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PART

I

INTRODUCTION

WHAT ECONOMICS IS ABOUT

LEARNING OBJECTIVES

After studying this chapter you should be able to:

- explain the meaning of ‘allocation of scarce resources’;
- define opportunity costs;
- draw a production possibility curve and use it as an analytical tool;
- distinguish between positive economics and normative economics;
- explain the nature, scope and limitations of economics.

1.1 THE ECONOMIC PROBLEM

Wants and limited means

‘You must cut your coat according to your cloth.’ ‘You can’t get a quart out of a pint pot.’ ‘You can’t make a silk purse out of a sow’s ear.’ How many of our everyday sayings draw attention to the fact that, in comparison with all the things we want, our means of satisfying those wants are quite inadequate! Just think of the extra things we could buy if our incomes were larger – new clothes, new furniture, a better car, foreign travel, a camcorder. The list has no end, for, even if these wants were satisfied, new wants would arise.

This, then, is the ‘economic problem’ – unlimited wants, very limited means. And we can never completely overcome the difficulty. But what we can do is to make the most of what we have. In other words, we *economise*.

In order to see more clearly what is meant by ‘economising’, we can study the spending decisions of a housewife. Indeed, this illustration is more appropriate than it may seem at first sight, for ‘economics’ is derived from a Greek word meaning ‘the management of a household’.

Our housewife’s task is to make her fixed housekeeping allowance ‘go as far as possible’; in other words, from limited resources she seeks to obtain the maximum

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satisfaction for the family. Certain goods – those she regards as necessities, such as bread, milk, tea and butter – are purchased in regular quantities almost by habit; but this does not mean that she would not vary her spending on them were there to be any significant change in their prices. Nevertheless, what really lies behind her spending decisions can best be seen if we concentrate on those goods to which she gives frequent consideration. As our housewife walks past the shop windows in the high street, a hundred and one different goods compete for the money in her purse. Should she buy beef or chicken for the Sunday dinner? Peas would be nice – but they are still so dear that cabbage will have to do for one more week. But how everybody would love new potatoes! And they've gone down 4p a pound since last week! Yes, she will buy new potatoes instead of old. And so our capable housewife goes on, comparing the prices of different goods and asking herself whether the pleasure her family will obtain from them will be worth their cost – the inroads they make on her limited housekeeping allowance.

But it is not only the housewife who has to economise. How the school-boy schemes to get the most out of his pocket-money! And the businessman faces the same problems in running his factory. Should he produce this good or that, or some of both? How many of each good? Should he employ extra labourers or would it be better to install a machine to do the work? Would it be more profitable to hire transport or to buy his own lorry? And so on.

Turn to the newspaper any morning, and it soon becomes obvious how often the government, too, is forced to choose as it plans the broad lines upon which the economy shall develop. Better schools, student grants and more hospitals – all are competing for the limited revenue it can safely raise by taxation. Extra houses, new roads and conservation areas – all are claiming a share of the limited land available. In these and many other instances, the government has the task of making the most of the nation's resources.

Opportunity cost

Thus we see that economics is really concerned with the problem of choice – the decisions forced upon us by the smallness of our resources compared with our wants (Figure 1.1). And, as we choose, so we have to sacrifice. If the newspaper boy spends his Christmas tips on a bicycle, then it is likely that he will have to go without the Play Station that he also wanted. In deciding to work overtime on a Saturday afternoon, a worker forgoes leisure time and the football match he would otherwise have watched. When the farmer sows a field with wheat, he accepts that he loses the barley it could have grown. And so with the nation. If extra materials and capital are required to accelerate the building of houses, roads and hospitals, then there will be less left for producing offices, power stations, sport centres, and so on. In all walks of life, having 'this' means going without 'that'. We therefore speak of 'opportunity cost' – the cost of something in terms of alternatives forgone (more accurately, in terms of the *best* alternative sacrificed).

