CHAPTER 1

The Economy and Economics

A Take a walk

The economy must be a very complicated, volatile thing. At least that's how it seems in the business pages of the newspaper. Mind-boggling stock market tables. Charts and graphs. GDP statistics. Foreign exchange rates. It's little wonder the media turn to economists, the high priests of this mysterious world, to tell us what it means, and why it's important. And we hear from them several times each day — usually via the monotonous "market updates" that interrupt most news broadcasts. Company X shares are up two points; company Y's are down two points; the analysts are "bullish;" the analysts are "bearish."

But is all that financial hyperactivity really what the economy is about? Is economics really so complex and unintelligible? Should we trust the "experts" with it all? Maybe we should find out what's going on for ourselves.

Forget the market updates. Here's a better way to find out about the economy — *your* economy. Take a walk. And ask some questions.

Start in your own household. How many people live there? What generations? Who works outside the household, and how much do they earn? How long have they been working there? How long do they plan to keep working, and how will they support themselves when they retire? Who performs which chores inside the household? Are there any children? Who cares for them? Does anyone else in your home require care? Do you own your house or apartment, or do you rent it? If you rent it, from whom? If you own it, how did you pay for it? What shape is it in?

Now walk through your neighbourhood, and the next neighbourhood. Are the homes or apartments all roughly the same, or different? Does everyone have a home? Do most people have jobs? What sorts of jobs? Are they well off? Can they comfortably pay for the things they and their families need?

Watch your neighbours going off to work, school, or other destinations. How are they travelling? In their own cars? On transit? Walking? How much money, time, and physical space is devoted in your neighbourhood to the process of "getting around"?

Is there a school in your neighbourhood? A hospital? A library? Who pays for those buildings? Who works there? How do those facilities compare with the private homes and businesses around them? Are they newer, or older? Nicer, or shabbier? Is there a park in your neighbourhood? Is there anywhere else a person can go without having to pay money?

© CCPA and Pluto Press

Are the streets clean? If so, who cleaned them? Is the air fresh or polluted? Can people in your neighbourhood safely drink the water from their taps? How much do they pay for that water? And to whom?

Walk through the nearest shopping district. What kinds of products are displayed in the windows? Were any of them produced within 100 miles of your home? Elsewhere in your country? In another country? Can your neighbours afford most of what is on display? Are they usually happy with their purchases, or disappointed? Do they pay with cash, bank cards, or credit cards? Can they afford what they buy?

Now walk to a local bank branch and see what's happening inside. Compare what you see (deposits, withdrawals, loans) with the activities you read about in the financial pages (leveraged buy-outs, financial speculation, foreign exchange). Which matters more to day-to-day life in your neighbourhood?

This is a good time to stop at a café. Pull out a pencil and paper. List your approximate monthly income. Then list how much of it goes to the following categories: Rent or mortgage (including utilities); income taxes; car payments or transit pass; groceries; other "stuff" (merchandise); and going out (entertainment). Can you comfortably pay your bills each month? Do you regularly save? Is your income higher than it was five years ago, lower, or about the same? If you had a little more income, what would you do with it? If you walked back to that bank and asked for a loan, would they give you one?

Apart from the places we've mentioned (schools, stores, and banks), what other workplaces are visible in your neighbourhood? Any factories? What do they produce, and what shape are they in? Any professional or government offices? Other services? Can you see any tall towers from your neighbourhood (if you live in a city)? Who works there? Can you guess what they do? Imagine the conditions in those offices (spaciousness, quality of furnishings, security, caretaking), and compare them to conditions inside your local school.

Have any new workplaces opened up recently in your neighbourhood? If so, what do they do? Did you see any "help wanted" signs posted in local workplaces? What kinds of jobs were they advertising for?

Now you can return home. Congratulations! You've done a lot more than just take a stroll. You've conducted a composite economic profile of your own community. It has no statistics, charts, or graphs (though you could add those if you wish, with a bit of work at the local library). But just by walking around your neighbourhood, you have identified the crucial factors determining economic affairs in your community:

- **Work:** Who works? Who works inside the home, and works outside the home? How much do they get paid? Is it hard to find a job?
- **Consumption:** What do people need to stay alive? What do they want, to make their lives better? How do they pay for it all?
- **Investment:** Private companies and public agencies must invest in maintaining and expanding their facilities, or else the economy (and your neighbourhood) goes quickly downhill. Who is investing? How much? On what types of projects?
- **Finance:** Most economic activity (but not all) requires money. Who creates and controls that money? Who gets to spend it? What do they spend it on?
- **Environment:** Everything we do in the economy requires space, air, and inputs of natural materials. Is the natural environment being run down by the economy, or is it being sustained?

