ECON 1000 Summer 2010 Lecture #1

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1 What is economics?

According to Alfred Marshall[1]:

> A Study of mankind in the ordinary business of life; it examines that part of individual and social action which is most closely onnected with the attainment and with the use of the material requisites of well-being.
>
> Thus it is on the one side a study of wealth; and on the other, and more important side, a part of the study of man....

According to Milton Friedman[2]:

> Economics is the science of how a particular society solves its economic problems. An economic problem exists whenever *scarce* means are used to satisfy *alternative* ends. If the means are not scarce, there is no problem at all; there is Nirvana. If the means are scarce but there is only a single end, the problem of how to use the means is a technological problem. No value judgements enter into its solution, only knowledge of physical and technical relationships....
>
> Economics, by our definition, is not concerned with all economic problems. It is a *social* science, and is therefore concerned primarily with those economic problems whose solutions involve the cooperation and interaction of different individuals. Furthermore, it is concerned not with the economic problem in the abstract, but with how a *particular* society solves its economic problems....

[1] Marshall, Alfred. Principles of Economics. 8th ed. Macmillan and Co., Ltd., 1920. http://www.econlib.org/library/Marshall/marPContents.html.

[2] Friedman, Milton. Price Theory. New Brunswick, NJ: Aldine Transaction, 2007. See also Robbins, Lionel. An Essay on the Nature and Significance of Economic Science. 2nd ed. London: Macmillan and Co., Ltd., 1945. http://mises.org/resources/126.

According to Gary Becker[3]:

> . . . what most distinguishes economics as a discipline from other disciplines in the social sciences is not its subject matter but its approach. . . .
>
> The combined assumptions of maximizing behavior, market equilibrium, and stable preferences, used relentlessly and unflinchingly, form the heart of the economic approach as I see it. . . .
>
> The economic approach is clearly not restricted to the material goods and wants, nor even to the market sector. . . .
>
> The economic approach does not assume that all participants in any market necessarily have complete information or engage in costless transactions. . . .
>
> Moreover, the economic approach does not assume that decisions units are necessarily conscious of their efforts to maximize or can verbalize or otherwise describe in an informative way reasons for the systematic patterns in their behavior. . . .
>
> In addition, the economic approach does not draw conceptual distinctions between major and minor decisions . . . or between decisions said to involve strong emotions and those with little emotional involvement. . .

[3]Becker, Gary S. The Economic Approach to Human Behavior. University of Chicago Press, 1978.

Herbert Gintis observes[4]:

> The behavioral sciences include economics, anthropology, sociology, psychology, and political science, as well as biology insofar as it deals with animal and human behavior. These disciplines have distinct research foci, but they include four conflicting models of decision-making and strategic interaction ... the psychological, the sociological, the biological, and the economic.
>
> These four models are not only different, which is to be expected given their distinct explanatory goals, but *incompatible*...
>
> My framework for unification includes five conceptual units: (a) gene-culture coevolution; (b) the socio-psychological theory of norms; (c) game theory, (d) the rational actor model; and (e) complexity theory....
>
> The rational actor model, developed in economic and decision theory, is the single most important analytical construct in the behavioral sciences operating at the level of the individual. While gene-culture coevolutionary theory is a form of "ultimate" explanation that does not predict, the rational actor model provides a "proximate" description of behavior that can be tested in the laboratory and real life, and is the basis of the explanatory success of economic theory. Classical, epistemic, and behavioral game theory make no sense without the rational actor model, and behavioral disciplines, like sociology and psychology, that have abandoned this model have fallen into theoretical disarray.

[4]Gintis, Herbert. Five Principles for the Unification of the Behavioral Sciences, May 13, 2008. http://www.umass.edu/preferen/gintis/NewUnity.pdf.

2 Economics vs. Folk Economics

The opposite of economic science isn't *no* economics, but what Paul Rubin calls[5] "folk economics". Because our brains evolved to solve the kinds of problems encountered in earlier hunter-gather societies, they aren't necessarily well-adapted to solving the economic problems of a modern market society:

> To summarize, we evolved in situations of little specialization and division of labor, little capital, low technological change, and little or no economic growth. There was some exchange, including intertemporal exchange of the same good, and possibilities of shirking. If there were wealth inequalities, they were probably due to shirking by refusing to share. If our minds evolved in this situation, then current innate economic modules should be adapted to this setting, and this appears to be the case.. . .
>
> The implication of this analysis is that for many economic problems, folk economics will get the wrong answer. Moreover, the answer will be wrong in predictable ways. Folk economics will stress the fixed sum, division-of-the-pie aspect of a problem, rather than the size-of-the-pie issues.. . .

