Sense and Nonsense in Economics Chapter 1
12 economists, 13 opinions

T Freedman

Sense and Nonsense in Economics

by

Terry Freedman

Chapter 1 : Twelve Economists, Thirteen Opinions

Sense and Nonsense in Economics

Chapter 1 : Twelve Economists, Thirteen Opinions.

The British Economy - or, come to that, any economy - can be better analysed and understood once the economist's approach has been grasped. There are, of course, "experts" who believe that they fully understand the present day behaviour of the economy. But will their knowledge enable them to follow the economic headlines of tomorrow?

The purpose of this chapter is to explain how the economist approaches a problem, and to introduce a few concepts which constitute the economist's "tools of the trade".

To most people, economists appear as a kind of clique whose sole reason for existence is to disagree with each other. While the economy hurtles headlong into what may or may not be a bleak wasteland of a future, economists seem powerless to do anything except argue.

Yet, surprising as it may seem, there is a great deal on which economists see eye to eye. Economics has been studied, in various guises, for many centuries; and in the last two hundred years, and particularly the last hundred, a number of concepts have been developed to make the study of

Economics more scientific.

The word "scientific" needs some clarification. It is easy to see that a study of the physical world can be called scientific. Mention the word "Physics", or "Chemistry", and many people will immediately think of a laboratory. Mention the word "scientist", and they will think of a person in a white coat. Can Economics really be called scientific, and can the economist really be thought of as a scientist?

"Science" literally means systematic knowledge, and "scientific" means using tools and procedures which will lead to the discovery of objective facts. Since Economics and the methods it uses accord with these definitions, as we'll see later on in this chapter, it may be referred to as a science,and the economist as a scientist.

In fact, because Economics is concerned primarily with human behaviour, it is more correctly known as a social science - a label it shares with other disciplines such as Sociology and Politics. Although the social sciences differ from each other in the concepts they use and the standpoint they take, they all use the scientific method. Thus they all formulate hypotheses - or suggestions -

regarding certain aspects of behaviour, and then see if these hypotheses are borne out by the facts. If they are, and if the hypotheses enable accurate predictions to be made about what people will do in a given situation, then a new addition to economic theory has been made. If not, the hypotheses are either rejected in favour of better ones, or discarded altogether.

So why do economists disagree with each other? There are three reasons for this. First of all, the statistical evidence required to prove or disprove a theory may not be readily available. Usually, it's only a matter of time before this is rectified. Far more difficult is the second reason, which is that a lot of data can be interpreted in a number of conflicting ways. A good example of this is the widespread evidence that the amount of money in an economy and the rate of inflation move together in the same direction. But this evidence in itself doesn't tell you whether an increase in money causes an increase in prices, or vice-versa.

A third and related reason for disagreement amongst economists is the fact that different economists may place more importance on some factors than others. It is here that we come across an important limitation in the

economist's use of the scientific method. A physicist can, in many cases, settle an issue by conducting a laboratory experiment in which all facts but one are held constant. In this way, the effect of that one factor on the situation in question can be clearly seen. The economists's laboratory is human society, and so this approach is not open to him. All he can do is to assume that all other factors are held constant when using a theory to predict what will happen. Increasingly, economic propositions are stated in mathematical terms in the interests of ojectivity and precision, and sophisticated statistical techniques, such as multiple regression analysis, are being used to separate out the effects of different factors on the data in hand.

But it most not be forgotten that, at the borderlines of knowledge, the natural scientists will disagree with each other too. This does not lead to them being accused of being unscientific or argumentative, perhaps because the use of the scientific method is more obvious to the lay person than the economist's use of it. Once the economist's approach is understood, the apparent differences between the physicist and the economist will be lessened. That is the subject of the next part of this chapter.

It is a common misconception that Economics is only concerned with money. It would be truer to say that Economics is more concerned with relative values, which are often expressed in terms of money. Nevertheless, Economics provides concepts and an approach which can be utilized in a wide variety of situations.

The economist takes as his starting point a common observable fact - that in general people want more than they can afford. This applies at all levels : the individual, the family, the community and the social level. In fact, we can say that, for all practical purposes, wants are infinite.

On the other hand, the resources we have at our disposal to satisfy our desires are, at any one time, limited. For an individual, these resources are ultimately expressed in terms of money - income and wealth. But for society as a whole they come in four main categories, these being land, labour, capital (in the form of goods and machinery, not money) and enterprise, or, if you like, risk-taking and managerial ability.