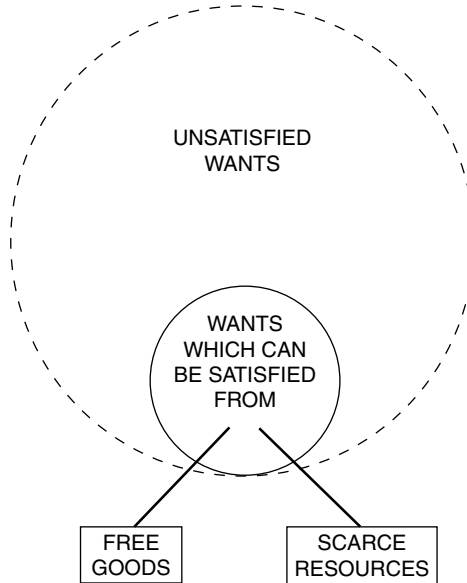


Figure 1.1 The economic problem

In practice, economising is not so much a complete rejection of one good in favour of another, but rather deciding whether to have a little bit more of one and not quite so much of another. It is principally, as we shall see in Chapter 5, an adjustment at the margin.

‘Free’ and ‘scarce’ goods

Few goods are so plentiful that nobody will give anything for them. Air, perhaps, is one of the few exceptions. Occasionally, too, there is such an abundant apple harvest that a farmer says ‘help yourself’. Such goods are termed ‘free’ goods. Usually, goods are ‘scarce’ – they can be obtained only by going without something else. With such goods we have to economise, and so they are often referred to as ‘economic goods’. It is worth noting, however, that over time there is no hard-and-fast dividing-line between economic and non-economic goods. Desert wastes can be transformed into rich agricultural land by irrigation; coal-mines are left derelict as new fuels are developed. Scarcity is relative to demand.

In future when we speak of ‘goods’ we shall be referring to economic goods, including, without further distinction, both commodities and services.

Nevertheless, as resources are transferred to manufacturing from agriculture, an ever increasing quantity of manufactured goods has to be given up to obtain an extra 20 units of agricultural produce. For instance, when 40 agricultural units are produced, the opportunity cost of an extra 20 is only 5 manufactured goods, whereas when production is 60 agricultural units the opportunity cost of a further 20 is 15 manufactured goods.

The reason is that resources are not equally suited to producing agricultural produce and manufactured goods. For instance, factory workers would need training in farm work, while land, tractors, etc. would have to be worked more intensively. The result is that the production-possibility curve is concave to the origin.

1.2 THE SCOPE OF ECONOMICS

Definition of economics

Scarcity forces us to economise. We weigh up the various alternatives and select that particular assortment of goods which yields the highest return from our limited resources. Modern economists use this idea to define the scope of their studies. But since there is no one definition which is completely satisfactory, we keep ours as simple as possible. *Economics is the study of how people allocate their limited resources to provide for their wants.*

Amplification

The field which a study of economics covers becomes clearer if we examine certain points of this definition.

1. Economics is a social science

This follows from the fact that economics studies how *people act*. As we shall see, this puts it at a disadvantage compared with the physical sciences which examine various aspects of man's environment.

2. Economics is closely concerned with the findings of other sciences

Because economics studies human behaviour, it must, in reaching conclusions, refer to other branches of study, particularly psychology, sociology and politics. The alternative, advocated by some economists, of restricting economics to pure scientific analysis, curtails its usefulness.

3. Economics selects a particular aspect of human behaviour

But, although economics is closely connected with such social sciences, it is distinguished from them by its concentration on one particular aspect of human behaviour – choosing between alternatives in order to obtain the maximum satisfaction from limited resources. This narrower approach is an improvement on Professor Alfred Marshall's definition – 'a study of mankind in the ordinary business of life' – because this, as it stands, would embrace all forms of human activity.

