Few people would claim to know very much about economics, perhaps seeing it as a complex and esoteric subject with little relevance to their everyday lives. It has been generally felt to be the preserve of professionals in business, finance, and government. Yet most of us are becoming more aware of its influence on our wealth and well-being, and we may also have opinions—often quite strong ones—about the rising cost of living, taxes, government spending, and so on. Sometimes these opinions are based on an instant reaction to an item in the news, but they are also frequently the subject of discussions in the workplace or over the dinner table. So to some extent, we do all take an interest in economics. The arguments we use to justify our opinions are generally the same as those used by economists, so a better knowledge of their theories can give us a better understanding of the economic principles that are at play in our lives.

> In economics, hope and faith coexist with great scientific pretension and also a deep desire for respectability.
>
> **John Kenneth Galbraith**
> **Canadian-US economist (1908–2006)**

Economics in the news

Today, with the world in apparent economic turmoil, it seems more important than ever to learn something about economics. Far from occupying a separate section of our newspaper or making up a small part of the television news, economic news now regularly makes the headlines. As early as 1997, the US Republican political campaign strategist Robert Teeter noted its dominance, saying, "Look at the declining television coverage [of politics]. Look at the declining voting rate. Economics and economic news is what moves the country now, not politics."

Yet how much do we really understand when we hear about rising unemployment, inflation, stock market crises, and trading deficits? When we're asked to tighten our belts or pay more taxes, do we know why? And when we seem to be at the mercy of risk-taking banks and big corporations, do we know how they came to be so powerful or understand the reasons for their original and continued existence? The discipline of economics is at the heart of questions such as these.

The study of management

Despite the importance and centrality of economics to many issues that affect us all, economics as a discipline is often viewed with suspicion. A popular conception is that it is dry and academic, due to its reliance on statistics, graphs, and formulas. The 19th-century Scottish historian Thomas Carlyle described economics as the "dismal science" that is "dreary, desolate, and, indeed, quite abject and distressing." Another common misconception is that it is "all about money," and while this has a grain of truth, it is by no means the whole picture.

So, what is economics all about? The word is derived from the Greek word *Oikonomia*, meaning "household management," and it has come to mean the study of the way we manage our resources, and more specifically, the production and exchange of goods and services. Of course, the business

of producing goods and providing services is as old as civilization, but the study of how the process works in practice is comparatively new. It evolved only gradually; philosophers and politicians have expressed their opinions on economic matters since the time of the ancient Greeks, but the first true economists to make a study of the subject did not appear until the end of the 18th century.

At that time the study was known as "political economy," and had emerged as a branch of political philosophy. However, those studying its theories increasingly felt that it should be distinguished as a subject in its own right and began to refer to it as "economic science." This later became popularized in the shorter form of "economics."

A softer science

Is economics a science? The 19th-century economists certainly liked to think so, and although Carlyle thought it dismal, even he dignified it with the label of science. Much economic theory was modeled on mathematics and even physics (perhaps the "-ics" ending of "economics" helped to lend it scientific respectability), and it sought to determine the laws that govern how the economy behaves, in the same way that scientists had discovered the physical laws underlying natural phenomena. Economies, however, are man-made and are dependent on the rational or irrational behavior of the humans that act within them, so economics as a science has more in common with the "soft sciences" of psychology, sociology, and politics.

Economics was perhaps best defined by British economist Lionel Robbins. In 1932, he described it in his *Essay on the Nature and Significance of Economic Science* as "the science which studies human behavior as a relationship between ends and scarce means which have alternative uses." This broad definition remains the most popular one in use today.

The most important difference between economics and other sciences, however, is that the systems it examines are fluid. As well as describing and explaining economies and how they function, economists can also suggest how they ought to be constructed or can be improved.

