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ECONOMICS

COURSE COMPANION



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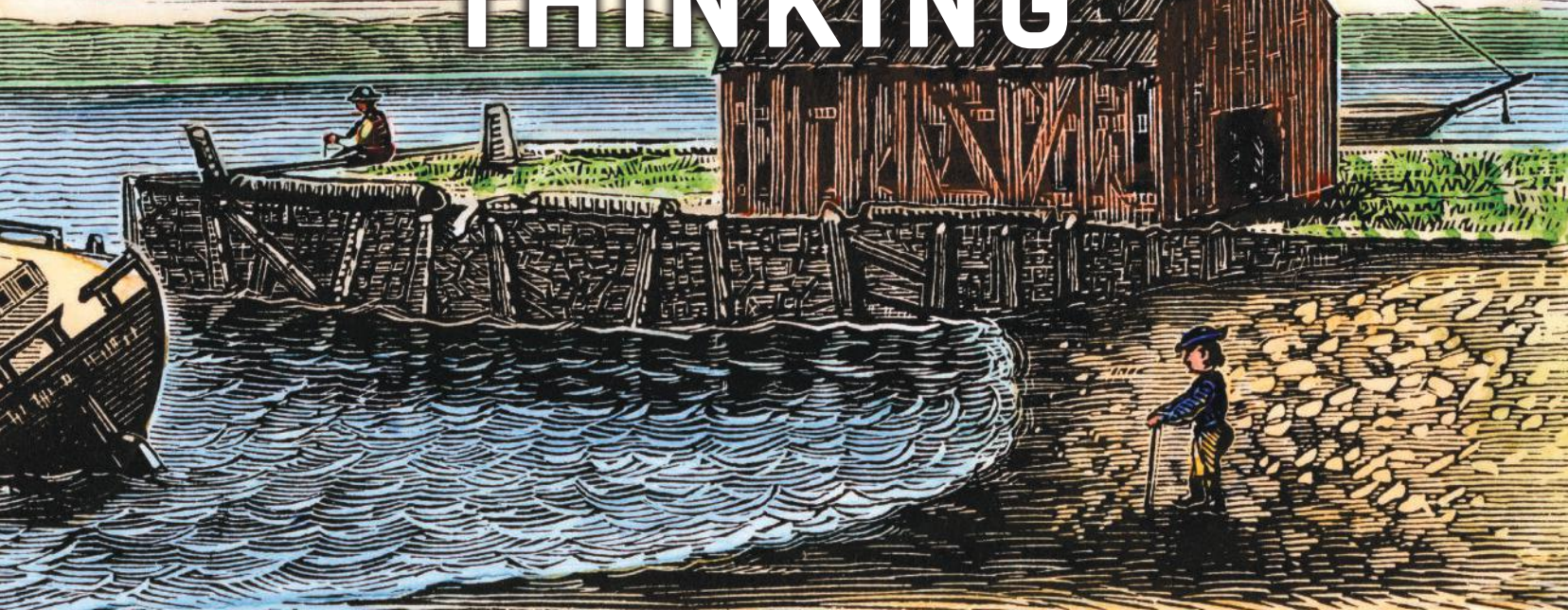
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2 THE EVOLUTION OF ECONOMIC THINKING



By the end of this chapter, you should be able to:

- Describe the basic ideas of Adam Smith
- Explain the meaning of *laissez-faire* economics
- Describe the evolution of microeconomic and macroeconomic thinking through the nineteenth century
- Describe the thinking behind Keynesian economics
- Describe the thinking behind monetarist/new classical economics
- Describe the growing role of behavioural economics
- Understand the concept of a circular economy.

There are full-length university courses on different aspects of the history of economic thought, and it is impossible to give the topic full justice within just a few pages. In this chapter, we introduce you to several names and theories associated with the evolution of modern economic thought. Some are treated in slightly more depth than others, and most are returned to later in the book. What is important at this stage is that you have some understanding of the evolution of the economic theory that we study today.

At the end of the chapter, you will see that the rapid changes in the world, and the tremendous threats that we are facing in terms of socioeconomic inequalities and threats to sustainability, may not be able to be explained through traditional, “orthodox” economic theories. This

has raised demands for a more “heterodox” approach to economics: one which incorporates a range of economic theories and questions the assumptions of many of the earlier models that have driven much of the decision-making of businesses and policy makers.

As Ha-Joon Chang shows in his excellent book, *Economics: The User's Guide* (highly recommended!), there many different ways of “conceptualising and explaining the economy”. This gives rise to very different economic theories and models, none of which is “right”. As he notes, “all theories, including natural sciences like physics, necessarily involve abstraction and this cannot capture every aspect of the real world”. But what is most important is his comment that “this means that no theory is good at explaining everything. Each theory possesses particular strengths and weaknesses, depending on what it highlights and ignores, how it conceptualises things, and how it analyses relationships between them.”¹ The fact that no one theory is “right” is what should encourage students of economics to adopt a heterodox approach where they consider issues from a variety of perspectives, using a range of theories.

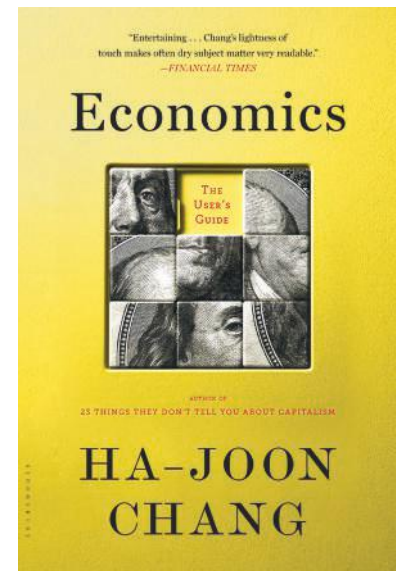
Let's look at some of these different theories and their origins.

Where did “modern” economics begin?

Classical economics – the eighteenth century

Until the beginning of the industrial revolution and the birth of capitalism, the prevailing view of economics was that there was a certain amount of gold and silver in the world, and that the amount of gold and silver a nation state had was the only measure of its worth. Under this theory of what is now known as *mercantilism*, rulers aimed to accumulate wealth by obtaining more gold and silver through trade. The goal was to maximize exports to earn more gold and silver, and use barriers to imports such as customs and tariffs to prevent gold and silver from leaving the economy. The government was heavily involved in controlling aspects of the economy. Having colonies abroad was one important way in which countries were able to produce and export goods to accumulate more gold and silver.

