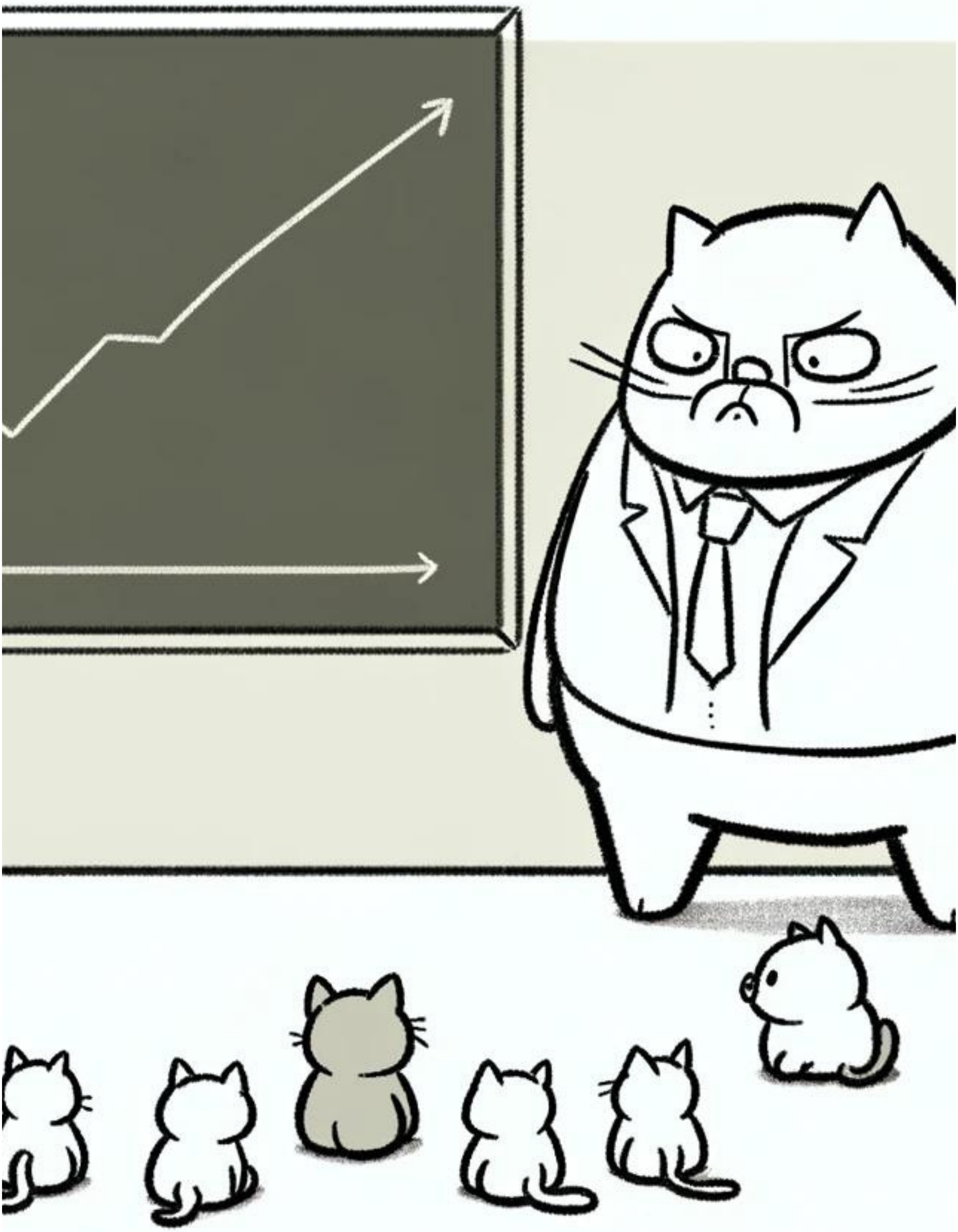

Thinking like an Economist

What is economics?