> The first lesson of economics is scarcity: there is never enough of anything to satisfy all those who want it. The first lesson of politics is to disregard the first lesson of economics.
>
> **Thomas Sowell**
> **US economist (1930–)**

The first economists

Modern economics emerged as a distinct discipline in the 18th century, in particular with the publication in 1776 of *The Wealth of Nations*, written by the great Scottish thinker Adam Smith. However, what prompted interest in the subject was not so much the writings of economists as the enormous changes in the economy itself with the advent of the Industrial Revolution. Previous thinkers had commented on the management of goods and services within societies, treating questions that arose as problems for moral or political philosophy. But with the arrival of factories and mass producers of goods came a new »

era of economic organization that looked at the bigger picture. This was the beginning of the so-called market economy.

Smith's analysis of the new system set the standard with a comprehensive explanation of the competitive market. Smith suggested that the market is guided by an "invisible hand," where the rational actions of self-interested individuals ultimately give the wider society exactly what it needs. Smith was a philosopher, and the subject of his book was "political economy"—it stretched beyond economics to include politics, history, philosophy, and anthropology. After Smith a new breed of economic thinkers emerged who chose to concentrate entirely on the economy. Each of these built upon our understanding of the economy—how it works and how it should be managed—and laid the foundations for the various branches of economics.

As the discipline evolved, economists identified specific areas to examine. One approach was to look at the economy as a whole, either at a national or international level, which became known as "macroeconomics." This area of economics takes in topics such as growth and development, measurement of a country's wealth in terms of output and income, and its policies for international trade, taxation, and controlling inflation and unemployment. In contrast, what we now call "microeconomics" looks at the interactions of individual people and firms within the economy: the business of supply and demand, buyers and sellers, markets and competition.

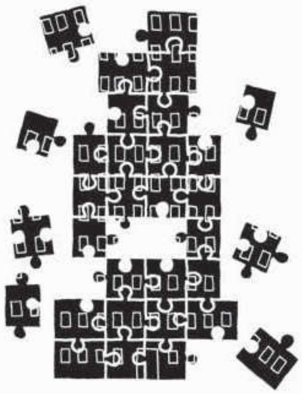
New schools of thought

Naturally, there were differences of opinion among economists, and various schools of thought evolved. Many welcomed the prosperity that the modern industrial economy brought and advocated a "hands-off" or laissez-faire approach to allow the competitive market to create wealth and stimulate technological innovation. Others were more cautious in their estimation of the market's ability to benefit society and identified failings of the system. They thought these could be overcome by state intervention and argued for a role for governments in providing certain goods and services and in curbing the power of the producers. In the analysis of some, notably the German philosopher Karl Marx, a capitalist economy was fatally flawed and would not survive.

> Economics is, at root, the study of incentives: how people get what they want, or need, especially when other people want or need the same thing.
>
> **Steven D. Levitt**
> **Stephen J. Dubner**
> **US economists (1967– and 1963–)**

The ideas of the early "classical" economists such as Smith were increasingly subjected to rigorous examination. By the late 19th century economists educated in science were approaching the subject through the disciplines of mathematics, engineering, and physics. These "neoclassical" economists described the economy in graphs and formulas, and proposed laws that governed the workings of the markets and justified their approach.

By the end of the 19th century economics was beginning to develop national characteristics: centers of economic thinking had



grown as university departments were established, and there were distinguishable differences between the major schools in Austria, Britain, and Switzerland, particularly on the desirability of some degree of state intervention in the economy.

These differences became even more apparent in the 20th century, when revolutions in Russia and China brought almost a third of the world under communist rule, with planned economies rather than competitive markets. The rest of the world, however, was concerned with asking whether the markets alone could be trusted to provide prosperity. While continental Europe and Britain argued about degrees of government intervention, the real battle of ideas was fought in the US during the Great Depression after the Wall Street Crash of 1929.

In the second half of the 20th century the center of economic thought shifted from Europe to the US, which had become the dominant economic superpower and was adopting ever more laissez-faire policies. After the collapse of the Soviet Union in 1991, it seemed that the free market economy was indeed the route to economic success, as Smith had predicted. Not everyone agreed. Although the majority of economists had faith in the stability, efficiency, and rationality of the markets, there were some who had doubts, and new approaches arose.