In effect, the economist limits the study by selecting four fundamental characteristics of human existence and investigating what happens when they are all found together, as they usually are. First, the ends of human beings are without limit. Second, those ends are of varying importance. Third, the means available for achieving those ends – human time and energy and material resources – are limited. Fourth, the means can be used in many different ways: that is, they can produce many different goods.

But no one characteristic *by itself* is necessarily of interest to the economist. If, for instance, you have two wants and you cannot choose between them, you are between the devil and the deep blue sea, and you will never get as far as the problem of allocating resources between them. Similarly, 'free' goods are of no interest to the economist since resources do not have to be allocated to obtain them although sometimes a free good such as air can become an economic good because of pollution – in Tokyo, vending machines sell clean oxygen at street corners. Nor is the mere scarcity of means necessarily of significance. Where resources can be used only in one way, e.g. lichen-bearing volcanic land in Iceland for rearing sheep, they do not, although scarce, have to be 'economised'. Using such land for sheep does not mean that the owner has less of other things. Its use therefore gives rise to no problems, and the economist is interested only in the relatively minor point of determining the earnings of such land. Only when all four characteristics are found together does an economic problem arise.

The difficulties

But, in pursuing such studies, economists face two major difficulties:

1. Economists cannot experiment

The task of a science is to formulate laws describing what will happen when there is a change in a given set of circumstances. The physicist and chemist can conduct their investigations by experimenting under controlled conditions in a laboratory. But because economists are dealing with human behaviour rather than with physical properties, their laboratory, it has been said, is the real world.

- (a) Since facts concerning people are difficult to ascertain, they can never be quite sure of the initial position.
- (b) It is impossible to isolate a group of consumers or business people in a test-tube to see how they would react to a given change. The most the economist can usually do as regards consumers' behaviour, for instance, is to take a sample survey which will suggest how groups as a whole will behave.
- (c) The economy is subject to continuous change, and so conditions cannot be held constant while the effect of one particular measure is observed.
- (d) Because the economy is so complex, no body of economists could follow through all the results of any given change.
- (e) Any measurements are usually approximate, and even so take time to collect.

Because of these difficulties, economists can only be approximate in their investigations in real life. Nevertheless, the information available is increasing and becoming more precise, e.g. through market research and government statistical enquiries. Thus economists' predictions are likely to gain in accuracy.

2. Economists cannot directly measure welfare

Since satisfaction, like love or pain, is personal to the individual, there is no absolute scale for measuring welfare. So the economist, using the best approximation, works on the principle that, because two loaves are better than one, an increase in goods represents an increase in welfare.

Even so, he cannot measure all goods. If he gives a value to the vegetables grown in gardens or to do-it-yourself repairs to cars, should he not logically include also something for housewives' cleaning and cooking services? Because it is impossible to know where to draw the line, the economist simplifies matters by confining attention to those goods which are exchanged against money (see p. 344). Since all these have a 'price' it is possible to make use of exact measurement and total dissimilar goods in terms of the common standard.

Nevertheless, the economist must be careful to include any costs or benefits which are not allowed for by an individual in making a decision. Or, if the project is so large that it is likely to have external effects elsewhere, for example a proposed new airport or motorway, a cost-benefit analysis may have to be used to cover these full effects (see Chapter 17). Moreover, since the economist can only quantify in terms of money, some costs and benefits which are not exchanged directly in a market, e.g. environmental costs and benefits, have to be given 'shadow prices'.

Positive and normative economics

Consider how the particulars of different estate agents describe the same room: the first, 'the living room is 4.5 metres by 3.5 metres', the second, 'the living room is deceptively spacious'. One can be verified by measuring; the other is a matter

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for the eye of the beholder. This leads us to the distinction between positive and normative economics.

Positive economics limits itself to statements that can be verified by reference to the facts. Thus the observation that 'the UK's real national income in 1997 was larger than in 1994, is a positive statement. In other words, positive economics holds that any hypothesis formulated should be testable against empirical evidence.

