

# POLITICAL ECONOMY



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# POLITICAL ECONOMY

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 HarperCollins *Publishers*

*Text selections are from chapters 1-4 of **ECONOMICS, Third Edition** by Ekelund/Tollison and chapters 7-10 of **AMERICAN POLITICS AND GOVERNMENT** by Hinkley/Goldman*

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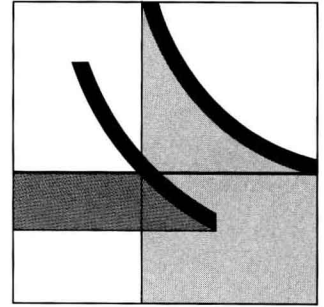
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**PART ONE**

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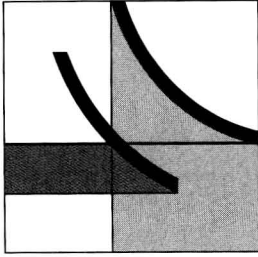
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Economic  

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Thinking  

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# I

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## Economics in Perspective

**D**oes economics matter? More to the point, why should you spend precious time and money learning economics when there are so many other activities, products, and services—not to mention other college courses—competing for your attention? The answer: Economics touches all facets of our lives from the trivial to the fundamental as consumers of gasoline and home computers, as voters for political candidates, and as workers and employers. Economics analyzes why we are poor or rich as individuals and extends its scope to government policies about inflation, unemployment, economic growth, and international trade. Economics not only deals with large issues, but with personal decisions as well—how much time to spend cleaning the apartment or studying, how to decide whether more education is called for, how to select a mate. Close study of economics gives us a new perspective on a wide variety of human activities and institutions. When you finish Chapter 1 you should understand

- how individuals, societies, and nations solve the basic economic problem caused by scarce resources and unlimited wants.
- the functions of prices and how they act as signals to producers, consumers, and governments in any economy.
- the basis on which all individuals actually make economic decisions.
- how economics gives insight into human behavior and social problems.

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### WHAT ECONOMICS IS (AND WHAT IT ISN'T)

Most people would say that economics deals with the stock market or with how to make money by buying and selling gold, land, or some other commodity. This common view contains a grain of truth but does not touch on the richness, depth, and breadth of the matter. Economics is a social science—the oldest and best developed of the social sciences. As such, it studies human behavior in relation to three basic questions about an economy: What **goods** and **services** are produced? How are goods and services produced? For whom are goods and services produced?

#### **Goods:**

All tangible things that satisfy people's wants and desires.

#### **Services:**

All forms of intangible but useful activities that are valued by people.

All societies and all individuals have faced these three questions. Since goods and the means to produce them have never existed in limitless amounts, the insistent questions—How? What? and For whom?—must be asked; for at least two hundred years, economists have tried to analyze how individuals and societies answer them. Consider some famous economists' definitions of economics:

*Adam Smith* (1776): Economics or political economy is “an inquiry into the nature and causes of the wealth of nations.”<sup>1</sup>

*Nassau William Senior* (1836): Political economy is the “science that treats the nature, the production, and the distribution of wealth.”<sup>2</sup>

*Alfred Marshall* (1890): “Political Economy or Economics is a study of mankind in the ordinary business of life . . . it is on the one side a study of wealth; and on the other, and more important side, a part of the study of man.”<sup>3</sup>

*Lionel Robbins* (1935): “Economics is the science which studies human behavior as a relationship between ends and scarce means which have alternative uses.”<sup>4</sup>

*Milton Friedman* (1962): “Economics is the science of how a particular society solves its economic problems.”<sup>5</sup>

*Paul Samuelson* (1980): “Economics is the study of how people and society end up *choosing*, with or without the use of money, to employ *scarce* productive resources that could have alternative uses—to *produce* various commodities and *distribute* them for consumption, now or in the future, among various persons and groups in society. Economics analyzes the costs and the benefits of improving patterns of resource use.”<sup>6</sup>

## Economics: A Working Definition

There is merit in each of the preceding definitions. Economics *is* the study of how nations produce and increase wealth. Economics also studies the activities of people in producing, distributing, and consuming wealth. It analyzes how people and societies choose among competing goals or alternatives.

