely by the state to meet the need of private individuals as determined by the state, guided by the social value of equality and the greater wisdom of the ruling elite. This regime visualizes humans as social beings only and is based on a collectivist ideology such as communism. In the extreme, affairs

in the economic order are ordered entirely by the limiting principle of intervention.

Production problems arise because this regime rejects competition on ideological grounds and redefines cooperation to mean subordinating the individual to the state. Other regimes, with their different ideological and social-value emphases, are not tolerated.

Slave-state regime. *Economic resources are owned, controlled, and managed entirely by the state for the state's own purposes. Human beings as workers are treated no differently than nonhuman economic resources. Humans are recognized neither as individual beings nor as social beings. Rather, they are reduced to mere instrumentalities by means of a slave ideology such as racism.*

The need of the slaves is met typically at a level below subsistence. Wants are dismissed as wasteful and irrelevant. The good of the state, which may be represented in such propagandistic words as the "fatherland," is installed as the dominant social value but never is determined by democratic processes. A ruling elite, instead, makes this determination, at times substituting their own individual good for the good of the state.

Economic activity is organized by the coercive power of the state. As with the dominant-state regime, production problems develop for the same reason: without competition and authentic cooperation, there is no actuating or energizing principle, other than the brute force of the state, organizing economic matters. Other regimes are not tolerated and routinely are destroyed.

Private-commons regime. *Economic resources are owned by private individuals but are controlled and managed in common to satisfy the wants and to meet the need of private-individual workers and owners which they, all alone, are not able to satisfy/meet at all or satisfy/meet adequately under other workplace regimes. The amount of need to be met in common is determined by the workers and the owners through an agreement whereby the property rights of the owners are subordinated to the need of both parties.*

Other implicated parties such as customers and suppliers are accepted more so as ends in themselves than as instrumentalities for the wants satisfaction and need fulfillment of the workers and the owners. The need of customers and suppliers is incorporated in the concerns of the workers and owners if for no other reason than the financial viability of the business enterprise depends critically on meeting their need.

This regime affirms the duality of human nature and rests mainly on a communitarian ideology such as personalism. Economic affairs are organized chiefly by a blending of the actuating principles of cooperation and competition. Other regimes, however, are permitted. One major risk in this regime is the corruption of cooperation into collusion which transforms it into a private-individual regime with potential for disregarding human need.

Worker-owner commons regime. *Economic resources are owned, controlled, and managed in common to satisfy the wants and to meet the need of individual worker-owners which they, all alone, are not able to satisfy/meet adequately under other regimes. The amount of need to be met in*

common is determined by the worker-owners. As with the private-commons regime, customers and suppliers are acknowledged more for themselves than as instrumentalities and their need is addressed for the same reason: the financial viability of the enterprise depends on meeting their need too.

This regime is based principally on a communitarian ideology such as humanism or personalism and the duality of human nature. Both cooperation and competition are used to energize economic life. Other regimes, with their different views of reality, are permitted. As with the private-commons regime, there is a risk that cooperation will be corrupted into collusion with the same negative consequences.

Due to the dominant role of the corporation in the U.S. economy, some mention of this organizational type in the context of the various workplace regimes is in order here. The private corporation can function within the worker-owner commons regime, the private-commons regime, or the private-individual regime. Much depends on whose material need is addressed and whose is excluded. To illustrate, a private corporation founded, owned, managed, controlled by an extremely individualistic, self-centered person who uses others for personal gain would be classified under the private-individual regime. The same business could be re-classified as an industrial commons through, say, a profound change of heart on the part of this person or by a change in the ownership, management, and control of the business which could occur with the death of the founder.

The public corporation can function under either type of commons regime. However, due to the separation of ownership and control, it cannot function under the private-individual regime. More is said about the public corporation in the following sub-section on the open-access regime.

Open-access regime. *Whether ownership is in private hands or the hands of the state, economic resources are controlled and managed by no one. There are no effective limits that self-serving users respect in utilizing these resources. As a consequence and in spite of the “invisible hand” of the market, natural resources are squandered. In the case of the natural-resource commons, this lack of restraint leads to what some refer to as the “tragedy of the commons.” By its very nature as a publicly-traded business enterprise, the public corporation may be forcibly dismantled as a commons by outside interests and reconstructed by them into open-access. To illustrate, institutional investors who demand short-term financial performance at the expense of long-term development and corporate raiders are capable of precipitating the same type of tragedy in the industrial order when they disregard the limits on appropriation that hold the public corporation together. “Taking the corporation private” effectively closes access to some of the abusers.*

The dominant social value in the open-access regime is unbounded freedom which serves only individual self-interest and in that regard it is akin to the private-individual regime. Cutthroat competition actuates economic affairs. At times, collusion is used to organize economic affairs but collusive agreements tend to dissolve due to the additional benefits available to the self-serving individual member who breaks the agreement.

Libertarianism is the central ideology. In the extreme, this regime reduces to anarchy as would happen, for instance, at a high-use public airport without air traffic controllers. Other regimes cannot exist under anarchy; neither can the open-access regime.

Attributes That Make an Industrial Workplace a Commons.

Oakerson¹ argues that there are eight specific attributes of the natural-resource commons: jointness, exclusion, indivisibility, operational rules, conditions of collective choice, external arrangements, reciprocity, and outcomes. It is our argument that, with certain modifications, those eight specific attributes also characterize particular industrial workplaces which, as a consequence, can be thought of as industrial commons. As pointed out in the last section, there are two commons regimes in the industrial order: the private-commons and the worker-owner commons. In what follows, there is no need to differentiate further between these two types.

Oakerson's descriptors for the eight specific characteristics of the natural-resource commons have been modified to apply to the industrial commons. We refer to them below as: joint use, limited access, optimal scale, workplace rules, collective internal control, external control of decision-making, cooperative spirit, and central purpose. Each is addressed in turn. Much of what follows derives from several years experience participating in on-site assessments of more than 40 companies in Louisiana for their quality- and productivity-improvement efforts or for their innovational activities in the product market.

Joint use. *“Jointness” was introduced to describe the special case of a pure public good in order to differentiate it from a private good. In the case of a pure public good, one individual's use does not subtract from the use of others, whereas with a private good use by one person shuts off use by anyone else.*

In the case of the natural-resource commons, jointness does not denote complete nonsubtractibility because clearly the bounty of nature is not a pure public good: what one individual uses is unavailable to others. Jointness in the natural-resource commons means that some limits must be established to align use with nature's bounty in order to keep the commons from being stripped bare. Jointness means that in the natural-resource commons use by various individuals must be constrained by the natural replenishment or maintenance of the resource. In the natural-resource commons, jointness really means nondepletion rather than nonsubtractibility.

In an industrial workplace joint use means that some limit on human beings using other humans has been established in order to maintain the “fertility” of the industrial commons. In other words, one person is able to derive benefits from the workplace without taking those benefits away from others in zero-sum fashion. Joint use can be promoted in the industrial commons by positive-sum practices such as gain-sharing and other productivity-grounded compensation methods which do for the delicate human ecology of the industrial workplace what conservation practices do for the fragile

¹ Ronald Oakerson, “Analyzing the Commons: A Framework,” in ***Making the Commons Work: Theory, Practice, and Policy***, Daniel W. Bromley (general editor), San Francisco: ICS Press, 1992.

eco-system of the natural-resource commons. Indeed, such practices are commonplace in the industrial workplace where currently they are referred to as “win-win” routines.

Just as nondepletion is a necessary condition for the natural-resource commons to continue to yield its bounty year after year, joint use is a necessary (but not sufficient) condition for an industrial workplace to function effectively as an industrial commons. In an economic order where individual freedom is highly valued, including the freedom to leave one job for another, where production processes are quite complicated calling for many different skills, and where economies of scale are an essential part of doing business, we suggest that firms which understand and practice joint use are more likely than other firms to survive financially in the long run.

Limited access. *The second attribute of the natural-resource commons -- exclusion -- also relates to the difference between a public good and a private good and for that reason is akin to the first attribute. In the case of a private good, potential buyers are excluded for using the product or service unless they have paid for it. With a public good, exclusion is not possible.*

Exclusion is the opposite of open access and given the potentially devastating effects of open access the natural-resource commons typically has an access-control problem. With jointness, limits are imposed on use itself; with exclusion, limits are placed on the number of users. Exclusion can be implemented by denying access either (1) to selected individuals whether they are members of the immediate community or not or (2) to everyone who is not a member of the immediate community. The number of users can be increased as the natural bounty of the commons permits.

The industrial workplace is a commons in the sense that access is limited by the hiring process and by the terminating process. As with the natural-resource commons, more (fewer) persons may be employed as the profitability of the firm rises (falls). Historically there have been many instances in which access to the industrial workplace has been limited arbitrarily according to a person's sex, nationality, race, religion, disability, and so forth. Equal opportunity and affirmative action are attempts to eliminate certain arbitrary methods of implementing limited access.¹

Optimal scale. *A third attribute of the natural-resource commons is indivisibility which means that the commons is of such physical dimensions that it cannot be divided among private property*

¹ Critics have branded affirmative action as another form of limited access that is instituted arbitrarily. Both advocates of affirmative action and its critics are wrong in the sense that both assess it globally, the one judging it universally good and the other judging it universally bad. A proper assessment is done only on a case by case basis through the application of the principle of the double effect. To illustrate, the principle of the double effect applies whenever an affirmative-action hiring decision has two effects, one that is morally good -- hiring a person who is a member of some group that has experienced discrimination in the past -- and one that is morally bad -- passing over an equally-qualified or even better-qualified person (or persons) who is not a member of that group. Accordingly, the decision to hire is ethically correct provided (1) the good effect is greater than the bad effect; (2) the bad effect is not willfully intended; and (3) the good effect does not follow from the bad effect but both effects proceed directly from the hiring decision. In terms of the fourth requirement of the principle of the double effect -- the action itself cannot be morally bad, lest the end be taken to justify the means -- the hiring decision clearly passes ethical scrutiny.

holders without impairing its bounty either by permanently impeding some of the forces of nature or by installing management systems that because of the reduced scale of operations are redundant and wasteful. Oakerson allows that, while there may be some ambiguity as to the precise physical boundaries that define a natural resource as indivisible, there is no ambiguity as to central role of boundaries in defining a natural-resource commons.

What we call “optimal scale” in the industrial order is the equivalent of indivisibility in the natural order. Optimal scale refers to a scope of operations such that any scaling down or scaling up renders the enterprise less productive. Optimal scale means operating with a plant size that achieves the lowest unit cost.

Conventional economics asserts that in the long run the forces of competition inexorably sweep the firm along toward its optimal scale. That being the case, the more competitive the marketplace is for a given enterprise, the more efficient becomes its workplace and the more likely it is to be classifiable as an industrial commons.

However, if one is inclined toward a Schumpeterian perspective, the “perennial gale of creative destruction” blows across the industrial commons with effects similar to a tornado roaring across the natural-resource commons. Optimal size, in other words, is highly problematical in the industrial order because of the rapid and continuous change taking place in products, services, resources, processes, markets, and structures for organizing work. We suggest, therefore, that at any point in time relatively few firms achieve optimal scale and therefore **actually are** an industrial commons. Nevertheless, with the passage of time, many firms reasonably are moving toward optimal scale and in that sense **are becoming** an industrial commons.

Workplace rules. Oakerson refers to the fourth attribute of the natural-resource commons as “operational rules” by which he means the specific limits put in place to protect the commons from overuse. In this regard, less subtractive uses are preferred to others that are more subtractive; compatible uses are favored over conflicting uses. In the natural-resource commons, specific limits relate to duration and type of use, along with the amount that can be appropriated under different uses.

Workplace rules do for the industrial workplace what operational rules do for the natural-resource commons. By stipulating how the work is to be done, work rules help limit the extent to which one person, particularly one who is strong, is able to use another, especially one who is weak, for personal gain.

Examples of such rules abound. For instance, on a unionized construction workplace, there are detailed rules governing which trade is to perform which tasks such as the installation of aluminum studs and how many persons are to be used in handling certain materials such as plastic pipe versus cast iron pipe. For commercial airline crews, there are specifics governing the use of alcohol before reporting to work and mandating both the maximum number of hours of continuous work and the minimum number of hours of rest between work assignments. To the extent that such rules contribute toward the efficiency of the work force and the orderliness of the workplace, the industrial

workplace is truly a commons. To the extent that work is created artificially by means of so-called make-work rules or “featherbedding” practices or that authentic rules are routinely violated, the industrial workplace is not a commons. The key difference is whether the work is consistently rationalized or not. If it is, the workplace is a commons.

Collective internal control. *The next attribute which Oakerson identifies with the natural-resource commons is what he calls “conditions of collective choice.” This attribute means that choices as to how the natural-resource commons is to be used are made by persons acting not as atomistic individuals but as members of the collective.*

Collective choice is governed by four main considerations: (1) the ability of the individual user to accommodate self-interest to the interest of the other users; (2) the remedies available to the individual user who is harmed by the actions of other users; (3) the willingness of the individual user to adapt his/her behavior to the collective decision; and (4) the opportunity for the individual user to stymie collective decision-making by means of a veto. These considerations raise a host of questions including the following. Is coordination voluntary or is it achieved through regulatory authority? What is the relationship between use rights and ownership? In what forum can disputes be settled and on what legal grounds?

In the industrial workplace, the first consideration addresses the extent to which a person is able to accommodate his/her individuality and sociality. Some of this is determined by the management's ability to identify and hire the kind of person who is able to fit into the company culture and to alter the culture in order to convince and help their individual employees to come together as a group or team. Some of this is determined by the individual and depends greatly on the life experiences of that individual. Some of this may be driven by market forces that bring the management and the employees to a realization that the survival of the company depends on each individual's ability to take into account the concerns of others. One general method currently in use in the industrial workplace to accomplish this purpose is the practice of seeing a fellow employee as a customer.

As to the second consideration, the industrial workplace has available numerous internal systems, some formal, others informal, for addressing the problem of any harm that may befall one employee at the hands of another. To enumerate several: the suggestion box, the open-door policy of the chief executive, the town-hall meeting, the grievance process, the ombudsman.

The third consideration is closing related to the first in that any deficiency with regard to a person's ability to take into account the interests of others makes the task of adapting individual behavior to the collective decision more difficult. Opportunities for meaningful participation in the decision-making process by the individual, along with the information and the authority needed to act effectively, are key to bringing the need of the individual into congruence with the purposes of the group. The quality circle is one mechanism for achieving such congruence as is the regular meeting for an operating unit. Another is creating a teamwork environment by such outside activities as a company-sponsored picnic or softball team and company participation in, say, the local Christmas parade. Others techniques include issuing company uniforms and explicitly linking some rewards and recognition to group performance as opposed to individual performance.

The fourth consideration is a problem in virtually every workplace in that every employee has some opportunity to frustrate the will of the group either overtly or covertly. An openly hostile and aggressive individual may be able to intimidate other members of the group to the point where they do not implement what has been decided collectively. A passive-aggressive person may be able to set in place barriers to the implementation process either stalling group action or completely frustrating it. The key question is not so much whether such a veto is available as whether the individual is willing to use it. Accordingly, the fourth consideration is an important matter largely to the extent that there is a failure to deal with the third consideration successfully.

Given the complexities involved in managing these four considerations effectively, it is problematical indeed as to whether a given industrial workplace, at any given time relative to the attribute of collective internal control, is actually classifiable as a commons. Only an on-site assessment would suffice to make the required determination. Additionally, a given workplace may at one time exhibit this attribute and at some other time may not, especially with different employees and senior managers.

External control of decision-making. *The sixth attribute that Oakerson associates with the natural-resource commons is “external arrangements” which refers to decision-making arrangements that are external to the commons. These arrangements may be constitutional, legislative, or bureaucratic, in that the natural-resource commons may require a change in the (state) constitution to permit it to exist, new legislation to let it operate, or the oversight of a rules-making bureaucracy in order to function on a day-to-day basis. Oakerson enumerates two other types of external arrangements -- one that is conflict resolving and the other is economic. By conflict resolving is meant third-party arrangements, such as courts of law, to resolve disputes between and among users. External arrangements in the economic order refer to the competitive forces of the marketplace that effectively set parameters within which the commons is required to operate in order to survive.*

All five types of external arrangements apply in straight-forward manner to the industrial workplace. A start-up firm first must establish itself in the eyes of the law as a sole proprietorship, partnership, corporation, or not-for-profit organization. A vast, changing, and continuously growing set of local, state, and federal statutes, such as building codes, health and safety regulations, and wage and hours laws, provide direction to and set parameters for decision-making in the industrial workplace. Typically these statutes are backed by a bureaucratic enforcement arm. As to external control of decision-making in the area of conflict resolution, note the impact of such federal agencies as the Equal Employment Opportunity Commission and the Federal Mediation and Conciliation Service. The role of competition in organizing the industrial workplace is so well known and documented that no further elaboration is required here.

Cooperative spirit. *“Patterns of interaction” is the term Oakerson gives to the seventh attribute of the natural-resource commons. By it he means the patterns regarding the choices made by the individual members of a group. These patterns develop in the context of the physical characteristics of the commons and of the relevant technology along with decision-making arrangements available to determine how the commons is to be used.*

In a natural-resource commons, individual restraint is necessary to preserve nature's bounty. In an ordinary exchange between an individual buyer and an individual seller, the burdens and the benefits for both parties generally occur simultaneously with the actual exchange itself in quid pro quo fashion. In other words, for the burden assumed by each party a direct benefit is returned by the other party. This quid-pro-quo reinforcement of reciprocity is absent in a natural-resource commons in that the burden of restraint practiced by the individual user supplies benefits to other users with no immediate benefit returned to that individual user who, in turn, derives benefits at some later date from the burden of the restraint practiced by the other users.

In managing the natural-resource commons, the challenge is to eliminate the “free-rider” -- the user who receives benefits without assuming the burdens of using the commons -- because such users plunder and ultimately destroy the commons. Concealment, deceit, intimidation, threats, and violence are symptomatic of a breakdown of reciprocity in the natural-resource commons.

In the industrial workplace, “cooperative spirit” is more descriptive of the required pattern of interaction between and among individuals than is “reciprocity.” Cooperative spirit means a disposition on the part of the individual to undertake certain tasks through collective action because the task cannot be completed at all or as well through individual action alone. As with the natural-resource commons, restraint is a requirement because unrestrained competition depletes the bounty of the industrial commons.

The operative social value that enables the cooperative spirit to flourish in the industrial workplace is teamwork. However, too much cooperation and too little competition dampens the creativity and entrepreneurship of the individual, robbing the firm of its edge in the marketplace. Too little cooperation and too much competition, on the other hand, expose the commons to the excesses of the “free-rider,” robbing it of some of its bounty. For workplace supervisors, the especially difficult task is blending the cooperative spirit and the competitive spirit, both of which energize the work process, in ways that are mutually reinforcing rather than mutually debilitating.

One method to accomplish this blending in the manufacturing workplace is to organize all of the assembly and sub-assembly work around both (1) teams whose members must cooperate in order to finish the work successfully and (2) two or more assembly lines that are encouraged to compete with one another to determine which is performing the best work with the least waste of resources. Another is to deliberately organize work and structure worker compensation so that two regular paychecks are issued. One is based on individual contribution as measured, for instance, by number of hours worked by the individual employee. The other is based on collective contribution as measured, for example, by decline in unit cost of the finished product.

Central purpose. *Oakerson refers to the eighth and last attribute of the natural-resource commons as “outcomes” by which he means “physical outcomes subject to human evaluation.” He affirms that the study of outcomes is value-laden and that efficiency and equity, most commonly, are the proper evaluative criteria.*

In the natural-resource commons, Oakerson defines efficiency in terms of overall rate of use. Inefficient use of the commons may take one of two chief forms: overutilization (an open commons) and underutilization (a closed commons). He defines equity in terms of distributive justice: Are individuals getting a fair return on their contribution? Inequity, he argues, undermines reciprocity which in turn leads to inefficient use of the commons. Pareto-optimality is recommended as the appropriate way to operationalize both the concept of efficiency and the concept of equity.¹

To a large extent, the central purpose of the industrial commons is no different than what Oakerson has proposed for the natural-resource commons, although our language differs: to meet human physical need, satisfy human physical want, and meet the need for work as such. Meeting human physical need and satisfying human physical want are embraced by Oakerson's efficiency plus equity under conditions of Pareto optimality.

However, meeting the need for work as such, that is the need to belong and the need for self-expression, is not contained within Oakerson's description of this attribute of the commons. In conventional economics with its deep foundations in positivism, need is an alien concept because it is value-laden and embracing it suggests that economics truly is a normative discipline. Thus, any topic such as poverty, which to even the introductory student clearly pertains to consumption, is discussed independently of consumer behavior. In addition, there is virtually no examination of the need for work as such even though, in the commons especially, the need to belong is self-evident.

The problem lies within conventional economics itself. Mainstream economists have contrived a view of human beings -- want-satisfying, utility-maximizing, privacy-protecting, commodity-acquiring -- to reinforce their claim that economics is a positive discipline which by virtue of its greater rigor, they assert, is superior to normative economics. Perhaps this heavy-handed bias within conventional economics accounts for why Oakerson does not include the need to belong as one of the central purposes of the commons.

Concluding Remarks.

Viewing the workplace as a collection of inert physical assets which under private ownership are held for the purpose of maximizing the rate of return to the owners is a perspective on the workplace that is most popular among mainstream economists. This view asserts that property rights are dominant.

Another view of the workplace is a collection of inert physical assets which, ownership notwithstanding, are under total control of the workers who by virtue of their labor are entitled to appropriate the whole product. This position argues that property rights are subordinate to personal rights. It has little following in economics.

Personalist economics views the workplace as a set of resources which, as with a natural-resource commons, yield more or less product (bounty) depending on how skillfully the organizing principles

¹ Pareto optimality is achieved when economic resources and output are allocated in such a way that no one can be made better off without making someone else worse off.

of competition and cooperation are blended. Here, the general purpose is not to maximize profits but to meet human material need and to satisfy human wants. Just as sustainability is a necessary condition for a viable natural-resource commons, profitability is necessary in a functioning industrial commons. In this perspective, property rights and personal rights are subordinate to human material need and wants.

The need/want perspective allows us to factor into our economics a more complete definition of human nature than one finds in conventional economics: clearly, want satisfaction and profit maximization are not the entire story. Further, and perhaps more importantly, it allows us insights into recent economic and financial phenomena which otherwise might not occur to us.

For example, systematic initiatives to raise productivity and to enhance quality by installing programs that make explicit use of the organizing principle of cooperation then may be seen as efforts to raise the bounty of the workplace and in so doing change it in the direction of or further develop it as an industrial commons. Leveraged buyouts and hostile takeovers may be seen as attempts to render the workplace into an open-access regime which too often lead in like fashion to the “tragedy of the commons.” Money managers with large institutional funds to invest and with very short time horizons may be seen in the same light as leveraged buyouts and hostile takeovers. “Taking a corporation private” then is an attempt to close the commons to external control that otherwise might strip the commons bare. Innovation in the industrial order is the equivalent of a new use for the natural-resource commons. Both put at risk the capacity of the commons to meet human material need and to satisfy human wants.

Mainstream economics glosses over unmet human material need especially as regards to how resources are (re-)allocated in a market economy. The conventional wisdom is that resources are (re-)allocated by means of price signals. A deeper probing of the (re-)allocation process reveals that it is unmet human material need in addition to relative prices that (re-)allocate economic resources. Thus the dilemma as to how to met human material need in a market economy.

The reconstruction of the modern workplace is better represented as an attempt to deal with the problem of unmet human material need in an environment which in practice is competitive more so than cooperative and preoccupied with self to the neglect of others. The key to changing the argument from one of property rights or personal rights to one of need is to see that rights derive from need and that rights are means to accomplishing the end of meeting human material need. As with the pre-industrial agricultural commons which was characterized by a “hierarchy of rights, one above another,”¹ the modern workplace is a hierarchy of rights deriving from the need of various human beings who use the workplace to meet that need.

¹ Marc Bloch, “The Rise of Dependent Cultivation and Seignorial Institutions,” in *The Cambridge Economic History of Europe*, M.M. Postan (editor), Volume I, second edition, Cambridge: The Cambridge University Press 1966.

This reconstruction means a balance must be struck between competition and cooperation as organizing principles and more fundamentally between individual freedom and community, the social values underpinning competition and cooperation respectively. As stated previously, too little cooperation and too much competition, expose the commons to the excess of the “free-rider,” robbing it of some of its bounty. Moreover, too much cooperation and too little competition dampen the creativity and entrepreneurship of the individual, robbing the firm of its edge in the marketplace. More and more U.S. enterprises, it seems, are discovering that functioning in effect as an industrial commons is one way to remain operational in a global economy where order, stability, security, and tranquility are greatly esteemed but only intermittently attained.

REVIEW SECTION: TOPIC 17

Central Concepts:

- mainstream economics view of the workplace
 - personal rights subordinate to property rights
 - competition to achieve maximum efficiency
 - main goal is profit maximization
- personalist economics view of the workplace
 - personal and property rights subordinate to main goal of meeting need, satisfying wants
 - organized by competition and cooperation
 - profits necessary to sustain the business
- workplace regimes
 - private-individual
 - democratic-state
 - dominant-state
 - slave-state
 - private-commons
 - worker-owner commons
 - open-access
- attributes of the industrial commons
 - limited access
 - optimal scale
 - workplace rules
 - collective internal control
 - external control of decision-making
 - cooperative spirit
 - central purpose

Important Questions:

- According to mainstream economics, who owns the firm?
- Who can claim the whole product of the workplace? The owners? The workers? The management?
- In what ways does an industrial workplace resemble a natural-resource commons?
- According to personalist economics, what is the more important goal of the firm?
 - Maximizing profits? Meeting need, satisfying wants?
- In your judgment, which rights – property rights or personal rights -- are more important?
- Why does the “free-rider” constitute a threat to the commons?

(continued on following page)

True/False:

- a. The workplace may be thought of as an industrial commons where property rights and personal rights co-exist. The commons expands as more and more personal rights are afforded the workers to participate in control of decision making. The commons contracts as more and more property rights are asserted restricting control of decision making to the owners, directors, and senior managers.
- b. Profitability is to the industrial commons what sustainability is to the natural resource commons.
- c. In organizing the workplace, mainstream economists view personal rights as more important than property rights.
- d. In a slave-state regime, economic resources are owned, controlled, and managed entirely by slaves.

Mark your answer below.



_____ Item a is true, items b, c, and d are false.

_____ Items a and b are true, items c and d are false.

_____ Item a is false, items b, c, and d are true.

TOPIC 18 HUMANNESS, PERSONHOOD, AND THE ACTING PERSON

To address humanness and personhood, examine the three levels of human action and what it means to *be* rather than to *become* a human person, and discuss how virtues and vices change a human being into an *acting person*.

*The **acting person** carries out such uniquely economic activities as producing, distributing, exchanging, consuming, saving, investing, credit-creating, lending, borrowing, innovating, developing, and (re-)vitalizing. In this topic, however, we are concerned with what it means to be a person, a living, breathing, existential actuality. Understanding more fully the meaning of personhood helps in understanding the role of the **acting person** in economic affairs.*

Humanness and Personhood.

*Whether by union of male and female or by cloning, human beings bring into existence other humans and in that sense all humans are contingent beings. Contingent beings are constituted of an actuating principle that defines them for who/what/whose they are and a limiting principle that defines them for who/what/whose they are not. In accordance with the actuating principle, they are persons because they are living, breathing existential actualities, made in the image and likeness of God, and therefore very nearly divine. They are fully individual beings and at the very same time fully social beings, neither one being diminished by nor subordinated to the other. Fifty years ago, John Maurice Clark rejected the strict individuality of **homo economicus** as avowed by mainstream economics, affirming instead human duality in these words:*

Man has a dual nature, individual and social; and however much individuals differ in their relative emphasis on these two sides, none is a whole man in whom either side is completely repressed.¹

They are, as well, body and spirit, the one no less than the other. They are creatures whose very nature demands that they be free to act, at times rationally, at other times emotionally. They are therefore self-determining, and remain persons as long as they live. Crosby combines both principles in the following:

For we will think that, given the depth and intimacy of our embodiment, the only safe assumption is that a new human person begins to exist as soon as a new human body is formed, and continues in existence as long as the body is alive.²

If we regard any human being as an object with only instrumental value, his/her personhood in a certain sense is denied. To illustrate, slaves are not considered persons because they have been

¹ John Maurice Clark, *Economic Institutions and Human Welfare*, New York: Alfred A. Knopf, 1957, p. 118.

² John F. Crosby, *Personalist Papers*, Washington, DC: Catholic University of America Press, 2004, p. 124.

reduced by others to material objects that can be bought, sold, traded, or taken. Prostitutes are not thought of as persons because they have been reduced to sexual objects for strictly commercial purposes. Suicide bombers are not viewed as persons because they have rendered themselves into instruments of death and destruction. Even so, all three still cling to their basic personhood because as long as they are living all three can be freed by human action. The slave can be emancipated. The prostitute can be convinced that sex is a gift not a commodity. The suicide bomber can be turned back by personally refusing to carry out the mission or by security forces.

The issue as to when in the very earliest stages of the life cycle a contingent being becomes a human is extremely controversial. No less controversial is the matter as to when such a being becomes a person. For instance, developmental biologist Scott Gilbert (pp. 1-17) identifies many different views on this matter which can be organized along three lines of thinking: the theological, the scientific, and the philosophical.

Nothing in economics informs us as to the exact moment in the life cycle when humanness and personhood first are present or prepares us to sort through that pressing issue. Nor is there any compelling reason to belabor that issue if one is willing to accept humanness and personhood as givens and assert that every economic agent is a human person. We, however, are not prepared to rest our case on an assertion which mainstream economics, by valuing human beings strictly as economic instrumentalities, in effect rejects out of hand. Instead, we insist that even though economic agents clearly have instrumental value they have more fundamentally an inherent dignity that makes them nearly divine. If that sacred dignity is denied for one human being it can be denied for any human being, and with that denial basic human equality is rejected. With human equality set aside, personhood can be denied to anyone who does not measure up to whatever critical value sets the standard for acceptance as a person. In the end that means that personhood is defined by those who claim to be smart enough to set the standard so precisely as to include only those who truly are persons, excluding all others, and are powerful enough and willing to enforce that standard.

Putting the elemental issue of personhood and humanness in the form of a question yields the following. Should humans be regarded as persons by virtue of who, what, and whose they are, that is in accordance with their nature, or by virtue of the value others attach to them, that is in accordance with the judgment of others? A norm of personhood and humanness that is based on human nature is an objective norm. On the other hand, a norm that is based on the value attached by others is a subjective norm. In the following, we propose that the proper norm of personhood and humanness is an objective norm.

*Our argument to the effect that all economic agents are persons rests on two propositions. First, humanness and personhood are inseparably one. Second, **becoming** a person is not the same as **being** a person. As to the first proposition, humanness and personhood are one because they originate in a contingent being at the very first moment when that being is brought into existence through the sexual union of a fertile human male and a fertile human female or cloning. This is not to say that they are fully developed human persons when humanness and personhood first are present. Fullness comes later through the normal process of growth and development.*

From the moment of fertilization every human being has all of the genetic material which he/she will ever have in his/her entire lifetime.¹ The unborn child clearly is distinct from its mother and therefore is an individual being. At the same time, he/she literally is tied by the umbilical to its mother and for that reason the unborn child is a social being. The unborn child is a sensate being, drawing back for instance from a needle inserted in the mother's womb. Moreover, the unborn child is an intelligent being in that without the mother's direct intervention, as she must in feeding the newborn infant, the unborn child takes from its mother only the nourishment necessary for growth and development, no more, no less. Also without the mother's direct intervention, the unborn child positions him/herself in the head-down position for a safe delivery.

*The unborn child, therefore, is an individual being, a social being, a sensate being, an intelligent being, not some other living creature such as a camel or cabbage, but a **human** being. Unless one is prepared to state unequivocally that the unborn child has no inherent sacred dignity and falls short of whatever standard may be used to define its basic worth as a human being, the child is a human person. Since nothing new is added after fertilization to change his/her fundamental human nature, a human being is a person from fertilization until the moment of death when he/she is reduced to dust. Thus, even though economic agents are individuals and objects in the sense that economics views them in the workplace as inputs or human resources, they are first and foremost human persons.*

*The second proposition in defense of our argument about the personhood of the economic agent is that **becoming** a person is not the same as **being** a person. To illustrate, psychotherapist Rogers asserted repeatedly in his widely acclaimed **On Becoming a Person** that a human being literally becomes a person implying that he/she, though fully a human being, at times might not be a person. Giavanola also seems to be caught in some confusion as well in using similar language though her intent is to flesh out the meaning of personhood by adding "human richness" – "... an internal multidimensionality and plurality which intrinsically characterizes each person and that every society should guarantee or at least promote."² Notice the similarities in their language.*

*... a person is a fluid process, not a fixed and static entity; a flowing river of change, not a block of solid material; a continually changing constellation of potentialities, not a fixed quantity of traits³
Such an anthropological richness ... allows us to think of human beings in a dynamic frame in which they are constantly involved in the process of 'becoming' themselves and realizing themselves.⁴*

Grisez and Shaw⁵ on the other hand understand personhood not as a problem of becoming a person

¹ Gilbert refers to this argument as the "genetic view," one of five with a basis in science. Scott Gilbert, "When Does Human Life Begin?," available at www.devbio.com/printer.php?ch=21&id=162.

² Benedetta Giavanola, "Personhood and Human Richness: Good and Well-Being in the Capability Approach and Beyond," *Review of Social Economy*, June 2005, p. 250.

³ Carl R. Rogers, *On Becoming a Person: A Therapist View of Psychotherapy*, Boston: Houghton Mifflin, 1961, p. 22.

⁴ Giavanola, p. 215.

⁵ Germain Grisez and Russell Shaw, *Beyond the New Morality: The Responsibilities of Freedom*, Notre Dame:

but one of being a person and emphatically insist on the distinction. To appreciate their argument one must first examine what they mean by the three levels of action and how each level is associated with a different type of freedom.

Human Action and Being a Human Person.

At the first level, which is associated with **physical freedom**, the action taken leads naturally to a specific outcome provided there is no physical constraint in place. The retriever has been trained and predictably fetches the downed duck unless the dog is physically restrained on a leash. The newborn baby naturally takes to its mother's breast provided it is not physically separated from its mother. At the first level, the action undertaken is very simple. For that reason, both animals and humans are capable of action at this level.

At the second level, which is associated with **freedom to do as one pleases**, the action is undertaken to achieve a specific end. At this level, two conditions must be in place: (1) the end must be desired and (2) the means employed must be sufficient to achieve the desired end. Thus, a farmer desires to plant a crop of corn in order to feed his cattle. Accordingly he tells his workers to plant corn and they carry out that task as instructed. The crop eventually matures, is harvested, and become available to feed to the farmer's cattle. Often the kind of freedom involved in action at the second level clashes with a requirement imposed by society that limits the freedom to do as one pleases. A woman is free to marry whomever she pleases but not someone who is a close relative. A man is free to marry whomever he pleases but not to beat his wife or abuse his children. Human beings are free to do as they please, provided they act responsibly. Because intentionality is required, only humans are capable of action at the second level.

At the third level, which is associated with **freedom of self-determination**, the significance of the action derives from the good that it produces in the person participating in the action. Fishing for the purpose of catching fish to be prepared and cooked for dinner is purposeful and foresighted and therefore is action on the second level. Fishing with another person in order to enjoy and strengthen a friendship is action at the third level. Reading a book like the **Diary of Ann Franke** in order to learn more about human goodness in the midst of evil is action at the third level. Reading the same book simply to fulfill a book-report requirement at school is action at the second level. It is third-level action which is associated with self-determination that makes one a better person.¹

*Persons are persons; the question for them is how to be what they already are. If the problem were how to become a person, it would mean that "personhood" was some sort of definite goal or objective toward which one could work by action at the second level. But this is clearly not the case. We already possess personhood. We are not working toward the goal of becoming persons; we are instead coping constantly with the difficult but fascinating problem of how to **be person**.*

*... persons are faced with the constant necessity of making choices and, in doing so, of determining themselves. How to use their freedom of self-determination -- how, in other words, to **be persons** -- is*

Notre Dame University Press, 1974.

¹ Grisez and Shaw, pp. 2-17.

the challenge which continually confronts them.¹

The question, if one follows Grisez and Shaw, is How does a human being grow and develop more fully as the person he/she already is? Their answer is that growth and development take place through the choices made at the third level of action in which the actor does not achieve the good or purpose intended but instead participates in it and this participation occurs over the entire period the action is undertaken. Action at the second level means looking into the future. Action at the third level means acting in a consequential way in the present. It is action at this level that affords the opportunity to grow and develop more fully as a human person.²

*A flower unfolds in a complex multi-stage process in which all along it is a flower for the simple reason that it cannot **become** anything other than what it has been since the very first stage of its development as a specific organism. Similarly, after birth, the child continues to unfold as a person, grows and develops as a person according to the potentialities present from the very beginning which empower it to act and by acting that child unfolds as a unique person. To illustrate, some are endowed with special mental faculties, and years later become teachers, inventors, researchers. Others with special physical talents become athletes, structural iron workers, ballet dancers. Still others have a special gift for evoking what is best in others, and become orchestra conductors, supervisors, coaches. Others are endowed with a caring nature, and become nurses, ministers, nannies. Every human being, every economic agent, is different, but all are alike in that all are persons.*

Personhood can be affirmed or denied, granted or taken away, conditional or unconditional. By representing the economic agent as an instrumentality, as a means to an end with a fundamental worth that derives from the contribution made to economic affairs, mainstream economics in effect makes the personhood of the economic agent conditional. In sharp contrast, while acknowledging that different economic agents make different contributions to economic affairs, personalist economics insists that every human being is endowed with a sacred dignity that is separate and distinct from his/her instrumentality, a dignity that cannot be denied, taken away, or rendered subordinate to instrumental value. The personhood of the economic agent is unconditional.

Virtues, Vices, and the Acting Person.

*As long as the child acts only at the first or second level, he/she remains an **innocent** person. Once he/she begins acting at the third-level the child becomes an **acting** person. This unfolding, this realization of one's own personhood, is a continuous process that takes place throughout one's entire lifetime. The child may become an evil person or a good person according to how he/she acts in a lifetime. The child becomes an evil person by embracing vices (bad habits such as acting unjustly, acting maliciously) or a good person by acquiring virtues (good habits such as acting courageously, acting justly),*

¹ Grisez and Shaw, p. 14, emphasis in the original.

² Grisez and Shaw, pp. 17, 21.

The Good of man is the active exercise of his soul's faculties in conformity with excellence or virtue, or if there be several human excellences or virtues, in conformity with the best and most perfect among them.¹

The Noble is that which is both desirable for its own sake and also worthy of praise; or what is both good and also pleasant because it is good. If this is a true definition of the Noble, it follows that virtue must be noble, since it is both a good thing and also praiseworthy.²

We add that a child becomes a weak or indifferent person by doing little or nothing, by not acting. Whether the child acts righteously, wickedly, or indifferently, he/she remains a person throughout, just as changes in weight and height, cognitive abilities, and other human skills and talents over the child's development as a teenager and later as an adult do not alter the essential reality that he/she is a person from the beginning of life to the end.

*Development from an **innocent** person to an **acting** person is a two-stage process.*

All free males are born with the potential to become ethically virtuous and practically wise, but to achieve these goals they must go through two stages: during their childhood, they must develop the proper habits; and then, when their reason is fully developed, they must acquire practical reason (phronêsis).

Although we must be fortunate enough to have parents and fellow citizens who help us become virtuous, we ourselves share much of the responsibility for acquiring and exercising the virtues.³

*The rate at which the transformation occurs from innocent person to **acting person** varies from one person to the next because each one is unique with a unique disposition to acquire this virtue or that vice.⁴*

Our attention is drawn to the four virtues commonly referred to as cardinal virtues: justice, courage, moderation, and prudence. Justice is rendering to others that which is owed. Courage is firmness in the face of difficulty and constancy in the pursuit of the good. Moderation restricts the attractiveness of pleasures and provides balance in the use of created goods. Prudence prompts one to select the best means to achieve a good end.

¹ Aristotle, *Nicomachean Ethics*, translation by H. Rackham, Book 1, Chapter 7, section 15, p. 33, 1934, available at www.bartleby.com/73/567.html.

² Aristotle, *Rhetoric*, Book 1, Chapter 9, 1366b, online version translated by W. Rhys Roberts, p. 1366b, available at www.public.iastate.edu/~honey1/Rhetoric/index.html.

³ Richard Kraut, "Aristotle's Ethics," *Stanford Encyclopedia of Philosophy*, May 1, 2001 revised June 3, 2005, pp. 3-5, available at www.plato.stanford.edu/entries/aristotle-ethics/.

⁴ Joseph Rickaby, "Chapter V: Of Habits and Virtues," *Moral Philosophy: Ethics, Deontology, and Natural Law*, London: Longmans, Green and Company, 1918, p. 2, available at www2.nd.edu/Departments/Maritain/etext/moral105.htm.

Following Aristotle, justice is the mid-ground between rendering too much to others and rendering too little, between favoritism and ripping off. Courage is the golden mean between the vices of cowardice (too little) and rashness or recklessness (too much). Moderation is the mean between gluttony and extreme self-denial, between workaholicism and sloth. Prudence helps us discern excess and deficiency in other areas, enabling us to locate the mean though not activating us toward that mean. Thus, prudence is fundamental to the other virtues¹

*We refer to the four as **practical** virtues because as Schall states² they relate not to thought or truth but to practical human action. Moderation and courage are always inward-directed, toward self; justice is outward-directed, toward others.³ Following Aquinas, prudence is not rational self-interest unless it is tempered by justice and friendship or love.⁴ It involves both the end sought and the means to attain that end, calls for reason rather than impulse, and takes counsel from others in the selection process.⁵ Prudence therefore is both inward- and outward-directed.*

*Justice is, to quote Schall “a very cold virtue,” “the most terrible of the virtues.”⁶ Strictly speaking, justice results in a condition wherein no one **owes** anything to anyone else. Schall describes this condition as an “isolated hell.”⁷ The remedy is found in the virtues of gratitude, benevolence, and charity.*

... relationships of justice, by themselves, are quintessentially impersonal. We get what is due -- no more, no less. This indifference to the person to whom we are just or who is unjust to us is what I meant earlier in suggesting that gratitude, benevolence, and charity are needed in addition to justice. We must be just even to our enemies, to those who hate us, to those we do not know or care to know.⁸

The virtue of forgiveness is another remedy for what is lacking in the virtue of justice. In economic affairs, forgiveness is the golden mean between enabling irresponsible financial behavior and crushing the human spirit under an unbearable load of debt. Forgiveness by definition must be given freely by the one who holds the debt claim. The physician who does not charge an impoverished

¹ Rickaby, pp. 5-8; Kraut, pp. 5-7.

² James V. Schall, “Justice: The Most Terrible of the Virtues,” *Journal of Markets and Morality*, Volume 7, Number 2, Fall 2004, pp. 414-415.

³ Schall, p. 410.

⁴ John Finnis, “Aquinas’ Moral, Political, and Legal Philosophy,” *The Stanford Encyclopedia*, December 2, 2005, p. 20, available at www.plato.stanford.edu/entries/aquinas-moral-political/#Vir.

⁵ John J. Elmendorf, “Chapter V On Virtues,” in *Elements of Moral Theology*, 1892, p. 4, available at www.maritain.nd.edu/jmc/etext/emt.htm.

⁶ Schall, pp. 419, 409.

⁷ Schall, p. 412.

⁸ Schall, p. 419.

patient for care that is rendered, the landlord who allows a single mother who has lost her job and cannot pay the rent to remain in her apartment with her children, the neighbor who does not accept reimbursement for school uniforms purchased for the children next door living with their grandmother who survives on a small monthly pension check exemplify the true meaning of forgiveness. In every instance, forgiveness involves a need that otherwise would not be met.

Bankruptcy reform¹ in 2005 strikes a new balance between the extremes of too much and too little, moving clearly away from canceling too much debt. While it provides relief for persons, families, or organizations that are unable to meet their obligations under justice, bankruptcy is relief that is legally coerced. In a bankruptcy judgment, creditors are forced to give up all or part of any claim to what is rightfully theirs. Bankruptcy is not forgiveness, it is cancellation. Writing off debt that is uncollectible, including a debt that has been assigned to a collection agency which has not been able to get the debtor to make payment, is not forgiveness. It is acquiescence because, even though there is no legal coercion, writing off forces the creditor to concede that the underlying claim will not be honored. Debt that has been legally cancelled or written off may reflect expenditures for things which were truly needed such as hospital care or auto repair or for things that were wanted at the time of purchase but not strictly needed such designer clothes or high-definition television. To repeat, the true measure of forgiveness in economic affairs is relief for what is owed that is given freely.

Debt that is cancelled through bankruptcy or written off as uncollectible impacts the firm's cost of doing business, its profitability which is troubling to the owners/shareholders, and may lead to higher prices which would be harmful to its paying customers. In the extreme cancelled and written-off debt could force the firm out of business which is harmful to all of its stakeholders. Like consequences may follow from debt that is forgiven though such outcomes are less likely because the creditor is not being coerced to cancel or write off debt.

In economic affairs, justice, courage, moderation, and prudence operate in the limiting mode. Justice limits ill-gotten gain (in a routine exchange one agent gets too little because the other agent takes too much). Courage limits evil from occurring when a person knows what do to in a difficult situation and is willing to confront that difficulty. Moderation limits excess in work, consumption, and leisure. Prudence limits recklessness in allocating resources toward some given good. All four virtues are learned (from others, on one's own) and therefore can be taught (to others). Children become aware of and learn justice first in large measure because family controversies often swirl around questions of justice.² "She messed with my drawing." "He hid my favorite hair ribbon."

To repeat what was stated previously, every exchange between economic agents -- buyer and seller, producer and supplier, employer and employee, borrower and creditor -- necessarily involves economic gain for both parties. What is gotten must be greater than what is given up. Otherwise,

¹ Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.

² Schall, p. 410.

exchange collapses. However, limits on the amount of economic gain are necessary to prevent one party from taking advantage of another and to assure that market exchange serves everyone fairly and effectively. Those limits derive from the duties that economic agents owe one another in justice, specifically equivalence, distributive justice, and contributive justice.

Courage, moderation, prudence, and justice are essential to an efficient, orderly, and peaceful economy. Mainstream economics asserts that these matters are addressed through the “invisible hand of the market.” Personalist economics argues that the “invisible hand” fails whenever economic agents have not learned and acquired the practical human virtues and do not practice them faithfully. Clark among others long ago asserted a similar view.

... in a modern economy it has become impossible to trust an “invisible hand” to turn crude self-interest into an efficient engine for meeting every social need. We must have a sensitive awareness of what our social needs are, and what the economic machine is doing to them; and we must work with conscious purpose to make that economy meet those needs.¹

¹ Clark 1957, pp. 180-181.

REVIEW SECTION: TOPIC 18

Central Concepts:

- acting person**
- humanness
- personhood
- contingent being
- virtue
- vice
- human action
 - level one
 - level two
 - level three
- freedom
 - physical
 - to do as one pleases
 - of self-determination
- innocent person
- practical (cardinal) virtues
 - justice
 - moderation
 - courage
 - prudence
- golden mean
- limiting ill-gotten gain

Important Questions:

- Why did we change our representation of the economic agent from **homo socio-economicus** to the **acting person**?
- Should humans be regarded as persons in accordance with their nature or by virtue of the value others attach to them?
- What two propositions form the basis for the argument that all economic agents are persons?
- Are all human beings also human persons?
- What is the difference between *being* a person and *becoming* a person?
- How does a human being grow and develop more fully as the person he/she already is?
- What differentiates the *acting person/person in action* from the *innocent person*?
- Why is it necessary to limit ill-gotten gain?
- How do justice, moderation, courage, and prudence limit ill-gotten gain?

(continued on following page)

True/False:

- a. Fishing with another person to strengthen a friendship is action at the third level.
- b. A child becomes a good person by acting virtuously such as acting courageously or justly.
- c. *Being* a person and *becoming* a person are one and the same.
- d. There is no essential difference between the *innocent* person and the **acting person**.

Mark your answer below.



_____ Item a is true, items b, c, and d are false.

_____ Items a and b are true, items c and d are false.

_____ Item a is false, items b, c, and d are true.

TOPIC 19 CAPITAL: PHYSICAL, FINANCIAL, HUMAN, AND PERSONALIST

To present physical, financial, and human capital and
introduce personalist capital

Mainstream economists have incorporated three forms of capital – physical, financial, and human – into their ways of thinking about economic affairs. Our examination of capital proceeds from the perspective of the individuality and the sociality of the human beings who design, finance, build, introduce, use, and maintain capital and, with human capital, in whom it is embedded.

Physical, Financial, and Human Capital.

*Due to its materiality, physical capital resides in **things**, is built for a purpose, is purchased and owned by a producer who is free to retain it, sell it, adapt it to other uses, misuse it, neglect it, abandon it. Physical capital can do nothing for itself or by itself, is neither self-improving nor self-renewing. Physical capital is depleted in use and has value strictly in instrumental terms. Physical capital originates in human action, embodies human intelligence, and evolves as human knowledge and understanding advance particularly in science and technology. To function effectively, even the most sophisticated physical capital requires human direction.*

Broadly construed, physical capital may be privately owned and controlled or publicly owned and controlled. Under private ownership and control, access is restricted and any returns accrue to the private owner. Under public ownership and control, access is less restricted and returns accrue to anyone with the know-how to take advantage of it – to turn its use into economic gain. This public form of physical capital which commonly is called “public infrastructure” includes ports and harbors, highways, canals, locks, dams and hydroelectric generating systems, airports, public transit systems, levees, bridges, water and sewage treatment systems, and the like. Physical capital of either type offers the economic agent the opportunity to become more effective and therefore more highly valued. The private form of physical capital which is held by a single person arises out of and reinforces human individuality, whereas the public form originates in human sociality and strengthens it. Physical capital held privately by a circle of owners gives expression to both individuality (more so when the circle is small) and sociality (more so when the circle is large).

Physical capital cannot materialize without financial capital, and in that sense the two are related as end and means. Unlike physical capital that must reside in things, financial capital is intangible and by definition does not reside in things. As with physical capital, financial capital originates in human action, evolves as human intelligence improves, and requires human direction. The two key economic agents in the fusion of science and technology on the one hand and financial capital on the other are the entrepreneur and the banker.

Financial capital is the command over the human and material resources needed in the construction of physical capital. As with physical capital, financial capital is identifiably either private or public in nature, and a reflection of human individuality or human sociality. In a capitalist economy, private financial capital derives from three sources: savings (including retained earnings and venture capital), the creation of credit by private commercial banks, and the issuance of stocks (equity financing) and bonds (debt financing). Private financial capital may arise through the efforts of a single person launching a new business and thereby reflecting human individuality or in the case of a more mature enterprise through the efforts of a group of persons working together thereby demonstrating human sociality.

Just as the means must precede the end that it serves, savings precedes physical capital. Savings also follows physical capital in the sense that physical capital when successfully applied in economic affairs generates a surplus or gain that can be retained or shared. Seen from this perspective private financial capital or more specifically retained earnings, though depleted in use, can be self-renewing. Thus, means and end are inextricably intertwined and virtually impossible to separate. Public financial capital is raised by issuing revenue bonds or tapping tax revenues, and can be used to improve the public infrastructure or in a partnership with private physical capital. Public financial capital exhibits human sociality in action.

Human capital is unlike the other two forms in the sense that human capital resides in human beings. Human capital is like financial capital in the sense that both are intangible and both are self-renewing. Human capital is like physical capital in that it is potentiality waiting to be actualized. However, physical capital by definition is not self-actualizing. Human capital is.

Because humans are self-actualizing beings capable of self-improvement and self-destruction, human capital can be enhanced or destroyed. Human capital can be exchanged in the sense that the employer gains access to human capital through the employment contract. The extent of that access and utilization depends critically on the employer's skill as a manager in converting potentiality into actuality.

Human beings become different persons in part as a consequence of changes in their stock of human capital. It flourishes in a human being through the teaching/learning process, and to the extent that human beings learn from other human beings, acquiring human capital is an outward-reaching process that underscores human sociality. To the extent that they are self-taught, accumulating it is an inward-directed process that emphasizes human individuality. Human capital withers in a human being in various ways. One is a self-imposed rejection of the learning process. Another is lack of opportunity. A third is incompetence on the part of the teacher. Obsolescence and physical incapacity are two others.

Other forms of capital are being recognized at least at the margins of mainstream economics. Most notable among them is social capital¹ which commonly is defined in terms of human networks,

¹ The other forms of capital include intellectual capital, natural capital, personal capital, and ethnic capital, cultural, linguistic, and scholastic capital.

human interactions, and human sociality and which contributes to economic development.

Personalist Capital.

Because the very concept of social capital is controversial and lacking in clear specificity,¹ we prefer in the following to use the term “personalist capital” which though it has greater specificity should not be taken as either radically different than social capital on the one hand or as its replacement on the other.

Personalist capital refers to a human development process in which certain good habits or virtues are learned, practiced, and acquired and by which a human being becomes more fully a human person. Similarly, personalist capital can depreciate and human development can be arrested and even reversed through the learning, practicing, and acquiring of certain bad habits or vices by which a human being deteriorates as a human person. The virtuous person accumulates personalist capital in a way that parallels the accumulation of physical and human capital – by investing in good habits. The wicked person destroys personalist capital by investing in bad habits.

*The **acting person** refers to a human being who chooses to act either virtuously or viciously, who is functioning at the third level of action. In economic affairs the **acting person** by definition is the economic agent who accumulates personalist capital by acting virtuously and who destroys it by acting viciously.² The innocent person refers to a human being who has not yet begun to engage in action at the third level and therefore has no stock of personalist capital (see schematic on next page).*

*This emphasis on the role of virtue in economic affairs is not a new idea. Notice in his **Moral Sentiments** that Smith repeatedly calls attention to the importance of sympathy, generosity, and benevolence. Notice as well that thrift and diligence are accepted in mainstream economics though perhaps not with the same emphasis. In the following we restrict ourselves mainly to the four practical virtues and the vices, the extremes, which those virtues seek to avoid.*

Personalist capital and person are constructed around the central concept of practical virtues and the vices -- the extremes that those virtues seek to avoid or limit. Plainly, no employer wants a worker who cannot limit his drinking (overindulgence) or one who steals (takes too much). No one wants to work for an employer who sweats his labor (pays too little) or with others who shirk their responsibilities (do too little). No consumer respects a merchant who misrepresents the quality of the goods for sale, (gives too little) or does not fully disclose interest charges on credit purchases (takes too much). No shopkeeper wants customers who promise to pay the balance owed later but don't

¹ See Peter Knorringa and Irene van Staveren, “Beyond Social Capital: A Critical Approach,” *Review of Social Economy*, March 2007, pp. 1-9.

² Elmendorf (pp. 1-2) claims that “as habits [virtues and vices] are generated and increased by acts, so ceasing from action diminishes them and sometimes totally destroys them.”