Alternative approaches

In the late 20th century new areas of economics incorporated ideas from disciplines such as psychology and sociology into their theories, as well as new advances in mathematics and physics, such as game theory and chaos theory. These theorists also warned of weaknesses in the capitalist system. The increasingly severe and frequent financial crises that took place at the beginning of the 21st century reinforced the feeling that there was something fundamentally wrong in the system; at the same time scientists concluded that our ever-increasing economic wealth came at a cost to the environment in the form of potentially disastrous climate change.

As Europe and the US begin to deal with perhaps the most serious economic problems they have ever faced, new economies have emerged, especially in Southeast Asia and the so-called BRIC countries (Brazil, Russia, India, and China). Economic power is once again shifting, and no doubt new economic thinking will evolve to help manage our scarce resources.

One prominent casualty of the recent economic crises is Greece, where the history of economics started, and where the word "economics" comes from. In 2012, protesters in Athens pointed out that democracy also comes from the Greeks but is in danger of being sacrificed in the search for a solution to a debt crisis.

It remains to be seen how the world economy will resolve its problems, but, armed with the principles of economics outlined in this book, you will see how we got into the present situation, and perhaps begin to see a way out. ■

> “The purpose of studying economics is …to learn how to avoid being deceived by economists.”
>
> **Joan Robinson**
> **UK economist (1903–83)**

ECONOMICS IS THE SCIENCE OF SCARCE RESOURCES

DEFINITIONS OF ECONOMICS

IN CONTEXT

FOCUS
Economic methods

KEY THINKER
Lionel Robbins (1898–1984)

BEFORE
1890 UK economist Alfred Marshall publishes *Principles of Economics*, which defines economics as "… that part of individual and social action which is most closely connected with the attainment and use of material requisites for well-being."

AFTER
1962 US economist Milton Friedman endorses Robbins's definition, yet expands the boundaries of what Robbins has defined as economics.

1971 US economist Gary Becker publishes *Economic Theory*, in which he defines economics as "the study of the allocation of scarce means to satisfy competing ends."

In 1932, the British economist Lionel Robbins provoked controversy by publishing his *Essay on the Nature and Significance of Economic Science*, which contained a new definition of economics. Robbins defined it as the science of human actions in the face of limited resources with multiple uses. He based his definition on the fact that human needs are infinite, yet there are only a finite amount of resources.

As one need is fulfilled, another one takes its place. However, there are only limited resources (land, labor, entrepreneurship, and capital) available to fulfill these desires. Scarcity means that every desire can never be satisfied.

Needs versus resources

The tension between unlimited needs and limited resources is the basis of economics. Every resource has an alternative use—for example, if a field is used for grazing livestock, it cannot produce a crop at the same time. This means that we have to decide the best way of using resources. Robbins believed that this is the key problem facing every society—deciding which goods to produce, and in what quantity, in order to best satisfy consumers. It is the very scarcity of resources that gives them their value.

Today, Robbins's definition is widely accepted, but some argue that economics should be seen in broader terms—as an investigation of how societies generate more resources over time. ■

Lionel Robbins's definition focuses on the fact that scarcity forces an economic choice—such as whether to use a field to feed cattle or grow wheat.

See also: Demographics and economics 68–69 ■ Opportunity cost 133 ■ Markets and social outcomes 210–13 ■ Shortages in planned economies 232–33

MAN IS A COLD, RATIONAL CALCULATOR

ECONOMIC MAN

IN CONTEXT

FOCUS
Decision making

KEY THINKER
Adam Smith (1723–90)

BEFORE
c.350 BCE Greek philosopher Aristotle claims that innate self-interest is the primary economic motivator.

1750s French economist François Quesnay claims that self-interest is the motivation behind all economic activity.

AFTER
1957 US economist Herbert Simon argues that people are not able to acquire and digest all available information about every topic, so their rationality is "bounded" (limited).

1992 US economist Gary Becker receives the Nobel Prize for his work on rational choice in the fields of discrimination, crime, and human capital.

As individuals we are **self-interested**.

↓

We aim to improve our **personal well-being** by consuming goods and services and achieving goals.

