CHAPTER 2: ECONOMICS AND THE ECONOMY

It would not be easy to avoid all discussion of economics in twenty-first century America. You would have to keep your distance from television, radio and newspapers, not to mention casual conversations on the job, over a beer, or at a family gathering. In fact, our society is saturated with economics, reflecting the great power that economic events have over our lives, even though the forces that produce them are often mysterious. Economics is like the weather, only more so: all around us, obviously important, subject to prediction but only slightly to control.

Unfortunately, much of the folk wisdom about economics — the assumptions behind the daily conversion in our lives and reflected in the media — is *wrong*. It misrepresents what economics is and what it has to say to us. Since we get these messages, consciously and unconsciously, dozens of times each day, the first step in studying economics is to *unlearn* the assumptions we pick up in daily life. This is not easy to do. I will discuss a few of the more common myths in this chapter, but it is my experience that deeply ingrained ideas do not fade away easily. You will want to return to these myths later on, as we gradually build up a body of theories to replace them.

Myth #1: Economics is the study of how to make money.

Economists are certainly interested in the strategies people employ in order to make money, but the purpose of economics is not to help anyone do this more successfully. The vantage point of economics is not any particular individual and their material goals, but rather society as a whole. *Economics is about what is beneficial for society in general.* What's good for any particular individual is not necessarily good for all of us as a group, and economics takes this distinction very seriously. Often economists are interested in interfering with the money-making plans of particular individuals or businesses in order to safeguard the interests of society instead.

A good example of this is the study of monopoly — a situation in which a single business controls all or most of a market. Monopoly can be very lucrative: get rid of your competitors and you can make higher profits. Economists are interested in the ways businesses exploit the power of monopoly, whether they raise prices and restrict options for consumers, or whether they engage in pre-emptive innovation and even price-cutting in order to discourage future competition. In this sense, they do study the money-making process. But the goal is not to make monopolists rich, since that can easily happen at the expense of society. Instead, the purpose of economic analysis is to anticipate how monopolists will use their power, what effect this will have on the rest of society, and therefore whether action should be taken to restrict this power or limit how it can be used. In their studies of these questions, economists should be guided by the desire to promote the well-being of all members of society and not just those who hold a monopolistic advantage.

Myth #2: Economics says that supply and demand in free markets solves all our economic problems.

To be honest, there is a germ of truth here: economists, as a group, are far more supportive of free markets than just about anyone else. They tend to be more pro-business, regarding profits as largely justified and beneficial. They are more likely than other academic specialists to question the desirability of regulations that limit the freedom of businesses to make money as they see fit. This hostility toward government often translates into a belief that supply and demand should govern economic outcomes, or that these forces are so powerful that it is not a good idea to stand in their way.

Most people, for instance, think it's a good idea for the government to set a minimum wage, a bottom limit to the amount employers must pay their workers for an hour's work. They think minimum wages contribute to fairness and reduce poverty. (People disagree on what this minimum should be of course, but not as often on the need for *some* minimum.) A high percentage — perhaps a majority — of economists, however, think there should be no such regulation of wages. In their view, if a worker is willing to work for a very low wage and an employer is willing to pay it, it would be unwise to interfere. The forces of supply (workers) and demand (employers) for labor should determine wage rates, and nothing else.

Nevertheless, it is much too sweeping to claim that economics is ever and always wedded to free markets. In situation after situation, economists are quite willing to support government or other forms of intervention in order to protect the interests of society from the actions of individuals in the marketplace. They do this because they believe that markets often *fail*; in fact, much of economic theory consists of a careful analysis of the causes and consequences of this failure. Economists are more likely to support the ideal of a free market, but they are perfectly willing to withdraw this support when markets misfire. We will see many examples of this over the course of this text.

Myth #3: Economics is about "economizing" — holding down costs.