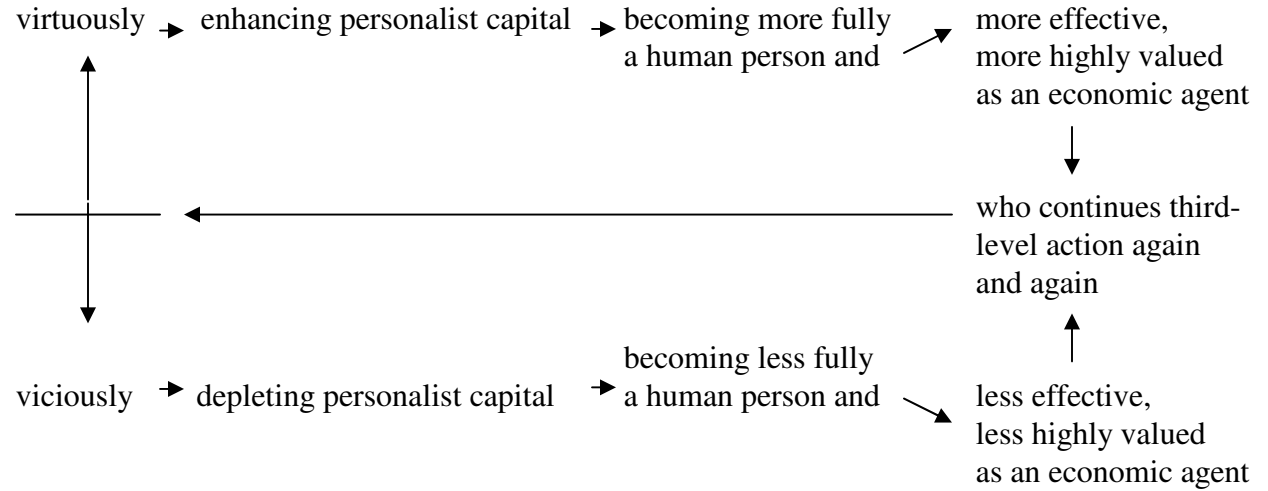
**ACTING VIRTUOUSLY OR VICIOUSLY AND PERSONALIST CAPITAL:
THE DEVELOPMENT OF THE HUMAN PERSON AS AN ECONOMIC AGENT**

Person initiates ...

... **first-level action**

... **second-level action**

... **third-level action¹**



← *The Innocent Person* → ← *The Acting Person* →

In terms of the four cardinal virtues, acting virtuously means *justly, prudently, courageously, moderately*.

In terms of the four cardinal vices, acting viciously means *unjustly, stupidly, faintheartedly, excessively*.

¹ Third-level action is associated with self-determination; the significance of third-level action is the effect (good or evil) on the person participating in the action.

follow through (take too much) or insist on being served before everyone else (demand too much).

As with physical capital and human capital, there is a distinct return to personalist capital. In general, employers prefer the diligent worker to the lazy worker, the stand-up guy to the wimp. Buyers favor the merchant who is always honest to one who is devious, the merchant who gives sound advice to one who simply doesn't know his/her product line or worse yet cheats his/her customers. These preferences are expressed and the personalist capital of a specific economic agent is rewarded (imperfectly because economic agents are not perfect human persons) through routine exchanges in the product market where price, quality, and terms of service after the sale are determined and in the resource market where resource prices including wages are determined along with hours of work and working conditions. Notice, for example, the employment difficulties encountered by convicts following their release from prison, public announcements from the Better Business Bureau and Federal Trade Commission identifying business practices and in some cases specific enterprises that are scamming the public, the complete collapse of Arthur Anderson following the public disclosure that it had been deliberately "cooking the books" for Enron.

Malthus appears to be saying that personalist capital is more important than human capital.

Talents, indeed, though undoubtedly a very prominent and fine feature of mind, can by no means be considered as constituting the whole of it. There are many minds which have not been exposed to those excitements that usually form talents that have yet been vivified to a high degree by the excitements of social sympathy. In every rank of life, in the lowest as frequently as in the highest, characters are to be found overflowing with the milk of human kindness, breathing love towards God and man, and though without those peculiar powers of mind called talents, evidently holding a higher rank in the scale of beings than many who possess them. Evangelical charity, meekness, piety, and all that class of virtues distinguished particularly by the name of Christian virtues do not seem necessarily to include abilities, yet a soul possessed of those amiable qualities, a soul awakened and vivified by these delightful sympathies, seems to hold a higher commerce with the skies than mere acuteness of intellect¹

Personalist capital is not transferable in the same sense that physical capital is transferable. The reason is simple enough: physical capital is a thing that is entirely distinct and separate from its owner and therefore can be bought and sold. As with human capital, personalist capital is embedded in a human being, cannot be detached from that human being, and therefore cannot be bought or sold. There is nothing inappropriate in referring to acts of virtue or vice as contributing to the accumulation or loss of personalist capital just because this kind of capital is lacking in materiality. Materiality has everything to do with physical capital, it has nothing to do with personalist capital. However, both are real assets in economic affairs insofar as both are valued in the market system. Physical capital that has no value is junk. Personalist capital that has no value is inconsequential.

Personalist capital also resides in communities of persons as social beings, but it must first reside in persons as distinct individuals before it can reside in communities. To illustrate, "Cajun

¹ Malthus, Thomas R., *Population: The First Essay*, Ann Arbor: University of Michigan Press, 1959, p. 131.

engineering” refers to a pride of workmanship in certain Louisiana Gulf Coast shipyards where Cajuns with limited formal educational backgrounds assert with pride that “if you can draw it, we can build it.” Cajun engineering is a form of personalist capital that is embedded in the culture and is passed from person to person, from generation to generation. If all of the children of the Cajuns working in these shipyards were to find their fortunes in other lines of work, the shipyard might survive with workers drawn from different cultural backgrounds, but Cajun engineering would not.

These two aspects of personalist capital – embedded in persons (the individual dimension) and residing in communities of persons (the social dimension) – approximate the relationship between physical capital and the public infrastructure in the sense that physical capital is owned by individual beings and the infrastructure belongs to the community. Put differently, there is no personalist capital in its social dimension and no public infrastructure when humans being act strictly as individual beings.

Ratnapala¹ uses “moral capital” in a way similar to our personalist capital in that he conceptualizes moral capital in terms of three virtues: justice, temperance (moderation), and beneficence. However, unlike our use of the virtue of justice which includes distributive justice, Ratnapala excludes it. Further, he does not include courage. And, most important, even though he uses “person” and “personhood” Ratnapala does not connect moral capital to person as distinct from individual. Rather he uses “person” as a synonym for “individual.”

In the mid-1990s Becker² used “personal capital”³ which along with social capital he sees as forming part of human capital. Using a utility-function approach, Becker argues that utility maximization depends not only on preferences based on current consumption activity but also on past and future consumption activity. He recommends expanding the concept of individual preferences to include “personal habits and addictions, peer pressure, parental influences on the tastes of children, advertising, love and sympathy, and other neglected behavior.”⁴

By personal capital (P) Becker refers to the impact of the agent’s own experiences and past consumption on current and future utilities. By social capital (S) he refers to the impact on the agent’s preferences from actions undertaken by others in the past. Becker’s expanded utility function is: $u_t = (x_t, y_t, z_t, P_t, S_t)$ where x , y , and z refer to different goods consumed. Utility maximization remains the rule.

¹ Suri Ratanapala, “Moral Capital and Commercial Society” in *The Challenge of Liberty: Classical Liberalism Today*, edited by Robert Higgs and Carl P. Close, Oakland: The Independent Institute, 2006, pp. 97-119.

² Gary S. Becker, *Accounting for Tastes*, Cambridge: Harvard University Press, 1996, pp. 3-12.

³ In 1888 Ingram used “personal capital” to mean that “... in agriculture nature labours along with man, whilst in manufactures nature does nothing, man does all ...” John Ingram, *History of Political Economy*, Edinburgh: Adam and Charles Black, 1888, p. 105.

⁴ Becker, pp. 3-4.

*By defining personal capital and social capital as he does, Becker in effect affirms that humans are both individual beings and social beings, and rejects the strictly autonomous individual dimension of **homo economicus**. Our conceptualization of personalist capital and Becker's conceptualization of personal capital are alike in that both incorporate good habits and bad habits. Becker, for example, extends economic analysis to include such good habits as honesty, sympathy, and caring, and bad habits such as lying, envying, and drinking or smoking excessively.¹*

The differences between Becker's personal capital and our personalist capital, however, are more significant than the similarities. First, we do not accept the utility-function approach² because Becker's personal capital is based on second-level action – consumption is undertaken for the utility that is gotten -- whereas personalist capital is based on third-level action. Second, Becker defines a good habit as one in which greater current consumption increases future utility.³ With a bad habit, on the other hand, greater current consumption decreases future utility. Third, though affirming the duality of human nature, Becker does not differentiate person from individual or personalism from individualism, and does not argue as we do that good habits and bad habits make a human being more fully or less fully a human person and thereby more effective, more highly valued or alternatively less effective, less highly valued as an economic agent.

*Fourth, Becker in substance rejects Aristotle's golden mean to the effect that certain good habits such as moderation **limit** consumption in order to protect human well-being. It is necessary for Becker to do this in order to preserve the utility-maximization rule. Fifth, Becker says the individual acquires social capital by the impact on his/her own preferences through action taken by others. We argue instead that action taken by others influences action taken by the individual, thereby influencing his/her own personalist capital, for better or for worse.*

*As with all mainstream economists, Becker in the end asserts that an economy functions best when it maximizes utility, when it achieves Pareto optimality. Libertarians are likely to argue that an economy functions best when it maximizes human freedom. Personalist economics, in contrast, claims that an **economy functions best when it maximizes personalist capital thereby enhancing a human being as a human person and rendering that person more effective and more highly valued as an economic agent.**⁴*

¹ Becker, pp. 7-12.

² Van Staveren and Knorringa state that the utility-function approach is one of three ways in which social capital is integrated into economic analysis. Irene Van Staveren and Peter Knorringa, "Unpacking Social Capital in Economic Development: How Social Relations Matter," *Review of Social Economy*, March 2007, p. 109.

³ Becker, pp. 119.

⁴ We do not deny that there is an underground economy where personalist capital is turned upside down, where the person who acts viciously rather than virtuously -- drug dealers, money launderers, and assassins for hire come to mind -- is more effective and more highly valued as an economic agent. Even so, this kind of economic agent remains a human person but has in effect diminished rather than enhanced his/her own personhood. Of necessity, society condemns them for what they do and attempts to undermine their ability to continue acting in that manner.

The personalist perspective for sure is a major departure from the mainstream economics way of thinking. In 2003, however, the chairman and chief executive officer of the U.S. equipment manufacturer John Deere affirmed these ideas.

I submit that pro-market competition will also drive corporations that aspire to create shareholder value over the long run to work in classically virtuous ways. These virtues, although not sufficient for prosperity, are necessary for sustaining it. The practice of them gives corporations the ability to create shareholder value both in the “short run” and the “long run.” And, it is only when a corporation survives over time that it contributes to human flourishing through goods and services that add value to the quality of life, an honorable way to make a living, the potential for wealth generation for those willing to risk investment, and support public and social needs especially through the paying of taxes.

So, I close with this. The remarkable, although imperfect, performance of vigorous pro-market capitalism is one that can and must be expanded. This will permit great corporations, large and small, those which practice the four cardinal virtues, to create value on an enduring basis, to be utilized as the means they can be in solving global problems, and to contribute to the greater good of human flourishing.¹

Much of modern life is taken up with the three principal economic activities: consumption, work, and leisure. Activities in these three domains of living can involve second- or third-level action. Second-level action has no subjective effects. Third-level action has subjective effects that afford opportunities for the acquisition or loss of personalist capital and therefore the development or decline of the agent as a human person. We take up all three activities in the next topic. With regard to consumption some repetition of what we said earlier is necessary.

¹ Robert W. Lane, “The Great Corporation: Vigorous Competition, Cardinal Virtues, Value Creation,” Augustana College, October 28, 2003, pp. 3-4, available at ww.deere.com/en_US/compinfo/speeches/2003/031028augustana.html.

REVIEW SECTION: TOPIC 19

Central Concepts:

- capital
 - physical
 - private
 - public
 - financial
 - private
 - public
 - human
 - personalist

Important Questions:

- How are physical capital and financial capital linked?
- Why are financial capital and human capital self-renewing?
- How does a person acquire personalist capital?
- Does mainstream economics accept or reject the proposition that virtue matters in economic affairs?
- Why does an economy function best when it maximizes personalist capital?
- Doesn't the presence of the underground economy where vice is more highly valued than virtue undermine the proposition that the economy functions best when it maximizes personalist capital?

(continued on following page)

True/False:

- a. Only physical capital matters in mainstream economics.
- b. A person acquires personalist capital by acting virtuously and loses it by acting viciously.
- c. Mainstream economics asserts that the economy functions best when it achieves Pareto optimality.
- d. Physical capital resides in things; human capital resides in human beings.

Mark your answer below.

- Item a is true, items b, c, and d are false.
- Items a and b are true, items c and d are false.
- Item a is false, items b, c, and d are true.

TOPIC 20

HOW CONSUMPTION, WORK, AND LEISURE CHANGE THE ECONOMIC AGENT

To consider how human persons develop as economic agents – as *acting persons* – through engagement in the three central economic activities of consumption, work, and leisure.

Mainstream economics depicts the consumer as unique, solitary, autonomous, self-centered, and self-made, traits that accent the consumer's individuality. For example, the practice of power dressing and the popularity of health foods give evidence of the consumer who is self-made. The trendsetter and the traditionalist are consumers with much individuality.

*Self-centeredness is necessary in the sense that healthy and normal human beings are expected to address their own needs and wants to the extent possible. In this regard, two virtues are critical. Self-centeredness degenerates into selfishness when the virtue of moderation is disregarded and the things sought after become ends in themselves rather than the means to satisfying their wants and meeting their needs.¹ If extreme selfishness is not checked by the virtue of sympathy or other-feeling that assures that both parties benefit from the exchange, a transaction involving agents who are **acting persons**, are free to act, cannot be completed. To the extent that these two virtues are neglected in economic affairs, personal and economic chaos follows.*

How Consumption Changes the Person Who Consumes.

The consumer behaves predictably in ways that are described as utility-maximizing, privacy-protecting, and commodity-acquiring. In Western culture, acquiring and accumulating goods are perceived as a sign of success. The consumer is free to choose whatever he/she is able to afford, makes those choices informed strictly by reason for the purpose of satisfying some want, and takes into account not only experiences in the past (is hind sighted) but also hopes and plans for the future (is foresighted).

Comparisons are made but they are rigorously intra-personal or inward-looking, wherein consumers evaluate their own wants over time without any regard for others. Adults typically plan years ahead for their retirement, carefully budgeting -- rationally planning income and expenses -- to achieve that goal. Need is entirely rejected by mainstream economics as a central determinant of consumer behavior because it is a value-laden concept. Mainstream economists think of consumption in terms of second-level action.

However, there is more to the consumer than mainstream economics admits. The consumer is a social being as well as an individual being, and as such is both alike and unique, at once communal

¹ Peter L Danner, *The Economic Person*, Lanham: Rowman and Littlefield, 2002, pp. 124-125.

and solitary, dependent in addition to autonomous, utility-satisficing no less than utility-maximizing, gift-giving in addition to commodity-acquiring, emotional and rational in decision-making, concerned for needs no less than wants, free to choose and morally accountable. Just as the trendsetter and traditionalist are persons with much individuality, the caring neighbor and the philanthropist are persons with much sociality.

In America, soul food and Cajun cuisine originate in specific cultures and appeal especially to persons born and raised in those cultural environments. Pre-teens are persons who are dependent on their parents for the things they need and want. Similarly, the elderly may become dependent on their adult children because of a debilitating condition.

Additionally, personalist economics represents the consumer as behaving in ways that are described as utility-maximizing and utility-satisficing, privacy-protecting and company-seeking, commodity-acquiring and gift-giving. At times, friends may share what they have, one friend taking less than the maximum available if he/she were to exclude the other, in order that the other friend might have more, thereby affirming and strengthening their friendship. Sharing and caring are actions at the third-level, helping transform the consumer into a human being who is more fully a human person. Hoarding and exploiting also are third-level actions, but they weaken rather than strengthen the consumer as a human person.

In personalist economics, the consumer is free to choose whatever he/she is able to afford, but is morally accountable for the choices made, makes those choices informed by reason and emotion, by mind and heart, for the purpose of satisfying a want or meeting a need. Fear drives some consumer choices, as at times with handguns and security systems. Some persons known as compulsive consumers or shopaholics are addicted to shopping. Their choices are not rationally determined, nor are they freely made.

As with mainstream economics, the consumer is not only hind sighted but also foresighted as when parents have to reduce their current consumption for years in order to set aside sufficient funds for their children's future education. Even though it is a value-laden concept, need is embraced by personalist economics because self-evidently it is a central determinant of consumer behavior. Plainly the consumer is both want-satisfying and need-fulfilling.

Because humans are both individual beings and social beings, consumers often struggle with decisions that require a reconciliation between the demands originating in the two-sides of their nature. A husband, for instance, may have to postpone buying new fishing gear because his wife needs to replace some of her clothing in order to be suitably dressed on her new job. An older sister with a steady job may be asked to help support a younger brother while he completes his college degree even though it means that she cannot buy the new car her heart is set on. A homeowner may have to forego buying new sod for his lawn in order to buy a privacy fence to block out the view of his/her neighbor's junk-filled yard. Mainstream economics construes such decisions strictly in terms of opportunity cost, what one gives up once a decision has been made from the available opportunities. Personalist economics sees these decisions not only as gains forsaken but also as

opportunities for consumers to advance and gain ground or retreat and lose ground as persons.

In addition to the negative impacts of acquisitiveness on the natural environment and on other persons from one's own consumption activities which are readily acknowledged by mainstream economics, John Paul sees two other dangers. The first is the effect of excessive consumption on the person of the consumer. The other is the effective denial of the principle of the universal destination of the material goods of the world by the affluent and comfortable who do not respond adequately to the needs of the poor. As to the first, he voices this warning:

A given culture reveals its overall understanding of life through the choices it makes in production and consumption. It is here that the phenomenon of consumerism arises. In singling out new needs and new means to meet them, one must be guided by a comprehensive picture of man which respects all the dimensions of his being and which subordinates his material and instinctive dimensions to his interior and spiritual ones. If, on the contrary, a direct appeal is made to his instincts -- while ignoring in various ways the reality of the person as intelligent and free -- then consumer attitudes and lifestyles can be created which are objectively improper and often damaging to his physical and spiritual health.¹

As to the second danger, by re-affirming the principle of the universal destination of the earth's goods² which states that the material goods of this world are intended for the use of all humankind and are not governed and protected absolutely in their use by the right of private property, John Paul says in effect that "need" must be re-instituted in our economics.

... there are many human needs which find no place on the market. It is a strict duty of justice and truth not to allow fundamental human needs to remain unsatisfied and not to allow those burdened by such needs to perish. It is also necessary to help these needy people to acquire expertise, to enter the circle of exchange and to develop their skills in order to make the best use of their capacities and resources. Even prior to the logic of a fair exchange of goods and the forms of justice appropriate to it, there exists something which is due to man because he is man, by reason of his lofty dignity. Inseparable from that required "something" is the possibility to survive and at the same time to make an active contribution to the common good of humanity³

*To John Paul, the material dimension of human existence matters much but is subordinate to the spiritual dimension. Indeed, extravagant regard for one's own material existence, which increasingly characterizes contemporary western culture, "... consumes the resources of the earth and [one's] own life in an excessive and disordered way".⁴ The danger is that consumption, carried to an extreme, reduces the consumer to a mere material being. Instead of **having** more, which modern economies celebrate and mainstream economics tacitly affirms, John Paul urges men and*

¹ John Paul II, *Centesimus Annus*, 1991, § 36, available at www.vatican.va.

² See, for instance, John Paul 1991, § 6.

³ John Paul 1991, § 34.

⁴ John Paul 1991, § 37.

women to **be** more, to develop the full potential of their personalities, to be a complete human person, and not just a self-absorbed human being.¹ In 1951 Lebret put the argument as to how consumption can diminish the person who consumes in a few simple words:

Man, in desiring “to have” rather than “to be,” in his eagerness to possess, closes in upon himself. He becomes hostile to others. He becomes the enemy of others²

In addressing a gathering of young people in Poland in 1987 in which he underscored the practical virtue of courage, John Paul added this powerful assertion:

*I referred to that episode [the defense of Gdansk in 1939 by young Polish soldiers fighting the German invading army], inviting the young people to reflect, above all, on the relation ‘between **being more** and **having more**,’ and I warned them: ‘**Having more** must never be allowed to win. If it did, we would lose the most precious gift of all: our humanity, our conscience, our dignity.’³*

In their 2004 study of the nature, scope, and effects of overindulgence,⁴ Clarke, Dawson, and Bredehoff⁵ identified five main areas of childhood overindulgence: toys, clothing, activities, privileges, and entertainment. They noted that childhood overindulgence has negative effects that extent into adulthood. One of those effects confirms John Paul’s insight.

*Some of the overindulged adults reported that they had confused **getting** with **being**. ‘I am if I get,’ one said. ‘I have to get in order to be sure I’m alive.’⁶*

Mainstream economics characteristically argues that human wants are unlimited, that growth in production is necessary to satisfy those wants, and that the normative concept of need has no place in a value-free science. It follows that one principal measure of human well-being is GDP per capita. Personalist economics, on the other hand, argues that the premise of unlimited human wants is ill-advised because without the limit imposed by the virtue of moderation development as a person

¹ John Paul spoke of the difference between *having* and *being* in an earlier encyclical letter wherein he calls attention to this difference as pointed out by Paul VI in *Populorum Progressio*. See John Paul II, *Sollicitudo Rei Socialis*, 1987, § 28, available at www.vatican.va.

² Louis J. Lebret, *Human Ascent*, translated from the original 1951 French text by Robert and Martha Faulhaber, Chicago: Fides Publishers Association, 1955, p. 25, emphasis added.

³ John Paul II, *Rise, Let Us Be On Our Way*, New York: Warner Books, 2004, p. 191, emphasis in the original.

⁴ Defined as giving children “too much of what looks good, too soon, and for too long... It is the process of giving things to children to meet the adult’s needs, not the child’s.” See Jean Illsley Clarke, Connie Dawson, and David Bredehoff, *How Much is Enough: Everything You Need to Know to Steer Clear of Overindulgence and Raise Likeable, Responsible and Respectful Children*, New York: Marlowe and Company, 2004, p. xvii. It is, in other words, a failure on the part of the adult to practice the virtue of moderation in providing for the child.

⁵ Clarke and others, pp. 40-41.

⁶ Clarke and others, p. 39, emphasis in the original.

is impeded. Further, wants must be differentiated from needs if one is to tackle the problem of poverty. Indeed the two are differentiated in virtually all poverty research and with greater refinement as poverty researchers dig more deeply into the problem. Therefore, all economics, not just personalist economics, unavoidably is value-laden. It follows that the rate of poverty is a better measure of human well-being and of the performance of the economy than is GDP per capita, and represents a higher goal for an economic development process which is consistent with the development of human beings as human persons.

Waters offers a concise account of the personalist¹ theory of economic development which centers on the entrepreneur and draws heavily from Schumpeter's insights regarding development, namely creative vision, funding, access to resources, dynamic competition, resistance, creative destruction, and the universality of cyclical behavior. Waters adds two other factors drawn from other sources: the natural working together of labor, management, and government, and the cooperation of workers, managers, and owners in the workplace.

*We quote directly only the first part of Waters' much longer but beautifully articulated argument which centers attention on the entrepreneur or in today's language of personalist economics, the **acting person**.²*

At the heart of economic reality is the change of old production functions and the creating of new ones. Initiating economic improvement is the triad of vision, innovation, and fund creation. Innovation or the launching of vision in the economy is the most vital. While the ideas and inventions (visions) are necessary, as is the third, financial support to permit access to scarce resources (capital), the most difficult work is in the promoting, organizing, and launching of technological and non-technological changes. It is the innovation that constitutes the creative economic activity and brings forth substantial differences in society³

There is more on the entrepreneur in the following section on work.

How Work Changes the Person Who Works.

Two changes transpire in the workplace: (1) the transformation of resources into goods and services and (2) the development of the one who works. The first change is outward-directed in the objective sense. The second is inward-directed in the subjective sense. At times the work is done poorly and the outcome is goods and services that are defective. Sometimes the work is mind-numbing and the

¹ Until the late 1980s personalist economics was a term not yet in use. Instead, Waters used the older, now dated term solidarist economics which starting in the mid to late 1990s has been replaced by personalist economics. See William R. Waters, "Social Economics: The Solidarist Perspective," *Review of Social Economy*, October 1988, pp. 113-143.

² J.M. Clark offers a different theory of economic development in which like Waters he rejects the determinateness of mainstream economics. Clark's main objection is with the concept of static equilibrium (see Allan G. Gruchy, "Theory and Policy in John M. Clark's Social Economics," *Review of Social Economy*, December 1981, pp. 246-249). Waters, on the other hand, objects principally to mainstream economics' premise of the individual as the basic unit of economic analysis (Waters, pp. 114-120).

³ Waters, p. 123.

result is a human being whose development as a person has been arrested. While acknowledging the instrumental dimension of work (action at the second level), personalist economics sees work primarily in terms of the **who** that worker is becoming (action at the third level). The difference between mainstream economics and personalist economics is seeing the worker as an economic instrument rather than a human person.

There are two dimensions to the process by which work changes the worker, is third-level action. Rightly organized, work provides opportunities for using one's creative skills and talents and for being brought together with others in a common enterprise. The one reflects the need of the human person that originates in individuality while the other reveals the need that is rooted in sociality. The need to belong that inheres in human nature as social beings is the foundation to the right of workers to associate for the purpose of representing their interests to the employer. Workers have a right to associate, to form a union, because acting collectively is a more effective means for conferring on wages, hours, and working conditions than is acting alone, and therefore a better means for provisioning their need for income, their need to belong, and their need for work that is challenging. Exercising that right and bargaining collectively depend critically on the goodwill of the employer. It follows that workers also have a corollary right to strike in order to deal with an employer who is lacking in goodwill. At the same time, employers have a corresponding right to lockout employees who are lacking in goodwill.

John Paul's recognition of the need to belong is embedded in his assertions that the fundamental dimension of human existence is co-existence,¹ that a person grows through "increased sharing in a genuinely supportive community"² in the workplace and is implied in his call to "solidarity and common action" as a reaction against "the degradation of man as the subject of work"³

Elsewhere in *Laborem Exercens* John Paul explains what he means by "man as the subject of work":

*Man has to subdue the earth and dominate it, because as the "image of God" he is a person, that is to say, a subjective being capable of acting in a planned and rational way, capable of deciding about himself, and with a tendency to self-realization. As a person, man is therefore the subject of work. As a person he works, he performs various actions belonging to the work process; independently of their objective content these actions must all serve to realize his humanity, to fulfill the calling to be a person that is his by reason of his very humanity.*⁴

¹ John Paul II, *Crossing the Threshold of Hope*, New York: Alfred A. Knopf, 1994, p. 36.

² John Paul 1991, § 41.

³ John Paul II, *Laborem Exercens*, 1981, § 8, available at www.vatican.ca.

⁴ John Paul 1981, § 6, emphasis in the original.

Whereas mainstream economics recognizes work only in the objective sense, John Paul is unyielding in his argument that the subjective sense of work is the more important.

... **the primary basis of the value of work is man himself**, who is its subject ... in the final analysis it is always man who is **the purpose of the work**, whatever work it is that is done by man -- even if the common scale of values rates it as the merest "service," as the most monotonous, even the most alienating work.¹

In a lecture series at the University of Michigan in 1947 J.M. Clark took the same stance:

The most important product of industry is what it does to the lives of the people who work in it; and for its own safety it needs to contribute to make well-balanced individuals whose social faculties are neither atrophied nor perverted.²

However, it is with regard to the need for creative opportunities that John Paul is most eloquent, instructing not from social ethics but from theological doctrine, citing Genesis and Revelations.

The word of God's revelation is profoundly marked by the fundamental truth that man, created in the image of God, **shares by his work in the activity of the Creator** and that, within the limits of his own human capabilities, man in a sense continues to develop that activity, and perfects it as he advances further and further in the discovery of the resources and values contained in the whole of creation³

John Paul cites **Gaudium et Spes** to make clear that he means work not just of the most challenging and fulfilling kind but also work involving " even '**the most ordinary everyday activities...** [wherein men and women] can justly consider that by their labor they are unfolding the Creator's work...' "⁴

Historically, human beings have been diminished as persons, have been objectified, by the practice of slavery which continues even today especially as regards to women and children who are forced into prostitution. Objectification in the workplace can take on a variety of forms: sexual harassment, starvation wages, excessive hours, unsafe working conditions, forced labor, termination without cause, suppression of union activities, discrimination, monopoly administration and disposal of the means of production, and the like. John Paul argues in effect that such practices reflect confusion in the workplace over the difference between person and object.

Everything contained in the concept of capital in the strict sense is only a collection of things. Man, as the subject of work, and independently of the work that he does -- man alone is a person⁵

¹ John Paul 1981, § 6, emphasis in the original.

² John Maurice Clark, *Alternative to Serfdom*, New York: Alfred A. Knopf, 1948, p. 50.

³ John Paul 1981, § 25, emphasis in the original.

⁴ *Gaudium et Spes* quoted in John Paul 1981, § 25, emphasis in the original.

⁵ John Paul 1981, § 12.

John Paul argues that over the years labor and capital were separated and set in opposition, as though both were impersonal forces, in an error that he calls “economism” in which labor is considered only according to its economic purpose. This error in turn is connected to the error of materialism.

*This fundamental error of thought can and must be called **an error of materialism**, in that economism directly or indirectly includes a conviction of the primacy and superiority of the material, and directly or indirectly places the spiritual and the personal (man’s activity, moral values and such matters) in a position of subordination to material reality. This is still not **theoretical materialism** in the full sense of the term, but it is certainly **practical materialism**, a materialism judged capable of satisfying man’s needs, not so much on the grounds of premises derived from materialist theory, as on the grounds of a particular way of evaluating things, and so on the grounds of a certain hierarchy of goods based on the greater immediate attractiveness of what is material¹*

To remedy the consequences of the error of economism, John Paul re-affirms the principle of the priority of labor over capital.²

*While both labor and capital are factors of production, production is to serve the material needs of labor, and capital is merely a means toward that end. Meeting those needs -- physical need, the need to belong, the need for creative opportunities -- effectively puts an end to the objectifying practices enumerated above including starvation wages and termination without cause. Capital strictly defined by John Paul as a collection of things **per se** has no such needs.*

*In **Centesimus Annus**³ John Paul makes clear that the priority of labor over capital means that the needs of workers are not to be compromised for the sake of **maximum** returns and profits. This rule forces mainstream economists to re-think the profit-maximization rule. John Paul is saying, in effect, that the profit-maximizing firm is an analytical and pedagogical anachronism.*

Work more so than consumption or leisure is crucial to understanding personhood and economic agency because if human sociality is not admitted in the workplace it will not be admitted in the marketplace or the household. And, seeing that for most adults work takes up more time and human energy than consumption or leisure, work is by far the most important economic activity giving shape and form to the human person. The nineteenth-century Jesuit poet Gerard Manley Hopkins put the matter in these simple words: “... What I do is me...”⁴ We add the following: because the good or service produced can be sold only when there is some gain for the buyer, “what I do is for

¹ John Paul 1981, § 13, emphasis in the original.

² John Paul 1981, § 12.

³ John Paul 1991, § 41.

⁴ Gerard Manley Hopkins, “As Kingfishers Catch Fire,” PoemHunter.Com – The World’s Poetry Archive, 2004, available at www.poemhunter.com/i/ebooks/pdf/gerard_manley_hopkins_2004_9.pdf.

others.” Sympathy or fellow-feeling is necessary to assure that the transaction is a positive-sum experience. Absent this virtue, the exchange can degenerate into a zero-sum, or worse yet, negative-sum experience.

Work and the persons who do the work change under the influence of the entrepreneur who introduces new products and services, sets up new processes of production, brings new materials into the production process, penetrates new markets, and initiates new business plans to run the economic enterprise. In that sense, the entrepreneur is the principal agent transforming the worker both as an instrument and as a person. In that sense, the entrepreneur sets in motion both second-level and third-level action.

The entrepreneur is the driving force behind the evolution of human communications from the oral and script stages into the electronic stage with its digital revolution because it is the entrepreneur who figures out how to transform a strictly technological advance in electronics into an economic gain, thereby making it possible to incorporate that advance into economic affairs. In that regard, the entrepreneur has played a key role in making economic agents more aware of others and of themselves and therefore in the development of personalism and the transformation of the economic agent from a human individual to a human person.

Because meeting and interacting with others were demanding and costly in the oral and even the script stage of human communication, economics more easily could construe humans as self-reliant, compelled to undertake work alone for whatever gains were associated with that labor, and inward-directed, aggressive, competitive individuals. When meeting (in real and virtual space) and interacting with others became more convenient and less expensive in the electronic stage, humans more readily can be seen along the other dimension of their nature as socially-reliant, open to working together especially on tasks that cannot be done as well or at all by the individual alone, and outward-directed, nurturing, cooperative persons.

Work is the principal means for humans to have more and to be more. The choices they make, in this regard, powerfully determine who they are, what they are, and to whom or to what they belong.

How Leisure Changes the Person with Time to Spare.

Work is such a central human activity that economics defines two other states in terms of work. Unemployment is the generally involuntary and unwanted **lack of work**, a state in which work is **missing**. Leisure is the voluntary and wanted **absence of work**, a state in which work is **not present**.

By construing leisure as time spent not working, mainstream economics does not differentiate between lack of work and absence of work. Leisure and work are linked in zero-sum fashion: more of the one means less of the other. Implied in this construction is that leisure is desirable simply because it is free of work that is onerous. Defining leisure in terms of **what it is not** assures that economics has little to say about leisure and its effects on the human person.

To be analytically serviceable, leisure has to be defined in the context of what it is rather than what it is not. Gerard Stockhausen supplies us with the following:

leisure ... [is] non-work that nourishes the health, happiness, and fulfillment of the whole human person. It is time and activity that is not driven by duty, accomplishment, or productivity, time and activity that celebrate being human rather than having and consuming material things. It thus includes such things as quiet time alone, "quality" time with family and friends, and engagement with the arts¹

Put more simply, leisure is third-level action that puts a person in contact with truth, goodness, and beauty, or fabrication, wickedness, and ugliness.

From this perspective, leisure is energetic rather than lifeless, purposeful instead of aimless. More precisely, leisure is like work in the subjective sense and consumption in that it is activity that helps a human being become more fully a human person. There is a special linkage between consumption and third-level leisure activities in that those activities are not cost-free. A visit to a museum to view a special exhibit featuring items on loan from a world-class collection requires travel and other expenditures. The ticket price is only a portion of the total cost of taking the family to a major league baseball game. Though it might be shared or borrowed later by others, a book to be read for enjoyment or edification was purchased by its original owner through a routine marketplace exchange. These leisure activities enhance the human person. In like fashion, a visit to a bordello, tickets to a match that turns riotous, the purchase of pornographic materials are third-level leisure activities that diminish the human person.

In a very real sense, humans are works of art in progress. They paint their own living portraits with third-level work, consumption, and leisure activities, becoming whole and complete, just as the artist creates a painting with brush and paints. And just as the artist may abandon the canvas before it is finished, humans may leave their own development arrested.

In the context of economic affairs, according to John Paul, there are two chief threats to human development: disordered work and consumption.

The historical experience of the West, for its part, shows that even if the Marxist analysis and its foundation of alienation are false, nevertheless alienation -- and the loss of the authentic meaning of life -- is a reality in Western societies too. This happens in consumerism, when people are ensnared in a web of false and superficial gratifications rather than being helped to experience their personhood in an authentic and concrete way. Alienation is found also in work when it is organized so as to ensure maximum returns and profits with no concern whether the worker, through his own labor, grows or diminishes as a person, either through increased sharing in a genuinely supportive community or through increased isolation in a maze of relationships marked by destructive

¹ Gerard L. Stockhausen, "Leisure in the Economic Thought of John Paul II," in a special collection of papers on John Paul II's vision of the social economy in the *International Journal of Social Economics*, Volume 25, Number 11/12, 1998, p. 1673.

*competitiveness and estrangement, in which he is considered only a means and not an end.*¹

Stereotypically both disorders are revealed, though not well understood, in the form of the workaholic and the compulsive consumer. To the one, working is everything; to the other, acquiring and having are everything. Neither one understands or values leisure. Both are like a canvas that a deranged artist has slashed with a knife, both are grotesque caricatures of what was meant to be. Drug abuse and pornography, John Paul says, reflect a human life in disarray through disordered consumption.² Filling that void, repairing that torn canvas, is the purpose of leisure. In this regard, John Paul compares human work and leisure to the six days of God's own work in creating the universe and His one day of rest.³

Following John Paul, a well-ordered human person is one who knows the difference between the needs of the body and the needs of the spirit, and understands that the means which meet the one do not also meet the other. Leisure is absolutely necessary to acquiring that knowledge and understanding. The challenge to the economic order and to economics is to value humans accordingly, to appreciate the full range of their needs, and to recognize that they are more than instruments of efficiency and profits, more than acquisitive beings. Humans are most especially ends in themselves, living works of art in progress who require leisure to become what they are meant to be: very nearly divine.⁴ They are, in other words, creatures who above all else are meant to be more, to develop the full potential of their personalities, rather than simply to have more.

Consumption, Work, and Leisure: Personalist Economics vs. Mainstream Economics.

Mainstream economics regards consumption as satisfying human wants and the prudent consumer as the one who maximizes the utility gotten from the available income. The concept of need is disregarded except when the issue of poverty is addressed and only when it is separated from consumer behavior. Whatever the consumer does with the goods and services purchased is strictly his/her own business because no one knows better than the consumer what will best satisfy his/her wants. For that reason, even when the food bought and consumed is virtually the same, there is no difference between having Thanksgiving dinner alone or spending it with family and friends. No difference between shopping for a suit, dress, or pair of shoes alone or in the company of another. No concept in the mainstream way of thinking that alone may mean loneliness and loneliness in turn can have a negative effect on the human spirit. This disregard for the human spirit derives from the premise of mainstream economics that the economic agent is an autonomous, utility-maximizing individual functioning mechanically as an embodied creature in a material, physical world where

¹ John Paul 1991, § 41.

² John Paul 1991, § 36.

³ John Paul 1981, § 25.

⁴ See John Paul 1995, § 84, paraphrasing the 8th Psalm, verses 5-6, and § 2. John Paul II, *Evangelium Vitae*, 1995, www.vatican.va. John Paul repeats this theme that human beings are very nearly divine in his *Memory and Identity*, New York: Rizzoli, 2005, pp. 98-99.

pleasure and pain are measured and compared in a decision-making process which is essentially passive. Anything relating to the human spirit is not economics even when it is tied closely to working or consuming.

*Personalist economics holds fast to the view that consumers are beings with a body and a spirit --- an embodied spirit -- and that they meet the needs and satisfy the wants of the body and spirit through the goods and services they buy and consume in a decision-making process which is essentially active precisely because they are living, breathing, existential actualities, not utility-calculating machines. They truly are **acting persons**. A muscle car is more than a vehicle for transporting a man's body from place to place. A tuxedo is an article of clothing but when worn by a woman can be a fashion statement as well. A bottle of fine Italian wine shared with a companion at dinner can strengthen a friendship and please the palate. Though personalist economics admits there are many difficulties in measuring the effects of consumption on the human spirit those effects are every bit as real as the effects on the human body.*

Further, personalist economics does not dismiss human need and separate poverty from consumer behavior. Rather, consumption not only satisfies human wants but also meets human needs. Since need is a normative concept, meeting need through consumption invariably involves value judgments as to what constitutes need. Thus there will be differences between researchers regarding how to define and measure the specific dimensions of need and for that reason researchers are well advised to state their specifics as clearly as possible. The disadvantage in doing economic analysis is that these differences make for differences in empirical results and therefore some uncertainty in the conclusions drawn from those results. The advantage is that consumer behavior is construed in a way that makes sense to the typical consumer who instinctively knows the difference between his/her own personal needs and wants and factors both into the decision-making process. Further, combining needs and wants links consumer behavior to poverty by raising the question as to what society should do for those persons and families without sufficient income to meet their material needs.

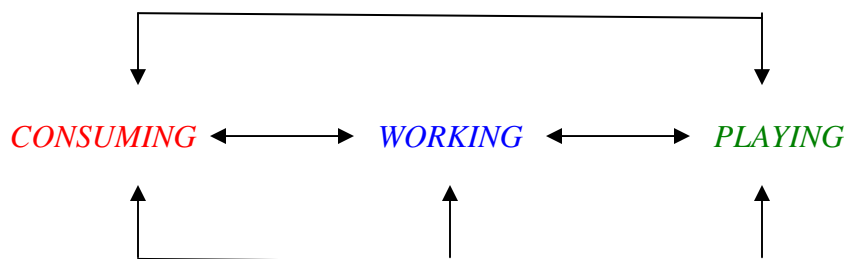
Personalist economics views work as having two effects on the working person. First, it provides income to purchase the goods and services which are needed or desired. Second, it provides opportunities to (a) associate with others in the workplace and develop a sense of belonging to a group with shared aims, and (b) to apply and enhance creative talents and energies. Mainstream economics regards the first but not the second as within the domain of the discipline because the first effect is objective in nature representing what the worker contributes to the production of goods and services whereas the second effect is subjective representing what the work itself does to the person of the one who works. The objective side of work demands a human body. Put differently, virtually no work can be accomplished by anyone other than an embodied human. In that regard there is little to choose between mainstream economics and personalist economics. The subjective side of work responds to the needs of the human spirit but the spirit first must be embodied because without the body no work can be done and therefore no subjective effect can be brought forth. Here personalist economics clearly departs from mainstream economics.

The second effect can be positive or negative. To illustrate, discriminating in pay and promotion and assigning a person to work for which he/she is overqualified turn the subjective effect negative. Designing and implementing a pay and promotion scheme based squarely on performance and finding the best match between the work to be done and the skills and talents of the worker turn the subjective effect positive. The objective effect of work is tied ultimately to the goods and services produced. The subjective effect is linked to the human spirit and for that reason has an impact on the development of the worker as a person. Anyone who works, even those with good-paying, challenging jobs, knows the difference between a good day at work and a bad day. And that difference often is reflected in their performance and physical appearance.

Just as it did with the subjective dimension of work, mainstream economics sees leisure which it defines as time spent not working as outside the domain of economics. This unfortunate definition which is drilled into the heads of students of economics from the very beginning tells us nothing about leisure. Personalist economics, on the other hand, sees leisure in terms of both the human body and human spirit and as crucial to personal development. A coffee break and a power-nap at work re-energize the body. Similarly, a good night's sleep allows the body to handle the demands of the following day. Bed rest after a surgical procedure helps heal the human body. A week in the mountains or at the seashore can infuse the human spirit with the beauty of the natural environment. An afternoon at a major league ball game with grandfather can instill in a youngster dreams of one day succeeding on the same field of play. Professional athletes at times describe their work as getting paid for playing a kids' game.

Leisure can be taken quite seriously as the continuation into adulthood of the play activity which is so vital to the development of children and what they are urged to do every day. In the end, leisure means setting aside time to care for the human body and spirit in ways other than the ones which are available through work and consumption.

Consumption, work, and leisure can be separated analytically but in practice they frequently are intertwined as three sets of pairs and a fourth set involving all three activities at once. The working



lunch combines work and consumption. The three-day holiday weekend mingles consumption and leisure. Working after hours at home and at the same time watching a college football game merges working and re-creating. The working vacation brings together all three. These three economic

activities have two things in common: (a) they involve both the human body and the human spirit and (b) they are subject to limits.

Certain limits are inherent in economic affairs and others must be imposed because humans are embodied spirits. Human materiality assures certain physical limits regarding consumption and work. The human body can consume only so much in one sitting so to speak, and can work continuously only for some fixed number of hours without rest.

Personalist economics likens capital equipment to a human being in that capital equipment cannot be run continuously without maintenance before it breaks down. Mainstream economics, on the other hand, likens a human being to capital equipment in that the economic agent is seen as a rational, utility-calculating and maximizing machine which is useful only insofar as it produces something of value.

Without other limits on what and how much we consume, on how long and how hard we work, and how much we allow for or indulge in re-vitalizing leisure activities, limits deriving from moderation that reside quietly in the human spirit, our development as human persons is arrested or misdirected. Disregard those limits, and consumption becomes gluttony and obesity, work transforms into obsession and exhaustion, and leisure changes into escape and boredom. The practical virtues, especially moderation, provide useful and effective limits on consumption, work, and leisure, and their faithful practice contributes powerfully to the realization of the full potential of the human person.

*To John Paul materiality matters importantly to human nature, and material means are necessary to meet human material needs. To a large extent, mainstream economics and modern culture agree. However, John Paul warns that material means will not satisfy the nonmaterial needs of humans, and condemns the “consumerism” of advanced western economies for perpetuating that false and dangerous value. Consumption is good, he says, unless it leads to a life spent in the enjoyment of material things as ends in themselves.¹ In mainstream economics, human wants are regarded as unlimited and having more is taken as essentially good. In personalist economics, **having more** matters less than **being more**. Acquiring more of the goods of the world is less important than developing more fully as a human person.*

The subjective dimension of human work, according to John Paul and affirmed by personalist economics, is more important than the objective dimension. Further, human work to John Paul is the continuation of God’s Act of Creation which lasted six days and was followed by a day of rest.² In like fashion, humans require a seventh day of rest to consider what they have done and what they ought to be doing. In other words, humans require both work and leisure to become more fully the person they were meant to be and leisure has the positive connotation of input to that development.

¹ John Paul 1991, §36.

² John Paul 1981, §25.

To the modern world, including the world of mainstream economics, leisure has only the negative connotation of time spent not working.

Because in personalist economics human beings are more important than mere things, labor is more important than capital. Indeed, humans alone have rights because they are persons, because they are endowed with an intelligence and free will which differentiate them from all other creatures. Aquinas calls them “the crown of creation,” a judgment shared by personalist economics. In the world of economic affairs and mainstream economics, intentionally and otherwise humans often are reduced from persons to things, objectified more and more in both the workplace and the marketplace.

Human beings are “embodied spirits” and as workers are resources to be applied to the production of goods and services. However, humans have worth not because they are useful toward some economic purpose though this kind of valuing has its own practical application in wage and salary administration and for that reason cannot be dismissed out of hand. Rather, each one has a dignity and worth beyond human measure. In mainstream economics and modern economic affairs, human value commonly is determined instrumentally. One’s own worth is determined by the value attached to one’s work. In personalist economics, this kind of valuing is superseded by the sacred dignity of every living, breathing human person.

Workers have rights in order to assure the preservation of their fundamental dignity as human persons and access to the means necessary for their material survival, such as the right to associate, the right to strike, the right to a safe workplace, the right to a day of rest. To some extent, mainstream economics and others engaged in economic affairs also affirm these rights but as legal rights, as flowing from the hand of government and therefore contingent. Personalist economics sees them as natural rights flowing from the hand of the Creator and therefore inalienable.

Humans are more than the one-dimensional self-interested, self-absorbed, and passive individuals of mainstream economics and contemporary western culture. They are the two-dimensional, active persons of personalist economics with an identity as separate and unique human beings never to be taken simply as a cog in a machine or as totally subordinate to the whole, and at the same time united in solidarity with family, company, neighborhood, region, nation, and all humankind. Human existence always is coexistence.

REVIEW SECTION: TOPIC 20

Central Concepts:

consumption
work
need to belong
need for opportunities to develop and utilize creative talent
leisure
consumerism
economism
principle of the universal destination of the goods of the world
truth, goodness, beauty

Important Questions:

How does consumption change the person who consumes?
Why does personalist economics regard as ill-advised the mainstream premise that human material wants are unlimited?
Why should the concept “need” be re-introduced in economics?
How does work change the person who works?
Which effect of work-- the good or service produced, the impact on the person of the worker -- is more important?
How does leisure change the person who has time to spare?
Which is more important, *having* more or *being* more?
In contemporary economic affairs, how are human beings reduced from person to objects?
Which economic activity – consumption, work, or leisure – is the means by which human beings *have more* and *be more*?
Why is the mainstream concept of leisure unsatisfactory?
How does leisure put a person in contact with truth, goodness, and beauty?
How are consumption and associated?
How does leisure enable a person to *be more*, to approach his/her full potential as a human person?

(continued on following page)

True/False:

- a. Work is the primary activity for *having more* and for *being more*.
- b. Mainstream economics and personalist economics agree that all human material wants are unlimited.
- c. The most important effect of work is on the goods and services produced.
- d. Leisure is defined properly as time spent not working.

Mark your answer below.

- ▼
- Item a is true, items b, c, and d are false.
 - Items a and b are true, items c and d are false.
 - Item a is false, items b, c, and d are true.

TOPIC 21 RE-CONSTRUCTING MICROECONOMICS: A SUMMATION

To summarize our argument that compared to *homo economicus* the *acting person* is a more accurate representation of the economic agent.

*In mainstream thinking, **homo economicus** is subject to change in that the economic agent is capable of acquiring or losing the human capital which is embedded in his/her nature. Further, mainstream economics acknowledges that at times **homo economicus** acts altruistically, in accordance with the needs and desires of others. Mainstream economics reconciles this kind of behavior with the self-centeredness of **homo economicus** by labeling it “enlightened self-interest.”*

*Even so, **homo economicus** overwhelmingly is never-changing because the (over-) simplifying proposition of self-interested behavior assures a predictability in economic affairs and in turn empirical findings from economic analysis about which there is greater (apparent) certainty. Further, the economic agent of mainstream economics never changes in that **homo economicus** ...*

*is unique, solitary, autonomous, self-centered, and self-made,
is privacy-protecting and commodity-acquiring,
makes intra-personal comparisons,
is utility-maximizing, free to choose and act, rational in all decision-making,
is strictly want-satisfying, both foresighted and hind sighted,
is self-reliant, and inward-directed,
has worth determined entirely by what he/she contributes to economic affairs,
is a self-contained, machine-like **individual being** whose nature is set forth by the
philosophy of **individualism**,
knows only “**I / me / mine.**”*

Strictly speaking, *homo economicus* is neither virtuous nor vicious and therefore never...

caring or heartless	trustworthy or inconstant	loyal or treacherous
just or unjust	faithful or deceitful	forgiving or merciless
grateful or resentful	kind or envious	diligent or lazy
loving or loved	moderate or self-indulgent	kind or mean-spirited

In decision-making *homo economicus* is never ...

conflicted or confused hesitant or uncertain

Notwithstanding Smith's *Moral Sentiments*, *homo economicus* is never ...

benevolent, generous, or sympathetic

*For some time we referred to the economic agent of personalist economics as **homo socioeconomicus**. We are replacing that term with the **acting person** -- for two reasons. First, the literature has become cluttered with similar terms such as **homo reciprocans**, **homo politicus**, **homo sociologicus**, **homo hobbesianus**, **homo darwinianus** and others which by and large mainstream economics has not taken seriously. Using **the acting person** and linking it to the philosophy of personalism avoid the problem of being thrown together with those terms and then being thrown out with them. Second, the **acting person** connects economic agency to human action in economic *in acting virtuously or viciously accumulates or depletes personalist capital, and thereby is more effective and more highly valued as an agent or less effective and less highly valued.**

*The **acting person** is ever-changing in the sense that the economic agent of personalist economics ...*

*is unique and alike, solitary and communal, autonomous and dependent,
self-centered and other-centered, self-made and culture-bound,
is privacy protecting and company-seeking, commodity acquiring and gift-giving,
makes intra-personal and inter-personal comparisons,
is utility-maximizing at times and utility-satisficing at other times, free to choose
and act but accountable for his/her choices, rational at times and emotional
at other times,
is usually need-fulfilling before want-satisfying, both foresighted and hind sighted,
is self-reliant and inward-directed and at once socially-reliant and outward-
directed,
has worth that ultimately derives not from **what** he/she contributes to economic
affairs but from **who** he/she is -- not an instrument, object, slave, or even
an individual -- a person made by the Creator to be nearly divine,
is a living, breathing existential actuality, an **acting person**, an **individual being**
and a **social being** whose nature is illuminated by the philosophy of **personalism**,
a divided self who often must resolve conflicts that arise between his/her
individuality and sociality.
knows both "**I / me / mine**" and "**we / us / ours.**"*

*The **acting person** can be either ...*

<i>caring or heartless</i>	<i>trustworthy or inconstant</i>	<i>benevolent or mean</i>
<i>loyal or treacherous</i>	<i>just or unjust</i>	<i>faithful or deceitful</i>
<i>generous or greedy</i>	<i>forgiving or merciless</i>	<i>sympathetic or insensitive</i>
<i>grateful or resentful</i>	<i>altruistic or egoistic</i>	<i>kind or mean-spirited</i>
<i>diligent or lazy</i>	<i>loving or loved</i>	<i>moderate or self-indulgent</i>

*In decision-making the **acting person** sometimes is ...*

conflicted or confused hesitant or uncertain

*Finally, and most importantly, mainstream economics asserts that in the end the economic agent, **homo economicus**, maximizes utility and profit and the economy functions best when it reaches Pareto optimality. Maximizing utility and profit is based on the proposition that the good invariably consists in having more. Personalist economics, in contrast, claims that most fundamentally the economy functions best when the economic agent, the **acting person**, maximizes personalist capital thereby enhancing him/herself as a human person and rendering him/herself more effective and more highly valued as an economic agent. Maximizing personalist capital rests on the assertion that the good always inheres in being more.*

Because this topic is itself a summation, there is no pressing need for the usual topic-ending review section.

MACROECONOMICS

Addressing Economic Affairs from the Perspective of Human Sociality

TOPIC 22 MACROECONOMIC CIRCULAR FLOWS

To show how economic sectors are linked by markets, how waste can be represented in the macroeconomic circular flow, and how to personalize the circular flow concept.

Topic 22 marks the beginning of our study of macroeconomics by which we mean economic affairs as seen specifically from the perspective of human sociality. With microeconomics, Marshall's scissors diagram was most helpful in arriving at an understanding of the inner workings of the market system from the point of view of human individuality. Macroeconomics requires a different pedagogical tool, the circular flow diagram. We begin with a simple market economy rendered in terms of a circular flow diagram that incorporates two sectors (workplace and household) and two markets (product and resource). The six flows indicate the nature of the interaction between the workplace and the household and differentiate the interaction occurring in the product market from the interaction taking place in the resource market. See the diagram on the following page.