Once upon a time, an economist called Lionel Robbins wanted to answer the question ‘what is economics?’. This is a good question, and arguably a strange one to not have been answered satisfyingly by as late as 1932, when economics had been well established as a discipline.

However, many subjects develop this way, with people asking and answering disparate questions only to eventually discover they are working on the same fundamental things, and then forming a discipline to work on these questions which derive from the same source. Medicine might start off as a study of various maladies, from battle wounds to toothaches, but eventually practitioners realise that the questions they are asking are all connected in being about the nature of the human body and human health. This improves the discipline and the practitioners, as a doctor faced with an unfamiliar illness will be well served by knowing how the human body should work normally, and all the things that have been seen to go wrong with it before. Therefore, for ‘economists’ it is important to try and work out what economics is, and what is and is not part of it.

If you were asked what economics is, what would you answer? Stop for a minute and think about it. I am willing to bet something like ‘the study of the economy’ came up, which is of course sensible. What is the economy then, beyond just whatever economists study? Perhaps your mind rushes to the stock market, to the Bank of England, to a newsreader saying the ‘economy’ is going well or poorly. This is definitely something economists study, and it would be profoundly weird to come up with a definition which does not include this in ‘economics’ but it also seems profoundly limited, which I am going to attempt to show you.

Who is the most beloved man in economics? There are many great economists, but there is one whose clear sighted genius has allowed economics to truly advance and step out of the darkness of ignorance. I am of course talking about Robinson Crusoe the castaway from the novel of Daniel Defoe. I joke of course, but Crusoe turns up nigh constantly in economics, because the concept of a castaway on an island is so useful for illustrating what we mean when we say economics. In addition, it is a very valuable way of illustrating what else is economics, beyond what we would normally think of as the economy, and how economics can be of use in all kinds of decision making.

So, Crusoe is, as he always is, on his island, entirely alone (economists largely do not bother to consider Defoe’s actual plotline and just have Crusoe be a lone castaway on an island). He has no money, nor any way to spend it if he had, yet even here, there is an economy.

Crusoe may fish, or collect coconuts, and only has 16 hours in the waking day to do so. He must evaluate his preferences, and ration his time, for it is scarce, at least in the sense that no matter what he does, he would always prefer more time, or more coconuts and fish than he is able to collect in the time he has.

This is the crucial fact, Crusoe is facing **scarcity**, and this is what makes it a matter of economics. If Crusoe could collect all the coconuts he desired in an hour, and all the fish he desired in 2, and had no other uses of his time, then there would be no economics to think about, at least beyond a trivial fact that he should collect all he desires. Crusoe's time is scarce, so he must make **choices**, he may have fish or coconuts, but not both (or at least, not all he wants of both).

This expands to the real world, beyond Crusoe's Island. With the money in my budget, I must choose between going out to write this article in a café (as I have done) or go out to dinner tonight, and I may not do both. There is **scarcity** and therefore there is economics. In the economy at large, when the chancellor brings out the budget it is a matter of economics because there is **scarcity**, if there was infinite resources such that we could do everything we possibly would wish to, there would be no meaningful choices to make, and thus no economics.

In case you haven't been alerted by all the scarcity in bold by now, economics is 'the science that studies human behaviour as a relationship between ends and scarce resources which have alternative uses'. In effect, when we are faced with scarcity meaning that we can't do all that we want with what we have, economics is the study of the choices we make. By extension, 'an economy' is a system of distributing scarce resources (BoE).

Economics does not care why we want what we want, only that we do. A man called Alfred Marshall called economics the study of human welfare (by which we mean wellbeing) and went as far to say that when we talk of war, there is no economics to be thought of, as welfare does not enter into it. This seems profoundly weird, that we might talk of welfare brings economics firmly into the subjective, do phones serve ones welfare? How do we produce a theory in terms of welfare when the idea of what is good for people is such a contested topic? Ultimately, to talk about preferences is far more objective. A phone may or may not serve my welfare, but I undoubtedly want one, and am willing to consider using scarce resources to obtain one, and thus economics merely must take our preferences as they stand, rather than questioning them.