In 1776, the first “revolution” occurred in economic thought and the *classical school* of economics was born. The “father” of classical economics is Adam Smith, a moral philosopher from Scotland, who published what is often referred to as the first book on modern economics, *An Inquiry Into the Nature and Causes of the Wealth of Nations*, in 1776. Smith's book, more commonly known as *The Wealth of Nations*, completely changed the way that economic activity was understood and became the backbone of economic theory for the classical school until later in the nineteenth century. Although there have been changes in economic thought since then, his observations form the basis of many of the theories that we still study today and his book is still considered to be extremely influential in terms of its contributions to economic thought.



The cover of *Economics: The User's Guide*, by Ha-Joon Chang

¹ *Economics: The User's Guide* by Ha-Joon Chang, Pelican Books, 2014

In comparison to the mercantilist theories that preceded him, Smith observed that the wealth, or prosperity, of a nation is not based on its accumulation of gold and silver. He proposed that a country's wealth is based on the value of the goods and services that it produces. In modern terminology, we would say that a country's wealth is based on its Gross National Product. Smith argued that the priority of governments should be to maximize the country's output, and he wrote about how production and productivity (output per worker) could be increased.

One of his major contributions to economic theory was through his identification of the benefits of specialization and the division of labour. His famous illustration of these benefits was through a story about a factory with ten workers making pins. In his story, he identifies approximately eighteen separate steps involved in manufacturing a pin. If each worker works alone and completes all eighteen steps, Smith suggested that they could each make ten to twenty pins for a total of 100 to 200 pins. However, when they divide up the tasks, with each one specializing in one or two of the steps, they can make 48,000 pins, or an average of 4,800 pins per person². The labour productivity of the workers, when they divide up the job and specialize in one or two tasks, is about fifty times higher than the work done if they operate individually. While he observed that this was just a simple example, his more technical observations about the benefits of the division of labour were significant in explaining how production and productivity across an economy could grow. As output increases, there are further and further divisions of labour and increases in productivity, leading to higher profits and the accumulation of capital to develop even better production technologies and more output. Overall, this would result in greater wealth and prosperity for the nation as a whole. Contrary to earlier thought, the wealth was not increased merely through trade and the acquisition of more gold and silver; wealth is increased by producing more output.

Another theory introduced by Smith, and developed by other classical economists, is the "labour theory of value". According to this theory, the value, or price of a good is the sum of the value of all the labour that was used in producing the good. So, for example, the price of a bushel of corn was determined by all the labour costs of the inputs involved in producing that bushel. Contrary to theories that were developed later, the value of a product was determined primarily from factors relating to the supply of the product.

One of Smith's most notable contributions to the discipline of economics is the metaphor of the "*invisible hand*". He observed that when private producers are left alone to decide what to produce and how to produce it, they are guided by an "*invisible hand*". They are not told what to produce by a government or any other authority. They choose what to produce based on what consumers want. In pursuing their own "self-interest" (ie higher profits for themselves), Smith observed that producers



"It is not from the benevolence of the butcher, the brewer, or the baker, that we can expect our dinner, but from their regard to their own interest"

—Adam Smith, *An Inquiry Into the Nature and Causes of the Wealth of Nations* (1776).

² Book 1, *The Wealth of Nations*, Adam Smith



also benefit consumers because the competition between the producers gives them the incentive to come up with better and cheaper products. So when producers seek to maximize their profits, they also maximize the satisfaction of consumers. This satisfaction or pleasure that consumers get from consuming products is known in economics as *utility*. And when producers supply the goods that give consumers the most utility, they create jobs and wealth for the nation as a whole. What was particularly innovative was the notion that markets are self-regulating, and will lead to an optimum outcome without government intervention. An economy based on free markets and competition is one which leads to full employment of resources and greater prosperity for the economy.

In *The Wealth of Nations*, Smith also showed how a country's prosperity grows through trade with other countries. He advocated that countries specialize in the production of goods which they produce more efficiently than other countries, export their surpluses to other countries and import goods which other countries produce more efficiently. This was contrary to previous views under mercantilism where governments restricted imports from other countries in order to protect their own producers. Smith's writings promoted the notion of free trade, or trade without government protectionist policies.

The conclusion that society as a whole prospers from the forces of competition and the invisible hand is the basis for the *laissez-faire* theory for which the classical economists are famous. *Laissez-faire* translates literally from French as "let do", but the term is used in English to refer to the capitalist economic system where production, consumption and trade take place in free markets with as little government intervention and as few regulations as possible.

This does not mean to say that Adam Smith advocated no government intervention whatsoever. In Smith's view, government responsibilities lay in the areas of defence, universal education, the provision of essential infrastructure such as roads and bridges, the establishment of legal rights and the punishment of crime. He wrote extensively about these obligations of governments in facilitating the pursuit of prosperity for nations.

How did Classical Economics develop in the nineteenth century?

Classical economics was developed in the nineteenth century through the work of many famous economists, including David Ricardo, Thomas Malthus, John Stuart Mill and Jean-Baptiste Say.

The classical economist David Ricardo is well known for the work he did on international trade. Similar to Smith, he agreed that countries should specialize in the production of different goods and trade freely

Exercise 2.1

ATL Thinking and Communication

1. In 1958, the political philosopher Leonard Read wrote an essay called "I, Pencil" to celebrate what he viewed as the tremendous benefits to be gained as a result of the "invisible hand". Writing in the first person, from the perspective of a simple lead pencil, Read aimed to show that no one person in the world has the knowledge and ability to single-handedly make an entire lead pencil from scratch. It is a cleverly crafted story illustrating the vast complexity of the supply chain and the author's wonder at the huge variety of resources, workers, machinery, technologies and skills that come together around the world to create a pencil. The essay is written as a tribute to the creativity that is unleashed through free markets. Read the story and try to identify the benefits of the "invisible hand" observed by the author.
2. A more modern interpretation of the essay "I, Pencil" was made in the form of a video celebrating the genius behind a smartphone (unsurprisingly called "I, Smartphone"!). Watch the video and comment on the similarities between the stories of the pencil and the smartphone.
https://www.youtube.com/watch?v=V1Ze_wpS_o0&feature=youtu.be

to increase global output. However, where Smith focused on what came to be known as the “absolute advantage” of one country compared with another country, Ricardo developed the law of “comparative advantage”. This theory is the basis of most international trade theory today, and is one we develop later in the book.

Much of classical economics is based on the work of Jean-Baptiste Say, who is famous for “Say’s law of markets”. A Frenchman who was known to be very much in favour of free markets and free trade, Say was strongly influenced by the writings of Adam Smith.