↓

We make decisions by **collecting information and calculating** which actions will help us achieve our aims without being too costly.

↓

Man is a cold, rational calculator.

Most economic models are underpinned by the assumption that humans are essentially rational, self-interested beings. This is *Homo Economicus*, or "economic man." The idea—which applies equally to men and women—assumes that every individual makes decisions designed to maximize their personal well-being, based on a level-headed evaluation of all the facts. They choose the option that offers the greatest utility (satisfaction) with the least effort. This idea was first expounded by Adam Smith (p.61) in his 1776 work, *The Wealth of Nations*.

Smith's central belief was that human economic interaction is governed mainly by self-interest. He argued that "it is not from the benevolence of the butcher, the brewer, or the baker that we can expect our dinner, but from their regard to their own interest." In making rational decisions suppliers seek to maximize their own profit; the fact that this supplies us with our dinner matters little to them.

Smith's ideas were developed in the 19th century by the British philosopher John Stuart Mill (p.95). Mill believed people were beings

See also: Free market economics 54–61 ▪ Economic bubbles 98–99 ▪ Economics and tradition 166–67 ▪ Markets and social outcomes 210–13 ▪ Rational expectations 244–47 ▪ Behavioral economics 266–69

who desire to possess wealth, by which he meant not just money, but a wealth of all things good. He saw individuals as motivated by the will to achieve the greatest well-being possible, while at the same time expending the least possible effort to achieve these goals.

Costs and benefits

Today, the idea of *Homo Economicus* is referred to as rational choice theory. This says that people make all kinds of economic and social decisions based on costs and benefits. For example a criminal thinking of robbing a bank will weigh the benefits (increased wealth, greater respect from other criminals) against the costs (the chances of getting caught and the effort involved in planning the heist) before deciding whether to commit the crime.

Economists consider actions to be rational when they are taken as a result of a sober calculation of costs and benefits in relation to reaching a goal. Economics may have little to say about the goal itself, and some goals may appear to be quite irrational to most people. For example, while to most of us it may seem a dangerous decision to inject the human body with unverified performance-enhancing drugs, for numerous athletes—in the context of the desire to be the best—the decision may be a rational one.

Some people have questioned whether the idea of *Homo Economicus* is realistic. They argue that it does not allow for the fact that we cannot weigh every relevant factor in a decision—the world is too complex to collect and evaluate all the relevant facts needed to calculate costs and benefits for every action. In practice we often make quick decisions based on past experience, habit, and rules of thumb.

The theory also falters when there are conflicting long- and short-term goals. For instance someone might buy an unhealthy burger to stave off immediate hunger, despite knowing that this is an unhealthy choice. Behavioral economists have begun to explore the ways in which humans act differently from *Homo Economicus* when making choices. The idea of "economic man" may not be entirely accurate for explaining individual behavior, but many economists argue that it remains useful in analyzing the actions of profit-maximizing firms. ■

Monks who lead a life of fasting and prayer, denying worldly goods in the expectation of an afterlife, act rationally within their beliefs, regardless of what others may think of their goal.

Parents' investments in children, especially through education, are an important source of an economy's capital stock, according to Becker.

Family economics

US economist Gary Becker (1930–) was one of the first to apply economics to areas usually thought of as sociology. He argues that decisions relating to family life are made by weighing costs and benefits. For example he views marriage as a market and has analyzed how economic characteristics influence the matching of partners. Becker also concluded that family members will help each other, not out of love, but out of self-interest in the hope of a financial reward. He believes that investment in a child is motivated by the fact that it often produces a better rate of return than traditional retirement savings. However, children cannot be legally forced to take care of their parents, so they are brought up with a sense of guilt, obligation, duty, and love, which effectively commits them to helping their parents. For this reason it can be argued that the welfare state damages families by reducing their need for interdependence.

ECONOMIES ARE EMBEDDED IN CULTURE

ECONOMICS AND TRADITION

IN CONTEXT

FOCUS
Society and the economy

KEY THINKER
Karl Polanyi (1886–1964)

BEFORE
1776 In *The Wealth of Nations*, Adam Smith argues that man has a natural tendency to trade and barter for profit.