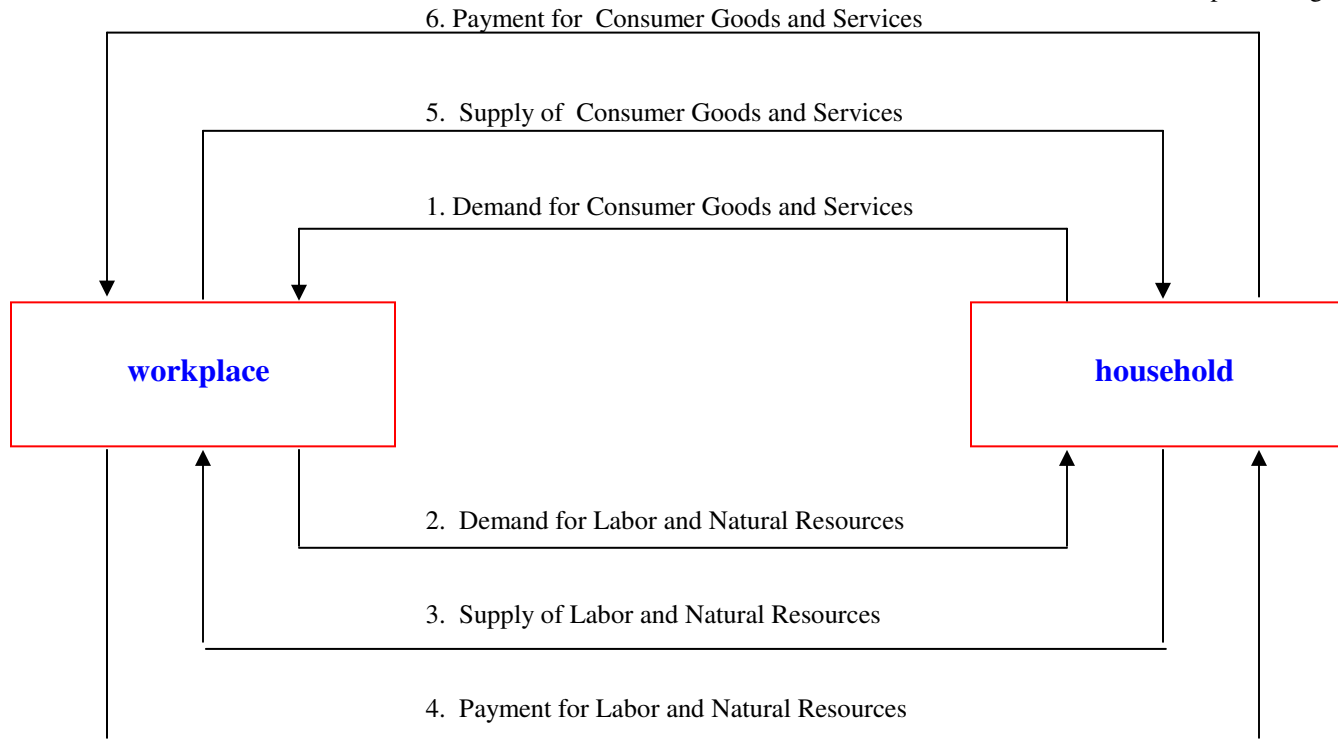
Flow 1 is the demand for goods and services that originates in the household because we begin with the premise of consumer sovereignty by which is meant that consumers ultimately decide what goods and services are to be produced by the choices they make as consumers. The demand for goods and services sets up a demand for the resources to produce those goods and services and is represented in the diagram by Flow 2. Here in order to simplify matters, we assume that all resources are owned by and held in the household sector. This derived demand for resources in turn evokes from the household sector a supply of resources (Flow 3), and since no one works for free, payment for the resources used is represented by Flow 4. Once the goods and services have been produced, they are transferred to the household as represented in Flow 5. The payment required to purchase those goods and services is represented by Flow 6.

The product market where the interaction of producers and consumers determines the prices of goods and services is represented by Flows 1, 5, and 6. The resource market where the interaction of producers and resource holders determine wages, salaries, rent, and dividends is represented by Flows 2, 3, and 4. As a way of tracking the performance of the entire U.S. economy, every quarter the federal government estimates Flow 4, which is officially designated national income, and Flow 6, which is known as national product. These two reports do for the macroeconomy what the balance sheet and the profit and loss statement do for the business firm.

There are two assumptions made in this diagram that we will address in the next diagram. First, consumers spend all of their income, and producers sell all of their production. Further, no account is taken of environmental contamination or depletion of natural resources. We address the

MACROECONOMIC CIRCULAR FLOW: MARKET ECONOMY

Product Market flows 1 -- 5 -- 6 determine ...
goods and services produced
prices of goods and services



Notes:

Flow 1, the demand for consumer goods and services, originates in consumer sovereignty.
 Flow 4 = Flow 6 because all of the income earned from the sale of the goods and services produced is paid to the householders who supplied the resources to produce those goods and services.
 No accounting is made of environmental contamination or depletion of natural resources.
 Consumers spend all of their earned income: savings = zero. Producers sell all of the goods and services produced: inventory = zero.

Resource Market flows 2 -- 3 -- 4 determine ...
wages and salaries
rents and dividends

environment later in Topic 22.

The diagram on the following page represents the capitalist economy. Flows 1 through 6 remain in place, but their flow lines are suppressed so that Flows 7 through 9 can be seen more clearly. Entrepreneurs, as we have seen, require financial support to bring their innovations to life. Their demand for financial resources is represented by Flow 7. There are two sources of supply for financial resources: the savings of householders or Flow 8b and the credit created by private commercial banks or Flow 8a. Included in Flow 8b are the funds made available by wealthy investors who are looking for new companies that are developing new products and services. Those wealthy investors are called venture capitalists. They are willing to risk their funds in the hope of backing a new company that proves to be hugely successful. The interaction between the creditors and borrowers of financial resources determines the money rate of interest, the interest paid on borrowed funds (Flow 8c), and the value of assets. This interaction takes place in the financial market. In this diagram no allowance has been made for borrowing by householders or corporate retained earnings.

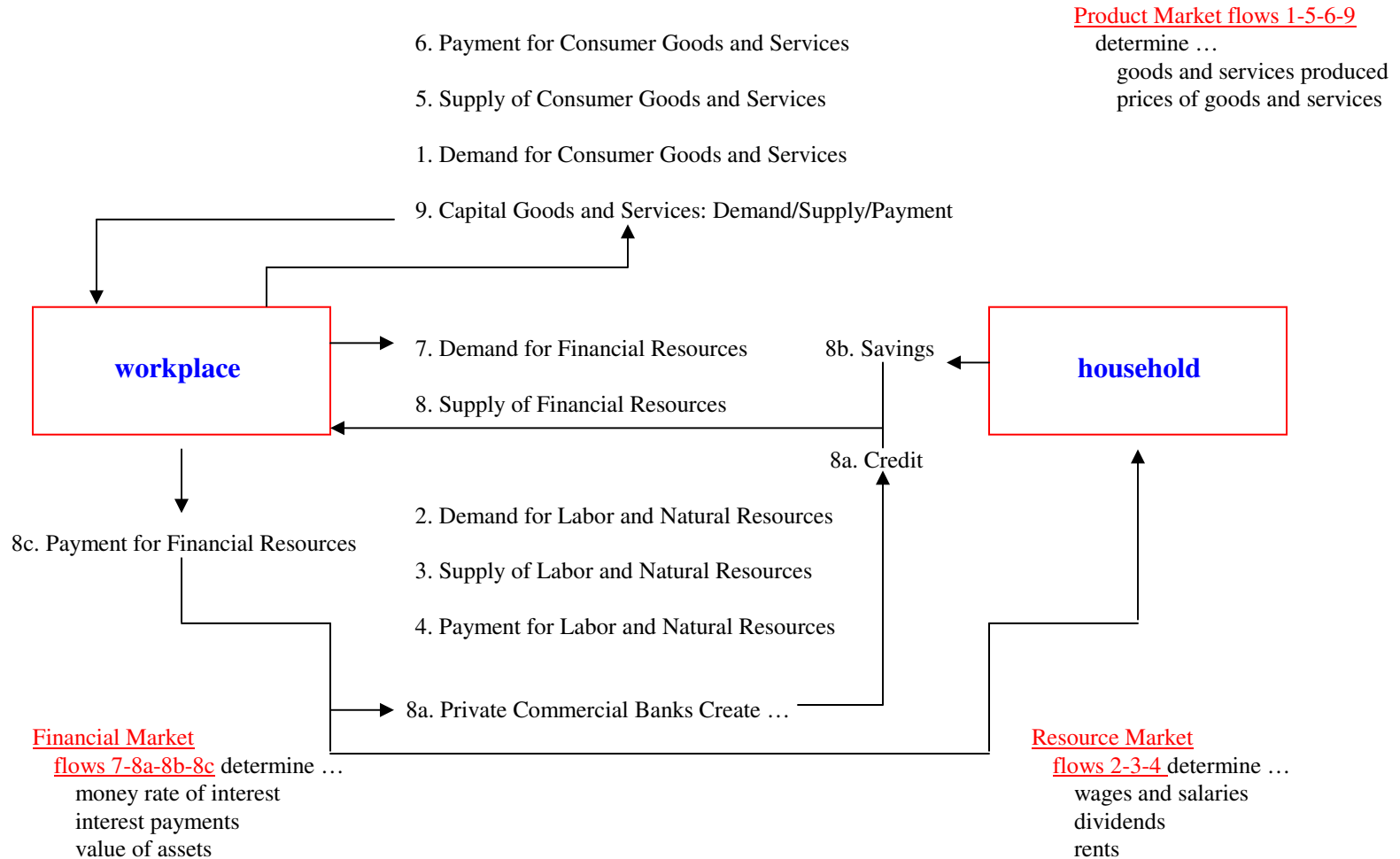
Entrepreneurs use the newly-acquired financial resources to purchase capital goods and services and to add to their inventories of finished goods that have not yet been sold. The demand for capital goods and services are now included in the product market as Flow 9.

The next diagram allows us to see the role of the government sector in macroeconomic affairs. This diagram refers to what is routinely called the mixed economy because it includes both the private sector and the public sector. Specifically, the government's demand for goods and services (Flow 10) makes it a player in the product market, purchasing goods and services from the private sector. Thus, the product market includes not only the demand for consumer and capital goods and services but also the demand for public goods and services.

The taxes necessary to purchase those public goods and services are represented by Flow 11 that is the only flow not represented in one of the three markets because taxes are not determined in a market. They are determined in the legislature and approved by a public official (president, governor, mayor), in the political order not the economic order.

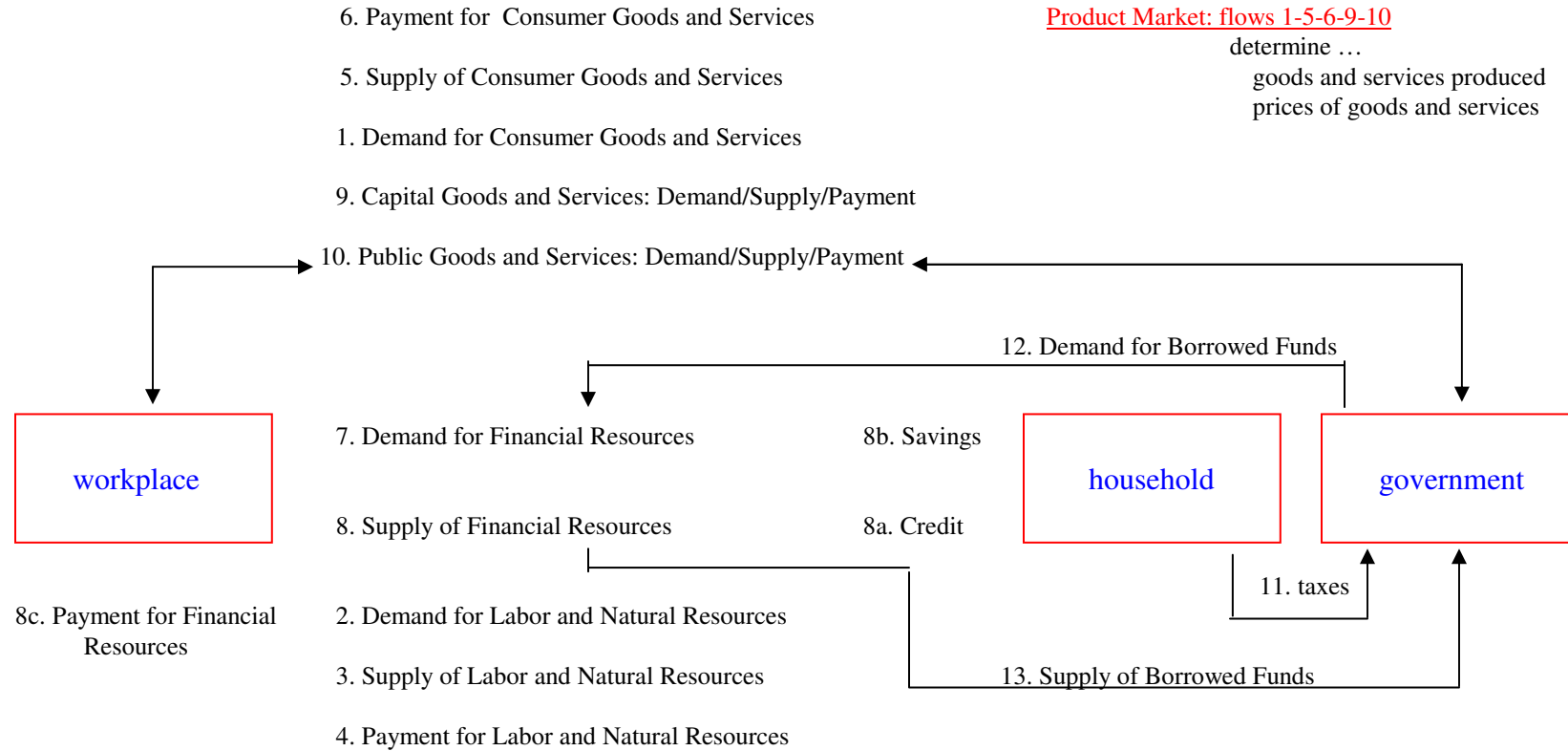
Governments have to borrow funds when tax revenues are insufficient to pay for all the goods and services purchased. At the federal level, the U.S. Treasury sells bonds (certificates of indebtedness with a fixed interest rate and a designated maturity date), and thereby becomes a player in the financial market. The total amount of money that the federal government has borrowed over the years and for which there are bonds that have not yet matured is called the public debt. Today that debt amounts to more than \$17.4 trillion. The interest paid on those bonds -- \$221 billion in FY2013-- is one of the largest items in the federal budget. The Defense Department spent \$819 billion in FY2013. The current statutory limit on the size of the public debt, which is set by act of Congress, is \$17.2 trillion and is raised as required. The limit, however, can be waived as happened in early 2013. Topic 31 addresses the public debt in the context of the financial meltdown of 2008.

MACROECONOMIC CIRCULAR FLOW: CAPITALIST ECONOMY



Notes: Flow 8b, household savings = [income earned – consumption expenditures]; no householder borrowing.
 Flow 9 includes inventories of unsold goods. No accounting is made of environmental contamination or depletion of natural resources.

MACROECONOMIC CIRCULAR FLOW: MIXED ECONOMY



Financial Market

flows 7-8a-8b-8c-12-13 determine ...
 money rate of interest
 interest payments and value of assets

Notes: Budget surplus -- tax revenues > expenditures -- presents 3 options: reduce taxes, increase spending, pay down public debt.
 Budget deficit -- expenditures > tax revenues -- requires government to borrow funds.
 No accounting is made of environmental contamination or depletion of natural resources.

Resource Market

flows 2-3-4 determine ...
 wages and salaries
 dividends and rents

A budget surplus occurs whenever tax revenues exceed government expenditures, and presents three options. First, taxes can be reduced. This option is in general favored by conservatives and Republicans. Second, government spending can be hiked. Liberals and Democrats prefer this option. Third, the overall debt can be paid down. This option has less political support than the other two, but has the special benefit of reducing interest paid on the debt and thereby making more funds available under the first or second option.

The diagram on the following page represents the foreign or international sector in terms of imports and exports. A U.S. import is a foreign-produced good or service that has been purchased by a U.S. producer or consumer. Payment for that import requires money to flow from the U.S. buyer to the foreign producer. A U.S. export is a U.S. produced good or service that has been purchased by a foreign producer or consumer the payment for which takes the form of a flow of funds into the U.S. economy. This diagram represents exports and imports as flows of goods and services rather than payment flows.

Services as well as goods can be exported and imported. A U.S. consumer flying to Europe on British Airways or Lufthansa is importing air travel service because the money to pay for that service is flowing out of the United States. A U.S. university that enrolls international students is exporting educational services because the money to pay for those services is flowing into the United States.

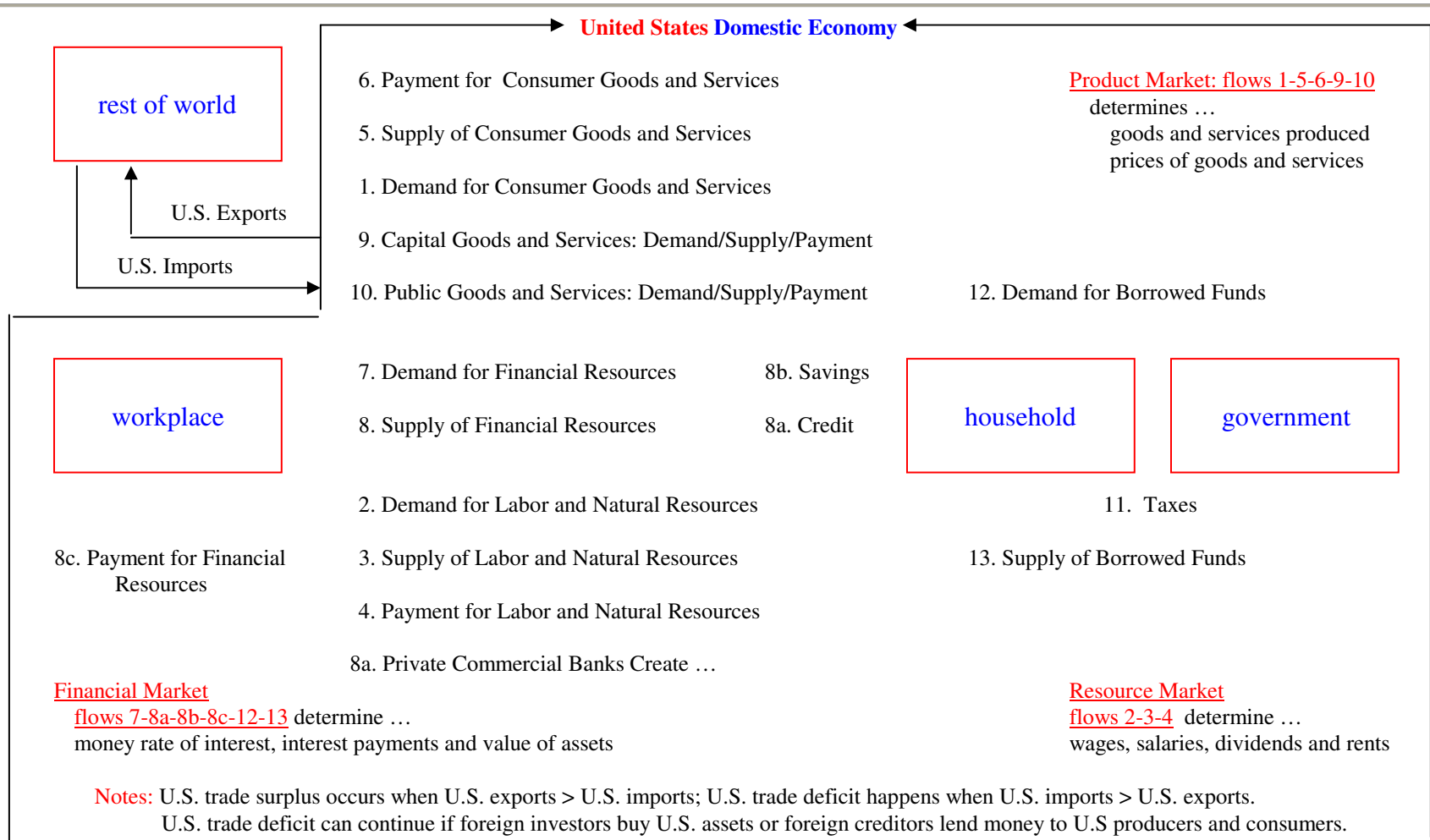
*At the end of World War II the United States was the world's largest trade surplus country (exports > imports) because the U.S. economy was the only major economy left standing in the aftermath of that devastating war. Today the United States is the world's largest trade deficit country (exports < imports). A **trade deficit (surplus) is not the same as a government budget deficit (surplus).***

The U.S. trade deficit in 2013 was \$475 billion. The U.S. economy can continue to run trade deficits as long as foreign creditors are willing to lend U.S. producers and consumers the additional money to purchase the imports that they are not able to afford from the money earned through the sale of exports. Or, as long as foreign investors are willing to buy U.S. assets and thereby provide U.S. producers and consumers with the additional cash to purchase the imports that they otherwise could not afford.

The Export-Import Bank of the United States was established in 1934 to aid in financing and to facilitate U.S. exports. Today the Bank provides guarantees of working capital loans for U.S. exporters, guarantees the repayment of loans or makes loans to foreign purchasers of U.S. goods and services, and provides credit insurance against non-payment by foreign buyers.

Our discussion of international trade next turns to the currency market, a special kind of financial market where currencies are traded on the basis of their exchange rates -- the value of one currency relative to another. Trades are made in anticipation of the gain from holding one currency versus another. If, for example, the U.S. dollar exchanges today for 105 yen and a currency trader expects

MACROECONOMIC CIRCULAR FLOW: GLOBAL ECONOMY



that the dollar will exchange for 115 yen next week, that trader would sell yen and buy dollars today in anticipation of the gain of 10 yen for each dollar sold and exchanged for 115 yen next week. Currency trades are executed through brokers who provide access to a network of international banks that buy and sell currencies electronically and through that trading activity set all currency exchange rates. The foreign exchange market is open 24 hours a day through exchanges operating at different times of the day in New York, Tokyo, Sydney, and London. On a daily basis, trading involves several trillion dollars On Thursday, April 23, 2014 the U.S. dollar exchanged for 102.34 yen.

A stronger dollar is one that exchanges for more of a given foreign currency than previously. Thus, the dollar is said to be stronger if \$1 exchanges for, say, 105 yen when previously it exchanged for 90 yen. A weaker dollar is one that exchanges for less of a given foreign currency than formerly. Thus, the dollar is said to be weaker if \$1 exchanges for, say, 0.90 euros when formerly it exchanged for 1.20 euros.

The language employed here, stronger and weaker, can be misleading. Stronger has two main effects, one negative and one positive. The same applies to weaker.

*A **stronger dollar**¹ means that U.S. consumers are advantaged because the dollar buys more of a foreign currency than before, effectively making foreign-produced goods cheaper. For example, if a Japanese DVD is priced at 25,000 yen and \$1 exchanges for 90 yen, the DVD costs \$278 (25,000 yen / 90 yen). If the exchange rate changes such that \$1 exchanges for 105 yen, the same DVD then costs the U.S. buyer \$238 (25,000 yen / 105 yen).*

By making foreign-produced goods cheaper, a stronger dollar strengthens the demand of U.S. consumers for foreign-produced goods and weakens their demand for U.S.-produced goods. This shift away from U.S.-produced goods means a drop in production at U.S. firms and fewer jobs for U.S. workers.

*A **weaker dollar** means that U.S. consumers are disadvantaged because the dollar buys less of a foreign currency than before, effectively making foreign-produced goods more expensive. For example, if a German camera is priced at 1,100 euros and \$1 exchanges for 1.20 euros, the camera costs \$917 (1,100 euros / 1.20 euros). If the exchange rate changes such that \$1 exchanges for 0.90 euros, the same camera then costs the U.S. buyer \$1,222 (1,100 euros / 0.90 euros).*

By making foreign-produced goods costlier, a weaker dollar weakens the demand of U.S. consumers and producers for foreign-produced goods and strengthens their demand for U.S.-produced goods. This shift toward U.S.-produced goods means a rise in production at U.S. firms and more jobs for U.S. workers.

¹ A stronger dollar is not to be confused with hard currency wherein the paper currency of one country functions as a medium of exchange in another country.

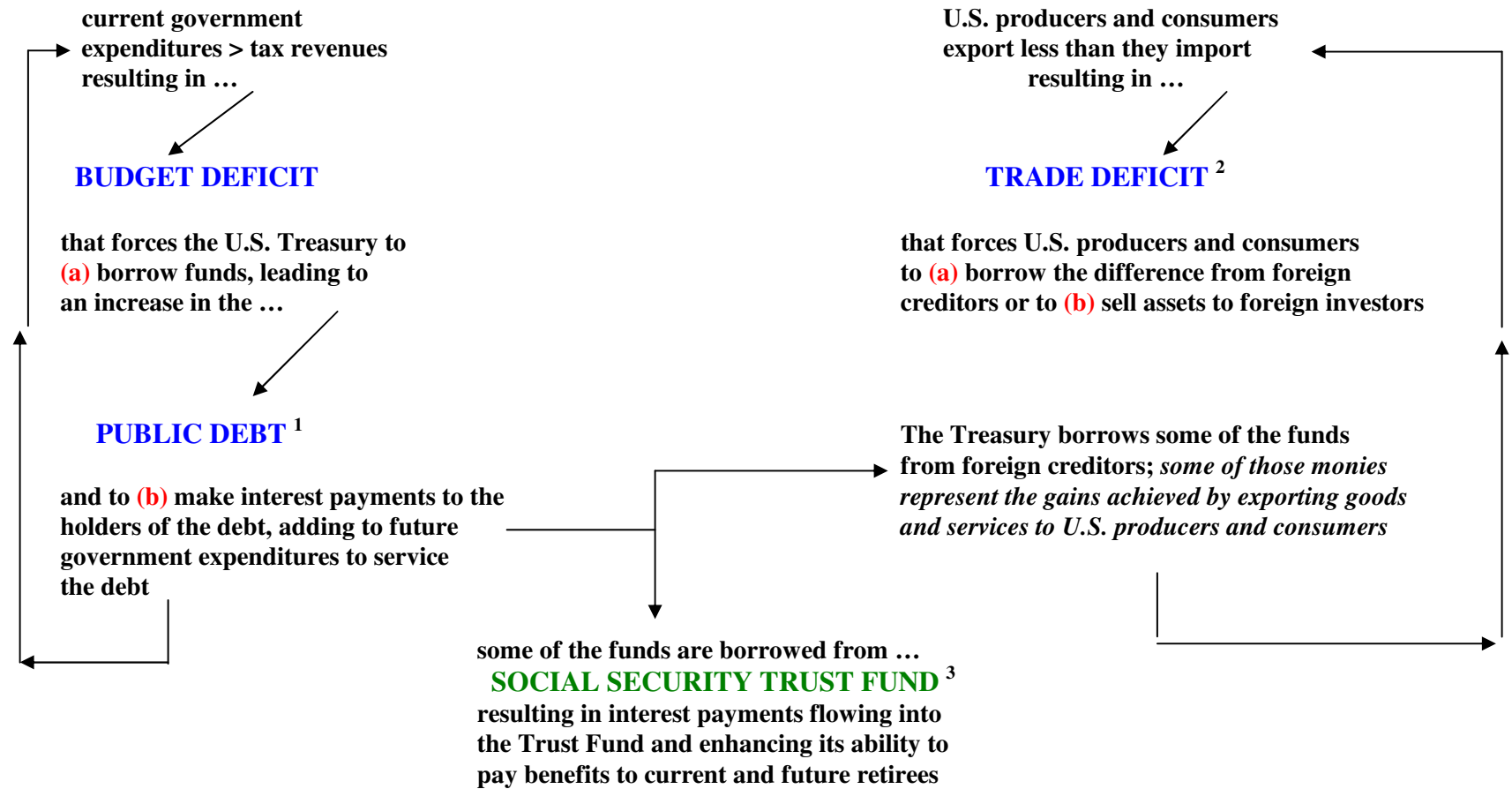
The diagram on the following page sets forth the connection between the budget deficit and the public debt on the one hand and the trade deficit on the other. A budget deficit forces the U.S. Treasury to borrow funds which adds to the public debt and compels the Treasury to make interest payments to the holders of the newly issued securities thereby adding to future government expenditures to service the public debt and making future budget deficits more likely. Some of the funds that are borrowed by the Treasury come from surplus monies in the Social Security trust fund obligating the Treasury to make interest payments to that trust fund for as long as the fund holds that debt. The Treasury also borrows from foreign creditors and some of those borrowings originate in the gains that foreigners have earned by exporting goods and services to U.S. producers and consumers. If foreign creditors decide to invest elsewhere or to sell their current holdings of securities issued by the Treasury (at the end of the year 2013, \$5.8 trillion of the public debt was held by foreign creditors), the Treasury will have to pay higher interest rates to attract the funds needed to cover future budget deficits.

The final macroeconomic circular-flow diagram in this series incorporates several new features. First, none of the flow lines have been suppressed though they have been rearranged, the foreign sector has been removed, and the layout changed from landscape to portrait in order to improve appearance and simplify presentation. Second, the diagram has been revised to replace the workplace, household, and government sectors with human beings: the producer/entrepreneur, the consumer/worker, and the public official. The creditor/banker for the first time is explicitly represented. Also for the first time, allowance is made for borrowing by householders. These changes are consistent with the emphasis that we have given to economics from the very first topic. Economics most fundamentally is about human beings carrying out their routine, everyday activities in economic affairs. Third, Flow 14 has been added to represent wasted natural resources allowing us to see environmental degradation in terms of the circular flow. Flow 15 has been introduced to represent wasted human resources, so that we can visualize from a macroeconomic perspective job loss, unemployment, and reemployment.

Flow 14 and Flow 15 are sufficient for our purposes because there are only two principal resources used in the production process. Discarded natural resources, Flow 14, can be either recycled or reprocessed and used again in the production of goods and services. A reprocessed item is one that undergoes some change before it is used again. A recycled item is one that is returned to the production process without being reprocessed. Both are shown as being returned to the process of production through Flow 3d.

Carrying capacity is a concept that has emerged as a result of heightened awareness of the importance of the environment to the well-being of all earthly creatures, especially human beings. Carrying capacity refers to the limit on the capability of our planetary home to absorb environmental contamination of the air, soil, and water. There is in other words a limit to the amount of Flow 14 that can be tolerated without impairing the well-being of every earthly inhabitant. Where that limit lies is precisely the question at the heart of the public discourse

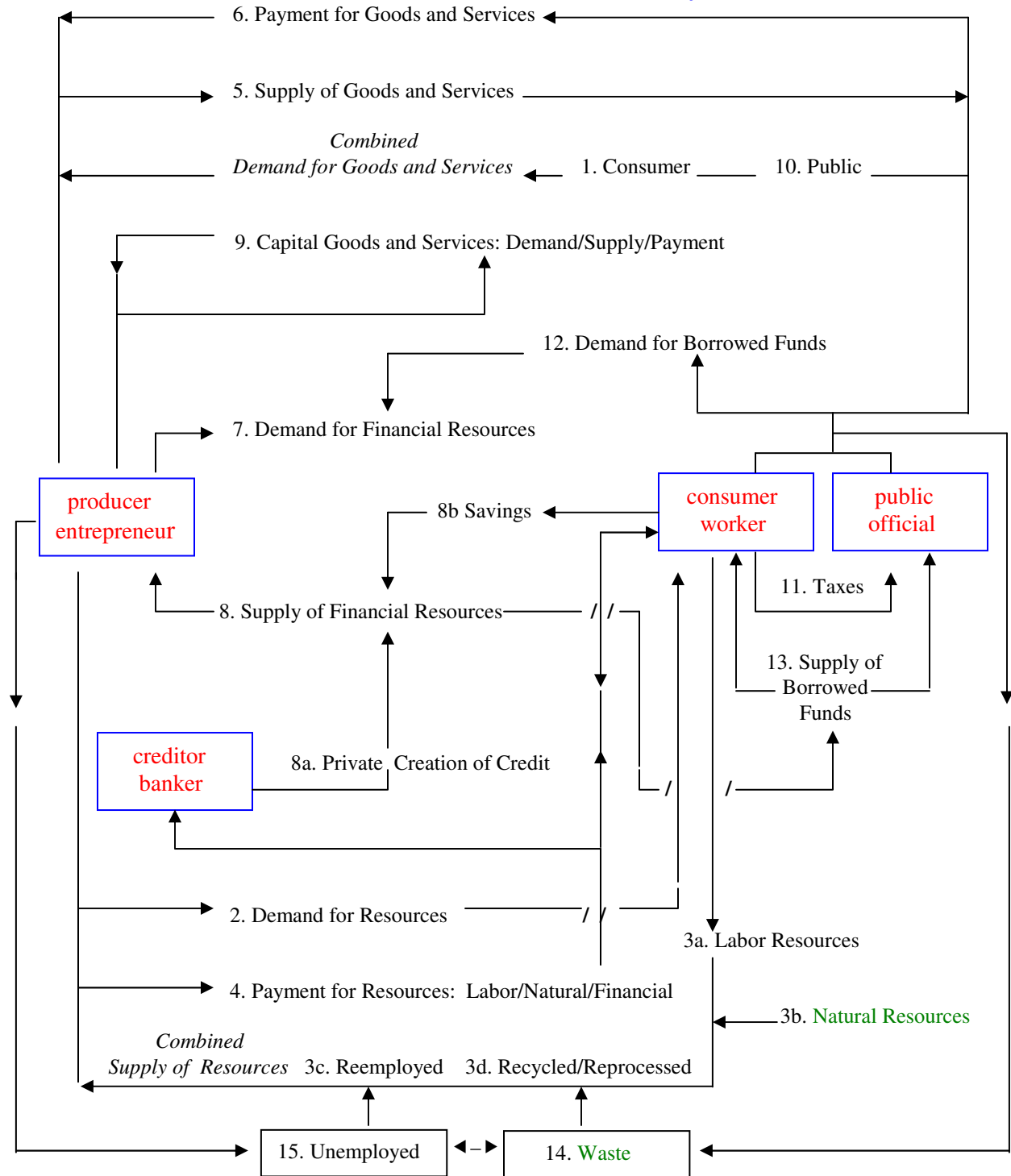
U.S. BUDGET DEFICIT AND TRADE DEFICIT



¹ current (2013) public debt = \$17.4 trillion / \$5.8 trillion held by foreign creditors / statutory limit = \$17.2 trillion. ² U.S. trade deficit (2013) = \$475 billion.
³ current generation of workers and their employers contribute to trust fund / current generation of retirees receive monthly benefit payments from the trust fund / lending funds to the U.S. Treasury is possible when there are surplus monies in the trust fund (contributions > benefits paid).

MACROECONOMIC CIRCULAR FLOW: PERSONALIST ECONOMICS CONTEXT

United States Domestic Economy



Product Market flows 1-5-6-9-10

Resource Market flows 2-3a-3b-3c-3d-4

Financial Market flows 7-8a-8b-8c-12-13

Though we know of persons who have been jobless for long periods of time, and we recall that during the Great Recession the United States was beset by massive and persistent unemployment, the average unemployed person remains jobless for only a short period of time. Indeed, during an economic boom when there are labor shortages, unemployment may run for just one or two weeks. Large proportions of the unemployed are on temporary layoff and subsequently are recalled by their employers. Others find new jobs. We represent both types through Flow 3c.

For the first time, new labor resources are differentiated from new natural resources. Flow 3a represents new labor resources as originating in the household sector. Flow 3b portrays new natural resources as the endowments of nature. Notice, we have included Flows 3a, 3b, 3c, and 3d in our macroeconomic representation of the resource market at the bottom of the diagram where we also take note of the flows specific to the product market and the financial market.

APPENDIX
Absolute Advantage, Comparative Advantage, and the Law of Nature

As stated in Topic 2, every exchange entails gain for the parties involved: what is gotten through exchange is more useful than what is given up. In global trade, gain originates in absolute advantage and comparative advantage. The person who is able to produce a good or service at the lowest cost is said to enjoy an absolute advantage in global trade because he/she is able to offer that good or service at a lower price than other producers, thereby expanding his/her trade and increasing profits, at the same time his/her trading partners are able to buy that good or service at a lower price. In other words, trade under conditions of absolute advantage results in gain for both trading partners.

Comparative advantage rests on the concept of *opportunity* cost from mainstream economics -- the cost of producing a given good or service in terms of the amount of some other good or service that might have been produced with the same amount of resources. To illustrate, using the same amount of resources a Swedish electronics manufacturer is able to produce either 2,000 cell phones per day or 4,000 pagers. Producing 100 cell phones in effect costs this manufacturer the *opportunity* to produce 200 pagers; producing 100 pagers costs 50 cell phones. A Finnish electronics manufacturer, on the other hand, is able to produce 6,000 pagers or 2,000 cell phones every day using the same resources. Producing 100 cell phones effectively costs this manufacturer the *opportunity* to produce 300 pagers; manufacturing 100 pagers costs 33 cell phones.

	<u>Swedish company</u> vs. <u>Finnish company</u>	
<i>Opportunity</i> cost of 100 cells phones	200 pagers*	300 pagers
<i>Opportunity</i> cost of 100 pagers	50 cell phones	33 cell phones*
	*: lower <i>opportunity</i> cost	

The Swedish company is said to have a comparative advantage in producing cell phones because it can produce 100 cell phones at an *opportunity* cost of 200 pages whereas for the Finnish company the *opportunity* cost for producing the same number of phones is 300 pagers (50 percent higher). The Finnish company has a comparative advantage with pagers because it can produce 100 pagers at an *opportunity* cost of 33 cell phones whereas for the Swedish company the *opportunity* cost for producing the same number of pagers is 50 cell phones (52 percent higher). As long as both companies have different *opportunity* costs, each one enjoys a comparative advantage in terms of the product for which it has the lower *opportunity* cost. The Swedish company should specialize in cell phones, the Finnish company should specialize in pagers, and through a bi-lateral trade agreement both countries would gain from having more cell phones and more pagers. In other words, trade under conditions of comparative advantage results in gain for both trading countries in the form of cheaper goods and services.

Trading on the basis of comparative advantage is an insight attributed to the early 19th century English classical economist David Ricardo and has remained a central tenet of economics for more than 150 years. However, comparative advantage has been challenged most recently by one of the most influential economists of the last 70 years -- Nobel Laureate Paul Samuelson -- who has

questioned its validity in an age of economic globalization.¹

Mainstream economics calls attention to what is gotten by means of global trade -- cheaper goods and services -- but not the dislocation and economic hardship that follow. Trade makes trading partners more dependent on one another. Domestic producers depend directly on foreign sources of resources (including financial resources) and supplies and indirectly on the governments in the countries where those resources and supplies originate. Instability in those countries due, for example, to war, famine, or natural catastrophe, can interrupt the flow of those resources and supplies. Financial resources may be withdrawn on short notice for the better returns available elsewhere; these financial flows, that often are sudden and unpredictable, are commonly referred to as “hot capital.”

In the pursuit of absolute advantage, domestic companies can relocate operations to foreign countries, thereby costing domestic workers their jobs, domestic suppliers their customers, and communities and local governments their tax bases. Domestic workers and their families who follow their employers to distant locations are uprooted from extended family members, neighbors, and their communities. Prompted by the prospect of greater gains from absolute advantage or comparative advantage, domestic companies may impose lower wages on their workers, replace senior high-wage workers with younger low-wage workers, or coerce suppliers into new agreements. Similarly, domestic companies may relocate operations to different parts of the country or switch to different product lines, thereby creating dislocation and economic hardship.

In a global economy rooted in the information/communications revolution, the manufacturing technology that gives rise to comparative advantage no longer is fixed in place. It is instead increasingly transferable and transportable and subject to piracy and reverse engineering. The winners are consumers who have access to cheaper imported consumer products, provided they have jobs to earn the income required to purchase those imported goods, and producers who have access to cheaper imported capital goods and new market opportunities for their finished products, provided they are able to continue innovating and producing goods in demand in an evermore competitive global economy. It follows that the law of nature is insufficient to assure that no economic insecurity and hardship are associated with global trade.

In the end, absolute advantage trumps comparative advantage. In a free-trade environment where there are few if any barriers to the entry of foreign producers into domestic markets and the entrepreneurial spirit is alive and well,² the low-cost producer always holds the high ground in any

¹ See Paul Samuelson, “Where Ricardo and Mill Rebut and Confirm Arguments of Mainstream Economists Supporting Globalization,” *Journal of Economic Perspectives*, Summer 2004, pp. 135-146. See also “Shaking Up Trade Theory,” *Business Week*, December 6, 2004, p. 116ff.

² Both conditions effectively ruling out bi-lateral trade agreements. See Thomas Friedman’s *The World is Flat: A Brief History of the Twenty-First Century* for an extended discussion of the ten forces that since 1989 have substantially changed how the global economy is energized, including such innovations as Netscape, open-sourcing, supply-chaining, off-shoring, and digitization.

competitive struggle. In an increasingly globalized world, comparative advantage has little meaning because to be effective comparative advantage requires that a country's labor, capital, and technology not move offshore. As Roberts has stated recently: "international immobility is necessary to prevent a business from seeking an absolute advantage by going abroad."¹

The specializing in and trading of cell phones and pagers between Sweden and Finland, which reflect both bi-lateral partners' own comparative advantage, break down when Sweden finds a lower-price supplier of pagers than Finland, and Finland finds a lower-price producer of cell phones than Sweden. Trade today is vastly different than in Ricardo's time largely because economic agents today have access to much better information on cost, price, quality, availability, financing, technology, product differentiation, and other factors that bear upon decision-making in economic affairs. Accordingly, our understanding as to how and why trade takes place and its effects across the globe of necessity should reflect the new realities of economic agency in 21st century. Martin put the new global economic reality as follows: "the Ricardian logic, based on so-called natural endowments, simply doesn't apply ... assuming that capabilities are static and advantages are permanent is a mistake."²

¹ Paul Craig Roberts, "The Harsh Truth About Outsourcing," *Business Week*, March 22, 2004, p.48.

² Roger L. Martin, "What Innovation Advantage?," *Business Week*, January 16, 2006, p. 102.

REVIEW SECTION: TOPIC 22

Central Concepts:

microeconomics and individuality; macroeconomics and sociality
scissors diagram and microeconomics; circular flow diagram and macroeconomics
goods and services:
 consumer
 capital
 public
consumer sovereignty
derived demand
exports and imports
deficit and surplus:
 budget versus trade
currency market
weak dollar/strong dollar
wasted resources:
 human: reemployed
 material: recycled/reprocessed
limit of carrying capacity

Important Questions:

In the macroeconomic circular flow model why does national income equal national product?
Explain what is meant by “demand in the resource market is derived from the demand in the product market.” In this model how is the role of the financial market represented?
What are the three domestic sources of the demand for goods and services?
In terms of a flow of cash, how is a product or service that is imported by the United States represented?
How is a U.S. export represented?
What is a trade surplus? A trade deficit?
What is a budget deficit? A budget surplus?
What are the two main domestic sources of financial resources?
Explain how it is possible for the United States to have the largest trade deficit in the world and to continue to run large trade deficits.
How can the macroeconomic circular flow be revised to accommodate waste and recycling?

(continued on following page)

True/False:

In the macroeconomic circular-flow diagram that represents a capitalist economy, there are two sources of the supply of financial resources...

- a. the savings of the household sector and the credit created by private commercial banks..
- b. taxes and the wasted natural resources and unemployed labor resources.
- c. imports and exports.
- d. the inventory of finished goods produced but not yet sold and the supply of newly acquired capital goods..

Mark your answer below.



_____ Item a is true, items b, c, and d are false.

_____ Items a and b are true, items c and d are false.

_____ Item a is false, items b, c, and d are true.

TOPIC 23 FOUR DIAGNOSTIC TOOLS

To present and critique four sets of tools useful in determining what ails the macroeconomy.

Topic 23 follows readily from Topic 22 and naturally precedes Topic 24 and the remaining topics in the following sense. The circular flow diagram does for the economics student what anatomy does for the medical student. That is the circular flow diagram allows the student of economics to see more clearly how the various sectors of the macroeconomy – household, workplace, government, and international – interact through the product market, the resource market, and the financial market. Further, the circular flow diagram improves our understanding of the macroeconomic significance of a government deficit and surplus and what they require or permit along with the importance of a trade deficit and surplus and what they require or permit.

Just as the medical student proceeds from the study of the human anatomy to diagnosis in order to be able to recommend a treatment modality that will successfully address the patient's injury, disease, or condition, the economics student learns the anatomy of the macroeconomy through the circular flow diagrams. Then that student is instructed in four rudimentary diagnostic tools in order to be able to recommend or at least understand how certain macroeconomic problems might be treated. And just as there are disagreements in medicine as to how a given injury, disease or condition should be treated, there are disagreements in economics as to how problems in the macroeconomy might best be addressed. Specifically, starting in Topic 25 we will see that there are four different schools of thought in economics on the proper way to treat the two most serious macroeconomic problems of inflation and unemployment.

The First Diagnostic Tool Measures Macroeconomic Performance in Terms of Production.

With the macroeconomic flow diagram representing the market economy, we observed that Flow 4 represents the sum of all payments for all of the resources used in the workplace to produce goods and services. This total payment flow is estimated quarterly by the federal government and is known officially as national income. Flow 6 on that diagram represents the sum of all payments for the goods and services purchased. This payment flow is estimated quarterly and is referred to as national product. Both of these estimates derive from a survey of employers that is administered quarterly and are released to the public in advance form based on incomplete source data one month after the close of the quarter and in preliminary form and final form based on more detailed and comprehensive data two months and three months after the close of the quarter. This tool emerged during the 1920s and has been further developed and refined ever since.

The most important estimates that derive from this diagnostic tool are known as GDP (gross domestic product) and GNP (gross national product). GDP is an estimate of the value of the goods and services produced by all companies operating in the United States whether those companies are

U.S. or foreign owned. GNP is an estimate of the value of the goods and services produced by all U.S.-owned companies whether they are operating in the United States or elsewhere. As diagnostic tools, GNP was developed before GDP, but today GDP is the preferred diagnostic tool because it measures what is happening to production in the U.S. domestic economy that is within the reach of such interventionist agencies as the Federal Reserve System. Attempting to intervene in the operations of U.S.-owned facilities located outside the United States is much more difficult and problematical.

There are two fundamental approaches to estimating GNP and GDP, the expenditure approach and the income approach. The expenditure approach estimates GNP and GDP via the product market by separately estimating expenditures on consumer goods and services, capital goods and services, public goods and services, and what is called net foreign investment (expenditures on exports minus expenditures on imports). When the U.S. macroeconomy experiences a trade deficit (exports < imports), net foreign investment takes on a negative value, and thereby results in lower estimates of GNP and GDP.

The income approach estimates GNP and GDP via the resource and financial markets wherein separate estimates are made of the various income streams corresponding to the different resources used in the production process: wages and salaries for the labor resources of workers, rent for the land and buildings of property owners, interest payments for the funds borrowed from lenders, and dividends for the monies invested by business owners and shareholders. Both approaches should yield the same estimate because all of the monies expended on the goods and services produced as measured via the expenditure approach are owed to and are paid out to the various resource holders whose labor and other economic resources were used to produce those goods and services.

In addition to the problem that arises in using this tool because the final estimates are not available until three months after the close of the quarter to which they refer, there are three other problematical issues. First, GNP and GDP estimates include all goods and services produced even those that some persons might find morally objectionable. To illustrate, the production of whiskey, cigarettes, and firearms is included in these estimates even though some persons regard those products as morally abhorrent. Second, GNP and GDP estimates include everything produced even the goods and services that some might find aesthetically objectionable, such as paintings or musical compositions that are offensive to the eye or ear. The rule in estimating GNP and GDP is simple and straightforward: if it is produced, it is counted. But counting at times presents a third problem. Some producers deliberately do not report their production or report only a portion of their production because they are trying to evade the taxes owed on that production, or because they are involved in illegal activities. This under-reporting means that the GNP and GDP estimates have to be used diagnostically in a way that recognizes this downward bias.

There are two principal components in the construction of a GNP or GDP estimate. The one component includes the amount of goods and services produced (the physical component) and the individual prices of each one of the goods and services produced (the financial component). The estimates themselves are rendered in dollar terms, such as “GDP for 2013 is estimated at \$17.090

trillion.” It is important in comparing one quarter to the next, or one year to another, to remove from the estimates the influence of any changes in prices that may have taken place from one time period to another. We will return to this issue later when we have addressed the diagnostic tool that measures changes in prices.

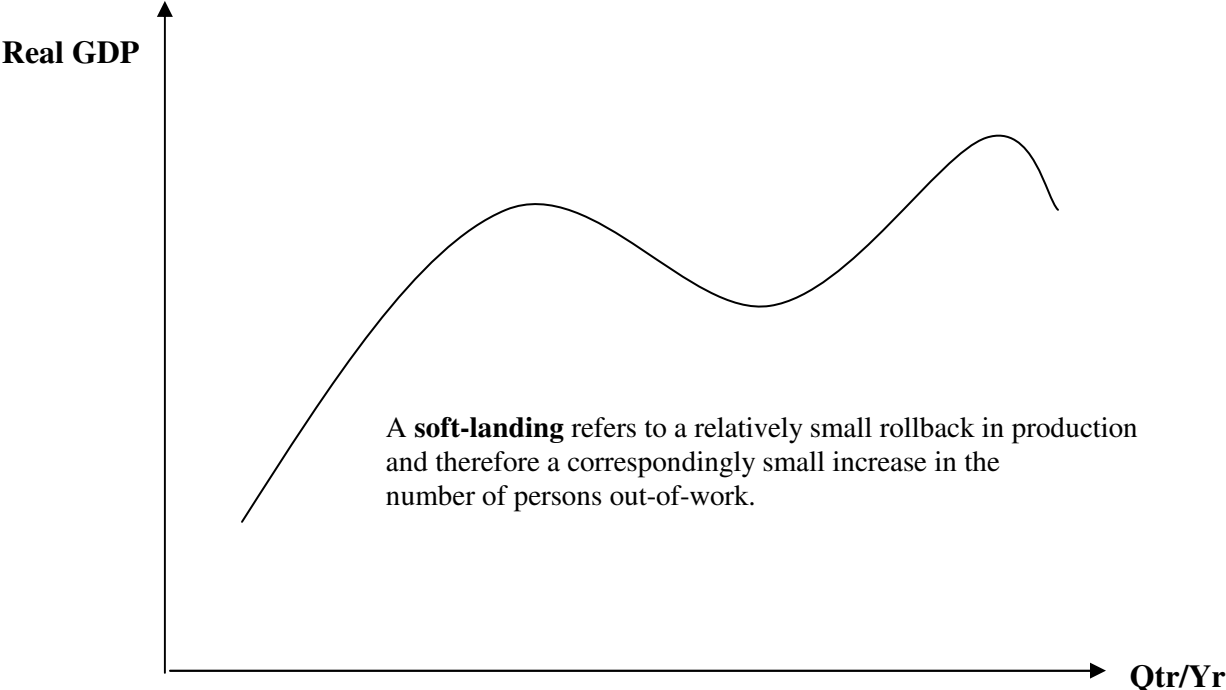
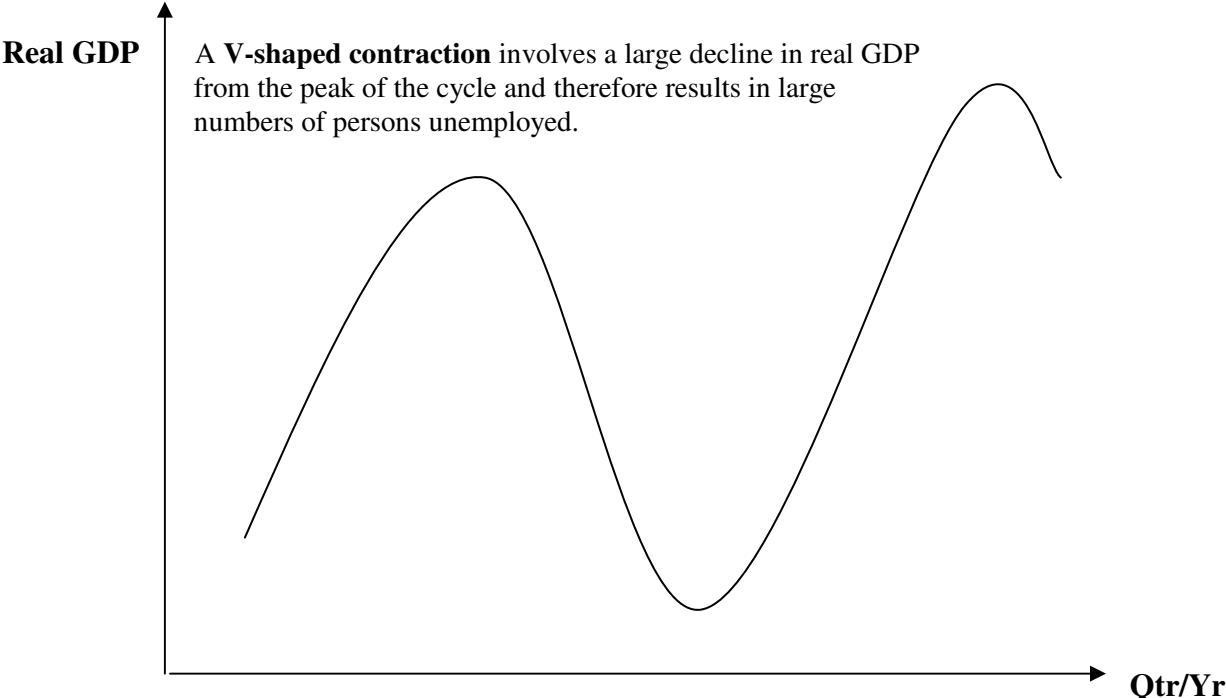
GDP estimates when they are plotted over time, afford a visual representation of macroeconomic affairs that economists call the business cycle. There are four phases to the business cycle: expansion, peak, contraction, and trough. These phases are repeated throughout economic history and have the general appearance of a sine wave. A contraction can be quite steep and deep in which case it is called a V-shaped contraction. Historically, a V-shaped contraction has been called “a crash.” A contraction that is shallow is called “a soft-landing.” See the diagrams on the following page. Since 2008 the Federal Reserve System has deliberately cut interest rates (the discount rate and the federal funds rate) to extremely levels to encourage more borrowing especially by entrepreneurs and more expenditures on capital goods and services in order to help recover from the V-shaped contraction of the Great Recession.

For many years, a recession was defined officially as two consecutive quarters in which there was a decline in GDP. However, the Business Cycle Dating Committee of the National Bureau of Economic Research uses estimates of GDP, employment, sales, personal income, and industrial production to date a recession. The seven-member committee considers and weighs the data and reaches a consensus judgment that settles the question as to when a recession started. The Committee announces its consensus to the public anywhere from six to eighteen months after the start of a recession. Since WW II, the average duration of recessions has been eleven months. It follows that the Committee’s consensus on the start of a recession often is reached after the economy has reached a trough and has begun recovering. See www.nber.org/cycles/recessions.html.

See Appendix A for more on how to re-define a recession in terms of human well-being rather than the conventional measures that reckon economic performance in terms of things such as GDP, income, and sales.

For a mature economy such as the United States, GNP and GDP in general increase about three percent per year under normal economic circumstances. Some years the increase may be either greater or less than three percent, and in a recession year GNP and GDP typically decline. In developing economies, higher rates of economic growth are possible and often occur. A three percent annual rate of growth (compounded annually) means that production doubles in approximately 24 years. A five percent growth rate results in a doubling of production in roughly 14 years. As we stated much earlier in the text, increased production is the key to higher living standards. For that reason, even a small boost in the annual rate of growth in a mature economy as indicated above shortens the period for achieving improved living standards considerably.

