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3 A Three-Dimensional Approach to Economics

Understanding capitalism has become essential for anyone who reads the newspaper, watches the nightly news, listens to political candidates, or simply wonders why it is so hard to find a good job or get enough free time. Since capitalism is an economic system, understanding capitalism requires some knowledge of economics. But what *kind* of economics? We call the approach presented in this book *three-dimensional economics*, and we often refer to it simply as *political economy*.

Until the beginning of the twentieth century the term *political economy* was used to refer to all of economics, and the field itself encompassed most of what is now divided up among the social sciences: anthropology, sociology, psychology, and political science, as well as economics. But around 1900 the term **political economy** was replaced by *economics*, and the boundaries of the discipline were narrowed: the study of markets became its primary focus. Inquiries into politics, psychology, history, and other aspects of society were then left to the other social sciences. Thus, it is no accident that anthropology, sociology, psychology, and political science came into existence as separate fields at about this time.

Political economy is a term we use for a theory that analyzes capitalism in terms of the three dimensions of competition, command, and change.

We prefer to use the older term *political economy* (rather than *economics*) to describe our approach because one cannot understand contemporary societies very well unless politics, economics, psychology, and the other social science disciplines are all brought together to study the complexities of modern life. Another way of describing the *political economy* approach, then, is to say that it is *interdisciplinary*.

Many people believe that the approach presented here makes more sense and is a more useful way of understanding our economy than what is sometimes called *neoclassical economics*—the “conventional” approach that is set forth in most economics textbooks. Ultimately, however, everyone who seeks to understand capitalism needs to consider a number of approaches to economics and decide which one, or which combination, makes the most sense and is the most useful.

What is certain is that no one should accept a particular approach to economics just because it is what some experts believe. Each person must make a choice for herself or himself, asking: “Does this make sense to me?” “Does this help me understand things that I have experienced and believe to be true?” Of course, not all opinions about economics are equally valid. A useful approach to economics,

whether it be political economy or some other approach, must be logically sound, internally consistent, and helpful in explaining what is known about economic reality ("the facts").

The main idea of this chapter is that *political economy considers all three dimensions of economic life: competition, command, and change.* The main points of the chapter are:

1. Capitalism is an *economic* system.
2. Every economic system can be analyzed in terms of three dimensions: a horizontal dimension (*competition*), a vertical dimension (*command*), and a time dimension (*change*).
3. Economics is about *values* (what ought to be) as well as *facts* (what is). It is useful to make values—and their role in any particular economic analysis—explicit. The values adopted in this book are simple: an economy should provide all members of a society with an equal opportunity to lead a flourishing life, and this objective is more likely to be achieved if the economy is *efficient, fair,* and *democratic.*

The fundamental concepts introduced in this chapter will be used throughout the book and will be further developed in later chapters.

Economic Systems and Capitalism

Over the span of human history people have organized their economic activities in many different ways. The variety of economic systems runs the gamut from tribal commonwealths, slavery, and feudalism to self-sufficient households, capitalism, and state socialism.

An **economic system** is a set of relationships among people that organizes the labor processes all societies need to sustain life.

What all these systems have in common—what makes them **economic systems**—is that they are all *ways of organizing the human labor needed in every society to produce the goods and services that support life.* No matter what type of society it is situated in, an economic system will determine *what* work is done, *how* it is done and *by whom,* and *to whom the resulting products are distributed.*

Economic systems are *relationships among people.* These relationships may be direct, face-to-face relationships, such as the interaction that occurs when you buy an orange from a grocer. At the other end of the spectrum, they may be relationships between people in different parts of the globe, for example the Iowa farmer producing grain that will later appear as bread on a table in Egypt. The relationships that make up economic systems may also be embodied in customs, laws, constitutions, political parties, or business corporations.

Economic relationships are shaped in important ways by the physical things and technologies used in production as well as by other factors such as geography, customs, religion, and whether production is primarily agricultural, industrial, or postindustrial (knowledge-based). Nevertheless, the *social relationships* among the various economic actors—producers and consumers, slave owners and slaves, feudal lords and serfs, employers and employees, borrowers and lenders—are the defining qualities of an economic system. Thus, the distinguishing features of any economic system may be seen in the social interactions among the economic players These interactions may, in varying degrees, be cooperative or competitive, altruistic or avaricious, equal or unequal, democratic or authoritarian.

How human work is organized differs from one economic system to another. To understand how work is organized in any particular society one must examine its economic system. The economic system that is the focus of this book, capitalism, is the one that prevails, in one way or another, throughout most of the world today.

Capitalism is quite familiar to most of us. In various forms it is the economic system not only of the United States but also of Great Britain, Japan, Chile, France, Russia, Mexico, Brazil, Germany, South Africa, and indeed, more than one hundred other countries. Thus, we can study capitalism directly because we experience it every day of our lives.

In a capitalist economic system most goods and services are produced at the direction of employers (businesspeople, entrepreneurs, capitalists, or managers of firms) who seek to make profits by selling the produced goods and services in markets. Most people in capitalist economies work for someone else (their employers) and receive a wage or salary in return. So work is organized for the purpose of making a profit; the employer, or his or her appointed manager, is the boss at the workplace; and goods, services, and people's capacity to work—their labor time—are all exchanged through markets.

To understand capitalism one must find answers to a number of questions. How is work organized? How do markets operate? How much of the output when sold will go to profits, how much to wages, and what will determine the relative magnitudes of these two types of income? Why do some workers get paid more than others? Who decides what technologies will be used, and on what basis will such decisions be made? How does our capitalist economy affect the way we develop as human beings? How does it condition our culture, influence our political system, and alter our natural environment? And, in turn, what reverberations will all these effects have on the capitalist economy itself?