© CCPA and Pluto Press

These are the building blocks from which the most complicated economic theories are constructed. And they are all visible, right there in your neighbourhood.

Don't ever believe that economics is a subject only for "experts." The essence of economics is visible to everyone, right there in your own 'hood. Economics is about life — *your* life.

B What is the economy?

The economy is simultaneously mystifying and straightforward. Everyone has experience with the economy. Everyone participates in it. Everyone knows something about it — long before the pinstripe-wearing economist appears on TV to tell you about it.

The forces and relationships you investigated on your walk are far more important to economic life than the pointless ups and downs of the stock market. Yet our local economic lives are nevertheless regularly affected (and disrupted) by bigger and more complex developments.

At its simplest, the "economy" simply means all the work that human beings perform, in order to produce the things we need and use in our lives. (By work, we mean all productive human activity, not just **EMPLOYMENT**; we'll discuss that distinction later.) We need to organize and perform our work (economists call that **PRODUCTION**). And then we need to divide up the fruits of our work (economists call that **DISTRIBUTION**).

What kind of work are we talking about? Any kind of work is part of the economy, as long as it's aimed at producing something we need or want. Factory workers, office workers. Executives, farmers. Teachers, nurses. Homemakers, homebuilders. All of these people perform productive work, and all of that work is part of the economy.

What do we produce when we work? Production involves both goods and services. **GOODS** are tangible items that we can see and touch: food and clothes, houses and buildings, electronics and automobiles, machines and toys. **SERVICES** are tasks that one or several people perform for others: cutting hair and preparing restaurant meals, classroom instruction and brain surgery, transportation and auditing.

Where do we perform this work? Productive work occurs almost everywhere: in private companies, in government departments and public agencies, and in the home. In cities, in towns, on farms, and in forests.

Why do we work? We must survive, and hence we require the basic material needs of life: food, clothing, shelter, education, medical care. Beyond that, we want to get the most out of our lives, and hence we aim for more than subsistence. We want a greater quantity, and a greater variety, of goods and services: for entertainment, for travel, for cultural and personal enrichment, for comfort. We may also work because we enjoy it. Perversely for economists (most of whom view work solely as a "disutility"), most people are happier when they have work to do — thanks to the social interaction, financial well-being, and self-esteem that good work provides.

How do we distribute, and eventually consume, the economic pie we have baked together? In many different ways. Some things are produced directly for our own use (like food grown in a garden, and then cooked in a household kitchen). Some things we must buy with money. We are entitled to consume certain products — like walking down a paved street, listening to the radio, or going to school — without directly paying anything. Importantly, some of what we produce must be re-invested, in order to spark even more economic activity in the future.

© CCPA and Pluto Press

So when you think about the "economy," think about work. What work do we do? What do we produce? And what do we do with what we've produced?

C The economy and society

The economy is a fundamentally *social* activity. Nobody does it all by themselves (unless you are a hermit). We rely on each other, and we interact with each other, in the course of our work.

It is common to equate the economy with wealth, profit, and self-interest, and hence it may seem strange to describe it as something "social." Indeed, free-market economists adopt the starting premise that human beings are inherently selfish (even though this assumption has been proven false by biologists and anthropologists alike).

In fact, the economy is not individualistic. It is *collective*, and in many ways it is *cooperative*. The richest billionaire in the world couldn't have earned a dollar, without the supporting roles played by his or her workers, suppliers, and customers. Indeed, our economic lives are increasingly intertwined with each other, as we each play our own little roles in a much bigger picture. That's why most of us live in cities (where the specialized, collective nature of the economy is especially visible). And that's how we can interact economically with people in other countries, thousands of miles away.

The economy is about work: organizing it, doing it, and dividing up its products. And at work, one way or another, we interact with other people.