THE BUSINESS CYCLE: V-SHAPED CONTRACTION VERSUS SOFT LANDING



The Second Diagnostic Tool Measures Macroeconomic Performance in Terms of the Prices That Consumers Pay for the Goods and Services They Need and Want.

Consumer prices have been estimated since World War I when the federal government became concerned that the diversion of production to the war effort would lead to shortages of consumer goods and services that in turn would lead to inflation across the board. Today the federal government conducts a monthly survey of the prices of about 85,000 select goods and services that are widely purchased by consumers. These monthly surveys are taken by Census Bureau enumerators who are dispatched across the country to record the prices that retailers are charging their customers for those 85,000 designated items. The information is released to the public in the month following the survey.

Before this vast amount of statistical information is released to the public, it is reduced to a single number, an index number that is officially designated and identified as the Consumer Price Index (CPI). To simplify, the sum of the prices of all 85,000 items included in the survey is recorded for the first year in which those specific items were priced, and that year is called the base year. The index number for the base year by definition is 100.0. With every month following the base year, those items are re-priced and the total re-summed, and that total is divided by the sum for the base year. So if the monthly average for all items in the base year was, for example, \$218,000, and in a month in any subsequent year the sum for those same 85,000 items was, say, \$243,900, the index number for that month would be:

$$(\$243,900 \div \$218,000) \times 100 = 111.9$$

That means that there has been an 11.9 percent increase in prices between the base year and the later month in question.

There are two major problems with the CPI. First, it cannot and does not take into account changes in the quality of the 85,000 items with the passage of time, whether those changes represent an improvement or a breakdown in quality. Second, the CPI includes the same 85,000 items month in and month out even when U.S. consumers no longer are buying an item in the index. Thus, if typewriter ribbons or nylon cord bias ply tires are included in the index, but Americans are buying ink cartridges for their printers and steel-belted radial tires for their cars, the CPI does not take that shift in consumer choices into account. The remedy that is employed to deal with those two problems is to reconstitute the 85,000 items from time to time¹ and reset the index number to 100.0. That means that the CPI is a more useful diagnostic tool for measuring changes in prices over the shorter term, say, 5 or 10 years than the much longer term, say, 50 or 75 years.

Experience with this tool over the many years of its development and use has led to a consensus as those changes in prices that are benign and acceptable and those that are dangerous and call for some kind of government intervention. Annual increases in the range of 3 percent or less are benign

¹ How often this is done is a judgment call. In March 2014 the base period was 1982-1984.

and acceptable, whereas yearly increases of 10 percent or more are dangerous and call for intervention. On a monthly basis, that means an increase of 0.2 or 0.3 percentage points is acceptable, but an increase of 0.8 or 0.9 points is dangerous. Two components of the CPI, food and energy, are well known for large month-to-month swings in prices. For that reason, a separate estimate is made excluding those two components that is called the core rate. This rate is used diagnostically along with the all-inclusive rate to help economists understand better the performance of the macroeconomy.

A special index that includes the prices of consumer goods and services and other selected goods and services and that is known as the implicit price deflator is used to remove the influence of changes in prices from GDP and GNP estimates. To simplify, this adjustment is made as follows.

$(\text{unadjusted GDP estimate} \div \text{implicit price deflator for same period}) \times 100 = \text{adjusted estimate.}$

Assume that the unadjusted GDP estimate is \$17.200 trillion for 2013 and the deflator for that year is, say 110.9. The adjusted estimate is:

$(\$17.200 \text{ trillion} \div 110.9) \times 100 = \15.509 trillion.

The adjusted estimate is called real GDP or constant-dollar GDP because the influence of price level changes has been removed. The value of the dollar in other words has been held constant since the base year. The unadjusted estimate is referred to as nominal or current-dollar GDP. The diagnostic tool of preference is real or constant-dollar GDP.

The Third Diagnostic Tool Measures Macroeconomic Performance in Terms of the Supply of Labor. This tool, along with the other two just examined, focuses the attention of the student of economics on the performance of the macroeconomy in terms of things, although in this regard there is some confusion regarding what is measured by the labor supply tool. The need for a third tool emerged during the Great Depression of the 1930s when we had massive and persistent unemployment but no accurate estimates of the number of persons employed and the number unemployed. A household survey instrument and interview procedure were developed experimentally in the late 1930s and put into place permanently in the early 1940s. Today, the Current Population Survey (CPS) interviews about 60,000 households every month and based on the information collected estimates the number of persons employed and the number unemployed. The survey includes approximately 110,000 persons every month. The interviewing is done by telephone by 2,200 Census Bureau enumerators.

The households are selected at random, are retained in the sample for less than two years, and are replaced in order to assure that the respondents in the household do not become bored answering the same questions month after month and begin to provide answers that are less than fully accurate. The number of persons in the sample assures that the estimated numbers of persons employed and unemployed are highly accurate. Thus, a change in the rate of unemployment from one month to the next that is just 0.2 percentage points is regarded as statistically significant, that is can be regarded

as within the margin of error and therefore reliable. The information is released to the public on the first Friday of the month following the month in which that information was collected.

The CPS is a collaborative effort. Data collection and processing are done by the U.S. Census Bureau. Data analysis and report writing are done by the U.S. Bureau of Labor Statistics. The commissioner of the Bureau of Labor Statistics is the person who releases the information to the public in a press conference held on the first Friday of the month.

To be counted as employed a person must either (1) hold a paid job for at least one hour per week, or (2) have an unpaid job in a business operated by his/her own family that requires at least 15 hours of work per week. As to the paid job, there is no requirement regarding rate of pay. Thus, anyone working at least one hour per week and who is paid even if it is less than the minimum wage is counted as employed in the CPS.¹

To be counted as unemployed a person must be (1) without a job, (2) looking for work, (3) able to work, and (4) available for work. If a person does not meet all four of these conditions, he/she is not classified and counted as unemployed. Condition (#1) means that a person does not have a paid job or is not an unpaid family worker. Condition (#2) means that the person must be looking for a current job not some job that starts well in the future. Thus a student who in the spring begins looking for a job to begin after graduation in the fall cannot be counted as unemployed. Condition (#3) means primarily that the person is physically able to work at the kind of work for which he/she is looking. If, for example, the person is an experienced auto mechanic or waitress and at the moment is bedridden due to severe lower back pain and muscle spasms, he/she is not able to work and is not classified as unemployed. Condition (#4) means that the person must be free to take a job when it becomes available. Thus, a mother with preschool children or a student with a full schedule of classes and labs may not be available for work.

The sum of the number of persons employed and the number unemployed is called the labor force. The rate of unemployment is simply:

$$\text{number of persons unemployed} \div \text{number of persons in the labor force.}$$

The labor force estimate is interpreted diagnostically as providing detailed information on the supply of labor available to the U.S. macroeconomy. From the very beginning, the CPS was designed explicitly for this purpose and this purpose alone. The labor force estimate though it derives from interviewing human beings literally has nothing to do with human well-being or in the case of the unemployed unmet human need, though at times some analysts and news commentators

¹ Employment data are also obtained from the Bureau of Labor Statistics Current Employment Statistics (CES) survey of 160,000 businesses and government agencies representing 400,000 worksites. For diagnostic purposes, we prefer the data drawn from the monthly household survey because it counts the number of *persons* employed whereas the payroll survey counts the number of *jobs*. The two figures diverge for a number of reasons including the fact that some workers are multiple jobholders, counted once in the household survey and twice in the payroll survey.

use it in that manner.

Roughly 155-156 million persons were in the civilian labor force in January-March 2014, either employed or unemployed, raising the question as to where the rest of the U.S. population of some 318 million persons are classified and counted. Those persons who are not included in the labor force are classified as not in the labor force. Included among those who are not in the labor force are persons below age 16, all those who are permanently retired from work, persons who stay at home to care for family members, everyone in the uniformed military service. There is a long-standing controversy regarding one group of persons who are counted as not in the labor force. They are the so-called discouraged workers who meet all of the conditions to be counted as unemployed except one. They have stopped looking for work because they have looked in the past without success and see no reason to continue to look since the search is futile. Critics of the present scheme that classifies the discouraged workers as not in the labor force argue that they should be counted with the unemployed and, if they were, the rate of unemployment would be higher than what is officially reported.

The labor force is dynamic in the sense that persons move from being employed to unemployed and back again routinely from one month to the next. Indeed, persons who are unemployed typically remain jobless for less than two months, though many encounter spells of unemployment that are much longer. And persons move into and out of the labor force itself from month to month. Students, for example, enter the labor force in the summer and exit in the fall to resume their studies.

For more on the dynamic nature of the labor force, see Appendix B on the gross-flows labor force data published every month by the Bureau of Labor Statistics based on information gleaned from the CPS but largely overlooked by the media including cable TV business channels.

Unemployment has eight effects. Four are negative, four are positive. Four affect the unemployed person and his/her family. The other four affect society at large. We turn to the four negative effects first. The one effect that comes to mind first is the economic hardship for the person who is jobless and his/her family. This effect, however, varies from person to person due to the different financial circumstances of the family and the role that person plays as a breadwinner. Some families are much more secure financially than others and therefore are much better able to withstand the loss of earnings when a family member is unemployed. Some are so secure financially that a spell of unemployment, even if it is long term and involves the family's primary wage-earner, may entail little or no economic hardship at all. Other families live in much more tenuous financial circumstances, and for them any unemployment even when it is short term and involves a secondary wage-earner, can bring on severe economic hardship.

Unemployment can be thought of in terms of a hole in the pavement. A person riding a bicycle at top speed late at night who does not see the hole and runs into it may be thrown from the bicycle and seriously hurt. In contrast, the driver of an 18-wheeler moving very slowly in heavy traffic in the daytime who runs into the same hole may be jostled a bit but almost certainly will not be injured. The difference is that the truck is a much sturdier vehicle than the bicycle and affords the driver

greater protection from injury. The information on unemployment collected through the CPS tells us nothing about the economic hardship of unemployment because the CPS was not designed for that purpose.

The second negative effect on the unemployed person and his/her family is the psychological, emotional, and physical hardship of unemployment. Persons who become unemployed sometimes begin to have doubts about the kinds of choices they have made in the past regarding education, training, employer, where to settle down, and the like, and those doubts can weigh heavily on them especially when their unemployment persists. Some are so dependent on a regular paycheck that when they are unemployed they are forced to put off certain expenditures such as dental care and medications and subsequently suffer physical, bodily hardship. The CPS tells us nothing about this negative effect.

The third and four negative effects of unemployment fall upon the rest of society. The third negative effect is that unemployment means a loss of production because the unemployed are not working. This effect is the one that the CPS from its very beginning was intended to measure. Since GDP and GNP estimates are available only on a quarterly basis, the information on employment and unemployment is used in the place of those estimates during the months when they are not available. When employment increases from one month to the next, it can be inferred that production too has increased. The opposite conclusion can be drawn when employment decreases from one month to the next. One reason for the misuse of the CPS information on employment and unemployment is that the Census enumerators actually interview men and women at home. However, they do so not to discern if and why those men and women might be experiencing hardship due to economic conditions, but to determine whether they are part of the labor supply and contributing to production.

The fourth and last negative effect is that the unemployed might turn to criminal activity as a way of supporting themselves. We know little of this effect with any statistical accuracy, but every summer public officials warn that unless teenagers find summer jobs they are likely turn to mischief.

There are two positive effects that unemployment may have on the person who is unemployed and his/her family. The first of these is that by forcing a person to look for work a spell of unemployment may lead eventually to a better job than the one he/she had before becoming unemployed. We know little of this effect from the CPS or other sources. The second of these positive effects is that the jobless person may turn to certain production activities at home such as roof repair, canning, wallpapering, gardening, and the like that they otherwise might not have done or might have paid someone else to do for them. We are getting more and better estimates of home production from sources other than the CPS.

The first positive effect of unemployment on the rest of society is controversial. Some economists argue that unemployment contributes to price stability while others disagree. The argument that it does runs as follows. When large numbers of persons are unemployed those who have jobs are reluctant to press their employers for pay raises for fear they might be replaced by someone who is

jobless. That relieves upward pressure on labor costs that for many employers are the major component of the total cost of production that in turn makes it less likely that employers will have to raise prices in order to protect their profit margins.

The second positive effect on the rest of society is the forgotten effect. Unemployment is the price we as a society pay in order to protect individual freedom. In the workplace, we think it important that the employee should be free to quit whenever it suits his/her purposes. And we think it important that the employer should be free to pick and choose his/her workers and dismiss them when they are not needed or when they are not performing acceptably.

The Fourth Diagnostic Tool Measures Macroeconomic Performance in Terms of Poverty.

This tool was developed in the mid 1960s in order to help evaluate the War on Poverty that had been suggested first by President Kennedy and was signed into law by President Lyndon Johnson. From the very beginning the way in which poverty was officially defined and measured has been controversial. The United States opted for what is called an absolute standard whereas much of the rest of the world has chosen a relative standard, and the United States remains committed to the absolute standard today. An absolute standard defines poverty by asking this question: How much income does an individual/family need to purchase the goods and services required to maintain a minimal standard of living? The relative standard ask this question: How much income does this individual/family have relative to the income of others? The absolute standard, or what I prefer to call the minimal-living standard, defines poverty in terms of human individuality. The relative standard, or what I prefer to call the income-distribution standard, defines poverty in terms of human sociality.

In the United States, the absolute or minimal-living standard is operationalized in terms of the cost of the food needed to provide a human being with a nutritionally adequate diet. Years ago, the U.S. Department of Agriculture estimated those food requirements and called the diet the Economy Food Plan. Every year the cost of purchasing the food items enumerated in the Economy Food Plan is estimated, and this estimate is multiplied by three. That overall figure becomes the poverty threshold. A person whose annual income is below that threshold is counted as poor. A person whose annual income is above that threshold is counted as not poor. Multiplying the annual cost of the Economy Food Plan by three is rationalized on grounds that years ago, the typical individual/family spent one-third of income on food. Thus, if one estimates the cost of the food minimally required to provide an adequate diet and multiplies that estimate by three, it follows that the result is an estimate of the income required to purchase all the goods and services needed to maintain human well-being, including shelter, clothing, transportation, medical care, education in addition to food.

From the very beginning this is the procedure that has been used to estimate the poverty threshold that changes every year depending on changes in food prices from one year to the next. And the thresholds are adjusted by size of family since larger families have greater needs. For a family of

four, the official poverty threshold in 2012 was \$23,681.¹ Critics have argued that the threshold figure is crude at best and should be developed through separate estimates for each of the essentials of living such as shelter, clothing, and medical care.

The relative or income-distribution standard is defined and measured in several ways. The most commonly used definition is that anyone with income below one-half of the median income of all persons is counted as poor. Median household income in the United States in 2012 was \$51,017, putting this poverty threshold at \$25,509. Others define and measure poverty in terms of one-third of the median, or in terms of the poorest 10 percent of the population, or the poorest 20 percent. Where the threshold is drawn depends largely on the person who is making the estimates of poverty. In other words, the threshold depends importantly on the values of the person making those estimates. Ultimately, though, what should emerge is a consensus among those who specialize in studying poverty based on the evidence that they collect on poverty and what that evidence reveals about the poor. In that regard, defining and measuring poverty is like defining and measuring a good hitter in baseball. Over the years, based on the experience of thousands of players and times at bat, a batting average of .300 or higher is widely regarded as the threshold average for a good hitter. Notice, however, that of late the definition of a great home run hitter has risen above what for years had been the unattainable total of 60 homers in a season.

To borrow from Alfred Marshall, asking which standard -- the minimal-living standard or the income-distribution standard -- is the correct one is like asking which edge of the scissors does the cutting. Both have a place in a proper definition because the minimal-living standard incorporates human individuality into the definition, and the income-distribution builds human sociality into the definition. We recommend such a definition because it conforms more closely to human nature than either one does alone. Further, including both in a single definition allows us to address a problem that plagues both standards. Since both use a sharply defined income threshold, both differentiate between those persons/families just above the poverty threshold who are counted as not poor, and those just below the threshold who are counted as poor. And more to the point, neither one differentiates between those who are just below the threshold and those who are well below the threshold, all of whom are counted as poor. This failure to differentiate appropriately among the poor is called the depth of poverty problem.

We argue that there is a common-sense way to differentiate appropriately and to include human sociality and human individuality in the poverty definition, using the information referenced in the foregoing. A person/family is poor when personal/family income is below both thresholds, and is not poor when income is above both thresholds. A person/family is marginally poor when income is above the lower of the two thresholds but below the higher of the two.

¹ This figure and others cited herein are taken from U.S. Census Bureau, *Income, Poverty, and Health Insurance Coverage in the United States: 2012* and 2012 American Community Survey.

We turn next to the actual poverty estimates for 2012 that are derived from the March 2013 CPS that includes a set of supplementary questions on personal/family income in 2012. The survey is taken in March on the premise that because householders are preparing their tax returns that are due on April 15, they know more about the details of their income for the preceding year in March than in January or February.

DEFINING AND MEASURING POVERTY TWO DIMENSIONALLY

Minimal Living Standard family of four threshold = \$23,681	Income-Distribution Standard family of four threshold = \$25,509
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Poor	income below both thresholds
Marginally poor	income below higher threshold but above lower threshold
Not poor	income above both thresholds

An estimated 15.0 percent of all **persons** in the United States -- a total of 46,496,000 -- were classified as poor in 2012. Poverty, however, varies widely across the population. For all white persons the rate was 12.8 percent, whereas for all black¹ persons the rate was 27.6 percent or more than twice as high. Among white persons in female-headed families in 2012 the rate was 30.3 percent. Among black persons in such families it was 41.2 percent.

The poverty rate among all **families** in the United States was 11.8 percent. The rate for all families is lower than the rate for all persons (11.8 percent vs. 15.0 percent) because some persons do not live in family households, though they may have roommates, and those persons are regarded as not pooling their financial resources. Persons in families, on the other hand, are regarded as pooling their resources. Pooling has the effect of bringing down the incidence of poverty, because everyone in the family is either poor or not poor, whereas in a nonfamily household, one person may be counted as poor while another in better financial circumstances is not.

Among married-couple families the rate was 6.3 percent. Female-headed families where there is no husband present are much more vulnerable to poverty. For all such families in the United States the rate of poverty was 30.9 percent. Poverty struck 8.7 percent of all married-couple families with

¹ The Census Bureau has not adopted “African-American,” using instead “black.”

children under age 18. It struck 41.5 percent of all female-headed families with children under 18.

An intact marriage makes such a difference because it is now commonplace for both husband and wife to be working, and their dual incomes push total family income above the poverty threshold.

Poverty is not just a matter of being stuck in a low-wage job. Persons and families enter poverty when the primary wage-earner dies or is injured, when there is a divorce or separation, or when there are additional family members to provide for as a result of the birth or adoption of a child or the taking in of elderly parents or other relatives. And they exit poverty through re-marriage or some other important life event.

*Additional information available from the CPS March supplement on poverty shows the difference in income between poor families in the United States and nonpoor families. Specifically, the average income of poor families in 2012 was \$83,142 below the average income of nonpoor families. The gap was even wider – \$92,791 per year or \$7,736 per month – when nonpoor married couple families are compared to poor female-headed families. The lesson bears repeating: regarding poverty, **intact families make a difference, a very substantial difference.***

A summary of the four diagnostic tools is presented on the following pages.

FOUR DIAGNOSTIC TOOLS FOR MEASURING MACROECONOMIC PERFORMANCE

Consumer Prices. Every month U.S. Census Bureau enumerators collect information nationwide on the prices of a set of about 85,000 goods and services purchased frequently by U.S. consumers. These data are reduced to a single number known as the *Consumer Price Index* (CPI) that is released to the public in the month following the month in which the information was collected. The CPI shows the percentage change in prices since the base period (the year in which the index number was set at 100.0). An index number of, say, 126.2 indicates that since the base period there has been a 26.2 percent increase in the prices of the 85,000 items in the set. The “core index” is a special version of the CPI that removes items such as energy and food known for wide monthly swings in price. On an annual basis, consumer prices are regarded as stable if the CPI indicates a change of 3 percent or less. **Prices are regarded as inflationary when the annual increase exceeds 3 percent, and become truly alarmingly when they increase by 10 percent or more.** Information on consumer prices first was collected during World War I. As consumer spending habits change over time and the items themselves change in quality, it becomes necessary to update the items included in the set, to designate a new base period, and to reset the index number to 100.0.

Production. Four times a year the U.S. Department of Commerce surveys employers nationwide on the production of goods and services. This information is released to the public in final form three months after the close of the quarter to which the information refers. The data are rendered into two estimates: GNP and GDP. GNP (gross national product) is an estimate of the goods and services produced by all U.S. companies operating in the United States or in other countries. GDP (gross domestic product) is an estimate of the goods and services produced by all companies operating in the United States whether they are U.S. or foreign owned. Since the prices of the goods and services change from quarter to quarter, GDP and GNP estimates are adjusted to remove the influence of changing prices so that the estimates reflect only changes in production. Today the preferred measure is constant-dollar GDP because it relates to production within the United States that is more responsive to U.S. monetary and fiscal policy. Some employers deliberately underreport production because they are engaged in illegal activities such as tax evasion. An increase in constant-dollar GDP of 3 percent per year is regarded as normal. **A quarter-to-quarter decrease in GDP is indicative of an economic contraction that if it continues to the next quarter is regarded by many as recessionary.** The development of this tool that originated in the 1920s is an ongoing project.

Labor Supply. The U.S. Census Bureau collects and processes information on employment and unemployment on a monthly basis from about 60,000 households that are selected at random. The collection instrument is known as the Current Population Survey (CPS). This information is transmitted to the U.S. Bureau of Labor Statistics for analysis and released to the public on the first Friday of the month following the month in which the data are collected. The large sample – about 110,000 persons are surveyed every month – assures a very small margin of error. A 0.2 percentage point change in the unemployment rate from, say 5.5 to 5.7 percent is regarded as statistically significant. Two estimates derive from the CPS: the number of persons employed and the number unemployed. The sum of the two estimates is called the labor force. The unemployment rate is calculated as follows: unemployed ÷ labor force. At first glance, this tool seems to be designed to elicit information on the well-being of workers. However, it was designed to provide monthly information that complements the quarterly information on production, and to proxy for GDP/GNP information in the months when that information is not available. The CPS was launched experimentally in the late 1930s and has been collecting monthly information on the labor supply since the early 1940s. **An unemployment rate of 3 percent is regarded as the lowest rate consistent with a free labor market. A rate of 10 percent is disturbingly high.**

Poverty. Estimates of the number of poor persons/families derive from a March CPS supplement that gathers income information for the preceding year. The income information is compared to absolute poverty income thresholds developed by the U.S. Census Bureau in terms of the income that the average person needs to buy the goods and services to live at a minimal-living standard. A family is classified as poor if reported family income is below the poverty threshold. Otherwise they are classified as nonpoor. The thresholds that are adjusted for family size are based on 3 times the annual cost of providing nutritionally adequate food. The multiplier of 3 is used because years ago the typical family spent 1/3 of its income on food. Other countries construct their thresholds in terms of a person/family’s income relative to the income of others. Information on poverty in the United States first became available in the mid-1960s. Of the four tools addressed herein poverty alone construes macroeconomic performance in terms of human well-being. Clearly a lower poverty rate is desirable. However, **no hard and fixed standard has been accepted as indicating that poverty has reached an irreducible minimum because entry into poverty is linked to significant life events such as divorce, death of the primary wage-earner, increased family size due to birth of a child or doubling up of distressed family members.** For that reason, it is impossible to eradicate poverty entirely.

APPENDIX A
Recession Defined and Measured in Terms of Human
Well-Being Rather Than Things¹

GDP estimates derive from a quarterly survey of employers and are released to the public in advance form based on incomplete source data one month after the close of the quarter and in preliminary form and final form based on more detailed and comprehensive data two months and three months later. Thus, real GDP data in final form for fourth quarter 2014 for example, will not be available until March 2015. If one suspects that a recession is underway in October 2014, that suspicion cannot be confirmed with GDP data until the following March. Even if economic analysts agreed fully on what causes a recession, the GDP data are not available in timely enough fashion to help policymakers prevent it from occurring. Notice how defining a recession as two consecutive quarters of declining GDP makes it even more difficult to intervene in a timely manner. If a recession begins in January it cannot be confirmed until the following September.

In addition to GDP data, the Business Cycle Dating Committee of the National Bureau of Economic Research uses estimates of employment, sales, personal income, and industrial production. These estimates are not cranked into a formula that yields a definitive answer regarding the course of the economy. Instead the seven-member committee considers and weighs the data and reaches a consensus judgment regarding the start of a recession. The Committee announces its consensus to the public anywhere from six to eighteen months after the start of a recession. Since WW II, the average duration of recessions has been eleven months. It follows that the Committee's consensus on the start of a recession often is reached after the economy has reached a trough and has begun recovering.

Thus, economic analysts, government officials, and the general public at times are left to their own devices regarding the start of a recession. Accurate information that is available in timely fashion is a critical consideration. For that reason, we recommend using seasonally-adjusted estimates of employment and unemployment both of which are available on a monthly basis and released to the public on the first Friday of the month following the month in which the household survey was taken.

Employment data are obtained from two sources: the household survey and the payroll survey. Our preference is the data drawn from the monthly household survey because it counts the number of *persons* employed whereas the payroll survey counts the number of *jobs*. The two figures diverge for a number of reasons including the fact that some workers are multiple jobholders. The unemployment estimate is a count of the number of persons who are not working but are looking for work, able to work, and available for work. For our purposes, included in the unemployment estimate is a count of the number of discouraged workers who are not working, able and available for work, but are not looking for work. These persons are not included in the official unemployment

¹ We repeat ourselves at times in the following in order to accommodate those who skimmed the material in Topic 23, perhaps reading only the one-page summary at the end, or did not read any of it at all.

estimate.

One important reason for selecting these two data sets is that they define recession not in terms of things such as sales, GDP, income, or industrial output but in terms of human well-being. Work has a powerful impact on the person who works not only in terms of income earned but also regarding a personal sense of belonging that working in the company of others engenders and the opportunities the workplace affords to utilize a person's creative talents and energies. Unemployment, especially long-term unemployment, deprives the worker of the means to meet those needs.

If one accepts loss of work as a type of socio-economic cancer, it makes sense to define a recession in approximately the same way that oncologists define a malignant tumor in terms of stages. We recommend a definition based on two-stages. The economy has entered a Stage I recession when the number of persons employed has been falling and the number of persons unemployed (including discouraged workers) has been rising for three consecutive months. It has entered a Stage II recession if that trend continues into a fourth consecutive month.

Intervention in the U.S. economy is called for only when Stage II has been entered or the unemployment rate (including discouraged workers) reaches six percent or higher. This two-stage definition of a recession is less than ideal but is simple, straightforward, timely, workable, and helpful to policymakers in preventing an economic "soft-landing" from turning into a "crash."

APPENDIX B

Gross-flows Labor Force Data

The U.S. labor force is much more dynamic than the monthly household and establishment surveys suggest. Entirely overlooked in the one-and-done public commentary are the data that indicate month-to-month change, that is the extent to which the status of the American working population changes from one month to the next. Those vastly underreported data are known as gross-flows data. They derive from the very same household survey that produces monthly estimates of the number of persons employed, unemployed, and not in the labor force.

The gross-flows data show how many persons change from employed in one month to unemployed or not in the labor force in the following month. Additionally they report the number of persons unemployed in one month who became employed in the following month or dropped out of the labor force, and the number who in one month were not in the labor force and in the next month were employed or unemployed. Those data also show the number of persons whose labor force status did not change from one month to the next.

Consider the following. The August 2011 establishment survey indicated that there was no net increase in the number of payroll jobs from the previous month. The gross-flows data for July-August indicated that there were an estimated 5.9 million persons who were either unemployed or not in the labor force (NILF) in July and were employed in August. At the same time 5.1 million who were either employed or NILF in July were unemployed in August. Another 6.3 million who were either employed or unemployed in July were classified as NILF in August. Thus, even though the establishment survey indicates no net change in the number of payroll jobs between July and August and the household survey pointed to a drop in the jobless rate that was not statistically significant, 17.3 million persons changed labor force status over that period.

Included among the 17.3 million were: younger persons leaving a temporary job to return to school, older persons entering retirement after years of work, and adult children on leave of absence from work to care for a dying parent (employed→NILF); workers who quit their job because it made them miserable and others who were fired because they were miserable workers (employed→unemployed or NILF); discouraged workers who stopped looking for work because there is no suitable work available in their area (unemployed→NILF); persons who found work quickly after losing their job and others who finally found a job after months of looking (unemployed→employed); the formerly sick who are well enough to resume working, persons returning to civilian life after military service, and mothers of newborn infants coming back to their job after maternity leave (NILF→employed); new college graduates entering the labor force for the first time as young professionals (NILF→unemployed).

It is instructive to think about these data in terms of the human activity taking place at a busy airport. At any given moment, some persons are boarding aircraft, others are exiting. Many are waiting for or rushing to their connecting or originating flights. Others still are remaining in their assigned seats on

continuing flights. Others are grabbing a snack in a sports bar or a magazine at a news stand. Some are checking their bags while others are trying to retrieve their checked bags. Many are there to accompany a business associate or friend to the ticket counter or to meet a loved one arriving on an incoming flight. On the tarmac, many are just arriving, others are departing.

The one-month data are the equivalent of a single snapshot freezing all of that human activity at one moment in time. This snapshot confirms that the airport is a very busy place. The gross-flows data are the equivalent of two snapshots taken one month apart. Comparing the first and second snapshots tells us something about the ebb and flow of human activity in the airport over time: where those people are coming from and going to.

With regard to job losses, the gross-flows data match the conventional wisdom. In the economic slump of 2008-2011, many more persons employed in one month became unemployed in the following month than in 2005-2007. To illustrate between October and November 2007, 1.7 million were counted as employed→unemployed. In the same two-month period three years later an estimated 2.5 million were classified as employed→unemployed. Additionally, 2.9 million unemployed workers dropped out of the labor force (unemployed→NILF) between October and November 2010 compared to 1.7 million three years earlier.

In other instances, however, the gross-flows data do not confirm the conventional wisdom. Based on the same October-November comparison, in 2007 an estimated 2.0 million unemployed persons found work (unemployed→employed) while three years later in the Great Recession that estimate increased to 2.5 million. Another unconventional finding relates to NILF→unemployed. In 2007, there were 1.9 million persons who were classified as unemployed who previously were not in the labor force. In 2010, that number had increased to 3.1 million.

What is most startling in terms of the conventional wisdom is that according to the estimates of month-to-month change throughout 2010 **MORE** persons previously unemployed were finding jobs than were losing jobs. And at the same time **MORE** persons previously not in the labor force were classified as unemployed than were previously employed and lost their jobs. **With the exception of the first three months, these very same NILF→unemployed findings held even in 2009, in the depths of the Great Recession.** What is also most telling, for three months in 2009, the number unemployed→employed was greater than the number employed→unemployed.

Three conclusions follow. First, even in a serious economic slump millions of American workers are actually able to find work, driven no doubt by the need to support themselves and their dependents. Second, the demand for workers does not disappear entirely even when the economy is burdened with massive and persistent unemployment. Third, even a month in which the net increase in payroll employment is zero and the change in the jobless rate is not statistically significant does not signify that little is happening in the labor force. As stated previously, between July and August 2011, 17.3 million persons changed labor force status.

Bureau of Labor Statistics gross-flows labor force data are available since 1990 and are accessible at the following BLS website: www.bls.gov/cps/cps_flows.htm#data.

REVIEW SECTION: TOPIC 23

Central Concepts:

- market basket
- price index
- gross national product (GNP)
- gross domestic product (GDP)
- disposable income:
 - consumption, saving
- constant-dollar estimate
- current-dollar estimate
- labor force:
 - employment
 - unemployment
 - rate, voluntary, involuntary, effects
 - discouraged worker
- poverty:
 - absolute standard, relative standard, *Economy Food Plan*
- business cycle:
 - unemployment, inflation, recession, soft landing

Important Questions:

- Which of the four diagnostic tools are alike? How are they alike?
- What is the difference between GNP and GDP?
- How many estimates of GNP are made in a year's time?
- What are the two approaches for estimating GNP? Why do they produce the same estimates?
- What is the *Current Population Survey* and why does it have such a low margin of error?
- Under what two conditions is a person classified as employed?
- What four conditions must be met simultaneously for a person to be classified as unemployed? How is the rate of unemployment calculated?
- What does the rate of unemployment actually measure?
- How are discouraged workers defined and classified?
- What is the fundamental difference between the one-month estimates of employment and unemployment on the one hand and the gross-flows estimates indicating month-to-month change in labor force status?
- Who endures the greatest economic hardship when they become unemployed?
- What are the four negative effects of unemployment? four positive effects?
- How is the *Economy Food Plan* used in the official U.S. poverty standard?
- What is an absolute standard of poverty? a relative standard?

(continued on following page)

Why should the official U.S. poverty standard incorporate both an absolute standard and a relative standard?

What are the four phases of the business cycle?

What is the official definition of a recession?

What two problems are associated with the business cycle? That one is associated with the expansion phase and peak, and that with the contraction phase and trough?

True/False:

In measuring the output of goods and services produced the preferred tool is ...

- a. real GDP.
- b. constant-dollar GDP.
- c. nominal GDP.
- d. current-dollar GDP.

Mark your answer below.



_____ Item a is true, items b, c, and d are false.

_____ Items a and b are true, items c and d are false.

_____ Item a is false, items b, c, and d are true.

TOPIC 24

THE CLASSICAL SCHOOL, UNMET PHYSICAL NEED, AND THE SAFETY NET

To explain the central dysfunction of an unregulated market economy.

*Classical economics dominated economic theory until the Great Depression of the 1930s when it no longer could explain the huge decline in production and employment and the resulting massive and persistent unemployment in the United States and every other key modern market economy around the world. The reasons for this failure in economic theory came to light in 1935 when the British economist John Maynard Keynes published **The General Theory**.*

Two years earlier on the occasion of his inaugural address, first-term President Franklin Roosevelt stated that “we have nothing to fear but fear itself,” and observed that he saw a nation “one-third ill-fed, ill-clothed, and ill-housed.” His New Deal political agenda was set in motion to address those problems. Since at that time no one knew precisely what had brought on the Great Depression and therefore how a full-employment economy might be restored, Roosevelt’s efforts were directed toward dealing with unmet human physical need. In that sense, he was proceeding in the same general way that a physician does when he/she has not arrived at a definitive diagnosis but the patient is in dire distress: he was treating the symptoms of the Great Depression.

Before the Great Depression the federal government’s role in domestic affairs was quite limited. Because the founding fathers were fearful that the U.S. president might become a tyrant like King George III of England, they created a system of governance that often is described as “checks and balances.” Each one of the three branches of the federal government – legislature, executive, judiciary – was established and empowered to limit the exercise of power of the other two. The legislature, for example, is authorized to enact laws and control taxes and spending but the president can veto any laws or budget passed by the legislature. The legislature, in turn, can override the president’s veto, and the judiciary can declare unconstitutional any law passed by the legislature and signed by the president. Federal judges are appointed for life by the president subject to confirmation by the Senate. The president can be removed from office by the Senate through the process of impeachment. All powers not specifically assigned in the Constitution to the federal government are reserved for the states, and the Constitution itself can be amended with ratifying votes by the legislatures of three-fourths of the states.

With the Great Depression and Roosevelt’s inauguration in 1933 the role of the federal government especially the executive branch expanded dramatically. Roosevelt called this broad response to the unmet need of millions of Americans “The New Deal.” This new social contract became the single most important thrust of his presidency into domestic affairs and has had a far-reaching and long-lasting effect even more than 70 years later. Nevertheless, the limits imposed by the founding fathers are clearly in evidence even today.

There were many initiatives undertaken by President Roosevelt during his first two terms of office to revitalize the U.S. economy. We focus on three that were especially important because all three were intended to relieve unmet human need. The three were the Social Security Act of 1935, the Wagner Act of 1935, and the Wage and Hour Law of 1938. The Wage and Hour Law set the first federal

minimum wage at \$.25 per hour that for a year-round full-time worker (40 hours per week, 52 weeks per year) amounts to annual pay of \$520. For many workers the new minimum wage effectively raised their pay and allowed them to more effectively provide for their own needs. Earlier attempts by the Roosevelt administration to establish a federal minimum wage were declared unconstitutional by the U.S. Supreme Court. In other words, President Roosevelt's hand in this matter was checked by the Court. By 1938 the composition of the Court had changed sufficiently for the new wage and hour law to pass the test of constitutionality.

The Wagner Act of 1935 acknowledged for the first time and officially guaranteed the worker's right to formally associate with his/her workmates, to form a union. Prior to that time, though unions had been established for many years in the United States, there was no federal law that guaranteed workers the right to form their own unions. Under the supervision of the National Labor Relations Board, an agency of the U.S. Department of Labor, workers decide through a certification election whether they want union representation, majority rule prevailing. In like manner, workers can dismiss their union representation through a decertification election. By requiring the employer to bargain collectively with the union representatives regarding wages, hours, and working conditions, workers are better positioned to improve their economic circumstances, especially when they can bring to bear the threat of a strike if the employer is unyielding, and thereby better provision their own needs.

However, in respecting the constitutional limits on the power and influence of the federal government, each state decides through its legislature how best to strike a balance of power in the workplace between the union and the employer. There are four basic arrangements that define this balance of power: the closed shop, the open shop, the union shop, and the agency shop. The closed shop requires the employer to hire only persons referred by the union. The employer is free to reject a referral he/she regards as unsuitable, but is not free to hire anyone who is not referred by the union. The open shop allows the employer to hire whomever he/she pleases, and the person hired is free to join or not join whatever union operates in that workplace. The union shop allows the employer to hire whomever he/she pleases, but the person hired must join the operative union in that workplace sometime shortly after starting his/her employment. The agency shop frees the employer to hire whomever he/she pleases, and that person is free to join or not join the operative union, but he/she must pay union dues on grounds that the union bargains for every worker and every worker has a duty in contributive justice to support the union.

The Social Security Act of 1935 addressed unmet human physical need originating from three sources: (1) growing old and no longer being able to work; (2) becoming orphaned and being too young to support oneself; and (3) losing one's job and being cut off from a regular paycheck. As to the first two – the elderly and the orphaned – the Social Security Act set up a single federal program with its own trust fund into which matching contributions are made by employers and employees and out of which benefits are paid to those elderly and orphaned persons who meet the eligibility requirements. To qualify for full benefits a person must be 65 years of age (66 for anyone born in 1943 or later) and have worked and made contributions into the Social Security trust fund for at least 40 quarters. This fund operates on a pay-as-you-go basis, the monies paid in benefits to the current generation of beneficiaries come from the contributions made by the current generation of employers and employees. Benefits are adjusted every year according to changes in wages and are paid until death.

In general there is a correspondence between wages, contributions, and retirement benefits. The more one earns and contributes, the larger the benefits. The program operates on the presumption

that every elderly person who is eligible for retirement benefits is needy. No one is required to demonstrate need. The program, in other words, is not means tested.

For the orphaned (officially known as survivors), benefits are paid only to those who are unmarried until they reach age 18 or 19 if they are attending elementary or secondary school full time. Under certain conditions benefits may be paid to dependent parents who are age 62 or older and to the surviving divorced spouse.

At times the Social Security trust fund has had more money flowing in through contributions than flowing out through benefit payments. This surplus has been used to purchase U.S. government securities that means that there has been a third stream of moneys – the interest paid on those securities – flowing into the fund. However, in the years ahead the trust fund likely will be severely strained to make benefit payments to a retired population that due to the baby boom of 1946-1960 brought much larger numbers of persons to age 66 beginning in 2012. A further strain will be added by the increased life expectancy of the elderly that means that the typical retired person will receive retirement benefits for a longer period of time, while at the same time there will be fewer workers making contributions to the fund. These dynamics set up the conditions for the full depletion of the retirement trust fund by 2035 (latest actuarial estimate by the trust fund trustees).

Over the years, two other groups vulnerable to unmet human physical need have been accorded protection under the Social Security Act: the disabled and the elderly in need of health care. Benefits for the disabled are paid from an earmarked trust fund that will be fully depleted by 2016.

The elderly in need of health care, however, are protected by Medicare that operates with its own trust fund into which contributions are made by workers, employers, and the elderly, and payments are made to health-care providers to reimburse them for the cost of health services rendered to the elderly. As with Social Security retirement, Medicare is based on presumed need. No means test is applied.

The Medicare trust fund is even more severely strained due to the high cost of modern medicine and the plain fact that most health care costs in a person's last year of life. It will be depleted by 2026.

One way this strain is being handled is through low reimbursement to health-care providers. Some physicians have responded to low reimbursement by refusing to accept persons on Medicare especially when the total cost of providing the service, including the cost of preparing, filing, and following through on claims transmitted to the Medicare administration, is greater than the reimbursement. Federal law makes it difficult and costly for hospitals to refuse service to anyone including Medicare patients, so the cost of treating Medicare patients that is not fully reimbursed often is shifted to other paying patients. Thus, war stories abound with regard to the extraordinary charges billed to those patients for such otherwise inexpensive items as aspirin and laxatives.

*The elderly who receive monthly Social Security retirement checks have their Medicare premiums deducted automatically every month. The amount they are charged for Medicare protection depends on their annual income as declared on their federal income tax return. The higher the income, the higher the premium. Under these rules, about 25 percent of all Social Security retirement beneficiaries are vulnerable to having their retirement benefit reduced from one year to the next. For them, Social Security has become in effect **means tested**.*

As a consequence, Social Security retirement has become less a social insurance program and more a social assistance program. The higher the declared income, the lower the retirement benefit. Any persons whose Medicare premium is greater than his/her retirement benefit is billed by Social Security Administration for the difference. That person's Social Security retirement benefit is zero. This is the beginning of means-testing Social Security retirement, not directly through a reduction of monthly benefit amount based on income while a person was working but indirectly through the deductions made to cover Medicare premiums that vary from one person to the next based on current income..

The Social Security Act of 1935 was the enabling legislation to protect persons who become unemployed and no longer receive a regular paycheck. However, it was decided at that time, no doubt in deference to the founding fathers' fear of an all-powerful federal government, that each state should design and administer its own unemployment insurance program because state economies simply are too vast and varied to be well served by a single federal program. Ever since, unemployment insurance has been a state responsibility and there is little support for converting to a single federal program. Each state requires employers to pay taxes based on their payrolls but the tax rate usually does not exceed three percent of payrolls and does not apply to wages paid that in a year exceed some predetermined amount.

Benefits are paid to a claimant who has established recent work experience and who has been temporarily laid off or permanently terminated by his/her employer provided the claimant's own conduct has not forced the termination. Typically benefits are limited in two ways: (1) to no more than 50 percent of the claimant's usual weekly wages; and (2) to no more than 26 weeks in a single spell of unemployment. Unemployment that lasts longer than 26 weeks, except under special circumstances, is not compensated. The beneficiary in other words has exhausted his/her benefits. States where the trust fund has been depleted by large numbers of beneficiaries due to high unemployment are able to borrow funds from the federal government in order to continue to pay benefits to the eligible unemployed. During the Great Recession, however, benefits were made available to the unemployed for much longer – up to 90 weeks – with the federal government providing the additional financial support to make that extension possible.

*All of the various public programs to provide aid to the needy, taken together, are commonly referred as the "safety net." Safety-net programs are of two types: social assistance and social insurance. Both types were established to meet human material need. Social assistance is based on **demonstrated** need. Social insurance is based on **presumed** need. Payments made under either type of program are regarded as entitlements in the sense that the claimant has a legal right to those payments that was specifically conferred by a law enacted for that purpose.*

Social assistance programs are financed from general tax revenues. Social insurance programs are financed from contributions paid by the employer, employee, or both into an earmarked fund from which payments may be made only to a qualified applicant. Payments from a social insurance

THE SAFETY NET: PROGRAMS OF AID FOR THE NEEDY

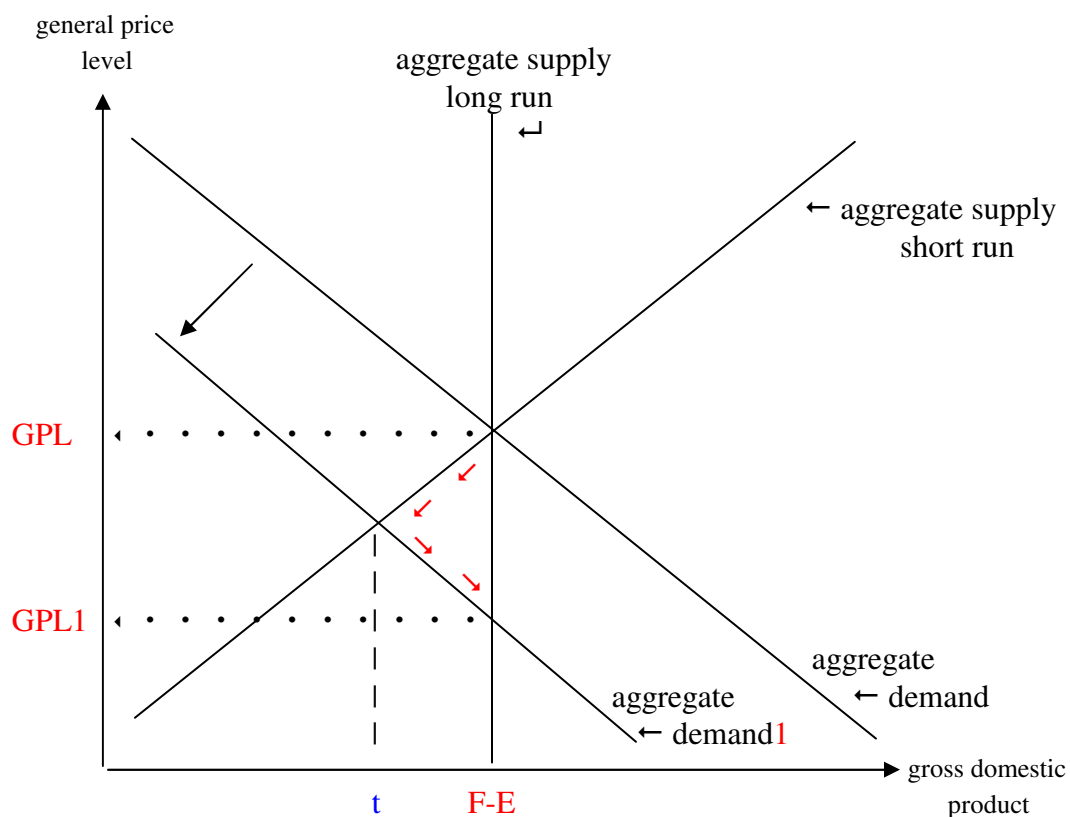
Program	Type	Risk
Social Security Retirement	Social Insurance → Social Assistance Federal Program also available from private insurance companies	Old age
Disability Insurance	Social Insurance Federal Program also available from private insurance companies	Disability
Survivor's Insurance	Social Insurance Federal Program also available from private insurance companies	Loss of wage earner
Medicare	Social Insurance Sickness > 65yrs. Federal Program also available from private insurance companies	Sickness
Medicaid	Social Assistance for low income persons. Federal/State Program also available from private charities	Sickness
SCHIP (State Children's Health Insurance Program)	Social Assistance Federal/State Program for children w/ income 100-200 percent of poverty	Sickness
Supplemental Security Income	Social Assistance Federal Program providing cash for food, shelter, clothing	Aged, blind, or disabled with little or no income
Food Stamps	Social Assistance Federal Program to help meet nutritional needs also available from state and local governments	Households with severely limited financial resources
Temporary Assistance for Needy Families	Social Assistance Federal/State Program of cash assistance and work opportunities	Dysfunctional families
Workmen's Compensation	Private Insurance	Injury on the job
Unemployment Insurance	Social Insurance Federal/State Program also available from special private program called Supplemental Unemployment Benefits.	Unemployment

program are regarded as not only a legal right but a property right as well because the claimant has made some prior contribution to the trust fund from which the benefits are paid.

Several types of safety-net programs in the United States are enumerated on the preceding page.

We turn our attention next in Topic 24 to the classical school and its way of thinking about macroeconomic affairs. As stated previously, classical economics dominated economic theory until the Great Depression of the 1930s when it no longer could explain the enormous decline in production and employment and the **massive** and **persistent** unemployment that followed. The

HOW PRICE FLEXIBILITY IN PRODUCT AND RESOURCE MARKETS RESTORES FULL EMPLOYMENT: THE CLASSICAL ECONOMICS PERSPECTIVE



Classical economics argues that when there is a massive deterioration in aggregate demand, as represented in the shift shown above, there is a temporary (**t**) loss of production and employment as the macroeconomy begins its adjustment to the shift by rolling back (**↙**) product and resource prices from the original macroeconomic equilibrium at **GPL**. The law of nature, however, restores full-employment accord at **F-E** when product and resource prices fall further (**↘**) until they achieve stability at **GPL1**. We find equilibrium an unfortunate choice because it renders economic affairs principally in terms of things. Our preference here and elsewhere is to refer to the condition associated with the intersection of aggregate demand and aggregate supply as **macroeconomic accord**.

essence of the classical argument is that the market economy has built-in self-correcting mechanisms that restore full-employment whenever unemployment occurs and stable prices whenever inflation takes hold.

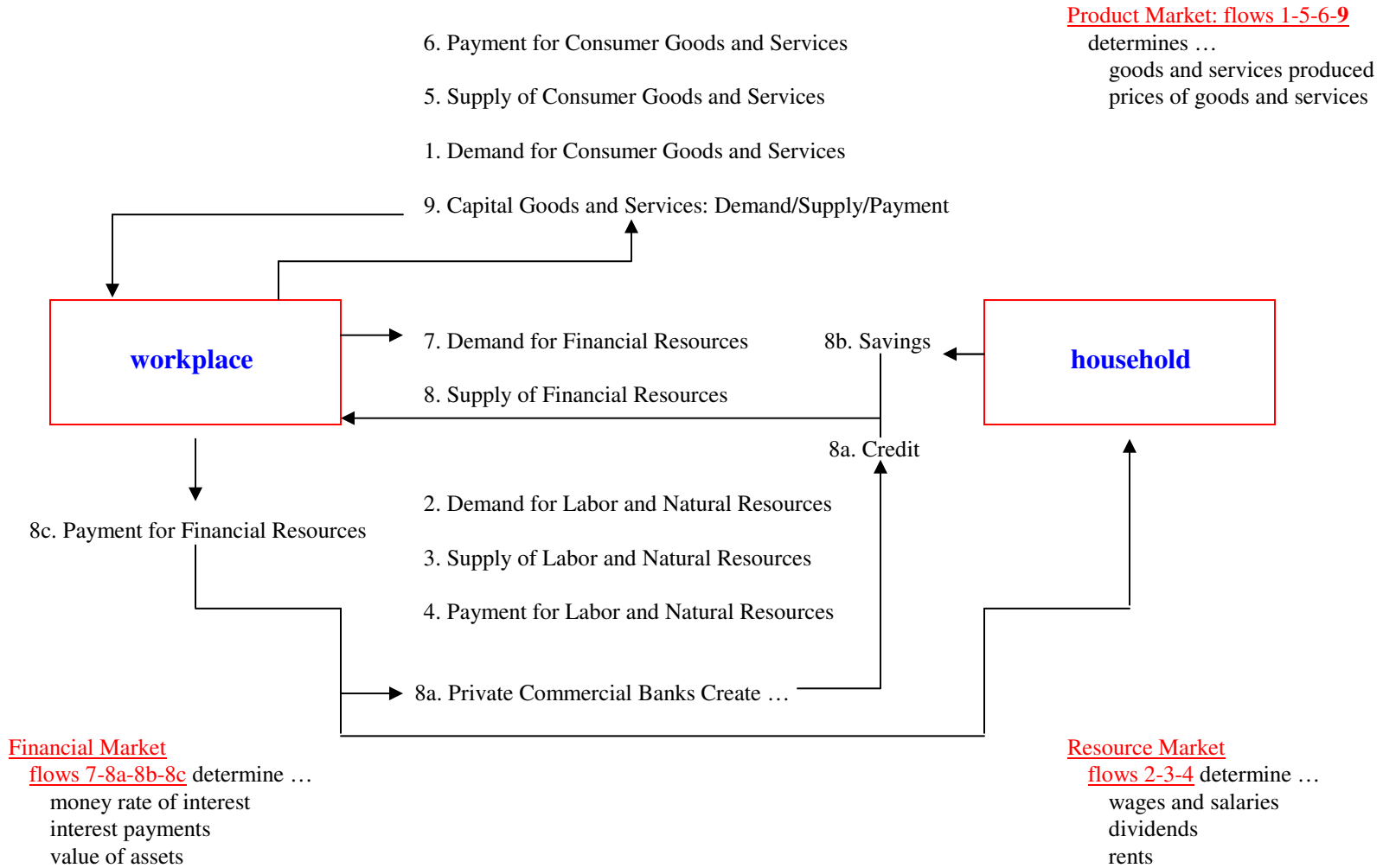
*The diagram on the preceding page displays the classical argument regarding the self-correcting mechanism operating in the product and resource markets (see on the following page the macroeconomic circular flow representing a capitalist or unregulated market economy). The essential premise is that aggregate demand – the demand of all goods and services produced as represented by **Flows 1, 5, 6, 9** – is a function of the general price level.*

*In that regard, the classical school presents aggregate demand the same way the demand for a single product or service is presented in the standard demand curve of the scissors diagram. Aggregate supply – the supply of all goods and services produced – is a function of prices in the short run but not in the long run. The short-run aggregate supply curve is presented in the same way the supply for a single product or service is presented in the standard supply curve of the scissors diagram. Aggregate supply in the long run, however, is not a function of prices and therefore is represented diagrammatically as a vertical line drawn through the intersection of the aggregate demand curve and the short-run aggregate supply curve. The national product or GDP at that triple intersection point is full-employment GDP, providing sufficient employment opportunities such that only about 3 or 4 percent of the labor force is unemployed. And, the general price level as measured in terms of a price index is stable at that triple intersection. **Thus, due to the law of nature a market economy is inclined toward full employment and stable prices.***

*Whenever there is a shift in aggregate demand downward to the left (identified as aggregate demand1) that for a short period of time leads to a decrease in production and employment and an increase in unemployment, the market economy through its self-correcting mechanisms will restore full employment because, though production and employment are falling, so too are prices in the resource market (see **Flows 2, 3, 4**) and the product market (see **Flows 1, 5, 6, 9**) on the following page. If prices are allowed to fall sufficiently full-employment is reestablished in the longer term where aggregate demand1 intersects with the long run aggregate supply curve. We will contrast this outcome with the outcome associated with Keynesian economics in Topic 25.*

*The next and last diagram in this topic presents the classical argument regarding the self-correcting mechanisms operating in the financial market (see **Flows 7, 8a, 8b, 8c** on following page). The essential premise is that the demand for money (MD) and the supply of money (MS) are determined by the price of money, by the rate of interest. Just as we observed regarding the role of prices in the resource and product markets, we note that prices play a key role in the financial market. Both MD and MS are represented in the left-hand side of the diagram as standard supply and demand curves in conformance with scissors diagram, the one (MD) downward sloping to the right, the other (MS) upward sloping to the right. The rate of interest and the amount of monies borrowed are determined by intersection of MD and MS. The right-hand side shows how much entrepreneurs will spend on capital goods and services as the rate of interest rises or falls. This function is downward sloping to the right because clearly entrepreneurs are willing to spend more on capital goods and services when interest rates are lower and therefore it is less costly to borrow the money necessary to purchase those goods and services.*

MACROECONOMIC CIRCULAR FLOW: CAPITALIST ECONOMY



Notes: Flow 8b, household savings = [income earned – consumption expenditures]; no borrowing by householders.
 Flow 9 includes inventories of unsold goods. No accounting is made of environmental contamination or depletion of natural resources.

