A1 – WHAT ECONOMICS IS ABOUT

[A Level Economics – Component 1: Microeconomics (H460/01)]

Specification Reference: 1.1

Learning Objectives

Candidates should be able to:
- understand the nature of economic inquiry;
- understand the nature of economic methodology – positive and normative economics.

Great Economists

Adam Smith
David Ricardo
Thomas Malthus
Karl Marx
Alfred Marshall
John Maynard Keynes
Milton Friedman
John Kenneth Galbraith

Basic Reading

Smith P. Economics for A Level Year 1. Ch 1 – Introducing Economics

Extra Reading

Anderton A. Economics (6th Ed). Ch 1 – Economics as a Social Science

The Internet

EconplusDal – www.econplusdal.com

Economics Help – www.economicshelp.org

Economics Online – www.economicsonline.co.uk

Tutor2u – www.tutor2u.net/blog/index.php/economics/

A1(a) – **What is Economics About?**

Alfred Marshall in 'The Principles of Economics' (1890) defined Economics as:
'… a study of mankind in the ordinary business of life; it examines that part of individual and social action which is most closely connected with the attainment and with the use of the material requisites of wellbeing. Thus it is on one side a study of wealth; and on the other, and more important side, a part of the study of man.'

The following nine issues give an idea of what economics is about.

(i) Prices – What determines the price of housing? What determines the price of oil? Why is a rise in the price of housing regarded as a 'good thing' while a rise in the price of oil is regarded as a 'bad thing'?

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(ii) Business and Profits – Energy companies may earn very high profits as a result of increased gas usage over cold winters. Is this good or bad? Should energy companies cut cut their prices and earn less profit?

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(iii) Wages and Earnings – What determines a person's income and why do some people receive much larger rewards than others even though they seem to contribute less to society? Consider: a footballer might earn more in a week than a doctor earns in a year. Why do tall people earn more than short people?

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(iv) The Environment – Research a recent environmetal disaster. Who is going to pay for it? Why are there likely to be more environmental disasters in the future?

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(v) Unemployment – is caused by: immigration; "welfare scroungers who can't be bothered to get a job"; increases in the national minimum wage; cheap imports from countries such as China which pay very low wages; the government. Discuss each one.

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(vi) The Economy – What is meant by a 'recession'? What caused the recession of 2008-12? If the banks are to blame for the recession, then should they be punished and if so, how?

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(vii) The Government's Budget – The UK government's budget deficit is very large. For the current fiancial year, how large is it expcted to be? How will it be financed?

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(viii) International Trade – Given that we can produce motor cars, clothing, railway engines, kitchen furniture and computers ourselves, then why do we buy them from abroad? Won't this cause British jobs to move abroad?

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(ix) The National Debt – Established in the late 17th Century along with the Bank of England, was this Britain's coolest invention ever? Note – it helps to explain why English and not French is the world's most important language.

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These are all big questions.

- The answers have an enormous influence on the quality of human life.
- They are very hard to answer. They generate great argument and debate; everyone has an opinion about them.

Comment on one of the ‘Views of the next generation’ (next page). Do they understand any Economics?

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Daniel Whitley, 20, Newcastle
"If the government reduced spending on less important areas, such as Britain's nuclear deterrent or defence strategy in general, it would be better positioned to reduce taxes and provide the economy with a much-needed fiscal stimulus. Although some people clearly argue laissez-faire free-market economies are the most attractive option for an ideal world, the credit crunch proved that more government regulation of Britain's banks is needed. This is especially true of the need to clamp down on the bonus culture that seems to exist among banks, particularly as they clearly haven't been performing to a bonus worthy standard in the first place."

Eva Light, 16, Kent
"If the government can spend all that they want on banks, why can't they be doing the same for everyone? It would be good for people travelling to school if they were ensured access to cheap and reliable buses, good for people with low incomes, and for the many who live in safe houses. We also need to do something to encourage people to stop using their cars so we can protect the environment and this would help that."

Hollie Ridley, 20, Brighton
"One of the most vital things the government can do for young people is actually offer them a future. For example, these huge university fees are unaffordable for most everybody and cannot fix the high deficit, because this is a class division. Perhaps the government should put a stop to these ridiculously high City bonuses or tax those who receive them, as this money could be put towards giving young people a start in life."

