ECONOMICS

Economic theories reflect different attitudes about **human nature** – which are likely to change over time. They aim to draw conclusions about **human behavior.**

Economics is the social science that studies the **production, distribution,** and **consumption of goods** and services, or what may be termed the "allocation of scarce resources." It focuses on the **behavior** and **interactions** of economic agents and how economies work..

Macroeconomics is concerned **with large-scale or general economic factors** (in aggregate), such as production, consumption, savings, investment, and interest rates. It focuses on factors affecting the economy including employment of resources (labor, capital, and land), economic growth, inflation, and public policies, especially monetary and fiscal policy.

Microeconomics analyzes particular **elements** of the economy, including individual agents and markets, their interactions, and the outcomes of interactions (households, firms, buyers and sellers, etc.)

In 1776 Adam Smith, in his *Wealth of Nations*, identified **land, labor, and capital** as the three factors of production and the major contributors to a nation's wealth. He discussed the potential benefits of division of labor and its role of as a fundamental principle of economic organization. Resource allocation theory postulates that, under competition, resource owners (labor, land, and capital) seek their **most profitable uses**, resulting in an equal rate of return when in equilibrium.

In his famous passage, Smith represents every individual as trying to employ any capital they have for their own advantage, not that of society. But by seeking his own gain, he is led by an "**invisible hand**" to promote an end which in no part was his intention – that of bettering society.

David Ricardo (1817) focused on the distribution of income among landowners, workers, and capitalists. Ricardo saw an inherent conflict between landowners on the one hand and labor and capital on the other. He posited that the growth of population and capital, pressing against a fixed supply of land, pushes up rents and holds down wages and profits. Ricardo proved the principle of **comparative advantage,** where each country should specialize in producing and exporting those goods where it has a lower cost of production, proposing a "fundamental analytical explanation" for gains from trade.

John Stuart Mill (1848) parted company earlier classical economists and pointed to a distinct difference between the market's two roles: **allocation of resources** and **distribution of income**. The market might be efficient in allocating resources but not in distributing income, he wrote, making it necessary for society to intervene.

Marxian economics, derived from the work of Karl Marx in *Das Kapital* (1867), descends from classical economics. Marx focused on the labor theory of value and the theory of surplus value which, he believed, explained the exploitation of labor by capital. The **labor theory** of value held that the value of an exchanged commodity was determined by the labor that went into its production and the theory of **surplus value (profit)** demonstrated how the workers only got paid a proportion of the value their work had created.

Neoclassical economics studies the **behavior of individuals, households,** and **organizations** (called economic actors, players, or agents), when they manage or use scarce resources, which have alternative uses, to achieve desired ends. Agents are assumed to act rationally, have multiple desirable ends in sight, limited resources to obtain these ends, a set of stable preferences, a definite overall guiding objective, and the capability of making a choice.

In microeconomics, neoclassical economics represents **incentives** and **costs** as playing a pervasive role in shaping decision making. An immediate example of this is the **consumer theory of individual demand**, which isolates how prices (as costs) and income affect quantity demanded. In macroeconomics it is reflected in an early and lasting neoclassical synthesis with Keynesian macroeconomics.

The study of **agent behavior** under **scarcity**, may go as follows: The continuous interplay (exchange or trade) done by economic actors in all markets sets the prices for all goods and services which, in turn, make the rational managing of scarce resources possible. At the same time, the decisions (choices) made by the same actors, while they are pursuing their own interest, determine the level of output (production), consumption, savings, and investment, in an economy, as well as the remuneration (distribution) paid to the owners of labor (in the form of wages), capital (in the form of profits) and land (in the form of rent). Each period, as if they were in a giant feedback system, economic players influence the pricing processes and the economy, and are in turn influenced by them until a steady state (equilibrium) of all variables involved is reached or until an external shock throws the system toward a new equilibrium point. Because of the autonomous actions of rational interacting agents, the economy is a complex adaptive system.

Supply and demand refers to the amount of a commodity, product, or service available and the desire of buyers for it, considered as factors regulating its price. Neoclassical economics systematized supply and demand as joint determinants of price and quantity in market equilibrium, affecting both the allocation of output and the distribution of income. It dispensed with the labor theory of value inherited from classical economics in favor of a marginal utility theory of value on the demand side and a more general theory of costs on the supply side.