Three-Dimensional Economics

In this book the complex relationships of a capitalist economy are examined, taking into account all three dimensions of an economic system: competition, command, and change.

Competition

Competition, or the horizontal dimension in economics, refers to aspects of economic relationships in which voluntary exchange and choice among a large number of possible buyers and sellers play the predominant role.

The first dimension is called **competition**, and it refers to that aspect of an economic system in which exchanges of one sort or another play the most important part. In capitalism, of course, competition and exchange occur primarily in markets. For example, when a motorist chooses to buy gasoline at a particular gas station, it is obvious that he or she is making a choice between competing suppliers.

The competition dimension of the economy is a *horizontal* one: it can be thought of as involving a relative equality of power among those offering the choices, engaging in exchanges, and competing with one another. In the gas station example, for instance, the sellers of gasoline must compete with one another to entice the motorist to come to their pumps. In the contest for customers, the gas suppliers are equal in the following sense: none can dictate to any other—or to the motorist—where the motorist will buy gasoline.

Political economy shares with conventional economics the view that an analysis of how competition works is essential to any attempt at understanding the economy. (As we point out in Chapter 11, however, political economy differs from the conventional approach on how competition actually takes place in a capitalist economy.) When, as in capitalism, much of economic life is organized in markets—not based, say, on ancient customs or on decisions imposed by central planners—markets are the terrain on which most of the competition is carried on and where most of the choices are made by individuals and firms.

Command

Command, or the vertical dimension in economics, refers to aspects of economic relationships in which power plays the predominant role.

The second dimension is called **command**, and it refers to those aspects of economic relationships that involve power, coercion, hierarchy, subordination, or authority. In capitalist (and many other) societies, command is a central aspect of the workplace, the household, and the government. It concerns relations among nations, classes, races, men, women, and other groups in society as well.

The command dimension is regarded as *vertical* because it necessarily involves people or groups who are unequal, some being "higher up" in a hierarchy than others. One person or group is "dominant," while the others are "subordinate."

It is not always easy to distinguish command from choice. Suppose a thief points a gun at someone and demands, "Your money or your life!" This is *literally* a choice. The victim could presumably choose to surrender either the money or his or her life, yet the thief's threat is easily recognizable as *in fact* a command to hand over the money.

A less extreme example would be a situation in which a boss asks a worker to do something and the alternative to carrying out the boss's request is to get fired. It may seem here that the worker has the choice of doing or not doing what the boss has asked, but, in reality, the boss's request is a command.

Although the prospect of getting fired is not comparable to the possibility of losing one's life, for many people the loss of a job will cause financial disaster. This, in turn, will make it difficult to put food on the table, pay the rent or mortgage payment, or land another job.

A has **power** over B if by imposing costs on B (or threatening to do so) A can cause B to act in a way that is to A's advantage.

One form of command is what we call **power**. We define power as follows. A has power over B if by imposing costs on B (or threatening to do so) A can cause B to act in a way that is to A's advantage. The employer has power over the employee in this sense.

Command may be exercised, however, without threats and costs being imposed. It may just be that one party influences or shapes the conditions under which another party will be making a choice. Thus, corporations often use their financial resources to alter the conditions under which consumers make choices. If, for example, an aspirin producer's television commercials can convince consumers that its product is "stronger," works "faster," or is "recommended by most doctors," people going to the store in search of relief for headaches will tend to choose this product more frequently.

The point of the aspirin commercial example is that command is not only the ability to impose costs on others. It is also the ability of one person or group to control others' information, playing upon their fears, hopes, insecurities, or other emotions and thereby influencing their actions in order to promote the interests of the powerful person or group. Thus, in the case of advertising, command is often used in subtle—and sometimes not so subtle—ways to shape or condition choice.

Command is used in many other ways to influence outcomes. One example of such influence is corporations making campaign contributions to sway the voting patterns of legislators or other politicians. Another is companies hiring recent immigrants to work long hours for low wages in unsafe or unhealthy workplaces because such people have few other employment opportunities. A third is a large meatpacking firm that dominates sales of meat to supermarkets and other retail outlets, giving it the power to write contracts with small chicken farmers that leave many of these farmers in poverty. In short, command refers to circumstances in which money and power give one person or organization the ability to influence the actions of other organizations or people. As we observe in later chapters, many economic relationships involve both choice and command, with neither one operating exclusively.

Change

Change, or the time dimension in economics, refers to the historical evolution of people and economic systems.

The third dimension of economic systems is called **change**. It concerns the passage of time and the ways in which, over time, the operation of an economic system will change the system itself. In capitalism, change occurs because big profits can be made by changing the existing conditions—by building new and better machines, by designing novel products to meet previously unknown needs, by expanding production, building factories in distant corners of the world, or succeeding in changing the rules of the game.

Central to the changefulness of capitalism is the system of investment for profit that creates an inexorable tendency for the economy to expand. With its expansionary drive, capitalism alters the conditions in which it operates—and within which people live and die. Capitalism's continuous expansion also transforms the ways in which the system itself actually works.

Change is called the "time" dimension because change always occurs through time. Thinking about change necessarily involves using concepts such as "before" and "after," "old" and "new," or "early" and "late."

Emphasizing the change dimension of economics reminds us that each economic system works differently at different points in time. It also brings out the fact that people participating in an economic system change over time.

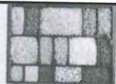
Each economic system has a history, and the way each system functions at any particular point in time will depend, in part, on its history. For example, American capitalism works differently in the twenty-first century from the way it worked in the nineteenth and twentieth centuries, and although it is still capitalism, an analysis of how it works in the present must be informed by a consideration of the ways in which it has changed. Similarly, American capitalism today differs from, say, German capitalism, in part because the nineteenth- and twentieth-century histories of these two countries differed.