The link between the economy and society goes two ways. The economy is a fundamentally social arena. But society as a whole depends strongly on the state of the economy. Politics, culture, religion, and international affairs are all deeply influenced by the progress of our economy. Governments are re-elected or turfed from office depending on the state of the economy. Family life is organized around the demands of work (both inside and outside the home). Being able to comfortably support oneself and one's family is a central determinant of happiness.

So the economy is an important, perhaps even dominant, force in human development. That doesn't mean that we should make "sacrifices" for the sake of the economy — since the whole point of the economy is to meet our material needs, not the other way around. And it certainly doesn't mean that we should grant undue attention or influence to economists. But it does mean that we will understand a great deal about our history, our current social reality, and our future evolution as a species, when we understand more about economics.

D What is economics?

Economics is a social science, not a physical science. (Unfortunately, many economists are confused on this point! They foolishly try to describe human economic activity with as much mechanical precision as physicists describe the behaviour of atoms.) Economics is the study of human economic behaviour: the production and distribution of the goods and services we need and want.

This broad field encompasses several sub-disciplines. Economic history; money and finance; household economics; labour studies and labour relations; business economics and management; international economics; environmental economics; and others. A broad (and rather artificial) division is often made between **microeconomics** (which is the study of the economic behaviour of individual consumers, workers, and companies) and **macroeconomics** (which is the study of how those individuals interact at the level of the aggregate economy).

© CCPA and Pluto Press

This all seems relatively straightforward. Unfortunately, the dominant stream in modern economics (**NEOCLASSICAL ECONOMICS**, which we'll discuss more in Chapter 4) makes it more complicated than it needs to be. Instead of addressing broad questions of production and distribution, neoclassical economics focuses narrowly on *markets* and *exchange*. The purpose of economics, in this mindset, was defined by one of its leading practitioners (Lord Lionel Robbins) back in 1932, in a definition that is still taught in economics courses today:

"Economics is the science which studies human behaviour as a relationship between given ends and scarce means which have alternative uses."

Embedded in this definition is a very peculiar (and rather dismal) interpretation of economic life. Scarcity is a normal condition. Humans are "endowed" with arbitrary amounts of useful resources. By trading through markets, they can extract maximum well-being from that endowment — just like school kids experience greater happiness by trading their duplicate superhero cards with one another in the playground. An "efficient" economy is one which maximizes, through trade, the usefulness of that initial endowment — regardless of how unequally production may be distributed, what kinds of things are produced, or how rich or poor people are at the end of the day. (This curious concept of efficiency is called **ALLOCATIVE EFFICIENCY**).

As we'll learn later in this book, by defining the fundamental economic "question" in this particular way, neoclassical economics misses many important economic issues related to production, innovation, development, and fairness.

I prefer to keep things simple. We'll stick with a much broader definition of economics: the study of how humans work, and what we do with the fruits of our labour. Part of this involves studying markets and exchange — but only part. Economics also involves studying many other things: history, technology, tradition, family, power, and conflict.

E Economics and politics

Economics and politics have always gone hand-in-hand. Indeed, the first economists called their discipline "political economy." The connections between economics and politics reflect, in part, the importance of economic conditions to political conditions. The well-being of the economy can influence the rise and fall of politicians and governments, even entire social systems.

But here, too, the influence goes both ways. Politics also affects the economy — and economics itself. The economy is a realm of competing, often conflicting interests. Determining whose interests prevail, and how conflicts are managed, is a deeply political process. (Neoclassical economists claim that anonymous "market forces" determine all these outcomes, but don't be fooled: what is called the "market" is itself a social institution in which some peoples' interests are enhanced at the expense of others'.) Different economic actors use their political influence and power to advance their respective economic interests. The extent to which groups of people tolerate economic outcomes (even unfavourable ones) also depends on political factors: such as whether or not they believe those outcomes are "natural" or "inevitable," and whether or not they feel they have any power to bring about change.

Finally, the social science which aims to interpret and explain all this scrabbling, teeming behaviour — economics — has its own political assumptions and biases. In Chapter 4 we'll review how most economic theories over the years have been motivated by political considerations. Modern economics (including this book!) is no different: economics is still a deeply political profession.

