

# Economics Module

Lecture 1

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# Reading

- Ha-Joon Chang ( 2014) Economics: The User's Guide.  
Pelican Books  
Chapters 1, 2 and 4

# What is economics all about?

Some common characterizations/definitions:

- The science which studies human behaviour as a relationship between ends and scarce means which have alternative uses. – *Lionel Robbins (1932)*
- The study of the allocation of scarce means to satisfy competing ends-*Gary Becker (1971)*
- Economics is, at root, the study of incentives- *Steven Levitt, Freakonomics ( 2005)*
- The subject matter of economics should be the economy – which involves money, work, technology, international trade, taxes and other things that have to do with the ways in which we produce goods and services, distribute the incomes generated in the process and consume the things thus produced – *Ha Joon Chang (2014)*

# Is there a clear boundary that defines the domain of economics?

## Examples

- Women's disproportionate burden of household work including childcare?
- Concentration of lower caste workers in manual scavenging
- Continuing civil war in several West African countries
- The history of technological progress
- Is all social phenomenon ultimately economic – the case for economic determinism
- Towards genuine interdisciplinarity in human sciences

# Diverse approaches to Economics

## **Fields of economics**

- Microeconomics
- Macroeconomics
- Development Economics
- Environmental Economics
- Financial Economics
- Econometrics

## **Schools of economic thinking**

- Classical
- Neoclassical
- Marxian
- Keynesian
- Institutionalist
- Behaviouralist and many more

# Microeconomics vs Macroeconomics

Microeconomics- economic theory constructed at the level of individual agents (individual, households, firms)

- Attempts to model individual behaviour on the basis of some well- formed assumptions like utility maximization or profit maximization
- Extensive use of mathematics including calculus

Macroeconomics- theory constructed at the level of the economy which is an aggregation of individual agents

- It is not a simple aggregation of micro behaviour but incorporates various interactions and feedback effects
- Concerned with economic growth, inflation, employment, fiscal deficit etc.

# Schools of economic thought

Classical School/political economy- the first structured body of economic thinking that emerged in Western Europe from late 18<sup>th</sup> century and continued to be dominant till late 19<sup>th</sup> century

- Usually Adam Smith's '**An inquiry into the nature and causes of wealth of nations**' (1776) is taken as the beginning of economics as a discipline
- Other notable classical economists include David Ricardo, Thomas Malthus and Karl Marx (Marx as a critique, more on that later)
- Some of the key ideas in classical economics: the invisible hand (Smith), efficacy of free trade between nations through comparative advantage (Ricardo), supply creating its own demand (Say)
- Analytical blocks were social classes with distinct interests (capitalists, workers, landlords) and the main analytical question was to understand the dynamics of the economy based on the interrelationship between these classes
- The primary focus was on production of goods (and to a lesser extent services)

# Neoclassical Economics

- Initiated in the late 19<sup>th</sup> century in the works of Stanley Jevons and Leon Walras and gradually acquired dominance in the 20<sup>th</sup> century with Alfred Marshall
- The analytical unit was the individual or the firm (microeconomics) with clearly defined goals of optimizing their self-interest and participating in market transactions
- Advent of calculus in economic theory which became more sophisticated over time
- The broad principle that self-interested economic agents participating in freely operating markets will generate socially optimum outcomes
- The focus changed to market exchange from production in classical economics
- Political economy became economics with the added connotation of a distinct 'science'
- Major contributors in the development of neoclassical economics in the 20<sup>th</sup> century- Paul Samuelson, Kenneth Arrow, Gerard Debreu



# Marxian Economics

- Analytical framework derived from Marx's own work in the magisterial 3 volume 'Capital' (1867 to 1894) and carried forward by other economists over the 20<sup>th</sup> century and beyond. Essentially a theory of capitalist dynamics
- Part of the classical economic paradigm(class based social analysis with a focus on the production process) but distinct in its fundamental criticism of the same
- Analytical building blocks: forces of production(technology, machines and labour power) and relations of production (property rights, employment relationship and division of labour)
- Labour theory of value as the guiding principle of economic valuation and surplus value appropriated by capitalists as the source of profits
- Marxian economic ideas were put in use in the Soviet economy (often in a mechanical way) but they also developed in Western academia although always at the margins.

# Keynesian Economics

- Named after the British economist John Maynard Keynes
- The key ideas of Keynesian economics are elaborated in Keynes's book 'General Theory of Employment, Interest and Money' (1936) and were based on the experience of the Great Depression (late 1920s- early 1930s) in the advanced capitalist world
- Keynesian theory has been foundational in developing the field of macroeconomics and remained dominant till the 1960s
- Main tenets: The role of uncertainty in determining investments, the possibility of demand deficiency in the economy leading to significant unemployment
- Can be seen as a rejection of Smith's understanding of the market system as a self-equilibrating mechanism
- The main policy prescription from Keynesian theory is the necessary role of governments in boosting demand through public investment

# Institutional Economics

- A line of economic thinking that lays precedence on social norms or institutions in determining economic outcomes
- Original ideas started in the USA in late 19<sup>th</sup> century and was an active line of economic research till the 1930s
- Major contributors: Thorstein Veblen, John Commons
- Criticism- lack of analytical rigour and dependence on descriptive material
- New Institutional Economics emerged in 1980s with the work of Joseph Stiglitz ( and others) where the structure of neoclassical economics was modified to account for institutional factors which impacted economic transactions
- Focus on private property rights as the main institution
- Institution here is defined as the 'rules of the game' i.e. rules that regulate economic exchange through the market system

# Behavioural Economics

- Take into account human behaviour influencing economic decisions
- Modification of Neoclassical school that human beings act rationally and selfishly always
- “The Behaviouralist school is so called because it tries to model human behaviours as they actually are, rejecting the dominant Neoclassical assumption that human beings always behave in a rational and selfish way. “ (Chang)
- Pioneering scholar: Herbert Simon
- The concept of ‘bounded rationality’- rational decision making within the limits of information deficiency and computational constraints faced by the human mind
- More recently behavioural economics has extended to experimental verification of human behavioural patterns- randomized controlled trials