SELECTED NOTES FROM CHAPTER FIVE

Markets

All economics is divided into two major parts:

MICROECONOMICS (micro = small): The part concerned with the behavior of people and organizations in particular markets; and

MACROECONOMICS (macro = great): The part concerned with the operation of a nation’s economy as a whole.

In this chapter we look at microeconomics, the study of particular markets, of which the two most fundamental concepts are supply and demand.

SUPPLY: The varying amounts of any good that its producers or owners are willing to offer at different prices. As we noted earlier in connection with demand, to the economist supply is not a point (a fixed amount) but a curve that relates quantity to price.

In the case of supply, price and quantity are ordinarily positively correlated; higher prices call forth increased supplies. Some suppliers are “price takers”; they must accept as given the price for their product that is set in the market. Among price takers are the producers of corn and wheat, leather and hides, coal and concrete, alcohol and ammonia, bricks and lime – products which are relatively homogeneous and which have many producers, so that it is easy for customers to substitute the output of one producer for that of another.

But some producers, called “price searchers,” have a greater measure of control over a market and look for customers willing to pay the prices they set. Price searchers include local
builders or merchants or candy concessionaires in a movie theater who can raise their prices above what outside competitors charge – because their customers find it inconvenient or more costly (including time and transportation costs) to go elsewhere. Some price searchers are big producers, like General Motors or the Aluminum Corporation of America, who are dominant forces in a wide market. And some are producers of highly specialized and desirable goods, such as Gucci shoes, Steuben glass, IBM computers, particular books, films, pharmaceuticals, musical instruments, etc.

Producers of different goods have varying degrees of “elasticity of supply” – the additional quantity they are willing to offer at higher prices. A few products have zero-elasticity of supply; there is only one Hope diamond, and no matter how much anyone is willing to pay, there will never be more than one Hope diamond – or one Mona Lisa, one Acropolis, one Marlon Brando. The market can bid the price of them skyhigh without increasing the supply.

But few goods are unique. Some are extremely elastic in their supply; you can get as many extra paper clips, cans of dog food, stockings, or copies of a best-selling book as you like, with little or no increase in price, or even a reduction in price over time.

Supplies of most goods are more elastic in the long run than in the short, because it takes time for producers to expand their plant for making more of the product to meet increasing demand. Many goods will fall in price as the volume of production increases, due to “economies of scale” resulting from better technology, savings on materials, lower fixed costs, etc.; this has been the case with radio and TV sets, ball-point pens, calculators, computers, and chickens.

The general public and most politicians underestimate the elasticity of supply; they don’t seem to believe, for example, that higher prices will bring forth more oil, or that increased
supplies will keep oil prices from going through the roof. Nor do they believe that lifting rent controls in New York will bring more housing – including existing housing – on the market.

Price is determined by the interaction of supply and . . .

DEMAND: The quantity of any good that would be bought at different prices. Generally speaking, the higher the price of anything, the less of it will be demanded.

One’s desire for a good is not the same as one’s demand for it. Desire has to be backed by money and a willingness to spend the money to become demand. When the price of a good falls, a person may or may not actually buy more of it, depending on what he thinks an extra unit of that good is worth “at the margin” – on what economists call its “marginal utility.”

Characteristically, goods have “diminishing marginal utility” – that is, the more you have of any particular good, the less you are willing to pay for an additional unit of it. If you have one auto, a second car may be worth considerably less to you, and a third may be worth far less than the cost of owning and operating one more car. A few products may seem to possess “increasing marginal utility,” so that the more you get, the more you want – like eating pistachio nuts or drinking beer or smoking cigarettes. But sooner or later, diminishing marginal utility appears to set in. Even a billionaire may find that he has no appetite for that seventh villa, that third yacht, or that sixth wife. An exception may be drugs like heroin, on which somebody is “hooked.” But these are pathological cases. Avid collectors of art, stamps, or rare books may also be slightly pathological – their appetites grow with consumption, rather than diminish.