© CCPA and Pluto Press

F Measuring the economy

GROSS DOMESTIC PRODUCT (GDP) is the most common way to measure the economy. But beware: it is a deeply flawed measure. GDP adds up the value of all the different goods and services that are produced *for money* in the economy. GDP is thus one measure of the total value of the work we do — but only for money.

In the private sector of the economy, GDP is based on the market prices of everything that's bought and sold. In the public and non-profit sectors, it is based on the cost of everything that's produced. In both cases, statisticians must deduct the costs of the many inputs and supplies purchased in any particular industry, from the total value produced by that industry. (This is so that we don't double-count the work that went into all those inputs.) In this way, GDP is designed to only include the **VALUE ADDED** by new work at each stage of production.

An obvious drawback of GDP is that it excludes the value of work that is *not* performed for money. This is a highly arbitrary and misleading exclusion. For example, most people perform unpaid chores in their households, and many must care for other family members (especially children and elders). Some of this household work can be "outsourced" to paid cleaners, nannies, and restaurants (the richer you are, the more you can outsource), in which case it is included in GDP. But it you "do it yourself," then it doesn't count! Volunteer work and community participation are other forms of valuable, productive work excluded from GDP.

This phony distinction has big consequences for how we measure the economy. Unfortunately, things that we measure often take on extra importance (with the media, and with policy-makers), purely because they *can* be measured. GDP underestimates the total value of work performed in the economy, and hence misjudges our productivity. It undervalues the unpaid work done within our homes and our communities. Because of sexism at home and in the workplace, most of that unpaid work is done by women; hence, GDP underestimates the economic contribution of women.

It's especially misguided to interpret GDP as a measure of human well-being. We've seen that there are many valuable things that are not included in GDP. On the other hand, many of the goods and services that *are* counted in GDP are utterly useless, annoying, or even destructive to human well-being — like dinner-hour telephone solicitations, many pharmaceuticals, excess consumer packaging, and armaments production. Moreover, just because a society produces more GDP never ensures that most members of society will ever receive a larger slice of that growing pie.

So we must be cautious in our use of GDP statistics, and we must never equate GDP with prosperity or well-being.

Despite these caveats, GDP is still an important and relevant measure. It indicates the value of all production that occurs for money. This is an important, appropriate piece of information for many purposes. (For example, the ability of governments to collect taxes depends directly on the money value of GDP.) We need to understand the weaknesses of GDP, and supplement it with other measures. Above all, we must remember that expanding GDP is never an end in itself. At best, properly managed, it can be a *means to an end*: improving human well-being. Indeed, there is a positive but imperfect relationship between GDP and human welfare (see box). This suggests that we need to be concerned with how much we produce, but equally with what we use it for.

To be meaningful, GDP figures must take several additional factors into account. If the apparent value of our work grows purely because of **INFLATION** (which is a general increase in the prices of *all* goods and services), then there hasn't really been any improvement in the economy. There-

© CCPA and Pluto Press

fore we distinguish between **NOMINAL** GDP (measured in dollars) and **REAL** GDP (to deduct the effect of inflation). There are many other economic variables (such as wages and interest rates) for which this distinction between nominal and real measurements is also important. The rate of **ECONOMIC GROWTH** is usually measured by the expansion of real GDP.

In addition, a country's GDP could expand simply because its population was growing — but this does not imply that everyone is becoming better-off. This is important when comparing growth rates across countries. For example, in countries with near-zero population growth (such as Europe and Japan), even a slow growth of real GDP can translate into improved living standards; this is not the case where population is growing more quickly. Therefore, economists often divide GDP by population, to get a measure called **GDP PER CAPITA**. This, too, can be expressed in both nominal and real terms. Growth in real GDP per capita over time is often used as a rough indicator of prosperity — although we must always remember that GDP excludes many valuable types of work, and says nothing about how production is distributed.

G What is a good economy?

Economics tries to explain how the economy works. But economists are equally (and justifiably) concerned with trying to make it work *better*. This inherently requires the economist (and every citizen) to make value judgements about what kind of economy is more desirable. Most economists, unfortunately, are not honest about those value judgements; they like to pretend that their profession is "scientific" and hence value-free, but this is a charade.