Normative economics, on the other hand, appreciates that in practice many economic decisions involve subjective judgements; that is, they cannot be made solely by an objective appraisal of the facts but depend to some extent on personal views in interpreting facts. Thus the statement that 'the UK's national income in 1997 should have been larger than it was' is a normative statement. As soon as we introduce the words 'should' or 'ought' we are making subjective valuations, that is normative statements.

Because in practice the distinction between positive economics and normative economics is often blurred, opinion is divided about the exact scope of economics, and so it is instructive to examine their nature in more detail.

1.3 POSITIVE ECONOMICS

Positive economics considers that economics can claim to be a science only if it is strictly scientific in its approach, eschewing normative judgements and adopting scientific methods.

First, it does not attempt to set out criteria for determining what is good or bad, what ought or what ought not to be – any more than physics attempts to say that liquids are 'better' than solids. It is concerned only with positive statements and with the consequences of certain actions. That is why, for instance, the economist must accept ends as given, expressing no opinion as to whether those ends are 'good' or 'bad'. On the other hand, he must point out that individual ends have economic implications for society as a whole. A man, for instance, may decide that he wants to get drunk every day. Here the economist must point out the full cost of this end – the cost to the man of getting drunk, plus the cost to society if he eventually becomes a charge on the National Health Service as an alcoholic.

Nor is the economist concerned directly about the physical aspects of the limited means – the mechanical principles of the plough, the chemical properties of the soil or the biological characteristics of the seed. Both ends and resources are accepted as given. The subject of study is how people mobilise these resources to achieve their ends and how efficient are the methods which they choose.

Second, economics science has a particular object in view – the establishment of principles, propositions, theories or generalisations stating the relationship of one thing to another. In this it goes beyond *descriptive economics*, which concentrates on a mere description of an economy – its institutions (firms, banks, government

organisations, etc.), its population, its system of taxation, and so on. But studies ended there could hardly be termed 'scientific'. While descriptive economics is desirable, indeed necessary, it merely describes the mechanism. What we really want to know is how the mechanism operates.

That is the task of *analytical economics*, which sets out to establish general principles about the way in which an economic system works. In discovering these principles, economics makes use of the methods of other sciences. These methods are: (1) induction, (2) deduction.

1. Induction

In the inductive approach, the economist observes facts, classifies those facts, and then tries to observe any causal relationship between them. For instance, he may discover that the price of eggs falls in the spring. This would be connected with the increase in the supply of eggs at that time of the year, and from this a generalisation can be established that an increase in supply, other things being equal, leads to a fall in price.

The weakness of the inductive approach is that the scientist can never be sure that the principles established are 100 per cent foolproof. Hence, whenever possible, he will try to substantiate by deduction what has been discovered by induction.

2. Deduction

With deduction, the economist starts from hypothetical assumptions (frequently referred to as postulates). Then, by a process of logical reasoning, he derives propositions from these assumptions. This is often termed 'model-building'. The sequence is as follows:

- (a) The economic phenomenon to be explained is selected. Of course, if the analysis is to be useful, the problem must be of practical significance.
- (b) The initial assumptions are made. These should be as close to reality as possible. But, although he is concerned with human behaviour, realistic assumptions are not impossible. In the main he is interested in market, not individual, reactions. Dealing in large numbers means that patterns of behaviour emerge, and it is possible to think in terms of an 'average economic man'. Thus it is quite reasonable to assume that, in disposing of his income, this average consumer will act rationally, seeking to obtain maximum satisfaction from it.

Of course, the economist has to simplify initially, confining himself to broad assumptions from which he can obtain only broad generalisations. Later, the assumptions can be changed according to particular circumstances, and the conclusions modified accordingly.

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- (c) Logical reasoning establishes what follows from the assumptions. Let us take a simple example. The economist wishes to discover what price will prevail in a market. He makes three assumptions:
- (i) a high degree of competition, on the basis of price, among buyers and among sellers, and between buyers and sellers;
 - (ii) more will be demanded the lower the price;
 - (iii) more will be supplied the higher the price.