So, we're not born knowing how to do economics, just as we're not born knowing, say, quantuum physics. This is good news for economics teachers, but bad news for economics students. Moreover, it's bad news for society: the failure of the average citizens to understand quantuum physics rarely causes problems, but widespread misunderstanding of economics has potentially disastrous implications. Rubin gives several examples of the conflict between economics and folk economics:

1. International trade: folk economics focuses on the effect of trade on jobs, rather than production and consumption.

2. Labor: folk economics focuses on the effect of technology or restructuring on jobs rather than the value of output in a sector; minimum wage laws and other regulations seen as only transferring income, not affecting employment rates.

3. Public finance: likewise, folk economics focuses on distributional effects of taxes and subsidies and ignores the incentive effects.

4. Tort law: jurors and others ignore the effects of product liability and medical malpractice decisions on investment.

[5] Rubin, Paul H. "Folk Economics." Southern Economic Journal 70, no. 1 (July 2003): 157-171.

3 What Causes the Wealth of Nations?

As Our Master observed over 200 years ago[6]:

> Among civilized and thriving nations ... though a great number of people do not labour at all, many of whom consume the produce of ten times, frequently of a hundred times, more labour than the greater part of those who work; yet the produce of the whole labour of the society is so great, that all are often abundantly supplied; and a workman, even of the lowest and poorest order, if he is frugal and industrious, may enjoy a greater share of the necessaries and conveniencies of life than it is possible for any savage to acquire.

To frame the question in a more politically-correct way, How did *Homo sapiens* progress beyond a state of mere subsistence to one of plenty? And why are some societies more successful than others at increasing their members' standard of living? Also, as Smith notes, this increase in the absolute standard of living for even a society's poorest members may coincide with an increase in inequality between members of that society. What determines the distribution of income and wealth in a society? And how is it related to the overall standard of living?

[6]Smith, Adam. An inquiry into the nature and causes of the wealth of nations. 1776.

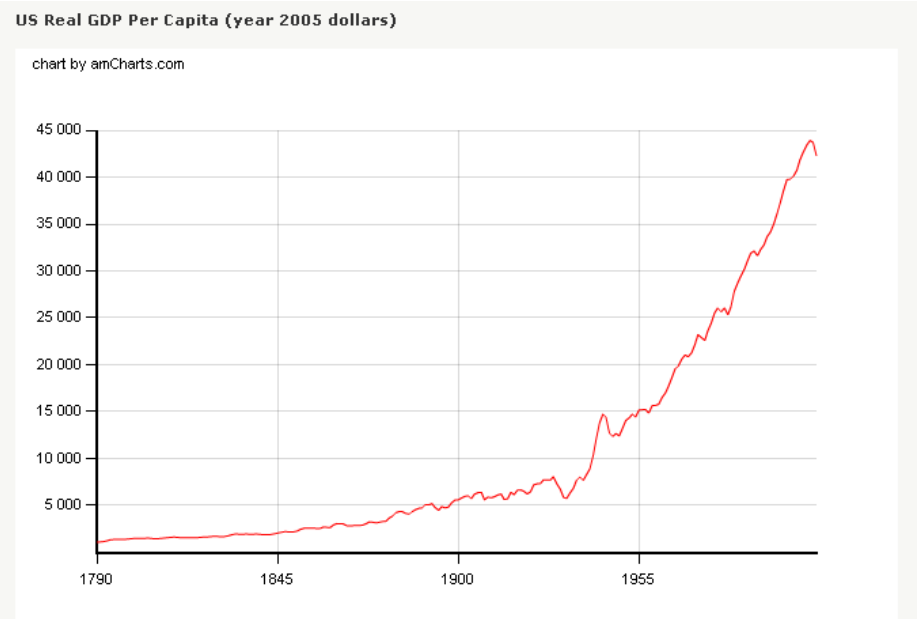

Figure 1: Real US per capita GDP, 1790-2009 (Source: http://www.measuringworth.com/)

4 Economics & Ethics

Another way of looking at the economic problem is as answering the following questions:

1. What shall we produce?
2. How shall we produce it?
3. For whom shall we produce it?

As you can see, these aren't purely technical questions. Which is better, a society that produces lots of bibles or lots of pornography? Is a society with more material goods better than one with less, even if it requires that some people work at dull, repetitive jobs? And do some people deserve a larger share of economic output than others? Your answers to these questions will be based, at least in part, on ethical considerations.

Economists distinguish between two kinds of statements about economic issues: roughly speaking, *positive* statements are statements about what is, while *normative* statements are statements about what should be. As a social science, economics is properly concerned with making positive statements about "the ordinary business of life". But understanding the tradeoffs involved also helps to clarify the ethical choices we face and their consequences.

5 To See and To Do

Explore the tools at http://www.measuringworth.com/. Compare the population and the per capita real GDP in 2009 to those in the year you were born and the year your mother was born. Explore real output per capita in the UK from 1300 to 2009.

Explore http://en.wikipedia.org/wiki/List_of_countries_by_GDP_%28PPP%29_per_capita. In which countries are citizens best/worst off by this measure? Speculate about why some countries do better than others. Are there any surprises? Could these anamolies be due to the measure we're using (GDP)?