A common thread runs through all definitions of economics. Each definition emphasizes the inescapable fact that resources—the wherewithal to produce goods and services—are not available in limitless quantities and that people and societies, with unlimited desires for goods and services, must make some hard choices about what to do with the resources that are available. Our working definition of economics may be expressed as follows:

<sup>1</sup>Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, ed. Edwin Cannan (1776; reprint, New York: Modern Library, 1937).

<sup>2</sup>N. W. Senior, *An Outline of the Science of Political Economy* (1836; reprint, New York: A. M. Kelley, 1938).

<sup>3</sup>Alfred Marshall, *Principles of Economics* (London: Macmillan, 1920), p. 1.

<sup>4</sup>Lionel Robbins, *The Nature and Significance of Economic Science*, 2nd ed. (London: Macmillan, 1935), p. 16.

<sup>5</sup>Milton Friedman, *Price Theory* (Chicago: Aldine, 1962), p. 1.

<sup>6</sup>Paul A. Samuelson, *Economics* (New York: McGraw-Hill, Inc., 1980), p. 2.

### Resources:

Those things used to produce goods and services. These include land, machines, energy, and human labor and ingenuity. Resources are also called factors of production.

Economics is the study of how individuals and societies, experiencing virtually limitless wants, choose to allocate scarce resources to satisfy their wants.

Unlimited wants, scarcity, and the choices they force on us are thus the key elements in understanding economics and the economic problem. Consider the nature of scarcity.

## The Economic Condition: Scarcity

### Scarcity:

The condition whereby the resources, goods, and services available to individuals and society are limited relative to the wants and desires for them.

What, exactly, is scarcity? More to the point, what are scarce resources? Dorothy Parker, an American humorist, once said, “If you can’t get what you want, you’d better damn well settle for what you can get.” The entire study of economics amplifies and expands on Parker’s proposition. As individuals and as a society, we cannot get all of what we want because the amount of available resources is limited. The role of the economist and of economics in general is to explain how we can make the most of this problem of scarcity—in Parker’s terms, how to get as much as we can of what we want.

The most important problem in economics is that while the wants of individuals and societies must be satisfied by limited resources, the wants themselves are not limited; rather, they are endless. We are never satisfied with what we have. Individuals are forever lured by more tempting foods, more cleverly engineered computers, more up-to-date fashions. Societies continually desire safer highways, more national security, greater Social Security benefits, or more cancer research. Problems of scarcity and unlimited wants—economics itself—apply to all nations regardless of political, social, and religious orientation. Moslems, Jews, and Christians all face the eternal problem of satisfying limitless wants with limited means. Methods of dealing with scarcity will, of course, differ from society to society depending on cultural differences and on particular endowments of resources within political boundaries, but the fundamental problem is the same everywhere.

Scarcity is relative to time and fortune. Our generation has many more services and goods to choose from than our parents and grandparents did. The quantity and quality of goods and services may have grown from primitive to modern times, but the supply of resources needed to produce them is limited, and human wants are not.

All scarce goods—from television to chlorinated water—are called economic goods. Their scarcity leads to costs. While it is customary to associate cost with the money price of goods, economists define cost as the value of the good or activity given up in place of the good or activity actually chosen. Since all unlimited wants cannot be met with scarce resources, individuals have to make choices—between, for instance, more steaks and more computer games. Societies may have to choose between safer highways and more accurate missiles. Cost is, therefore, the direct result of the scarcity of resources. Scarcity of resources means that both individuals and societies must endure the costs of acquiring more of any good or service. That cost is the value of the good or activity given up in place of the good chosen. Think for a moment about that scarce resource, time. Being absolutely limited in supply for each of us, time—or, rather, the use of time—bears a definite cost. No college student, certainly, has escaped being confronted with economic decisions arising from the need to allocate this costly resource. (See Focus, “Scarcity, Economizing, and the College Student’s Time.”)

### Economic goods and services:

Goods and services that are scarce.

### Costs:

An implication of scarcity; the necessary sacrifices associated with making any choice.