Demand and supply thus move in opposite directions for a given change in price. The conclusion he comes to is that the price of the good will settle where the amount supplied equals the amount demanded. Any other price will not be a settled price. If it is above, there will be more offered for sale than is demanded. Stocks will pile up, and some suppliers will lower their prices. As the price falls, so more will be demanded, and this will go on until demand equals supply. Similarly, when the price is below that where demand equals supply, shortages lead buyers to offer higher prices. As the price rises, so more will be supplied, and this goes on until demand equals supply (see p. 41). He has thus built up a model showing how price is determined in a market – a very useful piece of economic theory.

By modifying the assumptions he can make the model closer to real life or show how changes in the economic system work. For instance, suppose that, as a result of an advertising campaign, people's tastes change, so that they want more of the good at the market price than formerly. At the original price, demand now exceeds supply. As before, this will cause the price to rise and supply to expand until a new price is arrived at where once more demand and supply are equal.

- (d) As far as possible, propositions derived by deduction are tested by observed data. Often, however, such tests will prove impracticable, if not impossible, to undertake. For instance, the economist may be predicting outcomes which have no past parallels; he has therefore to await events before he can test the validity of his propositions.

If the principles established are not disproved by such testing, they can be used to predict what will happen in particular instances, for they show how the different parts of a system are related to one another. It should be noted, however, that such forecasts are not unconditional statements of what will occur. The nature of an economic proposition is simply of the form 'if this occurs, then such and such will result'. For example, if demand increases then, other things being equal, price will rise (see p. 43). When we apply general principles to particular cases, we are in the realm of what is often called *applied economics*.

It is this power to predict which enables firms and governments to plan with some degree of accuracy. The theory of price, for instance, would enable a building firm to make a useful forecast of the effect of an increase in the demand for houses on bricklayers' wages. Or, if there were widespread

unemployment in the economy, a knowledge of the principles determining the level of activity could suggest appropriate measures which the government might take to reduce it.

1.4 NORMATIVE ECONOMICS

Normative economics, or 'political economy' as economics was originally called, accepts the analytical methods of positive economics in formulating theories. But it considers that the rigid scientific stance adopted is defective in two main ways.

First, it holds that it is virtually impossible to avoid value judgements. For instance, since facts have to be used to test hypotheses, the *selection* of those facts depends on the judgement of the economist who may unconsciously let his individual bias creep in. Again, in holding that the preferences and ends of individuals in a society are the ones which count, it overlooks that the State may have different ends. Thus the State may ban certain drugs because their abuse can result in ill-health and crime, incurring costs to society. But which drugs are banned involves a value judgement by the State. Finally, in evaluating growth over a period, the economist holds that 'more is better'. However, this view is based only on a consensus opinion, and is thus a value judgement. In any case, even though there may have been an increase in income per head of the population over time, we have no *objective measure* of welfare to assess whether people are obtaining more satisfaction (see p. 9).

Second, and more fundamental, economics is rather sterile if not applied to policy objectives. Positive economics, by restricting itself simply to predicting all the relevant consequences of alternative policies, ends up by 'sitting on the fence'. In contrast, the earlier economists have pursued their studies chiefly because of the social benefits which can result. 'The compelling motive that leads men to economic study is seldom a mere academic or scientific interest in the movements of the great wheel of wealth. It is rather the sense that, in the world of business and of labour, justice stands with biased scales; that the lives of the many are darker than they need be. In these things lies the impulse to economic investigations.' (Professor A. C. Pigou *Unemployment*, 1913).

Thus the normative economist, while still seeking to solve problems as scientifically as possible by following the techniques of the positive economist, applies the results to suggest the course of action which appears to be economically more efficient than the others. In doing so, he enters the region of value judgements.