So, we have many wants and scarce resources, and therefore we make choices. This is a very nice concept, but what does it tell us? What are the choices we make and how do we make them? The next bolded concept I want to introduce you to is **rationing**. Generally, when we say rationing, we imagine something out of the blitz, but rationing is the 'artificial restriction of demand'. This is what we have to do when faced with demand which exceeds resources, along with our second bolded concept **incentives**. Incentives are any mechanism to encourage anything, but in this context we care about incentivising production. If our natural state is to want more than we have, then we need to find some way of increasing what we have, and reducing what we want, such that these things come into alignment.

So we restrict demand and encourage supply, very good, but how? Let us turn to two cases, which I think are the two ways of doing this. Firstly, let us look at the totalitarian dictatorship of Scott-topia, the denizens only care about bread and rest, with bread being distributed equally from a central stockpile, and produced by workers who work without payment. This issue is, the denizens of Scott-topia want to consume more bread than they want to produce. Each denizen would be sated with 20 loaves but each denizen would prefer to only grow 5 (as they would prefer to rest rather than work in the fields). Faced with this catastrophe, the magnanimous dictator of Scott-topia, Scott Chakravarti, mandates 2 directives: all citizens will consume 10 loaves of bread and if they consume more, they will be shot, all citizens will produce 10 loaves of bread as well, if they produce less, they will also be shot. Satisfied with this, Scott goes back to his palace made of solid gold, convinced he has in fact solved economics.

In the neighbouring Chakravarti-land, the denizens are just the same, but instead the magnanimous president Chakravarti Scott mandates a market for bread, bread will be provided in return for labouring in the grain fields. Thus, the citizens want bread less (as to have bread comes with a cost of having to have less rest time) but produce more (as producing bread comes with the reward of being able to consume it), and thus the situation settles at every individual producing and consuming 10 loaves. Chakravarti Scott embezzles all that was left in the stockpile and retires to his palace of solid gold, satisfied he has solved economics.

Gold palaces aside, these are the two approaches we tend to take to rationing and incentivising. Either we do it by 'fiat' or by 'markets'. Fiat is a far simpler system to understand, with someone deciding how much one should produce and consume, and simply forcing it to be so. This system often is implied to be very Soviet, with production targets and bread rations, but it doesn't have to be. In fact, virtually all jobs work on 'fiat'. When you are hired on to a company, your employer doesn't give you a task then bargain with you on the price, they merely impose it on you at the cost of losing your job.

Fiat can be very simple and very successful. For example, in WW2, food rationing made a great deal of sense; the government knew what its food stockpiles were, it knew the caloric needs of the population so artificially limited consumption. Likewise, firms work by fiat as it can be deeply inefficient to invoke markets and incentives when trying to get people to do things, better sometimes to just say ‘do that’ and have that be the end.

Yet fiat can have terminal problems, or at least markets can have great advantages over it. Firstly, markets force people to give up their true preferences. I fully intend to give this another article (so watch this space!) But put simply, when preferences are non-objective (there is a set, objective number of calories a person needs to live, but not a set amount of cake someone needs to be happy, or a set amount of leisure time to feel enriched for example), it is difficult to maximise utility, and this can lead to over and under provision of resources. Likewise, markets act as both incentive to production and disincentive to consumption and will fairly inevitably bring a system into alignment by price changes, which a fiat system won’t necessarily do.

Regardless, the way these mechanisms deal with scarcity and whether any of them do it better (and of course there are a million variations on the theme of fiat/markets) is ultimately a question of economics because they deal with scarcity. This concept is at the very core of economics, and when you next look at ‘economic’ news, you should try to understand it by looking at what is scarce, and therefore what choices are being made in response. I hope this has made you a more informed citizen, till next time!

Ian Chakravarti
our Braincell