“It is worthwhile to remark that a product is no sooner created than it, from that instant, affords a market for other products to the full extent of its own value.”

—Jean-Baptiste Say, *A Treatise on Political Economy* (1803).

According to Say’s law, it is the production of goods that is actually the source of all demand in an economy. This main theory has been paraphrased by others as meaning “supply creates its own demand”. This can be linked to the circular flow model in the previous chapter. The model shows that the economic activity of production creates incomes equivalent to the value of the output. These incomes are then used to consume other goods and services. By supplying goods, producers are effectively creating the purchasing power for consumers to demand other goods. Total demand in the economy comes about as a result of production.

Importantly, Say’s theory is used to argue that there cannot be any overproduction of goods within the economy and that economic growth is achieved by focusing on increasing production as a means of generating further demand for products. The conclusion of Say’s law, with its focus on the supply side of the economy, is consistent with classical economics in rejecting government interventions that restrict the operating of free markets.

What was the neoclassical school of economics?

The neoclassical school of economics emerged in 1870, with the work of William Jevons, Léon Walras and Carl Menger. These three economists were operating independently in three different countries, yet they shared some common conclusions and approaches.

A significant difference between the neoclassical and the classical theories relates to the determination of the value or price of a product. As noted earlier, Smith and other classical economists supported the labour theory of value which concluded that the value of a product is determined by the costs of labour and other inputs in the production process, so their focus was primarily on the production side. In contrast, the neo classical economists rejected the labour theory of value. They argued that the value of a good is determined by the value that consumers place on the good, based on the amount of utility that it brings them. They therefore placed significant importance on the demand for the product. Neoclassical economists believed that utility could be measured and given a monetary value. This is one small sign of the increasing importance of mathematical analysis in the neoclassical school.



The work of Jevons, Menger and Walras introduced what is known as *the marginal revolution*, because of their idea of “marginal decision-making”. Put very simply, this means that consumers decide whether to consume the “next” unit of a good depending on how much utility that extra unit brings them; producers decide whether to produce the “next” unit of a good depending on the extra cost of producing that good. An example of a neoclassical “marginal” theory was the development of the theory of diminishing marginal utility that is explained in the box below.

Law of diminishing marginal utility

Imagine that you have just completed a sports event on a very hot day. When you finish, someone offers you a bottle of water. It is likely that this bottle of water will give you a huge amount of pleasure, or joy, or satisfaction. The bottle of water is extremely useful to you. Economists use the term “utility” to explain this satisfaction, or usefulness that a product gives you.

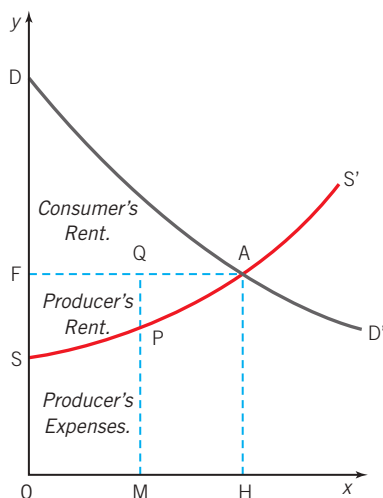
After you have finished the bottle of water you are offered a second bottle of water. You are still hot and a little thirsty, so you drink the second bottle. However, the benefit that this second bottle brings you is less than the first bottle. Economists use the term “marginal utility” to refer to the extra utility that you gain from consuming an extra unit of a product, the extra satisfaction. If you are offered a third bottle in a few moments, you may still feel thirsty, but the pleasure that this third bottle brings you is considerably less than the satisfaction that you gained from the first bottle, when you were so hot and thirsty. This very simple story illustrates the concept of diminishing marginal utility, which was an extremely important theory developed by neoclassical economists.

This marginal revolution marked a significant change between the theories of classical economics and the much more mathematical, scientific work of neoclassical economics. Although the classical school considered both supply and demand, they considered them separately, and placed more importance on the supply side because of their belief in the labour theory of value. Rejecting the labour theory of value, neoclassical economists placed more emphasis on the demand side, and developed complex mathematical functions to explain the interaction between production (supply) and consumption (demand) decisions to understand how prices were determined and hence how resources are allocated in individual markets.

For us, perhaps the most notable contributions to the neoclassical school came from the work of Alfred Marshall, whom some regard as the actual founder of the neo classical school. In his *Principles of Economics* (1890), Marshall was the first to present the visual supply and demand graphical model, which we still use today, to illustrate how prices are determined in a market. Marshall’s original diagram is shown in

Note

The terms demand and supply are central to economic analysis. Demand is defined as the quantity of a good or service that consumers are willing and able to purchase at different prices in a given time period, so the “demand side” refers to the behaviour of consumers. Supply is defined as the quantity of a good or service that producers are willing and able to supply at different prices in a given time period, so the “supply side” refers to the behaviour of producers. We look at these in much more detail in Chapters 3 and 5.



▲ **Figure 2.1** The “first” supply and demand diagram

Figure 2.1. Instead of the pages and pages of writing that characterized earlier works of economics, Marshall’s work was filled with diagrams to illustrate the theories and models. This was further evidence of the change in the way that economists approached the world, using mathematics and a much more scientific approach to explain economic behaviour.

In building their models to explain producer and consumer behaviour, it was necessary for neo classical economists to make assumptions. These assumptions, which continue to underpin contemporary economic theories, are based on the idea that both consumers and producers are assumed to be *optimizers* in seeking the best outcome for themselves; consumers are assumed to want to maximize utility and producers are assumed to want to maximize their profits.

In maximizing utility, consumers are assumed to behave in a rational way. This means that they are self-interested (in some interpretations, this is referred to as selfish behaviour). When faced with choices, it is assumed that consumers have full information about their options and they are assumed to be able to make judgments instantly about the marginal utility of consuming an extra unit of a product. Producers are also assumed to be rational when making choices about how to maximize their profits, and it is assumed that producers are able to calculate accurately the marginal cost of producing an extra unit of a good. In modern terminology, the assumptions built into the neoclassical model are referred to as “rational choice theory”.

The neo classical model is consistent with Adam Smith’s notion of the “invisible hand”. When producers are rationally trying to maximize their profits (acting in their own self-interest), they will compete with each other, thereby producing the best possible products at the lowest prices in order to give consumers the opportunity to choose their products rationally. According to the model, this process will produce the best possible outcome from society’s point of view.