Any economic system will undergo further change in the future. The present and even the future will become the past: what *is* today will *not be* tomorrow. Indeed, as noted in Chapter 1, capitalism is the most dynamic—or "changeful"—economic system yet to be observed in history.

Of course, many factors other than the normal, everyday functioning of the economic system may cause economic and social changes. A list of other kinds of change-inducing events might include wars, plagues, new discoveries, climate change, religious upheavals, or new scientific breakthroughs. In some cases the

economic analysis presented in this book may help to explain why these events occur. However, this analysis is mainly concerned with change as it emerges from the routine and persistent operation of the economic system. Similarly, with regard to human development the concern here is with how people adopt new tastes, values, ways of life, and even religions at least partially in response to their changing experiences of working and making a living.

The emphasis it gives to change is one of the qualities that distinguish political economy from neoclassical economics. This and other differences are summarized in the table at the end of this chapter.



Economics, Politics, and History

Economics is the study of *how people interact with one another, with nature, and with the other things they require in order to produce their livelihoods.* The three-dimensional approach to economics takes the view that, as important as they are, the processes of competition and market exchange on which conventional economics focuses are only part of the story. Processes of competition and market exchange are important. Indeed, they are the first dimension referred to in the triad of "competition, command, and change" that defines three-dimensional economics. However, the other two dimensions, command and change, are just as important.

The vertical dimension of political economy, command, takes the existence of power relationships into account. Conventional economists do not include these relationships in their analyses; instead, they leave power to be studied by political scientists. Abba Lerner, a prominent conventional economist, once commented that economics had become the "queen" of the social sciences by focusing only on those political problems that had already been solved. When political problems—such as a society's choice of a particular framework of laws or a system for the administration of justice—have already been solved, the ensuing relations can be conducted solely on the basis of contracts and market exchange.

Three-dimensional economics does not limit itself to the study of solved political problems. Focusing on command as one of the most important aspects of human social life, it sees the economy as a place where power plays a decisive role and where there have been—and continue to be—endless and often bitter struggles between workers and their employers, between buyers and sellers, among giant corporations, and between people and corporations to determine whose interests will be most benefited by public policy decisions. Thus, one reason for the presence of the word *political* in *political economy* is the recognition of the fact that power relationships are an important aspect of any economy.

The third dimension of three-dimensional economics, change, suggests that studying economics also means studying history. The process of change in society cannot be understood without considering the past and how it changed, eventually becoming the present. Change in political economy may be contrasted with the static approach of conventional economics that freezes time at a moment. Economic reality, according to political economy, is better represented dynamically—as a process of change rather than a frozen state of affairs. It is a movie compared to the neoclassical snapshot.

From the standpoint of political economy, the usual distinctions among the disciplines in the social sciences—history, political science, economics, sociology, anthropology, and psychology—are quite arbitrary. These distinctions divide social reality into parcels that reflect the traditional boundaries among university departments, but they obscure our understanding of how the economy works.

Neoclassical Economics

Neoclassical or **conventional economics** is an economic theory emphasizing the horizontal dimension of markets and voluntary exchange.

The **neoclassical** (or conventional) approach to economics, mentioned in both this chapter and the previous one, sees capitalism as a system of markets. The label *neoclassical* is given to conventional economics because this approach presents an updated version of some of the ideas of eighteenth- and nineteenth-century "classical" economics, articulated by Adam Smith in his influential book, *The Wealth of Nations*. Neoclassical economics is thus primarily an explanation of how markets and market systems work.

Neoclassical economics is mainly about competitive markets, that is, markets with many buyers and sellers, and it offers explanations of how economic systems made up of many competitive markets function. While understanding markets is essential to understanding capitalism, the neoclassical approach is founded on three very restrictive assumptions. The first, "economic man" (*Homo economicus*), was discussed in the previous chapter.

The second assumption underpinning the neoclassical approach is that when studying a market transaction, all essential aspects of it are covered in a contract. Accordingly, all other aspects and consequences of the exchange are treated as being of secondary importance.

A **contract** is an agreement, either written (explicit) or unwritten (implicit), that commits two or more parties to taking certain actions, such as making payments and delivering goods or services.

The concept of a **contract** is significant not only in economic analysis but also in many other areas, for example, the law. It is defined as an agreement, either written (explicit) or unwritten (implicit), that commits two or more parties to taking certain actions, such as making payments and delivering goods or services.

Neoclassical economists assume that contracts are *complete* in the sense that the *prices* resulting from them take into account everything that is important about a particular transaction. This is sometimes referred to as the *complete contracting assumption*. A **complete contract** is one that fully specifies, in ways that the courts will enforce, everything that each party to the contract is to do as a result of the contract.

A **complete contract** is one that fully specifies—in ways that the courts will enforce—everything that each party to the contract is to do as a result of the contract.

In making the assumption that all market transactions are based on complete contracts, neoclassical economists take for granted that the contracts into which we enter, explicitly or implicitly, whenever we buy or sell something are "complete" in the sense that (a) they cover everything of interest to both parties to an exchange, and (b) they can be enforced at no significant cost to either party. In contrast, an **incomplete contract** between two parties is one that leaves out certain aspects of an exchange and requires or imposes, upon one party or the other, significant enforcement costs.

An **incomplete contract** is an agreement between two or more parties that leaves out certain aspects of an exchange and requires or imposes significant enforcement costs upon one party or another.

