

CHAPTER 1

# Life, the Universe and Everything

WHAT IS ECONOMICS?

What is economics?

A reader who is not familiar with the subject might reckon that it is the study of the economy. After all, chemistry is the study of chemicals, biology is the study of living things, and sociology is the study of society, so economics must be the study of the economy.

But according to some of the most popular economics books of our time, economics is much more than that. According to them, economics is about the Ultimate Question – of ‘Life, the Universe and Everything’ – as in *The Hitchhiker’s Guide to the Galaxy*, the cult comedy science fiction by Douglas Adams, which was made into a movie in 2005, with Martin ‘The Hobbit’ Freeman in the leading role.

According to Tim Harford, the *Financial Times* journalist and the author of the successful book *The Undercover Economist*, economics is about Life – he has named his second book *The Logic of Life*.

No economist has yet claimed that economics can explain the Universe. The Universe remains, for now, the turf of physicists, whom most economists have for centuries been looking up to as their role models, in their desire to make their subject a true science.\* But some economists have come close – they have claimed that economics is about ‘the world’. For example, the subtitle of the second volume in Robert Frank’s popular *Economic Naturalist* series is *How Economics Helps You Make Sense of Your World*.

Then there is the Everything bit. The subtitle of *Logic of Life* is *Uncovering the New Economics of Everything*. According to its subtitle, *Freakonomics* by Steven Levitt and Stephen Dubner – probably the best-known economics book of our time – is an exploration of the *Hidden Side of Everything*. Robert Frank agrees, even though he is far more modest in his claim. In the subtitle of his first *Economic Naturalist* book, he only said *Why Economics Explains Almost Everything* (emphasis added).

So, there we go. Economics is (almost) about Life, the Universe and Everything.†

When you think about it, this is some claim coming from a subject that has spectacularly failed in what most non-economists think is its main job – that is, explaining the economy.

In the run-up to the 2008 financial crisis, the majority of the economics profession was preaching to the world that markets are rarely wrong and that modern economics has found ways to iron out those few wrinkles that markets may have; Robert Lucas, the 1995 winner of the Nobel Prize in Economics,\* had declared in 2003 that the ‘problem of depression prevention has been solved’.<sup>1</sup> So most economists were caught completely by surprise by the 2008 global financial crisis.† Not only that, they have not been able to come up with decent solutions to the ongoing aftermaths of that crisis.

Given all this, economics seems to suffer from a serious case of megalomania – how can a subject that cannot even manage to explain its own area very well claim to explain (almost) everything?

## Economics Is the Study of Rational Human Choice ...

You may think I am being unfair. Aren’t all these books aimed at the mass market, where competition for readership is fierce, and therefore publishers and authors are tempted to hype things up? Surely, you

would think, serious academic discourses would not make such a grand claim that the subject is about ‘everything’.

These titles *are* hyped up. But the point is that they are hyped up in a particular way. The hypes could have been something along the line of ‘how economics explains everything about the economy’, but they are instead along the lines of ‘how economics can explain not just the economy but everything else as well’.

The hypes are of this particular variety because of the way in which the currently dominant school of economics, that is, the so-called Neoclassical school, defines economics. The standard Neoclassical definition of economics, the variants of which are still used, is given in the 1932 book by Lionel Robbins, *An Essay on the Nature and Significance of Economic Science*. In the book, Robbins defined economics as ‘the science which studies human behaviour as a relationship between ends and scarce means which have alternative uses’.

In this view, economics is defined by its theoretical approach, rather than its subject matter. Economics is a study of **rational choice**, that is, choice made on the basis of deliberate, systematic calculation of the maximum extent to which the ends can be met by using the inevitably scarce means. The subject matter of the calculation can be anything – marriage, having children, crime or drug addiction, as Gary Becker, the famous Chicago economist and the winner of 1992 Nobel Prize in Economics, has written about – and not just ‘economic’ issues, as non-economists would define them, such as jobs, money or international trade. When Becker titled his 1976 book *The Economic Approach to Human Behaviour*, he was really declaring without the hype that economics *is* about everything.

