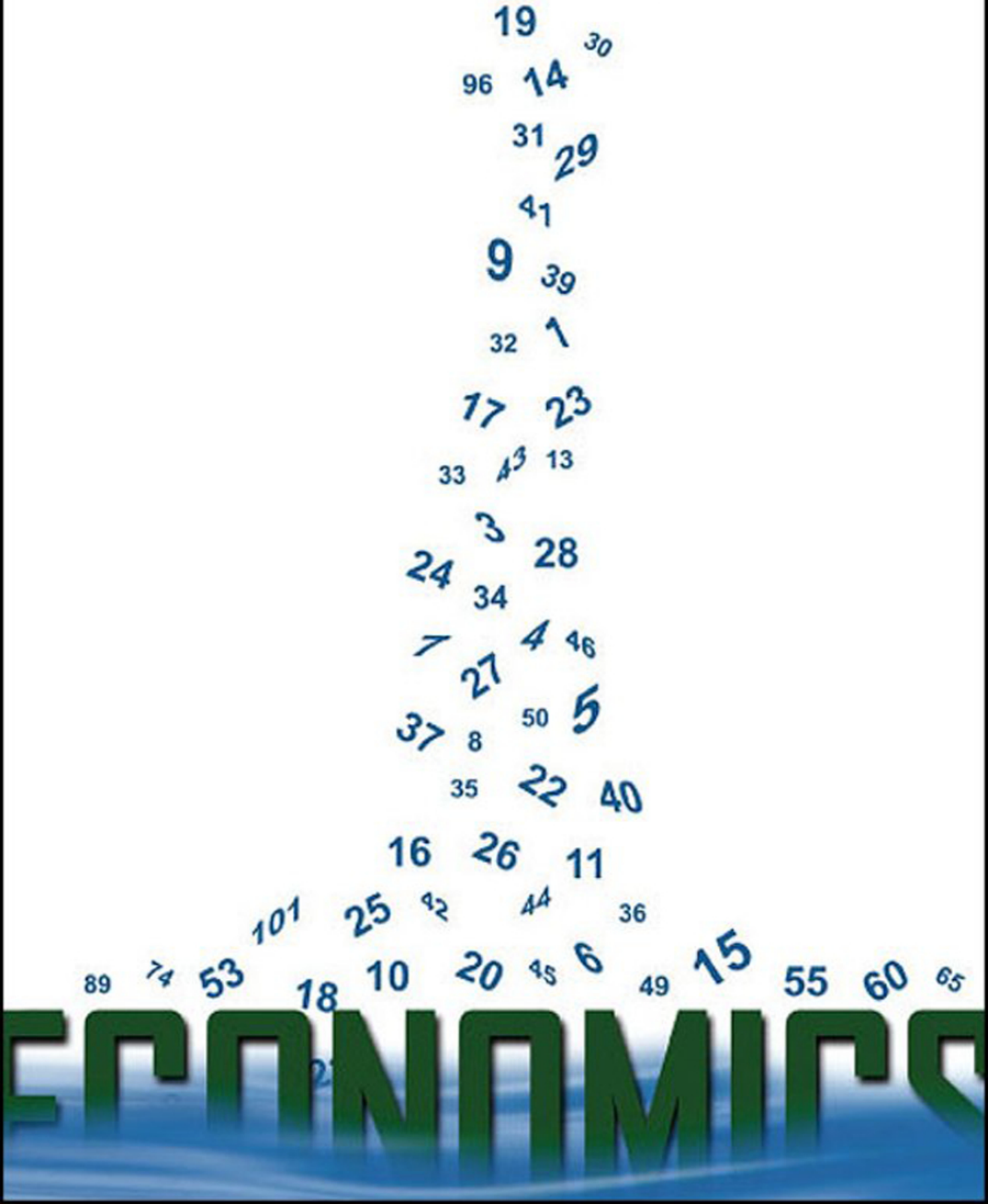
Economics for Amateurs

Anthony A. Sampson



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To Susan Hannah

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On a personal level I am grateful to my late mother, Marie-Louise, who gave me a good education, and to my wife, Susan Hannah, who has been a constant support.

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Introduction

About the Book

The aim of this book is to provide a short, easy-to-read guide to the basic ideas of economics. It is written for readers who have little acquaintance with formal economics, and who do not wish to spend a lot of time and effort learning economics. It works by using simple examples, rather like parables, which convey the ideas underlying the theory of economics, which can often be complex.