When a new car is purchased the contract is quite complete: the specifications of the car are described, the price is given, the payment plan is made clear, the warranty is spelled out, the limits on the liabilities of the producer are stated, and so on. When an employer hires a worker, however, the contract does not even mention some of the most important aspects of the bargain, such as the exact task (or tasks) the employee may be assigned to do or how hard he or she will be expected to work. The incompleteness of employment contracts is one of the most important issues given attention in the political economy approach. (Credit contracts are incomplete, too, but for a different reason: the exact amount the borrower is to repay is clearly specified, but the contract may be unenforceable if the borrower is broke when the time comes to repay.)

In making the complete contracting assumption, conventional economists picture a world in which exchanges are *voluntary* (the very idea of a contract implies that both parties have voluntarily agreed to it). Coercive—"command"—relationships are not in the picture because if everything that matters in an exchange has already been settled by contract, there is nothing for the exercise of power to be *about*. As the example of the employment contract makes clear, however, what is left out of an incomplete contract may have to be resolved by command. Moreover, when an employer issues an order to an employee, it may be necessary to hire a supervisor to make sure that the order is obeyed. In this case, the salary paid to the supervisor is a cost to the employer of having the contract enforced.

If the price paid for something in a market exchange *did* reflect all relevant aspects of the exchange, one could say "You get what you pay for," and vice versa. Thus, in the neoclassical economists' world, the things you might enjoy but do not have to pay for (such as the love of a friend or your neighbor's beautiful garden) are assumed to be either unimportant or the subject matter of some other discipline. Similarly, the things we get but would rather not get and are not paid to accept (such as a difficult supervisor or environmental pollution) are not given much attention.

Externalities occur when some of the effects of a market exchange are not reflected in the price and are thus "external" to the participants in the exchange.

Side effects on people other than those directly involved in a transaction are termed "external effects," or **externalities**. They are called this because they are said to be "external" to the transaction itself. For example, the price one pays for gasoline does not reflect the costs imposed on others as a result of its consumption—carbon monoxide emissions, smog, health costs, traffic congestion—so all such effects are externalities of the purchase and consumption of the gasoline. Economists generally agree that externalities are a fact of life in any modern economy. But in practice they are taken to be the exception, not the rule. The issues are: How widespread are they? And what should be done about them? Externalities are discussed at length in Chapter 9 of this book.

If by expanding the quantity of output an enterprise produces, the firm is able to reduce the average cost of producing a unit of output, then the production process has **economies of scale**.

The third important assumption of neoclassical economics is that *economies of scale* generally do not occur. The term **economies of scale** refers to a situation in which expanding the quantity of output produced in an enterprise per unit of time—or the *scale* of a productive activity—makes possible a reduction in the average cost of producing a unit of output.

Neoclassical economists assume that, beyond a modest scale of production, economies of scale are rare enough to ignore for most purposes. This in turn allows them to say that, in general, the average cost of producing a unit of a good will rise (or at least will not fall) as the rate of output is increased. This assumption flies in the face of the facts, namely, the prevalence in modern economies of large-scale production that allows many goods and services to be turned out at lower and lower costs per unit. (Think of music, pharmaceutical products, and this book.) The significance of the widespread presence—and growing importance—of economies of scale in modern economies is discussed briefly in Chapter 9 and at length in Chapter 11.

Why is it essential to neoclassical theory to assume that economies of scale do not exist or are of little importance? If economies of scale exist and are important, then the normal state of the economy cannot be competition among many small- or medium-sized firms. Smaller firms will find it impossible to thrive because larger firms will be able to produce at lower cost. When this is the case, the larger firms will be able to drive the smaller firms out of the market or to buy them out. There will then tend to be more monopoly than competition—and in that case the economics of competitive markets will be of little interest.

There is an additional reason why economies of scale may make the competitive markets of neoclassical economics the exception rather than the rule. The outcomes

of competition will often depend not just on which firm delivers a better product at lower cost. Market success may also depend on a firm's political influence, its ability to get a head start and enter a market first, or just the luck of being in the right place at the right time. Whatever the reason, if a firm gets to be a certain size before others do, it will have the advantage of being able to produce at a lower cost than its (actual or potential) competitors. Its greater size—and the cost advantage flowing from economies of scale—will enable it to leave the competition behind.

The three assumptions that underpin and define neoclassical economics can best be understood as part of a worldview dating from the seventeenth-century physics of Isaac Newton. From the standpoint of this worldview, all social and physical phenomena involve knowable and predictable motions of atomlike particles. Thus, the complete contracting assumption is a way of limiting an observer's view of the interactions among the particles so that these interactions may be seen as obeying a few simple laws. Similarly, the economic man assumption establishes the principle of motion of each particle. Finally, the assumption that economies of scale are negligible eliminates the advantages of head starts and accidents, and so implies that the past history of the interacting particles does not influence their current relationship. The end result, in neoclassical theory, is that the economy is viewed as a smoothly running machine, not one with the sometimes harmonious but more often conflict-ridden and sporadically chaotic human interactions that actually occur in a capitalist economy.

The neoclassical approach may be summarized in three interrelated points. First, the economic machine, as seen by a neoclassical economist, operates continuously and indefinitely into the future without any change in its basic design. It may need repair or replacement parts from time to time, but the machine itself—the economy—is relatively trouble-free and not very accident prone. Its few problems, such as recessions or technological unemployment, can easily be taken care of.