Deciding what economic goals to pursue will reflect the priorities and interests of different individuals, communities, and classes. It is an inherently subjective choice (which is why the word "should" appears several times in the following text!).

Here is my short list of key economic goals. The more of these goals an economy achieves, in my view, the better it is:

1. Prosperity. An economy should produce enough goods and services to support its citizens and allow them to enjoy life to the fullest. Prosperity does not just mean having more "stuff." It means enjoying a good balance between private consumption, public services, and leisure time. (Incidentally, leisure time is another valuable thing that doesn't appear in GDP statistics.)

2. Security. The members of an economy should be confident that their economic conditions are reasonably stable. They shouldn't have to worry about being able to support themselves (so long as they work, if they're able), to keep their home, and to pass on decent economic opportunities to their children. The economic insecurity and turmoil experienced by billions of people today imposes real costs on them. Even people who may never lose their job or home, spend a great deal of time and energy worrying that they might. That fear is costly. By the same token, economic security — being able to sleep at night without worrying about your livelihood — creates benefits that are not visible in GDP statistics.

3. Innovation. Economic progress requires us to think continuously about how to make our work more productive. This innovation includes imagining new goods and services (products), and better ways of producing them (processes). An economy should be organized in a way that promotes and facilitates innovative behaviour, or else it will eventually run out of creative energy and forward momentum.

© CCPA and Pluto Press

> *"The mode of production of material life determines the social, political and intellectual life process in general."* **Karl Marx,** German philosopher and economist (1859)
>
> *"It's the economy, stupid."* **James Carville,** political advisor to U.S. President Bill Clinton (1992)

4. Choice. Individuals have different preferences, hopes, and dreams (although those preferences are strongly shaped by social pressures). They should have reasonable ability to make economic decisions — including the sort of work they do, where they live, and what they consume — in line with those preferences. There is a gigantic, ideological myth that only free-market economies truly respect individual "choice." This is obviously wrong: the choices of billions of human beings are brutally suppressed by the economic hardship and social divisions which are a natural outcome of global capitalism. I accept that individual choice is an important economic goal — and I argue there are better ways to enhance true choice than through unregulated markets.

5. Equality. Inequality is harmful if it means that large numbers of people are deprived of the ability to work and enjoy their lives. In this sense, the goal of equality is bound up with the goal of prosperity (so long as we define "prosperity" correctly, as widespread well-being, rather than equating it with the growth of GDP). But I am also convinced that inequality is inherently negative in its own right. Even if those at the bottom of the economic spectrum still enjoyed some decent minimal standard of living, a concentration of wealth at the top will nevertheless undermine social cohesion, well-being, and democracy. For example, economists have identified a phenomenon called "positional consumption," by which people's emotional well-being is negatively influenced by unfavourable self-comparisons to the lifestyles of the rich and famous. When this occurs, inequality itself carries negative consequences, quite apart from the consequences of poverty. To this end, constraining the economic distance between rich and poor is an important economic goal. Equality also requires decent provisions to support those members of society who cannot work.

6. Sustainability. Humans depend on their natural environment. It directly enhances our quality of life (through the air we breathe, and the spaces we inhabit). And it provides needed inputs that are essential to the work we do in every single industry. As we'll see in Part 7 of this book, all production involves the application of human work to "add value" to something we got from nature. Maintaining the environment is important in its own right (all the more so if we accept that humans have some responsibility to the other species which inhabit our planet). It is also important in a more narrowly economic sense, since our ability to continue producing goods and services in the future will depend on finding sustainable ways to harvest (without continuously depleting or polluting) the natural inputs we need.

7. Democracy and Accountability. We've seen that the economy is an inherently social undertaking. Different people perform different functions. Some individuals and organizations have great decision-making power, while others have very little. How do we ensure that specific economic decisions, and the general evolution of the economy, reflect our collective desires and preferences? And how do we monitor and ensure that people and institutions are doing the work they are supposed to? Modern capitalism has a well-developed but narrow notion of business accountability (reflected in the specific institutional structures which ensure that joint-stock corporations act in the interests of their shareholders). Competitive markets also impose another narrow form of accountability, enforced through the threat of lost sales and ultimate bankruptcy for companies which produce shoddy or unduly expensive products. Democratic elections allow

© CCPA and Pluto Press

citizens to exert some influence (through their governments) over economic trends — although the ability of elected governments to manage a capitalist economy is fundamentally limited by the unelected power of businesses and investors. None of these limited forms of accountability provide for thorough or consistent ways of subjecting the economy to democratic control. Yet given the importance of the economy to our general social condition, we should expect more genuine and far-reaching forms of economic democracy and accountability.