## FOCUS Scarcity, Economizing, and the College Student's Time

College students know the principle of scarcity all too well. Indeed, a successful student needs an ability to make sound and efficient economic decisions, not only in the more obvious case of scarce monetary resources but in the allocation of scarce time resources as well. Time is a valuable resource to all human beings, but it exists in finite quantities of 24 hours a day, 168 hours a week, and (approximately) 720 hours a month.

Every student knows that he or she cannot have and do everything and that *economic* decisions, whether they are recognized as such or not, must be made every day. Most familiar is the weekly or monthly monetary budget derived from savings, family support, or private or government loans. Too grand a splurge on meals, clothes, or entertainment in the first weeks of the month demands a Spartan existence (peanut butter and TV) in that last week. (Poverty is a hard taskmaster!) Likewise, summer school attendance will produce a degree sooner, but at the expense of income from a summer job or other alternatives.

A student's time often must be allocated over a day or a week. A weekend trip to an out-of-town football game must

be "paid for" not only in monetary terms but also in less time to work on the English paper due on Wednesday. The end of a term always necessitates economizing: Given the limited time available, should an additional two hours be directed to chemistry or art history? Actual choices will depend on perceived net gain or potential net gain from the array of alternatives. Ordinarily, most activities or goods and services selected, if they are divisible, will be combined by the choice-maker to maximize satisfaction (for example, one hour spent on chemistry and one hour spent on art history).

College students are not alone, of course. For anyone, the choice may be between listening to a rock band or attending a Bach organ recital. We may have chosen a career in acting or dance instead of law or computer programming. A retiree may choose to return to the classroom rather than to spend time fishing or playing bridge. Economizing—maximizing the value of monetary or time resources under conditions of scarcity—forms the foundation of human behavior. Students, workers, politicians, philanthropists, business executives—all must make choices, and an analysis of these choices forms the basis of the social science of economics.



**Free goods and services:**

Things that are available in sufficient amounts and provide all that people want at zero cost.

**Human resources:**

All forms of labor and skill used to produce goods and services.

**Nonhuman resources:**

All resources other than human resources, such as machines and land.

You may feel that some things are not scarce and that some things—such as love, sunshine, and water—are free. In economic terms, **free goods** are goods that are available in sufficient amounts to satisfy all possible demands. But are many things truly free? Surface water is usually unfit for drinking except in areas far from human habitation. Water suitable for drinking must be raised to the surface from deep wells or piped from reservoirs and treatment plants, operations involving resources that are scarce even when water itself is not. Scarcity of winter sun in the North results in costly winter vacations in the snowbird states. And if you think love is free. . . .

## Scarce Resources and Economic Problems

There are basically two categories of scarce resources: human resources and nonhuman resources (see Table 1). **Human resources** encompass all types of labor, including specialized forms of labor such as management or entrepreneurship. **Nonhuman resources** include the rest of the bounty: land, natural resources such as minerals and water, and capital.

Examples of human resources abound. By definition, all human resources apply talent and energy to produce goods and services. The cook at the Chicken Shack, the hairstylist at the Mad Hacker, the chief executive of a computer firm, and the assembly-line worker at a General Motors plant all represent human resources. Obviously, labor includes a huge variety of skills, both general and precise. Knowledge, or know-how, is also part of human resources. Economists are interested not only in the scarcity of labor but in its quality. The quality of human resources can be enhanced through investments in education and training.

Economists view *entrepreneurship* as a special form of labor. An **entrepreneur** is a person who perceives profitable opportunities and who combines resources to produce salable goods or services. Entrepreneurs attempt to move resources from lower- to higher-valued uses in the economy and take the risk that they can make profits by doing so. Lemonade-stand entrepreneurs, for example, see an opportunity to make a profit by combining lemons, ice, and cups and by selling the resulting beverage product. *Management*, a second special form of labor, guides and oversees the process by which separate resources are turned into goods or services. The successful lemonade entrepreneur could hire a manager to oversee the opening of new stands around the neighborhood.

Human resources utilize nonhuman resources such as land, minerals, and natural resources to produce goods and services. A plot in Manhattan, an

**TABLE 1**

### Economic Resources

Economic resources include all human and nonhuman resources that are scarce in supply.