Supply-side economics is a macroeconomic theory arguing that economic growth can be most effectively created by stimulating business through **lowering taxes** and **decreasing regulation**. Consumers will then benefit from a greater supply of goods and services at lower prices and employment will increase.

Demand-side economics is a macroeconomic theory which maintains that economic growth and full employment are most effectively created by high **demand for products** and **services** (output is determined by effective demand). High consumer spending leads to business expansion, resulting in greater employment opportunities. Higher levels of employment create a **multiplier effect** that further stimulates aggregate demand, leading to greater economic growth.

Demand-side economists argue tax breaks for the wealthy produce little, if any, economic benefit because most of the additional money is not spent on goods or services. Instead, they argue increased governmental spending will help to grow the economy by spurring additional employment opportunities. They cite the lessons of the Great Depression of the 1930s as evidence that increased governmental spending spurs growth. **John Maynard Keynes** is the most celebrated of demand-side economic theorists. Additional proponents include Leon Keyserling, John Kenneth Galbraith, Hyman Minsky, and Joseph Stiglitz.

The Chicago School of economics is best known for its free market advocacy and **monetarist ideas**. According to **Milton Friedman** and monetarists, market economies are inherently stable if the **money supply** does not greatly expand or contract. Friedman effectively took many of the basic principles set forth by Adam Smith and the classical economists and modernized them. He claimed that the social responsibility of business should be "to use its resources and engage in activities designed to increase its profits ... (through) open and free competition without deception or fraud." **Ben Bernanke**, former Chairman of the Federal Reserve (FED), is among the economists today generally accepting Friedman's analysis. He is largely credited for guiding the economy through the Financial Crisis of 2007-2008 (Great Recession) by aggressively lowering the FED funds lending rate and deploying quantitative easing (purchasing $1.3 trillion of financial assets from banks and the government). (Wikipedia)

KEYNSIAN ECONOMIC THEORY

Fiscal policy is largely based on the ideas of British economist **John Maynard Keynes** (1883-1946), who argued that economic recessions are due to a deficiency in the consumption spending and business investment components of aggregate demand. Keynes believed that governments could stabilize the business cycle and regulate economic output by **adjusting spending** and **tax policies** to make up for the shortfalls of the private sector.

In Keynesian economics, **aggregate demand** or **spending** is what drives the performance and growth of the economy. Aggregate demand is made up of consumer spending, business investment spending, net government spending, and net exports. According to Keynesian economists, the private sector components of aggregate demand are too variable and too dependent on psychological and emotional factors to maintain sustained growth in the economy.

Pessimism, fear, and uncertainty among consumers and businesses can lead to **economic recessions** and **depressions**, and excessive exuberance during good times can lead to an overheated economy and **inflation**. However, according to Keynesians, government taxation and spending can be **managed** rationally and used to counteract the **excesses** and **deficiencies of private sector consumption** and **investment spending** in order to stabilize the economy.

To help stabilize an economy the government should run large **budget deficits (deficit spending)** during economic downturns and run **budget surpluses** when the economy is expanding (cushion for future requirements and to pay down prior debt). [Investopedia]

ECONOMIC SYSTEMS

An **economic system** is a system of **production, resource allocation** and **distribution of goods** and **services** within a society. It includes the combination of the various institutions, agencies, entities, decision-making processes and patterns of consumption that comprise the economic structure of a given community. As such, an economic system is a type of social system. There is often a strong correlation between certain ideologies, political systems, and certain economic systems.

All economic systems have three basic questions to ask: **what to produce, how to produce** and in **what quantities**, and **who receives** the output of production. An economic system is a way of answering these basic questions and different economic systems answer them differently. Many different objectives may be seen as desirable for an economy, like **efficiency, growth, liberty** and **equality**.

The analysis of economic systems traditionally focuses on comparisons between market economies and planned economies and on the distinctions between **capitalism and socialism.** In between are market-oriented **mixed economies**, the dominant form of economic organization worldwide.

Economic systems are commonly segmented by their **property rights regime** for the means of production and by their dominant **resource allocation mechanism**. Economies that combine private ownership with market allocation are called "market capitalism" and economies that combine private ownership with economic planning are labelled "command capitalism.” Likewise, systems that mix public or cooperative ownership of the means of production with economic planning are called "socialist planned economies" and systems that combine public or cooperative ownership with markets are called "market socialism".