My reason for writing this book stems from my experience of teaching basic economics to non- specialists. I have taught basic economics to metallurgists and chemical engineers at Sheffield University in England, to environmental scientists at Salford, also in England, and to management scientists at Sheffield, Salford, and Nottingham-Ningbo in China. Although most of my students were capable of dealing with the algebra and calculus required at an elementary level, I discovered that simple explanations of the kind presented in this book were extremely useful in helping the students understand "what it was all about." The necessary emphasis on technical competence can often hide the real meaning of what one is studying.

Economics can be a difficult and abstruse subject, especially if you wish to learn it rigorously, and at an advanced level. I personally have enjoyed learning it, teaching it, and writing about it. However, my experience in teaching economics has made me intensely aware of how dry, and far removed from the concerns of the world around us, economics can seem. Even students specialising in economics can find its presentation in schools and universities intimidating and not very enlightening. I believe, however, that the theory of economics can be useful, even for someone who does not aim to be an expert. It can help towards a better understanding of the world around us. It may provide some insights into the nature of economic and social problems, and give some idea of the contribution that a rigorous and dispassionate mode of thinking might provide. This book will be about the simple, but by no means obvious, propositions that make up the science of economics. It will also give you a flavor of the particular—some might say peculiar, or even perverse—way in which economists think.

Economics provides a method of thinking, systematically and rigorously, about economic and social issues. I hope that reading this book will help you to gain an informal insight into "how economists think." This book is intended to be about as easy, or difficult, to read as an article in the *Financial Times* or the *Wall Street Journal.* You would require no previous knowledge of economic theory, although you might be surprised at how much economic theory you know, without realising that you know it. John Maynard Keynes wrote that "practical men are the slaves of long dead philosophers," meaning that their view of the world is heavily influenced by the thoughts of thinkers, of whom they might not even have heard. In a similar vein, many people who claim not to know Shakespeare might exclaim "Alas poor Yorrick" on seeing a skull. Another point is that the heresies of one generation become the orthodoxy of the next. The life of Keynes himself illustrated both these things, although, unlike many other thinkers, he became famous, wealthy, and influential within his own lifetime.

The book is not a textbook, nor is it intended to help you to pass an examination. That, at any level, requires formal study. There are many excellent courses and teachers in schools, colleges, and universities. In all campus bookshops you will find readable and informative textbooks dealing with economics, whether you are taking a school leaving exam or a taught masters degree at Princeton. Economics is a difficult and rigorous subject, surprisingly so to the beginner, who might cope easily with the *Wall Street Journal* or *The Economist.* If you look at a university textbook in economics, even one intended for non-specialists like chemists, engineers, or students of management, you might get the impression that you were looking at a textbook on physics or mathematics.

Enlightened Self-Interest

Economics, as a body of thought, was a product of the Eighteenth Century Scottish Enlightenment, with the publication of Adam Smith's book *The Nature and Causes of the Wealth of Nations* (1786). Its aim was to explain the laws of motion of capitalist political and economic systems. How and why did some nations become prosperous, and some did not? What role should the state play, and what matters were best left to individuals? What type of tax system was fair and efficient, in the sense of having fewer adverse side effects? Smith was followed by David Ricardo's *Principles of Political Economy and Taxation* in 1817, and Karl Marx's *Capital,* published between 1867 and 1884. The trio were referred to as the "English classical school" of economics, although only Ricardo was English, Smith being Scottish and Marx German.

Economics has, to a large extent, become an apologia for capitalism. At its heart is a surprising proposition originally stated by Smith.

Under certain conditions, including

- Well-defined property rights, enforceable within an impersonal legal framework
- Freedom to enter binding contracts, whether verbal or written, so long as they are legal
- The absence of artificial restraints on trade

a system in which, subject to the above, people are free to buy and sell freely, and are free to pursue their own self-interest, can produce better material standards of living, for more people and over a longer time period, than any other system. Smith, in *The Wealth of Nations* (1776), wrote, "It is not from the benevolence of the butcher, the brewer or the baker that we expect our dinner, but from their regard for their own self-interest."

The proposition has been "proved" in many forms, and has been expressed in many ways. It has many names. The best known is the "Theory of the Invisible Hand," although to impress your friends you might talk about the "Fundamental Theorems of Neo-Classical Welfare Economics." Another term is "Enlightened self-interest" wherein we judge acts on the basis of their consequences, rather than by the motivation of the actor. Smith continues, "Every individual intends only his own security, only his own gain. And he is in this led by an invisible hand to promote an end which is no part of his intention. By pursuing his own interest, he frequently promotes that of society more effectively than when he really intends to promote it." This highlights another feature of economic thinking: the emphasis on incentives. It implies that, if the pursuit of private gain somehow fails to achieve a good outcome for "society," we must alter the incentives to bring about an alignment between private incentives and desired social outcomes.