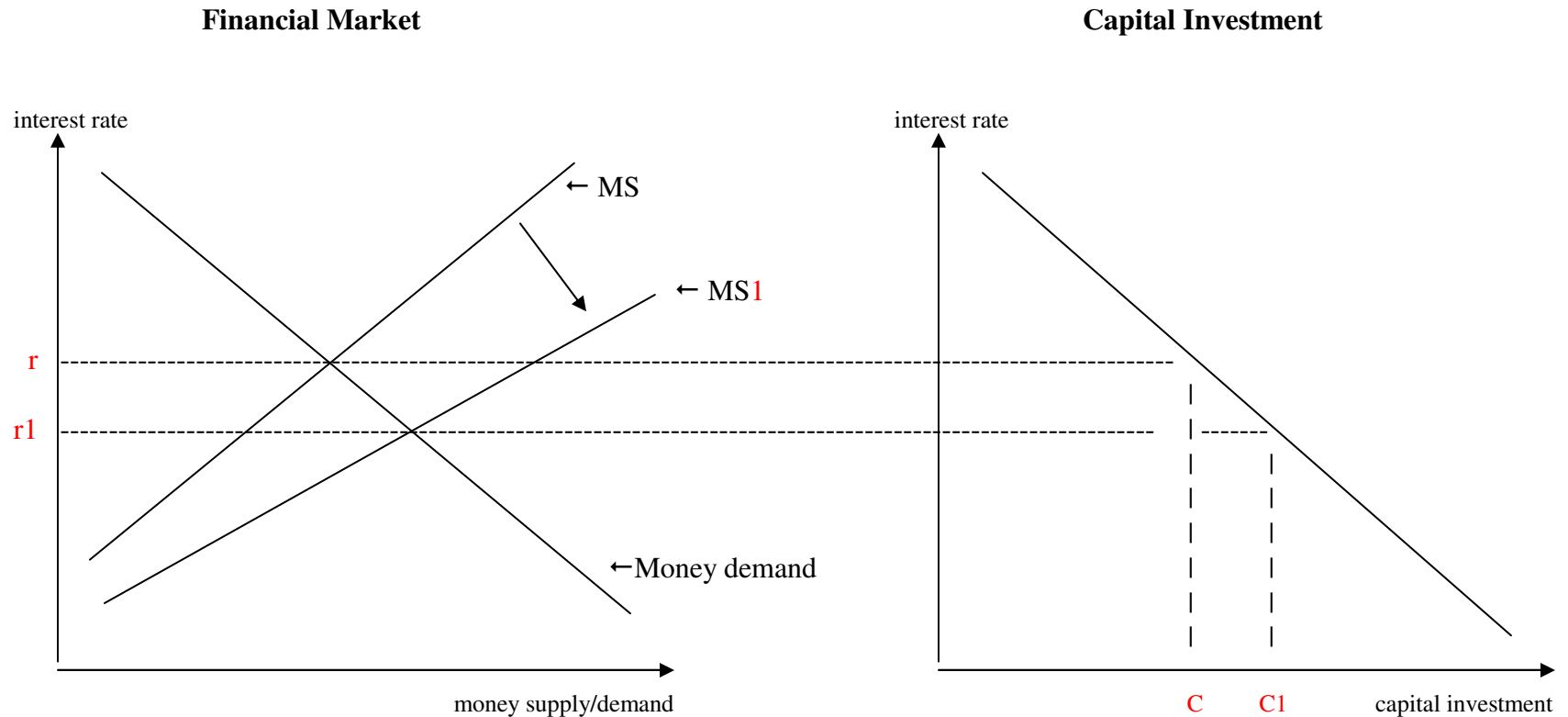
When aggregate demand shifts downward to the left as we observed in the diagram on the product and resource markets, consumers are spending less of their disposable income on goods and services (*Flow 1*) ↓ and are saving more (*Flow 8b*) ↑. This increased savings adds to the supply of money available in the financial market, shifting *MS* downward to the right and intersecting with *MD* at a lower rate of interest that leads to an increase in the funds borrowed. The lower rate of interest in the right-hand diagram leads to more spending of those borrowed funds by entrepreneurs on capital goods and services that helps boost aggregate demand. Thus financial markets help reverse the downward shift in aggregate demand.

To this point we have represented the arguments of the classical school regarding the problem of restoring full employment in diagrammatic form. We can render those arguments in strictly verbal form as follows. In the product and resource markets, unemployment rises due to an insufficiency of aggregate demand. This labor surplus has the immediate effect of any surplus - wages or the price of labor fall(s). Lower wages contribute to lower production costs, and due to those lower costs producers are able to reduce prices and still maintain their profit margins. Lower prices for goods and services result in an increase in aggregate demand that remedies the insufficiency of aggregate demand and in turn raises production and employment and rolls back unemployment.

The same line of argument applies to the macroeconomic problem of inflation. In the product and resource markets, inflation takes hold due to excess aggregate demand that in turn manifests as a labor shortage. This labor shortage has the immediate effect of any shortage - wages or the price of labor rise(s). Higher wages contribute to higher production costs, and to protect their profit margins producers raise their prices. Higher prices for goods and services result in a decrease in aggregate demand that remedies the original condition of excess aggregate demand and in turn lowers production and employment until stable prices are restored.

There is an aesthetic quality to the classical theory. In the case of unemployment, the lower wages of workers are matched by the lower prices for the goods and services that they need or want and therefore workers, though paid less, are able to maintain their standard of living while the problem of unemployment is being sorted out. Further, there is no incentive for organized labor to push for higher wages during a period of labor shortages because the higher wages will trigger higher prices for the goods and services they buy, and therefore those higher wages do not lead to a higher standard of living for labor.

HOW INTEREST RATE FLEXIBILITY RESTORES FULL EMPLOYMENT: THE CLASSICAL ECONOMICS PERSPECTIVE



When unemployment rises due to a decline in aggregate demand brought on by decreases in spending for consumer goods and services and increases in consumer savings (see **Flow 8b** in the circular flow diagram for a capitalist economy), the supply of financial resources -- the money supply -- shifts from MS to $MS1$ that reduces the rate of interest from r to $r1$. That rollback in the interest rate induces additional borrowing by entrepreneurs that boosts capital expenditures from C to $C1$. This increase in capital spending stimulates aggregate demand and helps restore full employment.

APPENDIX

Social Security: Good Investment or Bad?

In September 2007 Treasury Secretary Henry Paulson initiated a series of public discussions intended to forge agreement on what to do about the ever-deepening financial distress in the Social Security system that will see depletion of the disability trust fund in 2016, the Medicare trust fund in 2026, and the retirement trust fund in 2035. This financial crisis becomes much worse if one considers the financial condition of the system 75 years into the future for persons who to a large extent are not yet born.

According to Paulson, there are only two alternatives available: raise system revenues or lower benefits. Our attention in the following is focused on 2035 because looked at from the perspective of persons currently working for covered employers there is no good reason to maintain the retirement system given what it will take to preserve it.

When it was launched in 1935, Social Security was structured not as a social assistance program but as a social insurance program. Social assistance programs pay benefits from general tax revenues to persons who must *demonstrate* they are needy. Every needy person has a legal right to those benefits by virtue of the enabling legislation. Medicaid is a social assistance program. Social insurance programs pay benefits from earmarked monies paid into a trust fund by and/or for persons who are *presumed* to be needy and therefore do not have to demonstrate need. Every person covered by a social insurance program has a legal right to benefits by virtue of the enabling legislation and a property right based on the monies he/she paid into the trust fund or were paid into the fund in his/her name. Medicare is a social insurance program.

General tax revenues support a social assistance program. Contributions to a trust fund support a social insurance program. Medicaid is not the same as Medicare. Paulson's statement on the nature of the Social Security problem uses "taxes" much more often than "contributions." Is he saying that he sees Social Security not as social insurance but social assistance? Some clarification as to the nature of the program itself is necessary in order to deal properly with the nature of the problem besetting the program.

Given the huge increase in living standards since the launch of Social Security in the 1930s and the expanded opportunities to provide for one's retirement through private plans using one's own financial resources, the presumption that most in the working population are unable to provide for themselves in retirement without Social Security is called into question. Normal economic growth in the future means that presumed need among the elderly becomes even more difficult to defend.

Perhaps Social Security should be re-structured as a social assistance program. In years past this suggestion has been referred to as "means-testing" Social Security and was rejected. Such restructuring is a third alternative to the two offered by Paulson in which current Social Security retirees are fully protected until death, current enrollees can opt out of the program with minimum public protection in their retirement years if they are needy, and the program is shut down for

everyone else.

Under the third alternative of converting Social Security to a social assistance program ...

- Persons currently receiving Social Security benefits would continue to receive the benefits promised them as long as they live even if the trust fund has to be supplemented by general tax revenues.
- Persons currently working for a covered employer or who in the past worked for a covered employer would be given the option of continuing in the Social Security program and getting the benefits promised them or surrendering their legal and property rights and enrolling instead in a private retirement program with the understanding that they would be eligible for a social assistance retirement program paying benefits at the poverty level when they reach retirement age if they are able to demonstrate need.
- Persons never enrolled in Social Security would receive retirement benefits based on demonstrated need through a social assistance program that supports them at the poverty threshold. They would have no option to enroll in Social Security and would be expected to provide for their own retirement from their own personal financial resources.

The point at which Social Security revenues would fall short of benefits would occur sometime around 2035, forcing the system to supplement the trust fund from general tax revenues. At that point, however, the tax burden would be more widely shared because Social Security taxes are paid only by the current generation of covered workers and their employers. That burden could be reduced by basing annual benefit increases on the cost of living rather than basing them on average annual wage increases as presently done.

Medicare probably should continue as a social insurance program because presumed need makes sense for the elderly who typically can expect to face large health expenditures in which private insurance becomes increasingly expensive as they grow older. However, there would have to be some changes to the eligibility requirement for Medicare that at present requires at least 40 quarters of Social Security coverage.

The third alternative -- convert Social Security to a social assistance program and allow persons to provide for their own retirement with a poverty-level safety net to provide minimal protection -- removes the harsh reality facing *persons born between 1940 and 2000 who under the current law, according to Paulson, will receive less in lifetime benefits than they pay in taxes (contributions)*. That reality by definition becomes even worse if either one of Paulson's alternatives -- higher taxes (contributions) or lower benefits -- are incorporated in any reformed Social Security program.

A compulsory public retirement benefit program based on presumed need made sense in the Great Depression. It does not make sense today. Indeed, as Paulson himself admits, *most current and future workers would do better investing in essentially risk-free U.S. Treasury bonds than paying into the Social Security system*. A 2013 actuarial study by the Social Security Administration confirms that for a two-earner couple, each with career average earnings of \$66,000 or higher, Social

Security retirement is a poor investment. The rate of return typically is below 2 percent.¹

¹ See www.socialsecurity.gov/oact/NOTES/ran5/index.html.

REVIEW SECTION: TOPIC 24

Central Concepts:

aggregate demand = $f(\text{prices})$

human physical need:

presumed

demonstrated

entitlement programs:

social insurance

social assistance

pay-as-you-go

legal right

property right

President Roosevelt's New Deal:

treating symptoms:

1935 Social Security Act

1935 Wagner Act

1938 Wage and Hour Law

self-correcting mechanism

Important Questions:

According to the classical school, explain how a capitalist economy automatically self-corrects for unemployment through the (a) product market and the resource market and (b) the financial market.

How does a capitalist economy deal with the problem of inflation?

Explain the role of flexible prices, wages, and interest rates in the automatic self-correcting market mechanisms of the classical theory.

What does the establishment and continued use of the safety net over the last 60 years indicate about the validity of the classical theory?

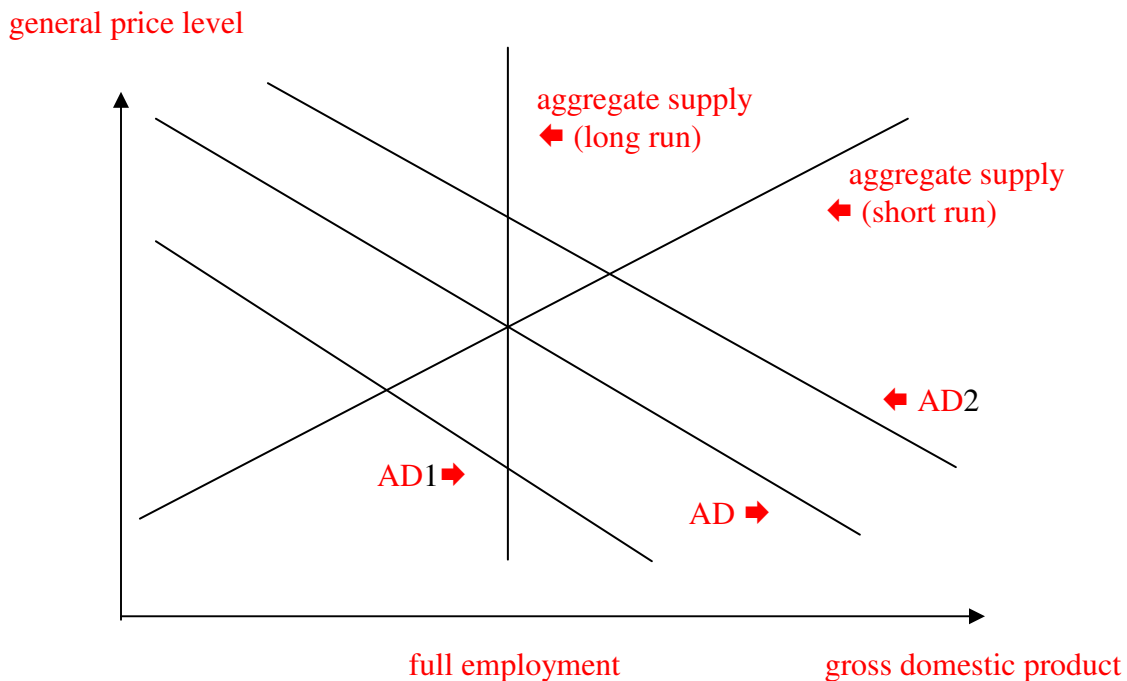
What is the difference between a social assistance program and a social insurance program?

(continued on following page)

True/False:

The Classical theory argues that unemployment is self-correcting because ...

- a. flexible wages, prices, and interest rates automatically restore full employment.
- b. an upward shift in aggregate demand from AD to AD2 (see exhibit below) leads to lower prices, thereby increasing the demand for goods and services and restoring full employment.
- c. a downward shift in aggregate demand from AD to AD1 triggers huge increases in government spending that stimulate aggregate demand through the Keynesian multiplier, thereby restoring full employment.
- d. a downward shift in aggregate demand from AD to AD1 leads to higher prices, thereby dampening the demand for goods and services and restoring full employment.



Mark your answer below.

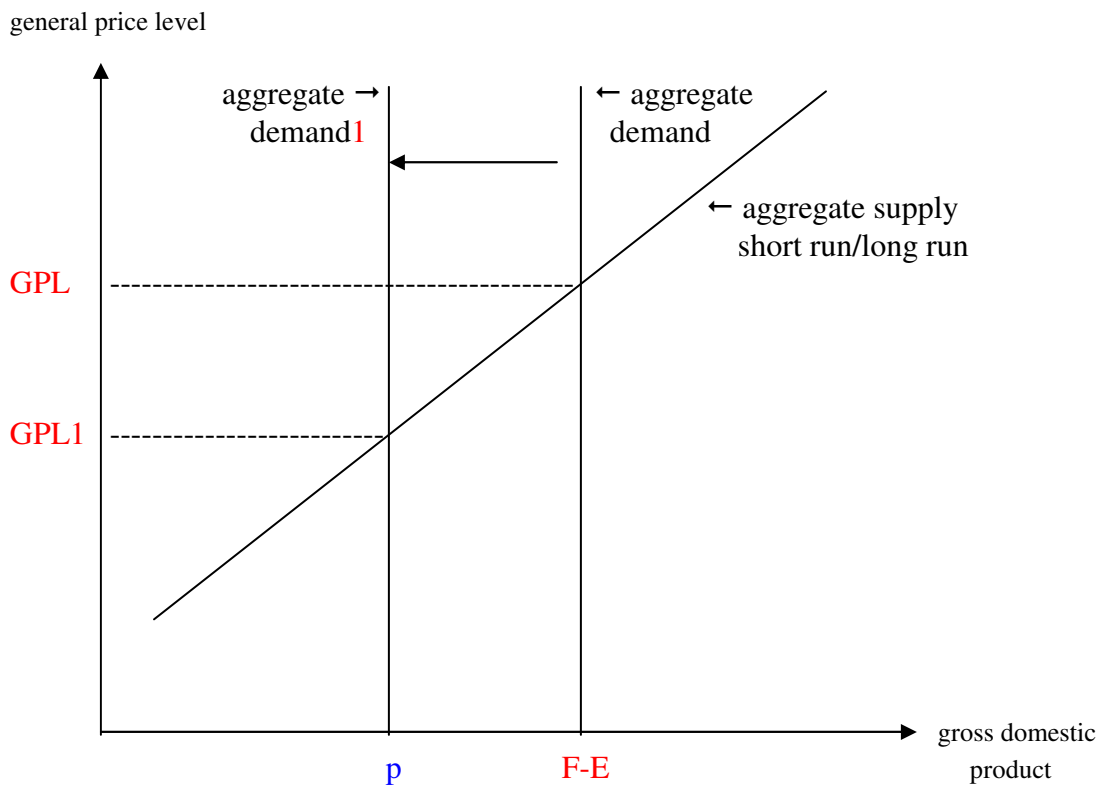
- Item a is true, items b, c, and d are false.
- Items a and b are true, items c and d are false.
- Item a is false, items b, c, and d are true.

TOPIC 25 THE KEYNESIAN REVOLUTION

To demonstrate how and why to intervene in macroeconomic dysfunction through the demand side of the product market.

The Keynesian (Ká-ne-zee-n) Revolution centers around three theoretical innovations: aggregate demand, the marginal propensity to consume and the associated multiplier effect, and the liquidity trap. The following diagram displays Keynes' understanding as to how the product and resource markets function in the context of aggregate demand.

WHY THE LAW OF NATURE DOES NOT RESTORE FULL EMPLOYMENT THROUGH PRODUCT & RESOURCE MARKETS: KEYNESIAN ECONOMICS PERSPECTIVE



Keynesian economics argues that when there is a massive deterioration in aggregate demand, as represented in the shift shown above, there is a permanent (p) loss of production along with massive and persistent unemployment because aggregate demand is not a function of prices and therefore does not respond to the fall in prices from GPL to $GPL1$. Because aggregate demand is a function of income and unless the disposable income of consumers is raised either by more government spending or lower taxes, the macroeconomy will continue to stagnate at p and $GPL1$.

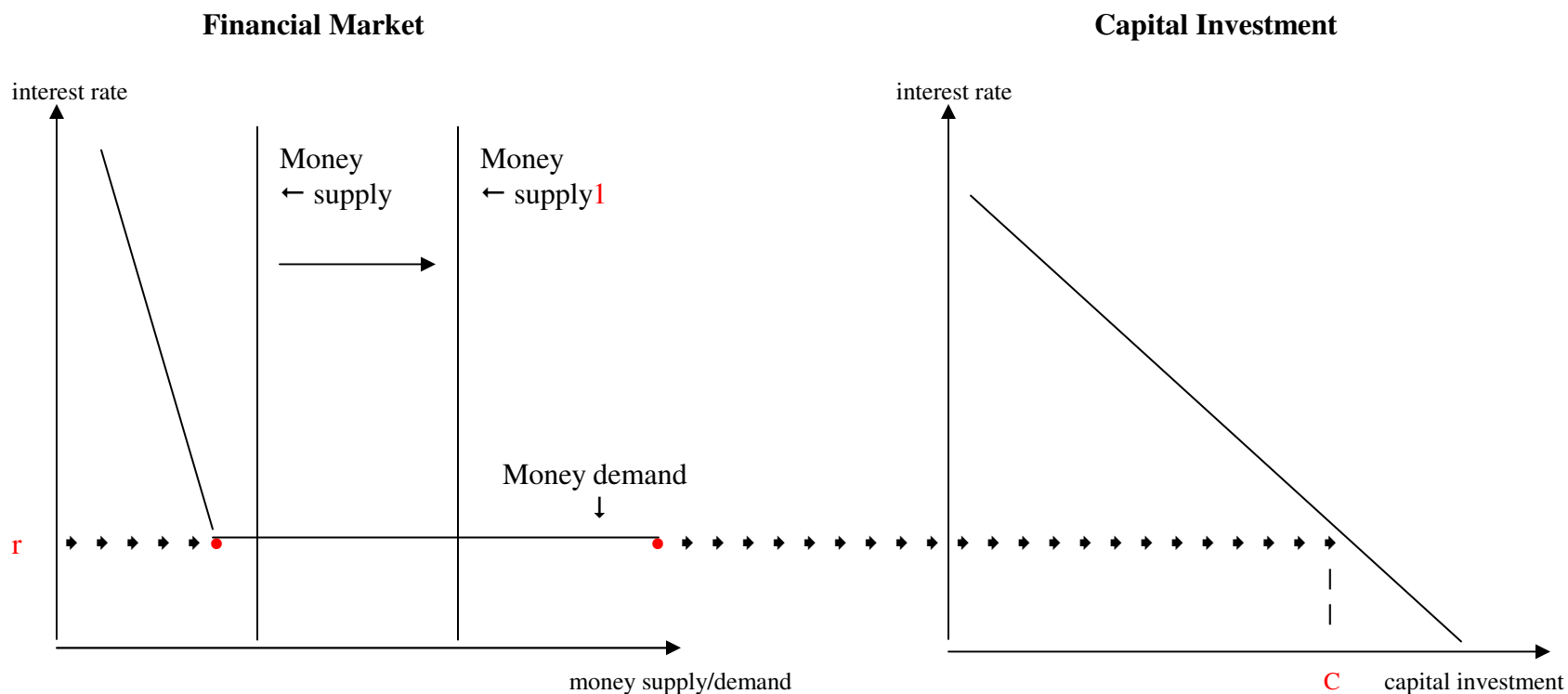
In Topic 24 we demonstrated the classical school's understanding as to how under the influence of the law of nature the product and resource markets function to restore full-employment whenever unemployment becomes a problem and stable prices whenever inflation emerges on the macroeconomic scene. Recall that the classical school argued that aggregate demand is a function of prices. Keynes sees aggregate demand much differently, as a function of income not prices. When aggregate demand is displayed in the context of a diagram in which the general price level is plotted along the vertical axis and national product or GDP is plotted along the horizontal axis, aggregate demand is expressed as a vertical line drawn well to the right of the vertical axis. Both short run and long run aggregate supply according to Keynes are rendered as a function that is upward sloping to the right. It has the same general shape and appearance of the short-run aggregate supply curve of classical economics that we already represented in Topic 24.

Keynes argued that aggregate demand is a function of income and not prices because consumers taken together are able to purchase the goods and services they need and want only when their income is sufficient for that purpose. Put differently, when large numbers of consumers are broke lower prices will not induce them to increase their spending. The principle of demand that works at the microeconomic level simply does not work at the macroeconomic level during a depression such as occurred in the 1930s. Thus the massive deterioration in aggregate demand that took place in the Great Depression can be represented in the diagram as a shift to the left from the original position of aggregate wherein the macroeconomy previously had been operating at full-employment GDP and stable prices. Mainstream economics refers to the intersection of aggregate demand and aggregate supply as macroeconomic equilibrium. As stated previously, our preference is to refer to the condition associated with the intersection of aggregate demand and aggregate supply as macroeconomic accord.

The shift in aggregate demand rendered in terms of Keynesian thinking to aggregate demand I means that a new macroeconomic accord is reached wherein there is a large fall in the prices of goods and services across the board, a huge cutback in production and with that cutback a major decrease in employment and a corresponding increase in unemployment. These indeed were the economic realities of the 1930s that the classical school argued would be remedied by the law of nature. The massive and persistent unemployment of that decade in the United States and throughout the major market economies of the world was proof that the classical school's macroeconomic theory was seriously flawed. And Keynes was able to demonstrate that the central flaw lay in the way they misconstrued aggregate demand as a function of prices. Full employment could not be restored until aggregate demand was stimulated sufficiently to return to its original position).

The diagrams on the following page allow us see Keynes' theoretical innovation that he called the liquidity trap. Keynes argued that the classical school defects were not confined to the product and resource markets. There were two serious flaws in the classical school's rendering of the financial market. First, the central banking authority controls the supply of money that means that it is not a function of the rate of interest as classical economics argued. Thus, the money supply (MS) should be represented diagrammatically as a vertical line drawn well to the right of the vertical axis.

WHY THE FINANCIAL MARKET DYSFUNCTIONS AND DOES NOT RESTORE FULL EMPLOYMENT: THE KEYNESIAN ECONOMICS PERSPECTIVE



When unemployment rises due to a decline in aggregate demand brought on by decreases in spending for consumer goods and services and increases in consumer savings (see **Flow 8b** in the circular flow diagram for a capitalist economy), an increase in the money supply from MS to $MS1$ triggered by the central bank cannot reduce the rate of interest below r due to the liquidity trap. In the liquidity trap consumers prefer to hold their savings in the form of cash rather than make them available for investment purposes because the interest rate is very low and macroeconomic circumstances so grim that they are unwilling to risk their savings for a small return on their investment. Because the rate of interest cannot be reduced below r capital investment cannot be stimulated to any level greater than C . Thus the liquidity trap causes the financial market to dysfunction because it cannot boost aggregate demand by stimulating capital investment.

Second, the demand for money, that is downward sloping to the right at high and moderate rates of interest, becomes horizontal at very low rates of interest, rates as low as they became during the Great Depression. The horizontal portion of demand for money (represented in the left-hand diagram as \bullet ————— \bullet) Keynes called the liquidity trap by which he meant that at very low rates of interest consumers want to hold on to as much cash as they can lay their hands on rather than make their savings available to entrepreneurs for investing in a new venture. The reason consumers behave this way is that during the Great Depression they have witnessed and experienced very grim economic conditions, they saw no end in sight for those conditions, and they were unwilling to risk investing their savings for a very low rate of return in a business venture that well might fail and to suffer the loss of those savings.

In the liquidity trap, any increase in the supply of money as represented by a shift to the right of MS produces no change in the rate of interest. In other words, the central banking authority's efforts to reduce the rate of interest by increasing the money supply from MS to MS1 are futile. There is no way to induce additional spending on capital goods and services as represented in the right-hand diagram, where capital expenditures are represented as a function of the rate of interest (downward sloping to the right), because the rate of interest is stuck in the liquidity trap. There is no way to stimulate aggregate demand, which depends importantly on the demand for capital goods and services, through the financial market. Keynesians used the phrase "money is a veil" to indicate that whatever is happening in the financial market should be disregarded; the important center of macroeconomic activity is the product and resource markets.

Thus did Keynes sweep aside the classical economics way of thinking about the manner in which product and resource markets and financial markets restore full employment accord through the law of nature.

Keynes, however, has a remedy in mind for insufficient aggregate demand that unlike communism and fascism, both of which were gaining in popularity and support in the 1930s, does not call for dismantling the market economy through government takeover. Keynes argued that a relatively small amount of stimulus to aggregate demand by increasing government expenditures or reducing taxes would be sufficient because the stimulus would have a multiple impact on consumer income and spending.

Just as dropping a stone in a pond generates several waves disturbing the surface of the water, with each wave having smaller amplitude than the preceding wave, stimulating the economy generates several waves of additional consumption expenditures each wave being smaller than the preceding one but taken together they have a multiple effect on aggregate demand and thereby on production and employment.

Suppose, for example, that the income of consumers rises by \$1,000 due to reduced taxes, and assume that consumers typically spend 90 percent of any additional income they receive (called by Keynes the marginal propensity to consume)¹ and save the rest. In the first-wave response to the

¹ Rendered in decimal form, MPC takes on its lowest value of 0 when consumers save all of the additional income received and its highest value of 1 when they spend all of the additional income received.

\$1,000 increase in income, consumption will rise by \$900 and savings will increase by \$100. Since the \$900 added spending on consumer goods and services becomes income for those persons who produced and sold those goods and services to the consumers in the first wave, the income of those producers/sellers has increased by \$900. If they in turn spend 90 percent, and save 10 percent, the second-wave response is that consumption increases by \$810, and because that spending becomes income for those who produced and sold the goods and services that were bought with the \$810, a third-wave response is triggered amounting to an additional \$720 consumer spending. And so on until the last-wave response has taken place.

Thus aggregate demand is stimulated by multiple waves of consumer spending that were triggered by a relatively small initial reduction in taxes. Keynesian economics next offers the following formula to estimate the total impact on aggregate demand.

$$\text{total increase in aggregate demand} = (\text{increase in first-wave consumption}) \times [1 \div (1 - \text{MPC})]$$

The mathematical expression in brackets is known as the multiplier. A \$1,000 increase in consumer income, with an MPC of .9, has a total impact on consumption expenditures and therefore on aggregate demand of \$9,000 = (\$900) x [1 ÷ (1 - .9)]. The multiplier with an MPC of .9 is 10. The multiplier with an MPC of .95 is 20; the multiplier with an MPC of .8 is 5. The multiplier in other words is much higher or lower for only a smaller difference in MPC. For that reason and inspired by the Keynesian revolution, economists in the 1940s and 1950s undertook consumer expenditure studies in order to put a firm number to the marginal propensity to consume.

*Using the diagnostic tool developed to estimate GNP and GDP it becomes possible under Keynesian economics to prescribe the exact amount of **additional government spending** or **lower taxes** to induce just the right amount of stimulus to aggregate demand that will restore full-employment accord. For example, if the macroeconomy is operating at, say, \$150 billion below full-employment GDP it would take only an additional \$15 billion in first-wave increased consumption to restore full-employment GDP as indicated in the following expression.*

$$\$150b = (\text{first-wave increased consumption}) \times [1 \div (1 - .9)]$$

*Increasing consumption can be accomplished in two ways: reduced taxes and increased government spending. To increase consumption by \$15 billion it would be necessary to put together a stimulus package of **reduced taxes** totaling \$16.6 billion that allows for 10 percent or \$1.6 billion going into consumer savings with the remaining \$15 billion going into first-wave consumption expenditures.*

$$\text{increase in aggregate demand} = (\text{reduced taxes} - \text{consumer savings}) \times [1 \div (1 - \text{MPC})]$$

*Estimating the amount of **additional government spending** that would accomplish the same purpose as reducing taxes is somewhat different as follows:*

$$\text{increase in aggregate demand} = (\text{increase in government spending}) \times [1 \div (1 - \text{MPC})]$$

*To increase aggregate demand by \$150 billion it would be necessary to increase **government***

spending by \$15 billion because each dollar of additional government expenditures would have a tenfold impact on aggregate demand by inducing multiple waves of consumer spending.

Keynesian economics works the same way whenever inflation is the problem since inflation is due to excessive aggregate demand that is driving up prices through across-the-board shortages of consumer goods and services. To dampen excess aggregate demand what is needed is a package of higher taxes or reduced government spending that will restrain aggregate demand and restore stable prices. It follows that Keynesian economics is able to restore full employment and price stability with only a relatively small intervention on the part of the government to either stimulate aggregate demand whenever it is insufficient or dampen aggregate demand whenever it is excessive.

Due to a widespread fear that the end of World War II would return the world's market economies to depression-like conditions, the U.S. government enacted the Employment Act of 1946 that mandated federal government intervention in the event of serious macroeconomic problems and authorized the president to appoint a council of economic advisers to recommend the best course of action to follow when intervention becomes necessary. As it turned out in the years immediately following the end of the war the forced savings¹ of World War II triggered huge increases in consumer expenditures on big-ticket items such as furniture, cars, appliances, and housing. The problem was not insufficient aggregate demand and unemployment but excess aggregate demand and inflation.

*President Truman was the first president to appoint a council of economic advisers but President Kennedy was the first to appoint Keynesian economists to his council of advisers. Kennedy used the two recessions occurring in President Eisenhower's second term of office (1957-1960) as justification for further government intervention in macroeconomic affairs and based that intervention on Keynesian economics. **In the United States this is the first time Keynesian economics is given a real-world test of its validity.** Lower taxes were recommended by his advisers and President Kennedy was able to get a tax reduction package through the U.S. Congress. This package worked as Keynesian economics had predicted. Reduced taxes stimulated aggregate demand by boosting consumer expenditures. The macroeconomy in the early 1960s was being stimulated in the direction of full-employment GDP.*

This success marks the golden age of Keynesian economics in the United States, and many Keynesians began to argue that with the right information it would be a relatively simple, straightforward task to "fine-tune" the economy, that is restore full-employment whenever unemployment becomes a problem and stable prices whenever inflation emerges on the scene. Further, a government budget deficit incurred to stimulate aggregate demand in order to restore full employment during a contraction would be balanced against a budget surplus to dampen aggregate demand in order to stabilize prices during a boom. Over the business cycle, therefore, there would be no net increase in the total public debt and thus no further strain on the budget to pay the greater interest payments owed on a larger public debt.

¹ Forced savings refers to the savings of consumer whose earnings were boosted by the surge in employment in war plants and shipyards. Additionally, the re-allocating of economic resources from the production of consumer goods and services to war production left consumers with little to buy except the bare essentials and war bonds.

Fine-tuning the economy without massive government intervention and huge interest payments on an ever larger public debt gave Keynesian economics such appeal that among economists in the 1960s the expression “all economists are Keynesian economists” was widely embraced.

REVIEW SECTION: TOPIC 25

Central Concepts:

- aggregate demand = $f(\text{income})$
- marginal propensity to:
 - consume
 - save
- multiplier effect
- liquidity trap
- “money is a veil”
- fine-tuning
- fiscal policy:
 - countercyclical

Important Questions:

Who was John Maynard Keynes and when and why did he publish **The General Theory**?

According to Keynes why doesn't the market system automatically and completely self-correct during periods of widespread unemployment?

How would Keynes restore the economy to full employment when large numbers of persons are out-of-work?

What is the mathematical expression for the multiplier?

What do Keynesians mean by the liquidity trap?

Why was the Keynesian solution to the problem of unemployment so attractive?

Specifically what steps do Keynesian economists recommend for dealing with the problem of unemployment? for inflation?

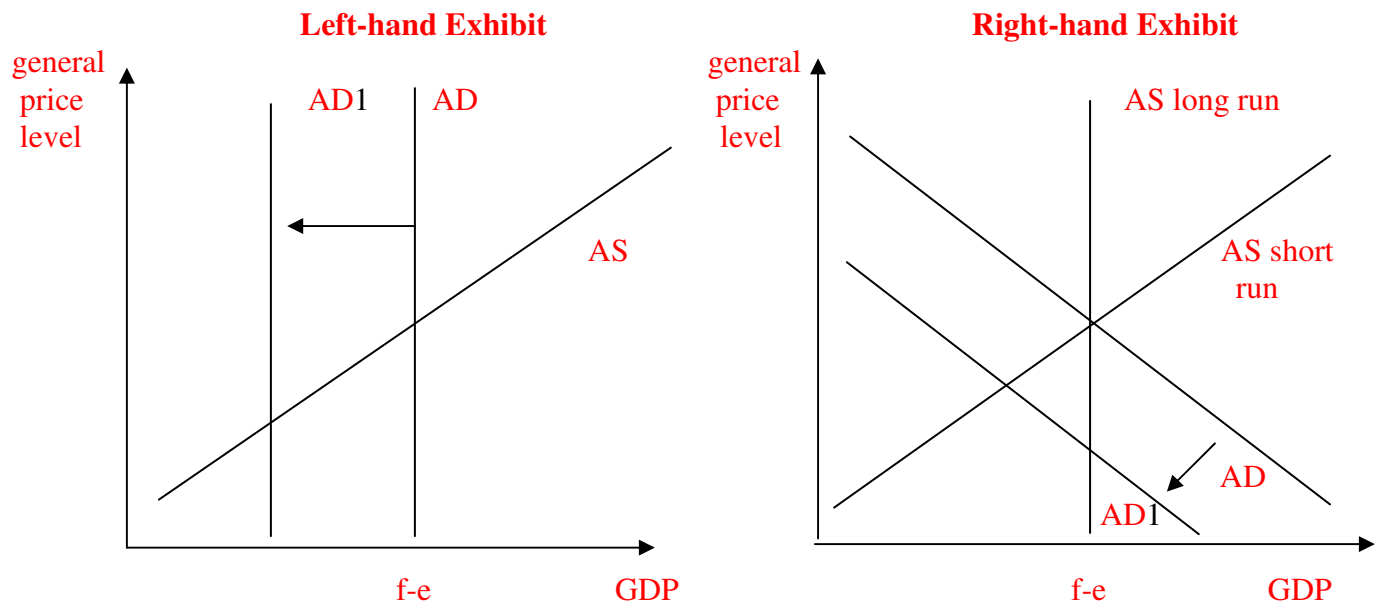
Why is the Keynesian theory regarded as revolutionary?

What happened in the late 1960s and throughout most of the 1970s to weaken support for the Keynesian theory?

(continued on following page)

True/False:

- The left-hand exhibit represents the Keynesian school's thinking about macroeconomic affairs. *AS = aggregate supply; AD = aggregate demand; f-e = full-employment macroeconomic accord.*
- The right-hand exhibit represents the Classical school's way of thinking about macroeconomic affairs. *AS = aggregate supply; AD = aggregate demand.*
- The Classical school's remedy for the problem of unemployment is grounded in the marginal propensity to consume.
- The Keynesian school's remedy for the problem of unemployment is grounded in the law of nature.



Mark your answer below.

- ▼
- Item a is true, items b, c, and d are false.
- Items a and b are true, items c and d are false.
- Item a is false, items b, c, and d are true.

TOPIC 26 THE MONETARIST COUNTER-REVOLUTION

To present how and why to intervene in macroeconomic dysfunction through the financial market by means of the money supply.

Keynesian economics dominated the economics profession for 30 years ending in the late 1960s. Its dominance regarding public policy was much shorter lived spanning the decade of the 1960s. The golden age of the Keynesian revolution came during the early to mid-1960s when the tax cuts originally recommended by President Kennedy proved to be just the right stimulus to restore full-employment accord. This period, which for many Keynesians had a euphoric quality, came to a close in the late 1960s because the U.S. economy, under the stress of vastly increased military spending to support the war effort in Vietnam that was financed not by additional taxes but by deficit financing, began to experience inflation -- an outcome not unexpected and clearly attributable to excess aggregate demand. But in the early 1970s a second problem emerged – heightened unemployment – that theoretically could not coincide with inflation because the one is associated with a business cycle trough and the other with a business cycle peak. The twin phenomena – unemployment and inflation occurring simultaneously – left Keynesians puzzled. What to do? Increase taxes and reduce government spending to dampen the excess aggregate demand that is causing inflation? Or reduce taxes and increase government spending to stimulate the insufficient aggregate demand that is causing unemployment?

*For a short while the Nixon White House in the early 1970s toyed with the idea of price controls to rein in inflation. But that suggestion was dropped as politically suicidal. The economic discourse was reduced to giving this twin phenomena a new name. Unemployment and inflation occurring simultaneously was called **stagflation**. The “stag” part came from “stagnation” that is descriptive of an economy experiencing unemployment; the “flation” part was taken from “inflation.” The difficulty, of course, is that giving the twin phenomena a name is not the same as understanding the twin phenomena and addressing it effectively. Keynesian economics lost its dominant role in economics and economic policy for the same reason that classical economics fell apart in the Great Depression: it could not provide a coherent answer to the troubling realities of macroeconomic affairs.*

By the mid 1970s, during Gerald Ford’s presidency, price controls again were suggested and the federal government had coupons printed for rationing gasoline that was in short supply due to the Mideast oil embargo. Again, however, a political reality check kept the White House from declaring an emergency and reverting to official gasoline rationing. Instead, the rationing took place at the gasoline pumps on a first-come, first-served basis. Across the U.S., drivers had to wait in long lines at the pumps – a sure sign of a shortage – to purchase the available supplies, and at times were frustrated by filling stations that were forced to close because their supplies had been exhausted.

There is no clear consensus even today as to why the U.S. economy was beset by stagflation in the late 1960s and well into the following decade. However, America was shaken severely by five major tremors -- a disastrous war in Vietnam, a constitutional crisis during Richard Nixon's presidency, the civil rights movement, the sexual revolution, and the Supreme Court's decision on the abortion issue -- that destabilized the U.S. economy just as a major earthquake brings down structures that were built to withstand minor to moderate earthquakes but not the kinds of shock associated with a major quake. Keynesian economics could no more withstand those tremors than classical economics could survive the devastating economic earthquake of the Great Depression.

***The monetarist counter-revolution** is properly considered a counter-revolution because it resurrected the equation of exchange from the body of classical economic theory that had been swept aside by the Keynesian revolution. The architect of this counter-revolution was Milton Friedman an economist on the faculty of the University of Chicago. Friedman was awarded the Nobel Prize in economics in 1976.*

The equation of exchange is expressed in mathematical form as follows: $MV=Py$. As we will explain below, the equation of exchange says that the money supply (M) influences the general price level (P) and real national product or GDP (y). And because the money supply influences GDP it impacts employment and in turn unemployment.

The equation of exchange is derived as follows. From the macroeconomic circular flow, we know that the payment for all goods and services produced is equal to the payment to all of the resource holders for the resources used to produce those goods and services. Simply put,

$$(I) \quad \text{national product} = \text{national income}$$

We also know that real national income is nominal national income adjusted for changes in the general price level, and similarly with real national product and nominal national product. Simply put,

$$(II) \quad \text{real national income} = \frac{\text{nominal national income}}{\text{general price level}}$$

$$(III) \quad \text{real national product} = \frac{\text{nominal national product}}{\text{general price level}}$$

Since national income is equal to national product, real national income must be equal to real national product. Thus,

$$(IV) \quad \text{real national income} = \frac{\text{nominal national income}}{\text{general price level}} = \text{real national product}$$

Dropping real national income from the left side of expression IV and moving the general price level to the right-hand side produces the following:

$$(V) \quad \text{nominal national income} = (\text{general price level}) \times (\text{real national product})$$

Applying the following abbreviations to the terms used in expression V:

$$\text{real national product} = y \quad \text{general price level} = P \quad \text{money supply} = M$$

and dividing the left-hand side of expression V by the money supply (M) and multiplying the result by the same variable (M) yields the following:

$$(VI) \quad M \times \frac{\text{nominal national income}}{M} = Py$$

Since the income velocity of money (V) measures the rate at which the money supply (M) turns over relative to nominal national income, that is nominal national income \div M, expression VI is the equation of exchange:

$$MV = Py$$

V is the income velocity of money, the rate at which the money supply (M) turns over relative to nominal national income. If V is known and held constant, expansion or contraction of the money supply allows us to control prices (P) and real national product (y) and thereby both employment and unemployment. **In essence, the monetarist counter-revolution is saying that only the money supply matters with regard to the macroeconomy.**

Monetarist economics replaced Keynesian economics in late 1979 as Americans increasingly became frustrated with the twin phenomena of inflation and unemployment. Friedman's extensive empirical studies of the role of the Federal Reserve System since its founding in 1913 indicated that in each and every instance in which the Federal Reserve intervened in macroeconomic affairs it made a bad situation even worse. For that reason, Friedman had no confidence in the competency of the Board of Governors of the Federal Reserve to use their discretion in macroeconomic intervention wisely. He insisted that the Board follow his monetary rule in shaping monetary policy, that it should manage the money supply such that it grows by 3 – 5 percent annually because his studies showed retrospectively that such a fixed rate of growth is most likely to bring stability to macroeconomic affairs

Friedman stated firmly that monetary policy based on the monetary rule is a much better way to intervene in macroeconomic affairs than is Keynesian-style fiscal policy that is internally flawed and is clumsy at best due to the political nature of budgeting process that typically drags on in Washington from January until late in the year, often only in the end to continue the spending levels of some prior budget agreement. Friedman did not promise an end to the business cycle if the Board of Governors adhered to his monetary rule. Rather, he stated that following the monetary rule would help moderate what otherwise would be larger fluctuations in the business cycle.

With its new mandate to intervene in macroeconomic affairs by managing the money supply, the Board of Governors decided that its efforts should be directed to bringing inflation under control. In 1979 consumer prices as measured by the Consumer Price Index increased by 11.3 percent. The

basic strategy was to contract the money supply and thereby drive up the rate of interest until borrowing became so expensive that consumers and entrepreneurs would shy away from further borrowing, would therefore spend less, and that in turn would dampen aggregate demand. That strategy would continue until price stability had been restored. The Federal Reserve in other words rejected Friedman's monetary rule in order to use its own discretion as how best to regulate macroeconomic affairs.

The Federal Reserve System manages the money supply by regulating the discount rate and the federal funds rate, by setting the reserve requirement that in turn influences a private commercial bank's excess reserves and the size of its loan portfolio, and by buying and selling government securities. We have addressed the first two methods in earlier topics. Our attention turns to the buying and selling of government securities, a process that is known as open-market operations.

*The Federal Reserve holds government securities specifically for the purpose of regulating the money supply. When the Federal Reserve **buys government securities** from a private commercial bank that has been holding them as interest-bearing assets it **expands the money supply** by adding an equivalent amount to that bank's required reserves. Those added reserves will support an increase in the monies in the checking accounts of the bank's loan customers through the credit-creation process. When the Federal Reserve **sells government securities** to a private commercial bank it **contracts the money supply** by removing an equivalent amount of that bank's required reserves that reduces its ability to make loans through the credit-creation process.*

In like fashion, when the Federal Reserve buys government securities from a private person or nonbank organization such as a pension fund or a mutual fund that has been holding them as interest-bearing assets, it pays for those securities by check that when it is deposited in a checking account adds to the money supply. When the Federal Reserve sells government securities to a private person or nonbank organization, it accepts payment by a check that when it clears the buyer's checking account removes that money from circulation.

*To induce a buyer to purchase a government security, the Federal Reserve can offer securities for sale at a price that is below the face value -- the amount that will be paid by the U.S. Treasury to the holder at the time of redemption. To induce a bondholder to sell a government security, the Federal Reserve can offer to pay more than the face value of the security. Every government security guarantees a fixed amount of interest to be paid every year to the person or organization who holds the bond. The amount depends on the interest rate specified on the bond. A \$100,000 government security that pays \$5,900 every year to the holder is making payment at an annual interest rate of 5.9 percent. If, however, the holder bought a \$100,000 bond for \$90,000, interest payments of \$5,900 per year amount to a return of 6.6 percent. The 6.6 percent is known as the **yield** on this bond. The yield is calculated as follows:*

$$\text{yield} = (\text{amount of annual interest paid} \div \text{amount holder paid for bond}) \times 100$$

The rate of inflation in terms of consumer prices did not fall immediately. In 1980 consumer prices increased by 13.5 percent and in the following year they climbed by 10.3 percent. By 1982, however, the rate of increase fell to 6.5 percent and one year later it had fallen to 3.2 percent. But dampening

aggregate demand by contracting the money supply drove the rate of unemployment to 9.7 percent in 1982 and to 9.6 percent in 1983. These annual rates were unprecedented in the 40-year history of the Current Population Survey, and the U.S. public simply would not tolerate such massive unemployment to rein in inflation. The monetarist counter-revolution lasted only a few short years, though strictly speaking since the Federal Reserve never implemented the monetary rule it can be argued that the monetarist counter-revolution did not fail because it never was tried.

There is no controversy in economics regarding the steps that the Federal Reserve System can take to expand or contract the money supply. It can expand the money supply by cutting the discount rate and the federal funds rate, lowering the reserve requirement, or buying U.S. government bonds. It can contract the money supply by boosting the discount rate and federal funds rate, raising the reserve requirement, or selling U.S. government bonds. The controversy centers around the impact that any given expansion or contraction in the supply of money has on macroeconomic affairs. Does a contraction in the money supply reliably dampen aggregate demand and reduce inflationary pressures? Does an expansion in the money supply reliably stimulate aggregate demand and strengthen GDP?

REVIEW SECTION: TOPIC 26

Central Concepts:

- equation of exchange
- velocity of money
- monetary policy
- open-market operations
- face-value
- yield

Important Questions:

- Why do we refer to monetarism as a counter-revolution?
- Who is Milton Friedman and why did he break from Keynesian economic thought?
- Why do the monetarists disagree with Keynes' position that money markets do not matter during heavy unemployment?
- What is the role of the equation of exchange in monetarist theory?
- What do the monetarists recommend as the best way for the government to regulate the economy?
- How does the Federal Reserve System help increase the money supply when it buys government securities from private commercial banks and other parties, and decrease the money supply when it sells government securities to those banks and other parties?
- What are the other two methods available to the Federal Reserve System to increase or decrease the supply of money?

(continued on following page)

True/False:

- a. The Monetarist Counter Revolution focuses macroeconomic policy on the government budget process -- on government expenditures and tax revenues -- as the best way to address unemployment during a business cycle trough and inflation during a business cycle peak.
- b. The Monetarist Counter Revolution focused attention on the financial market.
- c. Strictly speaking, the Monetarist Counter Revolution never was fully implemented because the Federal Reserve System did not follow Friedman's recommendation that the money supply should be increased by 3-5 percent per year, year in and year out.
- d. The Monetarist Counter Revolution said that monetary policy (managing the money supply) is a better method for addressing the problems of the business cycle than is fiscal policy (manipulating government spending and taxes).

Mark your answer below.



_____ Item a is true, items b, c, and d are false.

_____ Items a and b are true, items c and d are false.

_____ Item a is false, items b, c, and d are true.

TOPIC 27 THE NEO-CLASSICAL COUNTER-REVOLUTION

To demonstrate why it is best not to intervene in the macroeconomy whenever inflation or unemployment become a problem.

*The neo-classical counter-revolution restores classical economic theory to the dominant position it held among academic economists prior to the Keynesian revolution. In effect, the neo-classical counter-revolution has buried the Keynesian revolution and has re-affirmed the four premises that we examined in Topic 1. Those premises are, first, that the **INDIVIDUAL** is the central unit of economic analysis. Second, markets by means of the **LAW OF NATURE** automatically restore full employment whenever unemployment becomes a macroeconomic problem and stable prices whenever inflation emerges on the macroeconomic scene. Markets naturally tend toward macroeconomic equilibrium or what we have called economic accord. Third, it is possible to reach **CERTAINTY** regarding macroeconomic affairs provided one has all the required information and the correct theoretical framework. Fourth, a person's worth is determined by **CONTRACTS** that is by the contract a person signs that specifies the tasks that are to be performed and the payment he/she is to receive for performing those tasks satisfactorily.*

The neo-classical counter-revolution has added two new propositions to the body of classical economic thought: continuous market clearing, and rational expectations hypothesis. Continuous market clearing means that markets function in a way that automatically and continuously removes or clears away any shortages or surpluses that might develop. By performing this task continuously, the law of nature assures that in terms of macroeconomic affairs the kind of across-the-board shortages that contribute to excessive aggregate demand that in turn triggers macroeconomic inflation simply do not arise. And the law of nature assures that the kind of widespread surpluses that contribute to insufficient aggregate demand that in turn sets off macroeconomic unemployment just do not unfold. Thus, at the macroeconomic level, the law of nature assures full-employment accord with stable prices.

The rational expectations hypothesis asserts that economic agents including buyers and sellers, producers and consumers, employers and workers, entrepreneurs and creditors, and others know what the government is about to do, how that intervention is likely to affect them, and they do whatever is necessary to avoid any adverse effects. Thus, government intervention ultimately is frustrated and futile, and the macroeconomic problems of inflation and unemployment should be left to the law of nature.

The typical economic agent acts like an exceptionally skilled prize fighter -- Muhammad Ali in his prime comes to mind -- who anticipates his opponent's next move and is able to "slip" his punches. Doing this successfully for several rounds has the effect of wearing down and frustrating his opponent to the point where he becomes especially vulnerable to counter-punching and to being knocked down and ultimately knocked out.

Both propositions are suspect. Some markets clear away a surplus or shortage quickly while others do not. Labor markets, for example, do not necessarily clear away shortages and surpluses quickly. We have had a national nursing shortage for many years. We have had labor surpluses in Appalachia and along the Mississippi Delta even longer. When shortages and surpluses persist, the law of nature does not lead invariably and quickly to full-employment accord with stable prices.

The rational expectations hypothesis depends on two critical premises about human beings that appear to be contrived. First, humans know with certainty what the government is likely to do and how any such intervention is likely to affect them. Second, they will act rationally that means they will act strictly in their own self-interest, without regard for others, and totally devoid of any emotion such as fear or envy or revenge that might influence their decision-making behavior.

REVIEW SECTION: TOPIC 27

Central Concepts:

continuous market clearing
rational expectations hypothesis

Important Questions:

Why do we refer to neo-classical economics as a counter-revolution?
Why does the use of the rational-expectations hypothesis lead to a return of the classical paradigm?
What does the neo-classical school mean by continuous market clearing? Why does continuous market clearing make government intervention unnecessary?
Why does the rational expectations hypothesis make government intervention futile?

True/False:

- a. By the law of nature, Neoclassical (mainstream) economists mean that markets automatically restore full-employment macroeconomic accord (equilibrium) by continuously clearing markets of the shortages and the surpluses that cause inflation and unemployment respectively.
- b. The rational expectations hypothesis of Neoclassical economics means that economic agents typically anticipate government interventions in macroeconomic affairs and they take the steps necessary to avoid the impact of those interventions thereby making such interventions futile.
- c. Today in the United States, only a very small number of academic economists, especially those who have gotten their professional training in economics more recently, embrace Neoclassical economics.
- d. The Neoclassical Counter Revolution restored much of Classical economics, adding principally two new ideas: the liquidity trap and Say's law.

Mark your answer below.



_____ Item a is true, items b, c, and d are false.

_____ Items a and b are true, items c and d are false.

_____ Item a is false, items b, c, and d are true.

TOPIC 28 THE SUPPLY-SIDE COUNTER-REVOLUTION

To demonstrate why it is best not to intervene in the macroeconomy whenever inflation or unemployment become a problem.

The monetarist counter-revolution ended suddenly in the early 1980s because the monetary policy pursued by the Federal Reserve Board of Governors that targeted inflation caused record-high unemployment. Indeed, in September 1982, the rate of unemployment for the entire U.S. civilian labor force climbed to 10.1 percent, the first time in the history of the Current Population Survey that the jobless rate reached a double-digit figure. The rate remained between 10.0 and 11.0 percent until the following July when it dropped to 9.4 percent. In October 1979 when the Federal Reserve launched its attack on inflation by contracting the money supply the number of persons unemployed stood at 6.3 million. By December 1982 the jobless total had peaked at 12.1 million.