Up until the time of the “marginal revolution” and the models presented by the neo classical economists, the discipline of economics was formally referred to as “political economy” and the approach to the subject was largely philosophical. With its heavy reliance on mathematical models, equations and diagrams, neo classical economics effectively allowed the discipline of economics to be viewed as a science. From this point on, the discipline became known by its modern term “Economics”. This was part of a move to remove the subjective, normative questions from the study and give it more objectivity and rigour as a science in comparison with the philosophical approach taken by the classical economists.



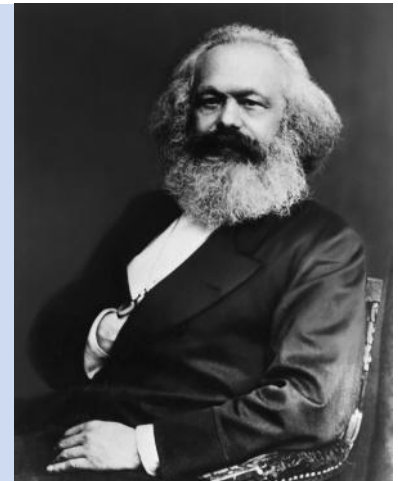
Karl Marx (1818–83)

Best known not as an economist or philosopher but as a revolutionary communist, Karl Marx's works inspired the foundation of many communist regimes in the twentieth century. He had a massive influence upon the shape of the world in that century. Although he was originally trained as a philosopher, Marx eventually turned more towards economics and politics. He attempted to prove his theories using mathematics. He felt that this was important, since he said that his book, *Das Kapital*, was a "scientific description" of the course that history would take.

Marx saw "capitalism", the free market system, as being only one of a series of methods of production. Marx predicted that there would be an inevitable breakdown of capitalism, for economic reasons, and that communism would be the natural end result. He issued the rallying cry, "the proletarians have nothing to lose but their chains ... working men of all countries, unite!"

Marx predicted that, eventually, society's ability to produce would grow faster than its ability to consume, causing growing unemployment. Thus the free market could not be depended upon to serve the best interests of workers and there would be a need for the government to take over the means of production, in a system known as communism.

The ideas of Marx continue to have a prominent role in economic and political debate today, with his views being associated with perspectives on the "left" of the ideological spectrum.



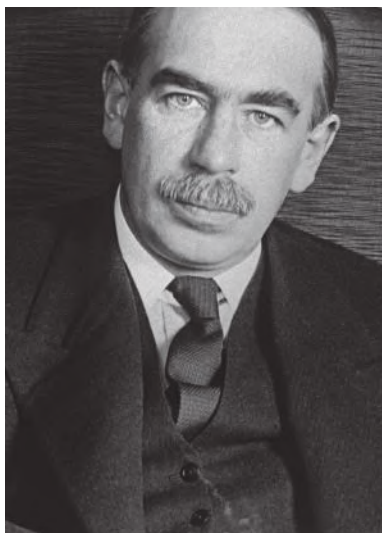
So what happened in the twentieth century?

In the first few decades of the twentieth century, the neo classical faith in the ability of the free market to bring about the best outcomes prevailed. Since individual markets were seen to move towards equilibrium when left alone to the forces of demand and supply, it was believed that the economy as a whole would move towards a general equilibrium with full employment of resources, without government intervention. While there would be up and down cycles in terms of economic growth, if there was any over-supply in the economy ("gluts"), the prices would drop, encouraging consumers to buy and eliminating the surpluses. The "orthodox" or generally accepted view remained that governments need not intervene – *laissez faire*.

The theory could also be applied to labour markets and used to explain why unemployment would not be a long-run problem. If there was unemployment of labour (ie an oversupply of labour), it would be a short-run phenomenon. Like any other market, if there was too much labour, then the price of labour (wages) would fall and producers would want to hire more workers at the lower price, thus eliminating the unemployment. There would be no need for the government to intervene to try to correct the problem of unemployment; market forces would do it automatically.

What is Keynesian macroeconomics?

In the 1920s and 1930s, the British economist John Maynard Keynes (pronounced Canes) was responsible for the next "revolution" in economic thinking and "Keynesian economics" emerged as a new school of thought. With his focus on the workings of the economy as a whole, Keynes is often considered to be the "father of macroeconomics".



John Maynard Keynes (1883–1946)

Keynes was born in Cambridge, England into a highly intellectual family, and was educated in the elite academic institutions of Eton and Cambridge. Although highly intelligent, Keynes did not focus exclusively on academics, but found ample time for literary pursuits and political activities. He was well-known for his involvement with the progressive literary Bloomsbury Group in London, which included many other intellectuals such as Bertrand Russell and Virginia Woolf. He joined the British civil service in 1906. In order to enter the civil service, he had to write entrance examinations and, ironically, he was not as successful in his economics exam as one might expect – but, as he explained later, “I evidently knew more about economics than my examiners.”

Following a short period with the civil service, Keynes went back to Cambridge and then went to work at the British Treasury (the government department responsible for government spending and taxation). He was a key representative of the British Treasury at the Paris Peace Conference in Versailles in 1919, but he was very much

against the conclusions of the Conference in which Germany was expected to make massive payments (reparations) to the Allied countries for World War I. As a result, he resigned from the Treasury and wrote *The Economic Consequences of the Peace*. His argument was that it would be impossible for Germany to pay the amounts that the Allied countries demanded it pay. He predicted that the consequences would be very damaging and he turned out to be quite right.

The view for which Keynes is most well-known, and most relevant to our introductory economics course, was published in 1936 in *The General Theory of Employment, Interest and Money*. As you should know now, the governing orthodoxy at the time was that of *laissez-faire*, which argued that government intervention in the economy should be carefully limited and focused on the supply side of the economy. This means that governments did have a role, but the role was in helping create the conditions necessary for maximum production. Put very simply, this would involve education to create skilled workers, infrastructure to make production and exchange possible, and the establishment of laws and the maintenance of order in order to guarantee stability. Keynes changed the focus and put forward the radical idea that it was demand, rather than supply, that determined the overall level of national income and more importantly, that governments had a key role to play in managing the level of *total demand* (known as “aggregate demand”) in the economy. Keynes’ *General Theory* grappled with the problem of mass unemployment during the Great Depression. He observed that the persistent levels of high unemployment of the 1920s were not going to disappear if left to market forces, as the *laissez-faire* economists would have people believe.

Contrary to what earlier economists theorized, Keynes argued that the problem during the Great Depression was one of insufficient demand in the economy. The demand from consumers and businesses was not enough to buy up the total output of goods and services being produced in the economy, resulting in a “general glut”. With excess supplies, firms would lay off workers, who would then have even less purchasing power to buy up goods and services, resulting in further falls in demand for goods and services and even less demand for workers. The solution, as Keynes saw it, was for the government to intervene to increase total



demand in the economy by spending more money itself and lowering taxes to allow households and businesses to spend more. Increasing aggregate demand was advocated as a means of bringing the economy out of the depression.