The central implication of this notion is that "markets," a shorthand term for private individuals and institutions pursuing their own interests, can do anything that needs to be done, and better than the government can do. Since the only criterion for what should be done is what people want to be done, there is a danger of circularity in the arguments for the "Laissez faire" (let things be) view that governments govern best when they govern least. However, it is fair to say that most economic disputation concerns the role of the state: what it should do, and what should be left to the market. If left to the market, what restrictions—for example, safety or labelling regulations—should the government impose? At the individual level, how should we organise our transport, educational, and health systems? How redistributive should the tax system be? Why should the state intervene in the markets for housing, education, or medical care? Should the state provide public services, or merely finance them? State-provided medical insurance, or education vouchers, to be spent how the recipient wishes, might be more efficient than state provision.

The above caveats to the defence of free markets are vital. Without well-defined and enforceable property rights, people would not enjoy the fruits of their labors and so would not labor. The same goes for contracts: doubt about whether the other party will fulfil its side of the bargain can be a powerful disincentive to economic activity. Theft, corruption, and high taxation can all break the link between effort and reward. One might also argue that a generally accepted moral code is also vital, a point not obvious before the collapse of the Soviet Union, and reinforced by recent problems in the financial sector.

A natural barrier to trade might be distance, or the inability of an individual to perform a particular task. An artificial barrier would be a rule preventing certain people from doing jobs within their capabilities, or preventing "interlopers" from entering particular markets. This would include monopolies and racial discrimination. Indeed Smith himself warned against the tendency of producers to gather together to fix output levels and raise prices against the "public interest." "People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices."

In recent times, we would add two more riders. The first is that individuals must bear the full costs of their actions, or be induced to take into account the effects of their actions on outsiders who are not party to the transaction. Pollution was not perceived as a pressing problem in Smith's day. Nowadays we would argue that a transaction between two parties is beneficial to the parties involved and, at first sight, since they are part of society, beneficial to society itself. Their transaction may, however, affect outsiders who are not party to that transaction. The transacting parties will determine the scale and nature of the transaction to suit their interests, and will have no incentive to take account of the effects of their action on outsiders. Most economists would now accept that the state can play a beneficial role in forcing people, like polluting firms, to bear the full consequences of their actions. Pollution is the classic example of this, and few would doubt that state intervention has been beneficial. The exception might be some extreme "Chicago" economists, who might argue, that once property rights to the environment have been properly delineated, the problem would be solved automatically [1]. Their arguments are subtle and elusive, but as the University of Chicago has, in terms of Nobel Prize winners, the best department of economics in the world, we have to take these arguments seriously. In a similar vein, Smith's contemporaries were less worried about the depletion of scarce resources.

The second rider concerns the distribution of income. In a free market economy, command over goods and services generally derives from having something that others are prepared to buy. This can lead to large inequalities of income, with some enjoying a high material standard of income and others unable to survive. As it happens, practically all modern free market economies practice income redistribution through the tax and benefit system. Even so, the confident statements of free market advocates must be taken in tandem with concerns about income distribution. The problem arises from the fact that we can only measure "welfare" or "well-being" in monetary terms.

Contemporary Economics

Modern economics is more than just the "Worldly Philosophy," using a broad canvas to explain the economic aspects of world history. As an academic discipline, it has developed into a formal science, and hence almost into a learned profession, although in the Anglo-Saxon world we are fortunate not to have professional bodies to establish professional standards, but which might also stifle independent and original thought. The nearest thing we have in the United Kingdom to a professional body along the lines of the British Medical Association is the Royal Economic Society. It publishes the *Economic Journal,* runs an annual conference, publishes classics in economics, and has a committee to lobby the government. Likewise, the American Economic Association publishes three journals, attracts the brightest and the best, and imposes no sanctions on heretics.

HOW MODERN ECONOMISTS EARN THEIR LIVING.

Few modern economists, outside universities, colleges, and schools, earn their living by contemplating the best way to organize societies. Your idea of an economist will be somebody like the journalists, academics, or city analysts you see interviewed on television, commenting on economic affairs. A city economist or journalist will be smartly dressed, lounging on a desk, probably in a large, open plan office, with computer screens in the background. An academic is less likely to wear a tie, and more likely to be interviewed in a study. He or she will also have a visible computer, and the walls of the study will be festooned with books and learned journals, some of which he might even have read. Most professional economists spend their days working with statistical data, invariably in front of a computer screen. Their daily task will, if they are lucky, allow them to use their technical knowledge of economics.