*At the same time the Reagan White House had been readying the United States for the **supply-side counter-revolution** ever since Ronald Reagan became the Republican candidate for president in the 1980 election. Recall that the monetarist counter-revolution was launched toward the end of Jimmy Carter's presidency. Reagan never embraced monetarism and for that reason found it rather easy to abandon that counter-revolution when unemployment reached unprecedented levels in his second year in office.*

The supply-side counter-revolution argues that government intervention in macroeconomic affairs should focus on aggregate supply and should center on finding ways to encourage employers to increase production in order to remedy the problem of high unemployment. This counter-revolution resurrected Say's Law – supply creates its own demand – from the ashes of classical economics. The deceptively simple Say's Law asserts that boosting production provides the jobs and the income necessary for consumers to purchase the additional consumer goods and services flowing out of the workplace, and in turn for entrepreneurs to pay for the new capital goods and services required to raise production. Say's Law calls to mind the effect of road construction/ improvement on traffic flow: traffic invariably increases because the new/improved road makes using it safer and more convenient. Supply (the new/improved road) creates its own demand (increased traffic).

Supply-side economics, also known as Reaganomics, was widely criticized by academic economists as lacking in theoretical substance, and never achieved the kind of respect and acceptance accorded either Keynesian economics or monetarism. In some circle it was called "voodoo economics." Even Reagan's vice-president George Bush when he was campaigning for the presidential nomination in 1980 used that phrase to attack Reagan's economic platform. Arthur Laffer is regarded as the intellectual architect of supply-side economics.

We call attention specifically to four key features of supply-side economics: de-regulation, marginal tax rates, capital gains taxes, and depreciation allowances. De-regulation, which was an important

part of Reaganomics, actually originated with Jimmy Carter's presidency in the late 1970s. Specifically, de-regulation rolls back at least some of the interventionist limits imposed by the government in the market system. Prior to de-regulation, airline companies had to get government approval to change the fares they charged and routes they flew. De-regulation meant that the airlines could freely decide what routes to fly and what fares to charge based on market supply and demand forces and their own financial and operational circumstances. By rolling back some of the regulatory limits, de-regulation in effect encouraged the formation of new airline companies that in competition with the established airlines would offer the American public better service and cheaper fares.

De-regulation in the savings and loan industry meant that S&Ls no longer were limited to offering home mortgages to their customers. They could for the first time make loans to consumers and entrepreneurs for other purposes, and could for the first time set up checking accounts and make loans through the credit-creation process. S&Ls became much more like private commercial banks and therefore much more competitive with those banks. The more intense competition would improve banking services and lower the price of those services especially the interest charges on loans and mortgages. De-regulation means that the law of nature has been restored.

More recently de-regulation has been extended to telecommunications, railroads, and trucking. But experience with Enron and Arthur Anderson, along with conflict-of-interest problems in financial services wherein financial analysts have been urging the public to buy shares in companies without disclosing that their employers have contracts with those companies to provide critical financial services such as extending them secure a line of credit or underwriting the issuance of new shares of stock, is forcing public officials to reconsider how well de-regulation serves the public interest.

Marginal tax rates are the rates that apply to personal income taxable by the federal government and to corporate income taxes. A simplified example relating to personal income taxes is shown on the next page. The same basic explanation applies to corporate income taxes payable to the federal government.

SIMPLIFIED MARGINAL TAX SCHEDULES FOR PERSONAL INCOME TAXES

Personal Income	Marginal Tax Schedule A	Marginal Tax Schedule B
\$5,000 or less	8.0 percent	8.0 percent
\$5,001 - \$15,000	15.0	15.0
\$15,001 - \$25,000	29.0	25.0
\$25,001 or more	50.0	30.0

A person with personal income of \$50,000 under Marginal Tax Schedule A would pay 8 percent on the first \$5,000 of income (\$400), 15 percent on the next \$10,000 (\$1,500), 29 percent on the next \$10,000 (\$2,900), and 50 percent on income in excess of \$25,000 (\$12,500). Total tax owed on

\$50,000 income under Marginal Tax Schedule A is \$17,300.

The same person with \$50,000 personal income under Marginal Tax Schedule B would pay the same tax on the first \$15,000 of personal income (\$400 + \$1,500), 25 percent on the next \$10,000 (\$2,500), and 30 percent on income in excess of \$25,000 (\$7,500). Total tax owed on \$50,000 income under Marginal Tax Schedule B is \$11,900. Total tax for that person is \$5,400 lower under Schedule B than under Schedule A.

Notice, however, that there is no tax relief for persons with income of \$15,000 or less. Taxes have been reduced only for those with income of \$15,001 or more, with much more relief for those with incomes greater than \$25,000 where the rate has been cut from 50 percent to 30 percent. The Tax Reform Act of 1986 provided much more relief for persons with higher incomes on the premise that those persons are engaged in business and providing tax relief to them would encourage them to expand their enterprises and hire more workers, possibly paying them higher wages, and in that way the benefits of their reduced tax burden would “trickle down” to persons with lower incomes. Indeed reducing the marginal tax rates on personal income was the single most important reform of the Tax Reform Act of 1986.

The capital gains tax applies to physical and financial assets that appreciate in value over time. If, for example, a person bought 1,000 shares of Microsoft at \$2 per share in, say, 1988 and sold those shares years later when the share price was \$50, the gain is \$48,000 [$(\$50 - \$2) \times (1,000)$]. If the capital gains tax is 50 percent, taxes due amount to \$24,000 ($.5 \times \$48,000$). If the capital gains tax is 30 percent, taxes due amount to \$14,400 ($.3 \times \$48,000$).

*Capital gains tax relief would encourage persons to invest in the stock market and through the gains that are realized over time with that kind of investing better provide for their own retirement, or for their children’s education, or some other financial goal. Providing capital gains tax relief to persons who own physical assets such as business property would give them an incentive to further develop that property so that when it is sold they would be able to keep more of the realized gain. Reducing taxes on capital gains that provides relief for persons in more favorable financial circumstances was justified on the same “trickle down” premise. However, the Tax Reform Act of 1986 effectively **raised** the capital gains tax by eliminating the rule that previously allowed taxpayers to exclude 60 percent of long-term capital gains from taxation. Removing this exclusion was done on grounds that capital gains ought to be taxed no differently than ordinary income. In May 2006 President Bush signed a tax-cut bill that extended until 2010 the 15 percent tax rate on capital gains and dividends that was first enacted as a temporary measure in 2003.*

Depreciation allowances refer to the way in which business assets are expensed over their lifetime use. A food distribution business that services convenience stores over a wide geographic area delivers the merchandise via truck. Assume that in a given year, this business purchases a truck that costs \$52,000. Assume further that this business prefers to pay cash for the truck in order to avoid interest payments if the truck were purchased through a commercial loan. On the company books, expenses would increase by \$52,000 and profits would decrease by the same amount. Taxes owed on those profits would decrease as well. Thus, if the business had profits of \$100,000 in that year without taking into account the truck expense, its profits would drop to \$48,000 when the truck

purchase is included as an expense.

However, the Internal Revenue Service will not allow this company to fully expense the truck in the year in which it was purchased. The truck must be expensed over its lifetime use, as it depreciates in value over its lifetime use. If the IRS rules that this truck has a lifetime use of 10 years and following the straight-line depreciation rule, 10 percent of the purchase price can be expensed in each of the 10 years. Thus, \$5,200 can be expensed every year until the \$52,000 truck is fully depreciated. That means that in the first year in which the truck is purchased only \$5,200 can be expensed. Profits drop not to \$48,000 but to \$94,800 (\$100,000- \$5,200) and, therefore, profits taxes are much higher in the first year.

If, on the other hand, the IRS rules that this truck has a lifetime use of 5 years, 20 percent can be expensed in the first year and profits taxes are much lower with the shorter write-off period. In the year of purchase, taxes would be owed on \$89,600 (\$100,000 - \$10,400) instead of \$94,800. This kind of tax relief gives businesses a further incentive to purchase capital equipment, increase production, hire more workers, and pay them more. The “trickle-down” premise also is used to justify accelerated depreciation schedules.

Advocates of supply-side economics took credit for the unusually long expansion phase that ran from a November 1982 trough to a July 1990 peak, a total of 92 quarters. Its critics blamed supply-side economics for the deficit spending during the Reagan years and for the more than doubling of the public debt in Reagan’s two terms as president.¹ Reagan’s advisers and supporters argued that the deficits were necessary to pull the economy out of the stagflation of the 1970s. Further, those deficits reflected increased military expenditures that were intended to bankrupt the Soviet Union if the USSR attempted to match them with increased military spending of its own. Reagan’s backers argued that the Soviet empire collapsed at the end of the 1980s importantly because its economy could not support the additional military spending.

As mentioned previously, supply-side economics never has enjoyed the same acceptance and approval of academic economists as Keynesian economics or monetarism. The author of this e-text does not share that negative view. Supply-side economics rests on the premise that just as the pilot is responsible for flying the twin-engine aircraft the entrepreneur shoulders the burden of driving macroeconomic affairs. Stimulating aggregate supply means in effect providing incentives for producers to become entrepreneurs. But Schumpeterian economics is not looked upon favorably by conventional economics, and so today supply-side economics does not have a strong and enthusiastic following among academic economists.

¹ Total public debt increased from \$998.0 billion on September 30, 1981 to \$2.857 trillion on September 29, 1989, see www.treasurydirect.gov.

REVIEW SECTION: TOPIC 28

Central Concepts:

Say's law
Reaganomics
trickle-down economics

Important Questions:

Why do we refer to supply-side economics as a counter-revolution?
What do supply-side economists recommend as a proper course of government action to create more jobs?
How is supply-side economics related to the federal budget deficit?
What is Say's Law?
What are the main recommendations of supply-side economics?
Why is supply-side economics sometimes called "voodoo economics"?
How is supply-side economics linked to Schumpeterian economics?

True/False:

- a. The Supply-Side Counter Revolution has many supporters in economics. However, it has never been implemented as public policy.
- b. The Supply-Side Counter Revolution contributed to large federal government budget deficits during the 1980s and thus to the federal debt.
- c. The Supply-Side Counter Revolution reached back into Classical economics and resurrected Say's law: supply creates its own demand.
- d. Some critics of the Supply-Side Counter Revolution call it "voodoo economics."

Mark your answer below.



- _____ Item a is true, items b, c, and d are false.
- _____ Items a and b are true, items c and d are false.
- _____ Item a is false, items b, c, and d are true.

TOPIC 29 MACROECONOMIC POLICY

To underscore the importance of productivity improvement in meeting human physical need more fully.

The salient differences between the various schools of thought relating to macroeconomic affairs are summarized below. Those differences, seen in the context of persons rather than things, can be represented in the following manner. Keynesian economics sees the consumer as the key agent, monetarist economics perceives the central banker as the principal agent, supply-side economics sees the entrepreneur as the critical agent, and neo-classical economics argues that macroeconomic affairs are best left to private individuals with public officials playing only a minor role. The exhibit on the following page illustrates those differences in the context of the last macroeconomic circular flow diagram presented in Topic 22.

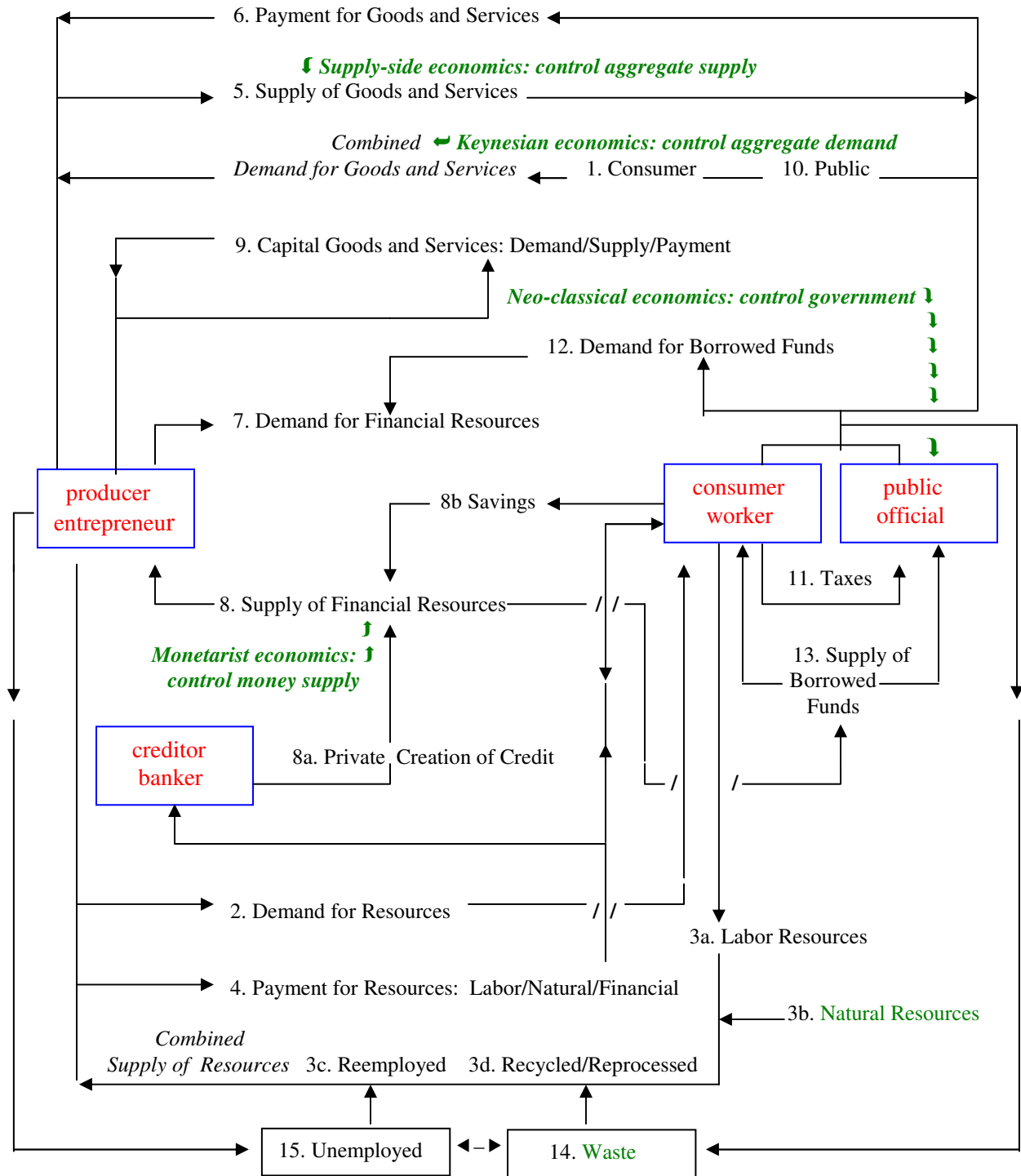
Classical school. *The market system has its own automatic and painless mechanisms for restoring full employment whenever unemployment is a problem and for restoring stable prices whenever inflation is a problem. Aggregate demand = $f(\text{prices})$. Classical economics collapsed under the weight of massive and persistent unemployment in the Great Depression of the 1930s because it could not explain why falling prices, wages, and interest rates did not restore full-employment.*

Keynesian revolution. *The market dysfunctions during a crisis such as a depression because aggregate demand = $f(\text{income})$. To restore full employment, stimulate aggregate demand by increasing government spending or decreasing taxes. To restore price stability, dampen aggregate demand by decreasing government spending or increasing taxes. Due to the multiplier effect, the amount of government stimulus or dampening of aggregate demand is relatively large. Also, budget deficits incurred during periods of unemployment are balanced against budget surpluses during periods of inflation. Thus, there is no tendency for the overall government debt to increase with the passage of time. Keynesian economics was abandoned in the 1970s because it could not address the problem of stagflation: double-digit inflation and double-digit unemployment occurring at the same time. Even so, it was used implicitly to justify the Bush administration's tax cuts of 2001 that were promoted on the argument that stimulating consumer spending would lift the economy out of the recession that started in 2000. And more recently by the Obama administration.*

Monetarist counter-revolution. *Keynesian intervention is clumsy and unpredictable. By resurrecting the equation of exchange $MV = Py$ that links prices and GDP (and therefore employment and unemployment) to the money supply, the monetarists argue that inflation and unemployment can be controlled best by carefully regulating the money supply. Since the Federal Reserve System historically has done a poor job of managing the business cycle, it is best to require the central bank to follow the monetary rule, increasing the supply of money at an annual rate of 3-5 percent. Monetarism was tried for several years starting in the late 1970s and was successful in achieving*

**SALIENT POINTS OF INTERVENTION IN MACROECONOMIC AFFAIRS:
ONE REVOLUTION AND THREE COUNTER-REVOLUTIONS**

United States Domestic Economy



Product Market: flows 1-5-6-9-10

Resource Market flows: 2-3a-3b-3c-3d-4

Financial Market flows: 7-8a-8b-8c-12-13

price stability. However, monetarism was replaced by supply-side economics during President Reagan's first term of office because in the early 1980s the prime rate of interest increased to more than 20 percent and the unemployment rate exceeded 10 percent for the first time in 40 years. Nevertheless, the Federal Reserve System has continued to manage macroeconomic affairs by controlling the supply of money and the rate of interest, though it never adopted the monetary rule.

Supply-side counter-revolution. Both the Keynesians and monetarists are wrong: it is aggregate supply, not aggregate demand, not the money supply, that is most important in driving the macroeconomy. By resurrecting Say's Law to the effect that supply creates its own demand, supply-siders strongly urge that to restore and maintain a macroeconomy characterized by stable prices and full employment entrepreneurs must be afforded better opportunities to keep the wealth they create. Thus, supply-siders recommend lower taxes, including capital gains taxes, and de-regulation of markets that over the years have fallen under too much government regulation. Supply-side economics was embraced by Ronald Reagan even before his election as president in 1980. Its supporters argued that in the 1980s supply-side economics produced the longest expansion of the economy on record. Its critics attacked it for more than doubling the public debt in the 1980s.

Neo-classical counter-revolution. With the addition of the rational expectations hypothesis and the continuous market-clearing premise, this counter-revolution recommends a restoration of classical economics -- a restoration of the four premises of classical economics. The individual is the basic unit of analysis; the law of nature assures that markets function efficiently and effectively; certainty means that with the right theory and information, economics can answer questions with certainty; and contracts determine the worth of every economic agent. Today neo-classical economics is the dominant way of thinking about economic affairs especially among younger professional economists with academic appointments. It is used today to justify more free trade.

Neo-classical economists typically deny any real substance to Keynesian economics, monetarism, and supply-side economics because for many of them "all economics is microeconomics." While accepting the neo-classical position on the significance of the economic agent acting freely in his/her own self-interest, personalist economists are more likely to attribute validity to the other three schools of thought because each one emphasizes a different role played by economic agents in macroeconomic affairs. Thus, the Keynesian economist focuses on the central role of the consumer and aggregate demand, the supply-sider calls attention to the role of the producer/entrepreneur and aggregate supply, while the monetarist emphasizes the role of the central banker and the money supply.

Fiscal policy and monetary policy by now are familiar terms. The one refers to using the taxing and spending power of the federal budget to better manage inflation and unemployment. The other refers to using the money supply as controlled by the Federal Reserve System to achieve the same ends. Incomes policy refers to direct government intervention in the product and resource markets to limit wage and price changes for the purpose of checking inflation by such means as voluntary wage-price guidelines and strict legal control of wages and prices. The last time wages and prices were under government control in the United States was during World War II. Voluntary guidelines have been used more recently by Presidents Kennedy, Johnson, Ford, and Carter. One such guideline asks labor and management to restrict wage hikes to productivity increases in order to control

upward pressure on the cost of production and therefore on the prices of goods and services produced. Industrial policy refers to direct government intervention in the form of taxes, subsidies, regulations, tariffs, import quotas, and the like to assist certain U.S. companies and industries to the disadvantage of foreign producers. This policy is defended on grounds that it is necessary for national security reasons or because certain U.S. companies simply are too small at the moment and need to be nurtured before they can begin to compete effectively with foreign companies. All of these policies are controversial because they raise the issue as to when the government should override the law of nature and intervene in economic affairs.

There is one area, however, that is not controversial. Productivity improvement, the systematic reduction of wasted labor and natural resources, is key to economic development and improved living standards. Simply stated, the principle of economic development asserts that living standards rise as productivity improves.

The table on the following page drives home that point using a case involving a hypothetical company that produces disposable ball point pens. Productivity improvement commonly is measured in terms of output per labor hour. Assume that we are visiting this company for the first time and we observe that it is producing 100 pens per labor hour, it is paying its workers \$8 per hour, and it is incurring other costs amounting to \$2 per hour. The cost per unit therefore is 10 cents, and if the firm has a profit margin of 2 cents, the price of the pen to the consumer is 12 cents. The profit per labor hour is \$2 (2 cents profit per pen x 100 pens produced every hour).

Assume further that the workers demand a wage increase to \$9 per hour even though there has been no improvement in productivity. The cost per pen rises to 11 cents and if the producer absorbs this cost, profits per labor hour drop to \$1. The additional dollar paid to workers comes at the expense of the owners who are earning one dollar less per labor hour in profits. If instead the producer passes the higher cost of production to the consumer in order to maintain his profits of \$2 per labor hour, the consumer pays for the wage increase. In both cases, whatever labor gains, owners or consumers lose. This dynamic is called a zero-sum interaction.

Assume now that the workers' demands for a wage increase to \$9 per hour are accompanied by a 10 percent improvement in productivity. Unit cost remains at 10 cents and with the usual 2 cents profit margin the owners get \$2.20 profits per labor hour. If a 10 percent increase in productivity leads to higher wages and profits, and no increase in prices, how much better off would workers, owners, and consumers be under a even larger productivity increase? With a 50 percent improvement in productivity through rigorous elimination of wasted labor and natural resources, the cost per unit falls to 7 cents and if there is no change in the price, a profit margin of 5 cents means that owners are rewarded with profits of \$7.50 per labor hour. But this outcome is untenable for two reasons. First, workers are not likely to make the effort required to improve productivity so substantially if all the gains are taken by the owners. Second, to sell 50 percent more pens, the producer will have to lower the price.

The next column displays the gain sharing case wherein the owners and workers agree beforehand to split the profits evenly as an incentive to the workers to improve productivity and maintain that improvement. Price is reduced to 11 cents that makes for a profit margin of 4 cents, that when evenly

shared means workers and owners alike get \$3 per hour in profits. Notice the symmetry implied in the gain sharing case. Productivity improves by 50 percent as do the profits of the owners, from \$2 to \$3 per labor hour, and worker compensation improves by 50 percent, from \$8 to \$12 per labor hour (\$9 in wages + \$3 in profits). We refer to the examples presented in these three columns as positive-sum interactions because the parties involved enjoy higher living standards without any one being made worse off.

PRODUCTIVITY AT THE DISPOSABLE PEN FACTORY

	baseline	----- zero sum ----- owner pays	----- zero sum ----- consumer pays	----- positive sum ----- productivity improvement of 10 percent	----- positive sum ----- 50 percent	----- positive sum ----- 50 percent	negative sum act dumb
Output/laborhour	100	100	100	110	150	150	80
Cost/laborhour	\$10.00	\$11.00	\$11.00	\$11.00	\$11.00	\$11.00	\$10.00
labor	8.00	9.00	9.00	9.00	9.00	9.00	8.00
other	2.00	2.00	2.00	2.00	2.00	2.00	2.00
Cost/unit	.10	.11	.11	.10	.07	.07	.125
Price	.12	.12	.13	.12	.12	.11	.145
Profit/unit	.02	.01	.02	.02	.05	.04	.02
Profit/laborhour	2.00	1.00	2.00	2.20	7.50	6.00	1.60
owners	2.00	1.00	2.00	2.20	7.50	3.00	1.60
labor	-----	-----	-----	-----	-----	3.00	-----

The last column displays the “go to work and act dumb” case. It shows what happens when productivity actually declines. A 20 percent erosion in productivity means that the workforce is producing an average of 80 pens per labor hour. This deterioration raises the cost per unit to 12.5 cents even when there is no increase in wages driving the unit cost higher. If the producer maintains the usual 2 cent profit margin, profits per labor hour fall to \$1.60. The decline in productivity forces consumers to pay more for the product, while owners suffer a loss of profits per labor hour. While the workers’ pay remains at \$8 per hour, they discover that their paychecks buy less than before especially if other workers are acting dumb on the job. All three parties, in other words, are made worse off by the erosion in productivity.

In December 1981 the leaders of the Polish Solidarity movement that for two years had been forcing concessions from the communist government of Poland were arrested in the expectation that without leaders the movement would collapse. The leaders of Solidarity advised their members not to react violently to the government's repressive action. Rather, they were told to "go to work and act dumb." Since the enterprises that employed those workers were state-owned the effect of this strategy was to force the government to increase prices and to accept smaller profits (officially called surpluses) from the state enterprises that in turn triggered a budget crisis since the government budget depended significantly on the surpluses generated by state enterprises. Slowly this strategy eroded the effectiveness of the communist government and finally in 1989 the government collapsed, and the leaders of Solidarity were invited to form a new government. One year later Poland had begun its transition to a market economy. "Go to work and act dumb" is a powerful means by which to bring down a company and in Poland to bring down a repressive regime. Everyone is made worse off and for that reason we refer to it as a negative-sum dynamic.

There is a dark side to productivity improvement at the microeconomic level, at the level of the private business enterprise. Workers who are fearful that productivity improvement is just another way for management to get rid of them simply will not respond positively to a productivity improvement initiative unless there are assurances that they will not be terminated. For productivity improvement to be successful in the ways we have indicated in the foregoing, workers may have to be re-assigned to unfamiliar work where their labor is needed. That means that workers can undermine a productivity improvement program by refusing re-assignment or by dragging their feet and behaving in a passive aggressive manner by deliberately taking more time to complete the newly assigned work than necessary and by wasting natural resources.

The information displayed in the table below is official data on productivity, compensation, and

PRODUCTIVITY, COMPENSATION, AND PRICES: 1990 - 2013

[1990 = 100]	2000	2005	2010	2013	percent change 1990-2013
Output per labor hour	125.0	146.5	161.4	165.8	65.8
Nominal compensation per labor hour	148.6	178.8	205.2	219.5	119.5
Implicit price deflator	117.5	128.8	139.4	147.1	47.1
Real compensation per labor hour	116.4	123.5	126.9	127.0	27.0

Source: Bureau of Labor Statistics, www.bls.gov.

prices for the entire U.S. economy in index-number form. Since 1990, labor productivity for the entire private-sector economy improved by 65.8 percent. At the same time, nominal labor compensation per hour rose by 119.5 percent but prices climbed by 47.1 percent. For that reason, real labor compensation per hour (hourly compensation adjusted for price increases) rose by 27.0 percent over the entire period. In constant-dollar terms, the worker who was earning \$10 per hour

in 1990 was earning \$12.70 per hour in 2013.

The rest of the information displayed below indicates what could have happened to real hourly labor compensation if productivity improvements since 1990 more closely tracked the normal improvement of 3 to 4 percent per year indicated by the historical record on productivity improvement in the United States. A 3 percent improvement every year could have resulted in a 97.4 percent improvement in hourly labor compensation, or nearly a doubling over a single generation. A 4 percent annual improvement would have increased hourly labor compensation by nearly 150 percent.

With stable prices and a 3 percent annual increase in labor productivity, the worker who was earning \$10.00 per hour in 1990 would have earned \$19.74 in 2013. The same worker whose productivity increased by 4 percent every year since 1990 would have been earning \$24.65.

The harsh reality of the last 25 years in the United States is that living standards are rising among American families not so much because workers are working smarter but because mothers and fathers are working longer hours and multiple jobs.

**WHAT WOULD HAVE HAPPENED UNDER MORE NEARLY
NORMAL PRODUCTIVITY IMPROVEMENT: 1990-2013**

Normal Productivity Increase* [1990 = 100]	2000	2005	2010	2013	percent change 1990-2014
Three percent	134.4	155.8	180.6	197.4	97.4
Four percent	148.0	180.1	219.1	246.5	146.5

*: compounded annually

APPENDIX

Economic Policy and the Problem of Aliens Working Illegally in the United States

Even the casual observer of economic affairs knows that economic policy depends critically on the quality of economic analysis which in turn is grounded in the accuracy of the information used in that analysis. Three pieces of information are of particular concern: wages, production, and labor supply. Information on production and labor supply has been covered in detail in Topic 23. They are covered in brief in this appendix for the reader who skipped that topic entirely or would benefit from a review. Information on wages has not been addressed heretofore. For reasons relating to fear of detection, the large numbers of illegal immigrants in the United States are having unaccounted for effects on wages, production, and labor supply.

Wage information. Quarterly data on wages and other labor-related information are analyzed and released to the public based on information collected by the Bureau of Labor Statistics in its National Compensation Survey. Included in the NCS are private business establishments and state and local government agencies. The BLS publishes estimates of wages for the United States, for regions of the country, and for 15 metropolitan areas. The data are released in seasonally-adjusted and unadjusted form. Not included in the selection process are federal government workers, the self-employed, military personnel, agricultural workers, and persons employed in households. These estimates are subject to the usual sampling and nonsampling errors. Sampling error relates to the fact that only a portion of the entire universe of employers is being surveyed. Nonsampling error derives from a failure to collect information from the establishments and agencies included in the sample.

Production information. Four times a year the Bureau of Economic Analysis surveys employers nationwide on the production of goods and services. This information is released to the public in final form three months after the close of the quarter to which the information refers. The raw data are used to produce two estimates: gross national product and gross domestic product. GNP is an estimate of the goods and services produced by all U.S. companies operating in the United States or in other countries. GDP is an estimate of the goods and services produced by all companies operating in the United States whether they are U.S. or foreign owned. Both estimates are adjusted to remove the influence of changing prices so that the estimates reflect only changes in production denominated in constant dollars. Today the preferred measure is constant-dollar GDP because it relates to production within the United States that is more directly responsive to U.S. monetary and fiscal policy.

Labor supply information. The U.S. Census Bureau collects and processes information on employment and unemployment on a monthly basis from about 60,000 households that are selected at random. The collection instrument is known as the Current Population Survey (CPS). This information is transmitted to the Bureau of Labor Statistics for analysis and released to the public on the first Friday of the month following the month in which the data are collected. The large sample – approximately 110,000 persons are surveyed every month – assures a very small margin of error. Two estimates derive from the CPS: the number of persons employed and the number unemployed. The sum of the two is called the labor force. The unemployment rate is calculated as follows: unemployed ÷ labor force. At first glance, this tool seems to be designed to elicit information on the

well-being of workers. However, it was designed to provide monthly information that complements the quarterly information on production, and to proxy for GDP/GNP information in the months when that information is not available. The CPS was launched experimentally in the late 1930s and has been collecting monthly information on the labor supply since the early 1940s. Other estimates of employment are available from the Current Employment Survey (CES) based on responses from a very large sample of employers selected at random. The CES is narrower in scope than the CPS because it does not include the self-employed, unpaid family workers, agricultural workers, or private household workers.

In June and July 2007 Mayo Research Institute inquired of the BLS regarding the counting of illegal aliens in the CPS and the CES. Here is the Bureau's reply:

Neither the establishment [CES] nor household [CPS] survey is designed to identify the legal status of workers. Thus, while it is likely that both surveys include at least some undocumented immigrants, it is not possible to determine how many are counted in either survey.

... it is not possible to estimate their number and, therefore, we do not make any adjustments to [the CES] data.

Your question talks about adjustments [to the CPS estimates] if any for undocumented aliens who deliberately misrepresent their labor force status. Since no questions are asked about their legal status, there is no way of knowing if there are any misrepresentations and who the illegal aliens are.

The Institute asked the BLS about any adjustments to the wage data for the presence of immigrants who are working illegally. This is the Bureau's response:

The NCS does not use any means to adjust wages for illegal workers. We simply ask the company to tell us how many employees they have, their job duties and title, and how much are they paid [sic] and over what period of time.

The BEA response in July to the Institute's questions regarding the impact on GNP/GDP estimates of undocumented immigrants working illegally could not have been more succinct:

BEA makes no estimates of the underground economy or any illegal activity.

One general conclusion. One general conclusion necessarily follows. The federal government's official statistics on wages, production, and labor supply do not fully take into account the millions of illegal aliens working in the United States.

Four other more specific conclusions also follow though not with absolute certainty. First, wages on average are lower than reported by the BLS because illegals work at lower rates of pay than do others in the labor force doing the same work. Their lower acceptance wage is what makes them attractive to employers. Second, GDP is higher than is reported because at least some of those who employ illegals do not fully report the production derived from their work efforts for fear of public

disapproval.¹ Third, employment no doubt is higher than estimated whether the data come from the CES or CPS because employers and householders have good reason to underreport the employment of those who are working illegally. Fourth, because fear of detection may lead some of the undocumented to answer the CPS in ways that lead them to be classified as not in the labor force when in fact they are jobless, the total number of persons unemployed may be higher than what is reported by the BLS every month.

The quality of the information on wages, production, and labor supply is not likely to improve unless the issue of illegal immigration is addressed satisfactorily. Until then, the task of doing the analytical work necessary to properly inform economic policy-makers remains more problematical and the findings from that work more questionable.

¹ Based on U.S. currency holdings Edgar Feige at the University of Wisconsin for years has been estimating transactions involving the production and distribution of illegal goods and services and other transactions involving income not reported to the IRS. Feige estimates that in 2008 unreported income amounted to roughly \$2 trillion and the unpaid taxes on that income ranged from \$446 to \$490 billion per year. Edgar L. Feige, "New Estimates of Overseas U.S. Currency Holdings, the Underground Economy and the 'Tax Gap'," *Munich Personal RePEc Archive*, WWW.mpra.ub.uni-muenchen.de/19564/.

REVIEW SECTION: TOPIC 29

Central Concepts:

principle of economic development
fiscal policy
monetary policy
incomes policy
industrial policy
zero-sum interaction
positive-sum interaction
negative-sum interaction
underground economy

Important Questions:

In general what is the difference between fiscal policy and monetary policy?
What is meant by incomes policy? by industrial policy?
Explain how the rate of productivity improvement *limits* economic growth in terms of real GDP.
What is the linkage between productivity and real labor compensation?
Explain how it is possible for real wages and profits to rise at the same time prices of goods and services are falling.

True/False:

At the microeconomic level, substantial productivity improvements (reductions in wasted natural resources and labor resources) ...

- a. tend to reduce the prices paid by consumers for the goods and services produced.
- b. tend to reduce the profits paid to owners/shareholders.
- c. have no impact whatever on wages and the cost of production.
- d. prompt the Federal Reserve System to increase the discount rate.

Mark your answer below.



- _____ Item a is true, items b, c, and d are false.
- _____ Items a and b are true, items c and d are false.
- _____ Item a is false, items b, c, and d are true.

RE-CONSTRUCTING MACROECONOMICS

TOPIC 30
SUBSIDIARITY AND THE PROPER ROLE OF GOVERNMENT
IN ECONOMIC AFFAIRS

To re-visit and extend the principle of subsidiarity in defining the proper role of government in economic affairs.

Although we addressed the principle of subsidiarity previously in Topics 3 and 8 it is instructive to revisit this principle since it helps us decide when and where government intervention in economic affairs is necessary. Subsidiarity in other words is informative across the full range of economic processes and with regard to several very important social and economic issues such as poverty, subsidies, and private-enterprise cooperation. Our comments regarding the proper role of government intentionally are selective rather than comprehensive.

To repeat what was said earlier: societies are constructed around functional elements or organizational units of different size and strength. The largest and strongest element in American society is the federal government. The smallest and weakest is the human person. Between those two elements are four other basic functional elements: state governments, local governments, private organizations such as businesses, unions, trade associations, and families. Within this set of four, state governments in general are the larger and stronger elements, while families are the smaller and weaker.

The principle of subsidiarity consists of two sets of instruction, one limiting and one actuating. The limiting set states that larger, stronger organizational units should not take over the functions of smaller, weaker units. The actuating set urges the larger, stronger units to help the smaller, weaker units function more effectively. Abraham Lincoln's formulation of this principle was:

In all that the people can individually do as well for themselves, the government ought not to interfere.¹

Subsidiarity reinforces the democratic principle by widening opportunities for smaller less powerful functional elements in the economic order to participate in decision-making processes that bear upon their well-being, thereby limiting the abuse of highly decentralized decision-making that may misconstrue the problem or the proper remedy and identifying the remedy that works best. In that regard, subsidiarity accentuates the sacred dignity of the human person.

Subsidiarity and the Five Economic Processes.

The principle of subsidiarity applies to all five economic processes: production, distribution, exchange, consumption, and investment.

¹ See Ralph Y. McGinnis, *Quotations from Abraham Lincoln*, Chicago: Nelson-Hall, 1977, p. 41.

With regard to production, distribution, and exchange, subsidiarity addresses the following two questions. When should a business enterprise be privately owned and controlled and when should it be publicly owned and controlled? When should intervention to limit competition and cooperation that is running out of control be undertaken by a private organization and when more appropriately should a public agency intervene?

Subsidiarity means, for example, if a private company is fully capable of producing electric power, there is no need for power generation to be under the control of a government enterprise. Instead, the government might offer the private company tax credits on its investments in new power generation facilities in order to help that company bring that power on line. It also means that if distribution can be handled effectively by private rail carriers, barge lines, or trucking companies, government in general ought not to interfere in their affairs, except for such public functions as providing for safe railroad crossings and maintaining ship channels and highways. In like manner, if the private establishments operating securities exchanges ordinarily need no assistance to function in an effective manner, there is no compelling reason for the public sector to take control of those exchanges unless a trading crisis arises that calls for swift action on the part of the central banking authority or some other government regulatory body.

By affirming a strong preference for private enterprise compared to public enterprise, the principle of subsidiarity effectively decentralizes ownership and control of economic activities that in turn (1) lead to a greater diversity of goods and services produced because entrepreneurs have a freer hand; (2) a smaller risk that large-scale mistakes will be made because in general private enterprises are smaller than public enterprises; and (3) private enterprises will be more responsive to their customers because they are driven by the profit motive. The key concern in this regard is efficiency in utilizing resources and in meeting needs and satisfying wants.

*As to the investment process, we are reminded that the entrepreneur is the key agent in economic affairs because the entrepreneur precipitates change through that process. Whenever the entrepreneur is successful, given a strong preference for private enterprise reflected in the principle of subsidiarity, the need for public-sector intervention and the scope of public enterprise likely are reduced. The key issues for the entrepreneur are freedom **from** excessive government control and freedom **to** risk investing in new ideas. Bankruptcy relief is, in effect, the **subsidium** that helps the entrepreneur start over and is preferable to government taking charge of a failing business.*

Finally, regarding the consumption process, in the United States an estimated 15.0 percent of the population or approximately 46.5 million persons were classified as poor in 2012.¹ From the very start, it is necessary to differentiate (1) those poor persons who use their resources responsibly and still do not have enough to meet their needs from (2) others who use their resources irresponsibly. Because assisting the irresponsible simply enables them to continue acting irresponsibly, it is important to do whatever is possible to restrict them from getting assistance.

¹ Go to www.census.gov.

Just as we had seen that the principle of subsidiarity is helpful in sorting out the issue of private versus public ownership and control of production, distribution, exchange, consumption and investment, subsidiarity is helpful in reaching a decision as to where in the social order the source of assistance for the needy should be located. Subsidiarity states that assistance should be located as close as possible to the persons and families in need. This decentralization helps limit two abuses. First, it helps reduce the abuse of persons applying for assistance who are not needy or who are irresponsible because, by being closer to the needy, the agency likely is better informed and better able to identify abusers. Second, it helps remedy the problem of the program staffer who is abusive to applicants, demeaning and belittling them, because with the agency closer at hand the applicant finds it easier to lodge a complaint with the supervisor about the abusive staffer, and to bring the problem to a successful resolution.

Two benefits flow from organizing assistance in a decentralized manner. First, applicants are more likely to participate in reforming the assistance program because they are closer to the administrative control of the program, thereby reinforcing the democratic principle that everyone should participate in the decisions that affect their lives. Second, a decentralized system allows for the development of different programs and with the passage of time the identification of the practices that work best.

In selling to the poor the firm has a special duty under the principle of subsidiarity that it does not have in selling to others. Since customers who the poor may require help from the rest of society for their unmet needs whereas well-to-do customers do not need such assistance, subsidiarity applies when one is selling to the poor but not to better-circumstanced customers. A firm that encourages the poor to buy things that are not needed, or that are beyond their means, or worse yet that are harmful violates both subsidiarity and contributive justice and thereby abuses not only the poor but the rest of society as well. Tobacco companies exemplify this kind of double abuse. Casinos are another. And to some extent so too are retailers who sell apparel, furniture, and consumer electronics on credit in poor neighborhoods.

The firm has a duty in subsidiarity not to force its poor customers to turn to others -- friends, relatives, public agencies -- for help in meeting need worsened by the firm's marketing and selling tactics. That duty may be set forth and affirmed by various means at its disposal. To illustrate, it may be affirmed in the company's mission statement, in its code of ethics, in its operating policies, in the behavior, attitudes, and personal values of the senior management, and notably in its advertising. To be effective, however, the firm must train its employees as to the importance of this obligation and how each one is expected to carry out his/her part of that obligation. In addition, the firm must faithfully monitor its employees on this obligation and must put in place the necessary procedures to enforce compliance. The overriding concern in consumption is meeting human material need.

Subsidiarity, Subsidy, and Need.

Subsidy is a type of assistance to a private enterprise granted by the government and justified according to the principle of subsidiarity only as long as it is needed by that enterprise to function effectively. For example, when a hurricane causes considerable damage to a factory that produces shoes, and if that producer is not able to repair the damage with the company's own financial resources, the government could intervene with financial assistance to help the producer restore the factory, re-employ the workforce, and resume manufacturing shoes.

If, however, a private enterprise receiving such assistance is not able to function effectively, the assistance should be discontinued and its function should be transferred to another private enterprise if possible with some assistance if such assistance is necessary for that private enterprise to manage that function effectively. As a last resort, that function could be assigned to a public enterprise.

Subsidy is entitlement when the assistance is available to needy private enterprises by law and is carefully administered by the government to assure that only needy private enterprises qualify for the assistance. Subsidy becomes dependency when it becomes a disincentive for a private enterprise to function effectively or function at all. Subsidy degenerates into abuse when a private enterprise no longer needs it to function effectively but continues to receive assistance. In the case of the shoe factory, it is an abuse of the principle of subsidiarity for the producer to continue to receive a subsidy when the factory is fully functional without it.

It is need, and need alone, that justifies the subsidy. In the absence of need the subsidy is not justified.

Subsidiarity, Outsourcing, and Cooperating Business Firms.

Outsourcing replaces an employee with a supplier for the purpose of cutting the cost of production and raising profits. When a public enterprise outsources a specific function to a private enterprise outsourcing is consistent with the principle of subsidiarity because the function and related decision-making have been moved closer to the human person who now has more opportunities to participate in the decisions that directly affect him/her.

When a private enterprise outsources a specific function to another private enterprise, outsourcing is consistent with subsidiarity if there are more opportunities for the human person to participate in the decisions that directly affect that person. It is not consistent with subsidiarity if there are fewer opportunities for the human person to participate in decision-making.

The principle of subsidiarity limits a larger, more powerful organizational unit to functions which smaller, less powerful units are unable to do at all or do as well even with help. Subsidiarity encourages a sense of community through the establishment of private organizations midway between the state and the person. There are two kinds of intermediary bodies in the economic order of special interest: supra-firm alliances and inter-firm partnerships. In contrast to mainstream economics which perceives cooperation as invariably zero-sum collusive behavior, personalist economics sees it as having positive-sum possibilities.

Inter-firm partnership. *An inter-firm partnership is cooperation between two or more firms in which there are no new formal organizational arrangements. A supra-firm alliance is cooperation between two or more firms by means of a distinct, formal organization which has a staff and its own decision-making role. Of the two, the supra-firm alliance is the more complex organizationally and more subject to attack as a collusive agreement and for those reasons we call attention in the following to four specific examples of such alliances: Abebooks, LOOP, Business Software Alliance, and PRIDE.*

Cooperation and decentralization of decision-making occur **within** business enterprises and organizations as, for example, when workers are empowered to participate in decision-making through the establishment of quality circles and large companies are restructured to allow their subsidiaries more control over decisions. These too represent subsidiarity in action as the word “subsidiaries” implies. However, they are not addressed herein because they are already very well-known and documented and in general involve a single functional unit wherein competition is subordinate to cooperation. Partnerships and alliances, on the other hand, occur across functional units wherein competition has to be dampened for cooperation to come to the fore.

An inter-firm partnership involves a nonformalized understanding between, for example, a producer and supplier, an employer and employment agency, an entrepreneur and a banker in which their day-to-day relationship is governed by more than the profit-maximization rule. Such an understanding may arise initially from the firms sharing common space such as a parking lot or garage, a hallway or elevator, a loading dock or delivery agent. An understanding may arise even among competing firms which form a critical mass in one location in order to better serve each one’s best interests without exploiting the others involved. Examples abound in the United States both today and years ago: Chicago (railroads), Detroit (autos), Silicon Valley (computing), Pittsburgh (steel), Milwaukee (beer), New York (financial services), Boston (medical education). Such partnerships known locally as “antique alley,” “farmers market,” “restaurant row,” or “flea market” develop even in small cities.

Supra-firm alliance. To be an authentically separate level of decision-making, the supra-firm alliance must be formalized and independent of and outside the control of the larger and more powerful public authority. The supra-firm alliance must be voluntary (so as not to take away the function of a member of the group that is functioning satisfactorily) and representative of the various private-individual organizations that are allied (so as to know more precisely its own domain). The supra-firm alliance should be supportive but nonintrusive in the sense that if a member encounters organization-specific dysfunction in the workplace and asks for assistance, the group should be ready and willing to provide whatever help it can in order to deal with the dysfunction in a satisfactory fashion.

At the supra-firm level, control of the workplace proceeds not through owning property but through sharing problems. Thus, the workplace at the supra-firm level may be defined as any work site(s) where dysfunction is occurring which cannot be managed satisfactorily at the intra-firm level and where the immediately affected persons voluntarily request assistance from a private group of persons all of whom are familiar with the work site(s), understand the dysfunction occurring there, and have some direct interest in the goods or services produced there.

The supra-firm alliance is to the economic order what the vital organ is to the human body. Just as vital organs in the human body are specialized cells with a specific function that is essential to physical health and well-being, so too the supra-firm alliance is a specialized group (usually, in an industry sense) of private parties to provide for the well-being of the economic order. Dysfunction is as inevitable in the economic order without such alliances as illness is in the human body with a failing or missing vital organ.

Supra-firm cooperation falls into two general classes: industry-specific and area-specific. As to the industry-specific type, the cooperating firms likely are competitors in the product market. With respect to the area-specific variety, the allies may compete in the product market and probably compete in the resource market, particularly the labor market. The following four examples reflect the great diversity of such alliances, and drive home the lesson in subsidiarity that when private enterprise acting alone cannot manage certain problems it is not necessary to turn immediately to government for assistance.

Advanced Book Exchange, or simply Abebooks (www.abebooks.com), is the world's largest online marketplace for used, rare, and out-of-print books. The exchange brings together 12,000 independent booksellers worldwide. Each seller decides which books to list, their general condition, price, and other information. Buyers can browse the books through a convenient search function. The on-line exchange allows buyers to comparison shop and sellers to reach a much wider market.

Louisiana Offshore Oil Port, known widely by the acronym LOOP (www.loopllc.com), is a limited liability company that offloads and stores foreign crude oil from tankers for eventual transport by pipeline to refineries throughout the Gulf Coast and Midwest. LOOP was organized in 1972 and has four owners: Ashland Oil, Marathon Ashland Pipe Line, Marathon Oil, and Shell Oil. To assure the safe handling of oil from deep draft supertankers the offloading is done at a terminal located 18 miles off the Louisiana coast in 110 feet of water. A pipeline transports the oil to onshore storage facilities and from there to the participating owners' refineries. LOOP was built and continues to operate only because the four owners understand that they can reduce the risks in offloading and transporting crude oil more effectively by working together than by operating independently. To reinforce cooperation, LOOP's board of directors is organized on the democratic principle that, irrespective of company size or ownership share, every participating company has just one vote. LOOP, in effect, is a producer cooperative.

The Business Software Alliance (www.bsa.org) was established to combat piracy of software products. BSA members include among others Adobe, Apple, Borland, Microsoft, and Symantec. To help reduce the unauthorized installation of proprietary software products without a license BSA has been supporting the preparation of an annual report on the extent of piracy and dollar losses by country every year since 1992. Unrestrained piracy takes away the economic gain (profit) necessary for private enterprise to survive and thereby destroys the very means by which new and better products and services are brought to the marketplace.

PRIDE of St. Louis, which was established in 1972, is a voluntary labor-management organization in the construction industry that meets monthly to identify and deal with stress points that interfere with the completion of building projects on time and within budget. PRIDE members include representatives from the various building trades, construction firms, architectural and engineering firms, and material suppliers. It is an excellent example of private group decision-making that seeks to find ways to deal with problems in the construction industry that cannot be addressed by private individual decision-making and eliminates the need for public group intervention.

Abebooks, LOOP, Business Software Alliance, and PRIDE are industry-specific alliances.

Cooperation Is Not Collusion.

*Ever since Smith's **Wealth of Nations** economists have stressed that competition is the force that organizes and energizes the market economy. Any effort to dampen competition, they have argued for more than two centuries, is harmful and for that reason is looked at askance.*

It follows that in mainstream economics, alliances and partnerships are regarded as collusive, as deliberate efforts on the part of producers to extract from consumers by devious means what they are not able to earn by honest means through competition. All such practices are characterized as zero-sum arrangements that are to be exposed and routed out.

We are not naive in this matter. Collusion and zero-sum practices for well over a century have plagued the U.S. market economy and have been used to victimize less powerful persons such as consumers, small businesses, and taxpayers. It is fully appropriate to break up such practices and to prosecute and punish the perpetrators.

Even so, we are not blind either. Cooperation also organizes and drives the market economy, although more so in an economic order where the social value of community is prized along with the social value of individual freedom which under girds competition.

The alliances and partnerships that we have in mind are expressions of the organizing and energizing force of cooperation. What distinguishes these alliances and partnerships from collusive arrangements is that they yield positive-sum outcomes. Rather than being condemned, these types of alliances and partnerships should be affirmed as means which ultimately help meet human material need and satisfy human wants.

Positive-sum cooperation at both the supra-firm level and the inter-firm level is entrepreneurial because it represents a change in the way economic affairs are organized and conducted. In the United States, inter-firm and supra-firm cooperation evoke the usual resistance that all entrepreneurs encounter. The successful entrepreneur understands at least intuitively that cooperation is not a substitute for competition and that cooperation is not possible without striking a new balance between the sociality of human beings and their individuality.

REVIEW SECTION: TOPIC 30

Central Concepts:

- principle of subsidiarity
 - limiting part
 - actuating part
- democratic principle
- five economic processes
- social question
- abuse of programs of aid to the needy:
 - recipient
 - administrator
- benefits from principle of subsidiarity:
 - recipient input to program
 - program experimentation
- firm's duty to the ...
 - poor
 - rest of society
- subsidiarity and ...
 - subsidies
 - outsourcing
- inter-firm partnership
- supra-firm alliance
- collusion vs. cooperation

Important Questions:

- What is the role of the principle of subsidiarity in addressing the social question?
- What is the relationship between the principle of subsidiarity on the one hand and democracy and the problem of abuse of entitlement programs on the other hand?
- Under what conditions is bankruptcy relief for a private business consistent with the principle of subsidiarity?
- When is a government subsidy justified? ... when is it not?
- What is the firm's duty to the poor?
- What is the difference between an inter-firm partnership and a supra-firm alliance?
- When is cooperation among otherwise competing businesses not collusion?

(continued on following page)

True/False:

- a. The principle of subsidiarity gives preference to locating the source of assistance as close to the needy individual/family as possible.
- b. All cooperation among competing business firms is collusion.
- c. Subsidies are inconsistent with the principle of subsidiarity.
- d. The principle of subsidiarity gives preference to public enterprise over private enterprise even when private enterprise is capable of performing its function effectively.

Mark your answer below.



_____ Item a is true, items b, c, and d are false.

_____ Items a and b are true, items c and d are false.

_____ Item a is false, items b, c, and d are true.

TOPIC 31 FINANCIAL MELTDOWN 2008

To help us understand how this meltdown happened and how best to deal with it when it happens again.

September 2008 brought to a head a financial crisis in the United States that quickly locked up financial markets and by shutting down vital sources of credit threatened to spread to product and resource markets and in turn to the entire global economy. Many commentators considered it the worst crisis since the Great Depression.

The meltdown was a long time in the making, having originated with defaults in sub-prime, adjustable-rate mortgages and spreading to giant investment banks in the United States and financial institutions elsewhere that had purchased huge bundles of mortgage-back securities on the promise of a return on their investment that would boost their bottom line. The crisis was further exacerbated by the development of credit default swaps that were intended to provide investors with insurance for any losses deriving from borrowers unable to meet their obligations.

Federal government intervention came swiftly though clumsily as it searched for the right remedies. It settled on bailing out financial institutions considered too big to fail. A vocal minority urged the government to let the markets deal with the problem by eliminating failed institutions. Their pleas were swept aside as too risky.

This topic addresses the financial meltdown of 2008 in terms of eight questions.

- What went wrong?*
- Who's responsible?*
- What caused the meltdown?*
- Are the assets toxic or the management?*
- Why are banks still failing?*
- How did AIG get tangled up in this mess?*
- Are the economic fundamentals strong?*
- How to deal with the public debt?*

This is by no means the final word on the meltdown. Even so, it should help us understand better how it happened and how best to deal with it when it happens again. And it will happen again because economic agents operating freely in a market economy make mistakes, at times very consequential mistakes.

What Went Wrong with U.S. Financial Markets and the Real Economy?

A simple enough question, with a simple answer – gross human failure. Although specific examples of human failure abound, the reasons for that failure aren't so simple to track down. It's best to begin with the basics.

All economies are systems designed by and set in motion by human beings acting alone as individuals or together as either private groups or public agencies. To refer to the U.S. economy as a market system means that decision-making is vested primarily in individuals and to a lesser extent in private groups such as professional and trade associations, labor unions, and public agencies.

The market system functions well when economic agents act knowledgeably, rationally, fairly, and with restraint especially as regards self-interest. Share prices on stock exchanges move up and down depending largely on the underlying fundamentals of the public corporations whose shares are being traded.