Is our present economy a good economy? In some ways, modern capitalism has done better than any previous arrangement in advancing each of these goals. In other ways, it fails my "good economy" test miserably. The rest of this book will endeavour to explain how the capitalist economy in which we live functions, the extent to which it meets (and fails to meet) these fundamental goals — and whether or not there are any better ways to do the job.

GDP and Human Well-Being

The United Nations Development Program produces an annual ranking of countries according to their "human development." The U.N. defines human development on the basis of three key indicators: GDP per capita, life expectancy, and educational attainment. We've already seen that using average GDP per capita is highly misleading, so the U.N.'s approach still suffers from bias. It attaches no value to social equity, leisure time, and other important human goals.

Nevertheless, it is interesting to compare the ranking of countries according to human development, with their ranking according to GDP. In general, countries with high human development also have high levels of GDP per capita (in part because GDP is itself one of the three variables considered, and in part because higher GDP allows a society to devote more resources to health and education). This indicates that economic growth is indeed very important to standard of living.

However, the link between GDP and human development is not perfect. Some countries (such as the Scandinavian countries) rank higher in the U.N. list than they do on the basis of GDP alone. This indicates they are more efficient at translating GDP into genuine human welfare (usually thanks to extensive public services, financed with high taxes.) On the other hand, countries which rank lower on the U.N. list than in the GDP standings are relatively ineffective at translating GDP into well-being; these countries (like the U.S. and the U.K.) have relatively low taxes and relatively weak public programs.

The accompanying table summarizes the key human development statistics for selected countries in the U.N. ranking. High-tax Norway (where government spends over 50 percent of GDP on public programs) ranks first; low-tax America ranks eighth (despite having the second-highest GDP in the world, after Luxembourg). For each country, the difference between its GDP rank and its human development rank summarizes its success at translating GDP into genuine well-being; this difference is reported in the fourth column (shaded). A positive score in this column indicates that a country makes the most of its GDP; a negative score indicates the opposite. Socialist Cuba — where average health outcomes are superior to those in the U.S. — manages to do more, given its GDP, to improve human welfare than any other country in the world. On the other hand, oil-rich Equatorial Guinea does the worst job of any country at channelling GDP into well-being.

© CCPA and Pluto Press

Table 1.1 **GDP and Human Well-Being**

Country	Human Development Rank	GDP Rank	GDP Rank–HDI Rank*	GDP per Capita ($US)	Life Expectancy (years)	Educational Attainment Index†
Norway	1	4	**3**	38,454	79.6	.99
Iceland	2	5	**3**	33,051	80.9	.98
Australia	3	14	**11**	30,331	80.5	.99
Ireland	4	3	**-1**	38,827	77.9	.99
Sweden	5	16	**11**	29,541	80.3	.98
Canada	6	10	**4**	31,263	80.2	.97
Japan	7	18	**11**	29,251	82.2	.94
U.S.	8	2	**-6**	39,676	77.5	.97
China	81	90	**9**	5,896	71.9	.84
India	126	117	**-9**	3,139	63.6	.61
Human Development "Over-Achievers"						
Uruguay	43	62	**+19**	9,421	75.6	.95
Cuba	50	93	**+43**	5,700	77.6	.93
Armenia	80	112	**+32**	4,101	71.6	.91
Madagascar	143	169	**+26**	857	55.6	.66
Human Development "Under-Achievers"						
Hong Kong	22	12	**-10**	30,822	81.8	.88
Saudi Arabia	76	45	**-31**	13,825	72.0	.72
Turkey	92	70	**-22**	7,753	68.9	.81
Equatorial Guinea	120	30	**-90**	20,510	42.8	.77

*Source: U.N. Human Development Report, 2006. * A positive score indicates better HDI ranking than GDP ranking.*
† Index based on literacy rate and combined school enrolment.

© CCPA and Pluto Press