In a **capitalist economic system**, production is carried out for **private profit** and decisions regarding investment and allocation of factor inputs are determined by business owners in factor markets. The means of production are primarily owned by private enterprises and decisions regarding production and investment are determined by private owners in capital markets. Capitalist systems range from **laissez-faire**, with minimal government regulation and

state enterprise, to **regulated** and **social market** systems, with the aims of ameliorating market failures or supplementing the private marketplace with social policies to promote equal opportunities, respectively. **Corporate capitalism** refers to a capitalist marketplace characterized by the dominance of hierarchical, bureaucratic corporations.

Mercantilism was the dominant model in Western Europe from the 16th to 18th century. This encouraged **imperialism** and **colonialism** until economic and political changes resulted in global decolonization. Modern capitalism has favored **free trade** to take advantages of increased efficiency due to **national competitive advantage** and economies of scale in a larger, more universal market.

In **socialist economic systems**, production for use is carried out; decisions regarding the use of the means of production are adjusted to satisfy economic demand; and investment is determined through economic planning procedures. There is a wide range of proposed planning procedures and ownership structures for socialist systems, with the common feature among them being the **social ownership of the means of production**. This might take the form of public ownership by all of the society, or ownership cooperatively by their employees. A socialist economic system that features social ownership, but is based on the process of capital accumulation and utilization of capital markets for the allocation of capital goods between socially owned enterprises, falls under the subcategory of market socialism.

The primary emphasis of socialist planned economies is to **coordinate production** to produce economic output to directly satisfy economic demand as opposed to the indirect mechanism of the profit system where satisfying needs is subordinate to the pursuit of profit; and to advance the productive forces of the economy in a more **efficient manner** while being immune to the perceived systemic inefficiencies (cyclical processes) and crisis of overproduction so that production would be subject to the **needs of society** as opposed to being ordered around capital accumulation.

Socialist economic systems (all of which feature social ownership of the means of production) can be subdivided by their coordinating mechanism (planning and markets) into planned socialist and market socialist systems. Additionally, socialism can be divided based on their property structures between those that are based on **public ownership, worker** or **consumer cooperatives**, and **common ownership** (i.e. non-ownership). **Communism** is a hypothetical stage of socialist development articulated by Karl Marx as "second stage socialism," whereby the economic output is distributed based on need and not simply on the basis of labor contribution.

There is no precise definition of a "**mixed economy**". Theoretically, it may refer to an economic system that combines one of three characteristics: public and private ownership of industry, market-based allocation with economic planning, or free markets with state interventionism. In practice, "mixed economy" generally refers to market economies with substantial **state interventionism** and/or sizable public sector alongside a **dominant private sector**. Mixed

economies tend to gravitate more heavily to one end of the spectrum. (Wikipedia).

SOCIAL DEMOCRACY

Social democracy is defined as a concept of government in which the **state** plays a key role in the protection and promotion of the **economic** and **social wellbeing** of its citizens. It is based on the principles of equality of opportunity, equitable distribution of wealth, and public responsibility for those unable to avail themselves of the minimal provisions for a good life. Modern social democracy is characterized by a commitment to policies aimed at curbing inequality, and oppression of underprivileged groups and poverty, including support for universally accessible public services like healthcare, education, elderly care, and childcare. It is viewed as a distinctive combination of **democracy, welfare, and capitalism**.

it is inaccurate to refer to this kind of arrangement as "socialism." It is more accurate to use the terms "**Social Democracy** or **Democratic Socialism**" to define this popular approach to socio-economic programs managed within most economies, especially those of advanced countries. This may be defined as a social and economic ideology that supports economic and social interventions to promote social justice within the framework of a liberal democratic polity and capitalist economy, aiming to create the conditions for capitalism to lead to greater democratic, egalitarian, and unified outcomes.

During modern times in the western world this notion of "**social democracy**" has emerged, most notably in Scandinavia, where its countries have achieved for citizens what is recognized as the highest standard of living among advanced nations. These Nordic nations, with their low inequality, free politics and strong rule of law, represent success stories. They credit this success to a mindset that favors a "**group**" or "**community**" solution for addressing pressing human needs. They embrace the notion that what serves the **common good** also serves the better **interest of the individual**.

The Scandinavian lifestyle is characterized by high incomes, a strong middle class, universal health care, state-supported public and higher education, and high psychological wellbeing. Much credit for the later component is given to the reduction in personal stress made possible by affirmative governmental support for **public health** and **education**, thereby allowing more discretionary time for building personal relationships.