Second, change does not occur as a result of the workings of the economic system itself. If something in the economy should happen to change, it will do so only as a result of an *external* influence, such as a major technological innovation or the spontaneous emergence of a new fad in consumer tastes. The development of the Internet, with its corresponding expansion of electronic communication or the sudden proliferation of peoples' desires for running shoes and designer clothing, might be seen as examples of such "external" influences. In fact, however, such innovations and changes in consumer tastes do not occur entirely as a result of forces external to the economy. Rather, they are most often brought about by capitalism's drive to increase profits, expand markets, and sell more products.

Finally, since the economy remains unaffected by its own operation, it does not have a history. It does not, in itself, have a past, present, or future. Thus neoclassical economics presents only a "static" analysis of the economy—static (or "stationary") in the sense that it is not "dynamic." When this shortcoming is considered along with its (previously discussed) lack of interest in power (command) relationships, one may conclude that the conventional approach offers only a one-dimensional analysis of capitalism, focusing exclusively on competition and exchange on the supposedly level playing field of the market.

Values in Political Economy

Most people with an interest in economics care not only about how our economy works (or does not work), but also about what is good or bad about it and how it might be made to work better. The economy is the subject of much controversy and debate.

It used to be said that if you wanted to avoid an argument, stay away from politics or religion. Today, better advice might be: don't mention economics.

Debate in economics is not only about "what is"; it is also about "what should be." This is sometimes referred to as the difference between "positive" (or "scientific") economics and "normative" (or "policy-oriented") economics, but, in fact, the boundary is not always clear. The "what is" question has to do not only with facts but also with their *interpretation*. Thus, differences arise when people disagree about what the facts are—*and what they mean*. The question "what should be," on the other hand, cannot even be addressed without explicit reference to *values*. In this case differences arise when people disagree about which situations are better and which are worse.

Getting the facts and their interpretation right is an essential task for *any* approach to economics. The facts regarding "what is" must be determined with enough accuracy that people with varying points of view can agree on them. Statements about how the economy works are either true or false, however difficult it may be to determine which, and one's judgment of their truth or falsity should not depend on one's values.

When one is choosing to examine a particular aspect of "what is," however, the choice will usually be strongly influenced by one's view of "what should be." If one places a high value on individual freedom of choice and less on fairness, one might be more interested in studying the way that markets and governments may affect one's freedom than in figuring out why women are generally paid less than men. This last topic would be of greater interest to someone who attaches a higher value to fairness. Nobody can be equally interested in all aspects of the economy, and your values will help you decide which economic questions you would most like your economic investigations to illuminate. You need to have some idea about where your lost car keys are in order to know where to point your flashlight.

Values also provide a basis for judging whether we think an economic system is good or bad, or, more specifically, what processes or outcomes of an economic system are better or worse. If you value democracy highly you probably have a very negative opinion of dictatorial regimes such as the ones that prevailed in the former Communist countries. But if you care a lot about increasing the amount of material goods available in a society, you have to be impressed by the record-setting increases in output achieved by Communist-ruled China in the last quarter of the twentieth century. There are, of course, a number of different values, or criteria, on the basis of which one may, explicitly or implicitly, evaluate an economic system.

We evaluate economic systems on the basis of how well or how poorly they organize economic activities so as to provide opportunities for all their participants to lead flourishing lives. Our use of the biological term *flourish* is deliberate: plants flourish—as long as they have enough water, sunlight, and nutrients. In Chapter 14 we discuss some of the elements that people need in order to flourish. But certainly they cannot flourish when they lack adequate food and health care, when they are not free or are denied opportunities for learning, or when they are not respected both as individuals and as members of groups.

The most basic question regarding an economy is: How does it affect people? And while each individual may have his or her own definition of "the good life," an economy that provides more people with more opportunities to lead flourishing lives is judged to be better than an economy that provides fewer people with fewer such opportunities. An economy is thus evaluated on more than just "economic" outcomes—individuals' incomes, for example. It is assessed on *all* of the ways it affects its participants.

How, then, are we to determine what is needed for a flourishing life? Can we say that one person's passion for opera is such a need, while another's craving for a BMW is not? In fact, though, judgments are not hard to make about many of the important issues to which our evaluation criteria may be applied. Imagine a child starving in a country where large quantities of grain are fed to cattle on their way to becoming steaks. Most people would not regard this as a good allocation of grain, even though this conclusion requires making a judgment about the value of a steak to one person relative to the value of enough nutrition to produce a healthy child to another. The world as we know it—sadly—poses many more problems similar to the steak versus the hungry child than to the BMW versus the opera.

An economy can provide the means for a flourishing life, or it can hinder the achievement of one. Of course, whether individuals actually do lead happy and free lives will be influenced by many more variables than how the economy is organized. To a significant degree, the achievement of a flourishing life will depend on the choices one makes. But economies can create conditions favorable to the achievement of a flourishing life, or they can generate conditions that make it difficult to live with dignity, freedom, and happiness.

An economy will impede the achievement of flourishing lives if jobs are mind-numbing or unsafe, if children die young of easily preventable diseases, if people remain illiterate or are not free to speak their minds or practice the religion of their choice, if malnutrition is common, if people are stigmatized because of their race, sex, or sexual orientation, or if other conditions that limit opportunities are generated. An economy is better to the extent that it reduces or does not create such conditions—not just for a few people but for everyone and to the greatest possible extent.

Whether an economy contributes to a flourishing life for all the members of a society will depend on a number of aspects of the way the economy works. Among these are its efficiency, its fairness, and the degree to which it is democratic.

Efficiency

The term **efficient** is applied to a labor process if the effort, time, intelligence, creativity, raw materials, natural environment, information, and machinery used in it are applied in a way that enhances people's well-being by equipping them with the things and the free time needed to lead a flourishing life.