This ran counter to the neo classical economists in two ways. Firstly, it went against the notion of **automatically** stabilizing markets; rather than leaving the economy alone, Keynes argued that it was an obligation for governments to intervene. Keynes acknowledged that while market forces might eventually result in full employment of all resources in the long run, this could take an unacceptably long time, with consequences too damaging (in terms of high and prolonged unemployment) for governments to accept. The policies that Keynes recommended were fiscal policies, related to government spending and taxation, and monetary policies, related to interest rates and the money supply.

Secondly, until the time of Keynes, it was felt that all economic agents (households, firms and the government) should operate within their means, and not spend more money than they had. In contrast, Keynes proposed that in order for governments to stimulate the economy by increasing overall demand, they should go into debt and “run budget deficits”. That is, they should spend more money than they earn from taxation revenue by borrowing money to make up the shortfall. The assumption was that in times when the economy was growing well, the government would take in more money in taxes and spend less so that the debts could be paid.

Keynesian economics is also referred to as “demand-side” theory, or “demand management”. Observing that economies typically pass through *business cycles* fluctuating between rapid rates of growth (with low unemployment and rising inflation) and slow growth, or recessions (with high unemployment), Keynes advocated “counter-cyclical” government policies. During an economic downturn, or recession, with high unemployment, governments should increase aggregate demand by using expansionary fiscal policy (increasing government spending and decreasing taxes) and expansionary monetary policy, operated by the country’s central bank (increasing the money supply and decreasing interest rates). During a rapidly growing, or booming economy, where an economy risks rapidly rising prices (inflation) governments should decrease aggregate demand by using contractionary fiscal policy (decreasing government spending and increasing taxes) and contractionary monetary policy (increasing interest rates and decreasing the supply of money).

Keynesian economics gained widespread acceptance and became the dominant economic school of thought until the 1970s, when economic realities could not so easily be explained by Keynesian theories. For example, Keynesian economics implied that economies could **either** face the problem of high unemployment during a downturn in the business cycle or the problem of high inflation during an upturn in the business cycle, and that if governments managed the level of aggregate

Key concept



INTERVENTION

demand, they could reduce the swings in economic activity to minimize both of these problems. Up until the late 1960s and early 1970s, those policies seemed to work and countries employing these policies enjoyed strong economic growth with low unemployment and low inflation. However, around this time, many economies began to face the problem of high unemployment **and** high inflation (known as *stagflation*), which Keynesian theory was unable to explain adequately. In fact, it was argued that governments using Keynesian policies were making the economic problems even worse. This cleared the way for a new way of looking at macroeconomics.



“Inflation is always and everywhere a monetary phenomenon.”

—Milton Friedman, *The Counter-Revolution in Monetary Theory*, 1970.

What is Monetarism (New Classical Economics)?

Monetarism emerged as the main challenge to Keynesianism in the late 1960s. This school of thought was made famous by the economist Milton Friedman, who received a Nobel Prize in Economics in 1976. Monetarists believe that the main determinant of economic growth is the total amount of money in the economy and so their focus was mainly on monetary policy.

Monetarists were most concerned with the issue of inflation in an economy, and observed that inflation was caused by too much growth of the money supply. In their view, a country’s central bank should **not** use monetary policy to try to deliberately increase aggregate demand in the economy by increasing the supply of money, as this would simply lead to higher and higher inflation. They believe that central banks **should** increase the money supply, but by a strictly controlled steady amount consistent with the rate of growth of national income. When money supply increases by more than the amount of output, then the economy faces a situation of “too much money chasing too few goods”. As a result, prices rise rapidly.

In the view of the monetarists, the best way to achieve economic growth is for the government to steer clear of demand management and for the central bank to control the growth of the money supply. Expansionary policies would only result in inflation.

A slight twist on the name, the new classical school builds on the work of the neo classical school and similarly argues that the economy will move automatically to a level of national income where all resources are fully employed. The new classical school revives the notion of rationalism through its theory of “rational expectations”. Applied to macroeconomics this assumption leads new classical economists to have similar conclusions about inflation as the monetarists. When governments employ expansionary policies, households and businesses will anticipate that inflation will occur and, acting in a rational manner, will behave in a manner that will actually cause wages and prices to rise. For example, if governments use expansionary policies, workers will rationally *expect* inflation to occur and so will demand higher wages.



If workers demand higher wages, producers will charge higher prices to cover their higher costs.

Economist Robert Lucas Jr. received a Nobel Prize in Economics in 1995 for having “developed and applied the hypothesis of rational expectations, and thereby having transformed macroeconomic analysis and deepened our understanding of economic policy”³.

Economists in the new classical school of thought are similar to the monetarists in their conclusion that governments should never try to manage the level of demand in the economy. They go back to the classical and neo classical economists in arguing that the only way that government can promote economic growth is by using policies that focus on the supply side of the economy by creating incentives such as tax cuts for businesses to become more efficient and for workers to work harder.

So what has happened so far in the twenty-first century?

What is behavioural economics? (Economics meets psychology!)

As you know by now, the neo classical approach makes the assumption that consumers behave rationally. That is, whenever a consumer makes a choice to consume a good or service, it is assumed that they have carried out an internal calculation of the benefit or utility that the product gives them in relation to the amount it costs to buy the product, in an intelligent, logical and selfish way.

However, in the real world, humans do not necessarily behave in this rational way and are not able to make these instant cost-benefit analyses. When faced with the millions of choices that we make on a day-to-day basis, we do not necessarily make intelligent and logical decisions, and we certainly do not have perfect information about relative prices of goods and the utility that each product will give us. Furthermore, we do not act in a purely self-interested way; we do actually care about how our choices affect others.

Challenges to the assumptions of consumer rationality have given rise to a branch of economics known as “*behavioural economics*”. This is a branch of economics which incorporates the insights of psychology and recognizes that the choices which consumers make are governed by many factors that are not consistent with the assumptions behind the neoclassical models.

Richard Thaler is regarded as a pioneer in the field of behavioural economics and won a Nobel Prize for his work in 2017. He argues that

³ <https://www.nobelprize.org/prizes/economic-sciences/1995/press-release/>

assumption of rational choice means that neoclassical models are based on people that do not actually exist!