As Americans we love the hundreds of "**social democratic" programs** forged to address our everyday needs. These include **essential services** that help provide our basic needs, i.e., water, electricity, roads, parks, etc. They include government-managed services that provide public safety and help ensure our survival, such as the military, police, fire protection, public health departments, environmental and consumer protection agencies, etc. They also include **publicly-owned institutions and programs** designed to elevate our civilization, both individually and collectively, i.e., public schools, higher education, scientific research, support for the arts, etc. Finally, they include **social safety net programs** that ensures a measure of equity and security

for the essential personal needs of all Americans, i.e., Social Security, Medicare, Medicaid, Public Assistance, etc.

OBSERVATIONS REGARDING SOCIAL DEMOCRACY

It is incorrect to refer to social democracy as "socialism" - when so labeled negatively by those whose central objective is often focused on individualism and the lowering of taxes, especially for the wealthy and corporations. Their implied meaning of the term "socialism" would be correct only when used consistent with its defined meaning: "an **economic system** that denotes the **ownership** of the means of production and distribution by a **group** or a **government**." No one within the major political parties is proposing that the government take ownership of the means of production and distribution within the economy. **Private ownership**, not public ownership, is inherent under social democracy.

As used derogatively in public discourse the politically-charged term "**socialism**" is nothing more than calculated "**fear-mongering**," especially when used by those seeking to minimize the role of government and advance their private interest over the public interest.

In reality, what is being discussed is the ongoing challenge of how to provide services or meet **essential needs** that are not adequately or affordably addressed by the private sector (a current example of this is the debate over healthcare). Since the free market (private sector) does not adequately meet many societal needs, the **duty** to do so falls on the government. Even then, the government usually employs a joint public/private arrangement or partnership to satisfy the need.

It may be observed generally, that the **more advanced a society the more sophisticated** is its **governmental programs** - both essential and safety net services. This sophistication facilitates a higher standard of living for **all members** of society.

MANAGING THE AMERICAN ECONOMY

The condition of the economy is determined, in **order of importance**, by the following factors:

- **Business Cycle**. The economy cycles through periods of expansion and contraction, based on a variety of economic conditions. Primarily, these include the availability of capital, resources, and labor. Also important is the prevailing business climate, i.e., a favorable attitude toward enterprise, governmental regulation ensuring a fair and equitable playing field, protection of investment, and demand for product and services. These and other factors translate into the economic concept of "**Risk Taking**," whereby players are motivated to risk time, labor and capital to generate economic growth. When weighing risk, players measure the potential for reward against anticipated cost. When conditions favor risk taking capital investment increases spurring the start of a new business cycle or the continuation of an existing one.

- **<u>Interest Rates</u>**. The **cost of capital** is a major factor for operating a business and achieving profitability. That cost increases proportionately with higher interest rates. The level of interest rates is determined by capital markets and the operation of central banks, managed by the **Federal Reserve System** (FED). The FED, sets short-term lending rates for its member banks, impacting money supply. These rates are the key tool used by the FED to implement **monetary policy**. Over time the expansion or contraction of the economy responds to the fluctuation of interest rates – lower interest rates reflect an expansionary monetary policy while higher rates slow the rate of growth in the money supply. Interest rates also impact the rate of inflation or deflation.
- **<u>Fiscal Policy</u>**. Fiscal Policy is the use of **government spending** and **tax policies** to influence economic conditions, especially macroeconomic conditions (demand for goods and services, employment, inflation, and economic growth). Fiscal and monetary policy are the key strategies used by the government to further its economic objectives. When private sector spending turns down, the government can spend more and/or tax less to directly increase aggregate demand (expansionary policy). When the private sector is overly optimistic and the economy expands too rapidly, the government can spend less and/or tax more in order to decrease aggregate demand (contractionary fiscal policy). In the face of mounting inflation and other expansionary symptoms, a government may employ contractionary fiscal policy (such as increasing interest rates). **Deficit spending** occurs when the government seeks economic expansion through expenditures without a commensurate increase in revenue. [Investopedia]

OBSERVATIONS REGARDING MONETARY AND FISCAL POLICY

Presidents, regardless of political party, are quick to **take credit** for a favorable economy. Likewise, they are quick to take blame for a failed economy. As noted from above, a president's influence over the economy falls behind that of the business cycle and monetary policy. A president is positioned to "influence" the economy by: (1) recommending spending and taxation policy and programs to Congress, the governing body which establishes fiscal policy; and (2) supporting actions that affect the expansion or contraction of the business cycle and capital investment. A president is not the driving force behind the economy, but can proactively be an influencer over those with private capital and those who control the federal purse strings who are.