This is a case of language playing tricks on us. The common meaning of economizing is to make do with less; it's a term we're all familiar with. It is natural, then, to think that this has something to do with economics as well. There is just enough truth to the idea to make it really insidious; economists, after all, look for ways to cut *unnecessary* costs. But, as we will see, costs alone have no meaning in economics — they matter only in the context of the benefits they make possible. "No pain, no gain" is as relevant to economics as it is to anything else: sometimes costs must be increased in order to take advantage of an opportunity. This is true for a business considering an investment possibility, or a student borrowing money to finance an education, or a country improving its infrastructure to stimulate new increases in productivity. Sometimes economizing is highly uneconomical.

There is another aspect to this myth that deserves mention. It is normal for businesses and individuals to look for ways to cut their costs by shifting them to others. Not every tax is paid or injury reported; sometimes natural resources that belong to the entire society, such as clean air and water, are used without any compensation. When this happens, some people's costs go down, but not necessarily the full cost to society. Since the perspective of economics is that of society as a whole, cost-shifting is not cost reduction at all. In other words, individual economizing may not be the same as social economizing, quite apart from the problem that benefits need to be considered as well as costs.

Myth #4: Economists want to increase the amount of money possessed by individuals or communities.

Sometimes it looks this way. Economists often speak of the need for more economic growth, measured as quantities of money. (At the time of this writing, the most recent measurement of the size of the US economy is just over 10 trillion dollars.) Certainly on an individual level, we are often concerned with increasing our income or savings. Isn't the goal of economics just to do this for everyone at once?

The problem with this view is that it mistakes the value of something for the units in which it is measured. Money in itself is meaningless: you can't eat it or live in it, and burning it provides just a tiny bit of heat. The real value of money, of course, lies in the value of the things you can buy with it — and it is these things that economics is concerned with, not money itself. The difference is important; as we will see, it is possible for the amount of money that people have to go up even when the real amount of "stuff" (actual goods and services) remains the same. (This is called inflation.) Moreover, many important economic costs and benefits do not show up in money transactions at all. A worker who receives training on the job is receiving an important benefit (as is also, perhaps, the employer), but this may not take a monetary form. A business that pollutes the local environment is generating a significant cost to society, but no money may change hands. Economics is concerned with "real" costs and benefits in this larger sense, not simply with the sloshing of money back and forth between people. Of course, flows of money are important and need to be kept track of, but this is only one part of what economics is about.

Is economics the study of the economy?

No. There is no single discipline or body of thought that studies the economy in all its complexity. Economics studies certain aspects of the economy, and it studies them in certain ways.

To see this, it helps to agree on what we mean by “the economy”. The concept is actually rather fuzzy; in fact, for most of human history people did not have this concept at all. The notion that some portion of our individual and collective lives could be set aside and labeled “economic” is a modern invention. Without going into the difficult theoretical issues that we would have to consider if we wanted an exact definition, we can speak generally about three aspects of economic life:

Economic institutions. These are systems of organization that play a role in the production, distribution or use of goods and services. Examples include corporations, government agencies (especially those that regulate the economy), markets (to be defined in Chapter 6), and families or other household groups (that distribute goods among their members, produce important economic services like child-rearing, and make decisions about who will provide what sort of labor in the paid labor market). Institutions that play a role in the economy also play other roles: they can be political or social institutions as well as economic ones. There is thus an important overlap between “the economy” understood as a system of institutions, and the other aspects of society. This is one reason economic reality is so difficult to see from the vantage point of just one field of study, such as economics.

Economic behavior. People and organizations engage in economic behavior when they participate in the production, distribution or use of goods and services. Some of this behavior takes the form of decision-making; other behavior involves carrying out decisions. You may decide to take a job, for instance; this act of choice is an example of economic behavior. So is the actual work you do once you begin the job. You might go one step further, and say that anything you do that affects your work, such as commuting choices or social connections established with coworkers, is economic behavior too. If you take this wider view (which is probably the most useful one), it is clear once again that much of our life is simultaneously economic and something else.