Human Resources	Nonhuman and Other Resources
Labor, including entrepreneurship and management	Land Natural resources, including minerals and water Capital

acre in Iowa, a coal deposit in Pennsylvania, a uranium mine in South Dakota, and a timber stand in Oregon are all scarce nonhuman resources. New deposits of minerals can be discovered, forests can be replanted, and agricultural land can be reclaimed from swamps. But at any one time, the available supply of nonhuman resources is limited.

*Capital*, another category of nonhuman resources, comprises all machines, implements, and buildings used to produce goods and services either directly or indirectly. A surgeon's scalpel, a factory, an electric generator, and an artist's brush are all used to produce goods and services and, thus, are considered capital.

Many different forms of capital may be needed to produce a single economic good. With a wheat harvesting machine, a South Dakota farmer can reap a huge crop. But the wheat must also be milled into flour and transported from South Dakota to bakeries in California. Once the wheat has arrived, bakeries must utilize brick or convection ovens to produce bread. The harvesting and milling machines, the railroad, and the baker's ovens are all capital goods, created to increase the amount of final production.

Capital—and the resources used to produce it—is scarce. To create capital, we must sacrifice consumer goods and services because the production of capital takes time away from the production of goods that can be consumed in the present. Societies and individuals must therefore choose between immediate consumption and future consumption. That choice is crucial to growth and ultimate economic well-being. We return to this important issue in Chapter 2.

## Other Factors Affecting Resources and Growth

Quantities of human and nonhuman resources are only one prerequisite for economic growth and well-being in an economy. The institutional framework of an economy, such as the nature of its legal system and its form of government, is also critical for economic growth and development, as are other factors such as technology and information. Consider, first, the nature of technology and information.

*Technology and information* assist resource utilization in a modern, functioning economy. **Technology**, in general, is composed of know-how, inventions, and innovations that help us get more from scarce resources. An improvement in technology implies that we can produce more. Existing technology is the outcome of many inventions, some of which were the invention of new resources—such as aluminum and hybrid plants. All inventions that increase the productivity of labor and capital can be considered improvements in technology. Innovation is the application of technology to the production of goods and services. Technology, then, helps make other resources less scarce.

**Information** is a scarce and costly ingredient in the economic process. The acquisition of information for economic decision making has never been free. In the nineteenth and early twentieth centuries, businesses hired armies of bookkeepers to provide sufficient information for managers to make decisions. The development of the digital computer in the mid-twentieth century made the storage and retrieval of information less costly (while having little effect on the scarcity of the information itself). Technology has progressed so rapidly that the quantity of information that could be stored in a warehouse-

### Technology:

Knowledge of production methods associated with producing a particular good.

### Information:

A scarce and important element in the process of economic exchange and growth.

sized computer in 1950 can now be placed on a chip the size of a fingernail! Advertising is a form of information that can help us economize on the use of scarce time. With price, quality, and other information provided through advertising, we can spend less time searching for goods and services. Information, then, helps us economize on the use of scarce resources.

Resources, both human and nonhuman, never operate in a vacuum; they always exist in some real-world setting that includes government, a legal system, and a structure of property rights. **Property rights** are those rules that establish and govern the ownership and control of resources. Property rights are established by laws developed within a society's traditions and social relations. **Institutions** are the sum total of the traditions, mores, laws, and governmental structures of an economy. Institutions in the United States include the Constitution and the laws of the fifty states. Some of these institutions restrict and define the rights to own and use resources. Others enhance the flow of resources between individuals and states. The U.S. Constitution, for example, guarantees the free movement of resources from state to state.

We live in a world filled with many governments representing many different institutional structures. Some countries are blessed with huge quantities of land and natural resources but still do not manage to achieve economic growth and development beyond the barest minimum. Prior to the 1980s, China's communist government directed almost all human and nonhuman resources from the highest levels of bureaucracy. Despite China's huge resource base, these institutions reduced the country's ability to produce economic development. More recently, and in spite of periodic political repression, the Chinese government has tentatively embraced a Western-style free market system in which some areas of the economy, such as agriculture, are given over to self-interested production, distribution, and exchange. However slowly, Western institutions and technology *are* being adopted in China because they have encouraged a more efficient use of human and nonhuman resources in producing goods and services.