One criterion for evaluating an economic system is that it should be **efficient**. There are many definitions of efficiency in economics. We use the term to mean that labor and inputs are used well rather than wasted. Inputs include effort, time, intelligence, creativity, raw materials, the natural environment, and machinery. Using these inputs well (rather than wasting them) means using them to enhance people's well-being by equipping them with the things and the free time needed to lead a full life. An economic system that uses its resources more efficiently than another is, according to this criterion, a better economic system. It is better because it increases people's freedom to use their time and energy for noneconomic ends such as leisure, play, and learning.

INPUTS AND OUTPUTS Engineers think of efficiency as a relationship between physical inputs and output. A production process is said to be *technically efficient* if, given the existing technology, the output of it cannot be increased without using more of at least one of the inputs.

In evaluating efficiency, we need to look at both the inputs into production and the outputs from production in a particular way. Efficiency is not to be confused with *profitability*, which occurs when a firm's sales revenues exceed its costs, taking account of all the inputs paid for by the firm. Chapter 13 gives examples of why profitability and efficiency are not the same thing.

Efficiency refers to the production of *useful* goods and services. The production of goods and services that are not useful should be left out of the efficiency calculation. For instance, the production of advertising (beyond the extent to which it simply informs the consumer) is highly profitable—this is why it is produced—but it is not useful. The same may be said of some forms of military goods production during peacetime.

All inputs used in the production of useful goods and services, whether they are paid for or not, must be entered into the efficiency calculation. One input that is often not taken into account is the natural environment. A profitable factory that uses up clean water by adding toxic wastes to it may, in fact, be inefficient when all of its inputs are considered. This is because in addition to the inputs it pays for, the factory is also using up (consuming or destroying) a part of the natural environment.

Still another input that is frequently ignored is household labor. When we consider all the useful inputs and outputs of an economic system, we include work in the home as well as the labor that is organized in factories and elsewhere.

A further input that is often overlooked is labor effort. This is not the same as the *time* that a worker spends "at work." An assembly line that speeds up production may increase a company's profits, but it may not be efficient if the increased output is made possible only by an even larger increase in the employees' work effort, leaving them with greater fatigue at the end of the day and increased susceptibility to health problems. One way of thinking about this aspect of efficiency is to consider people and their health not only as inputs in the production process but as outputs of it as well.

PARETO EFFICIENCY The definition of efficiency preferred by many economists is *Pareto optimality*, named after the economist Vilfredo Pareto (Pa-RAY-toh), who first thought it up about a century ago. It is the definition of efficiency preferred by many economists. An outcome is a Pareto optimum (sometimes called *Pareto efficient*) if there exists no *other* outcome (using available resources and technologies) that would make at least one person better off without making anyone worse off. If there is some alternative use of inputs and outputs that has the win-win quality that some could be made better off and none worse off, the outcome is said to be *Pareto inefficient*.

Notice two things, however. First, there are a very large number of Pareto (efficient) optima, each with a different distribution of goods among the members of society. Second, even if some people are starving while others feed caviar to their cats, the result will be Pareto efficient if there is no way of redistributing the goods that makes the poor better off *without making the rich worse off* (the cats do not count). There is nothing about Pareto efficiency that implies fairness. Fairness is a separate criterion.

Fairness

Fairness means that people in an economic system suffer the burdens and enjoy the benefits of that economic system equitably.

A second criterion for evaluating an economic system is **fairness**, which involves the distribution of the system's burdens and benefits. Burden refers to sacrifices such as the work necessary to produce goods and services; benefit refers primarily to the use of what is produced. Who does how much work? And who consumes the products of the work that is done? Just as in evaluating the efficiency of an economy, all the costs of—and gains from—production need to be included.

A fair economic system would be one in which its burdens and benefits were distributed *equitably*. When judged according to this criterion of fairness, an economic system that distributes its burdens and benefits more equitably than another does is a better economic system. It is better because it recognizes the equal worth of all human beings. When each person is valued equally, the pleasures of each are equally worthy of being promoted, and the pains of each are equally worthy of being avoided. Thus, though each of us is different, we are the same with regard to our right to enjoy pleasures and avoid pain.

The belief in the equality of human worth as an ethical benchmark comes from a variety of sources. Virtually every religion considers each human being to be equal in the eye of whatever god is held to be supreme in the particular religious faith. The authors of the U.S. Declaration of Independence proclaimed in 1776: "We hold these truths to be self-evident, that all men are created equal, that they are endowed by their Creator with certain unalienable Rights, that among these are Life, Liberty, and the pursuit of Happiness." (But the right to vote was not one of these "Rights." Voting rights went only to free white male property owners at first in most states. Many Native Americans and Asians were excluded from citizenship and voting for decades, and only got the full legal right to vote in the mid-twentieth century; ex-slaves got citizenship in 1878 but were often prevented from voting until the Voting Rights Act of 1965. Women got voting rights in 1920.)

Many, possibly most, people would agree with the framers of the U.S. Constitution: people should have equal rights to participate in governing their societies and to be respected as individuals. But *what else* should be equal? Hardly anyone would argue that every individual should have exactly the same things, for this would not respect differences among people with regard to what they like and dislike. Some people work hard and long because they value material things, while others value leisure or nonmaterial pleasures more and therefore work less; it does not seem fair that both sets of people should receive the same quantity of material goods. Thus, while equality is a value endorsed in this book, it is important to be able to answer the question: *Equality of what?*

The answer offered here—and one that is widely shared not only in the U.S. but also throughout the world—is that people should have an *equal opportunity* to live a good life, however they may conceive of this objective. Equal opportunity requires that, insofar as it is possible, people should be equally free of impediments to fashioning for themselves the kind of life they want, as long as the exercise of their freedom does not limit or otherwise impinge on the pursuit of a good life by others.