Economic outcomes. Economies have results. Things get produced, and resources are use in one way rather than another. People do certain types of work and receive pay in return. Goods and services find their way to specific consumers, who use them to greater or lesser advantage. The natural environment is preserved or degraded in the process. Health too is an economic outcome, as is education, and even choices over how many children to have, where to live, and how much time to devote to personal and community activities are economic to a significant degree. Once more, there is no clear dividing line between an economic outcome and an outcome that might be looked at from some other perspective, such as the family or the political system.

The closer one looks, the clearer it is that “the economy” is not a distinct thing walled off from the rest of life; it is really just one aspect of everything we are and do. It is far too diffuse and complicated to be captured by any single body of thought. Psychologists, sociologists, philosophers, geographers, political scientists, ecologists — all these and more have something to say. But this raises the question, what is the relationship between economics and the economy? If economics is not specifically “the study of the economy”, what is it?

What economics is.

There are two ways to describe what is distinctive about economics: it is a body of thought and an organized profession. Both are crucial to what we will be exploring in this book.

Economics is an intellectual tradition. It encompasses more than two centuries of research and speculation, recorded in books, journal articles, government reports, lectures, and other forms. This is a dynamic process, so new ideas do not simply sit side-by-side with old ones; the old ideas are often revised or pushed aside. At any point in time, economics is what economists of that era think and say. Some of this will reflect long-standing beliefs, but much of it will be new. It is important to look both backward and forward, to consider the roots of current doctrines but to keep abreast with their continuing evolution.

In particular, as we will see, economics is organized around a few core ideas, and these ideas distinguish it from other perspectives. Economists tend to be outcome-oriented (ends justifying the means), concerned with a tightly defined conception of efficiency, and disposed to thinking about the economy as a set of exchanges. Their theory is narrow in some respects and quite sweeping in others, but it is different from the theories you would find being discussed by practitioners of other social sciences. One of the purposes of this book is to make these core ideas available to you, the reader, so that you can make your own decisions concerning what is useful about the economic approach.

At the same time, economics is a profession. It is organized politically, sociologically and — yes — economically. It maintains professional organizations which help certify who is and is not a "real" economist. It organizes conferences and learned books and journals, which determine what ideas will be disseminated within the profession and to the larger public. It inhabits departments at colleges and universities which hire, fire and promote academic economists, determining which careers will prosper and which will be cut short. Finally, its leading practitioners are often given top positions in business and government, where their theories can be translated into action. While no academic specialty has as much power as the "practical" professions, such as law or management, economics has more power than most. It is common to find that high-level politicians, officials, and policy analysts rose through the ranks of the economics profession.

What this means is that economics is not just a way to think about reality; it is an important part of that reality. Even when they are wrong in their judgments, what economists think matters. As we will see, economists often adopt positions that are very different from those of the majority of the population. This adds to the visibility of their profession within the political process. It would be difficult to be an active citizen today without a critical understanding of economic arguments.

From my experience, students are often disappointed by the study of economics. They come into economics courses eager to learn about the economy, and instead they are up to their ears in the abstract and often arcane theories of the economics profession. I empathize with their plight, but I urge them to keep at it. Economics as an approach to studying economic life has its shortcomings, but economics is itself an important part of that life. There is value to knowing where economists are coming from — or, as Joan Robinson once said, the reason to study economics is "to learn how to avoid being deceived by economists."[1]

QUESTIONS

1. Are any of these myths familiar to you from your own experience? Did you have any of these assumptions about economics before reading this chapter?

2. Have you studied some aspect of "the economy" (as defined above) in other courses that were *not* economics? What topics did they focus on? How would you describe their perspectives?

3. In today's newspaper, find one example each of an economic institution, an economic behavior, and an economic outcome.

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1. *Marx, Marshall and Keynes*. 1955.