When we put these two ideas together, unlimited wants and limited resources, we have the basic economic problem, known as "Scarcity".

Because of the problem of scarcity we have to make choices about which wants we will satisfy and which we will leave unsatisfied. It is here that politics enters the picture, since the actual process of choosing is really a political process of decision-making. Thus in a community we may draw up a list of things which are needed, such as a new civic centre, a new youth club, improved library facilities etc. Out of this list we then select the ones we consider to be the most important, and then place these in order of priority. But the process of selection and ordering is a political one, as can be verified by the fact that the shortlist will vary according to which political party happens to be in control at the time.

Nevertheless, the economist's role in this process is a crucial one, for it is the economist's job to point out the likely consequences of making different choices. In other words, the economist's analysis precedes and underlies the political process. This is true at any level, including that of the government's economic policies.

So far we've seen that the basis of Economics is the idea of scarcity, from which follows the need to make choices. Out of this arise four concepts which are crucial to any economic analysis. These concepts, which will be dealt

with in turn, are opportunity cost, marginality, rationality and efficiency.

Opportunity Cost

Any choice involves a cost. In Economics this cost is expressed in terms of the next best foregone. Technically, this is known as "opportunity cost". Measuring the cost of something in terms of its foregone alternatives is rather more revealing than measuring it simply in terms of money. Several examples will make this clear.

A few years ago there was a furore about the destination of some of the money from Britain's foreign aid budget. This is the contribution which the country makes to help alleviate the plight of the people in poverty-stricken countries. £4m of this foreign aid was used to build a luxury hotel on a small West Indian island. The cost of this development, according to the Daily Mirror, was "20,000 pharmacies in areas of high sickness. Or class-rooms for 300,000 children. Or relief for people who will now die of hunger". Thus, according to the Daily Mirror, there was a straight choice between having a luxury hotel or, say, 20,000 pharmacies. Expressing the cost of the hotel in terms of opportunity cost is thus more informative

than simply saying it cost £4m, a figure which most people will find difficult to conceive of in practical terms.

There is also, however, another aspect to this, and one which isn't quite so obvious. Assuming that the people who were responsible for the hotel development were aware of the opportunity costs involved (a point which will be taken up when we look at rationality), and assuming that they were not unduly selfish or evil-minded, they must have had a logical reason for preferring the hotel to 20,000 pharmacies. Perhaps they thought that a luxury hotel would boost the island's income and so enable it to be more self-supportive. If this was their reasoning, then we can say that they saw the choice involved as being between the present and the future, ie. building pharmacies or schools now would have as its opportunity cost the higher level of growth which the islanders could enjoy in a few years' time.

Again, it can be appreciated that the final choice will involve a political process rather than an economic one. Perhaps economists would even disagree on the balance between present and future benefits expected to be enjoyed as a result of having a hotel or not having it. But the

actual method of analysis - the use of the concept of opportunity cost - will be accepted and used by all of them.

Another example of this interesting choice between the present and the future can be seen nearer to home, in the form of the Conservative Government's economic policy. According to the Government, less inflation now means less unemployment in the future. Now this view may be correct or incorrect, but it's important to see that as far as the Government is concerned it is correct. However, choosing the future in preference to the present is essentially a political choice.

An area in which the present has been chosen in preference to the future may be, arguably, in the sphere of economic growth. A decade or so ago a lot of publicity was given to the anti-growth lobby, which argued that the rate of industrial advance, coupled with the nature of much industrial activity, would lead to both the depletion of certain natural commodities and to environmental pollution. Their forecasts of <u>imminent</u> doom were later shown to be based on false assumptions. Nevertheless, their thesis may be a valid one for the long-term. But no government has attempted to slow down the rate of growth, showing that

either they disagree with the thesis or that they place a higher value on the present than on the future.

Another example of opportunity cost can be seen from literature published by the Campaign for Nuclear Disarmament. In 1973/74, for instance, the £2.9m spent on a Phantom aircraft could have paid for the building of 700 new council houses; the £6.6m spent on a frigate Ariadne could have been used to pay for the production of 5,700 buses.

This is, perhaps, a good point at which to state that it is not for the economist, in his role as an economist, to make value judgements about what is more desirable - a Phantom aircraft or 700 new council houses. The economist presents the choices, and suggests criteria for making them (as we will see when dealing with the concept of marginality) - but the final decision must rest with others.