Normally consumers, rich, poor, or middle class, vary their consumption patterns in response to prices going up or down for two basic reasons:

THE SUBSTITUTION EFFECT: Using more of a now less expensive product and less of
a more expensive one. If gasoline prices and taxes on “gas-guzzling monsters” go up, we may substitute smaller cars for larger ones, extra miles of commuting by bus for commuting in our own cars, or even apartments in town for houses in the suburbs or exurbs. One might even substitute status-enhancing clothes or jewelry for status-enhancing cars.

Shoppers routinely substitute cheaper chicken for dearer veal, Tide for Bold (or vice versa), etc., juggling new market prices and marginal utilities endlessly.

THE INCOME EFFECT: The effect of a price increase or decrease on the real income of a consumer. A price increase causes one’s real income to decline, a price cut makes it rise.

With a price decrease, the consumer has more money to spend either on that good or on other goods. Ordinarily, a price cut on a particular good makes it seem like a bargain, and that pleasant experience often leads us to buy more of it. Similarly, a price increase is experienced as unpleasant, and usually causes us to buy less of it – unless, as we noted in the case of Giffen’s Paradox, the income effect of a price increase is such that one must consume more of the “inferior good” (potatoes or spaghetti or bread) whose prices have risen, as a substitute for the “superior goods” (steak or lobster or entertainment) which one can no longer afford.

The substitution and income effects, taken together, determine the elasticity of demand for any product. The demand for coffee, wine, oil, and food products (taken collectively, not individually) is relatively inelastic; producers who realize this often try to restrict supply in order to get or keep their prices up; the Arab oil embargo of 1973 was a perfect demonstration of how, in the face of highly inelastic demand, oil producers were able to restrict supply and greatly raise
prices.\textsuperscript{1} Wine growers in France and milk producers in Wisconsin have been known to spill their products on the ground in order to keep prices up, in the fact of inelastic demand. Their aim is to keep a small increase in supply from causing a huge drop in price – and in their own incomes.

THE PRICE MECHANISM: Markets come into equilibrium at the price at which supply (the quantity offered) equals demand (the quantity demanded).

Sellers are satisfied (in the sense that they are selling all they want to sell at that price, and would not want to sell more at a lower price) and all buyers are satisfied (in the sense that they are buying all they want at that price and would not want more at a higher price).

Market prices may move up or down (or remain the same) in response to a host of factors causing shifts in supply (the whole supply curve) or demand (the whole demand curve) or both together.

\textit{Bad weather makes prices go up} – not just the prices of agricultural products, but of a great many other goods, ranging from steel to nightgowns, because of interruptions of production, breakdowns in transportation, power failures, etc.

\textit{Changes in technology cause shifts in supply curves}; a more efficient way of making transistors brings down the prices of calculators, computers, radios, television sets, record players, recorders. Increases in the scale of production, as we have seen, often bring down certain product prices.

Shrinking oil and mineral reserves contract supply, and prices move up. “Diseconomies” resulting from shrinking scales of production, as when the market for handmade pocketbooks, 

\textsuperscript{1}The cut in oil supply was only about 10 percent – but oil prices were quadrupled, with slight effect on consumption.
horsedrawn carriages, grandfather clocks, custom tailoring, and handmade furniture contracts, push up the prices of such products not only absolutely, but relatively far above what they were in the old days, when skilled labor was cheaper and more abundant.

Similarly, many factors can cause demand curves to swing up or down – booms or busts in the national economy, affecting the incomes of consumers; changes in taste – a President may increase the national taste for chamber music or hominy grits, a popular singer may increase (or decrease) the taste for orange juice; changes in “joint demand” – a fall-off in movie attendance may shrink the demand for popcorn, a rise of interest in skiing may increase the demand for liniment and orthopedic surgery; changes in fashion – the Hamptons may be in, Newport may be out; changes in the seasons, changes in military threats, changes in the livability or stench and danger of cities, changes in the public mood toward hope or despair, excitement or boredom – in brief, changes.

The price mechanism sensitively catches and reacts to all such changes. If equilibrium prices of particular goods move up, more will be produced – because benefits to producers will tend to exceed costs by a wider margin – and human and material resources will tend to shift to those uses.

If equilibrium prices of other goods move down, less of them will be produced, as the cost-benefit ratio for producers is squeezed, and resources shift away to other uses, where the cost-benefit ratios (measured by profits) are higher.