It means also that, because economics studies human behaviour, the economist's judgement is enhanced by taking into account the findings of other social sciences. For instance, most people would consider that the economist should have something to say on the question, 'Should income tax be made more progressive?' But the reply would have to be along the following lines: 'The tax yield would almost certainly increase; but higher-income groups might not work so hard. While I can suggest theoretical reasons for this, you should also consider what the psychologist

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has to say. Furthermore, the pattern of consumption may change as the rich have less income to spend. For possible social effects, consult the sociologist. Finally, it will also help in making incomes more equal. That concerns me in that it may increase the proportion of total income spent – but ethics and politics have most weight in deciding whether greater equality of incomes is desirable.'

1.5 CONCLUSIONS

Why economists disagree

The foregoing discussion throws light on the reasons why economists appear to disagree so often. Take the statement, 'Britain must remain in the European Union (EU) because it leads to a faster rate of economic growth.' Why might economists disagree on this?

First, they may not agree on the facts. Can we be certain that Britain's rate of economic growth has accelerated since she joined the EU? Facts are deficient; for example, calculations of Gross National Product (GNP) over time are not unambiguous (see pp. 345–50).

Second, they may disagree on the causal connection. Even if a faster rate of economic growth has been achieved since joining the EU, can we be sure that membership is the cause of this increase? There may be more than one explanation, e.g. the discovery of North Sea oil or increased capital investment in agriculture and industry. It may be difficult to decide which explanation fits the facts best.

Third, the statement really rests on a value judgement – that economic growth is a good thing. Some economists might consider that other objectives – more leisure, less worry, the protection of the environment, and so on – are in a fairly affluent society more desirable.

Fourth, they may unconsciously let individual bias creep into their analysis and interpretation of the facts. While, as scientists, economists try to be as objective as possible, they are often examining subjects upon which they have strong personal feelings. Thus an economist who is an ardent supporter of Anglo-American relationships may unconsciously fail to give full weight to evidence supporting an increase in the growth rate of the EU countries.

The economist as a consultant

Such imperfections do not mean that the economist is without value. If, for instance, he is employed in a business enterprise, the scope of his work is fairly well defined – to promote the success of the business in terms of profits. As regards government policy, however, the advice the economist can give may be less definite. In any case, the final decision will usually rest on the judgement of the politician. A government is seldom faced with a simple choice, since ends are

usually a compromise between alternatives. The first task of the economist is to point out any inconsistency between aims. For instance, the aim of economic expansion could conflict with the aim of balance-of-payments equilibrium.

In any case, the economist can indicate the full implications of a particular policy. For example, if a very high level of employment is the aim, then he should point out that this could make it more difficult to maintain a stable price level.

Finally, he may be able to recommend more economic ways of achieving a given end. This is possible because, although ends may be given, there are economic and non-economic means of achieving those ends. Is it better perhaps to obtain food supplies by importing from abroad or by home production?

For his part, the economist tries to be as objective as possible, establishing principles which, given certain conditions, show how the economy works and how it can be made to work better in real life. Furthermore, the principles can be applied to specific problems. Decision-makers may brush these principles to one side, either because facts necessary for a complete answer are not available or because different weight is given to assumptions. But at least economics provides a reminder of where objectivity ends and subjectivity begins.

CHAPTER SUMMARY

- Economics is concerned with making choices about the allocation of scarce resources.
- Production possibility curves can be used to illustrate the choices faced by society, and the nature of opportunity cost.
- Positive economics makes statements that can be verified by empirical evidence (reference to facts or data).
- Normative economics recognises that many economic decisions involve subjective judgements.

REVIEW QUESTIONS

- Why is economics considered to be a 'social science'?
- Use a production possibilities curve and the concept of opportunity cost to explain the difficulties facing a society in deciding how much of its resources to devote to defence expenditure and how much to consumer goods.



Visit the companion website for further questions



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