Marginality

Allied to the idea of choice and the concept of opportunity cost is the principle of marginality. Most economic decisions do not involve a straight choice between one thing and another. Rather, they involve a choice between

more of one thing and less of another or vice-versa. In other words, economic decisions are usually made at the margin.

This principle can be better understood by looking again at the examples given in the preceeding section.

Take the example of the choice between a luxury hotel and 20,000 pharmacies. This choice would assume a different dimension if we knew how many luxury hotels and pharmacies were already in existence on the island. If, for instance, there was already a luxury hotel, the opportunity cost of building another one would, assuming all other factors to be unchanged, be higher than if there were no hotel to start with. An alternative way of expressing this is to say that the "loss" of the 20,000 pharmacies would be greater if there was already a luxury hotel and a second one was built.

On the other hand, if there were already a large number of pharmacies, the cost of building the luxury hotel would not be as great as if there were too few. It may be, of course, that there were more pharmacies than were absolutely necessary in some parts of the island, while in other parts there was a shortage. But, in the absence of sensible

governmental planning, this situation wouldn't necessarily be rectified by a decision to spend the aid money on pharmacies rather than a luxury hotel.

When people get together and discuss economic affairs, it is this principle of marginality which is frequently overlooked. This oversight gives rise to a lot of non-sense being spoken about the economy and the government's (<u>any</u> government's) economic policies.

Consider the choice between inflation and unemployment. Most experts would agree that for all practical purposes there isn't a choice between no inflation with some unemployment on the one hand and no unemployment with some inflation on the other. The choice (if there is one - a point to be taken up at a later stage of the book) is more likely to be between a slightly higher rate of inflation with less unemployment and a slightly lower rate of inflation with higher unemployment on the other.

The true costs of each choice depends, once again, on the situation currently prevailing. If, for example, the rate of inflation is fairly low (as is the case in Britain now, at least by recent standards), with a high level of unemployment, then it can be agreed that a slight increase

in inflation is less costly to the economy than a slight increase in unemployment.

We can make this point even clearer by bringing the whole thing down to a more personal level. Suppose you have £20, which you decide you will spend on either a new pair of shoes or a new pair of jeans. The principle of opportunity cost will tell you that the cost of buying the jeans is the pair of shoes you've had to go without. Similarly, if you buy the shoes you will incur the cost of the jeans you've had to leave. The principle of marginality will give you more of a quantitative basis on which to base your final choice. If you already have four pairs of jeans but only one pair of shoes, then the opportunity cost of buying the jeans will be higher than that of buying the shoes. In other words, cost in this sense is formulated in terms of the satisfaction you would enjoy or forego as a result of making any particular choice.

Rationality

A fundamental assumption of Economics, and one which underpins all the things we've said about choice and marginality, is that of rational behaviour. We assume

that people will make a rational choice based on the information they possess. It may well be, of course, that as a person widens his or her knowledge about a certain situation, a choice which appeared rational before now seems less so in the light of the new information. Nevertheless, at the time the original choice was made, with the information then available, the decision is assumed to have been a rational one.

So what does the economist mean by rational behaviour? Generally speaking rationality means either maximising or minimising behaviour, depending on the matter under consideration. Consumers, for instance, attempt to maximise the satisfaction they get from using their incomes. Producers may attempt to maximise their profits, or to minimise their costs (which isn't necessarily the same thing).

Let's make a more detailed investigation into the behaviour of consumers. Consumers buy various goods and services, and save a certain proportion of their income, in order to maximise the enjoyment they derive from their income. The rational consumer, in fact, will spend his money in such a way that a higher level of satisfaction could not be obtained, given his present income and the

prevailing prices of goods and services.

Suppose that the price of one of the products bought by our rational consumer increases. A decision will now be taken, at the margin, about how much to consume of that particular good in the future. Note that the decision is at the margin. It is highly unlikely that the consumer will stop buying the product altogether. It is more likely that the consumer will review his expenditure and decide to spend slightly less on that product and more on a substitute.

For example, if the price of tea rose while other prices remained unchanged, the rational consumer may decide to drink slightly less tea and slightly more coffee. Thus the principle of rationality explains in a scientific way the commonsense notion that as the price of a product rises, demand for it will fall.

