The Actual Economy versus a Fictional Economy

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Imagine an economy with universal double entry book keeping. All transactions are recorded for every individual. Revenue enters on one side as a loan to the buyer from the seller. This renders it an asset to the seller. Outlays enter on the opposite side as a debt of the buyer to the seller so it is a liability of the buyer. The actual economy is now close to this fanciful description as credit cards and their like become universal.

A prominent economist once said, perhaps in jest, that the demand for every commodity is perfectly inelastic apart from the demand for cranberries. Implicit was his belief this follows from the standard economic theory of demand. This theory assumes a consumer is subject to a budget constraint such that the sum of the outlays on each commodity given by the price of the commodity multiplied by the quantity bought cannot exceed a given amount. If all prices were reduced by one half, purchase of the same quantities would lead to a surplus. It seems to follow that outlays on at least some commodity, say cranberries, must increase. This is a non sequitor. If all prices drop by 50 percent, then the receipts of the consumer would also drop by 50 percent. Nothing would impel a change in the quantities bought or sold. A theory of demand would not rule out zero price elasticities for all commodities if a consumer were satiated with every possible commodity. Sigmund Freud would not be surprised if there were such a consumer.

The standard theory of demand assumes individuals choose what to buy by maximizing their utility subject to a budget constraint. The theory assumes commodities are available to individuals at given prices. It assumes n commodities enter an individual’s utility function. Utility is a non decreasing, continuous function of quantities. It is determinate up to a continuous increasing transformation. This theory gives demand functions for the n commodities that depend on their relative prices and
the buyer's income or wealth as defined by the budget constraint. If satiation is impossible and the utility function is quasi-concave, then the quantity demanded varies inversely with its relative price. If the consumer buys only one unit of the commodity, then no matter what the price, still only one unit would be sold. Coffins come to mind. Unless the consumer plans to use coffins as a gift or is an undertaker, a lower price of coffins is not likely to spur a consumer to buy more than one. Defenders of the standard theory would drop the claim it applies to an individual consumer. They would say it applies to an aggregate of consumers. If so, the utility trappings are an encumbrance.

One can also cling to the standard theory and abandon defense of its far fetched assumptions. An example in another science comes to mind, positive physics. Assume the Earth is flat and is the center of the universe. The Sun and all the planets revolve around the Earth. This is a testable theory. Having passed these tests it was accepted in parts of the world for many centuries, even millennia. Some ancient Greeks rejected this theory. One even measured the circumference of the Earth with considerable accuracy. These fellows were ignored or forgotten in Western Europe until the 15th century. Nobody takes positive physics seriously any more. To abandon positive economics is long over due.