Given that humans are not necessarily rational, they do not necessarily always make the best choices about what to consume, and what not to consume. Behavioural economics aims to understand the decision-making process of **actual** human beings (rather than so-called “rational” human beings). It then uses this understanding to help consumers make better choices and to help governments design policies that will encourage consumers to make better choices.

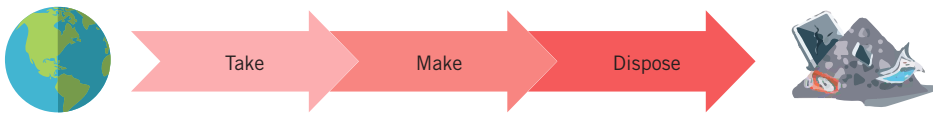
In the terminology adopted by Richard Thaler and his colleague Cass Sunstein in their book, *Nudge: Improving decisions about health, wealth and happiness*, consumers can be “nudged” to make choices **voluntarily** that are better for them and indeed, better for society. For example, when governments legislate that processed foods must have the nutritional values printed on their labels, they are then “nudging” consumers to make healthier eating choices.

The work on nudge theory by behavioural economists has had a big impact on governments and organisations all around the world, which are now nudging people in countless ways to help people make “better” decisions. These have contributed to improvements in people’s standards of living, their health, their communities and the environment.

Nudge theory is not without its critics. Any form of government intervention may be accused of taking away individual rights. There is also the concern that governments do not actually know what is best for people and so cannot be trusted to choose how to nudge people. This is a good example of the debate between those who believe that governments have an important role to play in the functioning of markets and those who believe that market forces operate efficiently on their own. However, behavioural economists argue that the belief that markets operate efficiently on their own is based heavily on the assumption that consumers act rationally and this assumption can be easily challenged. Their vast experimental work shows how the insights from psychology can be used to select carefully designed and tested interventions to nudge consumers in the right direction, without taking away their rights to choose.

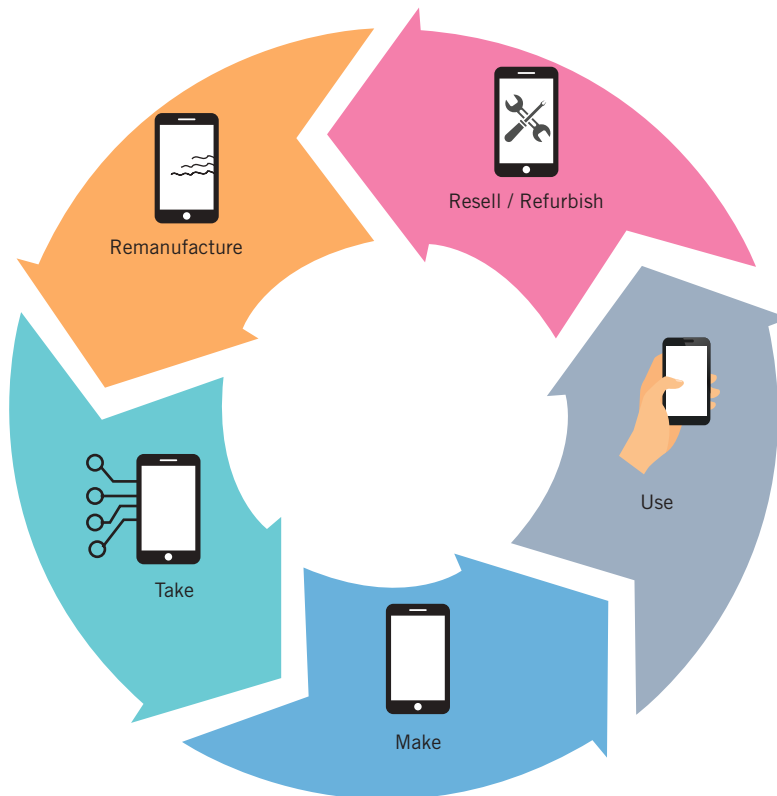
What is the circular economy? (Reframing economics in the twenty-first century)

There is increasing awareness that tremendous challenges to sustainability are the result of the fact that economic activity tends to take place within what is described as a “linear” economy. This has led to calls for a different approach to economic activity. One idea that has gained widespread support is that there is a need to move from a linear economy to a “circular” economy. This is best explained through the use of diagrams.



▲ **Figure 2.2** The take, make, waste approach

The linear economy, described as a “take-make-waste” approach, is shown in Figure 2.2. We take natural resources from the environment and use them to produce new products. Once used, these products are disposed into the environment where they end up in landfill sites or are incinerated, creating even more pollution. This type of economy is responsible for the overexploitation and degradation of natural resources. Moreover, it is resulting in unmanageable accumulations of waste with accompanying health and environmental risks. This presents tremendous challenges to sustainability.



▲ **Figure 2.3** The circular economy

In contrast, the circular economy shown in Figure 2.3 is described as a “regenerative” and “restorative” approach. Products are specifically designed to be long-lasting and the materials for new products come from reusing and recycling old products. There is much more emphasis on the design, maintenance, repair, refurbishment and remanufacture of products.

Did you know?

This is the Olusosun landfill site in Lagos, Nigeria. It is the largest landfill site in Africa. Approximately 10,000 tons of garbage ends up in this site every day. Much of this is electronic waste, such as computers, printers, phones and TVs, which arrives from all over the world on container ships. Because developments in technology are so rapid, there is a constant demand for new products, and people are throwing out old devices in shorter and shorter amounts of time, resulting in the global challenge of waste management.



Note

See chapter 28 for more on the Sustainable Development Goals.

The principles of the circular economy are consistent with many of the Sustainable Development Goals (SDGs). Throughout the world, governments are increasingly encouraging, or even requiring, the adoption of circular economy principles. For example, in 2019, the European Union released a comprehensive report on the implementation of its Circular Economy Action Plan.

From the perspective of businesses, there are great potential gains from adopting circular economy models, in terms of cost savings and compliance with national environmental regulations. Many companies have also adopted principles of circular economy.

Economics in action

ATL Thinking, Communication and Research

1. How has a country of your choice implemented circular economy principles? To what extent has it been successful in moving away from the linear economy?
2. How has a company of your choice implemented circular economy principles? To what extent has this benefited the company?