But what about the fact that some people buy more of a product when its price goes up? This occurence does not nullify the concept of rationality. It is quite true that some people may be behaving irrationally when they buy more as the price goes up. In general, however, there are usually good reasons for such a decision.

One reason might be snob appeal. Another might be a tendency to judge the quality of an article by its price. Yet another might be the expectation of future price rises of the product in question, which will lead some people to buy more now and stock up for the future. All these reasons are motivated by a desire to maximise satisfaction, however defined.

Another, rather different example of rationality can be seen in the case of a person deciding whether or not to work more overtime. One of the principles on which Mrs Thatcher based her 1979 General Election campaign was that high marginal tax rates had a disincentive effect on effort. Why, the argument ran, should a person work an extra hour of overtime if a large proportion of his extra earnings will go to the government?

If we put the argument in terms of Economics, what we are really saying is this : the cost of an extra hour of work is the leisure time that could be enjoyed instead. The higher the returns from working, the more costly it is <u>not</u> to work. The converse is also true. Thus Mrs Thatcher was saying, in effect, that lowering the rate of income tax would increase the returns to working and therefore make it more costly <u>not</u> to work, in terms of foregone

earnings. The rational worker would presumably choose extra work at the expense of leisure.

Yet even here it can be argued that a rational worker would make the exact opposite response to a reduction in income tax, ie. would actually work fewer hours than previously. After all, the same income could now be brought home by working fewer hours; the worker may therefore decide - quite rationally - that he'd prefer to enjoy his higher take home pay in the form of extra leisure rather than extra money.

It may appear to the reader that for every economic proposition there is a counter-proposition. What is the use of having a concept of rationality, when the economist can "prove" that almost any decision can be a rational one!

The usefulness of the concept of rational behaviour lies in the fact that it is the only basis on which to predict future behaviour. If people behaved in a completely haphazard way, there could never by any scientific study of human beings. The economist's assumption of rationality enables him or her to say, with some confidence, that given factors X, Y and Z, most people

will behave in such and such a way.

Even if the economist is sometimes proven wrong, a much greater understanding of economic processes, and in particular of the workings of the economy, which is the subject of this book, is likely to be gained by at least assuming rationality on the part of most people - which includes, of course, the Government. No doubt governments are occasionally incompetent, but for the most part more is to be gained by looking for rational reasons for their economic decisions than by doing otherwise.

Efficiency

We come now to the last of the four concepts which form the basis of all economic thinking, that of efficiency.

Efficiency has come to be, for some people, a dirty word, conjuring up an image of faceless people working like robots in appallingly sterile conditions. When the word "efficiency" is mentioned in the same breath as, say, the National Health Service, an angry response like "People before money" is provoked.

Yet in Economics the word has no such connotations. If

we accept that wants usually outstrip resources, thus requiring choices to be made, it follows that these choices should be made in the least costly way.

This is simply an extension of earlier passages in this chapter. Take, once again, the choice between the luxury hotel and the 20,000 pharmacies. A decision to build an hotel rather than the pharmacies should not only be taken in accordance with the principle of marginality, but also with the principle of efficiency : which choice would make the best use of the country's resources.

The article in the Daily Mirror, referred to earlier, states that most of the labour for building the hotel will have to be imported. The article says that because of this the islanders will derive hardly any benefit from it. This, however, is not necessarily true. Imported labour may enable the indigenous population to concentrate on what it is best at producing.

If we look at the National Health Service, it has failed to reduce the discrepancy between the incidence of illness amongst the better-off and that amongst the worst-off. In fact, the gap between the two sections had widened since 1948. It may be that the discrepancy would have

been worse still in the absence of the NHS. Nevertheless, it should be possible to improve the efficiency of the NHS in allocating health care between different income groups. Saying this should not be seen as putting efficiency above people, for the whole point of the improved efficiency would be to benefit people. Nevertheless, it has to be recognised that certain strategies to improve efficiency may give rise to disadvantages which outweigh any potential gains. Always, in human affairs, must there be a balance.

* * * *

Armed with these four concepts - opportunity cost, marginality, rationality and efficiency - it should now be possible to take an objective look at what has been going on in the economy, and to assess the solutions offered by the main political parties. The following two chapters present a bird's eye view of the recession experienced in Britain and the world. These will provide useful background material to the more detailed analysis which will follow.