Tom Jones, 18, Milford Haven
"Cut taxes, especially for people who cannot afford to pay. I was hoping to go to university to study German but I can't go now because my parents cannot afford to help send me. I'm looking for a part-time job and hoping to combine that with studying at college. Cutting income tax, road tax and fuel duty would help get the country moving again. I think people should stop borrowing all the time and start saving for things. We've lost a lot of high street chains; that means we've lost the focal point of our town. Now the streets they were on are deserted. Perhaps they should reduce the price of leases to make sure they are used again. If the government is bailing banks out then it needs to help get the country moving on a local level too."

Amy Avery, 14, Kent
"It is not going to help in the long run to put so much money into the banks. It would be better spent setting up businesses which last well into the future and making life better for poor people in Britain. I believe many people would agree with me, especially considering Comic Relief. The media spend a lot of time complaining about recessions and then suddenly we raise £17 million more than ever before. I think that shows that even in a recession people can have altruistic feelings for those less fortunate."

A1(b) – Debates in Economics

How does the economic system as a whole work? Economic theory has developed over the years in order to provide answers to this question.

Classical/Neo-Classical Theory

Classical economic theory is based on the work of Adam Smith in 'The Wealth of Nations' (1778) and David Ricardo in 'The Principles of Political Economy and Taxation' (1817).

They both wrote at the time of the Industrial Revolution in Britain and believed that rapid economic growth would be the best way to reduce poverty. Economic growth could best be achieved through limited government intervention – by a policy of 'laissez-faire'. Free markets and the 'invisible hand' of the price mechanism would guide consumers and producers to the most efficient use of resources. Businesses would be set up, jobs created and there would be full employment. They also advocated a policy of free trade between nations – trade would also lead to rapid economic growth as each country would specialise in the production of those goods it was best at: i.e. where they had a comparative advantage.

David Ricardo and Thomas Malthus debated the possibility of general 'gluts' in goods. This would lead to mass unemployment. Say's Law stated that 'supply creates its own demand': i.e. any increased output of goods would lead to increased expenditure on those goods. There would be no shortage of demand – any unemployment would be temporary.

During the Victorian era, the policy of 'laissez-faire' – free markets and trade and limited government intervention – led to rapid economic growth and rising prosperity. However, there were periods of unemployment over the trade cycle; i.e. recovery-boom-recession-slump.

Further analysis of the workings of the market system came from Alfred Marshall in 'Principles of Economics' (1890). His most important theory was of demand and supply. This can be used to show that if the price of a good or of labour were too high then it would lead to a surplus. If the price was allowed to fall then the surplus will be eliminated. Therefore, unemployment was caused by wages being too high. Wage cuts in 1926 led to 'The General Strike'.

During the 1930s, there was a world-wide depression – caused by the 'Great Crash' in the USA (1929) – and mass unemployment. In Britain in 1933, ¼ of the adult male population was without work. Classical/neo-classical theory had no solution to this problem.

Keynesian Theory

This is based on the work of John Maynard Keynes in 'The General Theory of Employment, Interest and Money' (1936). Modern macro-economic theory has developed from this book.
(Note – apart from 'Mein Kampf', it is the most influential book of the 20th century.)

Keynes argued that there was no automatic tendency for the price mechanism to achieve full employment – instead there could be permanently high unemployment. One explanation of this was the multiplier theory – a reduction in demand and output would lead to further reductions in demand and in output: i.e. a vicious circle.

Therefore, there was a need for government intervention in order to restore full employment: i.e. by increasing the demand for goods and services that would lead to increased output and employment. Keynes suggested:

'If the treasury were to fill up old bottles with banknotes, bury them at suitable depths in disused coalmines which are then filled up to the surface with town rubbish, and leave it to private enterprise … to dig up the notes again … then there need be no more unemployment, and with the help of the repercussions, the real income of the community, and its capital wealth also, would probably become a good deal greater than it actually is. It would indeed be more sensible to build houses and the like, but if there are political and practical difficulties in the way of this, the above would be better than doing nothing.'

Keynes was being ironic about the banknotes and the coalmines but the basic principle became the basis for policy in the UK with the White Paper on Employment (1944). Keynesian theory was the basis of economic policy between 1944 and 1976 and full employment was achieved throughout that entire period.