When property rights are not assigned to scarce resources, the resources tend to be wasted. The old adage "What is owned by all, is cared for by none" means the failure to legally assign property rights to specific resources will ensure that the resources will not be utilized in the most efficient fashion. Most Western economists believe that private rights over property—combined with free and unregulated private markets for human and nonhuman resources—are essential to growth in any nation. The success stories of relatively free and unrestricted economies such as Hong Kong, Taiwan, and Singapore—each endowed with very modest quantities of resources—are often presented as proof that noninterventionist institutions contribute greatly to economic development. The shift in New Zealand's economy from more to less regulation of resources has produced heightened growth there, while the coexistence of private property and extensive controls on resource use in the Indian economy has produced stagnation. The lesson to be learned from these cases is that institutions—especially the form of government and the nature of controls over resources and resource utilization—are keys to productivity and economic growth in any society.

Scarcity of resources *and* scarcity of imagination in designing institutions to facilitate resource use are at the heart of all economic problems. Resources can be augmented over time; indeed, we are much better off materially than our grandparents, and our grandparents were better off than their

**Property rights:**

Any legal and/or enforceable rights to the use of resources of any kind.

**Institutions:**

The sum total of the traditions, mores, laws, and governmental structures of an economy.



grandparents. At any one time, however, individuals and societies cannot get all of what they want. Given scarcity, individuals and societies must make choices, and a primary role of economists is to analyze scarcity and the process of choosing. With their analyses they make predictions and recommendations regarding productivity and economic growth.

## THE POWER OF ECONOMIC THINKING

All economists of all political stripes have common fundamental ways of thinking. These perspectives, at the core of the science of economics, appear many times throughout this book. When properly and consistently used, they brand a person as adept in the economic way of thinking. A look at these economic perspectives in simple, commonsense language should convince you that economics and economic reasoning are closely related to decisions you make every day. Indeed, economics may be usefully characterized as a way of thinking about both familiar and unfamiliar events.

### Resources Cost More Than You Think

What does it cost you to take a skiing weekend in the mountains or to make a trip to the beach during spring break? Your instant reply might include the costs of gasoline, auto depreciation, airfare, lift tickets, food, drink, entertainment, and a motel room. These money expenditures are called **accounting costs**, or explicit money costs.

Economists define *costs* more broadly than accountants do. In addition to the **explicit** (money) **costs** considered by accountants, economists consider additional **implicit costs** associated with an action. In the case of a ski trip, an economist would recognize that an additional implicit cost of a ski weekend is the forgone opportunity of using the time in its next most valuable use when all viable alternatives are considered. For example, if the student who goes skiing would otherwise have spent the weekend watching TV or working at a part-time job, an implicit cost of skiing is the income that would otherwise have been earned, if working is the highest-valued alternative. Therefore, the full economic cost of the ski weekend—the **opportunity cost**—equals the explicit money costs (that money does have an alternative use) plus the implicit costs of the forgone income. (See Focus, “Opportunity Cost: The Case of Professional Line-Standers.”) Opportunity costs always include all accounting costs.

Greg is a self-employed lawyer who charges \$125 per hour for his services. A next-door neighbor owns four large cats who howl at night, disturbing Greg’s sleep. Unable to convince his neighbor to quiet the cats, Greg spends 10 work hours preparing a lawsuit to demand satisfaction. Greg bears an opportunity cost, although he paid no lawyer to handle his case. If Greg’s next best alternative was to work for a client (and we assume that it is), he could have earned \$1250. An economist would say that his opportunity cost of the lawsuit against his neighbor was \$1250, for that is what his choice to prepare the lawsuit cost him in terms of forgone legal billings. Therefore, bringing the suit is costly to the lawyer even though no explicit costs (accounting costs) are incurred.

#### Accounting costs:

Actual money expenditures associated with any activity; out-of-pocket costs.

#### Explicit costs:

Accounting costs.

#### Implicit costs:

Nonpecuniary costs associated with the consumption of a good or service.

#### Opportunity costs:

The highest-valued alternative forgone in making any choice.