Of course, there will always be impediments to doing what we would like to do. For example, it sometimes happens, as it did to one of the authors of this book, that a person dreams of becoming a musician, but falling short on talent, has to settle for going through life as an economist! Equal opportunity simply means that people should be equally free of those impediments that are within our power to remove.

Some violations of equality of opportunity are obvious, as when employers or landlords discriminate against people on the basis of their race, sex, or age. But there are many less blatant forms of inequality, and they are to be found in most societies. When some children attend well-equipped schools and are taught by outstanding teachers while other children do not have comparable facilities or teachers, opportunity is unequal. When poor people must pay more for groceries because, for example, lacking a car they must shop at small neighborhood stores, or when people must pay higher interest rates to borrow money because of their race, sex, or where they live, opportunity is unequal. If some young people start off life with an expensive college education and a trust fund while others have only debts that have been passed on to them by their parents, opportunity is unequal. When, as a result

of different starting points, some hard-working people earn only the minimum wage while other people, working no harder, take home hundreds or even thousands of dollars per hour of labor, opportunity is unequal.

Unlike the idea of *equal outcomes*, the objective of *equal opportunity* often requires people to have access to different things or to be treated in different ways. For example, people with health problems need more medical attention than do those without them. Children with dyslexia or other learning disabilities need more attention at school to have the same learning opportunities as do others. Children of parents who cannot or will not help them with their homework may also need more help at school if equality of opportunity is to be achieved.

The criterion of fairness will always be controversial. Should it apply equally to everyone in the world? Or should it be applied only within a single nation? If the answer is that it should be applied worldwide, then we say that it is unfair that a child growing up in a particular part of India will, as a result of poor living conditions, live twenty years less than a child of the same age growing up in Norway.

A final question: to what extent is it fair to give people second or third chances? If certain people drink their way through college and, as a result, end up poor and unemployed, does fairness require that they be temporarily supported while they undergo job training?

Democracy

The third criterion for assessing an economic system is *democracy*. One important part of this criterion questions the extent to which the economic system promotes (or hinders) the democratic functioning of the government. Another part asks whether the system allows for the accountability of power when it is exercised in the economy. An economic system that promotes democracy in both areas is better than one that does not. It is better because the ability to influence a decision that has an effect on you gives you greater control over your life.

Democracy is a process with three characteristics: the exercise of power is accountable to those affected by it, civil rights and personal liberties are guaranteed, and citizens have relatively equal access to political resources and influence.

Democracy is a process that has three characteristics: accountability of power, respect for civil liberties and other guarantees of individual choice, and equal opportunity for effective political participation. First, decision makers (whether in the government or elsewhere) must be held accountable to the people affected by their decisions. This requires periodic review and possible replacement of public officials by means of democratic elections. Those who wield power in the economy—owners of firms, for example—can be held accountable by similar means. Democratic governmental bodies can regulate the actions of firms. If there is competition among many firms, consumers can hold sellers accountable for bad products by switching to other sellers—"voting with their pocketbooks"—and firms failing to serve consumers well will be eliminated.

Second, there must exist guarantees for the exercise of the civil rights and personal liberties that are commonly associated with democratic citizenship. The rights to freedom of speech and assembly, for instance, are essential for democratic decision-making.

Third, the citizens in a democratic polity must have approximately the same amount of resources with which to participate in the democratic process; this is necessary if citizens are to have roughly equal opportunity to influence how decisions are made. A system in which everyone can vote but a few people—campaign contributors, for example—have more political influence than everyone else is not democratic.

Democracy does not mean that all decisions have to be made through voting. Individuals should be free independently to make any decisions that will have consequences entirely or mainly felt only by the individuals themselves. For example, the choice of which food to consume for dinner is almost always a decision that affects only the eater or the eater's family.

When a decision imposes unavoidable effects on many people, however, democracy requires that individual choice give way to collective democratic decision making. For example, the choice between closing down or modernizing an old factory will affect many people: the investors, the workers, the consumers of the product, the people who live near the plant and may be bothered by its noise or pollution, the community that depends on the property taxes on the plant, and so forth. In this case, the democracy criterion holds that individual choice—for instance, the plant owner's right to choose whether to close the plant—is undemocratic. If the democracy criterion is applied, all those affected by the decision must be able to participate in the decision-making process.

Of course, to call the owner's decision undemocratic does not mean that the value of democracy should trump the values of efficiency or fairness. Either or both of these may recommend against a democratic decision. In the plant-closing example, for instance, it is not easy to see how the competing claims of the consumers, neighbors, workers, owners, and others could all be accommodated. Should each be given one vote? Or should plant closings be regulated by democratic national governments to minimize their adverse effects?

Some economists would think it odd to suggest that a private firm should be run democratically. Conventional textbooks ignore the exercise of power in the economy and treat organizations such as corporations simply as pass-through structures: inputs go in one side and products come out the other. Texts that ignore the power that is exercised in corporations will find nothing in them to democratize. Moreover, the right of people to participate in a decision-making process, the outcome of which affects their entire community, is not considered to be a problem that falls within the purview of economics.

Democracy and command are not necessarily inconsistent, although a command can certainly be undemocratic. For instance, orders issued by dictators or rules imposed by employers will be undemocratic if the people affected by the orders or rules have had no influence in the processes that led to their issuance or imposition. But a command may also be a means of carrying out a democratic decision. Take, for example, a national environmental protection law that was formulated with popular participation and then voted on and passed by a democratically elected legislature. To enforce this law, a governmental agency, backed by a federal court, may have to order polluters to stop polluting. In a different kind of situation, the command given to a worker by a democratically chosen manager in a worker-owned and worker-run cooperative would be another example of a democratic command. Implementing and enforcing democratic decisions requires commands.