Keynes also devised the Bretton Woods System (1946) which organised the world financial system until 1972 when it was under-mined by the USA which was financing the war in Vietnam by printing dollars.

During the 1970s there was world-wide inflation caused partly by the above and partly by OPEC quadrupling the price of oil in 1973-74. As a result, in Britain Keynesian policy was abandoned in 1976.

Monetarist Theory

The most influential monetarist economist is Milton Friedman. In 'Studies in the Quantity Theory of Money' (1956) and 'A Monetary Theory of the US' (1963) he argued that inflation was caused by an excess supply of money in the economy: i.e. 'too much money chasing too few goods'. Therefore, control of the money supply will lead to the control of inflation.

In addition, monetarists believe that free markets lead to the most efficient use of resources – therefore, governments should intervene as little as possible in the workings of the economy. They should follow a policy of 'laissez-faire'. In this, monetarism builds on neo-classical theory.

From 1979 onwards, Mrs Thatcher implemented monetarist ideas. Inflation was reduced but at a very high cost – unemployment increased to 3 million people (twice!). This was higher than at any time since the 1930s – we seem to have come full circle. It is perhaps the case that people who do not know any history are condemned to repeat it – very annoying if, as a result, you lose your job and maybe your home?

Conclusion

There is no one 'true' theory about how the economic system works – different theories can explain different aspects of the economic system and may be more or less appropriate depending on circumstances; e.g. does the economy suffer from unemployment or inflation?

ICT Research – Google and/or AI

Answer the following questions about **Economic Theory.**

(i) Adam Smith used the example of 'pin-making' to illustrate which principle?

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(ii) David Ricardo used the example of trade in wine and cloth between England and Portugal to illustrate which principle?

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(iii) Alfred Marshall used the analogy of a pair of scissors to illustrate which principle?

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(iv) J.M. Keynes argued that 'in the long-run we are all dead'. What did he imply?

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(v) Milton Friedman argued that 'too much money chasing too few goods' caused inflation. What theory was this based on?

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In what way have economists 'got it wrong' in the past few years, especially with regard to the 'credit crunch'? (Look up the article about the late Queen at the LSE.)

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A1(c) – Is Economics a Science? – Positive and Normative Economics

Many people argue that Economics is not a science, as economists do not seem to be able to agree about anything; e.g. Keynesians v Monetarists.

This is a false criticism – in all scientific subjects there are areas of disagreement and failure to arrive at a consensus may be due to the complexity of the issue.

The **scientific method** implies **objectivity**: i.e. the ability of the scientist to make a distinction between matters of fact and matters of personal opinion. This will give a distinction between **positive economics** and **normative economics.**

Positive Economics is concerned with what is, what was and what probably will be. It consists of objective facts and explanations about the workings of the economic system. They can be tested by referring to the available evidence; e.g. the level of duty on petrol leads to a rise in the price of petrol and to a fall in the quantity bought.

Normative Economics is concerned with what ought to be. It depends on our opinions or value-judgements about what is good or bad for individuals and for the economic system as a whole. They cannot be tested; e.g. the level of duty on petrol is unfair and penalises motorists.

Note – many newspaper articles and TV reports on Economics include opinions about what should be done concealed as matters of fact: i.e. they are not objective even if they appear to be.

Read the article 'Fact or opinion' and answer the following questions.

(i) Give two positive statements – one about smoking and one about unemployment. How can we prove them to be true or false?

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(ii) Give two normative statements – one about smoking and one about unemployment. How can we prove them to be true or false?

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(iii) Which of the following statements are positive and which are normative?

- The economy of South Korea is closer to a free market system than that of North Korea. ___
- The price of oil more than tripled between the years 2004 and 2008. ___
- A cut in wages will reduce the number of people willing to work. ___
- The government ought not to have introduced university tuition fees. ___
- Traffic congestion costs the UK over £3 billion pa. ___
- The government should spend more on the railways and less on roads. ___
- No family ought to pay more than 25% of its income in taxes. ___
- The best government policy is one that will increase economic growth. ___
- Economic growth should be higher so as to reduce unemployment. ___
- The UK economy will grow by 2% in the year 2016. ___
- Since the 1990s, inflation has fallen in most Western economies. ___
- The world distribution of income is unjust: poor countries have 58% of the world's population but only 4% of the world's income. ___