1915 Polish anthropologist Bronislaw Malinowski describes the *kula* system of the Trobriand Islands.

1923 French sociologist Marcel Mauss publishes *The Gift*, a study of gift-giving in traditional societies.

AFTER
1977 US economist Douglass North argues that Trobriander behavior can be explained using economics.

1990s Israeli economist Avner Offer shows that non-economic behavior plays an important role in modern economies.

Economists believe that people are rational, in that they will take the action that promises the highest economic return, whether this is choosing a car or a president. The Austrian-born economist Karl Polanyi turned this idea on its head. He said that the important thing about people is that they are social beings submerged in a "soup" of culture and tradition. It is this soup that is the nourisher of economic life, he claimed, not the profit motives of calculating individuals.

Island economics

In *The Great Transformation* (1944), Polanyi wrote about the Trobriand Islands, off Papua New Guinea, whose tribal economy was driven by non-economic behavior in

People are **social beings**.

Social beings **desire status**.

People gain status by acting in accordance with **cultural norms**.

These cultural norms **influence** economic organization.

Throughout history, cultural and social factors have been the **main fuel** of economic life.

Economies are embedded in culture.

See also: Economic man 52–53 ▪ Religion and the economy 138–39 ▪ Institutions in economics 206–07 ▪ Social capital 280

> The economic system is, in effect, a mere function of social organization.
> **Karl Polanyi**

striking ways. Trade, even today, happens through gifts, not by haggling. Islanders make dangerous voyages to neighboring tribes to give presents of red-shell necklaces and white armbands, and the practice is regulated by customs and magical rites known as *kula*. The gifts are not kept, but passed on. By showing generosity, the islanders enhance their social standing. The drive for status, not profit, is the motor of trade.

Tribal economies are, of course, different from those of today's industrialized countries. Polanyi argued that as European nations developed, custom and tradition were supplanted by the anonymity of the market. Even so, the soup of culture and social ties still sustains advanced economies.

The Israeli economic historian Avner Offer (1944–) has documented the role of non-market precepts in modern economic life, including those of gift giving and favors. Like the islanders, modern societies practice wealth redistribution—otherwise it would not be possible to build roads or raise armies. Home-based economic activities such as cooking, cleaning, and child care—in both traditional and modern economies—are done for their usefulness rather than for profit. Offer estimates that in late-20th-century Britain, this type of non-market production amounts to 30 percent of national income.

Individualistic economies

Polanyi believed that economies come from the "substantive" features of societies—their special histories and quirks of culture. For the economic purist all this is irrelevant, obscuring what really propels economies: the signals that prices send to rational individuals in whom the thirst for gain trumps religion or culture, even in the most traditional communities. These two positions can only be resolved if it is possible to reduce the social norms that govern whole societies to the actions of self-interested individuals. Polanyi rejected this. He believed that modern markets and social structures are in conflict, and that where markets expand, social upheaval inevitably follows. ■

Trobriand islanders follow unusual customs of gift exchange. Red-shell necklaces are carried clockwise around the islands by sea; white arm bands are circulated counter-clockwise.

Karl Polanyi

Born in Vienna to Jewish parents in 1886, Karl Polanyi was brought up in Budapest, Hungary, where he studied law. As a student he mixed with radicals such as the Marxist philosopher Georg Lukács and the sociologist Karl Mannheim. During World War I he served in the Austro-Hungarian army, then moved to Vienna, working as a journalist. He married a young revolutionary, Ilona Duczynska, and the two of them fled to Britain in 1933 to escape the rise of nazism.

In London Polanyi worked as a journalist and taught working people whose poor living conditions left a lasting impact on him. From 1940 until his retirement he lectured in the US but had to live in Canada and commute because his wife's involvement in the Hungarian Revolution banned her from entering the country. He died in 1964.

Key works

1944 *The Great Transformation*
1957 *Trade and Markets in the Early Empires* (with C. Arnsberg and H. Pearson)
1966 *Dahomey and the Slave Trade* (with A. Rotstein)