There is a popular notion that government can increase aggregate demand and fuel economic expansion and create jobs by **lowering tax rates**. However, there is little evidence that this action alone has ever worked.

Expansionary policy is popular – to a dangerous degree. Fiscal stimulus is **difficult to reverse** and people like the benefit of public spending and low taxes – actual repayment is usually

deferred indefinitely. There tends to be a consistent bias toward engaging in more-or-less **constant deficit spending** that can be in part rationalized as "good for the economy".

Without commensurate revenues government spending resulting from expansionary policies, ongoing programs, and tax cuts directly increases the national debt, a **burden** passed primarily to **future generations**.

Contractionary fiscal policy may be achieved by running budget surpluses. However, this method is politically unpopular so policy makers favor the tool of contractionary monetary policy, whereby they restrain unsustainable growth by curtailing the supply of money and credit with **higher interest rates**.

DEFINITIONS – ADDITIONAL ECONOMIC TERMS

AUSTERITY: A set of political-economic policies that aim to reduce government budget deficits through spending cuts, tax increases, or a combination of both. Austerity measures are often used by governments that find it difficult to borrow or meet their existing obligations to pay back loans.

CAPITALISM: An economic system based on the freedom of private ownership of the means of production and their operation for profit. Characteristics central to capitalism include private property, capital accumulation, wage labor, voluntary exchange, a price system, and competitive markets. In a capitalist market economy, decision-making and investment are determined by every owner of wealth, property or production ability in financial and capital markets.

ELASTICITY: The measurement of the percentage change of one economic variable in response to a change in another. An elastic variable (with an absolute elasticity value greater than 1) is one which responds more than proportionally to changes in other variables. In contrast, an *inelastic* variable (with an absolute elasticity value less than 1) is one which changes less than proportionally in response to changes in other variables. It is a tool for measuring the responsiveness of one variable to changes in another, causative variable.

Frequently used elasticities include price elasticity of demand, price elasticity of supply, income elasticity of demand, elasticity of substitution between factors of production and elasticity of intertemporal substitution. Elasticity is one of the most important concepts in neoclassical economic theory. It is useful in understanding the incidence of indirect taxation, marginal concepts as they relate to the theory of the firm, and distribution of wealth and different types of goods as they relate to the theory of consumer choice. Elasticity is also crucially important in any discussion of welfare distribution, in particular consumer surplus, producer surplus, or government surplus.

MULTIPLIER EFFECT: An effect in economics in which an increase in spending produces an increase in national income and consumption greater than the initial amount spent. For

example, if a corporation builds a factory, it will employ construction workers and their suppliers as well as those who work in the factory. Indirectly, the new factory will stimulate employment in laundries, restaurants, and service industries in the factory's vicinity.

SCARCITY: Refers to the basic economic problem, the gap between limited – that is, scarce – resources and theoretically limitless wants. This situation requires people to make decisions about how to allocate resources efficiently, in order to satisfy basic needs and as many additional wants as possible.

SOCIALISM: A type of economic system involving the public, cooperative (workers), or social ownership of the means of production and distribution. The economic framework may be decentralized and self-managed in autonomous economic units, as in libertarian systems, or centrally planned, as in authoritarian systems. Public services such as healthcare and education would be commonly, collectively, and/or state owned. In a market economy the form "Market Socialism" utilizes the market mechanism for the allocation of capital goods and the means of production.

SOCIAL DEMOCRACY: A social and economic ideology that supports economic and social interventions to promote social justice within the framework of a liberal democratic polity and capitalist economy, aiming to create the conditions for capitalism to lead to greater democratic, egalitarian and unified outcomes. Modern social democracy is characterized by a commitment to policies aimed at curbing inequality, and oppression of underprivileged groups and poverty, including support for universally accessible public services like healthcare, education, and elderly and childcare. Viewed as a distinctive combination of democracy, welfare, and capitalism.

Information sourced largely through *Wikipedia*