Key concept**INTERDEPENDENCE****Key concept****EQUITY**

Economics students demand an education that reflects post-crash world

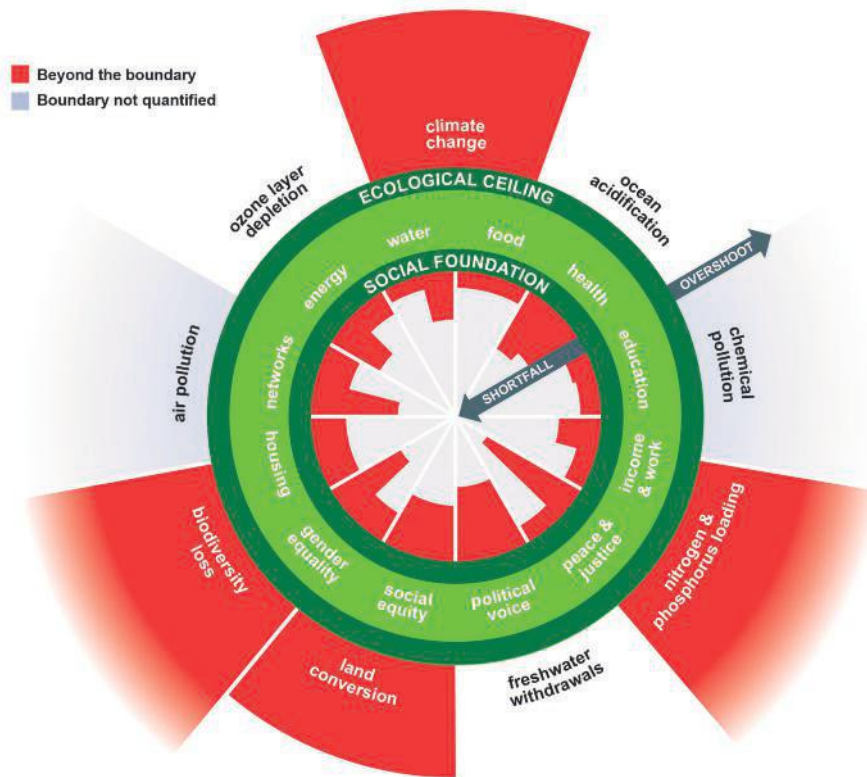
<https://www.theguardian.com/sustainable-business/economic-students-demand-education>

Kate Raworth's "embedded economy" model illustrated in Chapter 1 is another depiction of a circular economy, and the key feature is the interdependence that exists between the economy, society and the environment. Economic activity which does not appreciate this interdependence will increase the challenges confronting the globe today.

Raworth argues that economics must take a radically different approach that can deal with the challenges of the twenty-first century. She shows that policies based on traditional economic models have resulted in a narrow preoccupation with economic growth and a careless disregard for the negative consequences of "extreme inequalities of income and wealth coupled with unprecedented destruction of the living world". According to Raworth, the goal must be changed. It cannot simply be to achieve economic growth, or increases in economic output. *"For the 21st century, a far bigger goal is needed: meeting the human rights of every person within the means of the planet. Instead of pursuing ever-increasing GDP, it is time to discover how to thrive in balance"*⁴. For Raworth, this can only happen when one views the economy as operating within society and within the Earth's ecosystem.

Raworth has developed a ground-breaking diagram to show the challenges that we face and illustrate the world that she thinks we need. With its two concentric circles, Raworth's model looks like a doughnut (Figure 2.4), and she has used this metaphor of a doughnut to describe her vision.

⁴ **Source:** *Doughnut Economics: Seven Ways to Think Like a 21st-Century Economist*, by Kate Raworth, Random House, 2017



▲ **Figure 2.4** The doughnut economy, Raworth (2017)

The inner ring is the “social foundation”. These are the “basics in life” that we should rightfully demand for everyone: “sufficient food; clean water and decent sanitation; access to energy and clean cooking facilities; access to education and to healthcare; decent housing; a minimum income and decent work; and access to networks of information and to networks of social support.” In addition, the model shows that people should be entitled to gender equality, social equity, political voice, peace and justice. Anyone living within this boundary, in the hole in the doughnut, would be in a state of deprivation. These are not radical or unrealistic goals; the UN Sustainable Development Goals (SDGs), includes all of these, with a view to achieving the goals by 2030.

The outer ring of the diagram illustrates the Earth’s environmental limits, or boundaries. If we move beyond this outer ring, we are putting the Earth’s ecosystems, and our ability to live within this ecosystem, under great threat. Therefore, the “safe place” is within the two rings, in the doughnut. It is Raworth’s view that economic goals, models and theories must be adapted to ensure that we operate within this safe place, working towards a world where people’s human needs and rights are met within the environmental limits of the earth.

Key concept



INTERDEPENDENCE

Key concept



EQUITY

Key concept



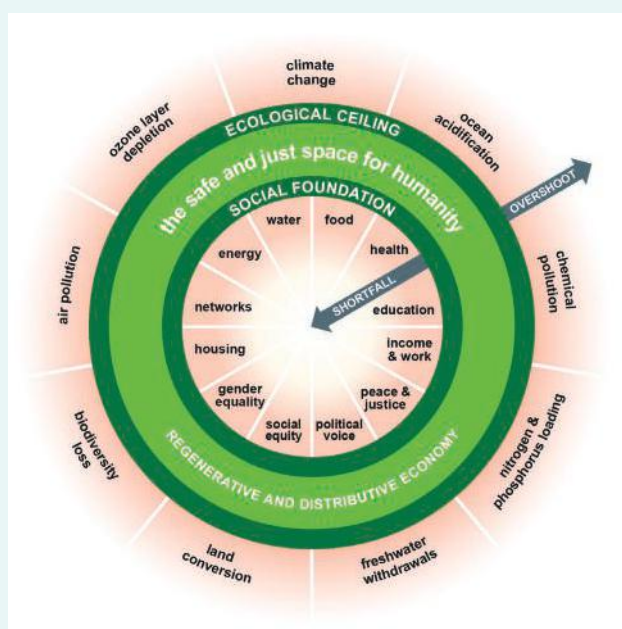
SUSTAINABILITY

Economics in action

ATL Thinking, Communication, Research

How are we doing today in terms of operating in the ecologically safe and just space for humanity?

As Raworth points out, with advancements in the ability to gather data, we are able to measure reasonably accurately how we are doing against each of the metrics in the doughnut, and although many things have improved in the social foundation, we are still within the boundary in all areas and beyond the outer boundary in threatening ways. At the time of writing, the following information shows that we are **not** operating within the doughnut. It is hoped that the UN Sustainable Development Goals will move us in the right direction.



“Many millions of people still live well below each of the social foundation dimensions.