***Greed** takes over when that restraint on self-interest is cast aside leading in the extreme to what the chairman of the Federal Reserve in 1996 called “irrational exuberance” -- a type of market failure in the sense that the underlying fundamentals of the corporations whose shares are being traded indicate that those shares are grossly over-valued. However, the opportunity to buy shares and cash in on the gains that derive from rising share prices that seem to continue indefinitely attract additional investors who drive prices even higher.*

***Fear** takes over when shareholders begin to realize that the shares they hold in fact are over-valued and they must sell quickly before the price falls precipitously and wipes out their gains. This too is a type of market failure in the sense that panic selling drives share prices well below the prices that the underlying fundamentals otherwise would support.*

*Financial markets dysfunction whenever human behavior is driven mainly by fear and greed, traits that are deeply embedded in human nature. Fear follows greed that has morphed into irrational exuberance but is not a proper corrective for that greed anymore than another round of drinks cures a hangover. Personal restraint on self-interest is the proper corrective. In the past we called that corrective **moderation**. Libertarians including many mainstream economists today argue otherwise: “let the market sort through the problem by shaking out the losers whose own bad judgment got them into trouble in the first place.” Their remedy can be characterized as a form of social Darwinism: the weak die, the strong survive.*

While attractive to many, that solution presents one major problem. Those who behave responsibly may be taken down with those who acted irresponsibly, as with homeowners whose property has slipped in value because their neighbors got mortgages they could not afford, eventually defaulted and were pushed into foreclosure. Limits have to be imposed on stock traders because experience has shown that left unchecked greed and fear can trigger not just a financial market meltdown but also a collapse of the entire economy. Reasonable limits, for example on naked short selling and buying on margin, are necessary to assure orderly trading activity and in the worst case scenario to ward off a bloodbath like the Great Depression of the 1930s.

Individuals, private groups, and public agencies impose those limits. Individual investors are routinely instructed to exercise due diligence – to carefully examine the details of an investment opportunity – before instructing their broker to invest their funds. Sadly, many did not and bought securities about which they knew little or nothing at all.

Private groups such as publicly traded corporations are required to have their books examined by independent auditors to assure their shareholders and the public that their performance is reported accurately. The same requirement applies to publicly-traded financial institutions including notably investment banks and commercial banks. Here too there was a failure to exercise due diligence and assets were carried on their books that initially were over-valued thereby inflating the institution's net worth. When it became clear that those assets were not producing the expected revenue stream, they had to be sharply lowered in value thereby reducing the institution's net worth, cash flow, and profitability. Inevitably the price of their shares tumbled, and for a small number of troubled commercial banks triggered a silent run – withdrawal of their deposits by electronic transfer -- forcing them to close or to be bought out under the supervision of the Federal Deposit Insurance Corporation.

In their eagerness to promote wider home ownership, Congress through its oversight committees failed to rein in the risky practices at Fannie Mae and Freddie Mac that purchased sub-prime adjustable rate mortgages on which borrowers simply could not make their monthly payments when interest rates and interest charges were ratcheted upward.

*Some commentators assert that the current financial market crisis originates from too little regulation. Others hold exactly the opposite view. Strictly speaking, both are wrong. The central problem is that there has been widespread failure to **enforce** the limits already in place, limits on individuals, private groups, and public agencies.*

One of the most important lessons of the current financial crisis is that regulation alone is not sufficient to control irrational exuberance or panic selling any more than a football rule against roughing the passer assures that quarterbacks will not be injured. What is necessary is strict enforcement and certain penalties for breaking the rule, breaching the limit, especially when it involves private groups or public agencies.

Nevertheless, just as quarterbacks are injured even with strict enforcement, so too financial markets sometimes dysfunction even under a strict enforcement regime. Because human beings including those who practice moderation in their everyday affairs make mistakes and do know and fully understand how markets change with new financial products and new global connections, enforcement can limit the damage but cannot prevent every serious dysfunction.¹

Economic history teaches us that the one thing the market system cannot do is assure the financial security of everyone.

¹ See Kane [p. 1] in which he describes the recent financial crisis as “a scandal of the highest order.” Edward Kane, “Ethical Failures in Regulating and Supervising: The Pursuit of Safety Net Subsidies,” September 2008, available at www.papers.ssrn.com.

Who's Responsible for the Current Financial Crisis?

The simple answer: Main Street, Wall Street, Capitol Hill.

Main Street. *For signing mortgages without sufficient financial resources to meet the obligations inherent in those mortgages -- to make monthly payments as set forth in the terms of those mortgage documents.*

For writing mortgages without evaluating the applicant's financial resources, without requiring the usual 20 percent down payment, because the institutions writing/originating those mortgages eliminated their risk by selling them to other financial institutions.

For bundling those mortgages and selling them to other financial institutions with an appetite for the high return promised but a blind eye for due diligence.

Who benefited? Low-income families, loan originators, building contractors, realtors, title companies, insurance and telecommunications companies, commercial banks, stores selling appliances, hardware, lawn and garden equipment, furniture, flooring and carpeting, paint and wallpaper ... the entire local economy.

Wall Street. *For selling insurance to the financial institutions holding those bundles of securitized assets in order to cover any defaults in the underlying mortgages.*

For embracing the accounting practice of "mark to market" that requires financial institutions to re-value their assets according to their current market value, even as the market for those assets deteriorates precipitously, rather than valuing them according to the discounted value of the future cash flows of those assets.

For paying generous bonuses to Wall Street regulars on the basis of the short-term performance of their working units thereby reinforcing an incentive to boost performance by buying and selling risky financial instruments.

Who benefited? Investment banks, hedge funds, companies selling credit default insurance, directors of aggressive financial institutions, anyone especially senior managers of financial institutions whose compensation depends largely on year-end bonuses, sellers of luxury goods, expensive housing and furnishings, exotic leisure activities.

Capitol Hill. *For encouraging Fannie Mae and Freddie Mac to buy, hold, and re-sell sub-prime mortgages as a way of extending home ownership to families at the margin of the mortgage market who were drawn in by assurances that their homes would increase in value over time.*

For allowing Fannie Mae and Freddie Mac to lobby members of Congress, contribute to their re-election war chests, offer assurance that all was well, and thereby turn aside any further efforts to examine their practices more carefully and exercise their oversight role more diligently.

Who benefited? Fannie and Freddie shareholders and lobbyists, Congressional Republicans and Democrats.

This enormous financial house of cards began tumbling down when sub-prime mortgage holders on Main Street could not continue to make their monthly payments as their mortgage rates were adjusted upward and at the same time many were losing their jobs.

What Caused the Meltdown?

Defaults, foreclosures, surplus housing stock, decline in the demand for new housing and the construction jobs tied to that housing, loss of business for building suppliers, realtors, title search, mortgage, and property insurers. Decline in property values for those who own their homes free of any mortgage and those who continue to pay their mortgages on time. Loss of tax revenues to local, state, and federal governments.

Financial institutions use mark-to-market rules to write down the value of the mortgage-backed securities they hold on their balance sheets, and sustain operating losses because the anticipated flow of income from those toxic assets has not materialized. The market capitalization of those institutions begins to fall as traders sell shares in those institutions, and buy and drive up the prices of more attractive holdings such as gold, or oil, or government securities.

Given the extent to which these mortgage-backed securities are held by financial institutions large and small, banks are reluctant to lend money to other banks even as the Federal Reserve drops the federal funds rate (the rate a bank can charge for inter-bank borrowings). To get the cash they need to continue operating on a daily basis and serve their customer base, banks turn to the Federal Reserve to borrow money through the discount window. Private loans including loans to Main Street businesses made under the condition that they are payable on demand are called by banks that are short of cash on hand. As banks with large holdings of toxic, mark-to-market mortgage-backed securities are forced to report their financial losses to the public, some of their depositors become restless and decide to withdraw funds from their accounts. Banks with insufficient cash on hand to cover those withdrawals are forced to close their doors in many cases permanently.

The problem is that there is no ready market for the toxic mortgage-backed securities, which originated on Main Street, and therefore no way to trade them for cash on Wall Street. With the rescue plan recommended in late 2008 by Treasury Secretary Paulson and modified by Congress, the federal government intended to purchase those securities from Wall Street by selling additional Treasury bonds in order to raise the cash necessary for the deal. When it became clear that this rescue plan wouldn't work because the banks and the Treasury Department could not agree on a price for those toxic assets, the plan morphed into direct cash infusions into the banking system.

The crisis is systemic with a downside feedback loop to match the earlier upside loop that fueled the bubble. The crisis is so massive that many experts think that only the federal government has access to the financial resources necessary to deal with it. Their mantra is "too big to fail." Others object to this view arguing that massive government intervention leads inevitably to government control of the banking system and through it the real economy. They insist that the best remedy, harsh though it may be and even when it hurts those who conducted their financial affairs responsibly, is to let failing institutions fail and rebuild the system on the foundations of the surviving institutions.

Are the Assets or the Management Toxic?

As we have just indicated, months after the financial crisis came to a head in late 2008 and the federal government intervened to rescue the banking system, banks still were loaded down with and frozen by toxic assets. Bankers were reluctant to confess that they even held such assets for fear it would frighten the public and correspondent banks. The government was afraid of paying too much for those assets and saddling the taxpayer with more debt or paying too little and further draining the net worth of the troubled banks. In other words, what's the right price for toxic assets in a market where buyers and sellers are holding back and therefore the exchange process has broken down and banks are trapped by their own toxic assets?

Let us assume, for the moment, that the government buys those assets at a price that is acceptable to taxpayers and bank stockholders. Does that solve our problems with the banking/financial sector?

Sadly, it does not. Those assets were purchased by senior executives who were eager to pad bank revenues with the enhanced earnings to be gotten from holding those assets but who did not investigate their quality carefully enough and seriously underestimated the risk involved. They did not know what they were buying and failed tragically to exercise due diligence and practice the required moderation.

Does capping the annual compensation of senior executives at \$500,000 as a condition for getting monies from the Treasury solve the problem? Yes, if the salary ceiling shames them into changing their ways. No, if it leaves in place precisely the management that got us into this problem and the directors who failed to protect the interests of the stockholders. To illustrate, if senior executives had rejected those assets when they were offered and directors had insisted on following that course of action, mortgages would not have been made available to persons/families who could not afford to make their monthly payments, housing prices would not have been inflated, the defaults that followed would not have taken place, the housing bubble would not have developed, and the credit freeze would not have happened because banks would have continued to trust one another knowing that due diligence and moderation protected them against collapse. The crisis in 2008 was set in motion by human beings and will take humans to put the proper remedies in place.

We need to replace the senior management and directors or change the way they operate. If we decide to replace the senior management and directors, will we be able to find trustworthy and competent replacements to assume the management and direction of those problem-banking institutions? Would those replacements not be drawn from the very same institutional culture that boosted performance by reckless decision-making rewarded and reinforced by huge bonuses? What would keep the expelled senior executives from simply finding work at other banks?

If these people indeed cannot be replaced, how do we change the institutional culture so that sound judgment and steadfastness are restored and recklessness and greed are driven out? This is the age-old question that has puzzled humankind since the ancient Greek philosophers. At this very moment, we face a terribly troubling dilemma: leave the senior management and directors in place and risk a repeat performance or replace them and risk poor performance.

There are two factors working in our favor: fear and role modeling. Some senior executives and their junior-level colleagues can be frightened into changing their behavior by severely punishing the ones who have most egregiously violated the public trust. Today that would be the persons who have amassed enormous wealth through ponzi schemes. They must be publicly disgraced, stripped of their holdings to the full extent possible so that their victims can recoup their investments to the full extent possible. And they should be prosecuted with no plea-bargaining and no “country-club” imprisonment. Upon release they should be banned for life from owning, working in, or serving as a director of a financial institution. Likewise for those elected officials sitting on Congressional oversight committees and public regulators who have either pushed the financial institutions under their supervision into risky behavior or turned a blind eye to clear abuses.

Other bank executives can change their behavior by the role-modeling of superiors and mentors who are recruited from the pool of retired military officers whose lives have been shaped and formed by the six articles of the military code of conduct and by duty, honor, and country. Other high-level replacements can be drawn from the senior managers of regional banks and local banks who have steered their institutions away from the false promises offered by bundles of high-risk assets.

Reforming and reconstructing our banking institutions in a one-time effort, which assures that the recent crisis will not happen again, is doomed to failure. Recall a similar mess in the 1980s with U.S. savings and loans that in a reckless pursuit of higher returns from risky investments collapsed under the weight of bad loans. It follows that reform efforts must be ongoing in order to change a dangerous and ultimately dysfunctional institutional culture. To extend Thomas Jefferson well-known admonition, “eternal vigilance is the price of freedom, fairness, and security in financial affairs.”

Finally, there is nothing fundamentally wrong with being paid handsomely for work done well and nothing intrinsically right about imposing a ceiling on the compensation of senior executives. The financial gains from work done well are the stuff that makes possible sharing and caring for others. There are more than one million public charities and private foundations in the United States that in the end not only rely on contributions from persons who have earned their financial rewards but also provide opportunities for their donors to transform financial gain into human virtue. And virtue, to the ancient Greeks, is the secret of the good life. The Treasury may find a way to remove toxic assets from bank balance sheets but unless virtue in the form of moderation, for instance, somehow is infused into the system there is no way to get rid of a toxic culture poisoning the ranks of senior bank executives.

Why are Banks Still Failing?

An extended analogy may help us come to grips with this especially puzzling question. A fire broke out in the U.S. banking system in September 2008 that overnight threatened to engulf not only the entire U.S. system but also banking systems elsewhere linked in a network of agreements, transactions, and mutual dependencies. An alarm was sounded and fire department personnel and equipment arrived on the scene but learned quickly they were not prepared for the kinds of combustible materials (derivatives) fueling the fire.

Containment was their immediate objective. A massive response was launched focused on combustibles (TARP first tranche with backup from FDIC) but nothing worked and the fire continued to rage out of control. Next they sprayed enormous volumes of water over the entire structure (TARP second tranche with FDIC backup) hoping that effort would suppress the flames that by then were igniting fear and anxiety around the globe. It didn't help that in January 2009 the senior firefighting team (Treasury) was being replaced while the fire had not yet been contained. Further heightening fear and anxiety were arsonists who enjoyed playing with fire (ponzi schemes) to enrich themselves at the expense of their investors.

Containment was achieved but the still smoldering combustible materials stubbornly resisted efforts to snuff them out forcing fire crews to remain on the scene months after the initial breakout. Managers of other structures in the system not immediately threatened by the fire were persuaded to let firefighters spray water on their structures on the premise that a little water (TARP Capital Purchase Program) would encourage them to step up their efforts to get credit flowing again.

Efforts to deal with the smoldering combustibles by hauling them away failed because no one could figure out how much to pay the haulers for removal services. Another suggestion was made to haul out of the damaged structures any and all materials of value yet untouched by the flames and to let those structures and combustible materials burn themselves out. That suggestion, however, has gotten no traction. Then the damaged structures that held those combustibles were forced by the legal system to retrieve them, clean them up, and make them viable (mortgage cram-down) even at the risk that they might become combustible again.

Fire inspectors reported that the blaze that between January 1, 2008 and November 12, 2010 consumed 311 banks started in the sub-flooring long before it broke out in September.¹ In spite of warnings from the fire prevention bureau, negligence on the part of senior managers eager to pocket the fees for holding the combustible materials and by building code enforcers willing to turn a blind eye to that negligence made it easy to accept and store those materials. Ignition came suddenly and unexpectedly from large numbers of cash-strapped homeowners defaulting on their mortgages.

A few powerful persons advocated repairing the broken financial system by nationalizing the banks, putting them under direct government control. But that's like asking firefighters to remain at the site, demolish the structures, and build others in their place. Opponents object to this remedy arguing that when the fire is out, firefighters should withdraw and leave the rebuilding to competent and trustworthy financial specialists who know best how to rebuild the system. However, the few who would nationalize the system are supported by the many who are persuaded that government knows best. At the end of the second quarter 2010, there were 829 banks on the FDIC list of "problem banks," up from 76 at the end of 2007² and the issue of bank ownership and control remained unresolved.

¹ FDIC, "Failed Bank List," 2010, available at www.fdic.gov/bank/individual/failed/banklist.html, pp. 1-15.

² FDIC, "Statistics at a Glance," 2010, available at www.fdic.gov/bank/statistical/stats/2010jun/FDIC.pdf.

*Just as the fire prevention bureau attempts to educate the public about hazards such as overloaded electrical circuits, blocked exits, and natural gas leaks, the general public needs to be better informed about the risks involved in financial ventures especially as new financial instruments such as credit default swaps are developed. The problem is that the U.S. financial system continues to operate with a fire prevention bureau that functions on just one broken principle – **let the buyer beware.***

*Negligence in storing combustible materials and in building code enforcement, not to mention arson, is a felony punishable by imprisonment. Those who were negligent, whether they are bank executives, regulators, or members of Congress on financial oversight committees, should go to jail. Removing the perpetrators is necessary in order to **reduce** the risk of a similar financial collapse in the future. Even so, there is no way to assure that a fire will not break out again even if the entire system were nationalized because the smartest and best-intentioned human beings can and do lapse into ignorance and negligence and are too easily enticed to reach for a deal that is too good to be true.*

How Did AIG Get Tangled Up in This Mess?

The insurance giant American Insurance Group got tangled up in the financial market meltdown through its financial products division that developed and sold credit default swaps to insure buyers that whenever they suffer a loss due to default on the assets they hold AIG would cover their losses. The premise on the part of AIG was the usual insurance premise: the funds taken in by selling insurance protection will be more than sufficient to cover the claims made for losses suffered. In other words, AIG makes a profit as long as normal conditions prevail in financial markets.

Banks purchased this insurance to protect themselves against defaults on their holdings of mortgage-backed securities and other assets. Municipalities purchased credit default swaps to insure that they would be able to pay their bondholders in the event of a fiscal crisis brought on by an economic downturn. When AIG's operating premise collapsed, it was not able to pay in full the amount owed to its insurers holding toxic assets. The \$182.5 billion government bailout package of AIG¹ allowed the insurance company to make good on those claims and protect its customers from collapse.

Ironically AIG actually saw its own collapse on the horizon. In its Form 10-K filed with the Securities and Exchange Commission in February 2008 the company stated that its “procedures may not be fully effective in mitigating risk exposure in all market conditions, some of which change rapidly and severely.”

The public outrage over bonuses paid to AIG employees reflects at the gut level some basic ideas of justice governing exchanges between buyer and seller, worker and employer, and others in a market system. Simply put, justice demands that both parties to any exchange are to trade things of equal

¹ Ieva A. Augstums, “AIG to Hold Conference for Financial Advisers,” September 30, 2009, available at www.google.com/hostednews/ap/article/AleqM5iCKDzPhkvOYkOMg9tPSobg3eh0VgD981PMCG0, p.1.

value and impose equal burdens on one another. This principle applies in all exchanges whether sealed by a written contract or not.

Parents teach this principle to a child who takes a piece of candy off the store shelf by insisting that the shopkeeper must be paid or the candy returned. It is violated by price gouging and shoplifting in the marketplace and embezzling and pilfering in the workplace. Nevertheless the fact that these practices and others are condemned as illegal confirms the principle and teaches the importance of compliance. Let the buyer beware is no substitute for this very practical principle.

*In the marketplace, justice demands in most cases at the point of sale when the seller transfers the item to buyer that the buyer is obligated to make payment in full. Commonly this transaction involves no written contract. Even so, the demands of justice apply. If the item is defective, the buyer usually can expect to return it to the merchant for a refund or exchange it for an equivalent item. If the buyer pays with a worthless check, the seller has legal options to recover the full amount owed. The rule is that a defect in the exchange voids the contract. The contract **per se** is not sacrosanct.*

One major exception to the strict application of this principle involves the sale of a big-ticket item such as an automobile or house where the buyer cannot make payment in full at the point of sale, borrows the money, and repays the lender over time. Those payments in the future include interest to cover the lender's risk that the borrower may default and the risk that inflation may erode the value of the money when it is repaid.

In the workplace, the employer is obliged to pay the worker promptly for the work performed. If the employer fails to make payment as agreed, the worker can sue the employer for unpaid wages. If the worker fails to perform as agreed, the employer can adjust the wage downward or fire the worker. Virtually every employment contract, whether written or strictly verbal, calls for performance evaluation as a way of affirming that both parties are being faithful to the terms of the contract. Common sense alone tells us that there must be a tight linkage between performance and pay, that there must be some equivalence between the work done and the wages paid.

*This is the nub of the problem, at least the public perception of the problem, regarding Wall Street bonuses in which AIG was contractually obligated to pay \$165 million to certain employees in the financial products division. Is there an equivalence between the work done and the compensation paid these employees? Judging by AIG's collapse as a viable company, there clearly were **serious mistakes in risk management** made by senior AIG executives, notably with credit default swaps that required AIG to make payments to their clients who purchased this product to insure themselves against the risk of defaulting on their obligations to their debt holders.*

One public commentator trying to dismiss the AIG bonus issue described it as a "pimple" on the face of an enormous bailout package and urged President Obama to apply himself to more important matters. This argument misses the point. The AIG bonus controversy was not about the money so much as it was about the underlying principle that demands equivalence in exchange.

This principle is critical to a properly functioning market economy. Without it all manner of abuses including the ones previously mentioned are tolerated and become commonplace. This in turn

weakens compliance with the other principles of justice regarding the relationships between a superior and his/her subordinates and between a member and the group to which that person belongs, leading to abuses such as discrimination, bribery, insider trading, and insurance fraud, thereby shaking the foundations of a market economy. For more on justice in the marketplace and the workplace, see Topic 2.

The Wall Street bonus system needs overhauling because what happened at AIG was not an isolated incident. It is commonplace to pay bonuses even when there is little evidence that the compensation paid to an employee matches that person's own performance or the performance creates any lasting value for the company. The bonus is paid to keep them from leaving and that's why it's called a retention bonus. In strict ethical terms, it really is extortion in which corporate managers, employees, and directors in effect form a conspiracy to fleece the stockholders because they are being paid twice, the first time for work done poorly, the second time for cleaning up their own mess. In the case of AIG they are fleecing the U.S. taxpayers who hold about 80 percent of the shares of the company.

Even though these contracts strictly speaking conform to the letter of the law, in ethical terms a contract arranged through a conspiracy is not valid and we should not hesitate to set it aside. A contract must be grounded on firm ethical principles if it is to be sustained. Otherwise, the contract and the law by implication endorse abuse in economic affairs.

The bonuses paid under the terms of those contracts are much more than a pimple on the face. They are a malignant tumor.

Are the Economic Fundamentals Strong?

The U.S. economy is like an aging, overweight left tackle on the offensive line. Big but not strong. Not willing to watch what he eats and drinks and maintain a vigorous off-season training regimen. No longer quick enough to protect his right-handed quarterback from a younger, trimmer, stronger defensive end attacking from the blind side. Reluctant to retire and give up his hefty salary and the hope of winning a Super Bowl ring.

The economy is a human system and as with any system built and operated by humans such as the judicial system, the military system, the educational system, it depends critically on the underlying culture – the totality of ideas, beliefs, convictions, ideals, values, principles shared by a people and expressed through their language, customs, music, art, religion, rituals, practices, mannerisms. Standing and singing the national anthem before a sporting event is deeply embedded in the American culture. So too are gifting the bride and groom at their wedding reception, attending worship service on the Sabbath, allowing an adversary to speak without interruption, enjoying turkey dinner with the family on Thanksgiving, paying one's respects to the family of the deceased. The fundamentals of the U.S. economy are not strong because they have been undermined by a culture that increasingly is coarse and corrosive.

The culture shapes and forms everyone raised and conditioned within its reach and in turn is re-shaped and re-formed by each new generation. Human beings as economic agents in effect carry that culture with them like a purse or wallet into the marketplace and the workplace. Notice, in this

regard, the historical importance to the U.S. economy of getting to work on time, recognizing the customer as always right, treating superiors, subordinates, and peers with respect, demanding no more than what is owed and giving more than what is required, sealing an agreement with a handshake, delivering in full according to the terms of the agreement, putting in extra time and effort when the company faces a deadline or crisis.

Consider, however, the following ways in which the American culture and the economy have changed and in our opinion have become coarsened and corroded.

- *Luck not hard work is the key to success. A sign over every casino reads “abandon hard work all ye who enter, you’re going to get rich today with the roll of the dice, the turn of a card.”*
- *At the university, athletics competes with instruction for resources. If fundamental values are expressed in financial terms, what does it say about U.S. universities that nearly all of the football coaches of the top teams are millionaires?*
- *Whatever is legal is ethical. If there is no law that prohibits an action or practice, not to worry, just do it.*
- *No pay is okay. If you want something like designer clothes or jewelry, you can have it even if you can’t afford it. If you need something like housing or emergency room care, you have a right to it even if you are unable to pay for it. Millions of Americans file for bankruptcy every year because they are overwhelmed by credit card debt and other bills they cannot pay. Others pay a premium for their purchases to cover debts that have been dismissed through bankruptcy.*
- *Death is the answer. When nothing else is effective in resolving a problem, death is the answer. Shooting sprees in the workplace, in the classroom. Growing acceptance of the idea that there is a life that is not worth living, of physician-assisted suicide, of mercy killing, murder-suicide and, with a shrug of the shoulder, gangbanging.*
- *Public officeholders are a privileged class. Power, influence, and money drive decision-making in public affairs where all three are worshipped. The results are incumbents holding on for decades with little or no apparent concern for the public good.*
- *Scapegoat your problems to someone else. If you’re a Democrat, the Republicans did it. If you’re a Republican, the Democrats did it. If you’re a reformer, insiders did it. If you’re a worker, the boss did it. If you’re a boss, the union did it. If you’re a teacher, parents did it. If you’re a preacher, the devil did it. If you’re ultra-conservative, fluoridation did it. If you’re far-left liberal, Wall Street did it.*
- *“Gotcha” is all that matters. Attack, intimidate, misrepresent, ridicule, demean, smear, and lie are becoming the dominant language of our public discourse.*
- *There’s a drug for any ailment. Wet or dry, injected or ingested, legal or illegal, there’s a drug available to address any human problem. And to make access easier, there’s a government program*

to either provide or pay for many of those drugs.

To connect our comments on culture to the performance of the economy, visualize the economy as a twin-engine aircraft that flies higher, faster, with a heavier payload when both engines operate at maximum efficiency. One of those engines represents the energizing force of competition, the other the driving force of cooperation. The plane's control surfaces such as its flaps and rudder allow the pilot to handle the aircraft in flight. In this analogy those surfaces stand for the limits imposed on the economy by public agencies such as the Federal Reserve, SEC, and OSHA that help assure the safe functioning of the system. The pilot represents business leaders notably entrepreneurs who decide where the economy is headed and which route to take to its final destination.

Culture relates to the economy the same way weather influences the aircraft. A culture of life and hope, that is affirmed most fundamentally when human beings are not totally self-absorbed and at least from time to time care about one another in economic affairs, speeds up the performance of the economy just as the aircraft performs better in good weather. In contrast, a culture of death and despair, which in the extreme is reinforced by a pervasive attitude that death is the answer to social problems, slows down the performance of the economy just as the aircraft performs less effectively in bad weather.

One compelling example comes to mind. The performance of the U.S. economy during the last three months of 2001 was more favorable than expected, especially in the wake of the atrocities committed on September 11. Was this due perhaps to the huge outpouring of help extended to the victims, their families, and the rescue workers that had an energizing effect on the economy by unifying Americans?

The engines of the aircraft operate on a fuel supply that represents the credit available through the financial sector. At this very moment, a huge financial crisis still threatens the entire economy in just the same manner as contaminated fuel threatens an aircraft in flight. The immediate problem for the crew is how to siphon off the contaminated fuel while the aircraft remains in flight and replace it with clean fuel. The fuel became contaminated by human failure in the refining, transportation, storage, or handling of the fuel as it was being pumped into the aircraft's fuel tanks.

Similarly, the 2008 financial meltdown was directly attributable to human failure in mortgage origination, securitization, trading, and asset valuation, brought on ultimately by a new cultural environment that tossed aside the tried and true practices of the past. Those toxic mortgage-back securities slowly are being removed from the financial system by the de-leveraging process and the Federal Reserve's asset purchase program known as QE (Quantitative Easing) 3. In the end a public agency or private party will acquire them, hold them, hope to re-sell them later when normal, stable conditions return to financial markets, or will simply write them off. The contaminated fuel, in other words, must be reformulated to make it usable again or dumped.

For years and on many occasions, John Paul II warned the west of its downward spiral into a culture of death and despair, to which we add crippling dependency. We are seeing the consequences of that descent in current economic affairs. All is not lost, however, if only we would accept his admonition and embrace once again a culture of life, hope, and personal responsibility. It

can be done, but it won't be easy.

How to Deal with the Public Debt?

Financial news commentators tell us more than we really want to know about our deeply troubled economy. A banking system on life support requiring billions of dollars of taxpayer monies simply to survive. Stock, bond, and commodity exchanges that in the twinkling of an eye wipe out a baby boomer's retirement nest egg. A federal government piling deficit spending on more deficit spending assuring that our grandchildren will be saddled with huge interest payments for years to come. A health-care system that every day produces new miracles of human survival and recovery all the while laboring under a reimbursement system that threatens its very foundations. An economy that produces more than \$17 trillion in goods and services every year and yet Americans are afraid that the system will fold like a house of cards. A culture in which state governments justify the lottery and casino gambling on grounds that the public revenues are needed to support education.

The public debt of the United States on January 1, 2014 was \$17.4 trillion. Since the end of World War II, that debt has increased every year except 1946-47, 1947-48, 1950-51, 1955-56, and 1956-57.¹ Since then we've had more than 50 consecutive years of deficit spending. Consumer debt today totals \$3.1 trillion.² Since every taxpayer is also a consumer, the debt load from these two sources is \$20.5 trillion. What can we label this mountain of debt other than a serious addiction to debt?

A 9-step recovery program would help address our addiction problem. In the following, economic recovery is defined as a monthly unemployment rate of 4.9 percent for the United States -- the jobless rate in January 2008 when the downward slide in jobs began.

- 1. Suspend all new government mandates, such as tougher automobile emission standards, until the U.S. economy and the auto industry have recovered.*
- 2. Initiate a binding national referendum on the debt ceiling every presidential election year. The ceiling presently is set by Congress and raised whenever it engages in deficit spending.*
- 3. Lay out a schedule to pay down the public debt with a one percent tax on all credit card transactions imposed at the point of sale and collected from credit care companies. This action will have the intended secondary effect of getting credit cardholders to think again before running up their personal debt.*

¹ TreasuryDirect, "Historical Debt Outstanding-Annual 2000-2010," 2010, available at www.treasurydirect.gov/govt/reports/pd/histdebt/histdebt_histo5.htm, p. 1; TreasuryDirect, "Historical Debt Outstanding-Annual 1950-1999," 2009, available at www.treasurydirect.gov/govt/reports/pd/histdebt/histdebt_histo4.htm, pp. 1-2; TreasuryDirect, "Historical Debt Outstanding - Annual 1900-1949," 2009, available at www.treasurydirect.gov/govt/reports/pd/histdebt/histdebt_histo3.htm, pp. 1-2.

² Federal Reserve, "Consumer Credit - G. 19," available at www.federalreserve.gov.

4. *Require a two-term president to balance budget deficits with budget surpluses over the first term in office and over the second term if re-elected, thereby adding nothing more to the public debt. In this matter Congress may not drag its feet in order to tie the president's hands.*
5. *Reject any federal or state legislative initiative to make filing bankruptcy easier.*
6. *Put all new highway construction on hold until every of the more than 147,870 structurally deficient or obsolete bridges in the United States¹ is safe to use.*
7. *Approve no new welfare programs for persons/families above 200 percent of poverty.*
8. *Suspend all new public expenditures on stadia and arenas and all current subsidies for professional sports teams until economic recovery has been achieved.*
9. *Prosecute members of Congress for the mistakes and failures of the public agencies for which they have direct oversight responsibility.*

This 9-step program will not get rid of the addiction. It simply separates the user from the addictive drug. Further, it will not assure that the addict will never again succumb to his/her addiction. Nor will it assure that our children and grandchildren will not become addicted. But it's a start.

¹ See FHWA, Federal Highway Administration, "Deficient Bridges by State and Highway System 2013 available at www.fhwa.dot.gov.

REVIEW SECTION: TOPIC 31

Central Concepts:

- meltdown
- toxic assets
- mortgage
 - sub-prime
 - adjustable-rate
- mortgage-backed security
- default
- credit default swap
- foreclosure
- irrational exuberance
- greed
- fear
- selling short
 - naked
- buying on margin
- due diligence
- ponzi scheme
- retention bonus
- refundable tax credit
- deficit
- public debt

Important Questions:

- What went wrong with U.S. financial markets and the real economy in 2008?
- Who was responsible for the financial meltdown of that year?
- What caused the financial meltdown?
- Were the financial assets toxic or the management?
- Why are banks still failing?
- How did AIG get tangled up in this mess?
- Are the economic fundamentals strong?
- How to deal with the public debt?

(continued on following page)

True/False:

- a. Foreclosures occur when homeowners no longer are able to make regular payments on their home mortgages.
- b. A toxic asset is a financial asset held in a bank's portfolio that has fallen sharply in value because it no longer earns the expected stream of income for the bank.
- c. A credit default swap is a financial instrument designed and sold by the U.S. Treasury to supply the funds necessary to cover a federal budget deficit.
- d. A financial meltdown occurs when the federal government runs a budget surplus.

Mark your answer below.



- Item a is true, items b, c, and d are false.
- Items a and b are true, items c and d are false.
- Item a is false, items b, c, and d are true.

THE VIABILITY OF A PERSONALIST ECONOMY

TOPIC 32

INTEGRAL HUMAN DEVELOPMENT¹

To demonstrate that the ultimate purpose of human society is human perfection, which in economic affairs is achieved by maximizing integral human development.

*Personalist economics follows Nobel Laureate Amartya Sen's argument that the task for economics is to enlarge everyone's capabilities set² and asserts uniquely that the economic agent, the **acting person**, adds to his/her capabilities set by acting virtuously in economic affairs and subtracts from that capabilities set by acting viciously. Acting virtuously contributes to personalist capital just as acting viciously diminishes it. Further, strengthening everyone's capabilities set enhances integral human development just as weakening that set impairs development. Personalist economics not only adds an important human behavioral element -- personalist capital -- to Sen's capabilities set but also links that improved set to integral human development and asserts that the ultimate purpose of the economy is maximizing integral human development that is achievable by maximizing that capabilities set.*

Integral Human Development.

*Personalist economics centers attention on human beings as ends in themselves and not merely as the means that activate economic affairs as suggested by mainstream economic theory. Following Bernard Dempsey, personalist economists affirm that the "basic purpose of the society cannot be other than the basic purpose of the real persons who compose it, that is their perfection."³ Years later, quoting from Paul VI's **Populorum Progressio**, Benedict XVI asserted the following on the linkage between perfection and integral human development:*

Integral human development on the natural plane, as a response to a vocation from God the Creator, demands self-fulfilment in a "transcendent humanism which gives [to man] his greatest possible perfection: this is the highest goal of personal development."⁴

For our purposes as economists, human perfection relates to human perfection in economic affairs and refers to the maximization of integral human development through activity in economic affairs.

¹ Dr. Luca Sandonà contributed several important insights in the preparation of this topic.

² Amartya Sen, "Human Rights and Capabilities," *Journal of Human Development*, Volume 6, Number 2, 2005, pp. 151-166.

³ Bernard Dempsey, *The Functional Economy*, Englewood Cliffs: Prentice Hall, 1958, p. 273.

⁴ Benedict XVI, *Caritas in Veritate*. June 29, 2009, §18, available at www.vatican.va. The full title of this encyclical letter is "*Caritas in Veritate* of the Supreme Pontiff Benedict XVI to the Bishops, Priests and Deacons, Men and Women Religious, the Lay Faithful, and *all People of Good Will* on Integral Human Development in Charity and Truth" (emphasis added). Including all people of good will in the title indicates that Benedict intended his remarks for persons both within the Church and beyond.

*In other words, the integral human development and human perfection of the **acting person**. Thus the following function:*

I. IHD = f (HC, SC, MWB, PerC)

*where IHD is integral human development, HC is human capital, SC is social capital, MWB is material well-being, and PerC is personalist capital. **In Sen's terminology, the independent variables in this function represent the capability set of personalist economics.***

***For our purposes, and speaking theoretically, maximizing IHD results in human perfection.** At first glance, we might object to the very concept of human perfection as humanly unattainable. Even so, we see examples in everyday life of persons striving for perfection in the work they do: in art, music, wine making, sports, bridge and monument designs, racing cars, and the like. Thus we have much admiration for the likes of Michelangelo and Chagall, Beethoven and the Beatles, the vineyards and wineries of Valpolicella and Napa Valley, Leo Messi and Michael Jordan, the designers of the Gateway Arch in St. Louis and the Eiffel Tower in Paris, Michael Schumacher and Richard Petty. What characterizes personalist economics is a focus on the practice of virtues and avoidance of vices as the pathway to human perfection.¹*

*Personalist capital indicates that the degree of a person's moral development is linked to three levels of human action.² The first level refers to reflexive or instinctive action that humans have in common with animals: the dog chases the cat up the tree; the basketball player leaps to grab a rebound. Action at the first level is associated with physical freedom. Second-level action is purposeful or intentional: the farmer plants seeds in the spring in order to harvest a crop in the fall. Second-level action is associated with unrestricted freedom; only humans are capable of action at the second level. Third-level action produces a change in the person who engages in that action: a loving mother donates one of her kidneys to save her child's life; a greedy financial adviser devises a scheme to defraud his/her clients. Third-level action is associated with **self-determination** -- the freedom to shape one's personhood by the choices one makes -- and is critical to the way in which personalist economics represents the economic agent and accounts for the acquisition of personalist capital.*

*As with the farmer who plants in the spring in order to harvest in the fall, **homo economicus** purposefully and intentionally engages in economic affairs in order to maximize personal net advantage in the form of profit or utility, acting with a kind of passive automaticity based on the pleasure/pain calculus that is identifiable with second-level action. The rational-expectations concept so deeply ensconced in standard economic theory proceeds from the assumption that economic agents relentlessly pursue maximum personal net advantage. It follows that if maximizing*

¹ Luca Sandonà, "Human Capital in Personalist Economics," *Global & Local Economic Review*, Volume 15, 2011, pp. 51-68.

² Edward J. O'Boyle, "The Acting Person and Personalist Capital," *Journal of Markets and Morality*, Volume 15, pp. 89-102.

personal net advantage is flawed, so too is rational expectations.

*Living, breathing human beings are capable of acting at the third level, but not **homo economicus**. If **homo economicus** were self-determining and therefore capable of moral development, mainstream economics no longer would be a value-free discipline because it then would have to take account of human behavior in economic affairs that is driven at least in part by moral considerations. Further, self-determination involves change, but to assure the predictability in human behavior – always maximizing personal net advantage – that makes for certainty in economic analysis, **homo economicus** must not change.*

At this third level the action derives its meaning from a good in which one participates by performing the action. The action's meaning does not come from its consummation (first level – physical freedom) nor does it come from a specific goal the action is meant to achieve (second level – freedom to do as one pleases). Rather it comes from a purpose in which one participates precisely through performing the action. This purpose does not come at the end of or sometime after the action. Instead, it is present in the performance all along, at every stage. In this kind of action one realizes a good by participating in it.¹

Consider the third-level case of the man who works as an investment adviser who devises a scheme to defraud his clients. Implementing that scheme is the action. Stealing is the purpose, in this case the evil, to be accomplished by implementing a scheme though, due to arrested moral development, he very likely sees as good. The defrauding, in terms of both intent and outcome, takes place from the very beginning of the action not just at the end. By participating in this evil action all along his moral development is further eroded. Notice that if his intentions instead were to help his clients invest their funds to provide for their retirement and to support their charitable giving, he would be participating in a good action all along and his moral development would be enhanced even if his investment advice did not produce the intended gains.

*From the perspective of **homo economicus**, acquiring human capital or social capital strictly speaking is action at the second level because its intended purpose is maximizing personal net advantage. Similarly, improving one's standard of material well-being is second-level action. However, for the actual living, breathing economic agent, acquiring human capital, social capital and improving one's standard of living can also be action at the third-level. For example, if by acquiring human capital in the form of a medical degree and applying it in her practice a woman intends to provide materially for her children and at the same time practice the Hippocratic Oath, she clearly is not just maximizing personal net advantage. She is enhancing her children's well-being and her own moral development. If by acquiring social capital a young man finds opportunities for personal advancement otherwise not open to him and uses it to approach his circle of friends and neighbors to help support the building of affordable housing for the needy, he has moved beyond maximizing personal net advantage. However, as stated previously, the **homo economicus** of mainstream economics is incapable of moral development, is limited to second-level action. In sharp contrast, personalist economics does not restrict the economic agent – the **acting***

¹ Germain Grisez and Russell Shaw, *Beyond the New Morality: The Responsibilities of Freedom*, University of Notre Dame Press, Notre Dame and London, 1974, p. 7.

person – to action at the second level. Rather, personalist economics allows the economic agent to become a living, breathing, existential actuality, whether for good or for evil.

Personalist capital is formed by actions at the third level and is influenced by personal ideals and interactive social relations. In fact, behavioral economics has proved that personal beliefs, habits, and values matter in economic decisions-making, and game theory has shown the importance of personal interactions. Personalist economics adds that in economic analysis questions regarding the meaning of human existence cannot be set aside. One acts in a certain way in consequence of his/her responses to **innate questions** such as who created him/her, why he/she is in the world, what he/she will become after his/her death, why evil exists, and the like. We cannot reduce these questions to temporary psychological sentiments because unavoidably they persist along the entire span of one's life. We cannot exclude them from economic discourse – as mainstream economics does through **homo economicus** -- because they are central to the way in which human persons approach economic issues.

Personalist capital is different than the other independent variables in the IHD function -- physical capital, social capital, and material well-being -- in the sense that personalist capital is **entirely** within the control of the **acting person** through third-level action. The other three, for various reasons, are only partially within the control of the **acting person**, or not at all. Furthermore, only the **acting person** can build up personalist capital for him/herself by acting virtuously or tear it down by acting viciously. Personalist capital, in other words, is uniquely and intensely personal.

For personalists the economic agent is conceived as an **irreducible** being, a **somebody**, not **something** produced by a combination of biological, psychological, and affective elements. Personal identity is **unique** because the economic agent is not an abstract and hypothetical concept stripped of any possibility of moral development but instead is a real human being who encounters moral choices and is shaped by the choices he/she makes. Human personality is basically **relational** because the economic agent achieves development within a network of interactive social relationships. All existence, in other words, is co-existence.

Hence, human development is called “integral” to indicate that development encompasses the entire range of human materiality, spirituality, and personality. While human life's material aspects are successfully treated by mainstream economics, personalist economics also studies his/her spiritual and moral traits, as suggested many years ago by Thomas Divine.

In addition to these (individual needs) there are certain social needs which arise from his living in community with others, such as a sense of security and of status, a sense of belonging in his group, a sense of competence and of attention resulting from such competence, and a sense of importance and of participation with others in the job he is performing. But as the fulfilment of those social needs must be found for the most part in that area in which man spends the greater part of his social life, i.e. economic activity, it follows that the final and ultimate goal of economic life is the development and perfection of human personality in so far as that lies within the sphere of economic activity. In other words the individual is not only, as co-producer of goods and services, the efficient cause of economic activity, he is, as consumer and social being, the final cause as well.¹

¹ Thomas Divine, *Economic Principles and Social Policy*, unpublished book-length manuscript found in the archives of

Personalist economics asserts that economic systems should provide humans with the goods necessary for acts of virtue, and economic institutions should offer “opportunities for, and habituation in, the practice of virtue itself.”¹ Personalist economics focuses on the decision-making process wherein the economic agent develops further as a human person by acting virtuously (for instance, through integrity and generosity) or deteriorates as a human person by acting viciously (for example, through villainy and stinginess).

It is commonplace in economics to view and represent economic affairs in zero-sum terms: a little bit more of this means a little bit less of that. A little more work, for example, means a little less leisure. However, this does not necessarily hold for personalist capital. More human capital for the physician, coupled with her commitment to the Hippocratic Oath, allowed her to provide for her family, add to her personal capital, and develop more fully as a human person. More social capital for the young man made it possible for him to advance in the workplace and at the same time build affordable housing for the needy through the joint efforts of his friends and neighbors. The human and social capital acquired and applied made it possible for both persons to acquire more personalist capital and thereby more fully realize their potential as human beings.

Negative developmental outcomes are possible depending on how human capital and social capital are put to use. If a woman uses her medical degree to defraud insurance companies or gain access to controlled drugs in order to feed her addiction, personalist capital deteriorates and personal development suffers. In like manner, if a man sets up a social network and charges adults for connecting them with children who have been trafficked for the sex trade, his personal development is arrested or even reversed depending on how much of his own personalist capital is depleted by this wicked practice.

Personalist Capital.

As personal intangible assets can be captured only indirectly through a praxeological examination of human actions,² we list the sequential postulates that determine personalist capital. First, morally good and evil values are respectively attested by morally good and evil actions. Second, every action has a different weight. Consider, the difference between a simple act of giving directions to a tourist versus a courageous and hazardous attempt to save another’s life. Third, every human action is influenced by personal history but not necessarily pre-determined by it. Consider the success that Alcoholics Anonymous has had in helping alcoholics overcome their addiction. Fourth, an occasional action typically has only a small effect on human habits, whereas repeated action often shapes those habits powerfully. Fifth, following Aristotle, we define the morally good habits as “virtues” and the morally evil ones as “vices.”

Raynor Memorial Libraries, Marquette University, 1960, Chapter 24, pp. 7-8.

¹ Stephen Worland, “Justice and Welfare Economics,” *Review of Social Economy*, Volume 17, Number 2, 1959, pp. 97-111.

² Ludwig von Mises, *Human Action*, Chicago: Contemporary Books, 1966, [1949].

Personalist capital in a specific time is given by the stock of virtues (V_i^P) acquired by a person from birth ($t=0$) through that specific time ($t=i$) net his/her stock of vices (v_i^P). Thus the following function:

$$\text{II. PerC} = \sum_{t=0}^i V_t^P - v_t^P$$

A virtue is a balance point between a deficiency and an excess of a trait. However, the greatest virtue lies not in the exact middle, but at a “golden mean,” which sometimes is closer to one extreme than the other in relation to a specific activity. Personalist capital is acquired/destroyed always and everywhere in accordance with action in economic affairs that is virtuous or vicious.¹ Thus the following function:

$$\text{III. PerC} = f(C, W, L)$$

where C is consumption, W is work, and L is leisure. Among the four cardinal virtues of justice, fortitude, prudence, and moderation,² personalist economics emphasizes moderation because moderation provides the needed limits to consumption, work, and leisure to assure integral human development. As Peter Danner observed: “**unlimited economic gaining is self-defeating**” (emphasis in the original). At the same time, he also stated:

Moderation is not especially fashionable. ... by braking the tendency to seek pleasures for oneself and, instead changing one’s preferences toward goods of higher values and away from baser sensual values, moderation is simply the rationale of a person’s fostering the right use of material goods. Moderation, by thus linking guiding and braking functions, achieves Aristotle’s principle that all true virtues steer between excess and deficiency.

*... just as moderation urges the right use of material things for self, justice directs their use for what is right for others.*³

Moderation can be represented in our understanding of personal consumption in terms of human wants and human needs. In Figure 1, the budget of a typical consumer is represented by B ; B' represents a smaller budget; x_1 a consumer good; x_2 another consumer good.⁴ Mainstream economic theory tells us that the optimal outcomes for the consumer are clearly identified with the points of

¹ Edward J. O’Boyle, “Meeting Human Need through Consumption, Work, and Leisure,” *International Journal of Social Economics*, Volume 38, Number 3, 2011, pp. 260-272. Luca Sandonà, “Personalist Microeconomics: Re-thinking Economic Agency,” *Risparmio*, Volume 59, Number 3, 2011, pp. 91-108.

² Deirdre McCloskey takes account of the three theological virtues of faith, hope, and charity because she argues that a person who believes in the existence of an after-death world is more motivated to act according to an upright conscience. McCloskey, *The Bourgeois Virtues: Ethics for an Age of Commerce*, Chicago: University of Chicago Press, 2006, p. 154.

³ Peter Danner, *The Economic Person: Acting and Analyzing*, Lanham: Rowman & Littlefield, 2002, pp. 122-125.

⁴ To this point, we have deliberately avoided using indifference curve analysis in order to present in one place its application to consumption in the context of needs and wants, and to work and leisure side by side. An indifference curve displays the various combinations of the x_1 (whatever good is plotted along the y-axis) and x_2 (whatever good is plotted along the x-axis) that yield the same utility and about which the consumer therefore is regarded as indifferent.

tangency. When the two items mapped on the axes are human **wants** and an important life event occurs such as a heart attack, pregnancy, or crippling injury wherein the consumer is advised to change his/her behavior, a new indifference map replaces the one above (shifting to the left in Figure 2) provided one or both items on the axes are included among those things that this consumer is to avoid or take in **moderation**.

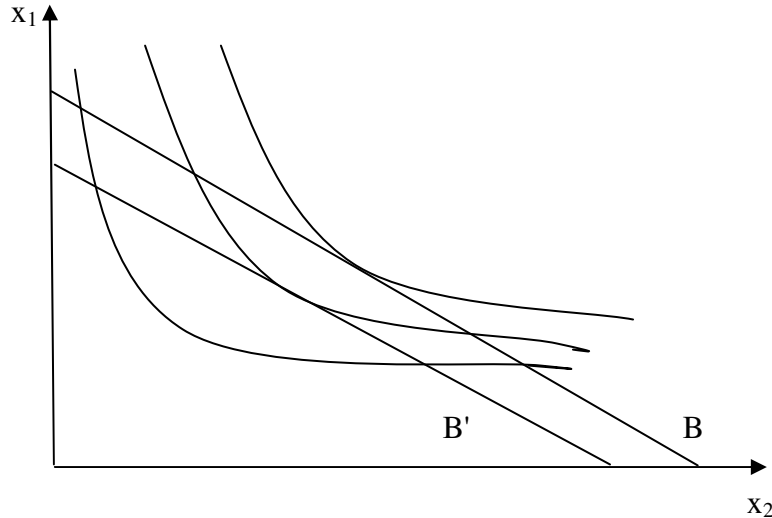


Figure 1

Under these circumstances budget **B** and budget **B'** also may change, as suggested in Figure 2, though this change strictly speaking is not necessary. With that shift in the indifference map, a new demand curve emerges, whether the budget constraints have changed or not. This new demand curve, which has shifted to the left, reflects the influence of the cardinal virtue of moderation on consumption (less is demanded at the same price).

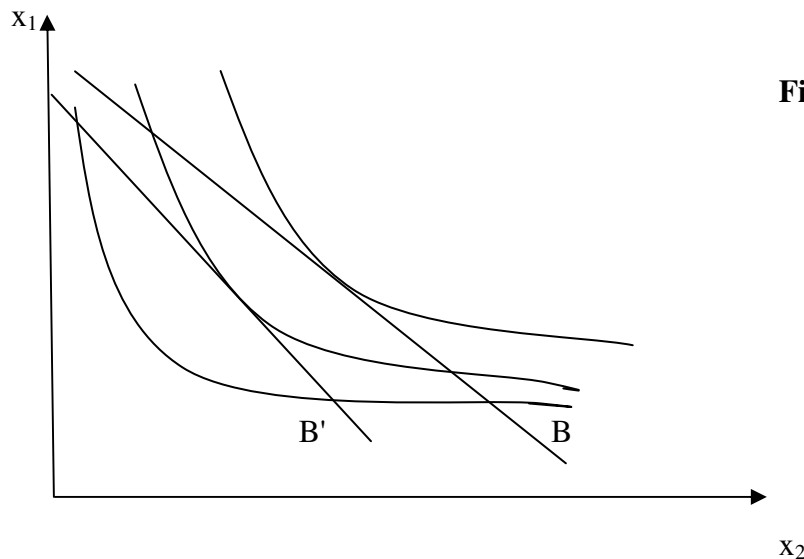


Figure 2

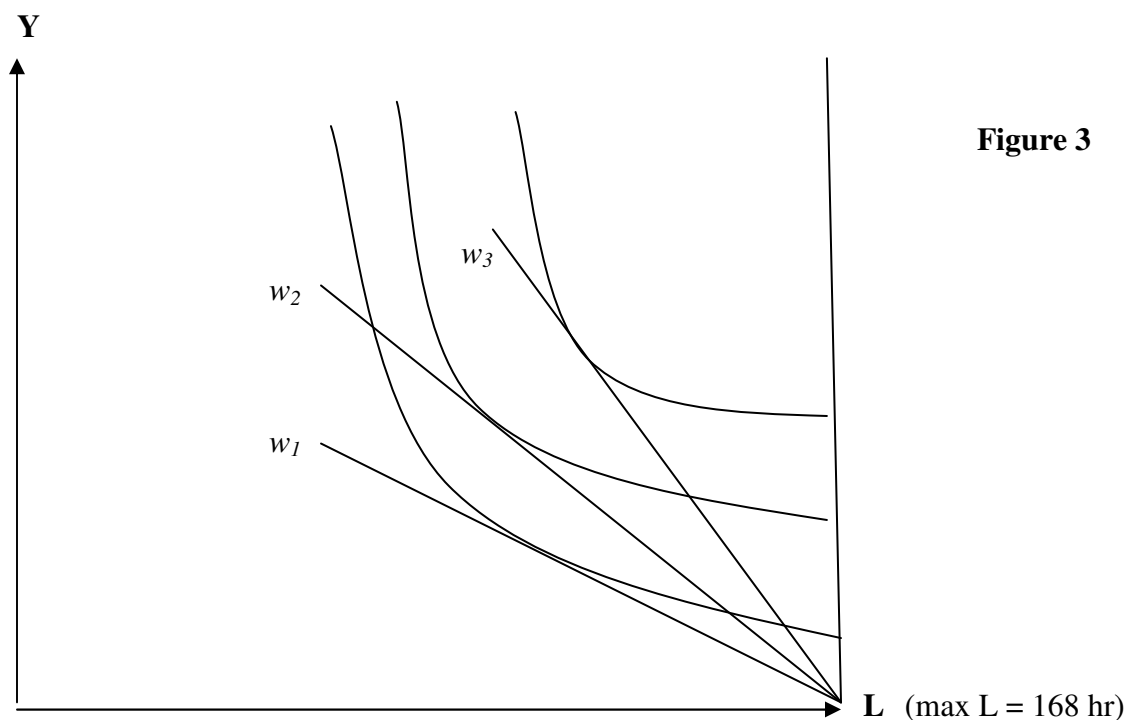
If, instead, the vice of gluttony has intervened in the life of this consumer, both the indifference curve and the demand curve would shift to the right (more is demanded at the same price). Because the

items mapped in Figures 1 and 2 are human **wants**, personalist economics has nothing further to say about the possibility of **unsatisfied** human **wants**. In that regard, personalist economics does not depart from mainstream economic theory: $\text{demand} = f(\text{price})$.

When it comes to human **needs**, however, the indifference map is of no use because the consumer clearly is not indifferent with regard to one human need versus another. Even so, a human need can be represented simply and successfully by a demand curve that is perfectly inelastic at the precise quantity demanded that is associated with basic or minimum need. Any amount less than that results in **unmet** need. Any amount greater than that is unnecessary: $\text{demand} = f(\text{need})$.