Similarly, consumers will drop out of a market (or buy less in it) as their own cost-benefit ratio declines with a rising price of a particular product. Conversely, they will buy more of a product when their cost-benefit ratio improves.
This is how a market economy allocates its goods and services; the price mechanism constantly flickers out millions and millions of signals. These bits of precisely articulated information help producers to decide what to produce and consumers what to consume, in order to make more money or increase their satisfactions.

INCOME DISTRIBUTION: The price mechanism also is the prime determinant of how income is distributed in a market economy – since income is the return to resources owners (including workers, who own and sell their own labor), as determined in the marketplace. You don’t have to like it. But whether you do or not, it is the supply and demand of particular goods and services in the marketplace (backed up by the force of law protecting individual ownership rights) that determine that some rock singer makes a million dollars a year and some professor of microbiology makes thirty thousand dollars and some textile worker seven thousand dollars and some luckless people nothing (unless they get unemployment compensation or welfare).

In the United States, the government takes a hand in changing the distribution of income. It taxes money away from some and transfers it to others. Its purported aim (as through the progressive income tax) is to take relatively more from the rich and (through public education, health, housing, and other programs as well as transfers) give relatively more to the poor. In fact, however, much that government does transfers funds to the middle class or even the rich; for instance, state colleges and universities benefit the middle class or rich much more than they do the poor, and so do Federal housing loans, urban redevelopment programs, highway programs, subsidies for airports and private airplanes, grants for research and the arts, and some programs to preserve wildlife and the woods (where the rich and middle class go, rarely the poor). This does not make such government programs necessarily wrong; the programs may be inherently
desirable – and beneficial in the long run also to the poor (if, for example, medical progress is fostered by research grants to the already well-off, or if subsidies to the development of solar energy ultimately protect the jobs and increase the living standards of the poor as well). Virtually every organized group in the society, from oil drillers to doctors to lawyers to farmers to workers to bankers to college professors to defense producers to old people to welfare recipients seeks to use the Federal government to increase its share of national income for allegedly worthy reasons.

But it is the operation of the market that fundamentally determines the distribution of income, although the role of government has grown increasingly important in shaping patterns. While government in the United States has not imposed an upper ceiling on individual incomes, it has put a rough floor under the lowest incomes. No one need starve or lack clothing, shelter, or health care – if he or she knows how to get help, which is a considerable if.

It is not only through government that various private groups attempt to alter the distribution of income in their favor. Discrimination against minority workers or women increases the take of male white workers, and some unions, whether openly or covertly, favor such discrimination. Management groups or university faculties may do (and in the past have done) the same. Government, through the equal-opportunity laws, tries to correct such discrimination.

The chief way that private groups seek to increase their share of income is by augmenting their monopoly power in the market.

MONOPOLY: A market structure in which there is complete control by one seller of the production or sale of a product or service. Those who praise monopoly say it permits strong firms to do research, be nice to their workers and benefit society. Those who damn it say it milks
consumers and leads to excessively concentrated political as well as economic power.

COMPETITION: The opposite of monopoly – a market in which many suppliers contend for sales and many consumers contend for available goods. Competition is considered a good way of keeping suppliers on their toes and passing benefits along to consumers. The foes of competition always insist that they are trying to prevent “cutthroat” competition – stores that underprice “unfairly,” osteopathic physicians who take clients away from M.D.s, foreign producers who “dump” their goods at prices below costs, gypsy taxi drivers who are breaking the fee structure of licensed cabs and allegedly taking bread out of the mouths of the children of legitimate cab drivers, etc. The simple rule is: Monopolists hate competition.

MONOPOLISTIC COMPETITION: The halfway house between monopoly and competition; monopolistic competition is where things are in most major American industries.

The question is how concentrated an industry must be before its market power is to be deemed injurious to the public interest. Alternatively, when can an industry be regarded as “workably” competitive? The antitrust authorities and the courts are supposed to sort out that difficult issue. They tackle it hesitantly, torn between the goals of efficiency and equity, a fundamental conflict within a mixed economy.