Balancing Efficiency, Fairness, and Democracy

Economic systems may be judged according to how well they meet the criteria of efficiency, fairness, and democracy. Some systems may be evaluated more favorably according to one or two of these standards, while other systems perform well in

relation to one or more of the other criteria. For example, slavery was efficient—at least in the production of some crops—but it was unfair and undemocratic. In contrast, production by independent producers (for instance, independent farmers who owned their own land in colonial New England) was probably less efficient than slavery, but it was fairer and might be thought of as more democratic. It is also possible that the ability of an economic system to perform well in relation to the standards of efficiency, fairness, and democracy will change over time as the economic system itself changes.

Moreover, it may be difficult for any economic system to make consistent progress toward meeting all three criteria simultaneously or with the same speed. For example, the efficiency criterion may conflict with the democracy standard in the following way: the achievement of efficiency—say, production of the greatest possible amount of useful goods and services with limited quantities of inputs—may require intense competition and a high degree of mobility of labor and capital, while these very same elements may make it difficult for worker-owned (or otherwise democratically controlled) enterprises or stable, democratically governed communities to survive.

Necessarily, then, our evaluations of economic systems will result in more complex judgments than simply "good" or "bad," "better" or "worse." Also, it is highly unlikely that everyone will agree on all of the issues involved. Each person's conclusions will depend on his or her own values, and as long as we remain autonomous individuals our values and the conclusions we reach on the basis of them will inevitably differ. To the degree that diversity and debate are good indicators of a healthy democratic society, such differences are to be welcomed.

In this book the values of efficiency, fairness, and democracy are not explicitly brought into the description and analysis of how capitalism works. Indeed, our analysis of capitalism should stand or fall without regard to a particular reader's values. The important question is whether the political economy approach offers a more fruitful way of understanding capitalism than that provided by neoclassical economics. We conclude this chapter with Table 3.1 summarizing the differences between the two approaches.

The contrast in Table 3.1 between neoclassical economics and political economy is of course not the only way one can subdivide economics. Indeed the subject is usually broken down into **microeconomics**, which is concerned with what individuals, families, and firms do (and why), and **macroeconomics**, which is about how decisions of the same individuals, families, and firms, together with government policies, determine outcomes for society as a whole. In Part 2 of this book—"Microeconomics"—we look at how buyers and sellers interact in markets, how firms seek to increase their profits, and how conflicts between employers and their employees regarding wages and work are resolved. In Part 3—"Macroeconomics"—we examine the interactions of individuals, firms, and governments, asking how they result in economy-wide outcomes affecting such things as incomes and opportunities, wealth and poverty, growth and stagnation, employment, unemployment, and inflation.

Microeconomics deals with decisions that individuals, families, and firms make (and why they make them).

Macroeconomics is about how the decisions of individuals, families, firms, and governments produce outcomes—such as economic progress or stagnation, inflation or unemployment—for society as a whole.

Having introduced the basic concepts of three-dimensional economics in this chapter, we proceed in the next chapter to explain how political economists analyze production in a capitalist economy, and how different relationships to the production processes define different groups with different economic interests.

TABLE 3.1 CONTRASTING PERSPECTIVES ON THE ECONOMY

NEOCLASSICAL ECONOMICS	POLITICAL ECONOMY
The main social relationships studied involve competition among self-interested people or between the firms in which they work.	The social relationships studied are cooperative as well as competitive, and generosity and reciprocity are considered along with self-interest.
Most economic interactions take the form of complete contracts.	Many economic interactions are not governed, or are not governed completely, by contracts.
Economic outcomes are determined by market forces. Power is exercised only by monopolies and governments.	The exercise of power is an important determinant of economic outcomes, even in competitive markets. Many economic outcomes are determined through bargaining between the parties or agents involved.
Constancy is the rule; change occurs only in response to forces outside the economic system.	Change is the rule, constancy the exception. Change, both in economic systems and in people, takes place through the workings of the economic system itself.
People's tastes and needs are determined largely by human nature or by other influences outside the economic system.	People's tastes and needs change and are strongly influenced by the economic system.
Knowledge and science evolve outside the economic system, governed by noneconomic forces.	Knowledge and science are strongly influenced by the economic system and by the exercise of power within it.
Economic inequality is given little attention and is measured by a single scale: income inequality.	Economic inequality is many-sided, encompassing differences of race, gender, status, property ownership, authority, income, political rights, and citizenship.
Economies are evaluated according to how well they do in relation to a limited view of efficiency.	Economies are evaluated according to how well they foster everyone's chance to lead a flourishing life; economic efficiency, fairness, and democracy can support the achievement of this goal.
Economies of scale (costs declining as output expands) are absent or may be ignored.	Economies of scale are common in modern economies and therefore must be taken seriously.

Suggested Readings

Ari Berman, *Give Us the Ballot: A Modern History of the Struggle for Voting Rights in America* (New York: Farrar, Straus, and Giroux, 2015).

Robert A. Dahl, *Democracy and Its Critics* (New Haven, CT: Yale University Press, 1989).

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Robert Nozick, *Anarchy, State, and Utopia* (New York: Free Press, 1974).

Louis Putterman, *Dollars and Change: Economics in Context* (New Haven, CT: Yale University Press, 2001).

John Rawls, *Justice as Fairness: A Restatement* (Cambridge, MA: Harvard University Press, 2001).

John Roemer, *Free to Lose: An Introduction to Marxist Economic Philosophy* (Cambridge, MA: Harvard University Press, 1988).