- Worldwide, one person in nine does not have enough to eat.
- One in four lives on less than \$3 a day.
- One in eight young people cannot find work. One person in three still has no access to a toilet.
- One in eleven has no source of safe drinking water.
- One child in six aged 12–15 is not in school, the vast majority of them girls.
- Almost 40% of people live in countries in which income is distributed highly unequally.
- More than half of the world’s population live in countries in which people severely lack political voice.

It is extraordinary that such deprivations continue to limit the potential of so many people’s lives in the 21st century. Humanity

Theory of knowledge

To what extent have individuals shifted the paradigms of economics?

Many economists argue that economics as a social science is in its infancy, and that with time, as empirical testing methods and the quality of data improve, it will become more reliable in making accurate predictions. Do you agree with this statement?



has, at the same time, been putting Earth's life-giving systems under unprecedented stress. We have transgressed at least four planetary boundaries:

- climate change,
- land conversion,
- nitrogen and phosphorus loading,
- biodiversity loss."

Source: *Doughnut Economics: Seven Ways to Think Like a 21st-Century Economist*, by Kate Raworth, Random House, 2017

Inquiry:

The information above was given in Rowarth's book published in 2018. How are we doing now?

To answer the question, you could take a look at the progress towards the Sustainable Development Goals. We come back to the SDGs in several chapters, and look at them in more detail in Chapter 28. However, given their importance, it would be valuable for you to have a look at them on your own now.

So what is the conclusion on economic thinking?

Whilst there have always been debates among different branches of economics and different schools of thought, many students of economics have grown increasingly frustrated with the focus and assumptions of mainstream economics (the theories that tend to be taught in high schools and universities). It has been argued that we are facing growing real-world crises, such as climate change and tremendous socioeconomic inequities, because businesses and governments have been using narrow economic theories as the basis on which to make their decisions.

The movement of students calling for change has grown and spread to many countries across the globe. There are demands to see the discipline of economics taught with much more questioning of the assumptions, and including many more varied schools of thought.

In our brief look at the origins of economic thought, we have looked at several which have gained the status of "mainstream" economics. However, there are many more approaches and schools of thought including Developmentalist Economics, Feminist Economics, Austrian Economics, Institutional Economics, Complexity Economics, Islamic Economics, Cooperative Economics and many more. Sadly, we do not have the time to go into all of them, but it is essential that you are aware that this multitude of approaches exists, and that economics is not all **just** new classical economics. With the growing awareness of the importance of circular economics, we may be looking at the next paradigm. Hopefully, students of IB Economics will accept the challenge of moving this forward!

Inquiry

Possible CAS activity

The demands by students all around the world that the teaching of economics adapts to the real world rather than clings to the assumptions and theories of new classical economics developed into the Rethinking Economics network (www.rethinkeconomics.org).

Task: Research the "Rethinking Economics" network to try to learn more about their recent work. They may even have a group near you. Joining up could be a worthy CAS project.

Exercise 2.2

ATL Thinking and Communication

Using information from this chapter, create an annotated timeline of the evolution of economic thinking from 1750 up to the present time.

Assessment advice

It is possible that a part (a) essay question in Paper 1, either HL or SL, could ask for a description of any of the areas of economic thought that have been looked at in this chapter. Some of the areas, such as Keynesian, New Classical, and Behavioural economics will appear later in this course book.



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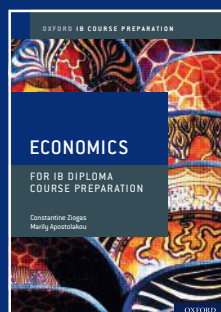
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8 Methods of Government Intervention in Markets

Exercise 8.3 Thinking, Communication and Research

Read the following text and answer the questions which follow:

Cotton producers hope to benefit from Brazil's subsidy battle with US

African cotton-producing countries are happy with Brazil's success in its case with the World Trade Organisation against the United States' continued use of subsidies in cotton production. "True, we don't benefit directly from the WTO ruling," said Prosper Vokouma, representative of Burkina Faso to the United Nations in Geneva, and coordinator of the C4. The C4 is the grouping of four cotton-exporting African countries of which Benin, Burkina Faso, Mali and Chad are the members. "But it has helped put the issue of the 'white gold' on the WTO agenda."

"The WTO ruling gives legitimacy to the C4's demands," Vokouma says. "It is a strong criticism of the massive and distorting subsidies. The WTO dispute settlement body has confirmed that US subsidies damage other countries' producers because of their impact on world market prices."

"We know that the US has a bad conscience regarding this issue. Some 2,500 large farmers share more than \$3 billion between them every year, whereas 20 to 30 million African cotton producers live in misery because the product of their hard work is not even enough to feed them," says Vokouma.

Studies by international organisations show that the total abolition of US subsidies would increase the world cotton price by 14%.

According to the charity Oxfam, this would translate into additional revenue that could feed one million more children per year, or pay the school fees of two million children in West Africa.

Source: Adapted from: <http://www.ipnews.net/2010/03/trade-war-better-african-cotton-producers-after-brazil-takes-success/>

1. Using an appropriate diagram, explain why "US subsidies damage other countries' producers because of their impact on world market prices" and how "the abolition of US subsidies" could "increase the world cotton price by 14%".
2. Comment on the advantages and the disadvantages of the abolition of US cotton subsidies.
3. The article was written in March 2010. Research the current situation with regard to US cotton subsidies. Have the C4 countries in Africa experienced a positive change in their circumstances?

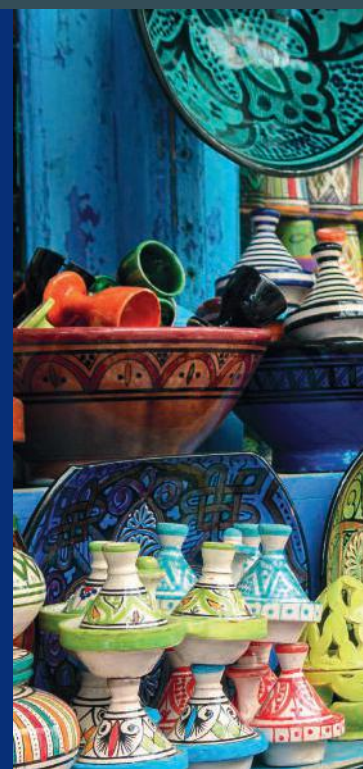
Why, and how, do governments impose price controls?

Although it may seem to be an optimum situation, the free market does not always lead to the best outcomes for all producers and consumers, or for society in general. Hence governments often choose to intervene directly in the market in order to achieve a different outcome. There are two key situations where this occurs:

- maximum prices
- minimum prices

We now look at each of these situations in turn.

Key concept INTERVENTION



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