This trend of applying the so-called economic approach to everything, called by its critics ‘economics imperialism’, has reached its apex recently in books like *Freakonomics*. Little of *Freakonomics* is actually about economic issues as most people would define them. It talks about Japanese sumo wrestlers, American schoolteachers, Chicago drug gangs, participants in the TV quiz show *The Weakest Link*, real estate agents and the Ku Klux Klan.

Most people would think (and the authors also admit) that none of these people, except real estate agents and drug gangs, have anything to do with economics. But, from the point of view of most economists today, how Japanese sumo wrestlers collude to help each other out or how American schoolteachers fabricate their pupils’ marks to get better job assessments are as legitimate subjects of economics as whether Greece should stay in the Eurozone, how Samsung and Apple fight it out in the smartphone market or how we can reduce youth unemployment in Spain (which is over 55 per cent at the time of writing). To those economists, those ‘economic’ issues do not have privileged status in economics, they are just some of many things (oh, I forgot, some of everything) that economics can explain, because they define their subject in terms of its theoretical approach, rather than its subject matter.

## ... or Is It the Study of the Economy?

An obvious alternative definition of economics, which I have been implying, is that it is the study of the economy. But what *is* the economy?

*The economy is about money – or is it?*

The most intuitive answer to most readers may be that the economy is anything to do with money – not having it, earning it, spending it, running out of it, saving it, borrowing it and repaying it. This is not quite right, but it is a good starting point for thinking about the economy – and economics.

Now, when we talk of the economy being about money, we are not really talking about physical money. Physical money – be it a banknote, a gold coin or the huge, virtually immovable stones that were used as money in some Pacific islands – is only a symbol. **Money** is a symbol of what others in your society owe you, or your claim on particular amounts of the society's resources.<sup>2</sup>

How money and other financial claims – such as company shares, derivatives and many complex financial products, which I will explain in later chapters – are created, sold and bought is one huge area of economics, called financial economics. These days, given the dominance of the financial industry in many countries, a lot of people equate economics with financial economics, but it is actually only a small part of economics.

Your money – or the claims you have over resources – may be generated in a number of different ways. And a lot of economics is (or should be) about those.

*The most common way to get money is to have a job*

The most common way to get money – unless you have been born into it – is to have a job (including being your own boss) and earn money from it. So, a lot of economics is about **jobs**. We can reflect on jobs from different perspectives.

Jobs can be understood from the point of view of the individual worker. Whether you get a job and how much you are paid for it depends on the skills you have and how many demands there are for them. You may get very high wages because you have very rare skills, like Cristiano Ronaldo, the football player. You may lose your job (or become unemployed) because someone invents a machine that can do what you do 100 times faster – as happened to Mr Bucket, Charlie's father, a toothpaste cap-screw, in the 2005 movie version of Roald Dahl's *Charlie and the Chocolate Factory*.<sup>\*</sup> Or you have to accept lower wages or worse working conditions because your company is losing money thanks to cheaper imports from, say, China. And so on. So, in order to understand jobs even at the individual level, we need to know about skills, technological innovation and international trade.

Wages and working conditions are also deeply affected by 'political' decisions to change the very scope and the characteristics of the labour market (I have put 'political' in quotation marks, as in the end the boundary between economics and politics is blurry, but that is a topic for later – see [Chapter 11](#)). The accession of the Eastern European countries to the European Union has had huge impacts on the wages and behaviours of Western European workers, by suddenly expanding the supply of workers in their labour markets. The restriction on child labour in the late nineteenth century and early twentieth centuries had the opposite effect of shrinking the boundary of the labour market – suddenly a large proportion of the potential employees were shut out of the labour market. Regulations on working hours, working conditions and minimum wages are examples of less dramatic 'political' decisions that affect our jobs.

*There are also a lot of transfers of money going on in the economy*

In addition to holding down a job, you can get money through **transfers** – that is, by simply being given it. This can be either in the form of cash or 'in kind', that is, direct provision of particular goods (e.g., food) or services (e.g., primary education). Whether in cash or in kind, these transfers can be made in a number of different ways.

There are transfers made by ‘people you know’. Examples include parental support for children, people taking care of elderly family members, gifts from local community members, say, for your daughter’s wedding.