In the case of unmet need that derives from not being able to afford the needed item, intervention may be required provided the consumer involved is not squandering his/her income on human wants. Intervention to address that unmet need might take the form of a transfer payment to make additional income available to the consumer or a mandate imposed on the producers of that item to make it available to the needy consumer at a lower price or entirely without charge.

The impact of moderation on work and leisure also can be handled through indifference curve analysis where leisure hours per week (L) are plotted along the horizontal axis with a maximum limit of 168 (24 hours x 7 days). Weekly income (Y) is plotted along the vertical axis, and different wage rates ($w_1 < w_2 < w_3$) are represented as different opportunity lines. This kind of analysis produces both a demand curve for leisure and a supply curve for labor because any weekly hours not spent in leisure are spent in work. Put differently, every additional hour of work makes for one less hour of leisure. See Figure 3.



Source: Joseph McKenna, *Intermediate Economic Theory*, New York: The Dryden Publishers, 1958, p. 141

A higher wage is represented by a steeper opportunity line. In general, a worker supplies more hours of work and demands fewer hours of leisure when the wage rate is higher. However, when the wage rate is sufficiently higher, the worker demands more hours of leisure and supplies fewer hours of work but still enjoys a higher weekly income. The result is the backward bending supply curve of labor. See Figure 4 where Y_h represents the hourly wage and W_h represents the number of hours of work. The exact shape of the backward bending supply curve depends on the income and substitution effects related to changes in the wage rate.

Moderation with regard to leisure -- the supply curve of labor shifts to the right where more hours of work are supplied at any given wage rate (see Figure 4) -- can be represented by a new indifference map (see again Figure 3). Thus, at any given wage rate, fewer hours of leisure are demanded.

Moderation regarding labor can be represented in similar fashion using a different indifference map. Accordingly, the supply curve of labor shifts to the left where at any given wage rate fewer hours of labor are supplied and more hours of leisure are demanded. Moderation, in other words, involves finding the **golden mean** between too much work/too little leisure and too little work/too much leisure.

With the usual full-time workweek defined as anywhere from 35 to 48 hours, more than half of the week's 168 hours are taken up with leisure activities. What goes into those hours depends very much on the unique circumstances of every human person. Leisure could include activities as varied as hobbies, entertainment, child care, rest, participation in community organizations, prayer and worship services, health care appointments, and social networking. At times it is difficult to differentiate between activities that are properly regarded as consumption versus leisure. Work, too, differs from person to person, including activities such as commuting, on-the-job training, volunteering, business travel, conferences, and mentoring.

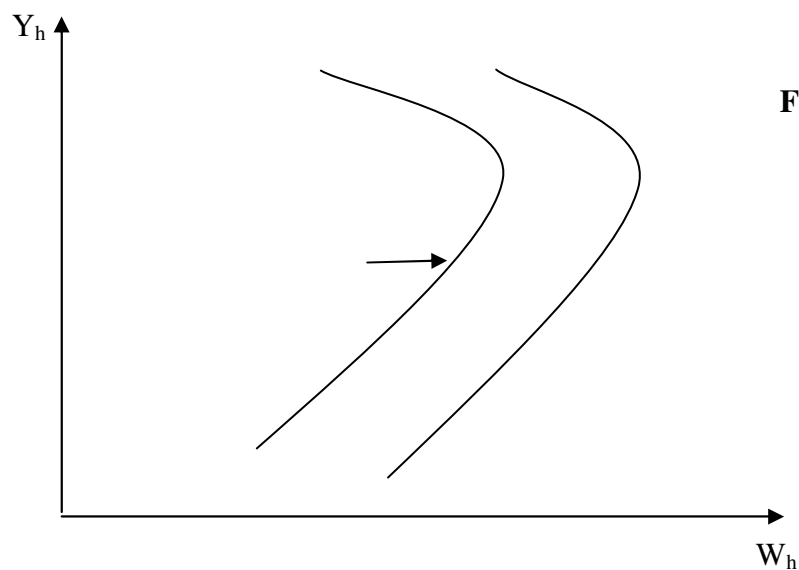


Figure 4

One of the important logical inconsistencies in mainstream economic theory is that there is no place

for human **needs** in microeconomics even though **unmet need** is examined in macroeconomics as poverty. To explain, unmet need regarding consumption is defined and measured mainly in terms of a comparison of the consumer's income to (a) the money required to purchase a basket of items objectively identified as basic needs, or (b) the income of others. The former is identified as an absolute standard of poverty and the latter as a relative standard.

The **unmet need** for work is defined and measured in terms of the lack of work or simply unemployment. We have not proceeded to the point where unmet leisure is recognized as a problem in conventional economic theory. However, anecdotally we know of persons who are exhausted and terribly in need of rest. Further, and most importantly for our purposes, limits on the number of weekly hours of work reinforce the **need** for days of rest, and vacation leave confirms the need for longer periods of rest. In this matter, moderation plays an important role.

Mainstream economic theory has not come to grips with the limits on work that derive sensibly from moderation because conventional economics defines leisure as "time spent not working." Personalist economics sees leisure as critically important to integral human development and human perfection **wherein maximizing IHD leads to human perfection.**

Aside from Divine and Dempsey, the two principals largely responsible for establishing the Catholic Economic Association in 1941 and constructing its intellectual foundations, no one in economics to our knowledge has suggested that integral human development is the most important purpose of any economic system. In this regard, we have suggested that maximizing integral human development can be incorporated into economic theory through a function that presents human capital, social capital, material well-being, and personalist capital as the independent factors driving integral human development.

Final Remarks.

In personalist economics the economic agent is an active, dynamic, creative, human person who is at once a social being and an individual being, who differentiates human material needs from wants, and who has a dignity above and beyond instrumental value. This anthropological conception radically contrasts with the conventional **homo economicus** as an atomized and fragmented individual. By linking integral human development to the capability set of human capital, social capital, material well-being, and personalist capital, personalist economics supports Sen's capability approach and demonstrates the social, reflexive, and committed nature of the economic agent. Personalist economics also adopts Schumpeterian phenomenological arguments in favor of the agent's active, dynamic, and creative characteristics.¹

¹Personalist economics argues that the **acting person** in effect originated with Schumpeter who according to Waters "restored the human person as the dynamic factor in the expansion of economic activity" and who thereby contributed to the change-over from the passive economic agent of mainstream economics to the active agent of personalist economics. See William R. Waters, *Entrepreneurship, Dualism, and Causality: An Appreciation of the Work of Joseph A. Schumpeter*, Ph.D. dissertation, Department of Economics, Georgetown University, Washington, D.C. 1952, editor's note. Accessible with different pagination than in the original at www.mayoresearch.org under "PUBLICATIONS."

*Human personality is described as an evolutionary and interactive process from birth through death. This process is connected with a person's understanding of the ultimate meaning of human existence. Human personality is related to a person's response to innate questions such as who created him/her, why he/she is in the world, what he/she will become after death, why evil exists, and so forth. In personalist economics, these questions determine the specific approach one takes in all human activities. Hence, natural morality is intertwined with integral human development. If one behaves virtuously, he/she develops more fully as a person, and becomes more esteemed by human community. If one behaves viciously, his/her development as a person falls short of its full potential and he/she becomes less esteemed by human community. Although a virtuous action may not always achieve its intended purpose, it can contribute to human **happiness** because it comes from the "inner voice" of the conscience that recognizes moral right from wrong in the decision-making process. Although free-rider and vicious actions may at times achieve their intended purpose, they basically lead to a person's unhappiness because they limit actions to apparent and earthly satisfaction without regard to any transcendental values.*

*Personalist economics treats the moral significance of human actions as endogenous elements of economic analysis. Consumption, work, and leisure are not conceived as morally neutral activities. One consumer good may have different effects on personalist capital than another and, thus, on integral human development. A consumer good used to meet a human need has an opportunity-cost **set at zero** because it is strictly connected to elementary human rights. A consumer good can satisfy a human want or meet a human need. A consumer good that addresses a human want can improve or diminish integral human development. A person can acquire consumer goods that enhance IHD, such as nutritious food, cultural trips, educational courses. Conversely, a person can acquire consumer goods that diminish IHD, such as cocaine, adult sex toys, pornographic movies.*

Likewise, a person can spend leisure time in re-energizing and re-empowering activities that increase IHD, such as charitable work, participation in community's organizations, and rest. But he/she can also spend leisure time in stressful or useless activities that reduce IHD, such as deliberately participating in life-threatening sports, engaging in idle gossip, bullying or harassing others.

Finally, work too has an impact on IHD. It has a positive effect, for example, whenever the worker reports to work on time, is prepared for the work at hand, performs the work assigned cheerfully and efficiently, and offers suggestions that lead to new and better products and production processes. Work has a negative effect on IHD, for instance, whenever the worker reports to work late, is not prepared for the work at hand, performs the work assigned grudgingly and inefficiently, and makes no suggestions on how to improve the product or work process or, worse yet, sabotages the production process.

Human perfection refers to the maximization of integral human development through the three principal economic activities of consumption, work, and leisure. In this regard, integral human development is a function of human capital, social capital, material well-being, and personalist capital. What characterizes personalist economics is a focus on the practice of virtues and avoidance of vices as the pathway to human perfection. It follows that maximizing personalist capital contributes to the ultimate purpose of human society -- the perfection of the persons who

form the basis of that society. To frustrate that purpose always is wrong.¹

¹ Daniel J. O'Neil, "Evolving and Implementing a Social Economics: The American Catholic Experience," *International Journal of Social Economics*, Volume 30, Number 12, 2003, p. 1274.

REVIEW SECTION: TOPIC 32

Central Concepts:

- integral human development
- economic agent
 - homo economicus*
 - acting person*
- human perfection
- capital
 - personalist
 - human
 - social
- human activity in economic affairs
 - consumption
 - work
 - leisure
- levels of human action and associated freedom
 - physical
 - unrestricted
 - self-determination
- virtue
 - cardinal virtues
 - moderation
- vice
- innate questions
- Aristotle's golden mean
- human want
- human need

Important Questions:

- What is the ultimate purpose of human society?
- How is personalist capital acquired? How is it lost?
- In economic affairs, what specific factors determine integral human development?
- How is human perfection linked to integral human development?
- How does moderation limit the three principal economic activities of consumption, work and leisure?
- Is Aristotle's golden mean the exact midpoint between the extremes of too little and too much?
- In economic affairs, how does engagement in virtuous activities and avoidance of vicious activities contribute to integral human development?

(continued on following page)

True/False:

- a. The ultimate purpose of human society is the production of **more** goods and services.
- b. Personalist capital is acquired by acting virtuously in economic affairs.
- c. Properly understood, the virtue of moderation provides limits to the three principal economic activities of consumption, work, and leisure.
- d. Human perfection is achieved by maximizing integral human development.

Mark your answer below.



_____ Item a is true, items b, c, and d are false.

_____ Items a and b are true, items c and d are false.

_____ Item a is false, items b, c, and d are true.

TOPIC 33 ECONOMIC FREEDOM

To demonstrate the central important of economic freedom to a market economy and how that freedom is best protected by a personalist economy.

*In economic affairs, as in other human activity, there are three kinds of freedom: freedom **from**, freedom **to**, and freedom **for**.¹ Freedom **from** means the absence of any physical constraint on or psychological compulsion regarding a person's acting. For example, freedom **from** a federal government that does not allow drilling for oil offshore; freedom from a state government that licenses casino gambling knowing that many who gamble are addicted. Freedom **to** refers to the freedom to do as one pleases, to buy and sell, to produce and consume, to borrow and lend, to hire and work, to invest, to innovate, and the like. Freedom **for** is the freedom to become a better person, to strive for human perfection by doing good and avoiding evil, by for instance submitting to the demands of the three principles of economic justice -- commutative, distributive, contributive.² Freedom **for** is called perfect freedom by some.³ We prefer to call it heroic freedom and is attested to in economic affairs for instance by the first-responder, the blood and living organ donor, and the whistleblower.*

In the following, we are concerned with three questions. First, what are the ways in which decisions are made in economic affairs? Second, what role does economic freedom play in a market economy? Third, how important is economic freedom in a market economy?

*The answer to the first question comes from Joseph Becker reinforced by William Waters. The answer to the second is based on a shortened version of Topic 3 on how a market system actually works. The answer to the third originates with John Paul II's extended remarks on economic freedom particularly in *Centesimus Annus*.*

What Are the Ways in Which Decisions Are Made in Economic Affairs?

The conventional wisdom regarding decision-making in economic affairs is that there are only two ways: the individual acting alone and the state acting collectively. Efforts to identify a "third way," which have occupied some Catholic social economists over the years, have been largely abandoned.

¹ Our understanding of the different types of freedom was greatly enhanced by: Germain Grisez and Russell Shaw, *Beyond the New Morality: The Responsibilities of Freedom*, Notre Dame, IN: University of Notre Dame Press, 1974, pp. 1-10; and Avery Dulles, "John Paul II and the Truth about Freedom," *First Things*, 1995, August/September, pp. 1-9.

² Commutative justice, often referred to as the principle of equivalence, requires the parties to a marketplace or workplace transaction to exchange things of equal value and impose equal burdens on one another. Distributive justice requires the superior to distribute the benefits and burdens of the group among his/her subordinates in some equal or proportional fashion. Contributive justice requires that insofar as a member of a group receives benefits from belonging to that group he/she must maintain and support that group. For more on the three principles of economic justice, see Topic 2.

³ Dulles, p. 7.

We are convinced, however, that there is a third way as indicated most effectively by Joseph Becker more than 60 years ago.

Society makes three major choices in allocating functions to its members: it chooses between the individual and the group, between the private and the public group, and between more and less democracy within groups. In each instance the principle of subsidiarity is a proper guide to the correct choice because the members of human society are persons, with the perfections and imperfections of persons. That is to say – taking the three justifications for the principle of subsidiarity in inverse order – rulers are not always able to do what is best for their subjects; even when they are able, they are not always willing; even when they are able and willing, the members may prefer to do it for themselves, for even good government is not a substitute for self-government when the governed are persons.¹

Becker adds that subsidiarity implies that “decision making should be shared as widely as possible” and that in political affairs “maximum democracy means full and direct participation by every member in every decision the group makes”.²

Years later William Waters found it necessary to underscore the third way because even prominent Catholic social economists were losing sight of it.

[Catholic] principles dictate a structure or preferred model, negatively if not positively. For example, market liberalism or laissez-faire, which assumes automaticity, is excluded by the principles; so is centrally planned socialism – subsidiarity does not allow it. By the time logic expunges most economic systems, one is left with an economy of group decision making, a solidarist one.³

Though it constrains economic freedom, the third way -- private group decision-making – limits the need for the state to intervene in economic affairs thereby protecting the individual from an even greater loss of economic freedom.

*These three ways to organize economic affairs are known as capitalism, socialism, and solidarism⁴ In addition to Becker and Waters, supporters of solidarism or intermediary bodies include Heinrich Pesch, Joseph Schumpeter, Goetz Briefs, Rupert Ederer, Franz Mueller, and Bernard Dempsey. **Our strong preference is to refer to solidarism as a personalist economy.***

Capitalism is an economic system constructed around a market structure that is based on the premise that private individuals know their own needs and wants and therefore should be free to

¹ Joseph M. Becker, *Shared Government in Employment Security: A Study of Advisory Councils*, New York: Columbia University Press, 1959, pp. 8-9, emphasis added.

² Becker, pp. 4-5.

³ William R. Waters, “A Comment on ‘Social Economics and the New World Order: A Roman Catholic Perspective’,” *Forum for Social Economics*, Volume 23, Number 1, 1993, Fall, p. 34, emphasis in original.

⁴ Solidarism is most closely associated with the work of the German Jesuit economist Heinrich Pesch. For more about his work see Ederer’s English language translation of Pesch’s *magnum opus Lehrbuch der Nationalökonomie/Teaching Guide to Economics*, by Heinrich Pesch translated by Rupert J. Ederer, The Edwin Mellen Press, ten-volume set, 2002-2003.

*control the decision-making process that allows them to best meet those needs and satisfy those wants. Capitalism is reinforced by the philosophy of individualism that originated in the 17th-18th century Enlightenment wherein the freedom of the individual is of utmost importance. Libertarians assert that no limits should be imposed on the freedom of individuals who by serving their own interests **ipso facto** serve the common good. Private groups are seen as collusive and therefore destructive of individual freedom and the common good. Public groups are seen as a direct threat to the freedom of individuals.*

Socialism is an economic system in which decision-making is located in a public authority and is based on the premise that private individuals do not always know their own needs and wants and that the common good is not well-served by individual freedom. This system insists on public control of decision-making in order to properly address human needs and wants and to protect and preserve the common good. Socialism is reinforced by a collectivist philosophy such as Marxism, fascism, or democratic socialism that have one thing in common: economic resources are best allocated by a system that constrains individual freedom and replaces markets with centralized decision-making as to how economic resources are allocated. Private groups are seen as a threat to public control.

*In **Capitalism, Socialism, and Democracy**, Schumpeter called attention to the growing influence of socialism in economic affairs.*

... I define (centralist) socialism as the organization of society in which the means of production are controlled, and the decisions on how and what to produce on who is to get what, are made by public authority instead of by privately-owned and privately-controlled firms. All that we mean by the March into Socialism is, therefore, the migration of people's economic affairs from the private into the public sphere.¹

In 1961 Waters called attention to the connection between economic freedom and Schumpeter's March-into-Socialism warning.

*... there is another important relation between Catholic social thought and Schumpeter's explanation of the passing of capitalism. Since the kind of socialism expected is characterized by centralized, autonomous, public control, we must anticipate the loss of one kind of economic freedom, viz., the freedom of private individuals and groups to make economic decisions; and this freedom, it need not be emphasized, is most important in Catholic thinking. Therefore, the work, **Capitalism, Socialism and Democracy**, alerts the Catholic, as no other piece of literature does, to the importance of arresting the tendency to socialism.²*

A personalist economy is an economic system that is constructed around a market structure in which decision-making is shared by private individuals, private groups, and public authorities but is located preferentially in persons who notwithstanding their human imperfections have the necessary competency to know their own needs and wants and therefore should be largely free to control the

¹ Joseph A. Schumpeter, **Capitalism, Socialism, and Democracy**, third edition, New York: Harper & Brothers Publishers, 1950, p. 415.

² William R. Waters, "Schumpeter's Contributions and Catholic Social Thought," *Review of Social Economy*, Volume XIX, Number 2, 1961, September, p. 136.

process that helps them meet those needs and satisfy those wants. At times, however, private individuals are unable to address their own needs and wants as for example when market forces relocate economic resources in a way that creates local pockets of unemployment and poverty or individuals find themselves at cross purposes as with disputes between employers and workers. Under those circumstances, a personalist economy proposes the establishment of private groups such as supra-firm alliances to intervene and help these persons sort through the issues that are keeping them from serving their own best interests. These private groups are grounded in solidarity in that they arise from agreement to pursue a specific objective not as individuals but through private group action. This action is not collusive in nature as long as the parties involved are not motivated by the opportunities to exploit others not included in the group.

These private groups represent the implementation of the principle of subsidiarity that underscores the importance of intermediary organizations between the human person on the one hand and the much more powerful public authority on the other hand. They have the effect of protecting the human person from a heavy-handed public authority and by establishing themselves closer to that person are able to provide greater opportunities for that person to participate actively and freely in the decision-making process. In a personalist economy, public authorities intervene only when the individual and private-group decision-making process break down.

*Shortly before his death in January 1950 Schumpeter spoke openly and approvingly of the reconstruction of the economy along the lines suggested in **Quadragesimo Anno** as an “alternative system to socialism that would avoid the ‘omnipotent state’” and in a private conversation with Goetz Briefs urged him and by implication his colleagues in the Catholic Economic Association to design such an alternative.¹*

Many years later Waters set down the hard-core differences between neo-classical economics, which serves as the foundation to our understanding of the capitalist system, and a personalist economy. As to neo-classical economics, there are four hard-core principles. First, the economy is self-regulating. Second, the basic unit of the economy is the utility-maximizing individual who functions in a competitive economic environment. Third, by virtue of humankind’s faculty of reason, economic science provides certainty regarding the workings of the economy. Fourth, behavior in economic affairs is regulated contractually as for example in the wage contract and the sales contract.²

As to a personalist economy, there are four hard-core principles. First, economic decision-making is regulated by private institutions and groups in which the public authority is limited by the principle of subsidiarity. Second, the basic unit of the economy is the person whose behavior is much more erratic than the utility-maximizing individual, at times acting rationally and at other times non-rationally because the person functions in an economic environment that is at once cooperative and competitive. Most importantly, however, the person has a sacred dignity that cannot be diminished

¹ Waters 1961, pp. 136-137.

² William R. Waters, “Social Economics: A Solidarist Perspective,” *Review of Social Economy*, Volume XLVI, Number 2, 1988, October, pp. 114-115. In this article Waters did not set forth the hard-core principles of socialism probably because he was an open advocate of solidarism.

in any way whereas the individual of neo-classical economics is valued instrumentally. Third, a personalist economy rejects the determinateness of neo-classical economics and identifies economics not as a natural science but a moral science. Fourth, most fundamentally the rights of the person are not contractual in nature. They are instead inalienable because they derive from their sacred dignity.

What Role Does Economic Freedom Play in a Market Economy?

The five economic processes of production, distribution, exchange, consumption, and investment are organized in a market economy¹ by three principles: competition, cooperation, and intervention. The first two are activating principles supplying energy to economic affairs. The third organizing principle – intervention – operates in the limiting mode acting as a force to limit certain abuses that may attend vigorous competition and cooperation.

Competition is the human disposition to undertake certain tasks individually for the individual reward. Cooperation is the human disposition to undertake certain tasks collectively because they cannot be done at all or as well by an individual working alone.

The limiting principle of intervention can be operationalized by a public agency or a private group. For example, the U.S. Department of Labor enforces the federal minimum wage limiting employers to paying their workers no less than the minimum. Private industry groups have intervened many times over the years to forge agreements on standards for specific items such as standard sizes for shoes, clothing, and tires, standard grades to identify different quality lumber and cuts of beef, standard factors to identify differences in insulation material and sun screen. And professional societies such as for lawyers, accountants, and engineers establish standards of professional practice and ethical conduct for their members. The effect of these standards is to limit producer/professional freedom to create individual standards that if carried through by all producers/professionals would lead to confusion and possibly chaos.

The effective utilization of the three organizing principles of competition, cooperation, and intervention requires the affirmation of a particular value across society. Competition clearly depends on society valuing economic freedom because how does competition come into play if human beings do not enjoy the freedom necessary to compete? Cooperation depends on the social value of community in the sense that tasks will not be undertaken collectively if the persons who are assigned those tasks are not willing to come together as a community or work as one. Intervention depends on the social value of equality if that intervention is to be successful and long-lasting.

But there is a price to pay for each of the three social values of freedom, community, and equality. Each one depends on a human beings faithfully practicing one of the three principles of economic justice. Economic freedom is undermined when commutative justice is violated because persons who have been “ripped off” lose some of their freedom to act and compete in economic affairs. Community cannot exist without the contributions of their members, without faithful adherence to contributive justice. Equality is denied when distributive justice is flaunted by, say, public officials who discriminate against some and play favorites with others.

¹ Hereafter, a market economy is one in which decision-making is largely in the hands of private individuals acting alone or private groups acting collectively.

In addressing economic freedom, one other principle requires our attention. The principle of subsidiarity states that (1) larger, stronger elements of society should not take about the functions of smaller, weaker elements, but instead (2) should help the smaller, weaker elements function more effectively. Subsidiarity protects the individual from an overreaching government and helps assure that he/she will be able to act freely in economic affairs.

By affirming a strong preference for private enterprise compared to public enterprise, the principle of subsidiarity effectively decentralizes ownership and control of economic activities that in turn (1) lead to a greater diversity of goods and services produced because entrepreneurs have a freer hand; (2) a smaller risk that large-scale mistakes will be made because in general private enterprises are smaller than public enterprises; and (3) private enterprises will be more responsive to their customers because they are driven by the profit motive.

Perhaps no one depends more on economic freedom in economic affairs than the entrepreneur because the entrepreneur precipitates change in the workplace and in the marketplace. The entrepreneur triggers change in the following five ways: introduction of a new good or service; penetration of a new market; utilization of different materials in the production process; introduction of a new process of production; and development of a new way of organizing, managing, administering the business enterprise.

Entrepreneurs are dogged in the pursuit of their new ideas, and simply do not give up in the face of opposition. Entrepreneurs are visionary in the sense that they see opportunities and possibilities where others see nothing beyond the present. Entrepreneurs often are associated with small companies including firms that they themselves established specifically to implement their innovational ideas. They are driven at times by the survival needs of the company, but are not always successful. However, they are more likely to accept the risk of failing and to try again in a culture where failure in business does not spell personal failure and they are free to act in economic affairs.

Successful entrepreneurs engage in a dynamic process that has two major effects. First, they create new business enterprises, new jobs, new resource requirements that translate into new opportunities for workers, resource holders, suppliers, investors, and communities. At the same time, they destroy old business enterprises, old jobs, established supplier networks that translate into financial hardship or ruin for other workers, resource holders, investors, and communities.

How Important is Economic Freedom in a Market Economy?

John Paul spoke eloquently in 1987 about freedom on the occasion of his meeting in Miami with President Reagan to celebrate the bicentennial of the U.S. Constitution.

Among the many admirable values of this nation there is one that stands out in particular. It is freedom. The concept of freedom is part of the very fabric of this nation as a political community of free people. Freedom is a great gift, a great blessing of God.

From the beginning of America, freedom was directed to forming a well-ordered society and to promoting its peaceful life. Freedom was channelled [sic] to the fullness of human life, to the

*preservation of human dignity and to the safeguarding of all human rights. **An experience in ordered freedom is truly a cherished part of the history of this land.***

*This is the freedom that America is called to live and guard and to transmit. She is called to exercise it in such a way that it will also benefit the cause of freedom in other nations and among other peoples. The only true freedom, the only freedom that can truly satisfy, is the freedom to do what we ought as human beings created by God according to his plan. It is **the freedom to live the truth of what we are and who we are** before God, the truth of our identity as children of God, as brothers and sisters in common humanity. That is why Jesus Christ linked truth and freedom together, stating solemnly: "You will know the truth and the truth will set you free" (Io 8, 32). All people are called to recognize the liberating truth of the sovereignty of God over them both as individuals and as nations.¹*

*John Paul's remarks on freedom extended to economic freedom in his 1991 encyclical **Centesimus Annus** and included the following characteristics of an acceptable economic system: subsidiarity and solidarity; humankind created for freedom; freedom and the universal destination of the goods of the world; economic freedom is only one element of human freedom; and the Church and freedom. For that reason, we quote selectively from that encyclical and at some length.*

Our attention turns first to his comments on the centrality of freedom to human nature and his warning with regard to the violent suppression of self-interest.

Moreover, man, who was created for freedom, bears within himself the wound of original sin, which constantly draws him towards evil and puts him in need of redemption. Not only is this doctrine an integral part of Christian revelation; it also has great hermeneutical value insofar as it helps one to understand human reality. Man tends toward good, but he is also capable of evil. He can transcend his immediate interest and still remain bound to it. The social order will be all the more stable, the more it takes this fact into account and does not place in opposition personal interest and the interests of society as a whole, but rather seeks ways to bring them into fruitful harmony. In fact, where self-interest is violently suppressed, it is replaced by a burdensome system of bureaucratic control which dries up the wellsprings of initiative and creativity. When people think they possess the secret of a perfect social organization which makes evil impossible, they also think that they can use any means, including violence and deceit, in order to bring that organization into being. Politics then become a "secular religion" which operates under the illusion of creating a paradise in this world. But no political society – which possesses its own autonomy and laws – can ever be confused with the Kingdom of God.²

*In **Sollicitudo Rei Socialis**, which was released four years before **Centesimus Annus**, John Paul makes the extraordinary statement that "... one must not overlook that **special form of poverty** which consists in being deprived of fundamental human rights, **in particular** the right to religious freedom and the right to **freedom of economic initiative**."³*

Notice John Paul's conditional approval of the market economy constructed on freedom and his rejection of socialism as an alternative even in those cases where private capital absolutely controls the decision-making process.

¹ John Paul II, "Meeting with the President of the United States of America Mr. Ronald Reagan, Address of his Holiness John Paul II," Vizcaya Museum, Miami, September 10, 1987, §3, emphasis in the original, available at www.vatican.va.

² John Paul II, *Centesimus Annus*, 1991, §25, emphasis in original, available at www.vatican.va.

³ John Paul II, *Sollicitudo Rei Socialis*, 1987, §42, emphasis added, available at www.vatican.va.

*In this sense, it is right to speak of a struggle against an economic system, if the latter is understood as a method of upholding the absolute predominance of capital, the possession of the means of production and of the land, in contrast to the free and personal nature of human work. In the struggle against such a system, what is being proposed as an alternative is not the socialist system, which in fact turns out to be State capitalism, but rather **a society of free work, of enterprise and of participation**. Such a society is not directed against the market, but demands that the market be appropriately controlled by the forces of society and by the State, so as to guarantee that the basic needs of the whole of society are satisfied.*¹

Elsewhere in *Centesimus Annus*, John Paul centers attention on the fundamental error of socialism.

*Socialism considers the individual person simply as an element, a molecule within the social organism, so that the good of the individual is completely subordinated to the functioning of the socio-economic mechanism. Socialism likewise maintains that the good of the individual can be realized without reference to his free choice, to the unique and exclusive responsibility which he exercises in the face of good or evil. Man is thus reduced to a series of social relationships, and the concept of the person as the autonomous subject of moral decision disappears, the very subject whose decisions built the social order. From this mistaken conception of the person there arise both a distortion of law, which defines the sphere of the exercise of freedom, and an opposition to private property. A person who is deprived of something he can call “his own”, and of the possibility of earning a living through his own initiative, comes to depend on the social machine and on those who control it. This makes it much more difficult for him to recognize his dignity as a person, and hinders progress toward building up of an authentic human community.*²

*John Paul’s condemnation of socialism derives importantly from the crisis in Eastern and Central Europe in 1989 where two factors played a critical role: “the violation of the rights of workers” and “the violation of the human rights to private initiative, to ownership of property, and to **freedom in the economic sector**.”³ The historical record regarding socialism, he notes, is that human alienation has not been reduced but collectivism has only added to it. The state, he argues, is to be guided by two principles in economic affairs: subsidiarity to assure economic freedom and solidarity to defend the weak, limit the autonomy of the parties who determine conditions in the workplace, and provide basic support for jobless workers.*⁴

Rather than condemning profits, John Paul offers the following conditional approval.

*The Church acknowledges the legitimate **role of profit** as an indication that a business is functioning well. When a firm makes a profit, this means that productive factors have been properly employed and corresponding human needs have been duly satisfied. But profitability is not the only indicator of a firm’s condition. It is possible for the financial accounts to be in order, and yet for the people – who make up the firm’s most valuable asset – to be humiliated and their dignity offended. Besides being morally inadmissible, this will eventually have negative repercussions on the firm’s economic*

¹ John Paul 1991, §35; emphasis in original.

² John Paul 1991, §13.

³ John Paul 1991, §§23, 24; emphasis added.

⁴ John Paul 1991, §§41, 15.

*efficiency. In fact, the purpose of a business firm is not simply to make a profit, but is to be found in its very existence as a **community of persons** who in various ways are endeavouring to satisfy their basic needs, and who form a particular group at the service of the whole of society. Profit is a regulator of the life of a business, but it is not the only one: **other human and moral factors** must also be considered which, in the long term, are at least equally important for the life of a business.*¹

Economic freedom is the foundation of the modern business economy.² Further John Paul re-affirms the Church's commitment to freedom as a necessary condition to assure the "transcendent dignity of the person."³ Even so, he recognizes that freedom in economic affairs is not absolute. Economic freedom, he asserts, is only one element of human freedom. When economic life becomes absolutized, that is

when man is seen more as a producer or consumer of goods than as a subject who produces and consumes in order to live, then economic freedom loses its necessary relationship to the human person and end up by alienating and oppressing him.⁴

While the right of private property assures that the goods produced belong to the persons who produced them and who thereby have a rightful claim on the use of those goods, that claim is not absolute. There is a higher claim on their use based on the principle of the universal destination of the earth's goods that states that the material goods of this world are intended for the use of all humankind and are not governed and protected absolutely in their use by the right of private property.⁵

Concluding Comments

John Paul rejects the notion that the Church has a model for organizing economic affairs. Instead he argues that economies must be organized "through the efforts of all those who responsibly confront concrete problems in all their social, economic, political, and cultural aspects, as these interact with one another."⁶ In this regard he underscores the importance of the market, private enterprise, the common good, economic freedom, subsidiarity, solidarity, worker participation in enterprise decision-making, the universal destination of the world's goods, the legitimacy of profit; and rejects socialism out of hand.⁷

¹ John Paul 1991, §35; emphasis in original.

² John Paul 1991, §32.

³ John Paul 1991, §46.

⁴ John Paul 1991, §39.

⁵ John Paul 1991, §§30, 34.

⁶ John Paul 1991, §43.

⁷ John Paul 1991, §§43, 48, 15, 30, 35; §§13, 35.

*How does capitalism -- John Paul's preference is business economy, market economy, free economy -- measure up as an acceptable system for organizing economic affairs? John Paul's answer, to simply, is that if under such an economic system freedom is absolute and its ethical and religious dimensions are denied it is not acceptable. If, on the other hand, economic freedom is not absolute, where it is constrained as we have indicated in the foregoing, that kind of economic system is acceptable.*¹

*How does a personalist economy measure up? Unlike capitalism and socialism, John Paul does not refer directly to a personalist economy -- the third way of organizing economic affairs. However, twice in **Centesimus Annus** John Paul addresses the significance of bodies in the social order between the individual on one hand and the state on the other.*

*... the social nature of man is not completely fulfilled in the State, but is realized in various intermediary groups, beginning with the family and including economic, social, political and cultural groups which stem from human nature itself and have their own autonomy, always with a view to the common good.*²

*Apart from the family, other intermediate communities exercise **primary** functions and give life to specific networks of solidarity. These develop as real communities of persons and strengthen the social fabric, preventing society from becoming an anonymous and impersonal mass, as unfortunately often happens today. It is in interrelationships on many levels that a person lives, and that society becomes more "personalized."*³

*Those of us who study economic affairs need to recognize that besides capitalism and socialism there is a third way -- a personalist economy -- to organize economic affairs. Waters, as cited earlier, asserts that the logic of Catholic principles actually **dictates** a personalist system.⁴ And John Paul with others has supplied a modern philosophical foundation for a personalist economy -- personalism -- to replace the absolutist individualism of the capitalist system and the suffocating collectivism of socialist regimes that he condemns in **Centesimus Annus**. Keeping all of the essential characteristics enumerated by John Paul including the market mechanism, economic freedom, and intermediary groups, and recognizing its contemporary rootedness in personalism, we have changed its name to a **personalist economy** where instead of referring to the economic agent as **homo economicus** we substitute the **acting person**.*

*Much work must be done to accumulate the evidence indicating that a personalist market economy offers a viable and practical "third way". In this regard, we have uncovered a few examples of cooperating intermediary bodies at work in the U.S. economy. For example, **PRIDE** of St. Louis, which was established in 1972, is a voluntary labor-management organization in the construction industry that meets monthly to identify and deal with stress points that interfere with the completion*

¹ John Paul 1991, §42.

² John Paul 1991, §13.

³ John Paul 1991, §49; emphasis added.

⁴ Waters 1993, p. 34.

*of building projects on time and within budget. It is an excellent example of private group decision-making that seeks to find ways to deal with problems in the construction industry that cannot be addressed by private individual decision-making and eliminates the need for public group intervention.*¹

*See Topic 30 for more on subsidiarity and cooperating business alliances including Advanced Book Exchange, Louisiana Offshore Oil Port, Business Software Alliance, and PRIDE. Other instances are needed that demonstrate the diversity of a **personalist economy** not only in the United States but in other countries as well. With its history of producer cooperatives, which emphasize cooperation in economic affairs, Italy offers considerable promise.*

The most important characteristic of these alliances is a separate administrative organization that subordinates the principle of competition to the principle of cooperation in a dynamic decision-making process that is positive-sum in that the alliance seeks to achieve gains for all of the parties involved whether they are directly represented in the organization or not.

*At a time when big government is getting bigger, creating even greater distance between decision-makers and the persons effected by their decisions, intermediary alliances based on non-collusive cooperation such as PRIDE and LOOP offer promise for slowing the **growth of big government** thereby helping preserve the free exercise of economic initiative and demonstrating the viability of a **personalist economy**.*

*A **personalist economy** represents a viable option to both capitalism and socialism because it is organized around private groups positioned between the individual person and the more powerful state, groups that emerge due to the inability of the individual person to adequately address specific economic problems. While economic freedom is the **most important** characteristic of a personalist economy, intermediary groups are its **distinguishing** characteristic.*

¹ See www.prideconstruction.org/english/about.html.

REVIEW SECTION: TOPIC 33

Central Concepts:

- freedom *from*, freedom *to*, freedom *for* (heroic freedom)
- capitalism
- socialism
- solidarism
- personalist economy
- economic processes
 - production
 - distribution
 - exchange
 - consumption
 - investment
- organizing principles
 - competition
 - cooperation
 - intervention
- social values
 - freedom
 - equality
 - community
- principles of economic justice
 - equivalence
 - distributive
 - contributive
- principle of subsidiarity
- intermediary groups
 - alliances
- fundamental human rights
 - religious freedom
 - freedom of economic initiative
- personalist economy

Important Questions:

- What are the three ways in which decisions are made in economic affairs?
- What are the four hard-core principles of neo-classical economics that form the foundation to our understanding of a capitalist economy?
- What are the hard-core principles of a personalist economy?
- Why is the entrepreneur so important to a market economy where decisions are made by private individuals or private groups?
- What role does economic freedom play in a market economy?

(continued on following page)

According to John Paul II, what are the fundamental characteristics of an acceptable economic system?

How important is economic freedom to a market economy?

What is the fundamental flaw of socialism?

Is the right to the profits earned by the enterprise absolute or conditional?

Is the claim to the use of the goods produced through private property absolute or accompanied by a second claim?

What is the distinguishing characteristic of a personalist economy?

True/False:

- a. A personalist economy is simply a type of socialist economy.
- b. The fundamental flaw of socialism is that the individual person is deprived of economic freedom and subordinated to the state.
- c. An economy that is activated by competition and cooperation necessarily embraces the social values of freedom and community respectively.
- d. Profit is necessarily to the proper functioning of a business enterprise in a market economy but is not the only or even the most important purpose of that enterprise.

Mark your answer below.



_____ Item a is true, items b, c, and d are false.

_____ Items a and b are true, items c and d are false.

_____ Item a is false, items b, c, and d are true.

TOPIC 34

THE EIGHTEEN TENETS OF A PERSONALIST ECONOMY

At the risk of oversimplification, but in the interest of providing a summary that is useful to the thoughtful student, a personalist economy is organized according to eighteen tenets of which the first one is the most important.

It is right and proper, if not actually necessary, to conclude this text with a discussion of the eighteen central tenets that constitute the core of a personalist economy. These central tenets, we insist, will endure though others very likely will emerge as we know more about how personalism shapes our understanding of economic affairs. Of these eighteen tenets, however, the first is by far the most important and likely will remain so.

1. The human person is the basic unit of economic decision-making and economic analysis. *Mainstream economics rests solidly on the premise of the individual as the basic unit of the economic decision-making who is governed by the law of nature and acts in a rational, self-interested manner. The common good is achieved by each economic agent pursuing his/her own self-interest by means of self-regulating impersonal forces of the market or simply **the invisible hand**.*

*Personalist economics sees as the basic unit of economic affairs the person who is both an individual being and a social being and at once both matter and spirit. At times, humans act according to the premises of mainstream economics. At other times they act in ways that are emotional, other-centered, and utility-satisficing. The common good is achieved by means of **the visible hand** of human beings acting collectively and, following the principles of solidarity and subsidiarity, through private organizations before turning to government for help.*

*Whereas the **individual** of mainstream economics is a passive, automatic, and predictable utility-maximizing machine, the **person** of personalist economics is a living, breathing, existential actuality who actively engages in economic affairs and is best represented by Schumpeter's entrepreneur.*

*The distinction between individual and person is directly traced to the advancement of human communication from the script stage of the classical economists to the electronic stage of contemporary economics that has profoundly changed human awareness of others and of self. Human beings are not the **never**-changing, predictable individuals of mainstream economics, no different today than they were in an age of drawn-out communication. They are the **ever**-changing, unpredictable persons of personalist economics who inevitably change as they interact with others in an age of instant communication.*

2. Human beings are sacred with rights originating in their very nature. *According to mainstream economics, human worth most fundamentally is determined contractually as for example in the wage contract. Voluntary exchange reinforced contractually is at the very core of a contemporary neo-classical economics which is returning to **laissez-faire** as the ideal economic order. Personalist economics insists instead that humans are sacred and therefore have a status in economic affairs*

wherein their inalienable rights are more fundamental than contracts. They are ends in themselves and never to be seen merely as inputs to be valued instrumentally. Following John Paul II, human persons are made in the image and likeness of God and therefore are very nearly divine.

3. Human beings are both want-satisfying and need-fulfilling. *In their effort to make economics value-free, mainstream economists argue that all consumer behavior is want-satisfying. They do this knowing that if they admit that consumer behavior is also need-fulfilling economics becomes value-laden because need is a normative concept that is defined differently by the persons who use it. For that reason in mainstream principles texts poverty which by definition is a normative concept is addressed separately from consumption as if the two were unrelated. Personalist economics recognizes that consumers are both need-fulfilling and want-satisfying because good economic analysis rests firmly on the foundation of what is real and true and not on what is convenient and contrived.*

4. Meeting the needs of the human body is an intermediate objective of an economic system. *Mainstream economists construct economics around things and thus the efficient utilization of economic resources is the primary criterion by which the performance of an economic system is to be judged. In personalist economics human beings matter more than things and for that reason meeting the needs of the human body is only an intermediate criterion by which an economy is to be assessed. In this regard, personalist economics affirms the preferential option for the poor: those who are neediest are to be served first because even the lowliest among us are very nearly divine.*

The ultimate objective of an economic system is human perfection, which in economic affairs is achieved by maximizing integral human development. Maximizing personalist capital, in turn, contributes to the maximization of integral human development.

Personalist economics perceives consumption, work, and leisure more broadly than does mainstream economics. Goods and services are consumed to meet not just the needs and wants of the human body but inevitably certain needs and wants of the human spirit. Work is for the dual the purpose of (1) earning the income necessary to acquire the needed and desired consumer goods and services, and (2) becoming more fully human by meeting the need to belong and the need to utilize and develop creative skills and talents. Leisure is not just what one does but what one is becoming, and as with work, leisure is seen in a communal and an individualistic context.

*In personalist economics, **having** matters less than **being**. The things one owns are less important than the person one is becoming. In the end, all three principal economic activities -- consumption, work, and leisure -- provide opportunities to acquire the virtues that contribute to personalist capital or the vices that diminish personalist capital.*

5. The acting person/person in action replaces homo economicus. *By effectively denying that humans are embedded in families, communities, neighborhoods, companies, civic organizations, and the like, mainstream economics has constructed a concept of the economic agent -- **homo economicus** -- that is a distortion of human nature. Personalist economics argues forcefully that humans are a union of individuality and sociality, sometimes in harmony, sometimes at odds, requiring a reconciliation of deeply personal conflicts such as between work and family, spending*

and saving. The **person in action** incorporates the sociality of human nature even at the expense of some determinateness in economic analysis because good science begins with the right constructs. Constructing economic agency around the **acting person** makes for a microeconomics based on human individuality and a macroeconomics based on human sociality and indicates the direction to be taken to finally create a unified body of economic theory.

6. Economics is a value-laden discipline that struggles to sort out the uncertainty in economic affairs. To mainstream economists, human reason unlocks the mysteries of the economic order that are expressed with certainty in determinate models, giving their economics the aura of an authentic positive science like physics. In personalist economics, the principle of certainty is not accepted *carte blanche*. Some indeterminateness is inevitable because human beings are not entirely knowable and their behavior is not completely predictable. Further, human beings alone are moral agents because humans alone have the intelligence and free will to make ethical choices. Economics therefore is a normative discipline, one that is value-laden as opposed to value-free. The challenge to the working economist in this regard is to know the difference between the facts discovered through systematic inquiry and the values that one attaches to those facts.

7. Decision-making centers on markets and institutions. In mainstream thinking, the economy is self-regulating wherein any intervention on the part of the government is regarded as a departure from the efficiency of the market system. Personalist economics accepts the market system subject to the constraint that at times it is necessary to intervene in the market through public regulatory bodies such as the Securities and Exchange Commission and the Federal Trade Commission or private organizations such as trade associations and unions in order to assure that the powerful do not devour the weak and the good of the community is not routinely sacrificed to the good of the members taken individually.

8. Justice and Christian charity are necessary to check abuses that derive from excessive gain-seeking behavior. In a market economy, transactions are driven by gain-seeking behavior. Without the prospect of some gain, an economic agent simply is not motivated to complete a transaction. However, at times agents are exploited, deceived, mistaken and consequently are deprived of the gain that is their due. The virtues of justice and Christian charity are twin bulwarks that help protect humans from the abuses that originate in the excessive gain-seeking behavior of others. The three principles of economic justice -- equivalence, distributive justice, and contributive justice -- specify the duties that apply to buyers and sellers in relating to one another, to superiors in relating to their subordinates, and to a person in relating to any group to which he/she belongs. These duties, if faithfully executed, protect human wellbeing by curbing the destructive human attraction to ill-gotten gains.

Christian charity goes beyond the passive Kantian imperative to not view humans as mere instrumentalities, requiring each follower of Christ to actively affirm every human being as a person. Christian charity, along with justice, eliminates the ill-will, disorder, and ripping off that otherwise is common to a marketplace and workplace, replacing them with goodwill, solidarity, and authentic bargains. Christian charity alone among economic resources perishes and has no value when it is held. Rather, it comes alive and takes on value only when it is given away, and uniquely is never depleted by use. Neither of these virtues is included in the mainstream economics way of

thinking.

9. Social justice requires the individual to do all that is necessary for the common good. Practicing social justice means practicing all three types of justice relevant to economic affairs: equivalence, distributive justice, and contributive justice. All three are necessary for the common good because all three foster the trust required for human beings to carrying out their everyday economic activities in common. It is unfortunate that some would reduce social justice to contributive justice alone.

10. Three principles organize economic affairs: competition, cooperation, and intervention. The first two activate economic affairs on the basis of two human dispositions. Competition is based on the human disposition to undertake certain activities alone for the reward to be gotten from completing those activities successfully. Cooperation derives from the human disposition to undertake certain tasks collectively because they cannot be done effectively by persons working alone or cannot be done at all by such effort. The decision to use competition is to organize economic affairs around the Many (individuals). The decision to use cooperation organizes economic affairs on the basis of the One (group). Thus, competition manifests human individuality while cooperation expresses human sociality. Intervention operates in the limiting mode and often involves government action to curb certain destructive human activities energized by competition or cooperation. To protect human wellbeing, such intervention is to be grounded in the virtues of justice and Christian charity. Even when it self-evidently characterizes the relationship between producer and supplier, cooperation is largely ignored by mainstream economics as an organizing principle because it is taken *ipso facto* as collusive behavior.

11. Five social values underlie the three organizing principles. Each one of the three organizing principles rests on a different social value. In the absence of these values in society as a whole, the principles cannot be used effectively to organize economic affairs or used at all. Competition depends on the social value of individual freedom. If persons are not truly free to act they cannot compete. Cooperation rests on the social value of teamwork, community, solidarity. Without those values being widely shared across society, collective action cannot be undertaken. Intervention rests on the social value of equality in the sense that it is necessary for collective action to stop the powerful from subordinating and exploiting the weak. A *laissez-faire* economic order backed by neo-classical economics is based on the social value of freedom *from* government restraint better known as liberty. In personalist economics, freedom also means freedom to act as a responsible human person.

12. Dynamic disequilibrium rather than static equilibrium is the order of the day. Mainstream economics represents both microeconomic and macroeconomic affairs in terms of a static equilibrium of supply and demand wherein the self-regulating forces of markets bring the system into balance by the systematic clearing away of any and all surpluses and shortages. This view of economic affairs has been characterized as mechanical. Personalist economics, on the other hand, represents economic affairs as organic wherein the economy is driven dynamically toward disequilibrium by innovational change -- creative destruction -- that depends critically on the support of credit-creating financial institutions. The difference is between the centripetal-like impersonal forces of the market bringing the system to rest and the centrifugal-like human energy of

the entrepreneur initiating change and triggering unrest in the system.

*Instructed by William Waters, personalist economics views economic development as based on creative destruction plus Schumpeter's other insights regarding development: creative vision, funding, access to resources, dynamic competition, and resistance to entrepreneurial change. Waters adds two other factors: the natural working together of labor, management, and government, and the cooperation of workers, managers, and owners in the workplace. At the very heart of economic affairs and therefore economic development is the entrepreneur, that agent of change, the quintessential **person in action**.*

13. Some limits are present in economic affairs and others must be imposed because humans are materialized spirits. *Capital equipment cannot be run continuously without maintenance before it breaks down. In like fashion, human materiality assures certain physical limits regarding consumption and work. The human body can consume only so much in one sitting so to speak, and can work continuously only for some fixed number of hours without rest. Further, without other limits on what and how much we consume, on how long and how hard we work, and how much we allow for or indulge in re-vitalizing leisure activities, limits that reside quietly in the human spirit, our development as human persons is arrested or misdirected. The three principles of justice, along with the practical virtue of moderation, provide useful and effective limits on consumption, work, and leisure, and their faithful practice contributes powerfully to the realization of the full potential of every human being.*

14. No less than his *Wealth of Nations*, Adam Smith's *Moral Sentiments* should inform our re-thinking of economic affairs. *Indeed, there are compelling reasons to include both masterpieces in a reconstruction of economics around person as the basic unit of economic analysis and personalism as its philosophical foundations, thereby making economics more relevant to contemporary economic affairs. **Moral Sentiments** and **Wealth of Nations** are complementary works that should be read and interpreted together to fully appreciate Smith's enormous contribution to our ability to describe and understand contemporary economic affairs more accurately. Had he lived in the electronic age, Smith probably would have seen more clearly the complementarity in his own work, and would have shared that more profound vision with his followers.*

15. The evolutionary model is superior to the cyclic model. *As with other disciplines such as history that "repeats itself," mainstream economics is constructed on a cyclic model that applies circular descriptions and explanations, such as the circular flow diagram and the business cycle, to economic events. In the cyclic model events are construed as identical and inevitable, and predictable, and legitimize the widespread use of econometrics in mainstream economic analysis. Using cyclic reasoning, and given the data required to operationalize their econometric models, mainstream economists are comfortable in asserting that changes in economic affairs can be predicted. What they do not fully appreciate is that one other requirement must be firmly in place: **homo economicus** is an utterly rational, **never**-changing, and predictable human individual. Without this rationality and constancy about human individuals as economic agents, and the automaticity that is characteristic of market economies, the cyclic model disintegrates for lack of predictability.*

*One can employ the cyclic model only by carefully including certain fundamentals for example by imputing values for unobserved variables and excluding others by such means as **ceteris paribus**. Further there is no real model or analogue for cyclicism -- that is the identical and inevitable repetition of an event or two (much less at an infinite number of) points in time. Following Walter Ong, we are persuaded that there is no way to posit a never-changing **homo economicus** without essentially casting aside evolution -- the central corporate discovery of all mankind -- and without effectively cloning all economic agents from a single cell taken from a hyper-rational abstract human being. The essential determinant of economic affairs -- the economic agent -- is evolutionary in nature not cyclic. It follows that our economics should be re-constructed on the foundation of evolutionary rather than cyclic thinking.*

16. The acting person/person in action maximizes personalist capital -- the practical virtues of justice, courage, moderation, and prudence. *Mainstream economics regards **homo economicus** as subject to change in that the economic agent is capable of acquiring or losing the human capital which is embedded in the agent's very nature. Further, mainstream economics acknowledges that at times **homo economicus** acts altruistically, in accordance with the needs and desires of others, and reconciles this behavior with the self-centeredness of **homo economicus** by labeling it "enlightened self-interest." Even so, **homo economicus** essentially is **never**-changing because that simplifying proposition assures a predictability of behavior in economic affairs and a certainty regarding empirical findings that fit comfortably in the view of economics as a hard physical science.*

*The **acting person/person in action**, on the other hand, emphasizes personhood and personalism in place of the individuality and individualism of **homo economicus**. The **acting person** directs attention to the economic agent as one who acts in economic affairs rather than as one who is socially embedded, to **what** the economic agent does rather than **where** the agent is situated. The **person in action** connects economic agency to work, consumption, and leisure that change the economic agent who in acting virtuously or viciously accumulates or depletes personalist capital, and thereby is more effective and more highly valued as an agent or less effective and less highly valued. The **person in action** is **ever**-changing.*

*In total disregard for the wisdom of the ages regarding moderation and human development mainstream economics asserts that above all else **homo economicus** maximizes net personal advantage in terms of utility and profit and that the economy functions best when it achieves Pareto optimality. Maximizing utility and profit is based on the proposition that the good invariably consists in **having** more. Without fear of compromising human development on the altar of that flawed proposition, personalist economics claims that most fundamentally economy functions best when the **acting person/person in action** maximizes personalist capital thereby enhancing him/her own integral human development and rendering him/herself more effective and more highly valued as an economic agent. Maximizing personalist capital rests on the proposition that the good always inheres in **being** more.*

17. Personalist economics follows Sen's argument that the task for economics is to enlarge everyone's capabilities and asserts uniquely that the economic agent, the acting person, strengthens his/her capabilities set by acting virtuously in economic affairs and weakens that set by acting viciously. *Acting virtuously contributes to personalist capital just as acting viciously*

diminishes it. Further, strengthening everyone's capabilities set enhances integral human development just as weakening that set impairs it. Personalist economics not only adds an important human behavioral element -- personalist capital -- to Sen's capabilities set but also links that improved set to integral human development and asserts that the ultimate purpose of the economy is maximizing integral human development that is achievable by maximizing that capabilities set.

*18. A **personalist economy** is based on the market mechanism, private enterprise, the common good, economic freedom, subsidiarity, solidarity, worker participation in enterprise decision-making, the universal destination of the world's goods, the legitimacy of profit, and personalist capital. A **personalist economy** represents a viable option to both capitalism and socialism because it is organized around private groups positioned between the individual person and the more powerful state, groups that emerge due to the inability of the individual person to adequately address specific economic problems. While economic freedom is the **most important** characteristic of a personalist economy, intermediary groups are its **distinguishing** characteristic.*

*By using non-collusive cooperation to work out solutions to problems, intermediary groups that operate in a **personalist economy** offer promise for slowing the growth of big government thereby helping preserve the free exercise of economic initiative. The most important characteristic of these private groups is a separate administrative organization that subordinates the principle of competition to the principle of cooperation in a dynamic decision-making process that is positive-sum in that these groups seek to achieve gains for all of the parties involved whether they are directly represented in the organization or not. Arising from the social nature of human beings who are encountering similar day-to-day economic difficulties, these intermediary bodies are as diverse as the individual nature of those human members and the specific economic problems they hope to resolve.*

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