Then there is charitable giving, that is, transfer voluntarily made to strangers. People – sometimes individually sometimes collectively (e.g., through corporations or voluntary associations) – give to charities that help others.

In terms of its quantity, charitable giving is overshadowed in many multiples by transfers made through governments, which tax some people to subsidize others. So a lot of economics is naturally about these things – or the areas of economics known as public economics.

Even in very poor countries, there are some government schemes to give cash or goods in kind (e.g., free grains) to those who are in the worst positions (e.g., the aged, the disabled, the starving). But the richer societies, especially those in Europe, have transfer schemes that are much more comprehensive in scope and generous in amounts. This is known as the **welfare state** and is based on **progressive taxation** (those who earn more paying proportionally larger shares of their incomes in taxes) and **universal benefits** (where everyone, not just the poorest or the disabled, is entitled to a minimum income and to basic services, such as health care and education).

*Resources earned or transferred get consumed in goods or services*

Once you gain access to resources, whether through jobs or transfers, you consume them. As physical beings, we need to consume some minimum amount of food, clothes, energy, housing, and other **goods** to fulfil our basic needs. And then we consume other goods for ‘higher’ mental wants – books, musical instruments, exercise equipment, TV, computers and so on. We also buy and consume **services** – a bus ride, a haircut, a dinner at a restaurant or even a holiday abroad.<sup>3</sup>

So a lot of economics is devoted to the study of **consumption** – how people allocate money between different types of goods and services, how they make choices between competing varieties of the same product, how they are manipulated and/or informed by advertisements, how companies spend money to build their ‘brand images’ and so on.

*Ultimately goods and services have to be produced*

In order to be consumed, these goods and services have to be produced in the first place – goods in farms and factories and services in offices and shops. This is the realm of **production** – an area of economics that has been rather neglected since the Neoclassical school, which puts emphasis on exchange and consumption, became dominant in the 1960s.

In standard economics textbooks, production appears as a ‘black box’, in which somehow quantities of **labour** (work by humans) and **capital** (machines and tools) are combined to produce the goods and services. There is little recognition that production is a lot more than combining some abstract quanta called labour and capital and involves getting many ‘nitty-gritty’ things right. And these are things that most readers may not normally have associated with economics, despite their crucial importance for the economy: how the factory is physically organized, how to control the workers or deal with trade unions, how to systematically improve the technologies used through research.

Most economists are very happy to leave the study of these things to ‘other people’ – engineers and business managers. But, when you think about it, production is the ultimate foundation of any economy. Indeed, the changes in the sphere of production usually have been the most powerful sources of social

change. Our modern world has been made by the series of changes in technologies and institutions relating to the sphere of production that have been made since the Industrial Revolution. The economics profession, and the rest of us whose views of the economy are informed by it, need to pay far more attention to production than currently.

## Concluding Remarks: Economics as the Study of the Economy

My belief is that economics should be defined not in terms of its methodology, or theoretical approach, but in terms of its subject matter, as is the case with all other disciplines. The subject matter of economics should be the economy – which involves money, work, technology, international trade, taxes and other things that have to do with the ways in which we produce goods and services, distribute the incomes generated in the process and consume the things thus produced – rather than ‘Life, the Universe and Everything’ (or ‘almost everything’), as many economists think.

Defining economics in this way makes this book unlike most other economics books in one fundamental way.

As they define economics in terms of its methodology, most economics books assume that there is only one right way of ‘doing economics’ – that is, the Neoclassical approach. The worst examples won’t even tell you that there are other schools of economics than the Neoclassical one.

By defining economics in terms of the subject matter, this book highlights the fact that there are many different ways of doing economics, each with its emphases, blind spots, strengths and weaknesses. After all, what we want from economics is the best possible explanation of various economic phenomena rather than a constant ‘proof’ that a particular economic theory can explain not just the economy but everything.

## Further Reading

R. BACKHOUSE

*The Puzzle of Modern Economics: Science or Ideology?* (Cambridge: Cambridge University Press, 2012).

B. FINE AND D. MILONAKIS

*From Economics Imperialism to Freakonomics: The Shifting Boundaries between Economics and the Other Social Sciences* (London: Routledge, 2009).